Staff Paper No. 89

SUPERVISORY POLICY INSIGHTS FROM US AND UK BANK FAILURES

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November 2013

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Published by The South East Asian Central Banks (SEACEN)
Research and Training Centre
Level 5, Sasana Kijang
Bank Negara Malaysia
No. 2, Jalan Dato' Onn
50480 Kuala Lumpur
Malaysia

Tel. No.: (603) 9195 1888
Fax No.: (603) 9195 1802 / 1803 / 1804
Website: www.seacen.org

ISBN: 978-983-9478-27-3

Printed in Malaysia by Graphic Stationers Sdn. Bhd.

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Abstract

The US Federal Deposit Insurance Corporation – Office of the Inspector General Report (2013) and the UK's Turner Report (2009) provide insights on the multiple contributing factors to bank failures that resulted in the unprecedented global contraction. Both reports mentioned that bank failures were often associated with failure in market discipline; corporate governance breakdown exhibited through weak underwriting and credit administration policies; risks of highly interconnected global banks and pursuing aggressive growth strategies using nontraditional and riskier funding sources. These bank failures that occurred in the US and the UK, which led to the Global Financial Crisis (GFC), offer unrivalled opportunities for accelerated learning.

In this essay, we try to summarize some common factors that contributed to bank failures in order to stimulate transformational thoughts, generate new ideas, help evolve best practices and cascade them into meaningful and practical policies. As a caveat, the selected lessons are limited to where the authors felt there is need for further discussion and debate. The views expressed are that of the authors and does not reflect the views of The SEACEN Centre and its Management.

Keywords: Bank Failures, Global Financial Crisis, Counter Cyclical Capital Provision, Securitization

JEL Classification: G01, G18, G32

Supervisory Reflections from US and UK Bank Failures

1. Introduction

In January 2013, the US Federal Deposit Insurance Corporation – Office of the Inspector General (FDIC-OIG) released a study on the impact of failed insured institutions during the global financial crisis. The study covered more than four hundred (400) failed institutions over a four year period (2008 to 2011). The study identified certain areas for improvement to strengthen the effectiveness of certain supervisory activities and help ensure the success of FDIC's ongoing resolution efforts. For the UK, Mr. Adair Turner, Chairman of Financial Services Authority (FSA), published a report in 2009 identifying the causes that led to the financial crisis and recommended reforms to overhaul UK's banking regulatory and supervisory framework. The Turner report distinguishes between national reforms which can be solely undertaken by the FSA and international reforms where global agreement is a prerequisite for its achievement.

Both reports provide insights on the multiple contributing factors to bank failures that resulted into the unprecedented global contraction. It is evident that there are causes commonly identified in both reports. It is observed that bank failures are often associated with failure in market discipline; corporate governance breakdown exhibited through weak underwriting and credit administration policies; risks of highly interconnected global banks and pursuing aggressive growth strategies using nontraditional and riskier funding sources.

An important aspect of both reports suggests that these factors resulted in imprudent accumulation of excessive leverage. We all know that financial crises have developed from excessive bank leverage. Like most crises in past economic history of the world, the underlying root causes of bank failures in the Global Financial Crisis (GFC) are not widely dissimilar despite the differences in the context and details. From recent and distant crises experience, one have always understood that risks are inherent in capital markets where agent's main incentive in economic decisions has heavily relied on profit motives. As one

attempts to mitigate the future occurrence of crises, it is helpful to bear in mind agent's profit motives as well as with wrong incentives and exploitation of weaknesses in regulation and supervision. Having this mindset will critically facilitate the formation of practical regulatory policies.

In this essay, we try to summarize some common factors that contributed to bank failures in order to stimulate transformational thoughts, generate new ideas, help evolve best practices and cascade them into meaningful and practical policies. As a caveat, the selected lessons are limited to where the authors felt there is need for further discussion and debate.

