

Chapter 10

A Fresh Start

In May of 2001, a group at the Financial Markets Group (FMG) of the London School of Economics convened a conference to discuss the proposals from the Basel Committee on Banking Supervision on the new Basel II bank capital regulation proposals. The discussions at the conference resulted in a paper (Danielsson, et al. (2001)) that was submitted to the Basel Committee in response to their call for comments on the initial Basel II proposals. Three conclusions of the report were summarised in the report's executive summary in the following terms.

- “The proposed regulations fail to consider the fact that risk is endogenous. Value-at-Risk can destabilise and induce crashes when they would not otherwise occur.
- Heavy reliance on credit rating agencies for the standard approach to credit risk is misguided as they have been shown to provide conflicting and inconsistent forecasts of individual clients' creditworthiness. They are unregulated and the quality of their risk estimates is largely unobservable.
- Financial regulation is inherent procyclical. Our view is that this set of proposals will, overall, exacerbate this tendency significantly. In so far as the purpose of financial regulation is to reduce the likelihood of systemic crisis, these proposals will actually tend to negate, not promote this useful purpose.”
[Danielsson et al. 2001, executive summary]

Eight years later, these conclusions still have resonance. But back in 2001, the group's proposals must have been as welcome as Banquo's ghost at Macbeth's banquet. The submission presumably failed the test of being "constructive", and it is hardly surprising that our comments did not have much impact on the ultimate direction of the Basel II process.

Realistically, none of us imagined that the submission would have a fundamental impact, although in our more optimistic moments we hoped that our arguments may have some marginal impact on the shape of the latest bell or whistle to be attached to the overall rules.

The Basel II rules could hardly be faulted for the lack of *quantity* of financial regulation, if quantity is measured in terms of thickness of the rule books. The Basel II rules famously generated reams of paper, all the while sapping the energy and patience of the hapless cadre of officials debating the exact value to be attached to some parameter in the credit risk model. The flaw with Basel II was rather with its twin assumptions – that the purpose of regulation is to ensure the soundness of individual institutions against the risk of loss on their assets, and that ensuring the soundness of each individual institution ensures the soundness of the system as a whole.

The Basel II process illustrates how changes in regulation are typically achieved incrementally. Incremental change has the strength that it builds on accumulated wisdom. But it is possible for such an incremental, and generally reactive, process to migrate over time in wrong, or just inferior, directions. It is a revealing piece of sociology on the intellectual underpinnings of the subject of economics and of the bureaucratic process. It is only with wrenching economic crises, such as the Great Depression, that there is a general willingness to review the fundamental tenets of the regulatory framework. With the global financial crisis that began in 2007, we may be experiencing another comparable shift in the collective willingness to review the foundations of regulation.

The financial crisis has generated a flurry of activity from numerous groupings with their own sets of proposals. The accumulated set of reports have some common themes, such as the importance of countering the procyclical nature of risk taking, and have sought to counter such trends by augmenting the existing set of rules.

The Geneva Report on the World Economy (Brunnermeier et al., 2009) argues for a fundamental reappraisal of the basis for financial regulation and sets out a proposal on how the existing Basel II regulations should be modified to incorporate macroprudential goals – in particular, how the existing Basel II

capital requirements ought to be modified by the multiplication by a systemic impact coefficient that depends on indicators of potential spillovers. The Squam Lake working group (2009) and Acharya and Richardson (2009) have also proposed changes in the rules governing bank capital that share the same purpose of curtailing the procyclical nature of the financial system, especially in the down-phase of the financial cycle when banks are close to insolvency. The resolution of problem banks has risen to the top of the agenda following the turmoil caused in the financial markets in 2008 and 2009. Appendix 1 of the report by the Committee on Capital Markets Regulation (CCMR (2009)) gives a useful table listing the various reports that have been issued up to May 2009, and cross-listing the various proposals against each report.

However, as desirable as such regulatory changes are, they are almost certainly inadequate by themselves in meeting the challenge of the next boom-bust cycle. As seen in these lectures, the main culprit for the boom-bust cycle is the underpricing of risk in the boom phase of the cycle. To summarise Andrew Crockett once more, risks increase in booms, and are only manifested in busts.

The question is how well one can meet underpricing of risks just with blunt regulatory tools that have to be codified and enforced as laws or regulations. Even if the a new set of rules and laws can be put in place that would have been effective at preventing yesterday's crisis, there is little guarantee that they will continue to be effective against new crises, riding on the back of as yet unimagined innovations designed to circumvent the rules. Some commentators have taken the possibility of avoidance as a case against relying on countercyclical regulation altogether, in favour of private insurance schemes that have an automatic element (see Kashyap, Rajan and Stein (2008)).

Many would part company with a sweeping rejection of the role of countercyclical regulation. Clearly, any regulation will be subject to constant probing for potential avenues for circumvention. But a leaky bucket is surely better than no bucket at all—all the more so, since any proposals for an automatic mechanisms for contingent capital and plans for orderly unwinding are fully consistent with an overlay of countercyclical capital regulation. But the sceptics do have a point on the effectiveness of an approach that relies solely on financial regulation, while everything else goes back to business as usual. Top of the list is monetary policy.

