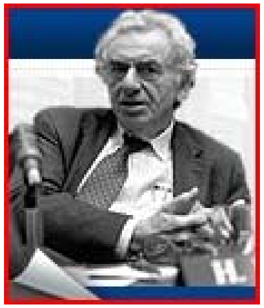


20th Annual
Hyman P. Minsky Conference:
Financial Reform and the Real Economy

25TH ANNIVERSARY
LEVY ECONOMICS INSTITUTE
of Bard College

MINSKY ON THE RE-REGULATION AND RE-STRUCTURING OF THE FINANCIAL SYSTEM

Will Dodd-Frank Prevent "It" from Happening Again?

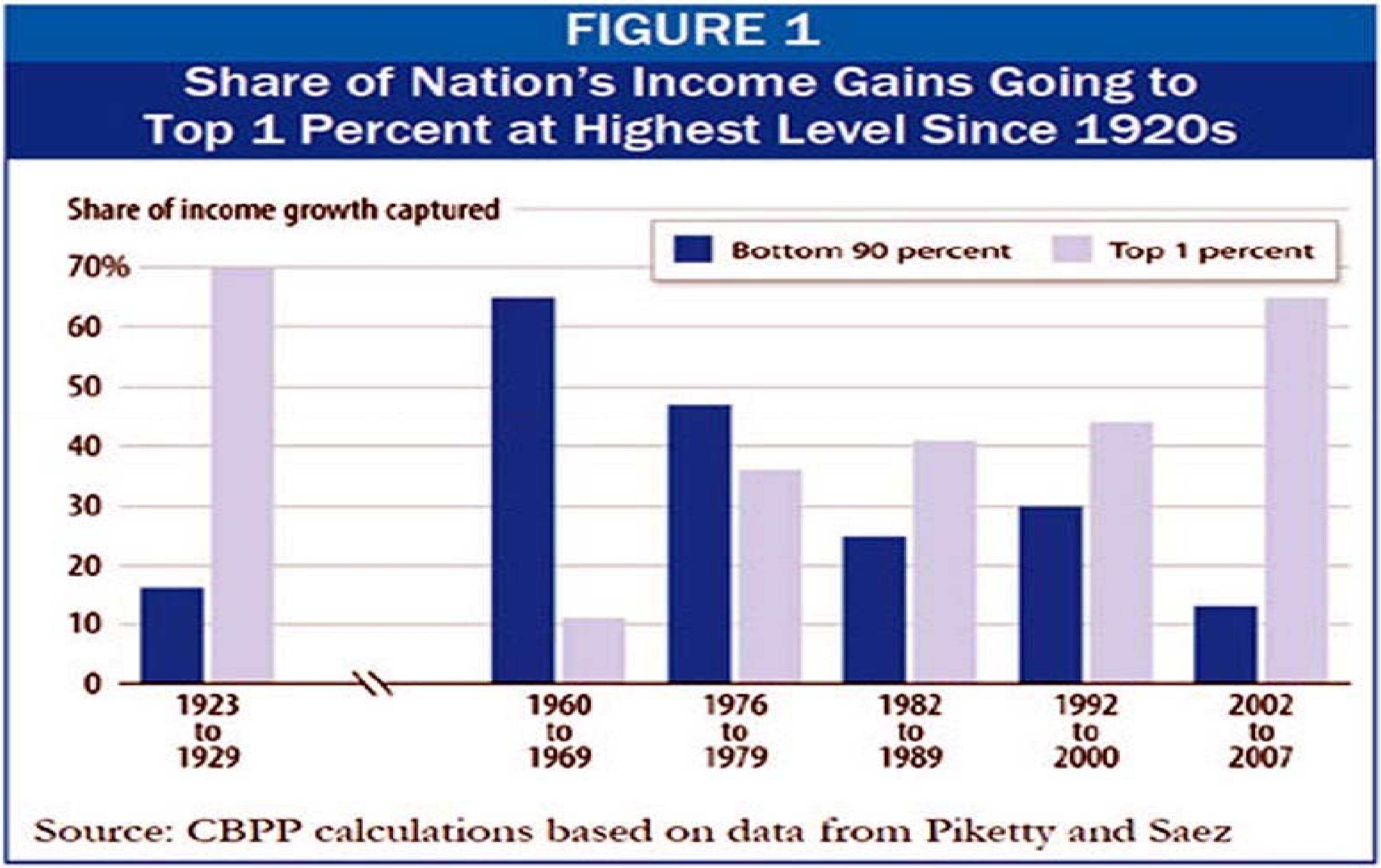
What Should Regulation Do?

- For Minsky any regulatory regime must be consistent with, and sensitive to:
  - the evolving nature of financial innovation
  - should seek to foster two critical structural objectives:
    - ensuring the long-term stability of the financial system, and
    - promoting the capital development of the economy.
- Can these objectives be made compatible??

