Implications of the Global Financial Crisis

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Abstract

The global financial crisis has provided clear evidence that the global financial system, including that of Australia, is founded on flawed economic theories. There is no scientific justification for sophisticated risk management, complex institutional structures or intrusive regulation. Australian financial system reforms should simplify corporate structures by restoring Glass-Steagall type separation, discourage anti-competitive conglomeration, reduce system leverage and prohibit over-the-counter derivatives in regulated institutions, decrease secrecy of complex institutional regulation, and increase consumer protection through transparent disclosure of regulatory data.

Introduction

The current Financial System Inquiry (FSI) reviews the 1997 Wallis Inquiry, the developments since those reforms and the global financial crisis (GFC). The FSI Interim Report indicates that many deeper implications of the GFC and recent developments have either not been understood or been simply ignored, largely because the assumptions have not changed. But the assumptions should change.

Observation

> *The Wallis Inquiry took place at a time when little downside to globalization and financialization was apparent. Academic theories of efficient markets and economic rationalism were driving financial deregulation and the creation of a market-based architecture for Australian financial regulation. The global financial crisis has provided strong evidence that the assumptions of the academic theories behind the Wallis Inquiry are false in significant ways.*

It may not be widely recognized that it was the economic paradigm, including academic theories and assumptions, which drove endogenously regulatory and systemic processes causing the GFC[1]. The economic paradigm assumes that the GFC is exogenous and therefore does not provide a framework for understanding that it was itself the main cause of the GFC. This is a key defect in all current efforts to reform the global financial system.

With the economic paradigm remaining firmly in place, there can only be cosmetic changes to the Australian financial system, given the assumptions. The Interim Report stated that *"the Inquiry considers that the financial system must satisfy three principles: efficiently allocate resources and risks, be stable and reliable, and be fair and accessible"*. This submission argues that the GFC shows that the global financial system has *not* efficiently allocated resources and risks, has *not* been stable and reliable, and has *not* been fair and accessible.

The Lucky Country

Perhaps there is a prevailing sentiment in Australia that "if it ain't broke, don't fix it", as Australia congratulates itself often enough for weathering the GFC better than most countries. However, despite the complacency, the FSI provides a rare opportunity to explore and express alternative reasons behind the lucky country.

Observation

> *Australia's financial system is a part of the global financial system. Australian thinking on banking and finance is largely derived from the rest of the world, particularly from the United States.*

1 Sy, W. (2012), "Endogenous crisis and the economic paradigm", *Real-world Economics Review*, Issue No. 59, pp. 67-82; available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2021675

Australian developments typically lag the leaders by six to 12 months, and sometimes by up to a decade – the case of mortgage securitization, for example. This "follow the leader" approach has worked to Australia's advantage in the GFC, when the leaders fell over a cliff while Australia watched in horror.

Like other countries, Australia did not see the crisis coming[2] and it did not do anything substantially differently, before the event, to forestall its potentially harmful effects. Its regulators were equally asleep. However, it had more resources to take remedial action after the fact because the Government, being less advanced in pursuing wrong economic policies, had less public debt than those of other countries. The resource boom from China's stimulus also played a role in maintaining Australian economic growth.

The Slowpoke

Australia was slow in realizing its dream of becoming the major financial services centre of the Asia Pacific region. This failure was a blessing in disguise, because the GFC originated from the leading financial services centres of America and Europe.

Observation

> *Australia's complacency about its financial system is not well-founded. Its relatively better economic performance in the global financial crisis is due to being less advanced in pursuing the wrong economic policies of the larger developed countries.*

2 Glenn Stevens, referring to the GFC, said "I do not know anyone who predicted this course of events": http://www.rba.gov.au/Speeches/2008/sp_gov_091208.html; even in November 2007 APRA was complacent about the market in mortgage securitization in saying "the capital and transparency required by regulators now seems somewhat second order relative to the capital and transparency required by the market": http://www.apra.gov.au/Speeches/Pages/basel-ii-and-securitisation-the-new-aps-120.aspx.

