How should the crisis affect our views about Financial Intermediation?

[Notes by **Andrew Crockett** on issues raised in the background note for the discussion on March 7. Andrew Crockett is Special Advisor to the Chairman, JPMorgan Chase and Co, but the views expressed here are in his personal capacity.]

I. Whose fault?

* The financial sector is prone to procyclicality (instability), which can be exacerbated or offset by government action.

* Factors that distort incentives and can give rise to instability are:

 - Leverage (encouraged by tax treatment of debt vs equity; applies to both households and banks)
 - Limited liability (applies to all sectors, but greater for financial sector)
 - Creditor and depositor protection (undermines monitoring incentives, raises moral hazard)
 - Principal/agent problems.
 - Government action may promote certain types of risky lending (eg to low income borrowers).

* Inadequate/inappropriate regulation to limit/offset instability bias and/or mispriced risk taking.

 - Regulatory capital insufficiently loss-absorbing
 - Capital ratios too low and risk weights inappropriate
 - No liquidity oversight
 - Regulation okay but supervision lacking
 - Inadequate oversight of shadow banks and other financial sector participants (eg, mortgage originators, rating agencies, money market funds)

(Note: Basel III addresses capital issues well; liquidity proposals are problematic; not clear how supervision will improve; and shadow banking remains a risk)

II. The social value of the financial sector?

* In aftermath of crisis, increased focus on costs of financial instability, relative to positive contributions of financial sector. Public focuses on negative, “casino banking”, “rent-seekers” etc. Positive contribution of intermediaries (“middlemen”) harder to grasp for non-economists.

* Financial sector adds value by:

- providing payment system, without which exchange economy not possible (note, some observers erroneously suggest this is the *only* significant source of positive externalities).
- permitting maturity transformation (the positive side of leverage).
- channeling resources from savers to productive investment opportunities
- providing information that maximizes the efficiency of resource allocation (finance rife with asymmetric information, which intermediaries can help ameliorate).
- permitting the hedging of real and financial risk.

* A well-functioning financial sector enhances the efficiency of static and dynamic resource allocation and permits the achievement of a higher (perhaps much higher) rate of investment and economic growth.

III. How active should regulation and supervision be?

* First objective of financial sector regulation should be to remove distortions and correctly align incentives for risk-taking. End excessive leverage, too big to fail; make deposit insurance risk-based.

* Not all distortions can be removed (eg, deposit insurance) Even if they could be, there would still be a case for regulation. As far as possible, this should be consistent with market-friendly incentives:
- capital requirements that induce appropriate risk-pricing, protect taxpayer.
- liquidity requirements that promote sustainable funding models.
- supervision that looks behind quantitative requirements to assess sustainability of business strategies.

* Risks of overzealous regulation (eg too high capital requirements)
- raise costs of financial intermediation for end-users (perhaps only a second-order consequence)
- diverts attention from role of supervision (capital not the only protection against risk)
- diverts intermediation into less-regulated channels
- may squeeze out certain socially beneficial intermediation

* Consumer protection. Key issue is how much to rely on transparency and competition, and how far to intervene to "protect consumers from themselves". This will be seen differently at different points in the cycle.

IV How to design financial institutions?

* In general, institutional structure in a market economy should be market driven. Exceptions may sometimes be justified (eg to prevent monopoly) but need to be justified by existence/threat of market failure.

* Governance reforms may be needed to mitigate principal/agent problems.

* Taxes should be justified by need to correct/offset externalities, not out of a desire to punish certain sectors. Note also that taxes on intermediary will usually fall on users, not providers of intermediary services.

* Taxes on financial transactions are often justified by the feeling that certain activities are "low value" or "unnecessary". Important to justify taxes on grounds of externalities.

V How to mitigate the effects of crises?

* Resolution authority for financial firms is key. There are well-known difficulties, but they should not be insuperable. Key requirements:
 - Losses fall on creditors and counterparties
 - Liquidity provision so that positions can be unwound gradually, and counterparties can access residual funds immediately.
 - Ability to segregate different parts of conglomerate group.
 - Ability to wind up failing firm before value reaches zero.

* Debt-equity conversion attractive in principle. To make market friendly, work is needed on triggers.

* Crisis insurance problematic. Definitional and trigger problems in insurance contracts.

* Note the problem of resolving individual firms is likely to be very different if a single firm is in trouble, than if there is a systemic crisis.

VI How limited is our understanding?

* Limited understanding opens scope for more research

* One problem is that negative externalities are more observable than positive ones. So the conclusion is to do more to prevent crisis, and worry less about negative effects on efficiency of intermediation.

* Poor understanding of "unintended consequences". These are sometimes regarded by regulators as a smokescreen by banks to resist reforms. But some of them are real concerns. Eg, current liquidity rules may have major implications for efficiency of interbank market. Is this intended?