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## Rethinking Financial Regulation

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### ABSTRACT:

Prompted by the experiences of the Global Financial Crisis (GFC), a rethink of financial regulation is underway. While largely reactive, in response to observed deficiencies in the financial sector and its regulation, there is also a greater focus in economic and finance research on the complexity of the financial sector and its implications for regulation, which the paper outlines. Individual countries can adopt different approaches to financial regulation, but a multinational agenda and framework driven by the G20, together with the internationally integrated nature of the financial system limits flexibility. For Australia, these international regulatory influences appear most significant in the prudentially regulated banking sector, even though the GFC had most impact on the non-prudentially regulated capital markets and investments sector.

## 1. *Introduction*

An international agenda for financial reform led by the G20 has developed in response to the Global Financial Crisis (GFC) of 2007 – 2009. Numerous committees and inquiries have investigated the causes of the GFC and identified failings in financial regulation and financial sector governance and management as two significant influences. But exactly what types of regulatory reform should be enacted is a question not well answered by reference to contemporary economic and finance theory. Developments in, and the complexity of, the financial sector have outpaced academic research and teaching, which has tended to treat the finance sector as something of a “black box”.

Consequently, regulatory responses to the GFC took something of a “belts and braces” approach, with myriad responses attempting to: restore liquidity and restart frozen capital markets; shore up confidence (such as by guarantees); temporary regulations; and fiscal and monetary stimuli.<sup>1</sup> While these responses arguably prevented the extreme financial disruption from leading to a major economic recession, they have changed the landscape within which future financial regulation must operate. In particular, the merit of the free-market ideology upon which most recent financial regulation had been based has been questioned by both the scale of the disruption and recognition that governments will not (or cannot) allow SIFI’s (systemically important financial institutions) to fail. Moral hazard is thus entrenched, and market discipline inadequate to achieve the purported benefits of deregulated financial markets.

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<sup>1</sup>For further detail see Kevin Davis, “Regulatory Responses to the Global Financial Crisis” *Griffith Law Review*, 19, 1, 2010, pp 117-138.

At a populist level, high remuneration (including on exit) of executives who presided over massive financial failures has fanned support for a “reigning in” of the freedom which financial deregulation had given to the industry. But, particularly as time progresses, the ability of the industry to lobby against restrictive regulation and legislation means that the extent, and nature, of reregulation may be much less than originally contemplated.

## 2. *The Severity of the GFC*

It is important to recognize the severity of the GFC shock to the world financial system and economy. Table 1 presents IMF estimates of anticipated bank losses on loans and securities over the period 2007-2010. It is evident that the GFC was primarily a trans-Atlantic phenomenon.

**Table 1: Anticipated Global Bank Losses (per cent): 2007 -2010**

	U.S. Banks	U.K. Banks	Euro Area Banks	Other Europe	Mature Banks	Asia Banks
Cumulative Loss Rate (percent)	8.2	7.2	3.6	5.1		2.1

Source: [http://www.imf.org/external/pubs/ft/gfsr/2009/02/c1/table1\\_2.csv](http://www.imf.org/external/pubs/ft/gfsr/2009/02/c1/table1_2.csv)

This translated into dramatic declines in stock market valuations of major banks. Table 2 shows how market capitalization of the ten largest banks at June 2007 had fallen by March 2009. Some major banks (particularly in the UK) were nationalized, while many received capital injections from government and widespread government support was provided via guarantees of deposits and debt.

**Table 2: Bank GFC Capitalization Experiences**

<i>Bank</i>	<i>Stock Market Capitalization (USD bill)</i>	
	June 2007	Mar 2009
Citigroup	254	14
Bank of America	217	44
HSBC	215	97
Indl & Coml Bank of China	211	188
JP Morgan Chase	166	100
Bank of China	155	115
China Construction Bank	155	133
UBS	126	28
Royal Bank of Scotland	120	20
Mitsubishi UFJ Financial	120	56

*Source: Financial Times*

Capital markets also “froze” as concerns about counterparty solvency and inability to accurately value complex financial securities became widespread. Illustrative of the disruption was movements in corporate bond spreads (margins over the government bond rate). In Australia, for example, BBB corporate bond spreads increased from below 100 basis points in the pre GFC period to a peak of 560 basis points in March 2009. Issuance of new residential mortgage backed securities virtually ceased.

The Australian banking sector largely escaped a “direct hit” from the GFC, having little exposure to the “toxic” assets plaguing other global banks.<sup>2</sup> But, there were significant flow-on effects and collateral damage. Heavy dependence on offshore capital market borrowings led to an increase in borrowing costs and increased interest rate competition for local deposits, and loan losses increased as many highly levered local entities went to the wall.