2. What Do We Know about the Recent Bank Failures? What Are the Prudential Lessons?

Sixteen years ago, the Asian crisis forced some economies in the region to undergo painful adjustments and far reaching economic reforms. Today, the world has witnessed another crisis. Although both crises were not quite similar, they have some aspects which are parallel to each other. The spillover and contagion we witnessed in 1997 where the turbulence spread from Thailand to South East Asia, Russia, China and Brazil was also present a decade later in 2007. The GFC widened from US and EU to the rest of the world. In just ten years, the size and speed of crises expanded systemically due to growing interconnectedness. As crises are prone to affect every economy because of larger spillover effects, the Asian region should learn from the lessons of the recent crises experience in order to minimize their vulnerabilities that may be triggered by external factors rather than by fault of their own. Here are some of the lessons that the authors have learned from the GFC which may prove to be useful in the Asian region.

2.1 Market Discipline Failure

The theory in economics that free market will bring about a socially optimum result because the "invisible hand" will promote what is best for all economic agents is challenged by the experiences in the US

and UK bank failures. These bank failures taught us that a totally unconstrained and unregulated free market has undesirable consequences. By allowing banks to continue its business of subprime mortgage lending because of the notion that it would not engage in business that is harmful to itself is a practical example of a market failure.

The Former Chairman of the US Federal Reserve Board, Mr. Alan Greenspan, was a great advocate of self-regulation. Credit is given to his intellectual honesty to admit that it was incorrect to believe that financial institutions and markets could largely be left to regulate themselves. This validated Mr. Hyman Minsky's financial instability hypothesis which provided a framework for how and when Adam Smith's invisible hand would break. Mr. Minsky originally wrote more than 20 years ago in 1992:

> *"In a world of businessmen and financial intermediaries who aggressively seek profit, innovators will always outpace regulators; the authorities cannot prevent changes in the structure of portfolios from occurring. What they can do is keep the asset-equity ratio of banks within bounds by setting equity-absorption ratios from various types of assets for different moments. If the authorities constrain banks and are aware of the activities of fringe banks and other financial institutions, they are in a better position to attenuate the disruptive expansionary tendencies of our economy (1992)"*[2]

One can only regret the fact that Mr. Minsky's sensible counsel was ignored. However, all is not lost from his teachings, we can still

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2. Today, what Mr. Minsky cleverly called "fringe banks and other financial institutions" is the equivalent of shadow banks.

3. There are three categories of debt structures: hedge, speculative and ponzi that characterizes Minky's financial instability moments. The essence is that stability is destabilizing because capitalists, observing stability in the present, will have the tendency to assume that stability will extend to the indefinite future. Thus, propelling agents' propensity to continuously engage in ever-more risky debt structures (including ponzi units) will undermine future stability. Please see Box Article for more detailed explanations of the three different debt structures.

benefit from his wisdom. The first sentence gives us the proper mindset that as long as we have deregulated markets and innovative financial system, we will have Minsky moments[3]. That is the reality - risk taking activities by financial intermediaries will always be present. We cannot eliminate them. It is just a matter of having good sense to have a regulatory policy to help moderate human nature. Thanks to Minsky's wisdom, we can suggest an insightful answer to potential market failure. This can be applied through equity absorption ratios on various types of assets on different times. This could also be interpreted to mean the use of dynamic counter cyclical capital ratios based on different business cycles. Another important insight from Minsky moments is that the three categories of debt structures have different risks based on the stability of funding. Such information must form part of what regulators collect from financial institutions and more importantly what regulators need to understand from the financial system.

Hyman Minsky's Economic Journey
(The Financial Instability Hypothesis)

Minsky took Keynes to the next level and his huge contributions come under the label of the "financial instability hypothesis". Minsky's key addendum to Keyne's work was to provide a framework for distinguishing between stabilizing and destabilizing capitalist leverage structure. There three distinct income-debt relationship for economic units, which are labeled as hedge, speculative and ponzi finance which can be defined as follows:

Hedge financing units are those which can fulfill all their contractual payment obligations by their cash flows: the greater the weight of equity financing in the liability structure, the greater likelihood that the unit is a hedge financing unit.

Speculative finance units are units that can meet their payment commitments on "income account" on their liabilities, even as they cannot repay the principal out of income cash flows. Such units need to "roll over" their liabilities (e.g. issue new debt to meet commitments on maturing debt).

