FINANCIAL REGULATION AFTER THE CRISIS: WHERE DO WE STAND?

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COMMENTS ON PRESENTATIONS BY NAVA AND HELLWIG

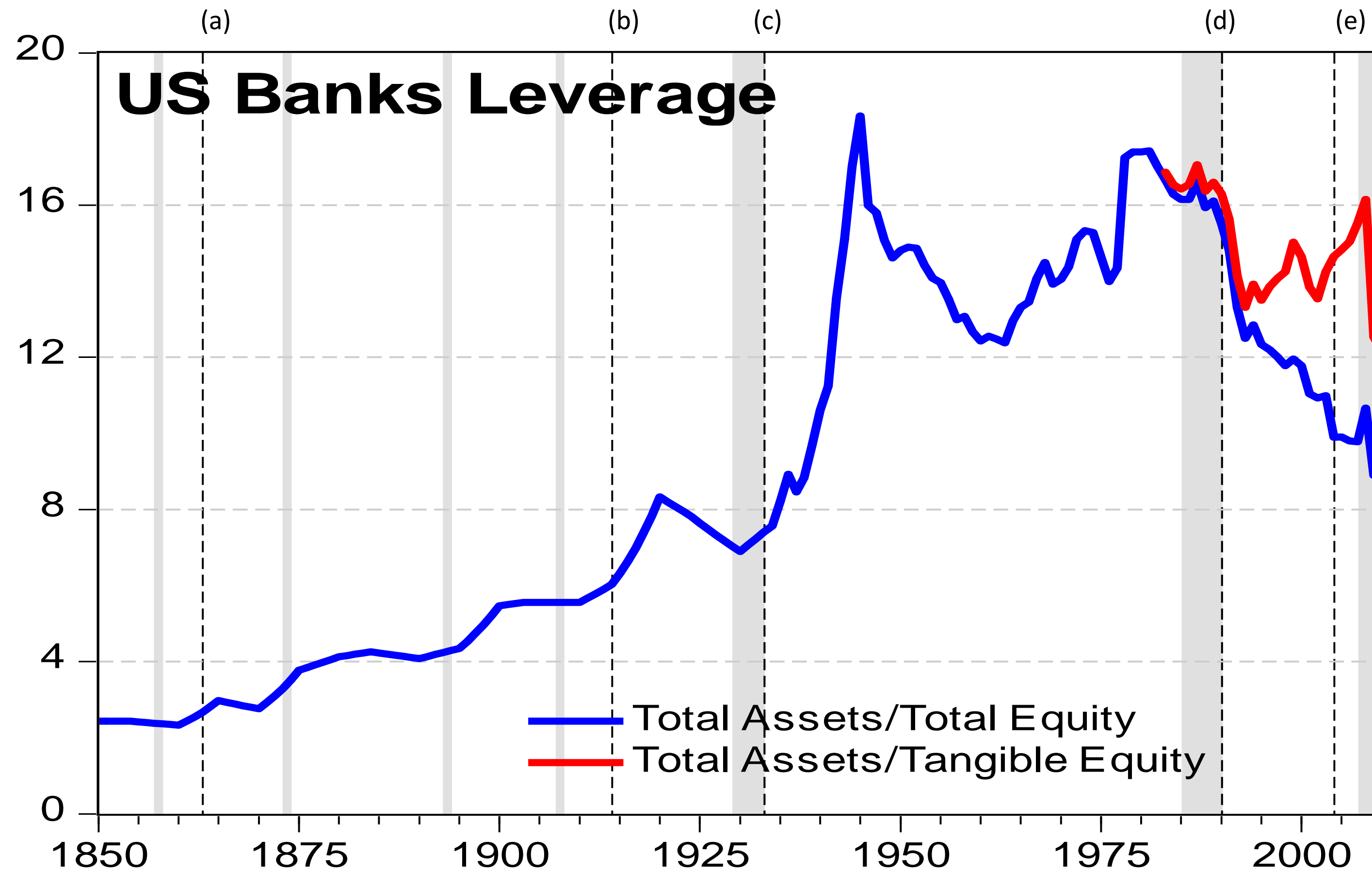
- Official response is weak and still far from giving banks the capital required for adequate confidence in their resilience.
- Increasing regulation on governance and risk control is unnecessary and counterproductive.
- European response on OTC markets encouraging but misguided by conflicts. How many competing regulated markets do we need?
- Risk weighting is not the problem, capital requirements are. The models are not the problem, when used wisely as HF did.
- Regulation of institutions was the problem. Unlikely it can be the solution. Regulate markets, not the participants.
- Reinstating market discipline, with material risk of failures, should ensure an overall decrease in institutional complexity down to levels that can be properly understood by their managements.

