MONITORING THE INDEBTEDNESS OF BANKS AND COUNTRIES: REFLEXIONS ON REGULATORY REFORMS AND INTERNATIONAL INSTITUTIONS

Portuguese Economic Development in the European Area 5th Conference

Lisbon, May 14, 2010
Olivier Blanchard’s prescient “adjustment with the euro” speech 4 years ago at this conference. In between, two major events:

- financial crisis
- eurozone crisis.

What have we learnt? Looking ahead, how should we proceed?

Despite a couple of differences, a number of analogies and common policy principles whether borrower is bank or country.
At abstract level (broad picture/bird’s eye view)

**Common framework**: Principal (lenders) - Agent (borrower).

<table>
<thead>
<tr>
<th>Policy</th>
<th>“Ex ante”</th>
<th>“Ex post”</th>
<th>Future</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Monitoring (transparency)</td>
<td>Borrowing MH</td>
<td>Potential liquidity shock/ concern about solvency MH</td>
<td>Future payoffs</td>
</tr>
<tr>
<td>✓ Covenants, liquidity and solvency requirements</td>
<td>✓ Crisis resolution (debt restructuring, liquidity provision, coordination, new covenants, ...)</td>
<td></td>
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</tr>
</tbody>
</table>
General theme (1): Regulation’s raison d’être

Collective action problem for dispersed investors
- small depositors/insurees/pensioners for financial institution
- foreign investors (private and sovereign)

✓ Representation hypothesis
  - prudential regulation
    [Dewatripont-Tirole 1994 *The Prudential Regulation of Banks*, MIT Press]
  - international financial institution

✓ Ultimately, to the benefit of the borrower: institutions are about making it credible that investors will recoup their investment. With competitive capital markets, borrowers are the direct beneficiaries of investor protection, as investors compete away the benefits from protection.
General theme (2): Need to take more an ex-ante perspective

Origins of crises during booms

✓ Ex post resolutions always painful; bailouts often ex-post unavoidable:
  • Direct cost of non-intervention: default
  • Indirect cost of non-intervention: domino effects
    - (a) cross-exposures; (b) learning about probability of bailout.
    A Lehman-style aftermath for Greece? Eurozone May 9 stabilization fund

✓ More leeway ex ante (trust building and regulation)
  Yet, for political reasons, focus is primarily on resolution.

✓ Euro crisis: eyes on ST; stabilization fund buys some time: what’s next?
I. FINANCIAL REFORM

[Selected topics on financial crisis and regulatory implications]

II. CURRENCY AND SOVEREIGN CRISES: SOME GENERAL THOUGHTS

III. EUROZONE
I. FINANCIAL REFORM

Basics of prudential regulation

Constant trade-off between:

✓ Bureaucratic, but sturdy regulation
  Basel I/ Cooke ratio (equity/risk-weighted assets ≥ 8%) with its trilogy of:
  - mechanical assessment of weights (risk) of assets; no market value accounting
  - poor measurement of portfolio risk (correlations)
  - poor assessment of liquidity risk
    [hybrid securities and LT subordinated debt in tier-2 capital; country specific measurement of liquidity.]
Finer, information-intensive/manipulable assessment of risk

Basel II

- MVA
- ratings
- internal models

Proposals for private or CDS-based deposit insurance, etc...

Among problems: if market expects bailout, CDS rates very favorable!
[For more details, see *Balancing the Banks*, Dewatripont-Rochet-Tirole June 2010, Princeton University Press.]

For conciseness, skip some standard topics...

- abundant liquidity in US
- risky consumer loans
- loose prudential regulation
- lax supervision by rating agencies
  [in passing, very lucrative business as auxiliaries of regulation]
- countercyclical regulation
  [in favor of keeping fair value accounting, despite its flaws; and of adopting countercyclical capital adequacy requirements: Farhi-Tirole 2010: bubbles not only may burst, but they burst at the wrong moment.]

... and focus on three others.
(1) *Systemic risk and cross-exposures*

Return to fundamentals of financial regulation

- protecting depositors, insurance policy holders, pension funds customers,...
- today policy interventions have a very different motivation: prevent systemic risk (domino effects). Mutual exposures (OTC). Has unduly taken center stage in design of public policies. Rescue of investment banks, AIG, ... is problematic.

Will the regulation of hedge funds or “Tier 1” institutions (increasing the reach of regulation) do?
✓ Protect regulated sphere against defaults of non-regulated players:

Use capital adequacy requirements to favor

- use of clearinghouses
- trade of standardized products

✓ Cross-exposures warranted only if lender monitors:

In passing: interbank lending guarantees meaningless.