When the US housing bubble burst in 2008, the Australian bubble was only half inflated, being equivalent to the stage of development of the US in about 2003. Australian mortgage securities were growing strongly to about 25 per cent of all housing loans, whereas in the US they had already grown to about 50 per cent. Securitization was considered desirable, according to academic theory, because it represented market-based lending which spreads the lending risk to a larger number of investors, in a process called disintermediation, thus avoiding the risk of failure of banking intermediaries in a housing market crisis.

We have learned from the GFC that exactly the opposite is true: securitization increases the risk of banking and financial system failure, contrary to the efficient market hypothesis of resource allocation. Academic theories have never been checked adequately against scientific evidence and they are based on unrealistic assumptions of moral and rational individuals making well-informed decisions in open and transparent markets.

Academic Fallacies

It is distressing to realize that most people in business and government have been taught many flawed academic theories as economic science. If Australia follows America, then Australia's future can be foreseen in America today (with 46 million on food aid). Even students are protesting now against being taught mainstream economics as though it is the truth or the only truth. They have enough sense to know what they learn today will appear tomorrow as the policies of business and government. Indeed, the policies of business and government today have been based on yesterday's economic theories, which we now know were wrong and unscientific.

There are too many serious economic fallacies taught in university to mention them all in this brief submission. There is one assumption which is central to the economic development of financialization, globalization and regulation of the past few decades. The "invisible hand" is an article of faith in mainstream neoclassical economics and is the assumption behind laissez-faire economic policies of the last few decades – e.g. financial deregulations.

A previous chairman of the US Federal Reserve, Greenspan, noted[3]: *"As I saw it, from 1995 forward, the largely unregulated global markets, with some notable exceptions, appeared to be moving smoothly from one state of equilibrium to another. Adam Smith's invisible hand was at work on a grand scale."* Few in charge of the financial system had disagreed with the belief of its leader.

However, the GFC proved clearly that blind faith in the "invisible hand" was unfounded when markets suddenly failed - in particular, mortgage securities markets disappeared virtually overnight when few understood how this could happen so suddenly, with regulators caught totally unprepared.

Observation

> *The "invisible hand" is not an adequate basis for understanding markets. In fact, by assuming markets work miraculously by themselves, the "invisible hand" has prevented sufficient research efforts to understand how, when and why markets work.*

One well-known cause of market failure is information asymmetry. But there is little detailed understanding of how or when this develops. The "invisible hand" of classical economics may well work for goods markets where buyers and sellers voluntarily transact directly for their own welfare. But financial markets have layers of intermediaries who interpose in the transactions in managing the money of other people. The true buyers and sellers often suffer from information asymmetry.

In fact, there are many markets today which are sufficiently dysfunctional to be considered failed markets. But they are largely unrecognized or simply ignored, because market failures are either defined out of existence or considered unimportant in mainstream neoclassical economics. The official assumption is: market failures and bubbles are unforeseeable, because they are exogenous. It is assumed that regulators do not cause nor can they prevent market failures – their job is to deal with the consequences[4] when they happen.

Flawed Regulation

Many, particularly among free-market adherents, fear that the acknowledgement of possible market failures will lead to more government interference and more regulation. Clearly, any government interference based on political ideology and not based on sound scientific understanding can do more harm than good.

More regulation is not necessarily the answer, because, before the GFC, there was already substantial regulation, at least in terms of the amount of reporting to regulators. Regulators did not know what to do with all the information they collected and the information alone was insufficient to prompt them to act before the crisis. The reason is due to the flawed concept of regulation based on the law which is either to punish wrongdoers or to enforce an adherence to legislated rules.

Observation

> *The current conception of financial regulation is based on failures - failures to comply with the law. Laws are enacted from past failures and failures cause laws to be legislated to prevent their reoccurrence. But financial innovations make those laws quickly irrelevant, because those laws may not apply to new products and new markets, which will then be new sources of future failures.*

Regulatory failures are usually rewarded with bigger budgets for "the bloodhounds to chase

3 *Page 367, The Age of Turbulence, The Penguin Press, New York, 2007.*

4 *Greenspan stated on several occasions that the regulator's job "to mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion." This idea contradicts the rationale that there is any value in supervision before a crisis occurs – regulators deal only with failures.*

the greyhounds". The consequence of the flawed concept of regulation is never ending cycles of failures and new laws, which we have witnessed over the years. Regulation should have the objective of making the financial system work well for all participants (i.e. everybody) and not just for selected "stakeholders" through law enforcement.

