Restructuring the financial system

A synthetic presentation of an alternative approach to financial regulation

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Premises

The morphology of financial systems has been shaped in the last decades by two main forces: the liberalisation of international capital flows and a new approach to regulation based on a *laissez faire* regime on risk production and allocation. This proposal only relates to financial regulation.

The main features of the resulting financial system are:

- High financial returns, which have pushed financial deepening to level never experienced before. The size of finance has become *per se* a systemic threat for the entire economy.
- The huge expansion of the financial pyramid that has interested financial assets, while monetary instruments remained almost stable in terms of GDP.
- Financial assets, derivatives in particular, are often characterised by unavoidable mispricing of risks, which produces an inferior type of liquidity. Long periods of apparently abundant liquidity are followed by sudden extreme illiquidity.
- The increased connections of depositary institutions with markets has decreased the quality of secondary liquidity.
- A much increased volume of volatile assets is financed by debt, making the production of asset bubbles followed by debt deflation an endogenous feature of the system.
- The financial interconnection among the various components of the economic system, not only inside the financial sector, has greatly increased.
- The size of many financial intermediaries has become systemic, well beyond any justification of efficiency. Size and interconnection amplify contagion during crises.
- The sectoral nature of regulation, added to the freedom to create and allocate risks, implies a physiological presence of unregulated financial operators, whose importance grows with the costs of the regulation.

Given these premises we propose a synthetic scheme for re-regulating the financial system following a structural approach.

The nature and general objectives of financial regulation

- Rules and incentives must guide the allocation of funds to finance a sustainable growth and development of the economy.
- Financial regulation must secure the stability and efficiency of the financial sphere by containing and monitoring systemic risks (top-down approach). It must not be its business making each institution resilient by dictating rules about how to measure and hedge risks (bottom-up approach). Regulation must design the boundaries on the actions allowed to operators and then leave institutions free to operate within the constrained environment. The resulting morphology must be consistent with market discipline imposing bankruptcies.
- Regulation must be composed of a limited set of simple rules. Supervision must have a clear and bearable mandate when monitoring and sanctioning the compliance to rules.
- Financial returns must be contained in order to limit the push towards an excessive financialization and to avoid a dynamic imbalance between real growth and financial returns.
- Financial deepening must be consistent with the effective autonomy of monetary and fiscal policy from pure financial needs. The size and volatility of the financial pyramid must be consistent with policy interventions that, also in times of stress, are primarily directed at safeguarding the necessities of the real sector.
- The size and interconnectedness of financial firms must be reduced at levels that do not pose systemic risks. The true market discipline is to let financial firms fail.
- Financial regulation must be all inclusive since finance goes beyond the financial sector. This means, *inter alia*, that non financial operators must not be allowed to act *de facto* as financial intermediaries.
- An effective financial regulation must include consistent fiscal rules and accounting standards.

Elements of a new regulatory framework

1. Risk containment.

- Regulators should agree on "a positive list of financial instruments and institutions. Anything that is not explicitly allowed is forbidden." (Buiter, Vox 2009). *In so doing regulators should follow criteria that balance the usefulness for the real economy with potential threats to overall stability.*

Structural regulatory measures must be reinserted, thus shifting from a regulation based on risk-measurement to one based on risk-control. If some types of risks are hard to value, pose systemic threats and no micro-hedging is effective to contain their consequences, simply they must not be created, or in any case it must be impeded their transformation into systemic ones. In other terms, risks must be restricted to typologies and at levels that can be managed at the micro-level (intermediaries), and monitored and contained at a systemic level (authorities). Quantitative aspects of risk creation and allocation are perhaps even more crucial than qualitative ones. Quantitative aspects of risk containment are dealt with in the following rules.

2. Leveraged and non-leveraged institutions

- Regulation distinguishes between leveraged and non-leveraged financial institutions. Leveraged institutions are intermediaries collecting debt of any sort.[1]

This distinction comes from two types of fragility linked to leverage. First, limits to leverage are necessary for containing the size and growth of the financial pyramid. Second, volatile assets financed by a given debt poses serious and specific threats of asset bubbles and debt deflation.

