

Financial Stability: Incentives Matter

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Introduction

Last week the IMF-World Bank meetings were held in Washington, and once again world financial leaders came together in a sincere effort to find solutions to the economic malaise plaguing many countries. Despite a myriad of reforms proposed or implemented subsequent to the financial crisis of 2008, we seem unable to escape its pull. The debate continues over whether we have done enough to assure a stable financial environment supportive of growth. What kind of incentives, fiscal conditions, central bank actions, legal frameworks, asset exposures, correlations and institutional interconnections must we address to assure that global financial markets work as they should through goods times and bad? The issues are truly global in nature.

There is a host of possible causes affecting the world's recovery and worth discussing.¹ My perspective is one of economic incentives, the important role they played leading up to the crisis and how they continue to affect events, making a fuller recovery more difficult to achieve. I will first focus on monetary policy and its longer-run effects on the economic environment within which financial firms operate. I will also offer my perspective of the effects of government guarantees on firm and market behavior, and steps that remain to be taken if, in my opinion, we are to achieve a more robust and stable growth path for world economies.

Monetary Policy Matters

We all understand the fundamental role of money as a store of value and medium of exchange. However, we have come to expect more from it. We have modified and expanded its role, captured its effects on short-term interest rates and found that it can influence the economy

¹ "The Nordic Banking Crisis from an International Perspective," speech by Stefan Ingves at the Banking, Insurance and Securities Commission of Norway Seminar on Financial Crisis, Oslo Norway, September 2002. <http://www.imf.org/external/np/speeches/2002/091102.htm>. In his speech recalling the Nordic financial crisis, Governor Ingves discusses four causes underlying the crisis: (i) bad banking management practices, (ii) lack of market discipline, (iii) inadequate banking regulation and supervision at a time of financial liberalization, and (iv) inappropriate macroeconomic policies against a background of asset price inflation and weak economic fundamentals.

broadly to stimulate or control economic activity. Central banks, by pushing interest rates below long-term equilibrium levels, have stimulated economic activity and achieved goals of higher employment. The perceived success of this tool has in the U.S. led to a broadening of the Federal Reserve's mandate to include the objective of full employment.

Monetary policy is a powerful tool, of course; but as we all know tools, when used too frequently, can harm as well as benefit an economy. Monetary policy over this past half century has contributed to economic growth, but all too often it appears also to have contributed to increased financial volatility and crisis. This should not be lost on today's policymakers.

As one measure of the accommodation of monetary policy in the U.S., during the past half century the real federal funds interest rate has been held below the average growth rate of GDP for that period more than 70 percent of the time. Coincidentally, during this period the U.S. price level has increased by more than six times. The U.S. suffered through a dramatic recession and banking crisis in the 1980s as inflation nearly overwhelmed its economy. Most recently, accommodative policies pursued just prior to the Great Recession in a effort to bring unemployment levels to below 6.5 percent saw, instead, it eventually rise to above 10 percent.

Despite this mixed record, monetary policy once again is the preferred means to attempt to stimulate economies. The world is awash in liquidity, and its effects have yet to play out fully within world markets. Stock values and long-term asset prices are increasing rapidly. The incentives around low interest rates and rising asset pricing invite portfolio shifts into longer-term assets, as returns demand that greater risks be taken.

The effects of such a monetary policy we know can be slow in coming but, if allowed to continue unchecked for an extended period, will sow the seeds of instability. History is full of examples that should not be ignored.

Concentration and Complexity: Threats to Financial Stability

On another level, we learned in the most recent financial crisis that one of the greatest threats to financial stability is the concentration and complexity of the world's largest financial institutions and the systemic risk they pose. In the midst of the 2008 financial crisis, regulators worldwide took actions needed to stabilize the system. However, their actions have left us with an even more highly concentrated, complex and interrelated financial system, which is more difficult to regulate and which poses an even greater threat to financial stability going forward.

The change in concentration over time has been quite dramatic. In 1997, the four largest U.S. bank holding companies had total assets equal to 4 percent of GDP; by 2006, that number had grown to 14 percent of GDP; and by the end of 2012, to 50 percent of GDP. For a country with both a large GDP and a large number of banks, a concentration of this magnitude is impressive, and yet, even these large numbers fail to capture the off-balance-sheet positions of these institutions.

The Wrong Incentives

This concentration of resources and risk has intensified market vulnerabilities to individual firms and has led to a steady extension of government protections to creditors of the largest banking firms. It has changed the fundamental incentive structure driving financial conglomerates' behavior and the functioning of the markets within which they operate. The more we study the implications of size, concentration and interconnectivity of firms to systemic risk, the more convinced we should be that these factors remain a threat to financial stability and sustained economic growth.

This protection of their creditors enables global firms to borrow at lower costs -- a subsidy related to size and complexity. Numerous studies have documented the existence of this subsidy and its effects on financial company behavior and financial risk. Also, while the subsidy varies depending on the state of the economy, its greatest value occurs under severe economic stress. Andrew Haldane of the Bank of England estimated that there was an annual subsidy of \$70 billion that grew 10 times to \$700 billion at the peak of the crisis in 2009.²

The ability of the largest firms to increase the financial system's risk profile has been facilitated further with the adoption of the Basel capital standards. These standards represent a global cooperative effort to set capital standards that would better account for banks' risk portfolio, thus making banking more market sensitive and more stable.

