Cycle Proof Regulation[1]

Who is to blame for the financial crisis? There are more potential suspects than in an Agatha Christie novel. Could it be the rating agencies, who seemingly dished out AAA ratings to anyone willing to pay enough? Could it be the politicians who deregulated banking even as bankers were taking ever more risks? Could it be the bankers who, even now, hanker after bonuses while they are inflicting losses upon losses on the taxpayer? Could it be regulators, who blinded by ideology, allowed effective leverage to pile up in the system? Or could it be Joe Citizen, who was not content with the ordinary yields he received and the small house he lived in?

There are plenty of suspects, and enough blame to spread. And the rush by all concerned to identify specific culprits other than themselves is understandable. With a suitably sleazy or incompetent villain, not only will blame be deflected from one's own deficiencies, and the public's lust for blood slaked, but also we will have done something to put the problem behind us. The political establishment loves to pin the blame on sleaze or incompetence, for these are actionable. Greedy bankers? Cap their bonuses! Ideological regulators? Increase capital requirements!

The broader point in this admitted caricature of the reform process is that we need to go beyond proximate causes. Who is without blame in the cast of suspects listed above? If all are to blame, should we be looking to more structural causes? And if we do find them, is it possible that they may not be fixed so easily?

One way to put this crisis in perspective is to remember that Citibank, the icon of American banking, has been near insolvency three times in the last three decades. In the 1980s, it was because of loans to developing countries, in the 1990s it was because of real estate loans, and now it is because of mortgage backed securities. And Citibank has not been alone. In the zeal to reform, will we close the stable door on sub-prime lending while ignoring doors that are opening elsewhere? Should we not ask whether there is something structural in banking that leads to instability?

Over the years, a number of economists have indeed argued that the financial system is prone to booms and busts. Here is a modern rendering why. In a competitive market, return can only be made by taking on risk. In the past, financial intermediaries, such as banks, used to be the primary route through which households had access to risk. Because competition was limited through regulation, banks could earn profits simply by providing households that access.

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[1] Remarks delivered by Raghuram G. Rajan, Eric Gleacher Distinguished Service Professor of Finance at the 2009 Credit Markets Symposium organized by the Federal Reserve Bank of Richmond in Charlotte, North Carolina on April 2-3. Rajan thanks Luigi Zingales for very useful discussion including some of the ideas in this talk.

Deregulation has allowed a profusion of intermediaries, so households can obtain exposure to a variety of risks at low cost – to market risk via an indexed fund or to risk free returns via a money market fund. This makes it harder for banks to generate profits. A bank can no longer pay employees high wages if the employees only earn the normal return on a risk – any indexed fund can do that. Bankers have to earn risk-adjusted profits – the elusive alpha produced by financial geniuses like Warren Buffet.

In the early stages of a cycle when many profitable real projects are looking for finance from still-cautious financiers, or in the early stages of a financial innovation such as mortgage backed securities when the innovative enjoy an oligopoly, there are still plenty of profits for the entrepreneurial banker. But as cycles or innovations mature, the easy money has been made. However, the pressure, whether real or perceived, on bank management to seek profits is unabated.

The easiest way for bankers to slake their investors' thirst for profits, given that Buffet-like financial acumen is rare, is to take on risk that is hidden from investors. So long as the risk does not materialize, the return can be passed off as risk-adjusted profit. Indeed, certain risks such as credit risk have the characteristic that they do not appear quickly, provided the banker takes a little care – loans, even to shaky borrowers, do not turn sour immediately. In the meantime, the banker enjoys high spreads on the loans.

Does the banker know he is producing fake alpha? Sometimes he does, and simply games the system, hoping the benefits gained from the period of high profits outweigh the costs when the risks materialize. But often the situation is novel enough that he does not, and he may genuinely belief he is creating alpha. This may be why Citibank has found a new way to lose money every decade. Indeed, as more banks crowd into a particular activity such as lending to sub-prime borrowers, returns may be boosted and risks suppressed for a while. When banks are very willing to refinance borrowers, no one defaults, and it appears that given the recent history of defaults, there are excess returns to be made in sub-prime lending. Until, of course, the cycle turns.

