Failure of Banking Regulation or Private Debt Build-up?

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Towards a Safer World of Banking: Bank Regulation after the Subprime Crisis by T T Ram Mohan, *New York: Business Expert Press, 2017; pp xvi + 166, $34.95.*

T T Ram Mohan is a financial economist trained in neoclassical finance and his book is an account of what has happened within the realm of bank regulation after the onset of the ongoing Global Financial Crisis (GFC) in 2007.

Not only is Ram Mohan a professor of finance and economics at the Indian Institute of Management, Ahmedabad, but has also served on several committees of the Reserve Bank of India and been a member of the Primary Market Advisory Committee of the Securities and Exchange Board of India. Hence, he is one of the best qualified finance scholars to share his knowledge and experience with general readers in India and beyond. As he points out, his book was aimed not only at students of business management, economics, and at bank executives, but it would also interest general readers "who are curious to know what the subprime crisis was all about."

Ram Mohan also mentions that he contends that while several factors can be blamed for the financial crisis of 2007, a failure of regulation was the most important one. This has been the point of view of neoclassical economics and finance since the onset of the GFC in 2007 and I contend that Ram Mohan's book is an excellent exposition of this point of view. Furthermore, that he was able to make it in less than 180 pages is a major accomplishment.

Apart from the concise foreword section, the book consists of five chapters. Although Mohan does not partition the book, I classify these chapters into three parts: Part 1 consists of Chapters 1 and 2; Chapters 3 and 4 comprise Part 2 and Chapter 5 is Part 3.

Too Big to Fail

I take an unusual route and start with Part 2, that is, Chapters 3 and 4, and leave my discussion of Part 1 to the end.

Chapter 3 discusses proposals put forward after the onset of GFC in 2007 in order to prevent the recurrence of financial crises.

One criticism of this chapter could be that it is about the proposals put forward in the advanced economies such as the United States (US), United Kingdom (UK) and European Union (EU), as well as by the Basel Committee under the auspices of the Bank for International Settlements (BIS) dominated by the advanced economy countries. However, I admit that emerging and developing economy countries have not put forward any significant proposal that is worth mentioning since 2007, so Mohan could not have done any better.

In this chapter, Ram Mohan discusses the concept of "too big to fail" banks (which he introduces in Chapter 1 for the first time) although he does not give even a brief historical account of the

failure of Continental Illinois National Bank and Trust Company in 1984 (when bank regulations in the US were way tighter than they were in 2007) and its subsequent rescue that gave rise to the concept "too big to fail." Had he done that, he might have reached a different conclusion in Part 1, I discuss this subsequently. After all, economic depressions and financial crises—almost all of which have been debt-driven irrespective of the regulatory environment—have been regular and repeating phenomena since the Neolithic Revolution of about 12,000 years ago with which a transition of human cultures from hunting and gathering to agriculture and settlement occurred.

Chapter 4 looks at possible ways of dealing with the "too big to fail" problem.

This chapter is a neoclassical assessment of the "too big to fail" problem ranging from incentives for banks to grow bigger such as ability to take bigger risks and economies of scale, to lack of incentives for depositors to monitors banks, to motivation of "managerial empire-building," and the like. In the neoclassical assessment, there are no social classes, there is no class struggle, no finance capital, no imperialism, no unequal development, no politics, and the like. Put differently, whatever happens in this world happens because of our choices and incentives, the problem is an agency problem in the sense that there are principals and agents, both parties are trying to cheat each other, and, because of information asymmetry, there is "adverse selection," "moral hazard" and so forth. Not that I have anything against the agency problem formulation, as it is the usual "master and slave" problem (or "lordship and bondage" problem) which occurs in any society where there are masters and slaves (Hegel 2016), but deregulation of financial activities, including banking, did not fall from the sky and was eagerly sought by finance capital in many countries since the late 1970s. Indeed, financial deregulation has always been an outcome of a class war waged by finance capital during the imperialist phases of capitalism (see, for example, Öncü 2016a) and hence it is endogenous to the system, a historical fact the neoclassical assessment fails to acknowledge.

