Centre for Banking & Finance Law
Faculty of Law

Public Lecture

Micro- and Macro-Prudential Supervision. Is the Present Model of Financial Regulation Destructive?

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The Centre for Banking & Finance Law (CBFL) at the Faculty of Law, National University of Singapore, seeks to generate scholarship and promote thinking about the vibrancy, robustness and soundness of the banking sector, capital markets and other financial services. Through the research our scholars undertake and the events we organise, we seek to create and share knowledge, to engage stakeholders in an exchange of ideas, and to enhance the appreciation of legal and regulatory issues. We aim to bring greater theoretical and analytical clarity to these issues, to examine their policy impact, and to be a catalyst for ideas on how to improve banking and financial systems at the national, regional and global levels.

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ABSTRACT:

Banking regulation has undergone substantial reforms after the 2008 financial crisis. In spite of these developments, European banks, especially, continue to experience serious difficulties. Central banks still operate in crisis mode and banks do not serve as intermediaries aimed at providing markets with sufficient liquidity. Stress tests prove inadequate. Capital adequacy rules requiring banks to rebuild capital at the bottom of the market are counterproductive and the new liquidity requirements constrain the business further. Modern bank rescue and resolution regimes are ineffective because they promote early bank runs and bail-out mechanisms are reinstated as the current Italian example is showing. A different approach is needed, and the lecture will analyze whether macro-prudential supervision can provide answers and how it should be designed to provide solutions.

NUS Centre for Banking & Finance Law (CBFL) Distinguished Visitor Lecture

Faculty of Law, National University of Singapore, Thursday 15 Sept 2016, 5pm.

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Professor JH Dalhuisen , Peter Ellinger Visiting Professor National University of Singapore, Professor of Law King's College London, Visiting Professor UC Berkeley.

Dear Guests, Dear Dean, Dear Colleagues, Dear Students, Ladies and Gentlemen,

Before I reach my subject, let me first say how honoured I am to give this CBFL Distinguished Visitor Public Lecture as the Peter Ellinger Visiting Professor. Professor Neo was so kind and thoughtful to organise a lunch with Professor Ellinger two weeks ago and I believe most people of any age would be very happy to have his state of clarity and alertness of mind. Of course I had already noticed the art collection he left hanging in the corridors on the third floor, another tribute to his wide ranging interests and generosity.

I have also been much honoured with my Visiting Professorship at NUS in its Global Law School. Transnationalisation is my subject and although it will be under some pressure now that globalisation has become more of a political issue – it always was - there is not much of a way back and we have to continue to think in terms of the international market place and how its operation finds legal expression and is balanced by the public interest expressed and operating at that level. It seems to me that finding a legal expression for that interest and who its proper spokespersons are is our major challenge.

Let me also say how happy I am to be in Singapore for longer than just a few days as I was when passing through for teaching in Sydney several times at the beginning of the Millennium. My wife and I rejoice in garden design and this is a paradise for us, right from our landing at the airport. But what is new is some

outstanding modern architecture especially that spectacular island sitting on top of Marina Bay Sands.

Speaking of islands, we spent some time in Betan earlier this week. What fascinated me most was at night the ships passing through the Straight. With the lights on, it is a beautiful sight. It looks indeed like a very busy street and it came home to me that it is the busiest and most important shipping lane in the world by far. I am glad to have seen some of it, not easy to forget.

I fear I must come down to earth, to my subject of today, and ask why financial regulation as we have it can be and often is destructive. I have nothing against regulation in principle, it can be and often is very necessary to find a better balance with market forces, but in international finance the simple reason is, as I shall try to explain, that we are not sufficiently understanding what we are trying to regulate. It is part of us not really understanding how a twenty first century western capitalist society works. We do not know why crises happen and especially not when, rationality being often long suspended. Indeed if we knew more, these crises could not happen at all or if they still did we would know what to do about them. That does not mean that I can offer a better insight, in fact I do not know anybody who has that deeper insight, although in international finance academia is certainly remiss at not trying better. The financial crisis of 2008 is also a crisis of academia that has not been able to give politician the tools to deal with the situation better. We seem to be an empty bottle on the waves of the sea, going defencelessly up and down with them. Financial chairs are hard to fill, the pull of a better rewarding practice is unavoidably great, but that is not to say that there is no need for trying. This being said, in finance at least I can ask for a change of emphasis in policy which can be more properly followed and measured.