Unfortunately, to be successful such an effort requires an ability on the part of a central authority to measure and anticipate shifts in risk that is beyond any authority's capacity to do. Too often this effort systematically misallocates risk weights, encouraging investments that in hindsight hold risk unrelated to the assigned weights. The outcomes of these efforts have been disastrous for world economies because high risk or politically favored activities receive weights too low for the risks assumed.

Basel also too easily creates the opportunity to manipulate a firm's balance sheet to enable greater leverage in an attempt to increase short-term returns on equity. Many of the largest firms in the world report Basel Tier 1 risk-weighted capital ratios of 12 percent or higher. However, when all assets are counted and only tangible equity is treated as capital, the leverage

² Haldane, Andrew. "On being the right size." Speech given by Andrew G. Haldane, Institute of Economic Affairs' 22nd Annual Series, The 2012 Beesley Lectures, October 25, 2012.

ratio falls to as little as 3 or 4 percent.³ This level of capital is too low, and it leaves the largest firms vulnerable to any significant economic shock they might encounter.

Management Incentives and Outcomes

Incentives matter, and financial managers, unless they are highly disciplined, often react too quickly to the incentives placed before them. Driven importantly by the incentives and market conditions outlined above, managers booked an unprecedented degree of risks over the decade leading to the crisis in 2008. A highly accommodative monetary policy with sustained low interest rates created an almost insatiable demand for credit.

The safety net within the U.S., one of the largest markets in which financial products traded, was extended to an ever-wider array of activities and firms. These markets were deregulated and liberalized, thus providing a vast supply of new financial products to meet this demand. Almost simultaneously, capital standards worldwide were dramatically eased, inviting an unprecedented degree of leverage within the global financial system. These conditions introduced an almost overwhelming opportunity for bank directors and managers to enhance return on equity by adding risk to their balance sheets at discounted costs.

Banks globally manufactured debt securities and created complex derivatives such as CDOs and CDO² to generate trading income and fees. These managers leveraged their banks' balance sheets from levels of 15 to 1, to 30, 40 and even 50 to 1. Those in the market who should have provided the discipline against such actions had become complacent, as they felt secure under the notion that the government would bail them out as a last resort.

³ Capitalization table for G-SIBs: <http://www.fdic.gov/about/learn/board/hoenig/capitalizationratios.pdf>

And finally, compensation tied to short-term returns not only perpetuated but also exaggerated the advantages of leverage for managers to the detriment of these institutions when problems became apparent. With little market oversight and too little board and management self-discipline, the financial industry self-destructed. We continue to experience the effects today.

These incentives, therefore, contributed in no small way to the Great Recession. More importantly, today, for all the laws and regulations that have followed the recession, many of these incentives remain in place.

Changing The Incentives

To begin to address these issues, we should change the incentives and not just add regulations in the expectation that this alone can control outcomes.

There is pressure building to change the course of monetary policy. World central banks, it appears, recognize that tapering down the current level of monetary accommodation might be in order. I would agree with this view. It would be advantageous to do so in such a way as to avoid the excesses that so often follow an extended period of highly accommodative policy. While we would all agree this has to be done with care to avoid an overly harsh market reaction, it should be done soon to avoid creating a too fragile economy dependent on an unrealistic interest policy of zero.

In addition, so long as the largest banks receive a government guarantee, explicit or implied, they should be limited in the kinds of activities they are allowed to conduct within that guarantee. Authorities around the world are beginning to address this issue in the form of the

Volcker Rule in the U.S., the Vickers' Ring Fencing in the U.K. and the Liikanen proposal for Europe. I would propose going further and separating fully the safety net's coverage for high-risk activities. Trading and other broker-dealer activities should be conducted in completely separate corporate entities.

And finally, the Basel capital standards should be revamped and prioritized using a tangible leverage ratio as the principle measure of capital across banks, across countries. The risk-weighted standards could be a secondary standard to judge bank concentrations of risk within the overall balance sheet.

These steps would do much to change the incentives driving management's actions. They would place markets at greater risk of loss, forcing them to play a more direct role disciplining excessive risk taking.

Management and markets respond to the incentives placed before them. Change the incentive, you will change the outcome.

Conclusion

There is no single solution to prosperity, and there are more policy areas to address than what I have outlined here today. Obviously fiscal policy plays no small role in determining an economy's stability and strength. The overall regulatory structure within which global firms operate is of significant importance in defining boundaries of their behavior and assuring

accountability. Still, incentives matter and how we define the role of monetary policy in setting the overall credit conditions within an economy will have an enormous effect on economic performance.

How we choose to subsidize and protect our largest financial companies will define their long-run impact on economic events within our economies. We have taken some steps to correct past errors in these incentive systems. However, if current conditions and emerging risks are an indication, we must do more.

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The views expressed are those of the author and not necessarily those of the FDIC.