Government Regulation and Moral Hazard

The Implications for Financial Regulation

Beesley Lectures 14th Oct. 2010

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Context

- Quoted primarily from Future of Banking Report
  - Member
  - Published June 2010
  - Before knew might become a member of Independent Commission on Banking
  - Took notes to ensure that what I said today would not be influenced by the ICB work
  - Everything I say today is based on those notes and not on ICB
- Nothing I say in any way represents the views of the ICB
  - Whose work is at an early stage

Context cont.

- Not from Banking
  - Lot to learn
  - Early days
- Not from Gas
  - big advantage when introducing competition
  - not steeped in ways of that industry
  - potentially dangerous
  - need to listen and be challenged

Purpose

- Purpose to stimulate discussion
  - complex
  - challenge welcome
  - early days, views will change
- Deliberately kept simplistic
  - sometimes because that is where I am
  - sometimes easier to bring out point

Topics

- Moral Hazard
- Future of Banking Report
  - banking model
  - size
  - structural reform
  - government guarantee
  - failure
  - prudential regime
  - competition (and competitiveness)
  - CPMA regime
  - competition and stability

Topics

- **Moral Hazard**
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Moral Hazard

Moral hazard occurs when a party insulated from risk behaves differently than it would behave if it were fully exposed to the risk

– Government Guarantee

More broadly, moral hazard occurs when the party with more information about its actions or intentions has a tendency or incentive to behave inappropriately from the perspective of the party with less information

- *Information Asymmetry*

Moral Hazard also arises in a Principal-Agent problem. The agent may have an incentive to act inappropriately (from the viewpoint of the principal) if the interests of the agent and the principal are not aligned.

- *Principal-Agent*

Wikipedia

Moral Hazard: Government Guarantee

- Government Guarantee lowers the price of risk

- Government Guarantee:
  - profits Privatised
  - losses Socialised
  - unlimited incentive to take risks
  - price of risk irrelevant to actions taken

- Problem not that banks say ‘how can I be reckless today’
  - but discipline normally provided by creditors absent
  - because State guarantee means there is absolutely no incentive to monitor the behaviour of the institutions to whom they lend

  - Future of Banking: written evidence
  - leverage increased because of conclusion Gov Guarantee existed
  - not just theoretical

  - **Government Guarantee is the key issue**

Moral Hazard: Asymmetric information

- Different from other industries
  - borrower pays interest
  - but until borrower repays or defaults
  - cost of lending not known
- Borrower knows more than lender
  - but lender benefits from portfolio
- On the other hand:
  - purchaser pays premiums
  - information opaque
  - value of product not known until maturity
  - comparisons difficult
  - moving costly or impossible
- Supplier knows more than consumer
  - and has control of terms and conditions, can vary

Moral Hazard: Asymmetric information

- Seller knows more about product than purchaser
- Purchaser unable to judge which seller giving best deal
- Future unknown:
  - will not know if good product for years
  - when it is too late
  - ‘good’ depends on luck, management and terms and conditions
- Banks deliberately sell complex products
  - customer repeatedly mis-sold or mis-buying
- There is no fiduciary duty
  - effective competition could provide protection
  - otherwise protection is through regulation
    - Difficult to be effective

Moral Hazard: Principal-Agent problem

- Depositors have to trust bank to manage funds
  - rely on regulator to ensure fair play
- Adam Smith: agents will not do job as well as principal
  - so negligence and confusion must always prevail
- Relations can be managed through:
  - law
    - Sometimes Trustee law with independent monitoring
  - regulation
    - Independent protector
  - or effective competition
    - Neither law nor regulation can replace rigour of market discipline
    - Interests of consumers and business need to be aligned with banks

Key Moral Hazard: Gov. Guarantee

- King: “our ability to sustain a large financial centre .. depends on demonstrating .. that that centre does not depend on taxpayer guarantees, because if it does we will have to reduce the size of it to a level proportionate to our ability to provide tax finance to underpin it”