WHERE DO WE STAND

- Reaction to the crisis with numerous legislative/regulatory actions broadly in the right direction (Dodd Frank, Basel III, FINMA's Capital Rules for Swiss Banks, Osborne's Regulations in the UK).
- But ultimate objectives remain unclear to legislators and regulators, allowing special interest groups to pursue their own agenda through intense lobbying.
- We try to clarify the objectives:

  - How much capital should banks have?
  - What businesses should banks be involved in?
  - What sort of financial markets do we want?

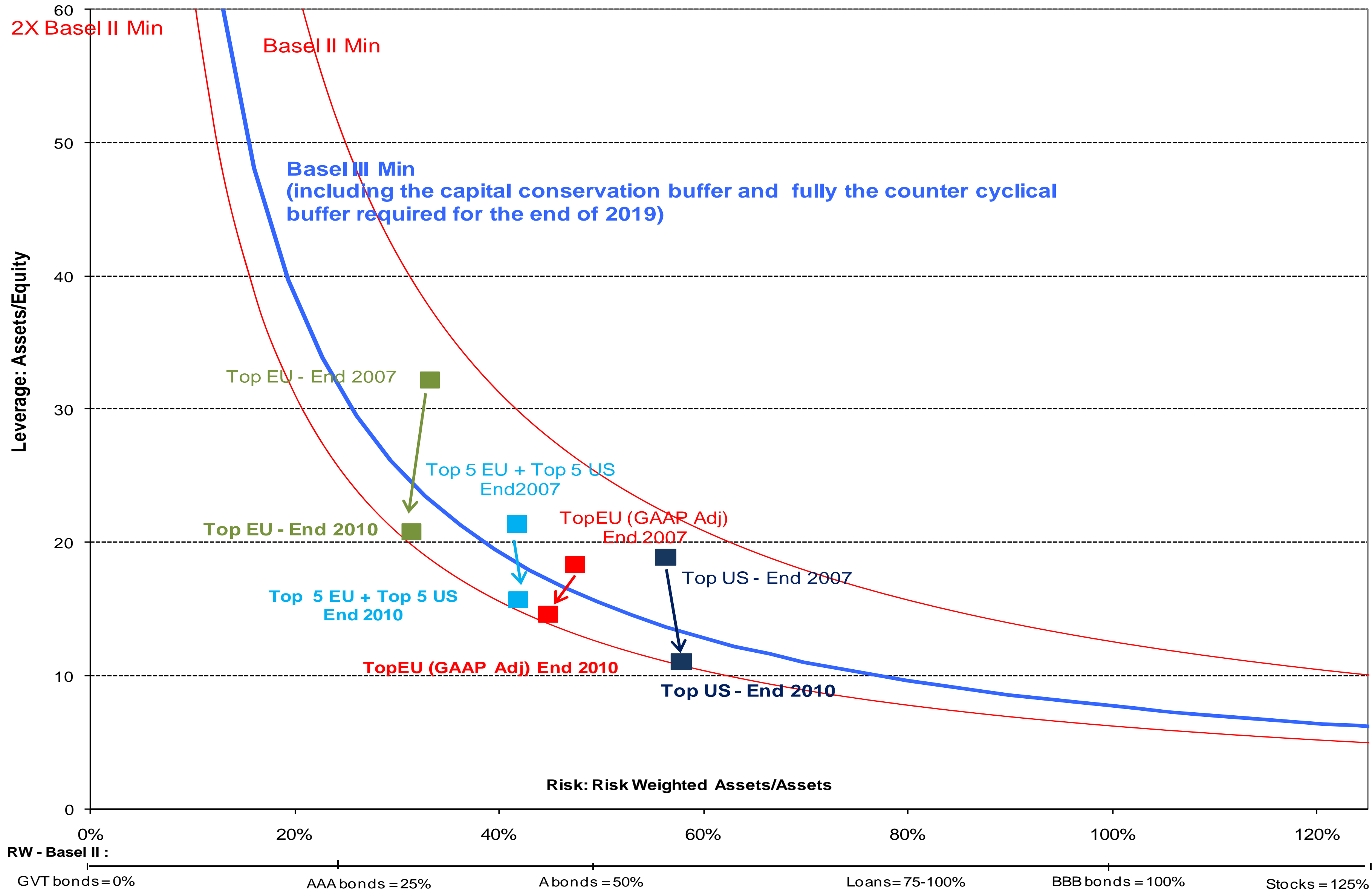
OVERALL LEVERAGE IS DECLINING



(a) National Banking Act – 1863
(b) Creation of Federal Reserve – 1914
(c) Creation of Federal Deposit Insurance Corp – 1933
(d) Implementation of Basel risk-based capital requirement – 1990
(e) Implementation of Basel II risk-based capital requirement – 2004

