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Major issues arising from the US financial crisis

Does deregulation necessarily mean instability? To what extent should risks be nationalised? These and other questions need hard answers to obviate a similar future fiasco. Risk-based supervision has become urgent

By **RAMKISHEN S RAJAN**

THE US financial debacle has highlighted some issues that policymakers in emerging economies and elsewhere need to pay particular attention to and grapple with when it comes to their financial sectors.

1) Is there an inevitable trade-off between financial deregulation and instability? While many emerging economies have been liberalising their financial sectors as a means of promoting efficiencies and product innovations (collateralised debt obligations, structured investment vehicles, hedge fund industry, exchange traded funds, etc), it is clear that this sector is a different animal altogether from other sectors like manufacturing. While disruptions in a manufacturing firm - even a very large one - will lead to some inevitable disruptions to employees in that firm as well as in ancillary firms, by and large these will be limited in scope and scale. This is unlike the financial sector, where disruptions in even medium-sized institutions could lead to a chain reaction of defaults and have marked repercussions on the rest of the economy. While there is no doubt that well-functioning and liquid financial markets are critical for overall economic growth, there are ample reasons to believe that markets cannot price risk appropriately.

Given the need for the central bank to possibly 'bail out' the financial system in times of stress, a government clearly cannot adopt a laissez-faire attitude towards this sector. Indeed, in October 2002, Ben Bernanke himself in a speech before the New York Chapter of the National Association for Business Economics, New York, noted the importance of 'supervisory action to ensure capital adequacy in the banking system, stress testing of portfolios, increased transparency in accounting and disclosure practices, improved financial literacy, greater care in the process of financial liberalisation, and a willingness to play the role of lender of last resort when needed'.

2) Should financial sector regulations be partial or comprehensive? By and large, the US commercial banking system has been tightly regulated, with the Federal Reserve standing ready to assist banks via the discount window in times of stress as a means of reassuring the public. This is so because a typical household depends on the commercial banking system as a financial intermediary and expects that their savings placed in such institutions are relatively safe.

Even a whiff of concern could lead to a bank run and outright panic. As against this, investment banks have been allowed a relatively free hand, and it is not surprising therefore that they have generally been highly profitable institutions. Depositors, equity and bond holders in such institutions are looking for greater returns and, presumably therefore, willing to take greater risks. The implicit assumption has been that these and other non-commercial banking institutions would not be 'bailed out' by the Fed. Indeed, until recently, these investment banks (primary dealers) were excluded from borrowing directly from the Fed, though this has changed recently (with changes to discount windows and the creation of other lending facilities).

The Bear Stearns debacle, which could have threatened to shut down a significant part of the US financial system (due to the heavy leverage of that bank as well as because of ripple effects via rising risk premiums), has emphasised that financial regulation cannot be partial as it offers scope for regulatory arbitrage - especially if there is an expectation going forward that the Fed will act as a backstop for financing, at least partially, in order to limit the extent of collateral damage to the financial system.

Congressman Barney Frank, chairman of the House Financial Services Committee, recently suggested that Congress should consider creating a 'financial services systemic risk regulator' which would offer a comprehensive and consolidated oversight of the US financial system and monitor any systemic risks. At the minimum, regulatory structures will need to be reviewed at some stage; it just cannot be 'business as usual'.

3) To what extent should risks be nationalised? Apart from the issues of moral hazards, there is the hitherto open question of how much of the risk should be nationalised. This issue often arises in crises in emerging economies where the central bank effectively absorbs some of the banking costs. It also arose during the Hong Kong Monetary Authority's (HKMA) extraordinary intervention in the equity market during the infamous 'double play' episode. It has also arisen now in the US with the Fed's US\$30 billion line of credit for the takeover of Bear Stearns by JP Morgan and the creation of the Term Securities Lending Facility (TSLF), whereby the Fed swaps its risk-free Treasury security holdings for riskier federally-backed and high-grade, private-label, mortgage-backed securities (MBS).

It may well be that the Fed might make a profit on this transaction over the medium term once markets stabilise, as in the case of the HKMA. But it may not.

More importantly, should the central bank be taking on such great balance sheet risks, which may eventually have to be borne by the taxpayers, and how much risk should the Fed take on? More generally, should financial sector profits be fully private while risks and costs are socialised?

Concerns

And, while scale is important to ensure that institutions are well capitalised and can compete internationally, is there a concern that some of them become 'too big to fail', and if so, would that create further moral hazard concerns and lead to reckless investments and poor risk management (that is, institutions try to scale up quickly and by large amounts via leverage as a means of 'gambling for resurrection')?

4) How should monetary policy respond to bubbles? As mentioned earlier, the Fed has been willing to accept selected MBS as collateral for loans via the discount window (earlier, it used to be mainly Treasury securities) as well as in its TSLF. Some have gone further and argued that the bust is so severe that the Fed should be willing to just buy up the MBS wholesale - something which has been toxic to the financial system and equity markets.

If this happens, the Fed is effectively limiting the extent of the bust in the financial sector and the overall economy. Similarly, sharp cuts in policy interest rates have also been used as a means of providing support to asset prices. So, if the Fed is willing to act to limit the incidence and extent of asset price busts through massive emergence support, should not then the central bank be willing to respond effectively to 'obvious' asset price misalignments in the upturn?

Yet many have argued that central banks should ignore asset price misalignments simply because they are hard to identify and measure. For instance, if the Fed were concerned about asset price bubbles, arguably it would not have kept interest rates so low for such prolonged periods during the latter part of the Greenspan era. (And, is Alan Greenspan to blame for creating the bubble in the first instance?) Surely, monetary policy response needs to be symmetric to both booms and busts, failing which there could be obvious moral hazard concerns.

(Even in the fire sale of Bear Stearns, while one could argue that the equity holders have not been bailed out, its bond holders and depositors clearly have been, as has the rest of the investment community as the markets have stabilised in the interim.)

It is paramount that policy makers learn the right lessons from the financial debacle in the US if they are to obviate such problems in the future. Risk-based supervision has thus taken on particular urgency.

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