

Regulate for What?
Restoring Financial Responsibility
回复金融责任性的监管

Chenggang Xu
University of Hong Kong
Tsinghua University

The Global Think Tank Summit
China World Hotel, Beijing
July 4, 2009

Market and Regulatory Failures

- A new type of market failure caused by default externality (破产风险外部化) created this financial crisis
- The existing regulatory regime cannot deal with this
- The current worldwide financial regulatory regime was developed as responses to the 1929 crisis
- The 2008 crisis and the 1929 crisis are driven by different mechanisms
- The obsolescence of regulation and the lack of understanding on the mechanisms of the crisis are consequences of two decades of deregulations before 2008
- What should be regulated and how to regulate are determined on the mechanisms of the financial crisis
 - Financial irresponsibility (无责任性金融)

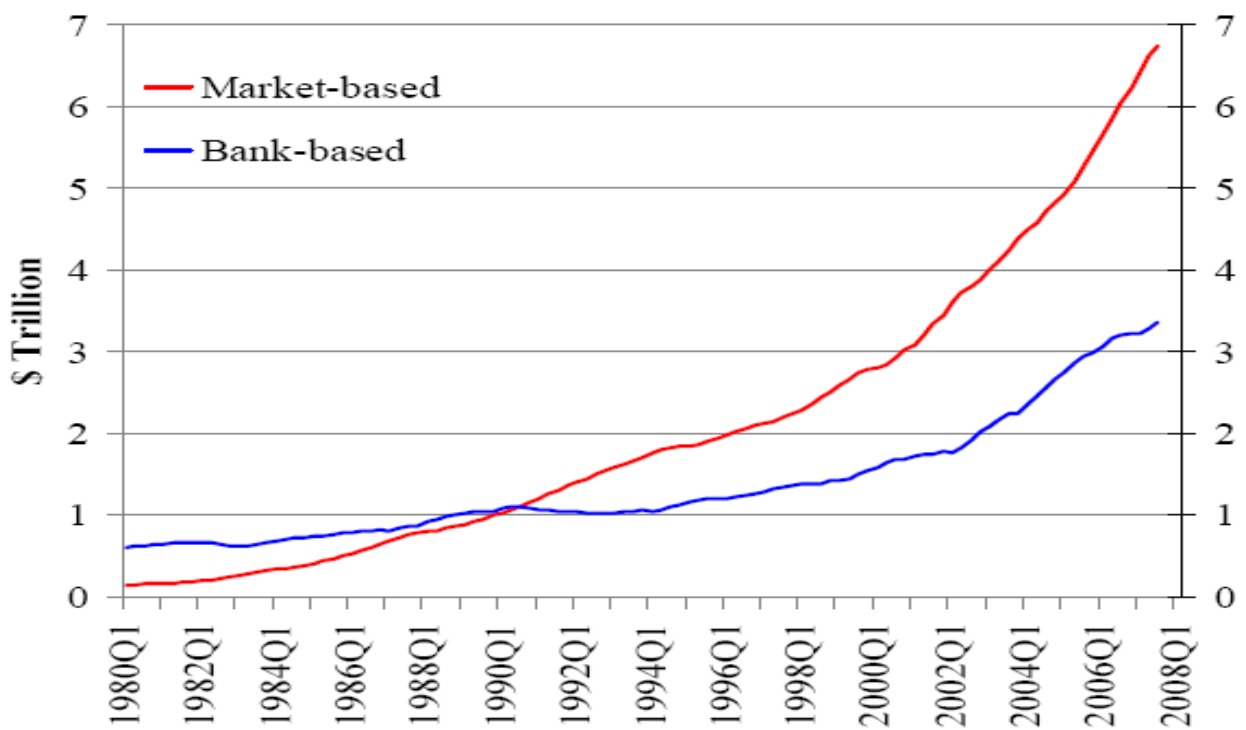
3 Basic Mechanisms of this crisis

1. Unregulated securitization makes **externalizing default risks** possible (破产风险外部化)
 1. Unregulated rating agents helped externalizing default risks
 2. Externalizing default risks creates worst moral hazard problems
2. Financial institutions, not regulated as banks, in securitization business become liquidity conversion machines and are subject to “**bank-run**” **vulnerability** (挤兑风险全面化)
3. **Unregulated financial liberalization + globalization** (金融机构巨型化全球化)
 1. Waves of bank mergers create super large banks – **Too-big-To-Fail (TBTF)** (大得垮不起) and they anticipate bailout [Moral hazard in risk taking]
 2. By taking over host countries banks super large multinational institutions spread out the hazards **worldwide** and they are also TBTF