3. Leveraged institutions

3.1 - Trading is forbidden for leverage institutions. Financial holdings or groups containing a leveraged institution are not allowed to include non-leveraged institutions with trading activity.

Trading poses three sets of problems for leveraged institutions. First, it highly increases the interconnectedness both inside the leveraged sector and between it and the non-leveraged one, hence counterparty risks and the force of contagion increase. Second, it gives room to conflicts of interest that no type of Chinese wall may de facto eliminate. Third, it may absorb substantial doses

[1] Insurance companies are not included in these categories. The present proposal do not for the moment consider the insurance sector if not for the points explicitly treated below.

of resources, which either require large dimensions or deviate these institutions from their primary function of intermediating between surplus and deficit units. This rule also constitutes a step in limiting de facto the size of financial intermediaries.

3.2 - Leveraged institutions are allowed to use derivative products only for risk mitigation purposes. They must single out the specific item reported in their balance sheet that is subject to hedging, on which only one derivative contracts is allowed for each typology of risk. These derivative contracts must be held to maturity.

This should contain the use of derivative instruments within physiological limits.

3.3 - Leveraged institutions are not allowed to hold participations of any amount in non-leveraged institutions with trading activity.

This rule means that leveraged institutions cannot hold activities based on trading. Regulatory arbitrage between differently regulated institutions is thus excluded.

3.4 - Leveraged institutions are not allowed to exert, directly or indirectly, any influence on the management of non-financial firms. Shares and other participations are limited following criteria of portfolio diversification.

3.5 - Non-leveraged financial institutions and non-financial firms may hold participations in leveraged financial institutions, but are not allowed to exert, directly or indirectly, any influence on the management of leveraged institutions.

The explanation of rules 3.4 and 3.5 is to disconnect the three sectors on the governance and ownership sides. They should also help each type of firm to focus on its line of business.

3.6 - Leveraged institutions may distribute financial products of non-leveraged institutions and insurance companies.

3.7 - Intra group transactions are not permitted.

Internal contagion, improper profit transfers, conflicts of interest are thus contained.

3.8 - Accounting consolidation is required in every cases in which, apart from owning a controlling share, the leveraged institution exerts any influence on the management of another financial entity or takes any obligation that may eventually result in supporting its activity.

3.9 - Derivatives, contingent liabilities and commitments are not allowed to be registered as off-balance sheet items.

Rules 3.8 and 3.9 are required to avoid regulatory elusions since according to rules 3.10-3.13 requirements on leverage and liquidity are progressive with size.

3.10 - Maximum leverage ratios are imposed. Leverage is defined as the ratio of un-weighted assets to Net Upper Tier 1 capital. Net Upper Tier 1 capital is equity capital plus disclosed reserves, net of participations and fixed assets. Different maximum leverages are set for the loan and the investment portfolios. The maximum leverage for the investment portfolio is lower than the one allowed for the loan portfolio. The value of the investment portfolio is defined at market prices.

3.11 - Maximum leverage requirements are established in relation to categories of intermediaries defined in terms of size intervals. Larger the size, significantly lower is the maximum permitted leverage ratio. The size refers to the consolidated balance-sheet distinguishing between the loan and the investment portfolios.

The main objective of rules 3.10 and 3.11 is to make large dimension and rapid growth costly and to create incentives for loan activity. They have also counter-cyclical features.

3.12 - Limits to maturity mismatches are introduced.

3.13 - A liquidity requirement is introduced in form of cash and public debt with sovereign risk not higher than the home country's one. The liquidity requirement is an increasing function both of the value of total assets and of the customer funding gap.[2] *The liquidity requirement must be consistent with systemic events. The above requirement take the form of reserves deposited at the central bank. These reserves cannot be mobilised and, when in the form of cash, are remunerated in accordance to the deposit facility rate decided by the monetary authority.*

[2] The customer funding gap is defined as (Loans – Retail deposits)/Loans.

This rule share with those on leverage the objectives to limit intermediaries' size and accelerated growth and to set counter-cyclical requirements. It has also the goal to reinforce the action of monetary policy.