[What about sovereign debt guarantees?]
(2) Maturity mismatch and the Central Banker put

(a) Overall macroeconomic fragility/sensitivity to ST interest rate

✓ Commercial banks have pledged substantial liquidity support to the conduits:

Table 1: Ten Largest Conduit Administrators by Size

<table>
<thead>
<tr>
<th>Conduits</th>
<th>Administrator</th>
<th>#</th>
<th>CP (in bn)</th>
<th>Assets</th>
<th>Equity</th>
<th>CP/Asset</th>
<th>CP/Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citibank</td>
<td></td>
<td>23</td>
<td>93</td>
<td>1,884</td>
<td>120</td>
<td>4.90%</td>
<td>77.40%</td>
</tr>
<tr>
<td>ABN Amro</td>
<td></td>
<td>9</td>
<td>69</td>
<td>13,000</td>
<td>34</td>
<td>5.30%</td>
<td>201.10%</td>
</tr>
<tr>
<td>Bank of America</td>
<td></td>
<td>12</td>
<td>46</td>
<td>1,464</td>
<td>136</td>
<td>3.10%</td>
<td>33.70%</td>
</tr>
<tr>
<td>HBOS</td>
<td></td>
<td>2</td>
<td>44</td>
<td>1,16</td>
<td>42</td>
<td>3.80%</td>
<td>105.60%</td>
</tr>
<tr>
<td>JPMorgan Chase</td>
<td></td>
<td>9</td>
<td>42</td>
<td>1,352</td>
<td>116</td>
<td>3.10%</td>
<td>36.10%</td>
</tr>
<tr>
<td>HSBC</td>
<td></td>
<td>6</td>
<td>39</td>
<td>1,861</td>
<td>123</td>
<td>2.10%</td>
<td>32.10%</td>
</tr>
<tr>
<td>Societe Generale</td>
<td></td>
<td>7</td>
<td>39</td>
<td>1,26</td>
<td>44</td>
<td>3.10%</td>
<td>87.20%</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td></td>
<td>14</td>
<td>38</td>
<td>1,483</td>
<td>44</td>
<td>2.60%</td>
<td>87.80%</td>
</tr>
<tr>
<td>Barclays</td>
<td></td>
<td>3</td>
<td>33</td>
<td>1,957</td>
<td>54</td>
<td>1.70%</td>
<td>61.50%</td>
</tr>
<tr>
<td>WestLB</td>
<td></td>
<td>8</td>
<td>30</td>
<td>376</td>
<td>9</td>
<td>8.00%</td>
<td>336.60%</td>
</tr>
</tbody>
</table>

Notes: January 2007, Administrator merged for all subsidiaries associated with bank administrator not necessarily liquidity/credit risk provider, Bank variables from Bankscope, selected largest bank with banking groups (usually bank holding company), dropped non-banks and corporates

Source: Chapter 2 in Acharya-Richardson (2009).
✓ Investment banks have gained market share.

[Investment banks rely on Repo and CP funding much more than commercial banks do.]

✓ Others: Primary dealers’ ratio of overnight to term borrowing has grown; MMFs; LBOs; subprime borrowers; ...
(b) Unprecedented bailouts:

✓ fiscal:
  - support to institutions
    [recapitalizations, purchase of CP, underpriced deposit insurance]
  - support to asset prices
    [as planned in TARP I and II; Geithner plan]

✓ monetary (nominal interest rate close to 0)

Monetary bailouts have costs too:

1. Real interest rate distortion
2. Implicit subsidy from consumers to borrowers
3. Sowing the seeds of the next crisis
4. Inflation, distortion in relative prices
Private leverage/capital insurance choices depend on anticipated reaction to overall maturity mismatch.

Policy instruments are imperfectly targeted to the institutions they try to rescue

- balance-sheet-risk choices are strategic complements.

When everybody engages in maturity transformation,
- authorities have little choice but intervening
- refusing to adopt a risky balance sheet lowers ROE.

Endogenous macroeconomic uncertainty
In contrast with CAPM predictions, banks, if confronted with choice of sensitivity of their risk to the market risk, will choose to correlate their positions.
Macro-prudential regulation

- efficient for state to provide liquidity in bad times
- but supplies too much of it in time-consistent outcome.

Regulator should oversee overall, and not only individual, maturity transformation.

Banks’ decisions have externalities on others pecking order: regulate big banks, large probability of distress in crisis, large weight in objective function.
International regulatory infrastructure
Cross-border groups.

(a) Public policies
- fiscal choices
- monetary policy
- deposit insurance
- bailouts
- bankruptcy procedures

are often protectionist/nationalist

[example : ring fencing by US authorities]

(b) Lack of visibility (mutual exposures,...)