The chapter concludes with the following in which TBTF stands for "too big to fail":

> Various reforms have been proposed for the TBTF problem. One, an increase in capital requirements that is intended to disincentivise banks from growing too big. Two, limits on scope of banks. Three, limits on the absolute size of banks. Four, living wills that will ensure orderly resolution of large banks in a crisis.
> The first two have been implemented in some advanced economies. The third has thus far remained in the area of discourse. The fourth is still work in progress. *We lack the confidence today that we have cracked the TBTF problem*. [emphasis mine] (p 124)

I cannot agree more. Finance capital never surrenders. It always fights back until its natural death resulting from a major financial collapse, which has not occurred yet. And, at some point in the next cycle, finance capital "reincarnates."

Out-of-the-box Proposals

Next, I look at Part 3, that is, Chapter 5.

Chapter 5 discusses out-of-the-box proposals to attack the instability problem caused by the financial sector.

In this concluding chapter, Mohan discusses some out-of-the-box proposals, namely, those made by Mian and Sufi (2014), Turner (2016), and King (2016), to deal with the financial instability originating from the financial system, and puts forward his own view that "taking a leaf out of the Indian banking model, perhaps some government ownership in the banking sector could conduce stability in banking."

This is a radical conclusion in the sense that all of the proposals discussed in the chapter, including Ram Mohan's own, are against the zeitgeist. But, possibly because all of these economists, including Ram Mohan, are neoclassical economists, what I see from the chapter and from my own readings is that they are not able to take their proposals to their logical conclusion. I leave the proposals of Turner (2016) and King (2016) aside, and look at the proposals of Mian and Sufi (2014) and Ram Mohan.

As Ram Mohan details in Chapters 1, 2 and 5, Mian and Sufi (2014) argue that the main problem with this financial crisis is the build-up of private debt (mainly household debt), and the way to contain the adverse effect of this private debt build-up on the economy would have been for lenders to forgive some of the debts owed by borrowers. They then propose "shared-responsibility mortgages" as a way of preventing financial crises. And this is what I mean when I say neoclassical economists are not able to take their proposals to their logical conclusion. Why not a "Partial Jubilee" as I proposed in Öncü (2017) or a "Full Jubilee" as I proposed in Öncü (2016b)?

As for Ram Mohan's own proposal that "taking a leaf out of the Indian banking model, perhaps some government ownership in the banking sector could conduce stability in banking," I am disappointed. Why not full nationalisation of the entire banking system and perhaps the entire financial system? Has not Ram Mohan himself talked about economies of scale in Chapter 4? Is not credit or, equivalently, money a quasi-public good in the sense that it is *excludable* but *non-rival* (to the extent of the constraint imposed by the capital adequacy requirement) in the sense of neoclassical economics,[1] and, because of high fixed costs and low (near zero) marginal costs, the banking sector a *natural monopoly* (Baumol 1977)? In such a natural monopoly of a quasi-public good, is not a full public solution the best according to the neoclassical theory in which Ram Mohan was trained?

Private Debt Build-up

To discuss Part 1, let me deviate from the book for a while and start with reminding ourselves what is meant by a ratio. And capital adequacy ratio is one such ratio.

Ratio = Numerator/Denominator

There are three ways to increase any ratio:

(i) Increase the numerator;
(ii) Decrease the denominator;
(iii) Do both.

And both have been done as far as capital adequacy-based banking regulations are concerned.

To see this, let us look at two changes that occurred after the 1978–80

Deng–Volcker–Reagan–Thatcher Revolution (see, for example, Öncü 2016a). A long list of other important banking and financial deregulations can be found in Sherman (2009), Acharya et al (2010), and elsewhere.