Shaded Areas point out US banking crises
Source: Federal Deposit Insurance Corporation

RISKINESS OF ASSETS IS BROADLY UNCHANGED



CURRENT BANKS' CAPITAL REQUIREMENTS ARE LOWER THAN ANNUAL VOLATILITY OF THEIR ASSETS

	Gov Bonds	AAA Bonds	A Bonds	BBB Bonds	Stocks
Annual StDev	2.9%	3.1%	4.6%	7.5%	15.8%
Basel II - Risk Weight Coeff.	0%	25%	50%	100%	125%
Basel II Minimum Capital	-	2%	4%	8%	10%
Basel II - Allowed Leverage	∞	50	25	12.5	10
Basel III Minimum Capital (including capital buffers of 5% of RWA)	-	3%	6.5%	13%	16.3%
Basel III - Allowed Leverage	∞	30	15	8	6

- Risk weight coefficients are roughly consistent with the relative volatility of the asset class they refer to. Capital requirements are not.
- Basel III has raised capital requirements to the level of the standard deviation of the asset class it refers to, except for government bonds.
- Minimum capital set at the level of annual portfolio volatility would still allow more than a 50% chance of banks being wiped out of their capital every 4 years. Or 90% probability of becoming insolvent every 13 years.
- It would seem logical to set prudential minimum capital requirements for banks at a multiple, not a fraction, of the annual volatility expected for the assets on banks' balance sheets…
- Banks depress RWA by assuming benefits from diversification but also have to hold additional capital for operational risks etc.

BANK CAPITAL AND EXCESSIVE COMPENSATION

- The problem of excessive compensation in big banks can be read as one of insufficient capital which leads to unreasonably high pre bonus ROE (due to both fat "R" and too small "E") which managements reduce to publishable ROE by pocketing the difference.

- The "R" is bigger than it should be also due to the "Too Big To Fail" rent position big banks enjoy as OTC market makers in securities and derivatives. There can be no differentiation between front running and market making when dealing with captive clients as in current oligopolistic OTC markets.

- The "E" is too small due to the grossly underestimated minimum capital requirements the banks have been regulated into. This was the devastating result of years of pondering by the sort of internationally coordinated regulatory effort, some people wish for more of today…

2010 COMPENSATION LEVELS AND ROE

Top US Banks	Total employees	Avg Actual Compensation (USD)	Actual ROE	ROE if Av. Compensation Fin Sector - (1)	ROE if Av. Compensation Fin Sector & 2x Capital
Goldman Sachs	35'700	443'725	11.5%	29.6%	14.8%
Morgan Stanley	62'542	256'596	9.0%	15.4%	15.4%
Wells Fargo	272'200	99'971	10.5%	16.3%	8.1%
JPMorgan	239'831	117'266	10.3%	16.3%	8.2%
Bank of America	288'000	122'045	-1.8%	9.1%	4.5%
Citigroup	260'000	93'962	6.7%	9.7%	4.9%
Average US	193'046	188'927	7.7%	16.1%	9.3%

Top European Banks	Total employees	Avg Actual Compensation (USD)	Actual ROE	ROE if Av. Compensation Fin Sector - (1)	ROE if Av. Compensation Fin Sector & 2x Capital
Barclays	147'500	124'747	7.3%	16.9%	8.5%
Societè Generale	160'704	78'748	10.4%	11.6%	5.8%
Credit Agricole	87'520	114'464	3.0%	9.0%	4.5%
DB	102'062	164'361	5.4%	21.5%	10.8%
BNP Paribas	205'348	97'415	12.3%	17.7%	8.8%
Credit Suisse	50'100	279'545	13.6%	18.5%	9.3%
UBS	64'617	251'200	17.2%	18.2%	9.1%
Average EU	116'836	158'640	9.9%	16.2%	8.1%
TOT AVERAGE	154'941	173'784	8.8%	16.1%	8.7%

