The Future of Global Finance: But First Some History

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“Financial Crises and Regulatory Reforms”

- Course I’ve taught for several years now with the economist Patrick Bolton

Some general themes to emerge:

1) There is no “end of history” to financial crises. Each set of reforms resets the financial system and creates the pathways for the next crisis

Financial Crises/Regulatory Reforms

- 2) Financial stability is a public good, quite costly to maintain. Much financial innovation arises out of the effort to provide functionally equivalent financial services without paying the financial stability "tax." Need for **Dynamic Precaution**

- 3) The most innovative elements of the Dodd-Frank Act are the effort to observe and address the dynamic flow of the financial system, through (i) the Office of Financial Research in the US Treasury; (ii) the authority of the Financial Stability Oversight Council to designate non-bank financial firms as systemically important; and (iii) the stress tests run by the Federal Reserve

History is the Future

- Two Depression-era examples:
- 1) Glass-Steagall
- 2) Deposit insurance

Glass-Steagall

- Glass-Steagall *itself*, not the repeal, as a foundation of the Financial Crisis of 2007-09
- Because: G-S produced the rise of market-based credit intermediation, in particular, financial firms that engaged in liquidity and maturity transformation without the safeguards of prudential regulation, public deposit insurance, and public LOLR facilities that we have come to think necessary to assure the stability of the banking system.

Glass-Steagall, 2

- **Rise of market-based credit intermediation**

Steps:

- Investment banks, because they could not make commercial loans, worked hard to create market-based substitute (firms rarely issue new equity; are always seeking debt finance, follow the money)

Glass-Steagall, 3

- Investment banks had advantages relative to banks:

1) could tap national funding market, unlike size-constrained banks in the US (awkward loan syndications)

2) rise of pension funds and other institutional investors provided funding source that did not need bank intermediation

3) Bankruptcy Act of 1978 eroded bank advantage in debt restructuring

Glass Steagall, 4

- Investment banks pursued a “spread” business, like commercial banks: fund long-term assets through short term borrowing
- -- provided a substitute for deposit insurance through short-term secured borrowing (repo)
- --- provided a substitute for LOLR through various explicit and implicit liquidity arrangements from the commercial banking system, often dependent on collateral
- Separation not so great: Financial Crisis showed that free-standing investment bank model is not sustainable

Glass-Steagall, 5 -- Silos

- G-S created 2 distinct institutions, 2 regulatory structures, and an intellectual divide between “banking” and “securities markets.”
- Philosophy: Bank Reg: “prudence”; Sec Reg: “disclosure”
- Academics were similarly divided in their pre-occupations
- -- US influence even in systems of “universal” banks
- The banking agencies were not empowered or experienced with prudential oversight of market-based credit intermediation
- The SEC was disclosure and enforcement based, with no systemic risk oversight mandate or experience; not engaged in prudential supervision

Glass-Steagall, 6 -- Silos

- The financial regulatory agencies were more focused in protecting their "clients" from competitive pressures rather than tracking the emerging systemic risks in the integration of banking and securities markets
- -- eg, the SEC and Money Market Funds (even *after* the Crisis)

Deposit Insurance: from stabilizer to crisis causer

- Upon initial adoption in 1933 during Great Depression, Deposit Insurance presented little risk of moral hazard.
- This is because it was coupled with a cap on interest rate that banks could offer to depositors ("Reg Q")
- Thus bank safety was self-enforcing: with little need to compete for funds, banks could earn a positive spread on lending without much risk-taking. The bank's franchise value was the shareholders' "skin in the game," not just capital.

Deposit insurance, 2

- Deposit insurance mostly provided protection against systemic threats (panic runs induced by financial crisis) or exogenous shocks (eg, a drought that hits all the farmers in the community)
- Deposit insurance thus did not provide strong incentives for extra risk taking (moral hazard)

Deposit insurance frankenstein

- 1970s: Oil price shocks, inflation, escalation in money market rates, creation of Money Market Mutual Funds, flow of deposits out of the banking system because of non-bank competitors
- And: the phase out of Reg Q
- Banks can now (must now) compete for deposits; the end of rents; reach for high-yielding assets

Deposit insurance frankenstein

- Leading to: Massive Moral Hazard from deposit insurance and a $350BB S&L crisis in the 1980s.
- Turns out that changing a rule (ending Reg Q) transformed the banking system

History is the Future Redux

- Once again:
- Financial stability is a public good, quite costly to maintain. Much financial innovation arises out of the effort to provide functionally equivalent financial services without paying the financial stability “tax.” Need for **Dynamic Precaution**