The dominant theme in central banking in recent years has been a narrow interpretation of the principle that the sole role of the central bank is to

focus on stable consumer price inflation and stable output over some fixed horizon. The Tinbergen separation principle is often invoked to argue that the central bank's role is just to look after price stability, and that financial stability is the lot of a specialist regulatory agency. This narrow view of monetary policy has driven many of the institutional reforms around the world, exemplified by the institutional reforms that set up the U.K.'s Financial Services Authority. No doubt, this trend is partly attributable to the dominant intellectual strands in macroeconomics ruling in academia and in central banks. The argument is laid out clearly in an often-cited speech by Ben Bernanke from 2002, when he was a Governor of the Federal Reserve.¹

My suggested framework for Fed policy regarding asset-market instability can be summarized by the adage, *Use the right tool for the job.*

As you know, the Fed has two broad sets of responsibilities. First, the Fed has a mandate from the Congress to promote a healthy economy—specifically, maximum sustainable employment, stable prices, and moderate long-term interest rates. Second, since its founding the Fed has been entrusted with the responsibility of helping to ensure the stability of the financial system. The Fed likewise has two broad sets of policy tools: It makes monetary policy, which today we think of primarily in terms of the setting of the overnight interest rate, the federal funds rate. And, second, the Fed has a range of powers with respect to financial institutions, including rule-making powers, supervisory oversight, and a lender-of-last resort function made operational by the Fed's ability to lend through its discount window. *By using the right tool for the job, I mean that, as a general rule, the Fed will do best by focusing its monetary policy instruments on achieving its macro goals—price stability and maximum sustainable employment—while using its regulatory, supervisory, and lender-of-last resort powers to help ensure financial stability.* [emphasis added]

Here, Bernanke is enunciating a principle that would have commanded almost universal support when he gave the speech. Indeed, in spite of the financial crisis, the Tinbergen separation of monetary policy from policies

¹Bernanke (2002), www.federalreserve.gov/boarddocs/speeches/2002/20021015/default.htm

toward financial stability is still the dominant intellectual strain within central banks. For those who espouse the Tinbergen principle, the new activist proposals for financial supervision and regulation are an opportunity to go back to business as usual, focusing monetary policy on the narrow issues of consumer price inflation and the output gap, leaving the messy and unglamorous business of supervising banks and ensuring financial stability to others - perhaps in another part of the central bank, separated from the core of the organisation that conducts monetary policy.

Thus, the greatest dangers of a consensus on the need for countercyclical regulation arises from not only from circumvention of the rules, but from the opportunities that the consensus will present to unreformed central banks to repeat their mistakes by taking a blinkered attitude to the financial system.

As we have seen in these lectures, financial stability is about regulating the price of risk, and monetary policy is inextricably linked to the pricing of risk. Changes to financial regulation will be for nothing if the intellectual landscape at the institution at core of the financial system (the central bank) does not change. If the central bank is unaware of the importance of financial stability, then changes in institutional arrangements, however far reaching, will have been for nothing.

Bernanke's 2002 speech is a revealing window on the mainstream thinking at the time about how far monetary policy should take account of financial stability goals. Indeed, the debate itself is posed narrowly as whether central banks should "prick" asset price bubbles. The suggested answer is "no" for the following reasons.

- Identifying a bubble is difficult.
- Even if there were a bubble, monetary policy is not the right policy tool in addressing the problem. An asset price bubble will not respond to small changes in interest rates. Only a drastic increase in interest rates will prick the bubble.
- However, such a drastic increase in interest rates will cause more harm than good to the economy in terms of future output and output volatility.

The claim that an asset price bubble will not respond to a small change in interest rates has mostly been argued in the context of the stock market, where the proposition is indeed plausible. However, the stock market is not

the best context in which to discuss the financial stability role of monetary policy, as stocks are held mostly by unlevered investors such as mutual funds. As we have seen in these lectures, much more central is the credit market and the financial intermediary sector, especially when backed by residential or commercial real estate. A difference of a quarter or half percentage in the funding cost may make all the difference between a profitable venture and a loss-making one for leveraged financial intermediaries. Adrian and Shin (2008c) present evidence that bears on this issue.

Focusing on the pricing of risk and the conduct of financial intermediaries is a better way to think about financial stability since it helps us to ask the right questions. Concretely, consider the following pair of questions.

Question 1. Do you know for sure there is a bubble in real estate prices?

Question 2. Could the current benign funding conditions reverse abruptly with adverse consequences for the economy?

One can answer “yes” to the second question even if one answers “no” to the first. This is because we know more about the script followed by financial intermediaries and how they set the price of risk in equilibrium (and then react to changes in the price of risk) than we do about what the “fundamental” value of a house is, and whether the current market price exceeds that value.

In any case, for a central banker, it is the second question which is more immediately relevant. Even if the central banker were convinced that the higher price of housing is fully justified by long-run secular trends in population, household size, rising living standards, and so on, policy intervention would be justified if he also believed that, if left unchecked, the virtuous circle of benign funding conditions and higher housing prices will go too far, and reverse abruptly with adverse consequences for the economy.

Following the trauma of the financial crisis, the climate of opinion has become more receptive to change. Some central bankers are at last beginning to redress the balance between monetary policy and policies toward financial stability that has been missing in recent years. But the window of opportunity for reform will not be open for long. Failure to seize this opportunity to put monetary policy and financial regulation on more secure conceptual foundations would be a lost opportunity. Future generations will bear the cost if we fail to seize this opportunity.