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# WHAT REGULATORY CHANGES TO AGREE TO

– Regulatory issues affecting the financial arena –

## Summary on *The Squam Lake Report: Commentary*

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The author, *Charles A.E. Goodhart* wrote a commentary on the Squam Lake Report[1] - a report on an economic conference, where leading U.S. financial economists from a wide spectrum of ideological backgrounds were supposed to see what regulatory changes they could jointly agree on, thereby influencing policymakers.

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Goodhart's commentary mainly consists of criticism, apart from one-sentence recognition of the roots of the crisis and the conclusions. He compiled a long list about the potential regulatory methods, which were not mentioned at all in the report. He does not say it explicitly but the underlying message of his paper is that the conference was totally pointless as many fields of the financial regulation were not discussed mainly because of a too diverse audience, whose members could only provide an opinion full of compromises. Moreover he also has formal and structural objections. According to him, the chapters are following each other almost randomly. I present here all the points, Goodhart is missing. Quoting him: „So my two main criticism of the Report are that in the attempt to achieve consensus and to influence policymakers, much of the regulatory debate was not covered at all, and what was covered was set out in far too general a fashion, skating over the difficult details.

*Direct constraints on the financial operations*

According to Goodhart the Report is missing the discussion about the class of regulatory proposals that would impose direct constraints on the operations of banks or other systemically important financial intermediaries (SIFIs). Goodhart prefers the regulatory measures that change incentives rather than the impositioning direct constraints of financial business activities and supposes the same opinion about the authors of the Report, but he cannot accept that the only thing they said on that topic was that the capital requirements should be higher for large banks. As the direction of structural constraints has many supporters, he expected that they do not skip this topic.

*Pigovian Taxes*

The regulations aimed to assure a safer operation of the Banks and SIFIs, by the general requirements as to hold more and better capital, or more liquidity or fewer short-dated wholesale liabilities, supported by a variety of sanctions. According to Goodhart, this approach is inappropriate, as the BCBs were until recently hesitant to propose a gradual ladder of sanctions that was strictly a matter for national legislatures. The Pigovian tax[2] could be an alternative for deterring behaviour leading to negative externalities, such as insufficient capital or liquidity. Such taxes can be the incentives mentioned in the previous paragraph, but the Report does not say anything about them. Perhaps it was largely finished before Obama brought the issue of bank taxes[3] into the limelight.

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[1] Charles A.E. Goodhart: The Squam Lake Report, 2011, *Journal of Economic Literature,* Vol. 49, No. 1, March 2011. pp. 114-119.

[2] A tax levied on a market activity that generates negative externalities. The tax is intended to correct the market outcome. In the presence of negative externalities, the social cost of a market activity is not covered by the private cost of the activity.

[3] President of the USA, Barack Obama laid down his proposal for a new tax on the nation's largest financial institutions in January, 2010.

*The lack of discussion abut procyclity*

According to Goodhart some measures need to be adopted of a countercyclical nature, to lessen the tendency of the combination of a risk-weighted CAR[4] (*capital adequacy ratio)* plus mark-to-market, to exacerbate leverage cycles. The phenomenon that the price of property like houses and bonds tends to rise when banks make it easy to buy them with borrowed money and fall when banks make it harder is called to leverage cycle. As a result of this phenomenon, without regulation leverage becomes too high in boom time and too low during crises. Goodhart is missing this kind of regulation from the Report.

*No mention about the other levered financial intermediaries*

One chapter of the Report is devoted to '*Reforming Capital Requirements'* but it refers almost exclusively to CARs for banks. Goodhart point is the following: if only the banks' CAR is regulated, thereby they are comparatively penalized, and that will provide an incentive for businesses to slip across the border to nonregulated intermediaries. „But there is no discussion of whether and how to extend CARs to other levered intermediaries, or to apply various forms of margin controls such as LTV (Loan to Value) or LTI (*Loan to Income*) ratios on personal borrowers in the housing market", as Goodhart writes.

*Skipping the issues of CoCos*

CoCo (*Contongent Convertible*) is a security similar to a traditional convertible bond in the aspect that there is a strike price (the cost of the stock when the bond converts into stock). What differs is that there is another price, even higher than the strike price, which the company's stock price must reach before an investor has the right to make that conversion. Goodhart considers CoCos being not so effective and in some cases they would even be positively dangerous. In his view socially speaking the best practice would be to impose such a large dilution on existing shareholders that they would have an incentive to issue new equity at the first hint of trouble, rather than wait for the conversion to be triggered. But the Report skips such issues by arguing the complexity of the advantages and disadvantages.

*Separation of the systematic regulator (Central Bank) and the responsibility of the regulation of business practices*

Goodhart's one of the very few positive commentaries on the Report is the agreement on the suggestion that the systematic regulator should not be responsible for the regulation of the business practices and consumer protection. Those roles should be given to one or more separate agencies.

*Criticism of the suggestion about the reporting obligation of financial institutions*

The Report suggests that all large financial institutions should report information about their asset positions and risks to regulators each quarter, but Goodhart thinks it would cause an information overload of the systematic regulator.

*Criticism of not rescuing systemic financial intermediaries*

Goodhart strongly criticises the opinion of the authors, that rescuing SIFIs are a great cost to the taxpayers. According to him, authorities will generally find that they have made a nominal profit exercises like TARP (Troubled Asset Relief Program) and injecting equity into banks and other financial institutions.

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[4] A ratio of a bank's capital to its risk. National regulators track a bank's *CAR* to ensure that it can absorb a reasonable amount of loss and complies with statutory Capital requirements.