- Need to get market disciplines back to work
  - no taxpayer reward for providing guarantee
  - no externalities

- Removing Government Guarantee requires
  - effective competition
  - firms to be allowed to fail

- Know not removed while Ratings Agency continue to factor in
  - government guarantee

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Future of Banking Report

- “Banking is a structurally flawed industry that has failed its customers, its investors, and the taxpayers who stand behind it”
- “Themes that played a central role in 2008. Over-leverage, mis-pricing of risk, cheap credit, all concealed by concomitant asset price inflation and opaque accounting practices”
- “Implicit Government Guarantee distorts incentives and the pricing of risk”
- “Need to resolve conflicts of interest and the ‘too big to fail’ which removes market discipline”

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Banking Model

- Changed from originate and hold
  - to originate and distribute
  - lessening incentives for oversight
- Banks turned to securities markets to fund themselves
- Enabling expansion of lending + reduced capital
- When crisis hit, models did not work
- Risk had been transferred and concealed
  - not reduced
- Amplified by modern financial instruments
  - and globalisation

Market for Banking Services

- Pricing opaque
- Prices distorted
- Competition not working effectively
- Conflicts of interest rife
- Damage caused to the real economy

- Radical reform is needed

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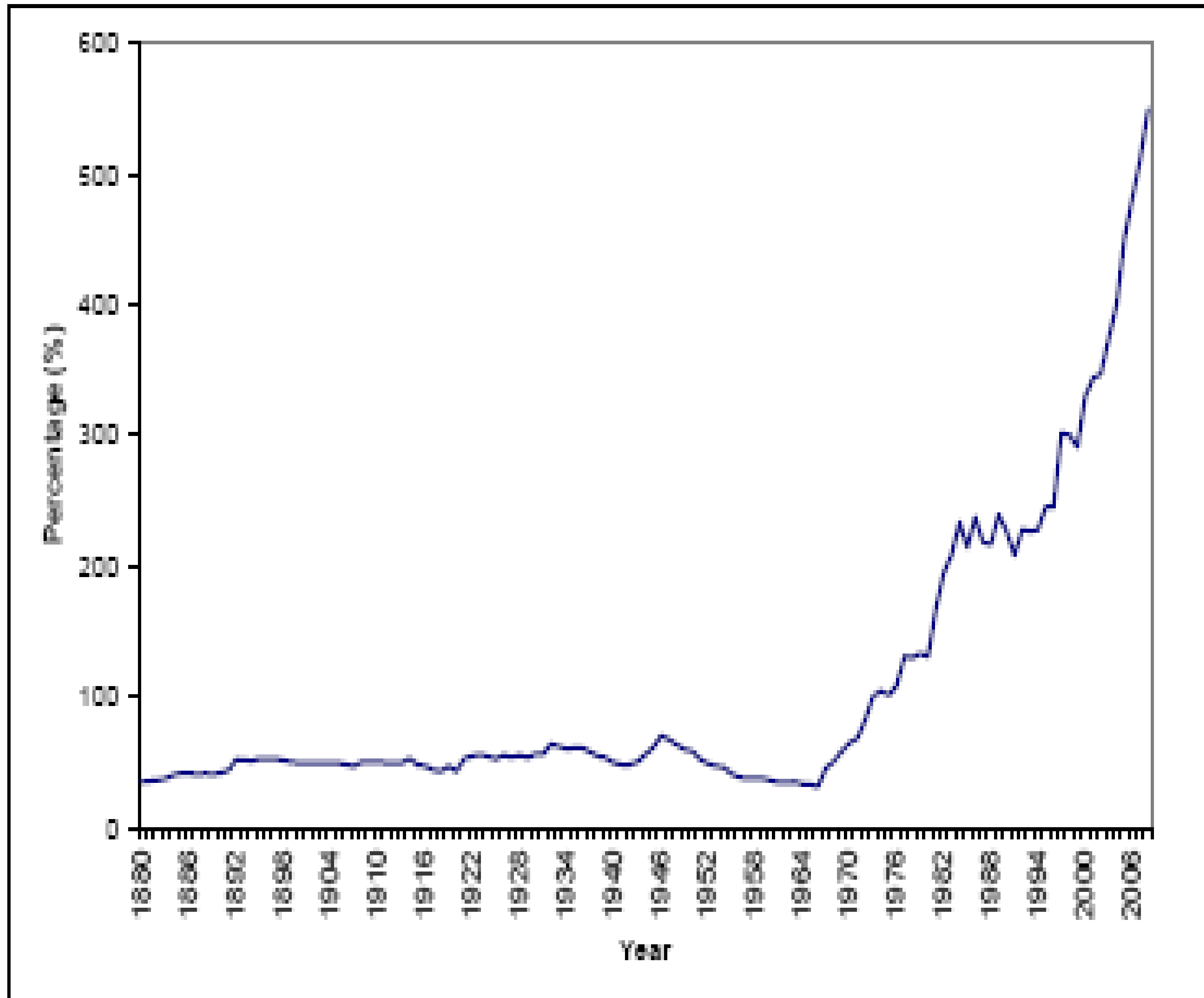
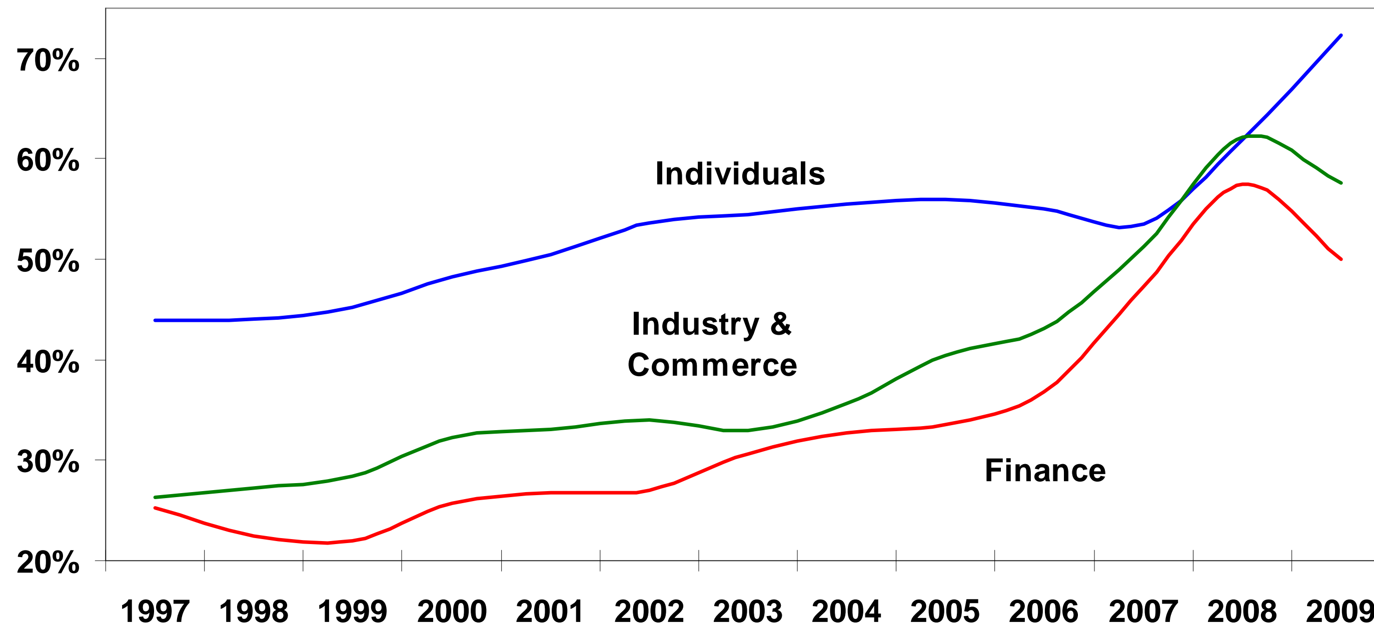
Banking Statistics

