COMMENTARY

Financial Regulation after the Crisis: How Did We Get Here, and How Do We Get Out?

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In this important paper, Jerry Caprio argues that the reforms of the Basel bank regulatory framework may, in fact, have deepened the vulnerabilities that brought on the global financial crisis. He goes further: Basel cannot be reformed, and attempts to do so distract from the task at hand while financial fragilities continue to rebuild. Caprio proposes a new regulatory structure, which in its philosophy and packaging offers a fundamentally new way forward. This is a paper by an expert, but written with a passion that emphasizes the urgency of change—a change in world view as much as in regulatory design.

Stepping Out of the Cognitive Bubble

Caprio starts by asking a simple question: What should public policy expect of the banking sector? He laments that the focus continues to be on the greater availability of credit to businesses and households. This preoccupation is manifest today in the constant drumbeat of "credit crunch" and the many efforts to increase credit supply. In practice, distinguishing between a decline in credit demand and supply is hard; many analysts are concerned that pushing supply could be counterproductive.

In addition, the longer-term vision of an ever-expanding financial sector remains the dominant model in much policy thinking. For example, Mark Carney (2013), the Governor of the Bank of England, visualizes a world in which global banking "increases in line with historical norms." In that world, with the United Kingdom maintaining its global share, he says, "U.K. bank assets would exceed nine times GDP," a ratio matched recently by Cyprus and Iceland. Governor Carney sees the task of financial regulators as that of making banks more resilient and crisis-proof rather than questioning the model of financial growth on steroids.

Author's note: *I am grateful to Michael Bordo for our ongoing discussions on these themes and particularly for his permission to let me draw on his ideas on the politics of learning.*

The global financial crisis was the product of a cognitive bubble. It visualized an ever-growing role for the financial sector. This cognitive bubble supported a financial bubble. Together, they reinforced each other. While some voices questioned the increasing share of finance in GDP, even these were mainly concerned by rapid bursts of financial growth, the "credit booms." The notion that when finance grows disproportionately large relative to the real economy, it may become impossible to tame was never seriously examined.

Caprio questions this single-minded pursuit of banking and financial growth. Regulatory reform, he says, must start from the goal of slower-growing but better-allocated credit. In his words,

> *Any solution that is effective will reduce the availability of credit from what it was in the extreme years during the run-up to the crisis, but despite the unwillingness of politicians to make that point, better-allocated credit would be a boon to societies. . . . the credit bubble in the 2000s featured unproductive investments in housing and a variety of consumer goods that left societies with high unemployment, a debt overhang, and little else, save some empty houses, the regrets of the borrowers, and the enlarged wealth of many in the financial sector. Nonetheless, bankers are protesting that the response in the pipeline will produce financial disintermediation, denying credit to many and reducing growth.*

The risk is clear. With signs of economic recovery, policymakers and bankers are recommitting to a model that almost brought the world economy to its knees.

Caprio's fire is directed at the Basel framework, which, in the new guise of Basel III, he regards as a continuation of a discredited bank regulatory system. Within Basel, the culprit remains the system of risk-weighting of assets. Caprio argues that when assets are weighted by their perceived risks, regulation is compromised on two counts. First, bankers and regulators are drawn into a game of allocating assets to risk categories, a game that bankers typically win. Second, more seriously, the procedure creates systemic risk. Banks invest disproportionately in asset classes designated to be low risk. But assets do not stay as low risk. They may have been misclassified in the first place, if their credit ratings are too optimistic. Or the economic and financial conditions may change: In that case, because several banks have invested in these assets, they suddenly become exposed to correlated risks.

Instead of stepping back from the mindless complexity and hazards of risk weights, the Basel process has determined that the complexity was insufficient.

The reaction, therefore, has been to double the bets. Basel evidently could not prevent the crisis; it must, therefore, be reinforced with greater complexity and intrusiveness.

Caprio's call is for stepping out of the cognitive bubble and starting afresh.