Ponzi units, the cash flows from operations are not sufficient to fulfill either the repayment of principal or the interest due on outstanding debts by their cash flows from operations. Such units can sell assets or borrow.

According to Minsky, if hedge financing units dominates, the economy is an equilibrium seeking system. In contrast, the greater the weight of speculative and ponzi finance in an economy, the greater the likelihood that the economy is a deviation-amplifying system. The first theorem of financial instability hypothesis classifies economy financing regimes under stable and unstable financing regimes. The second theorem of financial instability hypothesis is that over long periods of prolonged prosperity, the economy journey from stable to unstable financial regime. In particular, over long periods of good times, capitalist economies tend to move from a financial structure dominated by hedge finance units to a structure widely engaged in speculative and ponzi finance. Furthermore, if an economy with a sizeable speculative financial unit is in an inflationary state and authorities attempt to control inflation by monetary constraint, then speculative units will become ponzi units and the net worth of previously ponzi units will be quickly evaporate. Consequently, units with cash flow shortfalls will be forced to try to make positions by selling out positions which would likely lead to a collapse of asset values.

Prudential Lessons

a. Regulators should target excessive risks rather than products, services or activities. According to Minsky, one regulates excessive risks through moderating leverage. The reason why financial institutions increase leverage is to take on more risks than equity holders are willing and able to fund. When the asset to equity ratio is declining, it is a signal that debt is expanding. A regulation prescribing a narrow debt (say in excess of threshold size) will be subject to additional capital and liquidity requirements. The emphasis on higher capital and liquidity requirements has been embedded on new rules espoused by the international reform setting bodies. We agree that the size of individual banks is important as they may need to be bailed out in crisis situations. To a more important extent, we believe that any capital and liquidity requirements of individual banks must be both a function of total banking system and government's capacity to raise taxes and cut spending.

b. The appropriate leverage threshold would require detailed information provided by banks. The fact that the current information system did not fully capture the true nature of bank's leverage indicates that improvements are necessary. At issue is what information is made available by bank balance sheets and the frequency of such information. If understanding the leverage build up is the primary objective of managing leverage risks, then bank balance sheet is an insufficient source of information. In order to capture the transactions and relationships with counter parties that can lead to such a build-up, the submission of reports must be as frequent as possible (probably daily instead of monthly). We believe that daily data collected on payments and settlement transactions among financial institutions would be a good source of monitoring risk build up.

c. As espoused by Minsky, a constant regulatory capital ratio for various assets on different times has pro-cyclical effects. The undesirable effect of constant regulatory capital ratio can be mitigated by prescribing a counter-cyclical regulatory requirement.

While the benefits of a counter-cyclical regulatory requirement have been widely accepted. There continues to be debate on what instruments are best to introduce counter-cyclicality – i.e. capital vs. provisions, or limits on leverage. To us, the merits of the macro prudential instruments are unquestionable. However, the discussion should not focus on what instruments are best to introduce but consensually agree to use the combination of both. This is because giving different jurisdictions the discretion on which instrument to apply will open the opportunity for regulatory arbitrage. We argue that since it may be easy to arbitrage risk capital requirement alone or leverage constraint on a stand-alone basis, it is much more difficult to arbitrage both frameworks at the same time.

d. Based on the similar concept of counter cyclical capital, regulators can consider bank examination to be based on business cycle. This would mean that the periodicity of bank's examinations is determined by the phase in the business cycle. In effect, this is counter cyclical examination wherein boom cycles would warrant a more frequent examination.

e. Various forms of incentives for excessive risk taking lessened the effectiveness of market discipline as a regulatory tool. For instance, a bank incorporated as a limited liability structure is an obvious form of incentive. With limited liability, a shareholder can at most only lose the value of his investment. The losses beyond his investment are not borne by the shareholder. However, gains of any size are shared proportionately. The non-linearity of the pay off function for the limited liability shareholder creates and encourages excessive risk taking. Thus, the combination of limited liability and excessive leverage means that risky investments of almost any size can be placed by investors with this asymmetric pay off function. A simplistic way to mitigate this problem is for banks to be incorporated as partnerships or other forms of joint and several liability institutions. It is understood that this may have legal impediments for existing financial institutions but this could apply prospectively for those wishing to secure banking license.