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<sup>2</sup> Analyses of Australia’s GFC experience can be found in Christine Brown and Kevin Davis “The Subprime Crisis Down Under” *Journal of Applied Finance*, 18,1, Spring/Summer 2008, 16-28, and Christine Brown and Kevin Davis “Australia’s Experience in the Global Financial Crisis” Chapter 66 in *Lessons from the Financial Crisis: Causes, Consequences, and Our Economic Future* (edited by Robert Kolb), Hoboken, NJ., John Wiley & Sons, 2010

Instead, it was Australian investors in other financial structures (particularly collective investment schemes and structured products) who experienced most pain. A roll-call of Australian GFC financial failures includes: Basis Capital, Absolute capital, RAMS, Centro, MFS, Allco, Tricom, City Pacific, Opes Prime, Lift Capital, CHimaera, Storm Financial, Timbercorp, Great Southern Plantations, Babcock and Brown, Trio/Astarra. Australia, arguably, “led” the world in giving unsophisticated investors the opportunity to invest in extremely complex products, relying on a *caveat emptor* approach built around reliance on the assumed success of education, advice and disclosure in leading to informed decisions.

### 3. *The Foundations of Financial Regulation*

Several commentators have argued that financial deregulation was based on the *Efficient Markets Hypothesis (EMH)*, and that the GFC showed this conceptual basis to be seriously flawed.<sup>3</sup> That argument confuses two concepts. The EMH simply asserts that financial prices reflect available information, not that prices are right nor that the information is correct. While it is difficult to reconcile the magnitude of price movements in the GFC with that theory (ie that it all reflected “news”) rather than some systemic malfunctioning, that theory had little to do with the conventional wisdom regarding financial deregulation. Rather, the approach to financial regulation was built upon the longstanding hypothesis that competitive markets will generally, through the price signals generated, lead to optimality of resource allocation. (Of course the EMH is relevant here in that the price signals reflect available information). But unfettered markets

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<sup>3</sup> See, for example Chapter 1.4 of the Turner Review. Financial Services Authority *The Turner Review, A regulatory response to the global banking crisis* March 2009

may not be optimal if there are the classic imperfections of externalities (spillovers), imperfect information, market power etc. In these circumstances, regulation may be justified.

From this perspective, the GFC may be viewed as having highlighted that the imperfections were more significant, or of different types, than previously envisaged – suggesting a need for “more of the same” regulation. But an alternative perspective is to ask “Why would you start there”? Financial markets are characterized by (indeed have their rationale in) information deficiencies, incomplete markets, liquidity creation, potential for “non-rational” behaviour, and network interrelationships. There is much new and ongoing research examining what these characteristics mean for the operations of financial markets. For example, it has long been theoretically established that banks are subject to risk of “runs”, and more recent work derives similar results for financial markets whereby prices can depart significantly from “fundamentals”.<sup>4</sup> Such models focusing on liquidity creation tend to generate multiple equilibria, “runs” and market instability, in contrast to the standard model of competitive markets. And “limits to arbitrage” due to wealth constraints mean that financial firms (such as hedge funds) who generally provide valuable liquidity services to financial markets may at times be unable to take and hold positions which would generate profits due to prices departing from “fundamental” values.<sup>5</sup>

These models, which emphasize interactions between financial market participants lead fairly naturally into viewing the financial system as a network, and applying tools of network analysis to identify important

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<sup>4</sup> See for example Franklin Allen and Douglas Gale. *Understanding Financial Crises*. Oxford: Oxford University Press, 2007

<sup>5</sup> This literature is surveyed in Denis Gromb and Dimitri Vayanosy “Limits of Arbitrage: The State of the Theory” 2010, <http://ssrn.com/abstract=1567243>

nodes and connections which will determine how shocks are transmitted and moderated or amplified in the financial system.<sup>6</sup> In the modern financial system “runs” on banks or markets can involve liquidity crises induced by wholesale (rather than retail) investors making margin calls for increased collateral against short-term borrowings, not rolling over short term funding, and not being willing to invest in new security issues. Such actions lead to forced asset sales, which can further depress asset prices creating losses for the bank involved, and in turn prompt further margin calls generating a vicious cycle.

Currently, there is much effort being invested in better understanding the network characteristics of the financial system, and potentially designing regulations to reshape the network to enhance financial stability. Among such measures are:

- Central Clearing Counterparty (CCCP) proposals which would involve over the counterparty derivatives trades being novated to the central counterparty and thus creating a “hub and spoke” network of counterparty exposures rather than a “spaghetti junction” network of bilateral exposures between the original traders.
- Enforced Structural Change via proposals such as special taxes or levies related to size or complexity which would inhibit development of SIFIs (and also compensate governments for, and reduce competitive imbalances resulting from, implicit guarantees). Suggestions for narrow banking or limits on proprietary trading also have similar origins.