3.14 - Savings in capital, liquidity and provisioning requirements coming from risk transfer are admitted only when all risks are integrally shifted to unconnected subjects, i.e. only if no residual risks remain and no new obligation is linked to them.

This rule aims at preventing the creation of *ad hoc* vehicles to elude regulation. When the transfer of risks is complete it also eliminates moral hazard for acquirers of securitised assets.

3.15 - Two kinds of Buffer Reserves are introduced, for the loan and investment portfolios. These reserves are not included in Net Upper Tier 1 capital. Provisioning for the loan portfolio is based on expected losses computed through-the-cycle. Provisioning for the investment portfolio comes from unrealised gains in its market value. Credit and market losses, realised or unrealised, deplete the respective reserve. Only if reserves do not suffice, the difference is imputed to the income account. Fiscal treatment of provisions must follow supervisory rules, and not vice versa.

The objective of these reserves is to shield as far as possible the income account, hence distributed profits, and finally capital from short-term changes of borrowers' creditworthiness and asset price.

3.16 - All regulatory requirements must be observed both on a stand-alone and consolidated basis.

3.17 - *For leveraged depository institutions a public backed deposit insurance scheme is compulsory. Differentiated insurance premiums are derived from simple CAMEL-type peer review methods.*

The main objective of this rule is to give leveraged institutions the benefit of lower funding costs balancing the loss of returns coming from a rigid regulation. The current crisis has also made clear that taxpayers are in any case finally required to at least guaranty these debts. Finally, an explicit public safety net coupled with clear resolution procedures, see below rule 9, renders quicker and more accountable to deal with distressed cases than *ad hoc* interventions forced by a crisis.

4. Non-leveraged institutions

4.1 - Non-leveraged financial institutions must comply with rules on asset composition and minimum liquidity requirements, according to their stated function. These ratios increase with their size.

The overall objective of this rule is to push towards a large numbers of operators with heterogeneous investment strategies

4.2 - The accounting rules previously dictated for leveraged institutions, concerning consolidation, off-balance sheets and risk transfers, also apply to non-leveraged institutions.

5. Derivatives

- All derivative contracts must be traded in organised markets.

6. Markets

6.1 - When approving financial instruments to be traded in a market, the competent supervisory authority obliges markets to adopt strict standards of transparency and will not allow hard-to-value instruments.

6.2 - Minimum floors for haircut and margin requirements must be observed, at levels consistent with high historical market volatility.

6.3 - Supervisory authorities for organised markets may impose quantitative caps and limits of accessibility for derivative contracts.

Rules 6.2 and 6.3 should contain both the size and volatility of the financial pyramid.

7. Non financial firms

- Non financial firms, directly or through their financial divisions, cannot operate in the fields of leveraged and non-leveraged financial intermediaries.

This rule should avoid that the non-financial sector becomes a vast unregulated financial one.

8. Transparency

- False information to the supervisory authorities affecting regulatory requirements are considered as corporate fraud and are subject to prosecution for criminal penalties.

This rule constitutes an addiction to the traditional transparency requirements that we consider insufficient as incentives against the elusion of the systemic rules here proposed.

9. Crisis resolution

- Clear and binding crisis resolution procedures for leveraged institutions must oblige the transfer of losses to shareholders and unsecured creditors.

10. Multinational financial institutions

10.1 - Financial and non-financial institutions are forbidden any type of direct or indirect relation with countries whose institutions and markets do not possess a financial regulation homogenous with their own.

10.2 - Foreign financial institutions are allowed only as subsidiaries incorporated according to the law of the host country. Subsidiaries must satisfy regulatory requirements dictated by the host country on a local basis. Intra-group transactions of any sort are not allowed.

This rule should limit the contagion from and to the parent institution and make it easier the resolution of cross-border crises.

11. Supervisors' powers and accountability

- Supervisors are not allowed to change the existing rules, whose dominion is reserved to the legislative power, which is the sole regulatory authority. If an interpretation problem arises, supervisory authorities must subject its resolution to the regulatory authority. All supervisory authorities make their deliberations public and must subject them to quarterly scrutiny by the parliament. In these instances they report on the efficacy of the existing regulatory apparatus to pursue the stated goals of regulation and on the eventual need to introduce changes.