- Banking assets:
  - 1964 35% GDP
  - 2007 500% of GDP
- Asset backed securities
  - 1995 $200bn
  - 2006 $2,300bn
- Interest rate derivatives
  - 1990 $0
  - 2010 $310,000bn
- Was this expansion ‘economically useful’?
  - Turner revised from ‘socially useful’

Banking sector assets as a % of GDP
1880 – 2008 (Bank of England)



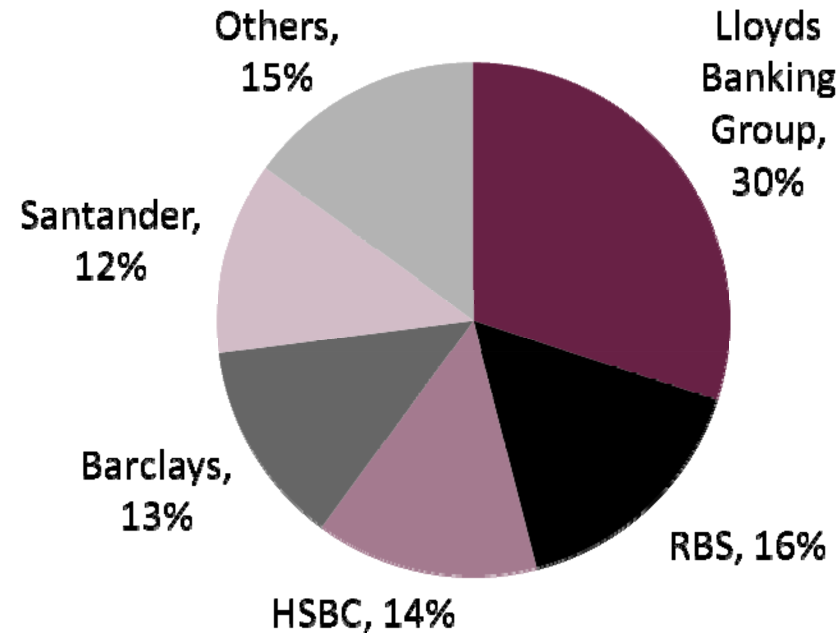
The Context



Competition: Does Size Matter? Regulation: Too big to compete?

- The four largest banks dominate the markets for current accounts, savings accounts, and mortgages
- The four largest banks supplied 71% of current accounts in 2009, compared to 66% in 2006. This excludes Santander, which only became a significant bank following recent mergers
- The four largest banks supplied 59% of savings accounts in 2008, compared to 44% in 2006
- The four largest banks supplied 67% of mortgages in 2009, compared to 47% in 2006

Market shares for UK personal current accounts



- Note: Market share measured by number of customers (2010).
- *Source: Mintel*

Oligopoly

- Myners: “this is an industry which to some extent, over probably the last two decades, has gouged its clients. It’s reported unsustainably high returns on equity .. A very competitive industry should not be able to sustain returns on equity of over 20%”
- Taylor: “paying out 50% of revenues to staff had become the rule, even when [because of accounting rules] the ‘revenues’ did not actually consist of money”
- Pitman: “incentives for sales targets have been a large part of the problem. .. It’s a little short of crazy to incentivise people to maximise the number of loans they’re going to grant”

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Separation

- King: “lessons from regulation in other industries I think are .. don’t try to pretend that regulators can ever be so clever as to stop banks from taking risks that will one day be serious, but try to make sure that if those risks do occur, that the system has firebreaks and firewalls within it so that the parts of the system you really care about and cannot afford to go under – the payment system and retail deposits – are completely separated from the things that could go wrong”