The point is that whoever are the culprits in this crisis, and I don't want to just finger the bankers, they all had a willing accomplice – the euphoria generated by the boom. After all, who is there to stand for stability and against the prosperity and growth in a boom? Internal risk managers, having repeatedly pointed to risks that never materialized during an upswing, have little credibility and influence -- that is if they still have jobs. It is also very hard for contrarian investors to bet against the boom – as Keynes said, the market can stay irrational longer than investors can stay solvent. Politicians have an incentive to ride the boom, indeed to abet it through the deregulation sought by bankers. After all, bankers not only have the money to influence legislation but also have the moral authority conferred by prosperity. And what of regulators? When everyone is for the boom, how can regulators stand against it? They are reduced to rationalizing why it would be technically impossible for them to stop it.

So as in Agatha Christie's *Murder on the Orient Express*, everyone is complicit in the crisis because, ultimately, it is aided and abetted by cyclical euphoria. And unless we recognize this, the next crisis will be hard to prevent.

Consider the dangers of ignoring this point. A number of recent committees have argued that capital requirements should be raised across the board for banks. The more thoughtful amongst these committees suggest raising them in good times and reducing them in bad times, so-called "countercyclical" capital requirements. While all these proposals are sensible prima-facie, they may be far less effective than intended.

To see why, recognize that in boom times, the market demands very low levels of capital from financial intermediaries, in part because the boom time euphoria makes losses seem remote. Capital is a costly form of finance, so when regulated financial intermediaries are forced to hold more capital than the market requires, they have an incentive to shift activity to unregulated intermediaries. The SIVs and conduits set up by banks during the current crisis reflect this regulatory arbitrage. Even if regulators are strengthened in the future to detect and prevent this shift in activity, banks can subvert capital requirements by taking on risk the regulators do not see, or do not penalize adequately with capital requirements.

Attempts to reduce capital requirements in busts are equally fraught. When the risk-averse market wants banks to hold a lot more capital than regulators require, it is no surprise whose requirement prevails. In sum, the implementation of higher capital requirements will be difficult because of regulatory arbitrage in good times, while the additional difficulty with reducing requirements in bad times is that the market may not be as generous as the regulator.

All this assumes that regulators and politicians can credibly commit to targeting a particular schedule of capital requirements over the cycle. Yet even this is questionable. Once memories of the current crisis fade, and once the ideological cycle turns, there will be enormous political pressure to soften requirements or enforcement. Of course, no one anticipates this at times like the current ones, when politicians need to do something, nay anything, when regulators have backbones stiffened by public disapproval of past laxity, and when bankers' frail balance sheets and vivid memories makes them eschew any possible risk.

This is not to say that there is no need for improving regulations or enforcement. But let us not reform under the delusion that the regulated, and the markets they operate in, are static, passive participants, or that the regulatory environment does not vary with the cycle. Faith in strong regulation is strongest at the bottom of the cycle, when there is little need for participants to be regulated. By contrast, the misplaced view that markets will take care of themselves, is most widespread at the top of the cycle, at the point of maximum danger to the system. We really need cycle-proof regulation, for a regulation set against the cycle will not stand.

Put differently, as Rahm Emmanuel has said, "a crisis is a terrible thing to waste". But the opportunity for reform during this crisis will be wasted if we put in place draconian regulations that will do little to increase stability in the near term, while imposing such severe constraints on growth in the longer term that they will be diluted by regulators or arbitraged away by the regulated. The opportunity to create sensible regulations that do induce stability would be lost.

What might be elements that would make regulation and regulators more immune to the economic and political cycle? One option is bright line rules – rules that are very clear on what is permitted and what is not, and whose enforcement is therefore easy for the public to monitor, even when regulatory backbone softens.