Regulation should be concerned not only with managing the regulated, either supervising or punishing them with the law, but also with helping the public to make more informed choices and decisions, using the data regulators collect. The public should be better informed to avoid questionable providers, institutions or products and risk aversion by the public would prevent potential problems from growing large and unseen until systemic failure.

For example, complaints about certain institutions or products are routinely collected by regulators mainly for investigating possible breaches of the law and enforcement. Such information would be useful and should be disclosed to the public, even when no laws appear to have been broken, because complaints may indicate market dysfunction which needs attention, even if problems are not directly related to the existing law.

Observation

Current financial regulation based on law enforcement and secret supervision creates an over dependence on the regulators for protection. This creates moral hazard in the financial system where everyone takes more risks on the understanding that the government is responsible for any regulatory failure.

The record of regulatory failures to protect individuals and the economy has been evident in recent years, with large numbers of scandal, fraud or crisis, both in Australia and overseas. The financial system should help, rather than hinder, everyone helping themselves by being better informed and by taking on more of their own responsibilities.

Recommendation

Where possible, regulators should publish complaints received from the public on financial service providers, institutions and products, using readily available internet technology.

If real regulatory action occurs only after failures of markets or institutions, the least the government could do is to help ordinary people protect themselves by being better informed, should they want to take the trouble to do so.

Institutional Supervision

One of the pillars of Australian financial regulation is institutional supervision to ensure soundness of financial institutions to meet their promises and obligations. The GFC exposes irresolvable contradictions to institutional supervision in Australia and particularly overseas.

Observation

The concept behind the US Federal Reserve, the UK Financial Services Authority and the Australia Prudential Regulation Authority (APRA) is seriously flawed because it is based on secret dealings between regulators and regulated institutions.

For example, only a few years after APRA was set up, a major general insurer, HIH, failed. Was APRA asleep and did not know what was going on? Or, if APRA did know what was going on, did it allow HIH to fail? Or again, if APRA did know what was going on, was it unable to supervise HIH's survival? What additional skills or knowledge does APRA have that HIH's board of directors does not have? On what basis does APRA have the right or the responsibility to decide which institution is allowed to fail?

Clearly, if the regulator is responsible for the regulated, their interests would merge and the regulator's interest in the survival of the regulated institution would conflict with its interest of ensuring a competitive market which must allow failures under capitalism. Secrecy was maintained in Australia during the GFC when Westpac and NAB came close to failure. Insolvency was forestalled during 2008 and 2009 through a combined emergency loan of US$5.5 billion from the Term Auction Facility[5] provided by the US Federal Reserve.

Lehman Brothers was allowed to fail in the global financial crisis by US regulators, who were then widely criticized for endangering the survival of the financial system. Thereafter, the "too big to fail" concept was developed and no other large financial institution was allowed to fail again. The incentive was thus created for every financial institution to become as big as possible. The "too big to fail" banks only got bigger as a result.

The institutional supervision part of financial regulation leads eventually to an incestuous relationship between the regulator and the regulated. The corruption created could lead to a system which is not fit for the purpose of meeting the objectives set out in the terms of reference of the Inquiry.

Observation

> *Institutional supervision in secrecy can create various types of corruption. The first is the corruption of the principle of capitalism, where any private enterprise should be allowed to fail and not be saved by government assistance. The second corruption is the "revolving door" where individuals can work for personal gain at the expense of the public largely without consequence or even being noticed. The third is the corruption of market function by obtaining and retaining insider information or the creation of information asymmetry to the disadvantage of investors.*

Countries with large regulated institutions display all the forms of corruption mentioned here and display the greatest dysfunction in entrepreneurial capitalism, in both personal and market integrity. Available economic data show clearly that these countries are on the path to rapid economic decline. It is reasonable to question how the corruption and the dysfunction may increase systemic risk.

5 *See http://www.federalreserve.gov/newsevents/reform_taf.htm*

Systemic Risk

The GFC has provided strong evidence that flawed academic theories have been used in credit risk models[6] by banks and credit rating agencies to provide wrong and unreliable credit ratings for many types of credit securities and derivatives. In the GFC, institutional supervision failed to reject unsound credit risk models or to challenge them on their technical accuracy because they were simply accepted as the economic paradigm.