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<sup>6</sup> See for example Andrew G Haldane *Rethinking The Financial Network*, 2009  
<http://www.bankofengland.co.uk/publications/speeches/2009/speech386.pdf>

- Subsidiarization requirements for international operations. Some countries (New Zealand is one) require that foreign bank activities in their country be established as a separately capitalized subsidiary, rather than a branch – thus giving the host regulator greater power.

Those types of strategies are linked to one aspect of “Macroprudential regulation” which is one of the main new regulatory developments fostered by the GFC.<sup>7</sup> This involves (generally) Central Banks taking on explicit responsibility for the systemic stability of the financial sector. In its cross-sectional dimension it involves assessing (and influencing) how the structure of the financial system responds to shocks. In its time-series dimension it involves taking actions to prevent the build up of systemic risk over time due to over-optimism, excessive risk-taking etc. But exactly how to do that, and to identify systemic imbalances from innocuous structural shifts, is another matter.

#### 4. *The Global Regulatory Framework and Australia*

Figure 1 attempts to provide an overview of how national financial regulation is influenced by international arrangements.<sup>8</sup> The G20 has become pivotal in the process with a financial reform agenda espoused in the declaration from Toronto meeting in June 2010 based on four pillars of:

- Strong regulatory framework and financial market infrastructure

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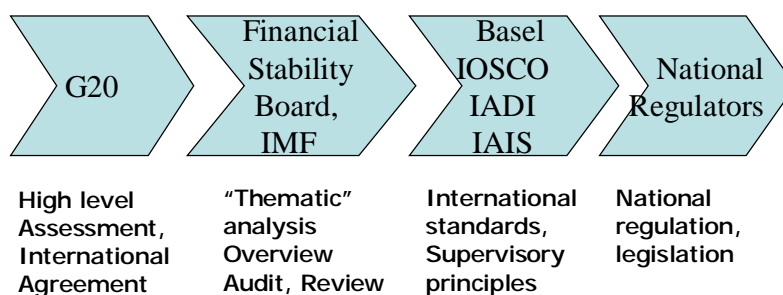
<sup>7</sup> An overview of macro-prudential regulation can be found in Jaime Caruana *Systemic risk: how to deal with it?* Bank for International Settlements, 12 February 2010.  
<http://www.bis.org/publ/othp08.htm>

<sup>8</sup> This figure is based on one presented by Justin Douglas of the Australian Treasury in “Bank remuneration rules – a case study of post-GFC regulation reform” *15<sup>th</sup> Melbourne Money and Finance Conference*, Brighton, Victoria, May 2010.  
<http://www.melbournecentre.com.au/Douglas.pdf>

- Effective supervision
- Resolution of systemically important financial institutions (SIFIs)
- Transparent international assessment and peer review

Figure 1

## The Global Regulation Process



To achieve this, the G20 replaced the Financial Stability Forum with the Financial Stability Board (FSB) to oversee and coordinate (with the IMF) a consistent international approach to financial regulation across the wide variety of institutions and markets within the system. As well as undertaking peer reviews of financial regulation in individual countries to complement the IMF FSAP's (Financial Stability Assessment Program), the FSB undertakes analysis of topics which are relevant across financial subsectors – each of which has its own international regulatory committees. Those include the Basel Committee (banking), IOSCO (securities markets), IADI (deposit insurance), and IAIS (insurance), each of which have produced numerous reports and guidance on regulations and supervision. Perhaps most well known among these is the Basel Committee which has modified its Basel 2 framework for banking supervision and

regulation in the wake of the GFC to *inter alia* change capital adequacy requirements and introduce new liquidity requirements for banks. While national regulators can, in principle, depart from the international standards determined by these organizations, they do so at the risk of inducing adverse consequences in international financial markets should their regulatory framework appear to be weaker than the international standard.

As well as topics such as capital and liquidity standards, the G20 Financial Reform Agenda is addressing issues such as accounting standards, banker remuneration, trading platforms, oversight of hedge funds and ratings agencies.

For Australia, there is something of a paradox in the interaction of the global regulatory approach and local experiences. Much of the international focus on cross-country consistency of standards is in the banking area, leading to pressure to implement enhanced regulatory requirements – even though the Australian banks survived the GFC relatively well. In contrast, there is less apparent harmonization and international pressure for adoption of common standards in the non-prudentially areas of securities markets, funds management and investment – where Australia experienced more of the GFC impact. Nevertheless substantial changes in the regulatory approach to the non-prudentially regulated sector are in train, involving changes to financial advising arrangements and a somewhat more prescriptive approach to acceptable business models (based on an “if not – why not” disclosure requirement) by ASIC.