For instance, some have suggested that banks with insured deposits should not engage in trading for their own account, an activity known as proprietary trading. This would be a modern version of the 1933 Glass Steagall Act that separated commercial and investment banking in the United States. In addition to making the system more stable by pushing volatility-inducing activities away from areas that cannot be allowed to sustain losses, it might be argued that the separation is enforceable -- because the lines are so clearly drawn, the public will know when they are being erased. Moreover, once in place, such separation will create pockets of rents that will generate defenders of the separation; the specialized proprietary traders will fight tooth and nail to prevent the commercial banks from encroaching on their turf. Finally, separation can create a variety of different players and strategies rather than a monolithic herd. This will lend stability to the system.

Yet these virtues may be more illusory than real. Glass-Steagall worked for a while only because there really was not much value to combining activities in the immediate post-Depression years. Over time, and long before the official repeal in 1999, it had been eroded in myriad ways. Not only are bright lines never so bright – for instance, how do you tell “illegitimate” proprietary trading from “legitimate” hedging – but also by standing in the way of private value creation, they generate enormous incentives to go around them. Moreover, the notion that the financial sector can be clearly separated into heavily regulated segments and lightly regulated segments is positively dangerous in a world where there are numerous connections between players, most important of which is systemic liquidity. While activity will drift to the lightly regulated segments during the boom, the consequences will come back to hit the heavily regulated segments in the bust.

A better way to protect against such drift is to regulate all levered institutions that engage in similar activities with a common but lighter touch. “Light” is not to say that regulation should not attempt to constrain the private sector when necessary, but that it should be both contingent and realistic. Contingent in that it should have maximum force when the private sector is most likely to do itself harm but bind less the rest of the time, realistic in that it should acknowledge the effects of the cycle.

Let me conclude with two examples of regulation that are likely to be less influenced by the cycle. The first is a different way to regulate capital. As I have argued, current proposals go against cyclical tendencies, requiring more capital in good times when no one believes the system needs much, and requiring less capital in bad times when everyone wants more. An alternative is what Anil Kashyap, Jeremy Stein, and I call capital insurance. The idea is to require systemically important levered financial institutions to buy fully collateralized insurance policies that will infuse capital into these institutions at times when the system is in trouble. Because these policies will be purchased in good times when the chances of a downturn seem remote, cyclical effects will tend to make them cheap and thus easier to enforce. Also, because the payout is not available immediately, firms cannot go out and increase their risks, using the payout as backing. Finally, because the policies pay off in bad times when capital is really needed, they protect the system in the right contingencies. I have no doubt that our proposal can be improved upon enormously, but it is a useful starting point.

The second example is what to do about “too-big-to-fail” institutions. In my view, this is the single most important regulatory issue stemming from the crisis. There is a lot of discussion about whether to impose higher capital requirements or limit the activities of these institutions so as to constrain growth. Such regulations may be necessary, but they tend to become very onerous when growth is high, thus increasing the incentive to weaken or bypass them.

Perhaps, instead, the weight of effort should be spent in figuring out how to make these institutions more “failable”. For instance, systemically important financial institutions might be asked to develop a business closure plan that will require them to resolve themselves over a weekend. The development of such “shelf bankruptcy” plans would be supported by the requisite enabling legislation – such as one enabling an orderly transfer of the institution’s swap books -- and would be stress tested by regulators periodically. It would have to be accompanied by additional regulation – such as requiring money market funds to have enough capital to survive the demise of a large financial firm they are invested in – that will limit the wider fallout from failure.

The need to develop such a contingent plan will give systemically important institutions the incentive to reduce complexity. It will not be much more onerous in the boom, and may indeed force management to concentrate on the unthinkable.

Let me conclude. I have expressed some concerns about the current trends in the public discourse, not because I do not think we need better regulation, but because I think we are in grave danger of fighting the last war, closing stable doors, and any other similar clichés you can think of. We have discovered we are not immune to the cycle. Let us not produce legislation and regulation that assumes the environment will remain as it is today for ever more. Instead, let us give some thought to cycle-proof regulation. Thank you.