Re-Regulation after the GFC

“The System Worked” after the GFC (Drezner)

- The Fed and other central banks stepped in to support markets

- Governments provided short-term fiscal support

(Although there was a shift to austerity in Europe, in 2010, following Rogoff & Reinhart’s work on public debt and growth)

- A (re)newed drive to regulate finance

Coordination through the G20

	Argentina	Cristina Fernández de Kirchner[20]	President
	Australia	Kevin Rudd[20]	Prime Minister
	Brazil	Luiz Inácio Lula da Silva[20]	President
	Canada	Stephen Harper[20]	Prime Minister
	China	Hu Jintao[20]	President
	France	Nicolas Sarkozy[20]	President
	Germany	Angela Merkel[20]	Chancellor
	India	Manmohan Singh[20]	Prime Minister
	Indonesia	Susilo Bambang Yudhoyono[20]	President
	Italy	Silvio Berlusconi[20]	Prime Minister
	Japan	Tarō Asō[20]	Prime Minister
	Mexico	Felipe Calderón[20]	President
	Russia	Dmitry Medvedev[20]	President
	Saudi Arabia	Abdullah bin Abdul Aziz[20]	King
	South Africa	Kgalema Motlanthe[20]	President
	South Korea	Lee Myung-bak[20]	President
	Turkey	Recep Tayyip Erdoğan[20]	Prime Minister
	United Kingdom	Gordon Brown[20]	Prime Minister
	United States	**George W. Bush**[20]	**President**
	European Union (European Commission)	Jose Manuel Barroso[20]	President

President Bush and the other summit leaders at a working dinner in the East Wing of the White House.

Source: https://en.wikipedia.org/wiki/2008_G20_Washington_summit

… and worked… through Covid

- After massive financial market instability in March 2020
- The authorities stepped in… massively
- Monetary & fiscal support have been substantial
- But – significantly – the Trump administration did not coordinate policies.
- In Europe (and UK) – an effort not to repeat mistakes of moving to austerity too quickly. Support for keeping workers in their jobs (Germany pursued this policy after the GFC)

G20 and Basel III

- Apart from dealing immediately with the GFC, G20 initiated principles of re-regulation, including:

- Higher reserve ratios and liquidity requirements:
  - Stronger Common Equity Tier 1 (CET1) capital (mainly common stock (i.e. shares): *CET1/RWA ≥ 4.5%* l ratios of risk-weighted assets.
  - Plus “capital conservation buffer”: mandatory 2.5% RWA
  - And “discretionary counter-cyclical buffer” (national regulators may require) 2.5%
  - Additional Tier 1 (AT1) Capital Requirement (Basel III+/IV): 1.5% RWA

  Therefore total Tier 1 capital requirement is: **CET1+AT1=4.5%+1.5%=6%**

  In practice (according to GPT-4, 17 October 2023) US banks today have Tier 1 capital ratios of between 12% and 16% or higher, and in the UK 13% to 17%+

Bank balance sheets

Traditional commercial bank

Assets	Liabilities
Reserves	Deposits
Short-term loans	Short-term debt
Long-term loans	Long-term debt
Other instruments	
	Shareholder equity

Large (multifunctional/universal) bank

Assets	Liabilities
Cash	Deposits
Loans	Other debt (mostly short-term)
Trading and other assets	Long-term debt
	Equity

Source: Anat Admati & Martin Helwig, *The Bankers' New Clothes*, Princeton University Press, 2013.

Risk-weighted assets

- **Banks have assets**, including central bank reserves, cash holdings, securities and loans. The riskiness of these loans varies, depending on collateral.
- Government bonds > mortgage backed securities > unsecured loans (like consumer credit)
- These are weighted to give an idea of banks' overall asset risks, and hence their capital requitements. See https://www.investopedia.com/terms/r/riskweightedassets.asp

- Liabilities: check (cheque) and deposit accounts, borrowings, bank capital (net worth, funds from selling equity, retained earnings)

Liquidity

- Leverage ratio *CET1/Total exposure ≥ 3%* (total exposure all consolidated assets, including non-balance sheet assets

- Liquidity coverage ratio (LCR):

$$LCR = \frac{\text{High quality liquid assets}}{\text{Total net liquidity outflows over 30 days}} \geq 100\%$$

New regulatory structures

- Monitoring of 30 Globally-systemically important banks (G-SIBs)…

  … by the Financial Stability Board (FSB), the Basel Committee on Banking (BCBS) and national authorities.

  Involving stress-testing

- Macro-prudential regulation of finance

Other post- GFC measures

- Bank resolution procedures ("living wills") have been established, to bail-in private investors.
- Standardised derivatives are now traded on exchanges (central counter-parties).
- Stronger consumer protection for households.

London Clearing House

Potential weaknesses of post-GFC regime

- Much new regulation
- Little or no structural change in banking and finance
- Too-big-to-fail has become an even bigger problem
- Shadow banking activities – probably not regulated enough
- The essential nature of global finance seems unchanged

Takeouts

- Significant regulation after GFC – through international cooperation
- No structural reform
- Resilient to Covid-19 shock & to the rise in interest rates since late 2021 – so far
- Macro-indicators (monetary policy and fiscal policy) are stretched –
  is this a "fuite en avant"?