Before doing so, I like to take a step back, better to see where we have got and to that end divide the period since WWII in three economic episodes, during most of which I was present and some kind of participant. The first part roughly between 1950 and 1975 denoted exceptional and broad based growth till the 1970s oil shocks when it came to a virtual halt - I believe Tony Judt's "Post War" is still the best narrative by far. His story ends in 2006 and could not therefore capture sufficiently what I call the second period and place it in contexts. That is the period between 1985-2008, a renewed growth period ended by the financial crisis. It became much more controversial and was followed by the period since 2008, characterised in the West, particularly in

Europe, longer already in Japan, basically by no growth at all, by increasing popular disenchantment with this state of affairs, and by a political caste that does not have the wit or self-confidence to explain nor the confidence of the electorate to be able to lead. Our politicians, in Europe but now also in the US, constantly like to blame others for the problems, like banks, immigrants, societal diversity etc., rather than blaming themselves, but they are at the centre of all of this, from financial supervision to Brexit. In the meantime, people start believing at least the negatives of their self-serving stories but it leads nowhere and is very destructive.

The first period was one of sustained growth, in Europe first a rapid catch up after the War, the German Deutschmark leading, and as from 1961 starting rapidly to revalue and recover against the US dollar, real wages in the 1960's/1970's alone multiplying 4 times. This happened regardless of cold war pressures, which in retrospect may have served to reinforce moderation and discipline, and it happened notwithstanding what may now be seen as the operatic student revolt in France in 1968, although less funny in its aftermaths in Germany and especially in Italy, indicative of more uncertain times to come. Exceptional growth in that early period allowed for a strongly redistributive system leading to a structure of welfare and a social safety net that was broad and affordable. These were good years in which in Europe the emerging EU became leading, uncontroversial, and was perceived as substantially contributing, even if there was a lull in its progression during the 1970s/early 80s. The UK joined in 1973 at the head of what became a long queue.

If I paint this first period as in fact idyllic, it was nevertheless true that is remained regional. Globalisation had not reached us and it meant perhaps much less for Africa, South America or the Middle and the Far East with the exception of Japan, Taiwan and South Korea. It is the second period from 1980 to 2008 which opened up borders but also became more problematic and was always more controversial. Let me start with the positive: real incomes still more than doubled and the movement became worldwide. Globalisation took off, the European Union expanded dramatically, the Soviet Union collapsed, the Maoist persuasion floundered although the expectation of a Trotskyist nirwana never completely faded. The Far East beyond Japan in particular started to contribute. But also other regions coped with a world population that moved from 2.5 to 7.5 billion within two generations, more to come we are told, while all became substantially richer.

But particularly in the West, this second period can also be understood differently. Although the more libertarian and neo-classical Reaganite and Thatcherite ideas may well have been an important impulse to get us out of the oil chocks of the 1970s, they also laid the groundwork for a more divisive society, and certainly for taking much more risk, facilitated by the end of the cold war which seemed to allow and justify it. Rather than political risk we turned to economic risk-taking and notably moved to a much more leveraged society, government, business, and consumers alike. It is an environment that is more fragile and easily given to distortions or imbalances/instability and this goes on: as we speak, there is a dollar equivalent of more than 26 trillion outstanding in Chinese corporate debt alone, more than three times the national GDP of China; the pension system in US is more than $ 4.3 trillion short, a quarter of GDP. When the Henkel company in Germany is now paid by investors for its bonds rather than Henkel paying them, the proceeds not meant for investment in its business but rather for some shadow banking activities, one must wonder what is next. Everything seems distorted, not in the least also the interest rate structure which has been seriously manipulated for years. It is called experimentation but is basically a form of groping in the dark in respect of economic realities whose verities are not liked. It is in this culture, as from the 1990's veering increasingly towards boom and bust, that banking was completely reinvented and acquired its present form. Had it been quite dull in the earlier period, it received an entirely new impetus and gloss and became central to this new world of leverage, greater risk, and economic rollercoaster, which became the new normal. It led a socialist British Chancellor of Exchequer, later Prime Minister, even to declare the end of boom and bust.