Europe. Creation of a European supervisor
- should not be a bureaucracy, and should resist lobbies,
- should be independent.
II. CURRENCY AND SOVEREIGN CRISES: SOME GENERAL THOUGHTS

Familiar questions:

- What makes a country attractive to foreign investors?
- Do countries borrow too much (crises usually preceded by large capital inflows)? Should one add some “sand in the wheels”?
- Should one avoid fixed exchange rates and monetary zones? Why are pegs, currency areas, and managed floating so popular?
- What role for the IMF?

[Later: Do we need an EMF?]
In defense of fixed rates:

- monetary credibility
- reduction in transaction costs

even though...

- delay impact of fiscal indiscipline
  
  [Tornell-Velasco 2000]

- if peg, country may be tempted to adopt too ambitious a peg to signal it is “strong”,

- if currency area, may not be an optimal one
  
  [Europe: limited labor mobility; limited risk-sharing mechanisms; limited wage/price flexibility.]
Fundamental issue: lenders’ confidence in ability/willingness of country to repay.

Three possibilities:

(1) restrict capital inflows/limit private and public indebtedness
(2) domestic politics make repayment credible
(3) look for a commitment device = mixture of:

- ex-ante outside monitoring
- ex-post accountability
Example of ex-post accountability debate

Topsy-turvy aspects of dangerous forms of finance.

Majoritarian view, in the wake of Asian and Argentinian crises:

✓ reduce exposure to dangerous forms of finance (avoid “original sin”):
  • debt liabilities, that are
  • short-term, and
  • foreign-currency denominated.

✓ encourage instead:
  • equity portfolio investment and FDI, and if debt liabilities:
    • long-term liabilities,
    • domestic-currency-denominated liabilities.
In defense of dangerous forms of debt. Flip side of risk exposure:

Dangerous forms of debt = policy-resistant liabilities (make governments more accountable).

Need to match stakeholders and political constituency:
- debt financing,
- short maturity structures,
- foreign currency denomination,
- home bias.

Otherwise, risk is borne by foreigners, encouraging moral hazard.

[Tirole AER 2003.]

With better ex-ante monitoring, one could dispense with dangerous forms of debt.
✓ competitiveness,

✓ control rights held by State, and their exercise

- structural policies (labor market policies, tax, bankruptcy and corporate governance regulations),
- fiscal deficit, pension reform, military spending,
- prudential regulation/regulatory forbearance,
- investments in non-tradable sector (real estate) rather than in export-oriented industries.
The IMF as investor trustee

**IMF’s mission**

Representation hypothesis: Think of IMF as being able to write and monitor missing contract with the government on behalf of lenders

- covenants/prequalification,
- crisis manager + extra conditions when country in distress (at minimum social cost).

Not so much a LOLR.

Ex-ante and ex-post conditionality.

**IMF acting as a delegated monitor: to the benefit of the borrowing country!**
✓ Refocuses mission: IMF as trustee.

[Political science and agency theory: organizational benefits from clear mission/focus/non-conflicting goals.]

✓ Requires political independence!
Avoiding stigmatisation

✓ IMF’s contingent credit lines (CCL) never used

  in same way banks reluctant to go to discount window or receive government assistance
  IMF’s flexible credit line (2009) – more ex-ante conditionality, little ex-post conditionality – different: meant to signal/reflect strong fundamentals/policies/track record.

✓ Stigma not an issue if application is mandated (by Eurozone for € countries?).
III. REFLECTIONS ON EUROZONE

✓ Portugal’s debt and competitiveness crisis

- nominal wage growth ≫ labor productivity growth
- composition effect (60% low-tech goods)
- large capital inflows (lots of private borrowing), overleveraged banks. Extremely serious problem. Danger of sudden stop (Portuguese banks shut out of global markets)
- procyclical fiscal policies & expansion of public deficit, although better record of fiscal adjustments than some other countries;
  [public accounts much more credible than Greece’s. Budget deficit from 6.1% to 2.6% from 2005 to 2007. Austerity program to reduce deficit from 9.4% in 2009 to 2.8% by 2013 has just been adopted. Some pension reform.]
- ST labor contracts; LT unemployment. Need for labor market reforms.
- Some sources of productivity growth: substantial potential productivity gains in, and expansion of tourism; product market deregulation/increase in competition in non-tradable sector.
Bottom line: Some needed reforms and further budget control, but two key issues are

(1) Overleverage of private sector (banks).

(2) Lack of competitiveness.

Outline

- Greece: current options
- looking ahead: how not to get there?
- what institutions for Europe?
GREECE’S OPTIONS (1) ORDERLY RESTRUCTURING

✓ **Bailout**  
  - restructuring of sovereign debt  
  - (mandated) debt/equity swaps for banks (PSI).

   Needed. Will buy time, but not address deficit and competitiveness issues.

