Charles Goodhart

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I. Introduction

The incentive for those in any institution, such as a Central Bank, is to justify and extol the virtues of the decisions that they have already taken. Criticisms of current regulatory measures are more likely to come from outsiders, perhaps especially from academics, (with tenure), who can play the fool to the regulatory king. I offer some thoughts here from that perspective. I shall try to make two general arguments; first that bank regulatory failures are better addressed by governance reforms than by raising capital and liquidity requirements ever higher; and second that the main lacuna has been in allowing banks to finance illiquid long-dated property mortgages on the basis of short-dated, runnable, uninsured wholesale liabilities.

II. Persons, not Inanimate Institutions, are Responsible for Decisions

So, to start off, I would contend that the regulatory failures that led to the crisis and the shortcomings of regulation since then are largely derived from a failure to identify the *persons* responsible for bad decisions. Banks cannot take decisions, exhibit behaviour, or have feelings—but individuals can. The solution lies in reforming the governance set-up and realigning incentives faced by banks' management.

Recent regulatory problems have been greatly reinforced by a widespread tendency to apply human characteristics, i.e. to anthropomorphise, to an inanimate institute, in this case a bank. We tend to talk about Bank X having assumed too much leverage, or having behaved in an improper fashion—rather than management of Bank X did such and such; We say that Bank X got bailed out rather than the creditors and clients of Bank X got bailed out.

The outcome has been a regulatory system primarily based on imposing a structure of regulations on *banks*, with insufficient concern about the incentives on *bankers* to adjust to, and to 'game', that system. By the same token there has been insufficient concern for reform of the incentive and control system facing bank managers. Some reforms of the governance structure for bankers have been introduced in the UK, for example in the guise of claw-back rules and the senior managers' regime. But even while the Bank of England has been in the van on this, I believe that much more could, and should, be done in this respect.

There are two questions that need reconsideration. The first relates to the scope of responsibility for outcomes in a hierarchical institution; the second relates to the downside that those responsible should face when failure or bad behaviour occurs. When bad behaviour occurs at a lower level, e.g. traders conspiring to rig Libor, or junior employees mis-selling products onto uninformed customers, should managers, directors and CEOs be able to shelter behind the fact that they did not know what was going on? Should they, could they, have taken steps to find out? There is surely a case for reversing the burden of proof. Each manager should be held responsible, and subject to suit, unless they can demonstrate that they took all reasonable measures to oversee and to constrain the actions of their juniors. The New Zealand procedure of requiring all Directors to sign an affidavit stating that they have checked and approved all internal control mechanisms could be adopted.

Similarly the personal liability of shareholders could be related to their informational advantage and capacity to influence decisions. Junior employees and outside shareholders, up to a holding of X% of market value, would keep limited liability. Junior managers, and large shareholders, could have double liability; senior managers, perhaps, treble liability, and CEOs perhaps unlimited liability.

We would be told that such measures would make banks unduly risk averse and prevent qualified bank managers going into the profession. Where is the evidence for that? Banking worked on the basis of unlimited liability up to the second half of the 19^{th} Century, and banks then took plenty of risks.

Having argued that the desideratum for financial regulation should have been to reform the incentive structure, I consider four areas of current and recent banking reforms where failure to consider the incentive and informational structure adequately has weakened their efficiency.

1. **Higher Required Capital Ratios**

Left to themselves, bankers will meet higher Capital Adequacy Ratios by deleveraging and withdrawing from low profit, possibly safer but capital intensive business. This will have adverse effects on economic recovery and capital markets.

The need is to impose incentives on bankers, and shareholders, to restore the level of equity (or to redeem a prior public sector injection of equity) to a desired *quantum*, by preventing any share buy-backs, dividend payment or increase in managerial compensation until that quantum (n.b. *not* ratio) was reached. This was done in the USA with the TARP. On the whole, it was not done in continental Europe. So banking recovery has been weaker in the latter.