First of the changes came in 1981 in the US when the US central bank, the Federal Reserve (Fed), and the Office of the Comptroller of the Currency (OCC) introduced numerical capital guidelines for the banks. They defined three types of capital: (i) primary capital, which consists of common stock, perpetual preferred stock, capital surplus, undivided profits, reserves for contingencies and other capital reserves, mandatory convertible instruments, and an allowance for possible loan losses; (ii) secondary capital, which consists of limited-life preferred stock and qualifying subordinated notes and debentures of the bank subsidiaries, and (iii) total capital, which is the sum of primary capital and secondary capital. After a few revisions by the Fed and OCC, the Federal Deposit Insurance Corporation (FDIC) joined the flock and, in March 1985, adopted the same capital adequacy standards.

However, although these ever changing (see, for example, Alfriend 1988) guidelines were intended to improve the capital positions of banks, they also paved the way for banks and other financial institutions to manipulate the numerators of their capital adequacy ratios upwards as many items included in the primary and secondary capital were discretionary, or better said, fictitious. The primary capital and secondary capital are called Tier I capital and Tier II capital these days, respectively, not to mention that they no longer look like how they were defined initially.

Although its origins go back to 1952 (Alfriend 1988), second of the changes came in 1986 also in the US when the Fed proposed risk-based capital adequacy guidelines. These guidelines were about the denominator of the capital adequacy ratio. Alfriend (1988) summarises the Fed proposal as follows:

> Under the Fed proposal, assets and certain off-balance sheet items were assigned to one of four broad risk categories and weighted by their relative riskiness. The sum of the weighted asset values served as the risk asset total against which primary capital was to be compared. The resulting ratio was to be used together with the existing primary and total capital-to-total asset ratios in determining capital adequacy.

When you risk-weight the assets, you pave the way for banks and other financial institutions to manipulate the denominators of their capital adequacy ratios downwards.[2] And, when you pave way for banks and other financial institutions to manipulate the numerators of their capital adequacy ratios upwards and the denominators of their capital adequacy ratios downwards, you pave the way for them to manipulate their capital adequacy ratios upward. Despite some modifications, these US guidelines were internationalised by the BIS, Basel Committee of Banking Supervision through the Basel Accord of 1988—also known as Basel I—which became law in the Group of 10 countries in 1992 and adopted by another about 100 countries later, at least, in name.[3]

The rest is history, so to speak, and on 7 December 2017—after about 10 years since the onset of the ongoing financial crisis—Basel III was "finally" finalised. During its announcement, the European Central Bank Governor Mario Draghi, who heads the Group of Central Bank Governors and Heads of Supervision (GHOS), said the following:

> Today's endorsement of the Basel III reforms represents a major milestone that will make the capital framework more robust and improve confidence in banking systems. The package of reforms endorsed by the GHOS now completes the global reform of the regulatory framework, which began following the onset of the financial crisis.[4]

Let us hope so and turn back to Part 1 of Ram Mohan's book.

Explanation of causes: In the Foreword section, Ram Mohan informs us that while the first chapter examines the record of financial crises, the second chapter examines the causes of the financial crisis of 2007.

However, my view of these two chapters is different. These two chapters are about Ram Mohan's debate with the Mian and Sufi (2014) claim that "banking crises have more to do with the buildup of private debt; they are not about banks *per se*" to convince himself that although a build-up of private debt was certainly an important cause, a failure of regulation was the primary cause. One minor criticism I have within this context is that Ram Mohan makes no reference to Fisher (1933), Minsky (1975, 1982), Godley (1999), Keen (2013) and several other Keynesian/post-Keynesian economists who brought forth the significance of private debt in financial crises and severe economic recessions although none of them claimed banking crises "are not about banks per se."

Had Ram Mohan discussed these authors' theoretical contributions, he could have reached the alternative conclusion that neither regulatory failure nor private debt build-up was the primary cause of this financial crisis as these two processes feed each other and are endogenous to the system. As I mentioned earlier, deregulation of financial activities has been eagerly sought by finance capital since the 1970s and the above two changes in capital adequacy requirements paved way for the banks to extend excessive credit, which led to the private debt build-up Mian and Sufi (2014) identified as the main source of this financial crisis. In this, the austerity programmes that have been implemented by the governments around the globe played a major role too. If the government borrows less, who is going to borrow more other than the private sector so that the money supply can continue to grow?