f. While a non-limited liability structure cannot apply for existing financial institutions, another way to mitigate the asymmetric pay off function for shareholders is to introduce a regulatory debt to equity convertibles. There is at least unanimity in this instrument's usefulness as a regulatory tool but the debate must continue to revert to unresolvable operational issues. The challenge stems from the mechanism and design of the convertible security. Unless this practicality issue is resolved and empirically tested, the perceived usefulness shall remain a theoretical idea. We would like to mention a few points for discussion. The trigger design must both have a bank-specific and regulatory component. The first component is triggered once a bank does not abide by the specific covenants of the financial instrument contract. This has the benefit of an objective criterion relating to a specific bank. The second requirement compels a proactive regulatory action. It is emphasized that both conditions must be present to warrant conversion. The satisfaction of both conditions is necessary for check and balance purposes. If conversion is triggered solely by regulatory declaration, authorities would face enormous pressure when deciding whether to make such declaration. Replacing regulatory declaration with only an objective criterion would also be problematic because the aggregate data to be used for such trigger is likely to be measured with time lags.

2.2 Corporate Governance Breakdown

The contribution of corporate governance breakdown to the GFC is best summarized by the remark of one CEO, Mr. Chuck Prince. The former CEO of Citigroup told the Financial Times on 10 July 2007 (explaining why his company was still making leveraged loans to private equity groups), *"As long as the music is playing, you've got to get up and dance.... We're still dancing"*. The expression not only characterizes financial markets inherent profit motives but also the compelling force in corporate governance breakdown. If Citigroup CEO Chuck Prince had not agreed to dance, his board would have dismissed him. If the board had not done so, there would have been a shareholders' revolt.

The extreme pressure from the board and shareholders is related to the issue on financial sector remuneration and bonuses. The asymmetric pay off function of CEOs was an incentive to take excessive risks. If the risky venture pays off, the CEO would reap substantial gains. If it does not, he loses his job in the worst case. Some of the asymmetry in the pay-off function cannot be completely corrected. Limited liability is one cause of the asymmetric pay-off function (an issue explained in detail in section 2.1.d). Even more important is the fact that labor (including star traders and executives) cannot be expected to credibly commit to stay with the current employer. There is always a risk that talent can be poached by the competitor. In effect, this allows "stars" to extract massive bargaining hand from the company. From a financial stability perspective, it is irrelevant whether remuneration in the financial sector is excessive. What is relevant is the wrong performance indicators attached to the "bonus" scheme. It should be linked to long-term profitability. The current structure is tied to short term success where bankers would venture into risky bets in the last quarter of each year to maximize Christmas bonuses. While the responsibility of addressing this problem lies first and foremost with shareholders and the board of directors, it is also a shared responsibility of regulators because the internal incentive structure of a bank is as much a driver of the operational risk, market risk, and credit risk as it is on bank's asset allocation or funding strategies.

Another contributory factor to the corporate governance breakdown is the bank's shortcomings in transparency and information disclosure. The accounting rules that existed during the financial crisis offered substantial discretion to the banks. In particular, the implementation of fair value accounting (FVA) on trading portfolio assets allowed banks flexibility to hide losses and their true risk exposure. For instance, assets held for "trading" are valued at market prices and fluctuations in values would have been reflected through the profit and loss account. On the other hand, assets held "available for sale" are still valued at market prices but fluctuations in valuation are only reflected in the balance sheet, not the profit and loss account. Moving assets from the "trading" to "available for sale" category allowed banks

not to record losses and therefore, make bank's capital position appear healthier than reality.

If this is the circumstance that unfolded during the crisis, one would argue that the shift in asset category was not the cause of the illness of failed banks but just a way for the banks to cover the sickness. So, this is not a case that a mere accounting rules change would have prevented bank failures. But, it is a deliberate abuse and exploitation of rules that exacerbated the condition of failing banks. A natural question is: Did the bank's internal auditors notice anything malicious on why there was a shift from one accounting rule to another? How come the bank's external auditors did not raise a potential accounting irregularity?