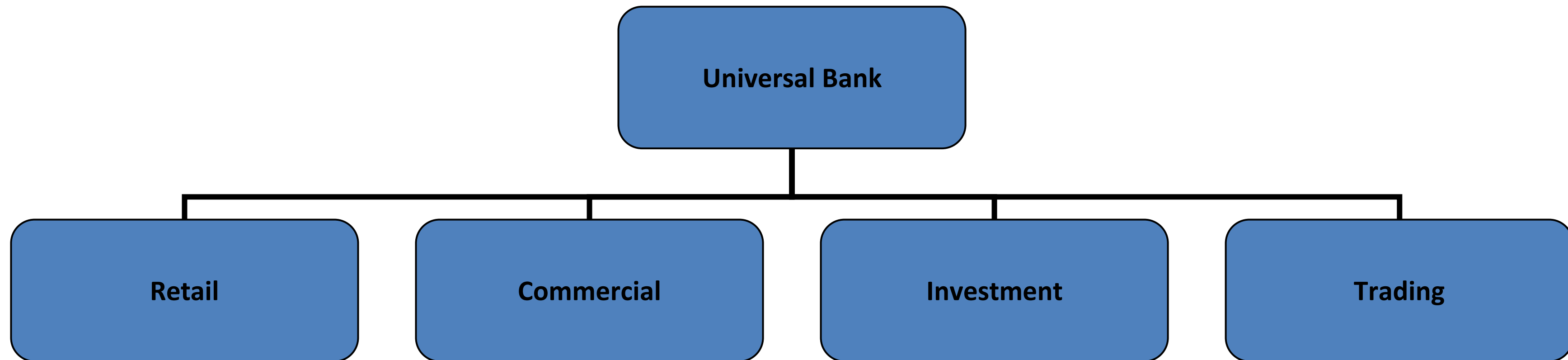
Pro-Structural Reform

- Banks provide essential utility services
- Banks need discipline of facing potential failure
- Diseconomies of scale in banking
  - [and economies of scale in ‘utility’ services]
- Broad scale banks too complex to manage safely
- Interconnections mean need to insert
  - firewalls and firebreaks
- Solution lies in smaller simpler institutions

Anti-Structural Reform

- Radical reform needs global agreement
- Modern world has sophisticated needs
  - requires broad trading and banking system
- Narrow Banks risky too
  - particularly if many have same strategy
  - systemically risky
- Glass Steagall did not work
  - US has more bank failures than any other advanced economy
  - crisis caused by excessive leverage and inadequate capital
  - not by wide scope
- Can be addressed by less radical solutions
  - than breaking up banks

Structure: Natural break points



Structural Reform recommendations

- Powerful and persuasive evidence in support of restructuring banks
- Compulsory separation has the potential to solve many current and persistent problems

- Extend Volcker rule to prohibit banks that advise clients from trading any form of securities
- Separate corporate advice from investor advice

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Problem: Government Guarantee

- Reduces the price of risk
  - If guarantee explicit:
    - no constraint to risk-taking
    - infinite cost to taxpayers
- Enables and incentivises high leverage
  - increasing risk of failure
  - forcing taxpayers to support failing banks
- Removes creditors incentive to oversee risk exposure
- Regulators and guarantees take the place of markets
  - impossible to control
  - necessarily rely on crude, costly and
  - inefficient and/or ineffective measures

Steps to date not enough

- New rules on leverage ratios and capital adequacy
  - increase safety margins
- But this is not enough to create a healthy industry
  - incentives remain 'as much as can get away with'
  - economise on equity
- If incentives remain unchanged
  - regulation shifts problem elsewhere

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Necessity of enabling failure