Default Externality disables financial responsibility 破产风险外部化破坏金融责任性

- In a traditional mortgage a bank originates a loan and retains default risk
- Unregulated securitization cracks this mechanism fundamentally
 - Converts default risks from internal risks into external risks – default externality
- Backed by securitization mortgage provider transfer default risks to others when selling all mortgages to financial institutions
 - No need to worry default risks many mortgage providers even forge information => fatal informational problems start at the very basic level
- By packaging mortgages into securities and selling the securities the financial institutions could transfer default risks to others
- Rating agents mislead worldwide investors to buy high risk assets as safe assets – high demand enlarged default externality substantially
 - Enlarged default externality pool idiosyncratic default risks into systemic risk

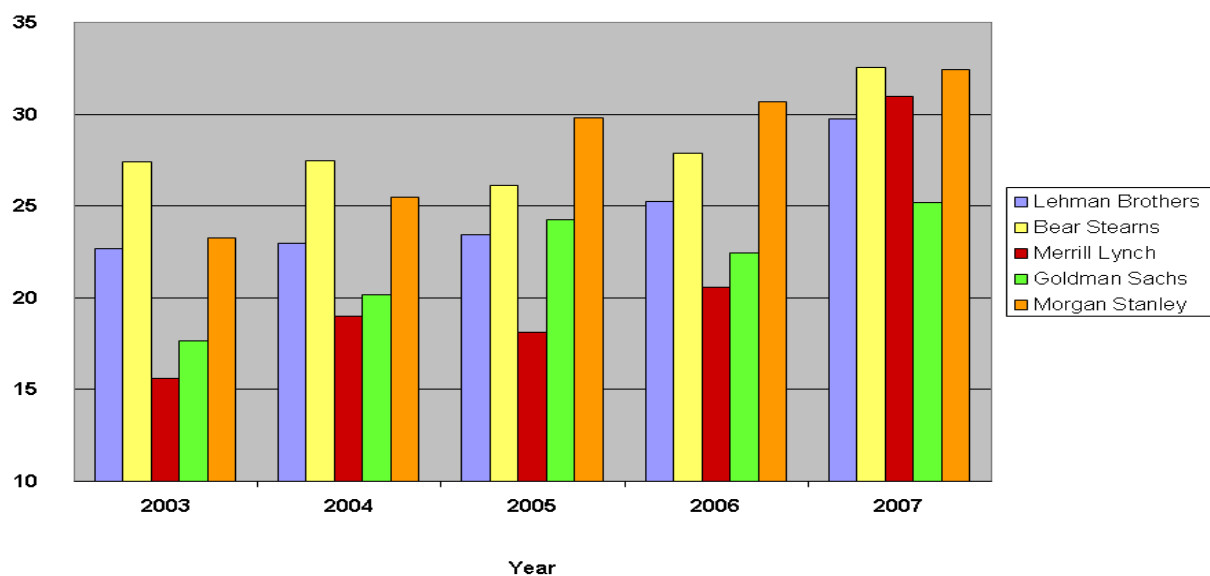
Securitization became the major way of mortgage financing since 1990



Financial institutions took unprecedented high leverages

Leverage Ratios For Major Investment Banks

The leverage ratio is a measure of the risk taken by a firm; a higher ratio indicates more risk. It is calculated as total debt divided by stockholders equity. Each firm's ratio increased between 2003-2007.



Source Data: Company Annual Reports (SEC Form 10K)

Too-big-to-fail and financial irresponsibility

大得垮不起和无责任性金融

- Credible bankruptcy threat is the cornerstone of financial responsibility
 - Together with externalizing default risks unregulated bank mergers since the 1990s have weakened bankruptcy threat significantly
- Deregulation + liberalization created unregulated bank merger waves created dominance of few large banks
- Facing crisis the central bank has to bailout large failing banks on time as the LOLR (最终贷款人)
 - Otherwise it can trigger a melt down of the whole system (Leman Brothers)
- Top managers of super large financial institutions anticipate government bailouts
 - Given their size this expectation is self fulfilling
 - Disasters follow when they are not afraid of bankruptcy

Globalized financial irresponsibility

- In recent 20 years many countries' banking are controlled by foreign super financial institutions through unregulated merger & acquisitions
 - In many Latin American and Central-Eastern European countries most of the banks are foreign controlled
- Foreign banks have incentives to save themselves at the cost of host countries when they face facing financial crisis
 - They are much less responsible to the host country's welfare
- When banking is dominated by foreign super banks the LOLR function of this country's central bank is disabled
- When banking is dominated by foreign super banks the host country's regulation and reforms face great challenges
- The above concerns directly hinder China's financial reform

Responsibility Restoring Regulation (回复责任性的监管)

- **New regulation must restore financial discipline**
- **Responsibility restoring regulation**
 1. All the channels of externalizing default risks should be blocked by regulation or regulated institutions
 2. The size of financial institutions should be regulated that too-big-to-fail should not be a norm
 - Severe penalties for CEOs of failing TBTF institutions
 3. The operation of multinational financial institutions should be regulated to protect stability of the host countries when these institutions become too large in host countries
 4. All the above regulations should be coordinated worldwide to make them effective

Thank you!