Prudential Lessons

a. The straightforward measure agreed in international reform setting bodies is to limit the ability of the board and CEOs in extracting excessive remuneration from the firm by requiring the shareholders to have binding votes on the remuneration packages of top managers and earners. In order to tie the bonus payouts to long-term profitability, the payout must be distributed over a period of years. Ideally, it will only be paid on profitable years and no payouts on loss-making years. Under this scheme, bankers are given the incentive to stay on with the company and continue to contribute to its long-term profitability.

   This approach assumes that the shareholders are as informed and experienced in assessing pay packages as the members of the board of directors. Most corporate decisions are made by the board rather than shareholders precisely because board members are able to become better educated about the issues confronting the firm, and so bring about better outcomes than would result from direct shareholder vote. One might argue that the situation is no different with executive compensation. Shareholders are not necessarily as well informed about the complexities of executive compensation or the dynamics of the CEO labor market as are members of compensation committees. We agree that the growth

of shareholder advisory groups may work to limit this concern since such groups specialize in understanding the intricacies of pay structure and may be in a better position to evaluate compensation plans relative to other firms.

Karpoff, Malatesta and Walkling (1996) and Gillan and Starks (2000) have both reported that non-binding shareholder resolutions appear to have no consistent effects on corporate performance and shareholder values. This evidence suggests that advisory "say on pay" is not likely to affect corporate pay levels, though it may succeed in putting a spotlight on companies with governance failures.

Bebchuk and Spamann (2009) make a further argument against say on pay for financial firms. Because of such firms' high leverage and incentives for excessive risk-taking, "say on pay" could have the effect of amplifying such risk- taking by giving management larger equity stakes and hence more reason to adopt shareholders' preference for a high-risk strategy.

On balance, we endorse *advisory* "say on pay" on the grounds that compensation committees should have an understanding of the views of shareholders. But we do not support a *binding* "say on pay". Boards should continue to be given the discretion to design sophisticated pay packages that are appropriate for the firm as a whole and that produce the right incentive alignment. If a company's governance structure is working properly, its board would disregard the advisory say on pay.

b. To mitigate an abuse of an accounting rule, auditors must improve vigilance in conducting audits. This can be done through enhancing core competencies of auditors especially when auditing financial institutions involved in innovative financial products. To a certain extent, auditors must acquire some knowledge and perspective of a bank practitioner to effectively carry out their responsibilities.

2.3 Risks of Highly Interconnected Global Banks

The adverse impacts of the GFC spread globally due to growing interconnectedness. These inter-linkages are inevitable because of globalization. As every aspect of the economy could be global so could finance. Banks are global but regulation is national. The global bank failures have taught us that whenever the span of the market and the domain of mobility of financial institutions exceed the span of control of the regulator, it creates the perfect recipe for a disorderly supervisory and resolution regime. Every country wants to have an internationally active financial sector in its jurisdiction. The financial sector produces employment, profits and taxes and help economic growth. National regulatory standards have been used as an instrument to compete for financial sector business – to attract it from abroad and/or to stop it from leaving for foreign new pastures. The result is the opportunity for regulatory arbitrage which financial market players are more than willing and able to play. This is a fact in the political economy that banks are going to exploit. As regulators, we just need to accept this fact and prepare for the cross border risks that these global banks bring.

Prudential Lessons

a. A college of national supervisors existed for the European Union (EU) at the time of global financial crisis. It was rendered less effective because it was based on the principle that the home-country regulator takes the lead and be the dominant player in the college for any given cross border bank. Based on the recent experience of bank failures, the pain of financial collapse was primarily felt in the host country, where the branch or subsidiary operates. Thus, control has to be located where the pain is felt. For us in the Asian region that are contemplating to set up colleges of supervisors, the wisdom that the host regulator should have control of cross border banks must be critically taken into visible form and substance. Moreover, the cross-border banking system that existed during the crises should not survive in its current form where they are completely controlled by the parent with little ring-fenced capital resources in the host country regulator. Moving

forward, foreign branches must be independently capitalized in the host country, with ring-fenced assets and subject to the regulation and supervision by the host country regulator. Looking into the distant future of ASEAN financial integration agenda, a single systemic regulator for cross border banks similar to the case of European Union ("European Banking Authority") might be tenable for the Asian region.