In the West, we live with the consequences of that epoch, its expectations, its ethos, and ultimately its frustrations and its cost, also at the level of the political debate, of tolerance, societal diversity, free movement, and equality and that in a period where we may still say that we never had it so good, although clearly not good enough in the minds of quite a few in who envy and bitterness take hold, although at least statistically there is little evidence of people being left behind, even of the divide between rich and poor becoming much larger. In fact, the 2008 route did not end in a major depression and the economic consequences did not go beyond what could be expected in any economic cycle, not worse than what was experienced by the 1980s. The saving of banks by government was necessary and at least in the US successful

although much less so in Europe whilst negative interest rates make things only worse for them and for investors generally. Altogether, we may have entered the Indian summer of western capitalism and democratic liberalism – it is quite possible. Clearly, the jack is out of the box in terms of expectations, but how do we satisfy them or has frustration become inevitable? In particular, could it really be true that we now all want to live till hundred, the considerable cost of getting there being paid for by government plus 35 years of pensions to live in the state we think we are entitled to? But who is to pay for all of that with a sharply negative birth-rate in many countries and a hate of immigrants whilst the few youngsters we still have are barred from jobs by those who believe they are entitled to life-time job protection preferably with inflated pay and pension rights. All the while, we lament the divisiveness of this type of a society, but want more from it. This is turning into a crisis of capitalism that morphs into a democratic malaise and a loss of important values and balance. I do not need to mention the populist movements, not in the least also in the US and their deeply negative and authoritarian biases. Britain now wants out of the EU in a bid to become small in its own way, apparently aspiring to much more from this kind of society whilst keeping the rest out.

Early warnings there may have been against the new tide, first in the Savings and Loans debacle in the US, already in the 1980s, in the Scandinavian banking crisis in 1996, in the Far East and Russian financial problems in 1997, in the long banking crisis in Japan, in the collapse of the tech boom in the US after 2001, and in the abuse of financial engineering in Enron, but things picked up again quickly thereafter. However, especially in Europe, the show was up after 2008, Japan is not far behind although its unemployment rate remains admirably low, and we see how difficult it is to reconsider our situation, indeed how little leadership there is to tell us what is necessary in terms of discipline, which we call austerity while still borrowing more and, like in the UK, running large trade deficits at the same time. Perhaps someone should tell us that those two periods of exceptional growth are not likely to recur and should not determine our expectations, that our standard of living must be earned in each generation, and that little growth was always the normal. Rather we should try to hold on to what we have and perhaps also give up on the bizarre idea that we always must live better than our parents. That was true for the after-the-war generation, but it was not their achievement rather their luck as it was the bad luck of their parents who had to go through two wars and did do a great

deal *worse* than all those who had come before them; so much for always doing better.