✓ **Slow process.** Probably a mixture of:

1. **Productivity growth**
2. **Competitive disinflation**  
   [high unemployment, political hazards, .... Portugal: already low wage inflation.]
3. **Increase in VAT + decrease in payroll taxes**
4. **Commitment to a budgetary rule**  
   [key is institutional framework: More on this shortly.]
(1) **Keeps euro, defaults and changes parity on bank deposits (etc.).** Debtor expropriation. Does not solve competitiveness problem.

(2) **Keeps euro, defaults, and mandates reduction in wages and prices.** Complexity of oversight of this “internal devaluation” process.

(3) **Exits (and defaults).** Chaotic period (introduction of new currency, conversion of contracts, prevention of runs before change of currency, exchange rate discovery, ...); loses benefits of belonging to eurozone.
Like for banking crisis, the seeds of currency crises are sown during better times:

- no credit tightening, booms, bubbles, ...
- loose public policies, including high cyclically adjusted deficit (e.g., 1999-2000),
- competitiveness loss.

Need credible resolution mechanism.
Weak European institutions

[1997 Stability Pact and its 2005 weakening (long lag before penalties levied, more discretion on thresholds)]:

Lack of credibility
- Greece misreported even before admitted to eurozone in 2001.
- Recent violations of rules (no bailout rule, ECB rating threshold).

Too political: even if deficit countries were not allowed to vote, Ecofin Council would not exert sufficient pressure.

IMF’s “lack of transparency/accountability” is precisely what gives it (some) commitment power.
[e.g., less rosy forecasts for growth and speed of deficit reduction/tougher demands – see Greece –; credible suspension of disbursements – see Argentina. If anything, IMF is too political.]

Bad record in current crisis.
(a) Playing time, (b) blaming speculators: does not enhance investor confidence.
EUROPEAN MONETARY ZONE’S PEERS

Whom do we resemble?

(1) Argentina, Brazil

Subgovernments.

(2) US

Different in many respects:

- Labor mobility (out migration)
- More risk sharing: redistribution through welfare state, bank bailouts, etc.
- Stronger local institutions?

[No state downgraded yet. State supreme courts’ preventing politicians from stealing from public pension fund, etc. But federal state may end up bailing out California.]
A EUROPEAN MONETARY FUND?

The case for an EMF

- more instruments of retaliation
  - [possibly: withdrawal of structural funds; ECB disqualification of sovereign debt, ...]
- externalities from default primarily on European investors and system.

The case against an EMF

- lack of competency initially
- limited geographical scale: less pooling of insurance, less surveillance of global economy, and difficulty to build a reputation
- high risk of being a political institution.

Problem: independence may conflict with 1st argument in favor of EMF.
THE NEED FOR FISCAL RULES AND FOR AN INDEPENDENT BODY

✓ **Fiscal rule**: solidarity (explicit & implicit guarantees) requires monitoring.

✓ **Fiscal Policy Council**
  [e.g., Calmfors]
  - professional body
  - independent.

Missions:  
- may range from forecasts to constraints on the preparation/choice of domestic budgets
- monitoring of policies.

✓ The more binding the constraints, the higher the risk of creative accounting.
Country debt cannot automatically become Eurozone debt!

An example: Von Weizsäcker-Delpla blue bond–red bond proposal:

(a) solidarity (actually single eurobond) up to 60% of GDP [or less if bad policies]
   - red debt (beyond 60%) meant to be domestic debt.

(b) Can default on red debt (large spreads unless great fundamentals).

(c) Independent Stability Council.

Philosophy

- use market signals (red bonds resemble subordinated debt)
- provide more flexibility in country’s liquidity management
  - default no longer atomic bomb; but also means that default more tempting
  - substitutes: credit line; private sector preferred equity, or coco bonds that convert to equity in time of stress, ... ]
Questions:

- Market ensures early “intervention” only if no expectation of soft budget constraint on red debt [analogy with wholesale debt just prior to crisis]
  - complement with monitoring & fiscal rules.

- Like any decent scheme, needs reliable measure of debt and sustainability.

- Jumpstarting the process (like qualifying for the euro).

Alternative:

- Standard IMF-style liquidity support with conditionality.

- Contributions: during good times
  
  [hard during bad times. Can’t ask countries in trouble to put down high amounts. Europe: where will the € 440 billion credit guarantees come from? ]
IV. CONCLUDING REMARKS

✓ Crisis resolution, whether banking or exchange rate, is never pretty. Choice between the bad and the ugly.

✓ Political economy:

  • leads to a focus on orderly resolution (ST)
  • confers low political payoff to proper institution building (LT) and ex-ante careful oversight.

Stabilization fund buys time, does not address fundamentals.

✓ Time for bold institutional options!