- Firm insulated from Failure
  - is insulated from market discipline
  - subject only to regulatory oversight
    - can’t be as effective as the market
    - cost and inefficiency high
- Finance is too big and important to economy
  - to continue allowing unnecessary costs and inefficiencies
- Banks must be structured so can fail
  - without catastrophic damage to customers or economy
- Aim to force liquidation before net assets below zero
  - Resolution Agency takes action earlier than in other industries
  - taxpayer protection, creditors take outturn pain

Remedies to enable failure

- Core deposit and lending functions ring-fenced
  - taken over and supported by resolution body to avoid confidence collapse
- Depositors put ahead of creditors
  - reduces depositor returns
  - increases cost of bank capital
  - creditors re-impose market discipline on risk
- Basic Depositors kept whole
  - guarantee funded by levy (price?)
  - taxpayers should not subsidise depositors
  - creating more distortions and unfairness

Remedies to enable failure

- Supplier of Last Resort required
  - ensure continuation of key services
  - provide confidence while resolution takes place
  - confidence to depositors (prevent bank run)
  - and to finance short term, temporary liquidity (prevent liquidity run and asset price deflation)
  - not at a loss to taxpayers

- Living Wills
  - enabling Resolution agency to run essential services
  - Lehman's exposed an unprepared system
  - counterparty positions known
  - creditor hierarchy known
  - address International resolution

- Aim to resolve over weekend as Federal Deposit Insurance Corporation (FDIC)
  - but for all institutions

- Creditors will lose money
  - this will put up the cost of debt
  - as it should since the Government Guarantee and its implicit taxpayer subsidy must go

Too Big to Fail (TBTF)
Too complex/interconnected to Fail
Systemically Important Financial Institutions (SIFIs)

- Living Will $\cong$ Safety Case
  - created / owned by Company
  - Regulator challenges, does not approve
  - details how deal with risk and events, particularly failure
  - details how key services continue to be delivered
- If Living Will exposes that Gov Guarantee still required
  - remedies put in place over acceptable timeframe (e.g. Data, Systems)
  - firewall balance sheets (subsidiaries)
  - split up into separate corporate entities
- Licence to operate withdrawn if Living Will not credible

Resolution regime

- FT “the point about a resolution regime is that the balance sheet of a failed bank is distributed among the solvent survivors. Thus the natural process of concentration is given an extra push. At the extreme, this could leave us with a handful of banks so big that in a systemic crisis they could no longer swallow each other”
- Resolution Agency must have regard to competition

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More Supervision?

- King on Citibank: “management best team to run a bank. Building full of regulators living there. None of these people managed to stop the risks materialising or things going wrong. Now I cannot believe that any regulator around the world could honestly pretend that they would do better than what happened there”
- Haldane: “there are natural incentives within the financial system to generate tail risk and to avoid regulatory control” .. “putting uncertainties to one side, assume that the policymaker could perfectly calibrate tail risk in the system today, and the capital necessary to insure against it. Banks would then have the incentives to position themselves one step beyond the regulatory buffer, to harvest the higher returns that come from assuming tail risk. They do so safe in the knowledge that the ability of a supervisor to control this risk may be impossible”
- Taylor: “I don’t believe that regulators can outwit necessarily determined traders. The traffic wardens don’t break up the drug cartels”

Supervision vs. Principles

- Increased supervision not the solution to
  - identifying and preventing future financial crisis
  - or making market discipline work
- Supervision will ultimately fail
- Need board to take fundamental responsibility
  - prudence
    - critical duty
  - much as Boards do for safety today
    - where if safety standards are found wanting
    - directors and others can go to jail and/or fined
    - safety culture transformed since HSE moved to principle based regulation
- Regulators there to set principles
  - not rules
  - and to enforce the principles