Of course, as the accumulated private debt increased, finance capital sought more deregulation, resulting in more private debt, resulting in more demands for further deregulation and so forth. In this feedback loop, theoretical contributions of neoclassical economists for further deregulation should not be overlooked, despite that many of them

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appear to have changed their minds after the onset of the crisis.

Let me now conclude with stating that neither Mian and Sufi (2014) nor Ram Mohan is wrong for reasons I tried to explain and express my gratitude to Ram Mohan for starting this debate in his book. While discussing why any of these has happened is beyond the scope of my review, I hope that future researchers will read the debate Ram Mohan started and open a path towards a safer world of banking.

To Sum Up

I strongly recommend this book by Ram Mohan, a well-qualified neoclassical finance scholar and practitioner, to anyone who is interested in understanding what has been going on since the onset of the GFC within the realm of bank regulations. Of course, from the point of view of neoclassical finance and economics.

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NOTES

1 To see why, I refer the readers to Öncü (2017) and references therein.

2 Indeed, this was one of the main arguments of what Acharya et al (2010) called "Manufacturing Tail Risk" to mean increased probability of a banking (financial) system failure.

3 Group of 10 countries consists of eleven countries, which are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the UK and the US.

4 BIS Press Release, 7 December 2017.

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Also, the European Investment Bank will free up a further EUR 20 billion in working capital lending to SMEs.26 As of the end of April, 24 EU countries had either expanded or announced new guarantee schemes to support banks in providing SME loans. The majority of these measures include specific provisions for smaller companies (Austria, Denmark, France), whereas others can be used by any company affected by COVID-19 (Germany, UK).Â created equity funds for distressed companies. In this case the equity fund includes both public (EUR 75 million) and private (EUR 50 million) funds and is managed by ALTUM (the Latvia Development Bank). Another eight countries have implemented, or are considering facilitating equity contributions. Towards a Safer World of Banking: Bank Regulation after the Subprime Crisis by T T Ram Mohan, New York: Business Expert Press, 2017; pp xvi + 166, $34.95. T T Ram Mohan is a financial economist trained in neoclassical finance and his book is an account of what has happened within the realm of bank regulation after the onset of the ongoing Global Financial Crisis (GFC) in 2007. Not only is Ram Mohan a professor of finance and economics at the Indian Institute of Management, Ahmedabad, but has also served on several committees of the Reserve Bank of India and been a member of the Primary Market Bank regulation and deposit insurance have their origins in the private arrangements among banks, as described above in the discussion of bank clearinghouses and other private bank coalitions, and theoretically by Gorton and Huang (2001). Governments took over these insurance schemes and regulations fairly recently, although in the USA there were various earlier deposit insurance arrangements sponsored by state governments [see White (1983), Calomiris (1990) and Wheelock (1992b)].Â Such a systemic failure could result in the freezing up of business credit, with a resulting drop, potentially catastrophic, in economic activity, and employment.Â The Essence of Bank Regulation. The stability of a financial system is of crucial importance for the smooth operations of the real economy. Banking regulations are a form of government regulation that subjects banks to certain requirements, restrictions, and guidelines. In general, banking regulations seek to uphold the soundness and integrity of the financial system. Following is a list of banking regulations: The most common objectives are: Prudential â€“ to reduce the level of risk bank creditors are exposed to (i.e. to protect depositors).Â Regulation F â€“ Designed to limit the risks that the failure of a depository institution would pose to other insured depository institutions. Provides requirements relating to interbank liabilities. Regulation G â€“ Disclosure and Reporting of CRA-Related Agreements. The regulators have often increased. both the probability of bank failure and the costs of such failures. In the. process, the regulations have tended to socialize the costs of failure by. shifting them from private depositors of the failed banks to general. taxpayers. In addition, the imposition of prudential regulations have identified banking. as "unique," and at times have involved potential government financial. assistance.