b. Today, it is safe to say that global banking and foreign subsidiaries are here to stay. Thus, the well known problem of "too big to fail", too interconnected to fail", too complex to fail" and "too international to fail" will continue to be an issue faced by regulators. The core of the problem is size. Even if a financial business is highly interconnected and international (its total exposure to the rest of the world and the exposure of the rest of the world to it are complex), it can still be allowed to fail if the total amount involved and the size of its balance sheets are small. All other dimensions (interconnectedness, complexity, international linkages) only matter if the institution in question is big. So how do we prevent an institution from becoming too big to fail? Strict competition policy is one way. The other way is to tax the size of a financial institution. This can be done through capital requirements that are progressive in the size of business (as measured by proportionate contribution to the size of total balance sheet or some other metric). It is emphasized that the regulation to tax size is different from regulations aimed at mitigating risk (i.e. limiting exposures and minimum capital standards). This is to say that a set of regulation to mitigate threats to financial stability can be broadly divided into policies that regulate size and policies that regulate risk (regardless of size). *By preventing an institution from becoming too large, there is a collateral benefit of escaping potential moral hazard problems.*

2.4 Aggressive Growth Strategies through Financial Innovation

While financial innovation is at the early stage in many SEACEN economies, lessons in this area can be imminently useful as emerging Asia progress towards deeper and sophisticated development. In the

years before the GFC, banks in advanced economies had to turn to financial innovation in order to sustain high growth in assets and profitability. Banks adopted an "originate and distribute model" whereby the bank originates loans and transfers them to a Special Purpose Vehicle (SPV) which then packages them into Collateralized Debt Obligations (CDOs) for sale to other investors. The uncertain future cash flows from loan mortgages were pooled, securities were issued against the pool and the securities were tranched with various credit enhancements. However, the securitization process weakens the incentive to collect information about the creditworthiness of the borrowers and to continuously monitor the relationship by breaking the link between originator and borrowers. In effect, securitization became an inducement for banks to be imprudent because it can transfer the risk away, although the total risk in the financial market does not change. Ahead of the crisis, this incentive was entirely absent.

The ratings process contributed to the proliferation of structured products. It is thought that the asymmetric information problem that existed between the originator and the subsequent investors in the securitized assets would be mitigated or resolved by the rating agencies. As it turned out, the ratings process would become deeply conflicted. The rating agencies marketed a range of services to the same parties they are rating. The rating agencies were engaged and paid by the more informed party (the issuer of securities). This situation brought about enormous conflict of interest. Even if this conflict of interest could have been mitigated in some way, the more fundamental problem would remain as the rating agencies knew little or nothing about the underlying assets backing the securitized structures they are rating.

Prudential Lessons

a. One way to mitigate this securitization problem is to force the originator of the loan to hold on to a sizable part of the highest risk tranche of the securitized assets. This keeps alive the incentive to monitor borrowers because the originator will still assume a loss in case of problems arising in the maintained relationship.

b. Securitization as well as new products and instruments has the promise to be useful but also the potential to be harmful. The unchecked and inevitable pace of financial innovation in the capital markets can be contained if we follow the wisdom used in the field of medical research. Before a new drug is released and marketed, it is tested for years. Only after a series of testing, experimentation and scrutiny, will a medical drugs regulator allow it to be sold to public, often with the added requirement of a prescription from a licensed physician. Similarly, the process could be followed in the banking industry. New banking products and instruments must be tested extensively by experts and to the regulator's satisfaction. If a product is approved, the regulator could establish a positive list of permitted financial instruments and products. Anything outside the list is prohibited. Even with the approved list, some instruments can only be sold with the financial equivalent of a prescription from a licensed physician. We accept that this may slow the pace of financial innovation and make it more costly and less remunerative. But it will not stop financial innovation. It reduces the risk of new toxic instruments being distributed, misused and abused.

c. The UK's Turner report suggested the extreme approach of taking out rating agencies in the regulatory process by eliminating the role of external ratings in Basel II capital risk-weightings. The conflict of interest in rating agencies was suggested to be mitigated by restricting them to any other commercial activities (i.e. consulting services) except rating services. In addition, when credit rating agencies role cannot be completely eliminated, we suggest that rating agencies could be paid in the securities they are rating (at least in part) and that these securities be retained for some minimum holding period.