Observation

> *The fine tuning that is implied by the internal ratings-based (IRB) model of risk management of major banks is not scientifically proven. All such models are based on the ergodic fallacy, which is the assumption that historical statistics are the same as future statistics. The global financial crisis has provided strong evidence which falsifies this assumption – future risks may be unknowable.*

Fine tuning risk management to reduce the margin of safety is an oxymoron, because the risk that the mathematical models are wrong has not been taken into account to justify the complacency implied by the fine tuning. In the GFC, the numbers of defaults and levels of losses greatly exceeded credit risk model predictions, not by percentages, but often by several times.

Given grossly inadequate performance of credit risk models, it would take many years of proper scientific research for new models to be used safely. Regulatory permission for authorized deposit-taking institutions (ADIs) to fine tune their risk management with credit risk models should be recalled, pending further research and investigation.

Moreover, the IRB models are primarily used by large banks, with adequate resources, to argue unjustifiably for lower capital requirements.

6 *Sy, W. (2008), "Credit risk models; why they failed in the credit crisis", JASSA The FINSIA Journal of Applied Finance, Special Issue 2008, pp. 15-20. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2396994*

The increased leverage of big banks gives them a cost advantage over smaller banks, making the big banks riskier and making them even bigger than "too big to fail".

Recommendation

The IRB approach should be abandoned to provide greater simplicity, systemic safety and competitive neutrality for all authorized deposit-taking institutions (ADIs) regardless of size or resources. Regulators generally do not have the same incentives or resources to challenge properly the IRB models, which under-estimate risk based on accepted, but flawed, academic theories. IRB models effectively allow big banks to set their own capital requirements, thus providing a cost of capital advantage over smaller ADIs.

Credit risk models have not changed substantially since the GFC, which showed that they were misleading, inaccurate and actually increased systemic risk. Many credit risks are unquantifiable, either because there is insufficient data or there is no relevant data. Pretending that the only risks which matter are the risks the credit models have quantified would be a serious under-estimation of risk, which contradicts the objectives of stability and reliability.

Contagion Risk

In the era of financialization, derivatives held the promise of reducing financial system risk through the use of new instruments for risk management for financial institutions. Exactly the opposite happened: systemic risk increased. Financial markets have been more and more volatile as the use of derivatives increased over time.

While derivatives can be used to reduce the risk of a given balance sheet, the risk reduction is in practice compensated, or more than compensated, by an increase in the size of the balance sheet itself, leading to net increased risk and leverage of the institution, offset theoretically by "insurance" through derivatives with other counter-parties. The illusion of better risk management led to the institutions taking more and more risk.

Observation

The result of using derivatives is a financial system with increased leverage, with highly geared institutions all insuring one another through derivatives, creating effectively one single highly leveraged system where individual institutions are locked together through mutual obligations. This system is extremely fragile because one single institutional failure could potentially cause systemic collapse, through "contagion".

The regulators who allowed this to happen obviously were not concerned about systemic stability. The global financial system has become a fragile entity due to the use of more than 700 trillion dollars of over-the-counter (OTC) derivatives[7]. A system where all elements are inter-locked has no benefit of risk diversification or resilience which comes from having many independent elements. Through mutual insurance, the system becomes more like one single entity, with little tolerance for the failure of any one of its parts.

The consequences of failure of the global financial system have to be suffered by the rest of society. This is exactly what has happened since the emergence of the GFC, which has extracted so much from society that the global economy risks collapse into depression. The global financial system badly needs to de-risk and to increase stability by eliminating inter-connectedness as much as possible through the prohibition of mutual insurance using OTC derivatives.

OTC derivatives are virtually impossible to regulate, because they are inventions of financial engineering. The complicated mathematical calculations are difficult to check, being often exploratory and not scientifically verified. It would be wasteful for regulators to try to keep up with the understanding of instruments of arbitrary complexity. Judging by their published research, regulators have never demonstrated competence or authority in the sophisticated mathematics used for derivatives.