Prudential Regime

- Purpose should not be to bail out banks
- Key duty to ensure that Banks can fail
  - without causing significant harm to vital banking services
  - without threatening the wider economy
  - without requiring taxpayer money
- Where bank Too Big To Fail
  - power to withdraw licence until bank restructured so it can fail
- Responsibility for Prudence returns to Board
  - not delegated to regulator
    - who has become a supervisor
    - taken on responsibility for keeping banks alive
- Not the role of the Prudential Regulator to stop banks failing
  - that is the role of the board and management
  - policed by its creditors

Systemic Risk Regulation

- Oversee liquidity and capital standards
  - at macro level
- Keep under review interdependence of banks
  - and exposure to shocks which affect the sector
    - eg property
- Role to act counter cyclically
  - take the punch bowl away
  - some think this is not possible
  - is it?

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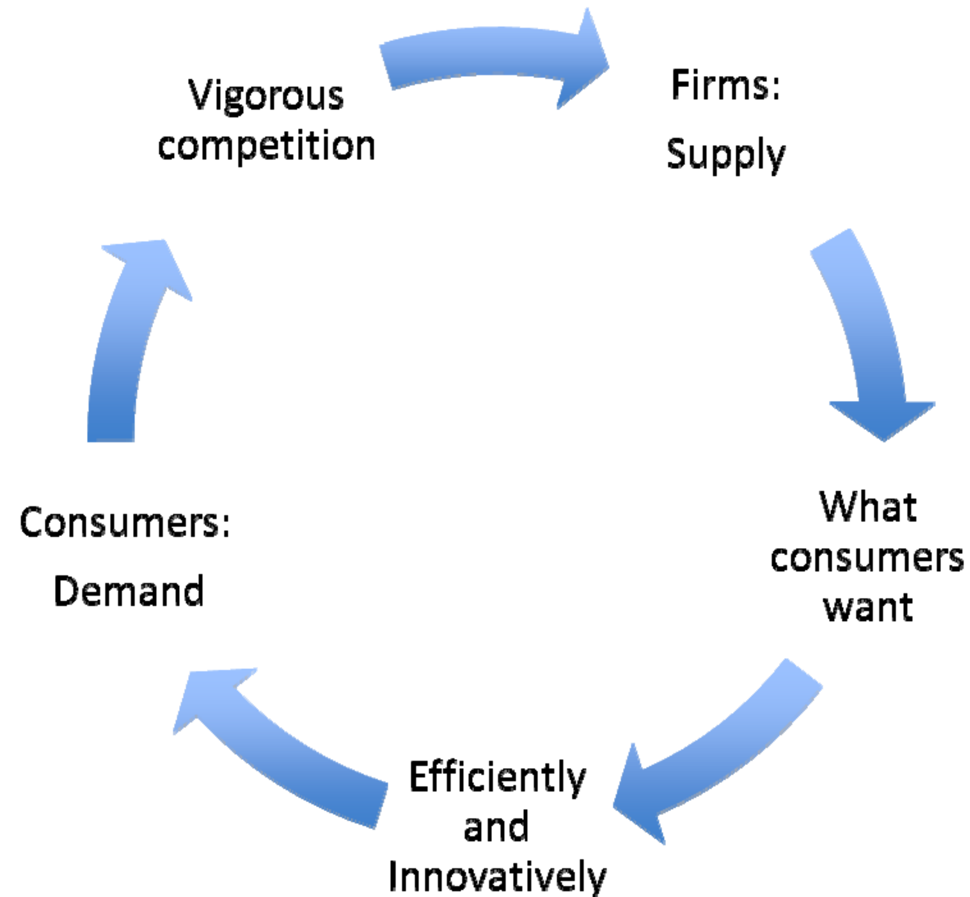
Ensure Effective Competition



Efficiently protects consumers and the real economy (no externalities)

Competition not Effective

- Principal-Agent problem
- Asymmetric information
- Enduring cross-subsidies
- High profits / high remuneration
- Price distortions ubiquitous
  - some introduced by FSA
  - Government Guarantee