2. Bail-in

Outsiders, even large bond-holders, remain at a serious informational disadvantage and so they are unlikely to be able to constrain the riskier actions of management to a significant degree. If such informational asymmetry is recognized by providing protection for all small bond-holders, with a holding of less than X in value, then all large institutional investors will maintain a holding of precisely X-1 in all such bail-inable bonds.

Whereas the principle, that bond-holders should not be (completely) rescued by a transfer from taxpayers is sound, the idea that such bail-in can fully replace a public-sector bail-out in the face of a severe systemic shock is unduly optimistic. Avgouleas and Goodhart (2015) argue that history shows that when a bank's difficulties reflect broader macro problems rather than bank-specific issues, imposing haircuts on creditors of one bank is likely to accelerate panic and risks contagion to other institutions, which may require public funds to shore up the system as a whole. Indeed, the extent of penalty to be imposed on bail-inable bond holders in the European Union (8% of a bank's liabilities, including own funds) before any public support becomes available, is so great that the failure of one bank, unless for totally idiosyncratic reasons, is likely to lead to a widespread collapse of the bank bond market as a whole, at least for a time, with implications for contagion.

Moreover, a bank resolved by bail-in may have had its equity base restored, but will nevertheless be clearly weaker than it will have appeared before, with the likely consequence that it will face a major outflow of deposits, such as occurred in the aftermath of the rescue of Continental Illinois in 1984, (see Carlson and Rosa, 2016). The injection of public sector capital under bail-out will be replaced by the injection of public sector liquidity from the Central Bank (or in the USA from the Treasury) under bail-in, which could put them in the political firing line.

3. Structural Reform

Although losses for retail depositors and failures of payment mechanisms were conspicuous by their absence in the recent crisis, this was largely due to the policy of bail-out. If bail-out is to be cut back, perhaps further safeguards need to be introduced to maintain 'essential' banking activities. One set of suggestions is to impose constraints on the structure of banking, to make banks smaller, or less complex. The proposals of Vickers, Volcker and Liikanen come to mind.

But so long as bankers have an incentive to assume more risk, then they will try to work around such structural changes. If, instead, incentive structures were changed to impose appropriate penalties for failure on the banker, then bankers would themselves choose whatever structure, perhaps smaller and simpler, would provide them with an acceptably reduced chance of failure. Historically, unlimited liability for bank shareholders was abolished principally to allow larger banks capable of financing big business (and big government) to emerge. If the current concern is that banks have become too big and too complex to manage, or to allow to fail, why not just raise the managerial penalty for failure?

Managers on the spot will have a better idea of what they can safely undertake, than illustrious independent outsiders. Leaving the current incentive system unchanged, while seeking to enforce structural change by diktat will have bank management, and their skilled professional advisers, seeking loop-holes.

4. Fines for Bad Behaviour

The current practice of imposing massive fines on banks for the prior misbehaviour of some of their (prior) employees is monstrously unfair and inefficient. It is unfair because it primarily hits shareholders, who had no direct responsibility, bank clients, since the bank involved has to cut back and raise profit margins to meet impaired capital adequacy, and the economy as a whole because such fines represent a massive head-wind against bank participation in the economy. It is inefficient because shareholders can apply little effective pressure on management, and current management can generally claim that the misbehaviour occurred under past management, all the while secure in the likelihood that by the time current malpractice comes to light, and to adjudication, they too will have long been retired from the job and able to claim ignorance of such events, as a splendid letter to the FT recently pointed out most lucidly.

Regulators should not levy fines on Banks, despite them having the legal status of a person, and instead apply the fines to those responsible at the time of the offense, whether subsequently retired or not. As earlier noted, the onus of proof should be on the managers of those who committed the misdeed, and so on up the hierarchy, to convince (a jury) that they took all reasonable steps to prevent the misdeeds of their subordinates. The size of fine could be related positively both to the extent of negligence and to rank.

