Financial Regulation and the Financial Instability Hypothesis: A Ponzi-finance Approach To Financial Reform

Eric Tymoigne
California State University, Fresno

April 2009

Traditional View: Bad-Bank Approach

- Bank failures result from the idiosyncratic characteristics of banks: mismanagement, fraud.

- Regulation and supervision should:
  - Train supervisors to detect frauds.
  - Set incentives to foster "proper" behaviors.
  - Set norms that define "imprudent" risk management.
  - Let the financial sector innovate and let "the market" select the "good" innovations.
  - Foster maximum competition and self-regulation.

Problems with this Approach

- Ignores systemic risk, i.e. risk that emerges from the financial interdependence of financial institutions (FIs).
- Ignores the needs for, and source of, position-making operations.
- Ignores the dynamics that are set forward during an enduring economic expansion: FIs are willing and are forced to take more risks (on asset and liability sides).
- Focuses on detecting "bubbles" and mispricing: difficult to justify ("the market" knows best) and highly unpopular ("wealth killers").

Implications

- Bad-bank approach to regulation:
  - Is too permissive: e.g. as long as CARs are met it is assumed that a FI is "prudently" managed, even though the FI may be involved in dangerous financial practices.
  - Misses important dynamics: it is when everything is "normal" (i.e. when regulatory ratios are met) that regulators should be the most concerned.
  - Is too rigid: does not account for financial innovations (including "creative" accounting), and may set up too stringent regulatory standards (especially if set after a big financial disaster) that constrain economic growth.

- New regulations are made rapidly irrelevant by new financial practices and new products.

- The power of persuasion and justification of regulators and supervisors is weakened by focusing on wrong indicators of financial sustainability.

⇒ Traditional regulation is subject to tremendous political and social pressures to be lax in good times, and is rapidly outdated by financial innovations.

A New Framework: Emphasize Position-making Operations

- (Defensive) Position-making operations: refinancing and/or liquidation in order to be able to service debt commitments.

- 3 types of financial positions:
  - Hedge: no position-making operations expected (unexpected operations are implemented through liquid and reliable sources).
  - Speculative: stable position-making operations relative to given outstanding debts.
  - Ponzi: growing position-making operations expected relative to given outstanding debts.

- Ponzi finance is unsustainable and there are only two ways to get out of it:
  - Expected transformation into hedge finance: production-related financing operations (temporary Ponzi).
  - Collapse and/or large financial restructuring: Pyramid process (structural Ponzi).

- FIH: over periods of enduring economic expansion, there are forces that push more and more economic units, voluntarily or not, away from hedge finance and into Ponzi finance.

- ⇒ Position-making approach to financial regulation focuses on:
  - Detecting sensitivity of balance sheets to adverse changes in asset prices, in expectations, in interest rates, in after-tax revenues, etc.
  - Detecting potential and actual position-making needs and sources of FIs: how much is needed? how reliable are the sources?
  - Detecting financial interdependences (systemic risk) at the individual, sectoral, and macroeconomic levels.
  - Detecting, discouraging and eliminating Ponzi finance.

- ⇒ This approach focuses on the financial practices (illegal AND legal) sustaining a trend (production, price) rather than on the trend itself:
  - It is not necessarily a question of fraud: legal Ponzi finance is dangerous.
  - It is not necessarily a question of mispricing or market imperfections: even if everybody agrees that there is no "bubble," a price-trend may be unsustainable (because it is based on a Ponzi process).
  - It is not necessarily a question of moral (greed), or lack of education, or behavioral biases (irrationality, bounded rationality): market mechanisms may force even the most altruistic and conservative economic units to be involved into Ponzi finance because their economic survival depends on it.

Policy Implications

- All financial institutions need to be regulated, independently of their size, how new they are, and their government backing (insured):
  - Unregulated (non-government insured) FIs are Ponzi-prone.
  - Ponzi processes may be sustained by many small lenders rather than by big FIs.
- Develop cash-flow accounting at the macroeconomic level (flow of funds and national income are not enough): cash-flows are central to detect Ponzi processes and position-making needs.
- Government oversight and approval of financial innovations. Take the medical drug approach:
  - Only for some people: qualification should be based on cash inflows and, secondarily, cash reserves (exclude available refinancing sources or possibility to liquidate the encumbered asset).
  - If side effects kill you or leave you in bad shape, it should not exist: forbid Ponzi processes.
  - A “good” invention is one that promotes the safety of the population (profitability is not a criterion for government approval, and is judged by companies through extensive market analysis prior to submitting an invention to government approval process).

- Alleviate competition in the financial industry (promote constructive competition over free-market competition):
  - Compensations based on survival of a company as a going-concern.
  - Patent system for financial innovations.
- Promote a financial structure that limits the growth of financial fragility:
  - Maturity matching: limit needs to rollover debts.
  - Cash-flow matching: create financial instruments that meet the needs and affordability threshold of customers (government can be involved in the creation of new financial instruments and may give monetary incentives to develop them).
  - Limit the size of FIs to what can be supervised and regulated properly.
  - Cash-flow-oriented rather than collateral-oriented financial system: "pre-loss creditworthiness:"
    - "*How* will you repay on time?" Rather than "Will you repay on time?"
    - "Can the borrower meet payments on his own (i.e. without refinancing or liquidation)?" Rather than "Will lenders be able to recover their stake?"
    - Collateral can be included in a second analysis to determine potential for decline in value, but not to determine if the borrowers can meet payments on their own.
- Promote financial education and independence of financial regulators (they have been under-staffed, under-funded, and undermined for too long): focus training on detecting legal and illegal Ponzi processes (main source of fraud and moral hazard).