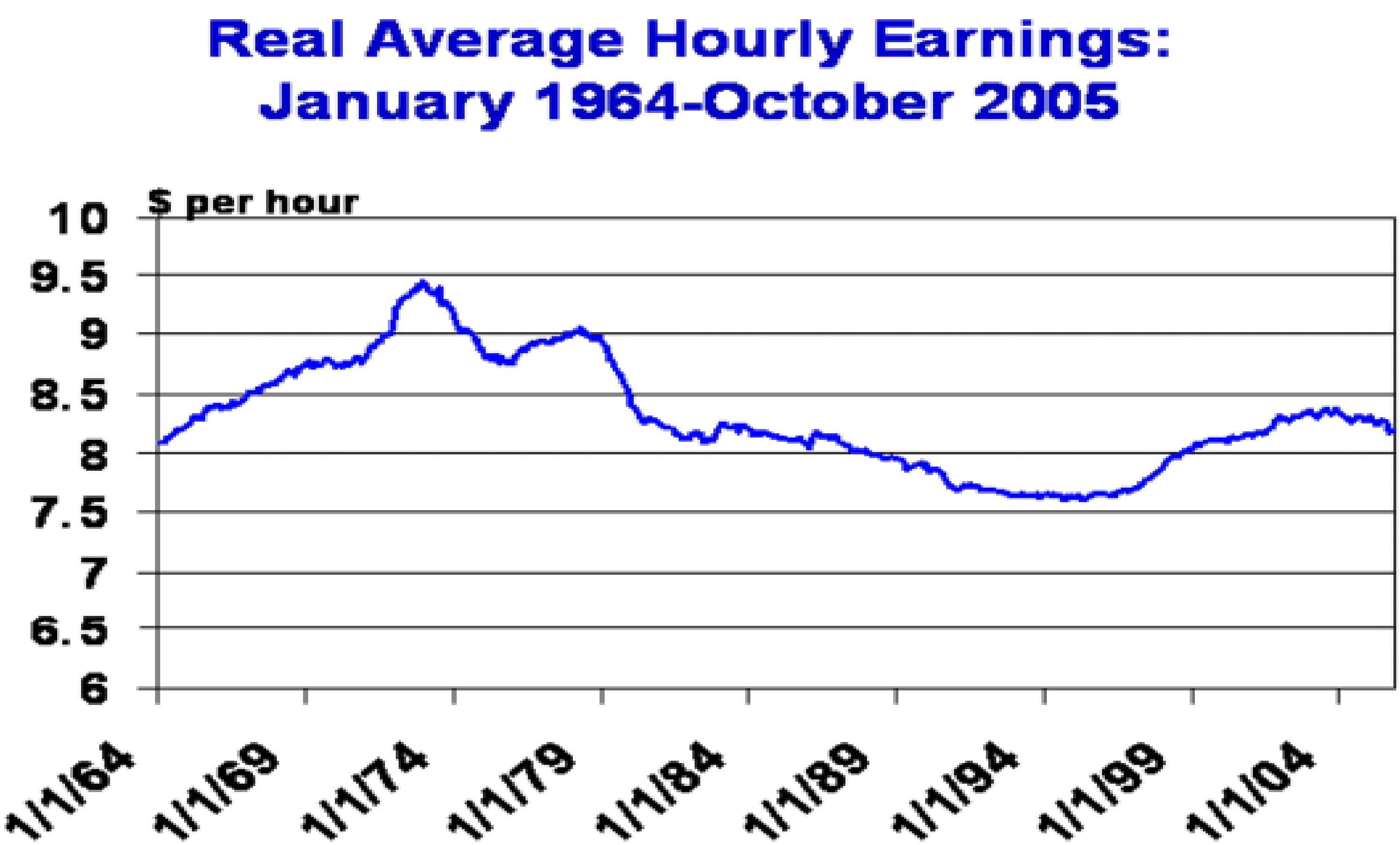
Is Finance Promoting the Development of the Real Economy?

- “The vexing question confronting regulators is whether this rising share of finance has been a necessary condition of growth in the past half century, or coincidence. “
- “In moving forward with regulatory repair, we may have to address the as yet unproved tie between the degree of financial complexity and higher standards of living.”

