



24th Annual Hyman P. Minsky Conference on the State of the US and World Economies



Is Financial Reregulation Holding Back Finance for the Global Recovery

Panel:

Can Better Regulation Prevent the Next Crisis?

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Minsky's Answer: Better Regulation Alone can Never “Prevent” Financial Fragility

- Minsky quoting Henry Simons: “[B]anking is a pervasive phenomenon, not something to be dealt with merely by legislation directed at what we call banks”
- For Minsky this suggested that “a fundamental flaw exists in an economy with capitalist financial institutions, for no matter how ingenious and perceptive Central Bankers may be, the speculative and innovative elements of capitalism will eventually lead to financial usages and relations that are conducive to instability”

Two “Minsky Maxims”

- 1. Regulation needs to be “Dynamic”
 - we know that the capitalist economy produces endogenous fragility
 - Each regulatory round is response to a financial crisis
 - Usually tries to eliminate causes of last crisis
 - Will always induce new “financial forms and institutions” through regulatory arbitrage/innovation
 - Thus will not recognize or apply to new areas of fragility
 - Subprime auto loans replace subprime mortgages?
 - “The trigger to the next crisis will not be the same as the trigger to the last...but there will be another crisis.” J. Dimon

Two “Minsky Maxims”

➤ 2. Dynamic regulation requires coherent Economic policy

- Minsky's 1960s work on the Fed Discount Window:
 - Monetary Authority should focus on financial stability
- Monetary policy measures can transform Financial Fragility in Financial Instability
 - Minsky was influenced by rate increases to *STEM* inflation and reduce activity levels (e.g. 1966 Credit Crunch)
 - BUT interest rate reductions to *CAUSE* inflation can also be disruptive
 - What will the next bond market “tantrum” look like?
 - J. Dimon: Sept/Oct 2014 rate spike was “a warning shot across the bow”
 - OFR Annual Report 2014 There is a tradeoff between mitigating excessive risk-taking and promoting the mandated macroeconomic objectives of the Federal Reserve.
 - Monetary policy measures can transform Structure of Financial Fragility and Bank Business Model
 - 1970's Shift from Asset Management to Liability Management
 - 1990s Shift from Originate and hold to Originate and sell
 - Capital Markets become crucial
 - Reduce coverage of regulation: off balance sheet structures

Current Regulatory Policy

- Basic Aim of Post-Crisis Regulation:
 - Prevent taxpayer criticism of Congress for bailing out financial institutions rather than households
- Main tools:
 - **Volcker Rule:** reduce FDIC subsidy to risk taking
 - **Rapid Resolution Authority:** to make bankruptcy safe for Too Big To Fail banks
 - **Enhanced Owners' Equity:** to cover anticipated losses from next financial crisis
 - **Liquidity Buffers:** To prevent liquidity crisis producing insolvency
 - **Stress Tests:** to gauge Capital Adequacy
 - But still do not assess interbank exposures
 - Scenarios assumes present balance sheet structure is unchanged - but changes will have contributed⁵ to crisis!

Current Economic Policy

- Basic Aim of Post-Crisis Monetary Policy:
 - Move impaired assets off bank balance sheets
 - Support prices of impaired assets
 - Prevent Deflation
 - Generate expectations of rising prices to raise real rate of return and stimulate creation of new real assets
- Main tools:
 - Expansion of Fed Balance sheet
 - Zero Nominal Interest Rate Policy
 - Negative real (& soon to be nominal? NIRP?) interest rates below real return to capital
 - Quantitative Easing: Yield curve flattening

How Does Monetary Policy Impact Financial Stability?

- Minsky's Simple Explanation:
- “Banks are profit maximizing organizations.
- The return on owners' equity is
- $P/B = (P/A) (A/B)$
- where P is profits, B is the book value of owners equity, and A is assets.
- Given this profit identity, bank management endeavors to increase profits per dollar of assets and assets per dollar of equity.”

H. P. Minsky. 1977. “Banking and a Fragile Financial Environment.” *Journal of Portfolio Management*, 3, no. 4 (Summer



Current Policy and the “Minsky Maxims”

- Higher capital requirements raise B and reduce (A/B) (leverage)
- Increase dealer capital costs of market making
- Liquidity ratios reduce asset returns (+ collateral scarcity)
- ZIRP + QE reduce (P/A) balance sheet return on assets (RoA)
 - Reduce riskless earnings from riding the Government debt yield curve
 - Lower fixed income borrowing costs reduces business demand for loans
- Regulatory and Monetary Policy Act cumulatively to lower (P/B) (RoE)
- Monetary Policy levers higher Regulatory capital buffers into greater incentives to increase returns on equity
 - Higher RoE can be achieved via:
 - higher leverage,
 - financial innovation,
 - regulatory arbitrage,
 - Non-banking, off balance sheet activities
 - Insurance does it too: “captive reinsurance”
 - Fee and commission income