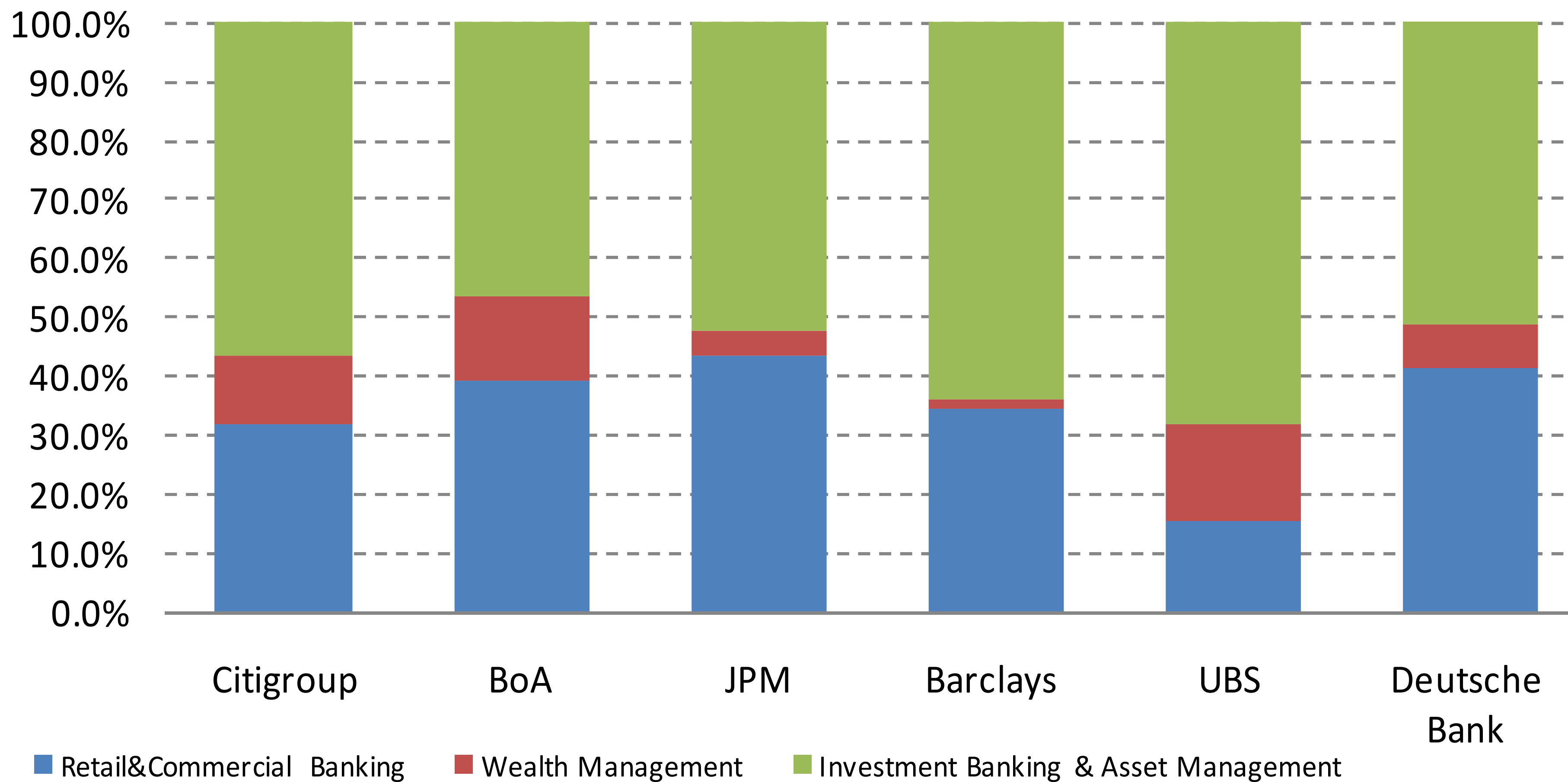
(1) ROE if Avg compensation was USD 75000

HOW MUCH MORE CAPITAL DO BIG BANKS NEED?

Compared to the capital they now have, big banks would seem to need:

- Financial analysis derived guess: about 2 times their current capital.
- Compensation derived guess : about 2 times.
- Hedge Fund comparison derived guess: about 2 times.