Of course, the threat of personal liability and loss could make bankers overly cautious, as is often said of US medical practice, with unnecessary and costly tests of patients to reduce the threat of suits. As usual, there would be an optimum internal degree of liability, but we are currently well below it.

If a bank CEO knew that his own family's fortunes would remain at risk throughout his subsequent lifetime for any failure of an employee's behaviour during his period in office, it would do more to improve banking 'culture' than any set of sermons and required oaths of good behaviour. The root of the problem is the bad behaviour of bankers, not of banks, who are incapable of behaviour, for good or ill. The regulatory framework should be refocused towards reforming incentives.

III. The Structure of Housing Finance needs Reform

Critics of banking, especially of investment banking, have attributed much of the blame for the Great Financial Crisis of 2008/9 to the rapid growth of financial derivatives. This was an easy target, since it blamed clever bankers for hood-winking simple people like ourselves; it was all their fault! But the criticism was at best only partially valid; thus the Lehman derivative book was profitable, and the AIG imbroglio was as much due to asset concentration (a long-standing source of weakness) as to the fact that that concentration was in writing CDS swaps.

More important, this criticism redirected attention away from the main underlying source of banking weakness, which was the readjustment of bank assets away from short-term, self-liquefying loans to business' working capital towards property-related lending, especially to home-buyers, in the form of long-term, illiquid, mortgages. Adair Turner, and Moritz Schularick and Alan Taylor, have described empirically how this has developed over time. With such lending growing faster than retail (insured) deposits, it has been largely financed by a rapid growth in short-term, runnable, wholesale deposits, with the creditors being both uninsured, informed and sensitive to any tenuous threat of danger.

Financing long-term illiquid assets on the basis of flighty short-term wholesale deposits should be anathema to anyone (like myself) brought up on Banking School precepts. Moreover, it was the involvement of our banks in such housing finance, especially in the USA, Ireland and Spain, that actually triggered the Great Financial Crises. So why have there been so few calls to reform its structure? Perhaps the would-be reformers and critics realise that housing finance, unlike derivatives, is politically sensitive. Another reason is that the regulators calm themselves with the assessment that mortgage debts, especially those with recourse to the mortgagors' other assets and earnings, are repaid whenever possible and have the added margin protection of the downpayment.

Consequently, mortgage finance, except at high LTV ratios, gets beneficial treatment in bank risk-weighted capital assessments. But this is short-sighted for two reasons. First, if mortgagors have to scrimp on their expenditures elsewhere to meet their financial liabilities, it will still cause a recession, as Mian and Sufi showed. Second, and more important, the housing market exhibits considerable inelasticity and self-amplifying mechanisms.

Some banks, or other financial intermediaries, involved in the housing market, are always going to take on too much additional risk in the pursuit of profit. When a down-turn in the housing market occurs, the wholesale market will close to these riskier institutions. But their attempt to replace the lost liquidity by selling mortgages or mortgage-backed securities (MBS) on the open market will only drive down the prices of such assets, as will also foreclosures of defaulting mortgagors will drive down house prices. The result will be to weaken asset prices still further leading to a self-amplifying downwards spiral.

Currently there has been a revival of interest in narrow-banking, that transactions balances in banks should only be backed by completely safe assets. For reasons that I have expressed elsewhere, I think that this goes too far as a generality, (Goodhart, 2015). But there would be considerable merit in applying this proposal with respect to long-term property finance. Thus, such mortgage finance could not be provided by banks, or any similar non-bank intermediary, until long-term, stable counterpart liabilities had been put in place. This should not be too difficult to do. The structure of mortgage finance in Denmark provides a good starting point.

This change would, almost certainly, make the provision of housing finance a bit less flexible and a bit more expensive. But it was the migration of such housing finance from specialist institutions to mainstream banks in the 1980s that has really put our financial system at risk, *not* the growth of derivative markets *nor* of investment banks. Proposed reforms such as the separation of investment from retail banking, as per the Vickers Commission, have been aiming at the easier, but incorrect, target.

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