Since the 1990 there were undoubtedly important technological gains, the whole internet revolution, substantially free movement of people - the other precondition for growth - but by assuming what were extreme forms of leverage, we are in a different world where much is monetary fluff, not sustainable growth. We live quite happily with this state of affairs until there is a financial crisis which is then the fault of banks. But is it? The reaction is to regulate them more, that is also the uninformed popular demand, but how and for what? The easy answer and result is to make banks smaller, but whatever we may think of leverage, liquidity then dries up at the worst moment when it is needed most and economies must expand. Smaller banks were never the solution, they cannot provide the liquidity we need and are also riskier which stress tests prove all the time - it is a romantic idea - although of course a large bank in trouble means a greater headache. Borrow more or print money is then the answer; we will sort things out later. In the meantime, there is no incentive for structural reform and these smaller banks are still expected to contribute to restart the bonanza. What became the banks' undoing is then supposed to be their virtue, their problem becomes the solution at the same time! Lend more, indeed very necessary at the bottom of the cycle but how with stricter capital and liquidity requirements?

Again let us step back, and see what happened in the 1980's. I was there some of the time as Secretary General of what is now the International Capital Market Association (ICMA). First, we thought we had acquired a much better handle on financial risk and its management: in particular, derivatives developed as major hedging instruments against market risk - they had long been known but were made effective through computer power which also provided more information better to handle credit risk and to consolidate it on a daily basis. Thereafter, we got securitisations and credit default swaps. Second, whatever risk remained, we thought we could manage it in a much more sophisticated assessment of the necessary capital buffer. That was Basel I in 1988, followed ultimately by Basel II, the effect of which was virtually to reduce the capital requirements to zero. Leverage ratios were rejected. Liquidity management was not considered a regulatory issue, although it was and it is illiquidity that is the true killer of banks, not lack of capital; there was more than enough of that at the beginning of 2008, at least by the capital

standards of those days. The continuing emphasis on capital, whatever adequacy may mean in that context - was probably always misplaced.

It was nevertheless the happy world in which banks were not only allowed but were being pressurised into providing loans to the multitude, consumer loans, credit card balances, or affordable housing, with support through securitisation when bank balance sheets became too large and special facilities even here for mortgages, see Freddie Mack and Fanny May in the US, and regulation was not to be a bar. Banks may have exploited the opportunities, may have abused the situation, no doubt, but it must never be forgotten that it was government policy that brought them to it. Bankers were lauded, given honours, huge bonuses and pensions until all went wrong, honours had to be returned, bonuses capped, pensions cut, etc.

For the purposes of this lecture it is the conclusion that counts: regulation did not make the slightest difference, and micro-prudential supervision as we now know it probably never will because it is not made for this kind of world. To be always safe, it would require capital which is far too large in most parts of the cycle. This type of regulation may have made things worse and can even be seriously destructive as it is pro-cyclical in nature and encourages banks at the top of the cycle to lend even more, when they are in fact at their most dangerous and need curtailing most. The flip-side of this type of regulation is to make banks build capital in economic crises when their liquidity providing function and supervision of borrowers is most needed but already under great pressure. If we are truly concerned about financial stability, this is not the way. In the meantime, stress tests proved fakes whilst the political and regulatory response drags on but banks are hardly considered safer, at least by investors, see the recent Brookings Paper of Natasha Sarin and Lawrence Summers: "Have big banks gotten safer? " (Sept 2016). Even though they do not make the case against present regulation, they caution against complacency.

Instead, it is submitted that we need *macro-prudential supervision* which is very different, back to pure policy, not a judicial system of hard and fast rules based on largely fixed capital adequacy and liquidity requirements and for the rest ever bigger rule books. Macro-prudential supervision is in my view a separate facility operating besides fiscal and monetary policy but at the same level, through which the regulator decides the size of banking and its product range at each stage in the economic cycle by freely varying capital adequacy

and liquidity requirements and leverage ratios, potentially doing away with them completely in bad times but increasing them dramatically in good times when the sky would seem the limit. Like fiscal and monetary policy, the key is here to break the pro-cyclical nature of economic activity, in this case of banking in particular, which is excessively prone to it and that has long been known.