The "Bali" Framework

To mark a radical departure, Caprio proposes that a new group constitute itself as the "Bali Committee," rather than the Basel Committee. The framework he proposes for their consideration attempts to balance the need for simplicity with the hydra-headed nature of finance. Thus, while he favors simpler rules, he is sensitive to the concern that bankers will quickly find ways to subvert the rules. Identifying the sweet spot where the rules are simple but not simplistic is the perennial challenge.

Caprio's proposal has four elements: more equity capital relative to unweighted assets; contingent convertible debt; some hard-wired ratios; and a sentinel, who provides informed commentary to limit the risk of new cognitive bubbles.

The case for a higher equity-to-unweighted assets ratio has been generally accepted. It is a case most forcefully made by Anat Admati and Martin Hellwig (2013). They ask for ratios much higher than currently visualized, perhaps, as high as 25 percent. They are not impressed by the claim that Basel has made progress in this direction; their assessment is that Basel would allow as much as 97 percent of assets to be financed by borrowing. Caprio is clearly sympathetic to this way of thinking, although he does not propose specific equity benchmarks.

The second element of Caprio's proposal is greater use of convertible debt: debt that would automatically convert into equity when the equity ratio risked falling below the desired level. These so-called CoCos have been more controversial. Some, such as Admati and Hellwig, are concerned that convertible debt instruments will remain prone to the destabilizing character of debt—the event of a conversion could create panic in financial markets. But this is really a matter of design, which needs to ensure that the conversion is smooth, incremental, and automatic.

Caprio refers his reader to a paper by Calomiris and Herring (2013) as having proposed a credible design for CoCos. Indeed, that paper offers an elegant trigger for conversion. It proposes that the conversion occur when the 90-day moving average of the ratio of the bank's market equity value to the sum of its market equity value and face value of debt falls below 4 percent. The moving average disregards temporary market moves, and the buffer of 4 percent implies that the conversion does not wait until the problems have become stark and unmanageable.

With proper design, CoCos offer the prospect of not just adding equity at critical moments. They potentially improve banks' incentives for prudent action. Calomiris and Herring (2013), as well as Kashyap, Rajan, and Stein (2008), are concerned that excessive equity will allow the banks' management to take imprudent risks. In contrast, bondholders are more vigilant. Thus, CoCos can provide the monitoring associated with bondholders but, by creating a smooth conversion to equity, they can minimize the inevitable drama associated with discontinuities of debt restructuring and default.

In this regard, drawing on Goodhart (2010), Caprio makes an important observation about the philosophy of regulation. Regulatory design should avoid on-off solutions inherent in benchmarks and thresholds: The regulated banks have an incentive to work around such boundaries. For this reason, Caprio is disinclined to set limits on executive compensation. Rather, he suggests that the compensation formulas be made public so that the stakeholders are aware of the incentives driving bank management. Nevertheless, Caprio seems torn on this theme. He concedes that there may be a need for a third element in regulatory design—in addition to more equity and CoCos—banks will probably need some hard limits, such as loan-to-value ratios on home lending.

The fourth and final element of Caprio's proposal is the creation of a sentinel. With his long-time coauthors, James Barth and Ross Levine, Caprio is in search of the best way of making regulators more accountable. Even when regulators are not corrupted, they can be sucked into outdated assessment criteria and procedures. A sentinel could provide commentary on a regulator's decisions and thereby force the regulator to be more publicly accountable. Pointing to the failures of Irish regulation and supervision in the years before the crisis, Caprio wonders if the presence of a sentinel may have prevented the regulatory complicity in fostering egregious lending behavior.

The concept of a sentinel is attractive and deserves serious consideration. But it should be adopted with the knowledge that the sentinel may itself be sucked into the cognitive bubble. In the Irish case, the closest process similar to that of a sentinel was the International Monetary Fund's Financial Sector Assessment Program (FSAP), administered in Ireland in 2006. The FSAP's verdict was that the Irish banking sector was in good health, a judgment that has added to the list of failures of international economic and financial surveillance. The staff of the FSAP team is comprised of international experts and clearly has no skin in the game. Yet, prevailing norms do influence even the experts.