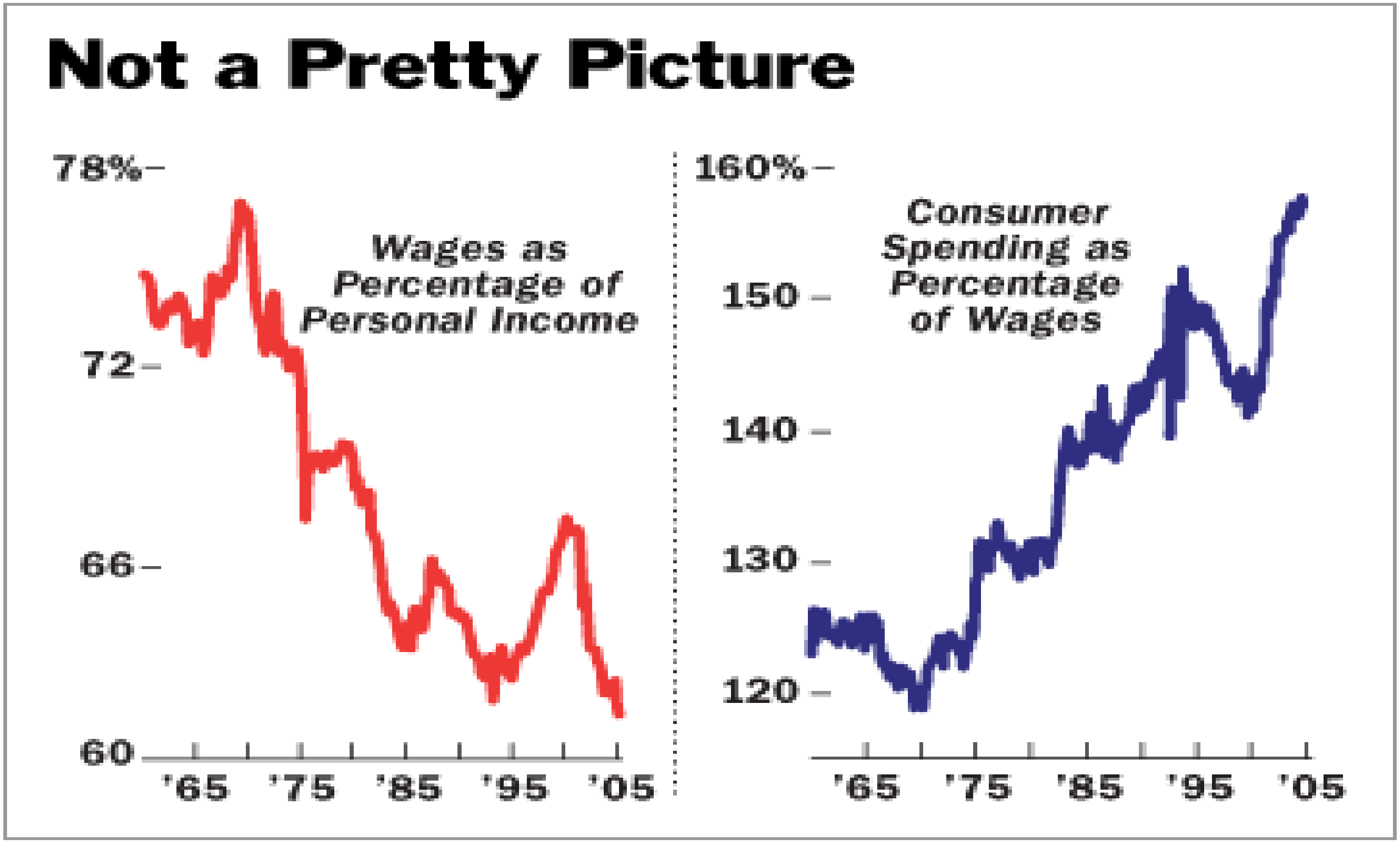
Yes? But not for everybody



"With notably rare exceptions (2008, for example), the global "invisible hand" has created relatively stable exchange rates, interest rates, prices, and wage rates."



Financing the Capital Development of the Economy?



Is the Right Regulation Possible?

- "The problem is that regulators, and for that matter everyone else, can never get more than a glimpse at the internal workings of the simplest of modern financial systems."
- "In the most regulated financial markets, the overwhelming set of interactions is never visible."
- "Today's competitive markets, whether we seek to recognise it or not, are driven by an international version of Adam Smith's "invisible hand" that is unredeemably opaque."

Consequences of a theory in which distress cannot occur

- 1999 Financial Services Modernization Act
  - Abolished the segregation of financial institutions and allowed creation of integrated multi-function financial holding companies
  - Allowed US banks to compete on level global playing field with “universal banks”
  - Based on increased efficiency achieved by
    - cross-sales of financial services
    - cross-hedging of risks within large multifunction financial conglomerates.
    - symbiosis across different financial services would increase incomes as well as decrease the risks borne by the larger institutions.

Consequences of Multifunction FHCs

- Larger financial institutions
  - Larger than either commercial deposit-taking banks or noninsured investment banks had been in the past
  - Expansion not limited to the provision of any particular service as under Glass-Steagall.
- Risk spread across activities increased the correlation of risk across activities.
- RESULT: Financial conglomerates that were both too big and too integrated to resolved if they became insolvent.
  - Rather than distributing risk to those most able to bear it, risk was distributed and redistributed until it became impossible to locate who was in fact the counterparty responsible for bearing the risk.
  - Counterparty risk thus joined the more traditional funding/liquidity and interest rate risks facing financial institutions. It replaced what was initially the most important of bank risks: lending or credit risk.

