CARRRESEARCH

WHEN THE SLEEP OF REGULATION PRODUCES MONSTERS

Matthias Thiemann explains how shadow banking benefits from the structural separation of global and national financial regulators.

In the summer of 2007, structured products migrated into the banking system ripping huge holes in the balance sheets of major financial institutions. These products were swiftly renamed toxic assets for their sudden devastating effects on ostensibly healthy institutions.

Structured products are created through the process of securitization which is supposed to transfer risk out of the banking sector. It turns out that securitization was actually concentrating risky assets in side-pockets called special purpose entities (SPEs) which lie just outside the boundaries of banking conglomerates. Indeed, if the banks seemed to be in good shape, it was because these SPEs were hiding the troubles. During the run-up to the financial crisis, bank managers were sequestering structured products off-balance sheet so they would not have to account for them in risk provisioning. The creative use of SPEs is a form of regulatory arbitrage. It exploits the fact that regulation can never anticipate all the possible ways of designing legal constructs to circumvent prudential regulation, the safety requirements for banking.

The banking sector is arguably subject to the heaviest oversight in the world. Nonetheless, that summer, the sharp influx of structured products from the shadow banking sector surprised even regulators. Retrospectively, we do find warning signs that risk was building up in SPEs. In 1999, the first working paper of the Basel Committee on Banking Supervision noted the degree of regulatory arbitrage surrounding the Basel Accord of 1988 (Jackson et al. 1999).

The bank-based shadow banking system is a response to a specific tool of regulatory control called core capital requirements, invented in the late 1970s. Regulators had wanted to force banks to reduce their leverage and their capacity to earn money from people's savings. Under core capital requirements banks must own a certain percentage of the money they invest, thereby reducing the maximum amount of borrowed money they can use for their businesses (Admati and Hellwig 2013).

It is no coincidence that structured investment vehicles were developed in 1988, in the very same year the Basel Accord instituted core capital requirements as a central pillar of global banking regulation (Ehrlich et al 2009). By placing assets outside the balance sheet of banks and into structured investment vehicles, banks were able to evade core capital requirements for these assets. Instead, they could use almost 100 per cent of the money they had borrowed thereby increasing their leverage.

To understand the phenomenon of bank-based shadow banking, it is important that we recognize the degree to which regulations like core capital requirements structure the products banks end up offering investors. Regulatory costs are so important in product design that the failure to achieve a certain regulatory status can kill a potential offering. That's why there's an entire industry of smart, well paid engineers inside the big international law firms, auditing firms and banks that exists for the sole purpose of working out regulatory arbitrage opportunities. Not only are these professionals well resourced, often much more so than regulators, they also generate the revenue to pay for the service they provide whenever they come up with successful strategies for evading regulatory costs.

Regulatory arbitrage poses the acute question of how to control risk-taking in the banking sector when the industry for avoiding regulatory control is self-feeding – it pays for itself. This suggests that the 'sleep of reason may produce monsters'. In other words, increased regulation is not necessarily the answer to wresting control of the shadow banking sector. The clear incentive to avoid regulation also suggests that it is not enough to blame the ideology of self-regulation (the consistent demand to not regulate on the grounds that market participants can protect themselves), for letting shadow banking go unchecked.

Under Basel III, banks stand to gain more by avoiding now heavier requirements.

My research investigates the institutional fractures which permitted the shadow banking sector to flourish before the crisis. One important structural fault line – the need for countries to compete through regulation – helps explain why there was a lack of attention to the bank-based shadow banking system before the crisis. In setting international standards for bank safety regulation, including the core capital requirements, the Basel Accord opened up a "global" market for banking services across all countries that are deemed to be in compliance with those standards.

The basis of competition between banks from different countries, however, is heavily structured by differences in regulatory costs. This means that when the Basel Accords set a global minimum, national regulators resist imposing heavier regulations to protect the competitiveness of their banks. What is more, for the sake of maintaining their competitive position, national regulators have been inclined to turn a blind eye to activities designed to circumvent the global accord in this newly created market place.

A second, more subtle reason that shadow banking was overlooked is the cognitive capture of the regulators by the regulated. Regulators observe risk in this sector through the same tools as bankers. The institutional foundation of this cognitive capture is that banking regulators do not sufficiently monitor the acts of creative compliance in which bankers engage. In order to enforce regulation, regulators often depend on measurements and social constructions provided by the banks themselves.

Regulatory arbitrage consists in constructing a legal format that is identical in economic substance to another transaction, but avoids regulatory costs. These legal formats are often constructed so they will not appear in the data given to banking regulators. So for example, since Basel I, banking regulators have imposed their core capital charges on the basis of the consolidated accounts of banking conglomerates. But since regulators do not monitor the debates between auditors and the banks over which entities should or should not be consolidated as part of the banking conglomerate, by the time they get the data to begin their work, most of the SPEs had already disappeared from the balance sheets. This is successful regulatory arbitrage.

The two conditions I've discussed – protecting global competition and cognitive capture – were somewhat indistinguishable at the ground level. When confronted with an otherwise uncertain future, the one thing national regulators knew was that domestic banks would face negative consequences if they re-imposed regulatory costs on innovative and untested structures. The tension between global and national regulation only bolstered regulators' well known weariness to enacting precautionary measures that would apply only locally to limit the expansion of financial innovation.

The institutional fractures I have documented here continue to exist. The current system diminishes national regulators' incentives to act before a global response has been formulated, even though they will bear the damages of the collective delay. There is a deep structural bias for regulators to be lenient, despite their keen awareness that we must curtail regulatory arbitrage. What is worse, by raising core capital requirements, Basel III has made the rewards for regulatory arbitrage even more attractive since banks now stand to gain more by avoiding the requirements.

The institutional lessons I've drawn out are an attempt to move beyond stale ideological arguments about the place of regulation in finance. Asking whether we should or should not regulate financial innovation is the wrong question. What matters is to understand the effect of particular regulatory choices within the reality of institutional configurations. Regulators working in a global system need to find quicker ways to react. They also need to find ways of making unilateral regulatory action less economically punitive to the country that deems it necessary to enact them.

Finally, the agents who engage in regulatory arbitrage need to be included in a system of information exchange so that regulators can detect attempts to circumvent regulation. On this point, it is discouraging that regulators merely use rather than participate in negotiating the financial statements of the banks they regulate.

Reference

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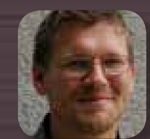

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