7 *Notional value of outstanding contracts, Bank for International Settlement (BIS) statistics: http://www.bis.org/publ/otc_hy1405.htm*

The fact that OTC derivatives are essentially unregulated and their values could be "mark-to-model" or "mark-to-myth" means there is enormous scope for fraud, where trillions of dollars of losses could be hidden. They also provide a powerful tool for manipulating markets on ordinary exchanges by hiding off-setting trades with counter-parties in the OTC market to create a false market direction.

Regulated financial institutions should be forbidden to use over-the-counter (OTC) derivatives. The use of plain vanilla derivatives traded on organized exchanges should be restricted to within certain prescribed limits.

Recommendation

> *Over-the-counter derivatives should be prohibited because they are difficult to regulate and they lead to unacceptable systemic risk. At the very least Australian deposit-taking institutions should be encouraged to free themselves of derivatives and be able to advertise themselves as "derivatives free" (if that is the case) to get recognition for lower risk from credit rating agencies.*

Most OTC derivatives have been used by gigantic global financial institutions such as JP Morgan Chase, Citibank, Goldman Sachs and Bank of America. While they trade mainly with each other, somehow they all manage to declare profits from their derivatives books. How everyone can win in a zero-sum game is a mystery, which regulators have not bothered to investigate. OTC derivatives for these institutions have the potential to be the equivalent of the off-balance sheet accounting for Enron in the 1990s.

Big Risk

The argument for being "big" is usually based on benefits from the economy of scale which however, serves only the self-interest of big corporations, because the benefits are captured highly visibly and admirably as profits for those corporations. But the losses are taken invisibly and silently by the rest of society, with a net "dead-weight social loss" to the society as a whole. The undesirability of monopoly and oligopoly for society as a whole is well-understood.

Financial institutions become big largely through conglomeration of separate businesses - for example, through merger of investment banking, commercial banking, funds management, stockbroking and so on. The "one stop shop" concept of vertical integration creates a long chain of fee extraction points for conglomerates and enables them to hide and transfer costs along the chain to maximize profit for shareholders. The systematic wealth transfer to shareholders is a major cause of wealth inequality in society today.

The opacity of the true costs for different elements of the chain creates information asymmetry and prevents competition among the different businesses representing those different elements. The result for society is the high fees and costs for consumers and investors in banking and superannuation[8] which we witness today. Product disclosures required by regulation are merely lengthy legal documents disclaiming liabilities of the product providers rather than informative documents which help consumers make sound financial choices.

Observation

> *Australian banks and superannuation funds have created multi-layered service structures to lengthen the chain of fee-collection points to maximize profit for shareholders, at the expense of society as a whole. Vertically integrated firms have the ability to hide and transfer costs, increasing information asymmetry and reducing market competition.*

When big banks complain that there is sufficient competition, they are talking about competition among their peers to make the most profit, not about market competition to benefit consumers. If they had their way they would want to get even bigger, to be more "efficient",

8 *See for example, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829333 or http://grattan.edu.au/wp-content/uploads/2014/05/811-super-sting.pdf*

by taking over[9] or eliminating their competitors. Such thinking is very narrowly focussed on the self-interest of one institution and its stakeholders.

The efficiency gain from economy of scale in the operation of one single institution, which is highly visible, is not sufficient compensation for a much greater, but less visible, efficiency loss in the market. The world is about to learn, particularly since the GFC, that having large profitable financial institutions may be paradoxically bad for the economy and for society as a whole. The total benefit to society is reduced (as we have always known) and the benefit is concentrated in the hands of the monopolists and oligopolists at the expense of everyone else, leading potentially to unsustainable wealth disparity. As stated above, Australian developments lag behind those of UK and US[10], which provide lessons and early warnings.

Recommendation

If a financial institution is "too big to fail" then it is simply too big. Anti-trust laws should be applied to break up big corporations.

Of the different lines of business of a big financial conglomerate, the biggest part in terms of capital usage, market exposure and system risk is investment banking and principal trading because of the high leverage of the business from extensive use of derivatives. There is good reason why financially speculative investment banking should not comingle in anyway with economically essential commercial banking.