Policy Created Large Size and Complexity

- Impetus for large size was also the result of a change in the instruments of monetary policy introduced by the globalization of the market for provision of financial services.
- The Basel Committee global rules for risk-adjusted capital adequacy ratios.
  - Up to that time, monetary policy had been primarily implemented through adjustment of reserve ratios, and then, more exclusively, through open market operations. While the capital ratios were meant to make riskier activities more expensive to fund, and thus less profitable and less attractive, they had a rather perverse result.
  - First, this encouraged banks to expand their activities in the riskiest, highest-return activities in each particular risk category.
  - Second, it encouraged banks to move as much as possible of their lending that had the highest risk weight off their balance sheets and into special-purpose vehicles (SPVs) that largely escaped regulation and reporting.
- Created a new type of counterparty risk
- Since credits no longer formally the responsibility of the bank, transferred credit risk to the SPVs and removed incentives to apply creditworthiness analysis of securities sold off-balance-sheet entity.
- When the crisis hit the risks came back to the banks

Benefits of Large Size

- Even regulators admit that such institutions will not be allowed to fail.
- Implicit Government Guarantee (moral hazard):
  - allows use of riskier, higher-return investments, bolstering the top-line earnings
  - Lower credit risk lowers borrowing costs
  - Improves earnings
- Smaller banks find it more difficult to compete
  - Returns are lower
- Resulting concentration allow larger banks to impose higher charges for customer services
- Cumulative process supports increasing size,
- Minsky: both borrowers' and lenders' risks are reduced for large conglomerate banks and have increased monopoly power over prices.
  - This may be the real cause of the favorable performance of large bank groups.
  - This may not be the result of the efficiency of large banks
  - It may be the result of a government "subsidy" that can only be withdrawn with difficulty

Dodd-Frank does not challenge GLB

- The crisis was not the result of the size and integration of multifunction institutions
- Caused by the absence of a mechanism to allow all bank and non-bank financial institutions to fail
- Caused by lack or regulation on Large Systemically Significant Banks
- Accepts that banks will continue to be large and integrated.
  - Treasury Secretary Geithner “I don’t have any enthusiasm for . . . trying to shrink … the financial system in our economy as a test of reform, because we have to think about the fact that we operate in the broader world”
  - “Financial firms are different because of the risk, but you can contain that through regulation.”
- The two major pillars of the reform package are thus
  - Regulations to better manage risk of large, “systemically significant” financial institutions
  - Effective means to force liquidation without anything but temporary public assistance when regulation proves to be inadequate.
- Dodd-Frank legislation thus accepts mainstream theoretical framework
- Stability obtained by more complete markets and synergies in the provision and hedging of financial services.

Major Provisions of Dodd-Frank

- The Financial Stability Oversight Council
  - Definition of Systemic Significance
  - See the Systemic Future: Forecasting Financial Fragility
- The Volcker Rule: Proprietary Trading
  - "Business of Banking" client exemptions
- Swaps and futures regulation: Lincoln Amendment
  - "Business of Banking" client exemptions
  - What is a Market?
- Resolution of failed institutions: OLA+Living Wills
- Provision of Liquidity: section 13(3)
  - LLR lessons of Bear, Lehman, AIG Lehman
  - Minsky: A Fully Open Fed Window

Major Provisions of Dodd-Frank

- The future of securitization: risk retention
  - Off balance sheet regulations
  - SEC regulations
- Capital and leverage ratios: BIS rules
  - Micro approach to systemic risk
- Reform of credit rating agencies
  - Why do they exist?
- Regulation of hedge funds:
  - Are they a Risk?
- Multiple and overlapping regulatory authorities
  - Conflict in the Fed's Role

Can Dodd-Frank prevent "It" from happening again?

- Full implementation will require over 200 rule-making provisions by regulatory agencies, over 60 special reports and, and an additional 22 reports.
- Places major responsibility on those writing the specific rules
- Places an even greater burden on supervision of those rules.
- Already includes the exemptions of the activities incidental to the business of banking that brought down Glass-Steagall
- The most important failing is that it leaves in place the underlying business model for financial institutions and the contradictions inherent in the 1999 legislation that were at the core of the crisis.
- Indeed, the underlying logic of the Fed and Treasury rescue operations has been to restore this system.
- If the problem was the structure of the financial system, then Dodd-Frank will not prevent another crisis.
- **What Should have been Done? We created the Complexity, we can take it away.**
  - **Repeal GLB and limit the size and activities of specific institutions**
- How to Restore "Traditional Banking"
  - Minsky on What Banks Should Do