But there is an important additional point to make: I already said that the new credit culture of that second period and all expectations built on it, is a jack-out-of-the-box that cannot easily be put back as there would be substantial social cost and it is here to stay. We lit the fuse and have built a society that completely depends on credit which would not appear reversible. Even in a country as quiet as Denmark we now learn that borrowers owe their banks on average three times disposable income – doable as long as their assets keep their value (unlikely for house hold goods) and they hang on to their jobs. Leverage is our way of life, we want the rollercoaster, we want credit for all, students, consumers, house buyers, the so-called social function of banks, a human right! Stability that would deny us these facilities is not wanted, and now probably also comes at too low a level of activity; the half-baked effort in the EU in this direction is a serious drain on its growth prospects; it is not the society in which we live or which we want. Banks (besides capital markets and now perhaps also the shadow banking system and Fintech) are at the centre of this and need a large degree of freedom to properly operate in this environment. To repeat, this type of banking cannot be stabilised by the old micro-prudential supervision and set of rules, one size for all, forcing banking to operate at too low a level of activity in bad times or killing it altogether. The continuing banking crises in Europe testify to this. Banks must be allowed to dig themselves out of their holes and re-establish their function, no kind of micro-prudential regulation or regulator can do it for them.

Now of course the Germans think differently: they do not speculate in real estate and live in rented accommodation. Only the rich have credit cards and - listen to this - they save before they buy a car, have you ever heard of that? In that world banking is a bad business. With large savings, banks are forced to invest in murky products and commonly come unstuck not in their loan book which is too small, but in their investment book; for the rest they must do investment banking outside Germany as at home the legal system is not made for that kind of activity. This is a very different world, I mention it because it is much behind the financial reregulation in Europe but for other countries a

dead-end street unless Germany indeed means to change the credit culture in the EU completely, but it would have far reaching consequences in terms of activity in many EU countries, which have a very different culture and set of expectations. I have no doubt that this was also an undercurrent in the Brexit vote, although hardly articulated.

As I posited, the answer is in a different type of financial regulation altogether which is what I perceive macro- prudential supervision to be. In the mind of many, perhaps also G-20, it remains a vague concept. Indeed even now it is connected with a modest form of capital and liquidity requirement variation during the cycle, but it is certainly not yet its essence. It is also supposed to give some inspiration and direction to micro-prudential supervision suggesting probably some greater regulatory discretion in what in England is called a judgment approach to this kind of more traditional regulation, and finally there is an active role foreseen for macro-prudential supervision in banking insolvency or what we now call banking resolution. These three roles are in fact very different and it must be asked whether they should be combined, but the greatest flaw is that the policy role in curtailing banks at the top of the cycle and deregulating them at the bottom, remains underdeveloped. As far as impacting on micro-prudential supervision is concerned, it will upset the rule based nature of that system and its justiciability. As for banking resolution, one may well ask whether the present idea of great discretion is compatible with the rule of law, especially when it comes to a bail-in or to the separation of the banking assets and liabilities between a good and bad banks. It has already given rise to serious legal issues and that is not at all surprising. Insolvency without rules is not a good idea.

Trying to separate banks and governments in picking up the pieces in such situations is in my view also entirely misconceived. It is now the way of G-20 but when things go seriously wrong, it is precisely the task of governments to save the banks which they control through regulation and that will always remain the bottom line. Anything else will only destabilise the banking scene further when it is at its weakest. After all, a bank is never stronger than its clients, whatever bankers' misdeeds. It goes back to the so-called social function of banks and government pressures in this regard. What is there in any event against nationalising these institutions in bad times in order to make a profit when they are refloated later? Look at AIG in the US and the car companies, it is a kind of private equity scheme that may make a great deal of

sense, unless, like in European banking, the subsequent idea is not to let banks properly revive.