Traditional commercial banking ran quite satisfactorily when separated from speculative trading activities of investment banking under the Glass-Steagall Act. For many years, traditional bank failures were nothing like the financial system failure in the GFC, which occurred less than ten years after the repeal of the Glass-Steagall Act in 1999.

Attempts in the US to re-introduce some form of separation of investment banking from commercial banking through "ring fencing" of the Dodd-Frank Act lack any acceptable logic, for the following reasons:

- The economically essential commercial banking does not benefit from the trading activities of investment banking, but is exposed to speculative failures through joint ownership by a parent company;
- Shareholders are disadvantaged from being forced to invest in a conglomerate and would benefit from investing in separate businesses in various proportions, according to their risk appetites;
- Regulators do not have the incentives or resources to challenge effectively the conglomerates under complex laws when conglomerates are financially well-resourced.

Regulation through the enforcement of complex laws is ineffective. Several years into the GFC, nearly every major global financial conglomerate has been fined millions or billions of dollars for money laundering, market rigging, securities fraud, etc., without any palpable change in behaviour. The sizes of their fines, large though they may appear, are negligible compared to their profits or their balance sheets. Paying fines would be factored into the cost of doing business. In any case, they continue to receive trillions of dollars of public financial assistance.

There is every reason to believe that "ring fencing", like "Chinese walls", "invisible hand", "the emperor's new clothes", etc. is probably an imaginary device to help wishful thinking. Ring fencing is based on complex regulation and is

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9 David Morgan, international panel member and ex-CEO of Westpac argued over many years for abandoning the "four pillars" policy to lower bank fees (e.g. http://www.news.com.au/finance/markets/westpac-chief-rattles-four-pillars/story-e6frfm30-1111112476119)

10 See for example, http://www.huffingtonpost.com/eric-zuesse/us-is-now-the-most-unequa_b_4408647.html costly to implement in many ways – therefore, unlikely to be effective.

Recommendation

> *Since financial speculation involving derivatives is impossible or costly to regulate, it should not be regulated. Instead, investment banking should be separated from other banking activities, treated like hedge funds, as completely private enterprises.*

There has been no convincing argument or any evidence to show how financial speculation benefits society as a whole. Countries which have the greatest activities in financial speculation have also the worst overall economies, relative to their peers.

Summary

Financialization, which was the driving force behind the Wallis Inquiry held a lot of promises – many of which were dashed in the GFC and are unlikely to be met:

- greater trading volume and active management did not lead to more accurate market prices, as seen in greater market volatility and market failures;
- more asset bubbles did not lead to better allocation of resources;
- major countries with larger financial sectors show greater secular declines in economic growth.

The financial sector facilitates financial exchange and wealth redistribution, but its activities do not enhance wealth creation – just the opposite happened in the finance-dominated countries. Australia's four major banks, capitalized at $469 billion, account for nearly 28 percent of ASX 200 listed companies; together with five other financial institutions they account for one third of the Australian equity market.

It is not obvious that an economic structure with a very dominant financial services sector is a cause for celebration. If this sector were doing a good job of channelling finance and efficiently allocating resources, there would be no concern about whether the financial system is positioned "to best meet Australia's evolving needs and support Australia's economic growth", which is one of the primary focuses of this Inquiry.

While Australia is not a vanguard of change, the FSI should make provisions which will make changes easier and less traumatic, if major changes do eventuate from global development. Changes in economic thinking and education – manifested in popular movements, in new geopolitical alignments, etc. – are already in progress. For example, students are protesting against the harmful economics education they are receiving. Movements such as Occupy Wall Street are protesting against the growing wealth inequality and high unemployment. The BRICS countries are now creating an alternative currency system to bypass the existing US-dollar based system.

Even within the existing flawed framework, Australia should seek to reduce risk and simplify the financial system wherever possible by:

- being more sceptical of unproven and unscientific economic theories;
- being less dependent on the illusion of complex regulation to protect society;
- breaking up big institutions into smaller independent units to increase competition;
- simplifying the regulatory processes to create system robustness;
- informing ordinary people with data and facts to help them protect themselves.

To conclude with a parable: "Once upon a time, a man was unaware that he lived in a flood-prone area. He did not have insurance. A flood came but he was left unscathed. He congratulated himself on his fine judgement. Then another flood came. He lost his house and was swept away."

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