2.5 Regulatory Forbearance as a Cause for Concern

In the recent unprecedented global crisis, the clamor of taxpayers on why regulators failed to take action on the failed financial institutions reverberated across the world. To the credit of US and UK regulators, both have publicly admitted they could have acted faster and done

more sooner than later. In the ensuing discussions on financial sector reforms, there was a lot of debate on how regulatory forbearance contributed to the crisis. The International Monetary Fund has gone as far as modeling the forbearance behavior. Vega, Kahn, Matta and Sole (2011) consider that regulatory reforms have overlooked the incentives for regulatory agencies' forbearance and information sharing. The model concludes that regulators have a natural tendency towards some forbearance, but where authorities have an expanded mandate to explicitly oversee systemic risk they would tend to be even more forbearing towards systemically important institutions. The European Union (EU) has also focused on the issue. In 2011, Directorate General Internal Market and Services published a document on the technical details of a EU framework for the management of failing credit institutions. It made clear that European jurisdictions is expected to establish "resolution authorities" which will be separate and distinct from the supervisor, specifically to address the impact of possible regulatory forbearance as and when such issue arises.

To the advocates of regulatory forbearance, it justifies such policies on protecting the economy's macroeconomic stability and taxpayers from bailouts. It further justifies that forbearance give some time to troubled institutions to recover as economic conditions and corrective actions take effect. Proponents also point to the fact that placing a bank into receivership destroys asset and franchise value and results in excessive costs.

Although regulatory forbearance has some benefits, it imposes costs on the financial system and increases moral hazard. In exercising forbearance, regulators must use informed judgment. They must be able to distinguish between institutions that will recover after a period of forbearance and those institutions that will not. The recent crisis would bear witness to the fact that regulators were unsuccessful in their judgment and paid unparalleled costs. Moreover, the ability to predict that economic conditions will correct insolvencies of failing institutions requires foresight and financial modeling that is beyond regulators' capabilities. If this was the case, regulatory judgment must have erred on the side of conservatism. Regulatory forbearance is also criticized because it results from perverse regulator incentives.

Furthermore, forbearance is inconspicuous and defers unpleasant consequences. Therefore, it is less likely to draw criticism and eliminate reputational risks. With the benefit of hindsight, regulators admitted guilt of forbearance after the recent financial crisis. This forbearance led to a modern day bank run which inevitably forced governments to spend billions of dollars to prevent what could have been the next Great Depression. We recognize that regulatory forbearance was not the sole cause of the financial crisis, but it was instrumental in increasing the severity of the crisis.

Prudential Lesson

Drawing insights from the proponents and critics of regulatory forbearance, the issue to address is the discretionary nature of forbearance policies. Taxpayers' interests must be protected from inappropriate regulator incentives and the financial losses associated with forbearance problems. A key constraint is to limit regulators' ability to use discretion. Installing checks and balances to mitigate these risks must be the subject of debate. The whole idea is to restrict regulators' bailout power by making it more difficult to orchestrate. Also, thinking of ways and mechanisms for taxpayers (as a form of market discipline) to force regulators to take corrective action faster and sooner is a challenge that needs serious contemplation.

3. Final Thoughts

The history of bank failures and financial crises including the ones in the US and the UK, show how weaknesses in banking systems and banking supervision may contribute to financial instability. Based on our findings, the prescription to avoid, or at least minimize the impact of future crises includes a combination of factors: a banking oversight that is less reliant on self regulation because of market discipline failure, an incentive compatible regulation to address issues on corporate governance, greater coordination among international banking supervisors for due risks of highly interconnected global banks, enhanced core competencies of supervisors especially in examining innovative

financial products and risks arising from regulatory forbearance problems.

Indeed, there are always benefits from looking at the rear view mirror but it is of greater importance to be looking forward in the windshield. For Asia and other non-crisis country, one should not waste the good lessons from the recent crisis.

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