

Chapter 10

The Unlevel Playing Field

“We want to create good incentives. We want to tilt the playing field so that risks flow to where there is risk capacity within financial systems”

One reason that market discipline was seen as such an important pillar in the pre-crisis approach to banking regulation was the implicit model that regulators had in mind: financial crashes occur randomly as a result of a bad institution failing and that failure becoming systemic. The historical experience is rather different. Crashes follow booms. In the boom almost all financial institutions look good, and in the bust almost all look bad. Differentiation is poor. The current crisis is another instance of this all-too-familiar cycle. But if crises repeat themselves and follow booms, focusing on micro-prudential regulation of instruments and institutions and ignoring the boom will do little to prevent the next crisis.

Requiring the banking system to hold more capital on average will not improve the resilience of the financial system as a whole unless there is also a better match of risk taking to risk capacity. Indeed, piling up capital requirements may act as an anticompetitive barrier, reinforcing the spectre of a few banks holding a government hostage because they are too big to fail.

Micro-prudential regulation was often accompanied by a misguided view of risk as an absolute, constant property of an asset that can be measured, sliced, diced, and transferred.

This is an elegant view of risk and has the merit of allowing banks to build highly complex valuation models and to sell highly complex risk management products to handle and distribute risk. But it is also an artificial construct that has little bearing on the nature of risk.

In reality, there is not one constant risk. The three broad financial risks – credit risk, liquidity risk, and market risk – are very different. Moreover, the potential spillover risk from someone holding an asset depends as much on who is holding the asset as on what it is. Different holders have different capacities for different risks. The distinction between ‘safe’ and ‘risky’ assets is deceptive.

The capacity for holding a risk is best assessed by considering how that risk is hedged. Liquidity risk—the risk that an immediate sale would lead to a large discount in the price—is best hedged over time and is best held by institutions that do not need to respond to an immediate fall in price. A bank funded with short-term money market deposits has little capacity for liquidity risk. Credit risk—the risk that someone holding a loan will default—is not hedged by having more time for the default to happen, but by having offsetting credit risks. Banks, with access to a wide range of credits, have a far greater capacity than most to diversify and hedge credit risks.

The way to reduce systemic risk is to encourage individual risks to flow to where there is a capacity for them. Unintentionally, much micro-prudential regulation did the opposite. By not requiring firms to put aside capital for maturity mismatches and by encouraging market-to-market valuation and daily risk management of assets by everyone, regulators encouraged liquidity risk to flow to banks even though they had little capacity for it. By requiring banks to hold capital against credit risks, regulators encouraged credit risk to flow to those that were seeking the extra yield, but were not required to set aside capital for credit risks, and had limited capacity to hedge that risk. No reasonable amount of capital can remedy a system that inadvertently leads to risk-bearing assets being held by those without a capacity to hold them.

What can regulators do? They need to differentiate institutions less by what they are called and more by how they are funded or the nature of their liabilities. They should require more capital to be set aside for risks where there is no natural hedging capacity. This will draw risks to where they can be best absorbed. They also must work to make value accounting and risk management techniques sensitive to funding and risk capacity. Instead, under the current system, the natural risk absorbers behave like risk traders, selling and buying when everyone else is doing so.

Capital requirements encouraging those with a capacity to absorb a type of risk to hold that risk not only will make the system safer without destroying the risk taking that is vital for economic prosperity; they will also introduce

new players with risk capacities. This would both strengthen the resilience of the financial system and reduce our dependence in a crisis on a few banks that appeared to be well capitalised during the previous boom.

One of the striking things is that many of our recommendations challenge the notion, championed by big banks, of a level playing field. To some extent we have a story of returning to segmentation, but not along the lines of what institutions are called or what they say they do, as under the old Glass-Steagall, but along the lines of what capacity for risk they have. Rhetorically we could say that this is a Glass-Steagall for the 21st century. But we don't want to be binary, banning this, stopping that and limiting that as this would create bad incentives. We want to create good incentives. We want to tilt the playing field so that risks flow to where there is a risk capacity within financial systems. We want to tilt the playing field away from short-term funding of long-term assets. We want to tilt the playing field so that lending is pushed away from the boom and towards the subsequent contraction. We want to tilt the playing field so that cross-border capital flows away from countries experiencing a feast of capital and towards those experiencing a famine. We want to tilt the playing field away from an excessive focus on short-term activity. In financial matters, if not on the sports field, we see much merit in an unlevel playing field.