To repeat, small banking can never be the answer, certainly not when we still want our economies to expand. In fact further consolidation, therefore even bigger banks, may be expected now banks are being squeezed. Where we are and the way we live, the banking system must take very considerable risk to survive and prosper, first in the projects it supports and subsequently also in what other related risks it must or will assume especially in trading. The key is that macro-prudential supervision if properly understood should force banks to build capital in the best of times, not the worst, limit dividends and bonuses and organise a safety net for all of banking at that moment but leave these banks well alone at the bottom of the cycle and then allow them to recover and rebuild themselves as they think best, except of course for conduct of business, where regulators could do a great deal more as they now do in the US, or in market integrity issues: money laundering, fraud, etc. where further tightening may well be needed especially in respect of individual bankers who habitually still go free whilst the banks as institutions are severely punished, weakening them in the process even further and convincing no one. Mere misjudgement is, however, not part of it. Risks must be taken but they must be regulatorily curtailed at the top of the cycle.

This is the simple policy proposal I make. I do not believe that anything else is likely to work and do the job of creating financial stability at a sufficiently high level of activity during the cycle. It means that if there is too much consumer lending, increase the capital for new business to 30 percent or more, the same when mortgage lending gets out of hand, or when we must start fearing substantial loan losses among other borrowers. If the fear is that there is too much proprietary trading, increase the capital and liquidity requirements, in particular no more funding through deposits or other short term facilities, etc. An inflexible Volcker rule was never the answer. Reduce on the other hand the capital requirements to zero when there is insufficient activity. Same for liquidity requirements and leverage ratios.

What about Singapore? Like the Swiss found out, it is too small for a boom and bust financial culture. The whole country might fall with it like Iceland did, and Singapore keeps its banks now rightly tight, at the moment especially guarding against a real estate boom, perhaps more like the German model, see also the modest impact of the 2008 crisis. It may also sit well with Muslim culture in

this part of the world that seeks balance as is clear also in sharia financing, inefficient as it may be. Whether London after Brexit would be right again to take on more risk, released from EU regulatory constraints is an important issue. Before long the whole Continent might lay its risk off on London whilst claiming back the juiciest bits, especially Euro swap clearing. Here again, the macro-prudential approach should be adopted and London would indeed be free to do so in a stronger form of Brexit and show that it is a better way. Not all of Brexit is darkness but its problem is that it has no ideas nor a program. The new prime minister seems to wait for divine inspiration.

One now sees that the EU at last is objecting to even more capital in the finalisation of Basel III, which the Americans desire for competitive purposes, their banks are strong enough at the moment, but just containing the capital adequacy requirements is not the right answer, it is in their dynamic application. On the other hand, one sees green shoots in favour of greatly more regulatory dynamism even at the Fed whilst dramatically increasing leverage ratios. Even Basel III incorporated the notion of variable capital to a limited extent. The Bank of England under its present leadership might be well equipped for it and has already used to limited flexibility that Basel III gives.

Ladies and gentlemen. Economically speaking we live in a dangerous world of high risk which we cannot wish away. Our society cannot prosper without it. We like and probably have no other choice than always to push out the boat as far as possible in order to find where the rocks are. In this environment with present insights banks must be given a lot of room to operate. But we are not defenceless and can find some rudder. That is not in ever bigger micro-supervisory rule books, it is in clear policy and in the simplicity of concept. That is where the shift to macro-prudential supervision when properly understood will help and will give us a necessary new direction but it implies greater responsibility for policymakers and government. That is their role and task, not to take their hands of everything in a box ticking micro-supervisory mentality and in a resolution regime that only means to transfer the responsibility for what happened to others. Has it ever occurred to us that the systematic breaking down of trust in society, not in the least by politicians, is the reason that we have this type of regulation which only debilitates growth? Did it ever occur to us that this kind of regulation was never there to save us, but only to protect and whitewash the regulator or government? Has it also ever occurred to us that this attitude is connected with the continuation of the financial and economic crisis in Europe and also feeds into its political malaise. We talk

about austerity all the time, often how bad it is, may be – although governments have never spent more in peacetime, but in order to make some progress, it is our attitude to financial regulation and to banking in particular that should be fundamentally reviewed.

Thank you very much.