Current Policy and Regulatory Environment encourages Fragility

- Increasing RoA is limited by monetary policy, so higher returns come only with higher risk activities,
 - e.g. historical low “high yield” spreads
 - Or higher risk trading activities in Z-NIRP securities
- Increasing leverage is limited by the imposition of Regulatory capital and liquidity ratios
- The only remaining solution is regulatory arbitrage and financial innovation which always creates fragility
- Minsky: Banks have also been ingenious in developing techniques for financing business and financial institutions. These include the developing of covert bank liabilities, such as lines of credit and bank guarantees of financing. (Minsky 1977)⁹

Structure of Financial Markets also undermines Impact of Regulation

- Impact of regulation eroded by what Minsky called “Money Manager Capitalism”
 - Principal - Agent controls distorted if Principals are represented by Investment managers who track short-term benchmark equity performance
 - And Principals pick managers on performance
 - Reinforces the incentive for Management to seek higher asset returns through more risky allocation
- Also eroded by use of stock-options to represent identity of Principal and Agent
 - Produces joint incentive to increase equity returns
- Both increase incentive to increase returns via more risky balance sheets

Changing Regulatory Role of Bank Capital

- Traditionally an Operational Constraint
 - Internal Monitoring - Skin in the game:
 - Equity Capital = Principal; Management = Agent
 - More Capital at Risk, Higher incentive for Principal to monitor Agent risk
 - External Monitoring - Market Discipline
 - Higher risk operations, lower equity multiples, higher capital costs, make it more costly to engage in risky behavior
- Is there any evidence that either internal or external monitoring works?
 - Requires balance sheet transparency that does not exist
 - And incentives may be inappropriate
 - Market evaluates footings and earnings growth,¹ not risk

Today Capital is to cover Catastrophic Systemic Risk

Reverses Traditional View

- “Levels of capitalization appear to have had no direct causal relationship to the incidence of bank failure.” (Voyta, 1976)
- “it is not possible to devise a generally acceptable measure of capital adequacy since the essential function of capital is to serve as a defense against the occurrence of unpredictable events.” (Lucille Mayne, 1972)
- ”The capital account of a bank is not adequate to maintain solvency in the event of a major liquidity crisis ... Effective defense against ultimate crisis comes from lenders of last resort.

This does not mean that the government is expected to bail out mismanaged institutions; *but neither should financial institutions be expected to be so overcapitalized as to bail out government's mismanagement of the economy.*

As a matter of fact and practicality, the economic disaster case {STRESS TESTS?} should be excluded as a relevant scenario for capital adequacy purposes.” (Voyta)

Pro-cyclicality of Capital Ratios

- In 1934 bank capital ratios rose, as depositors withdrew funds
- In the 1920s Florida Real Estate Crisis the best predictor of failure was not capitalization, but a rapid rise in assets, deposits and share price which allowed banks to raise more capital
- J. Dimon has recently stated that in the event of a crisis JPMChase would be unwilling to accept deposit transfers from weaker banks because of the it would require higher supplemental capital
- Currently higher deposits incur higher capital charges, a factor pushing toward negative nominal interest rates
- Impact on Dealer Markets: 1987 Crisis no one answered the phone - no market liquidity

Capital Ratios and Financial Structure

- In the last crisis “Banks continued to lend freely because effectively they are the “lender of last resort” to their clients as the Federal Reserve is to the banks”
- Market depth ... a precursor of liquidity ... of 10-year Treasuries ... today is \$125 million, down from \$500 million at its peak in 2007.”
- In the next crisis “It will be harder for banks either as lenders of last resort or as market-makers to “stand against the tide”.
- Non-regulated “lending-systems and payments systems” compete with banks in providing liquidity but will collapse in a crisis
- Bank liquidity only exists because of the monopoly on the payments system

Stability Comes from Stable Bank Incomes, not Capital

- Minsky: Fragility is determined by “validation” of Bank Assets: Income flows to meet debt service
- Minsky: Big Government is a major component of Financial stability: setting a floor on incomes
- Traditional View: Standard risks met from current income and charge-offs
- Glass-Steagall: Guaranteed Bank incomes by granting a monopoly on deposit business and Req Q zero funding
- Do we have an metric to determine the appropriate level of bank Capital? 12%? 15%? 30%? 100%? Narrow Banking?
- After the 1980s Latin Debt Crisis insolvent US banks operated happily under Volcker’s “regulatory forbearance”
- Or should we look at tradeoff between Bank Capital and Bank earnings: The structure of the Financial System

Thank You

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