In concluding his paper, Caprio recognizes that regulatory processes have much inertia and, despite the evident need for change, the response is slow—and even injurious. He recognizes that politics often trumps good sense. But he does not delve into the political dynamics of Basel. This intractable issue deserves more attention, not least for the success of Caprio's sentinel, who risks being captured by the same political forces that have stymied regulatory progress. The rest of my comment is devoted to sketching a taxonomy of the politics of institutional learning.

The Politics of Institutional Learning

It is conventional wisdom that a crisis triggers reforms. The vested interests lose their grip and those that were disadvantaged by the earlier system gain new voice to promote change. These plausible dynamics, unfortunately, do not always materialize. Jared Diamond (2011) documents how societies often choose to fail. On a less sweeping scale, in Abiad and Mody (2005), we find that while balance-of-payments crises do generally create a constituency for reform, the more complex banking crises evoke a weaker response.

Successful reform requires, as Diamond (2011) highlights, a shift in group decisionmaking, which in turn appears to require many ingredients. In the midst of the Great Depression, President Franklin Roosevelt was able to push through the New Deal, which fundamentally changed the social contract in the United States. A crisis was met by leadership but was also made possible by a favorable political configuration: Roosevelt had the two houses of Congress behind him. Together, they were able to exploit the critical juncture.

The willingness to learn must also be present. Diamond (p. 439) refers to the contrast in handling the two crises between Cuba and the United States. The Bay of Pigs invasion in 1961 is widely regarded as a disastrous decision. The groupthink that led to the decision was marked by a "premature sense of ostensible unanimity" and President John Kennedy's discouragement of disagreement. That disaster did induce learning. The Cuban missile crisis about 18 months later evoked the opposite response. On this occasion, President Kennedy encouraged dissent and contrary views among his advisors.

Learning in politically autonomous institutions does occur provided a technocracy is in place. But the risk is that such learning can be backward-looking, solving the previous crisis even as new challenges unfold. Because the response focuses on the parameters of the previous crisis, such learning may be characterized as "least-squares" learning. Rotemberg (2013) describes the evolution of the Federal Reserve in those terms. Some may argue that the IMF is also capable of such technocratic, least-squares learning; others remain concerned that the IMF's ability to learn is constrained by political influence (Thacker 1999 and Barro and Lee 2005).

Complexity, groupthink, and politics act most adversely in coordinating a large number of actors, each with some veto power. The Basel process comes closest to meeting these criteria. The past compromises to achieve the Basel consensus have made it a clumsy system in which different parts resulting from delicately negotiated agreements don't fit together well. With veto authority held by many, forward movement becomes difficult. This leads to a form of "Groundhog Day" learning, with glacial progress. As Caprio remarks, "following one of the most wrenching financial crises in history, the approach to financial regulation is essentially more of the same." In his discussion of the Caprio paper, Takeo Hoshi points out that the system of risk-weights is also being adopted for the new liquidity regulations. The conundrums in assigning such weights have not been a deterrent.

It is, therefore, remarkable that despite these constraints, Switzerland has made progress in its regulatory approach. While still working off Basel, the Swiss authorities have moved more rapidly with demands for larger equity buffers and CoCos. The equivalent of a sentinel does not quite exist, but the Swiss National Bank adds its macroprudential voice to the deliberations of the financial regulator, the Financial Market Supervisory Authority. The risks to Switzerland arising from the fragility of its big banks have focused all the minds. The private sector can normally be expected to push back on reforms—and there is much evidence worldwide of efforts to roll back even the reforms that have been put into place—but the Swiss lesson is that private actors do eventually learn to live with new structures. The policy task is to demonstrate the feasibility of a new approach and change the incentives to make that approach operational.

Conclusion

With his alternative framework, Caprio has called on regulators to change course or risk facing another humbling and costly crisis. It is a thoughtful alternative that challenges the core philosophy of the current regulatory system. Under his proposed system, the financial safeguards required by banks would be large enough to rein them in, and the balance would shift from rules to higher quality information. In setting out his regulatory vision, Caprio is aware that the politics will push back. But perhaps there is a way forward. Rather than attempting adoption of a new framework in one fell swoop (even if the Bali location helps a meeting of the minds), a few more examples of pragmatic advance, such as the Swiss initiative, will act to diminish the inertia of groupthink.

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