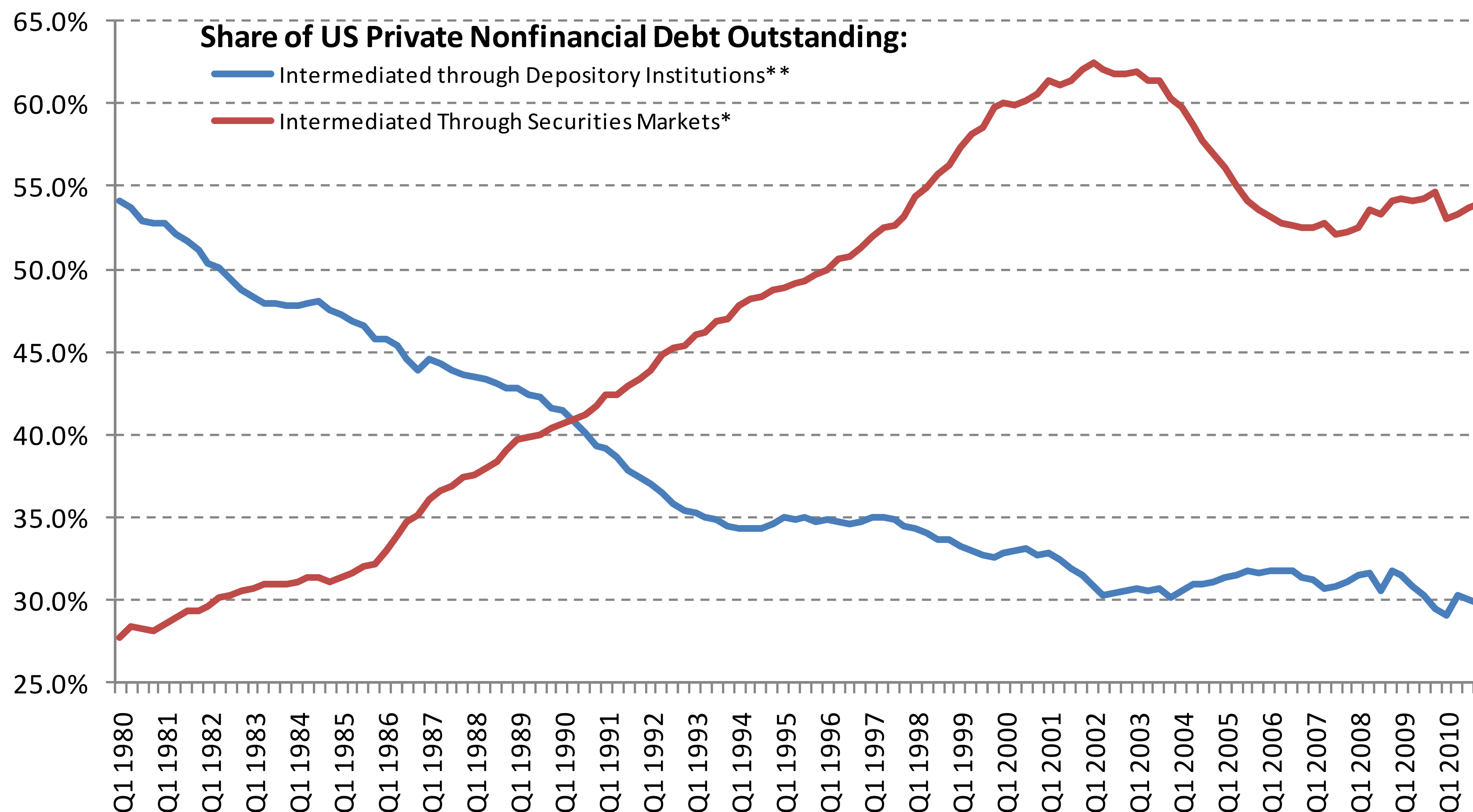
SEGMENTAL BANKS BALANCE SHEETS (2010 ANNUAL REPORTS)



*Adjusted to US GAAP

BANKS' BUSINESS LINES

Declining relevance of banks as credit providers



* Corporate Bonds, Commercial Paper and Asset Backed Securities

** Mortgages, C&I Loans and Credit Card Debt that remain on banks' balance sheet

Source: Flow of Funds Report – Federal Reserve

WHAT MARKETS DO WE WANT?

- From efficient markets as an hypothesis to more efficient markets as an objective. Markets have no better alternative: but how do we improve them?
- In most countries, markets' supervisors (SEC, CFTC) have lost influence in favour of banks' supervisors (Fed) who generally have little market culture. Many lessons historically learned by exchanges have hence been forgotten with disastrous consequences.
- Network theory should provide the theoretical framework to validate old lessons and highlight new dangers. For instance the current hubs and spokes financial network configuration is notoriously prone to catastrophic failures.
- Credit differences lead to oligopolistic trading.
- Not all products might be tradable
- Cost of trading should be raised via Tobin tax?