- Banking sector highly concentrated
  - Size is not the only concern for competition
  - Indicator
- Barriers to entry

- **Lack of effective competition a key issue**

Competition not Competitiveness

- Financial services not effectively competitive
- Currently the duties conflict?
  - Turner "not sure .. regulator should have regard to competitiveness.. subtle way create a conflict of interest"
  - Supporting status quo
  - Discouraging new entrants
- International competitiveness created through:
  - effective competition
  - without subsidy or special treatment

London as a Financial Centre

- London has two advantages
  - large scale activity – hub contributes to economy
    - valuable for netting trades
    - pool of talent
    - many economies of scale
    - benefit from other participants being local
  - government guarantee – cost to economy
    - subsidy to Banks
    - no obvious public quantifiable benefit
    - some clear dis-benefits
- What happens over time if UK stops guarantee?

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Remedies for effective Competition

- CPMA: Primary Duty to Promote Competition
  - ex-ante powers via licence conditions
  - utility regulatory regimes
  - pro-active intervention to encourage effective competition
    - e.g. reduce barriers to entry
  - pro-active intervention to reduce Moral Hazard:
    - asymmetric information
    - agent-principal problem
  - pro-active intervention to stop anti-competitive behaviour
    - portable accounts
  - pro-active intervention to get rid of conflicts of interest
    - could require structural remedies
    - could require Competition Commission referral
      - If proposed solution includes forced divestment
  - pro-active promotion of transparency
    - even where some commercial confidentiality might be claimed

Concurrent Powers

- CPMA: Concurrent powers with OFT
  - refer markets to Competition Commission
- Claimed that effective competition concerns
  - subordinate to FSA regulation
  - since agreements or conduct by a dominant firm
    - which would usually breach competition law
    - not subject to enforcement
    - if ‘encouraged by any of the Authority’s regulating provisions’
- Competition law considerations disregarded when
  - public interest test for mergers widened to include ‘financial stability’

- Need to make clear that primary duty is to promote competition

Consumer protection not working

- FSA and OFT regulation not working for consumers
- E.g. Product Protection Insurance (PPI)
  - designed to cover debt payments if ill or redundant
  - sold alongside mortgages, credit cards, loans
  - widespread misselling to people who could never claim
  - clear example of a poorly functioning competitive market
    - lack of disclosure
    - asymmetry of information
    - inappropriate default setting – had to opt out
    - inappropriate commission structure encouraging sales
      - independent of customer needs
    - excess profits

How Regulation dealt with PPI

- Super complaint in 2005 by Citizens Advice Bureau
- OFT market study in 2006
  - led to market investigation reference in 2007 to competition commission
  - CC rules would ban sales of PPI alongside credit products in 2009
    - would have to wait 7 days before approaching a customer
    - unsuccessful appeal by banking industry
    - CC confirmed ruling in May 2010, remedies due July 2010
    - some 5 years after CAB issued super-complaint
      - and that was some years after problem was indentified
- FSA did not take any action

- CPMA with a duty to promote competition would pre-empt

Competition not competitiveness

- Need to use market forces wherever possible
  - not exclude them
  - regulation and monopoly are not a substitute
    - expensive and inefficient
    - money transferred from non-financial sectors to financial sector
    - consumers and real economy get a poorer outcome
- Is this what we want?
- Is it fair?

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Competition vs. Stability?

- Are competition and stability in opposition?
- Competition re-enforces Stability:
  - prices not distorted
    - e.g. Gov. guarantee not distorting price of risk
    - cross-subsidies not distorting behaviour
      - creating winners and losers
      - distorting product offerings which reduces financial strength
    - creating barriers to entry
  - failure good
    - imposes market discipline
    - inefficient firms or those with poor management exit
    - needs Resolution regime to provide confidence during inter-regnum
      - supplier of Last Resort
- Arguments saying stability is in contradiction to competition?

- Questions
- Comments
- Challenges