The Financial Sector and the Crisis

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100th BRE-CASE Seminar
Warsaw, 22 January 2009

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- **Two key inter-related concepts:**
- (A) Leverage
- (B) Cyclicality and Regulation

A. Leverage

Most enterprises have a debt to equity ratio of 2 or 3. Many banks, especially European, had a debt/equity ratio > 50.

Factors causing high leverage:

1. Maintain Return on Equity (RoE) when interest rates low;
2. US monetary policy promised future low short-term rates;
3. Expectations of future increases in asset prices, (housing prices and sub-prime);
4. Regulatory arbitrage (less in USA than in Europe);
5. Growth of wholesale short-term money market, (belief in efficiency of markets).

Self-Amplifying Spirals, or Endogenous Risk

Asset prices up → Profits and Capital up (mark to market)
Profits and Capital up → Apparent risk down
Apparent risk down → Increase Leverage
Increase Leverage → Asset prices up

But what goes up, must come down. US sub-prime house market was the trigger.

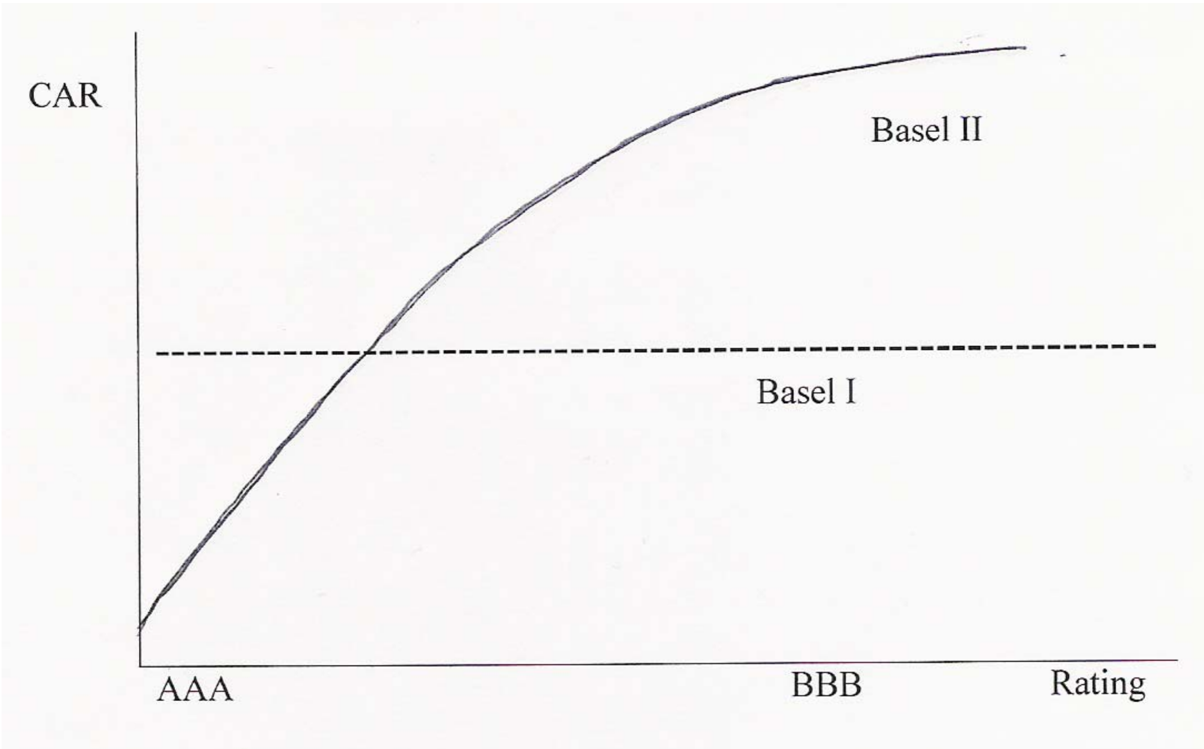
Queries: Why did it not spill over into goods and services inflation, (housing not in HICP, China, technology)?

Why did regulation not stop it?

Liquidity requirements virtually abandoned.

Basel II capital adequacy requirements (CARs) procyclical.

B. <u>Regulation is Procyclical</u>



Ratings migrate downwards in bad times.

Basel II plus mark-to-market a procyclical doomsday machine.

What to do about it?

1. **<u>Liquidity Requirements, but</u>**
   (a) Central banks have different procedures for accepting collateral (CGFS)
   (b) Home/host and cross-border (FSA)

2. **<u>Leverage ratios:</u>**
   (a) Separate from, or interactive with, Basel II, (SNB or Geneva Report)
   (b) Just banks or more widely?
   (c) Housing Loan to Value ratios?

3. **<u>Counter-cyclicality, state-varying requirements</u>**
   (a) How done? Leverage ratios, growth rates?
   (b) Cycles vary from country to country, so host determines; cross-border problems?

<u>NB:</u> Crisis management expensive. Only the nation state has the money, power and democratic legitimacy.

C. What will this lead to?

1. Leverage based on short-term borrowing in wholesale markets will be cut back: return to retail banking.

2. Originate to distribute will continue; faults were:
   (i) Too often pretend to distribute;
   (ii) Incorrect model of probability distributions;
   (iii) Slice and dice disrupts lender/borrower link, e.g. in renegotiation;

   But concept valid.

3. Some shift to host in home/host relationship.

   Europe? It is a fiscal question.

   Cross-border banking? Some pull-back from globalisation? Shift towards host country control?

4. Lehman Bros was contagious. All systemic banks now protected. Should systemic banks get tougher regulation?

But smaller, weaker banks folded into bigger banks (HBOS/Lloyds: Wachoria: Wamu). Competition concerns ignored. Oligopolistic structure enhanced.

NB: Big banks behaved as badly or worse.

WHAT TO DO?

- **(a) Nothing**
- **(b) Tougher regulation**
- **(c) Break up (after analysis?)**

D. Conclusions

- Return to retail banking.
- Less globalisation, more host country control.
- Perhaps counter-cyclical control over credit and asset price cycles.
- Controls over leverage applied to all intermediaries.
- Twin peaks:

  --Macro-prudential instruments in Central Bank

  --Micro-prudential instruments in FSA.
- Should be broadly favourable to Poland

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