

Birkbeck 2.13 FIR. 2008-9. Lecture 1. Financial system in crisis: the background.

Introductory

The macroeconomic background. Structure of the module.

The core principles of bank management.

Deregulation.

Historical phases in UK and US; from asset management to liability management; banks and nbfis.

Financial innovation.

Instability; sophistication of regulation; technological developments.

Globalisation.

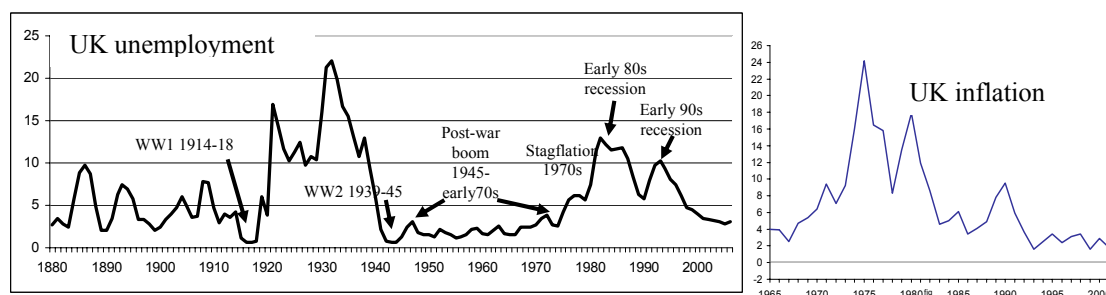
Pull and push factors.

Introductory.

Problems of textbook theory in conditions of rapid change.

- Some classic concepts worth studying, e.g. asymmetrical information, panic and bank runs, etc.
- Balance this with need to take account of dizzying speed of innovation, crises, etc.

Macroeconomic background: Period of relative macroeconomic stability since early / mid-1990s: low unemployment; low inflation.



‘NICE’ years, mid-1990s to 2007: Against this favourable background, financial system has proved resilient to severe shocks that in less stable times could well have precipitated very major panics:

Some scares in the 1990s:

- Asian, Russian financial crises.

But subsequent shocks taken in stride:

- End of dotcom boom
- Enron scandal
- Hedge fund collapses (LTCM 1998, Amaranth 2006)
- Crises in companies’ pension funds (GM, etc.)

Result has been prolonged mood of confidence (*over-confidence!*?).

→ enormous lending / borrowing spree, accelerating over past 5 years to new peaks.

It has been widely claimed that:

- The innovations / hedge arrangements, etc. can claim to have reduced the vulnerability of the financial system to quite severe shocks during the recent period of macroeconomic stability.
- BUT: Its untested nature also raised worrying questions:
 - Would all this make the system *more* vulnerable in *unstable* conditions and in the face of *major* shocks and *panics*?Are we now getting an answer to this question?

Preview: Issues addressed in this course

This course follows current dominant practice of centralising information theory in the analysis of financial structure and regulation:

- It explores the shortcomings and inefficiencies of financial markets and institutions.
- It asks whether and how regulation can reduce the risk of failure.
- It explores the ways in which the financial sector interacts with the wider economy.
- It addresses topical issues regarding current UK financial regulation.

See further in Aims and Objectives in Module Handbook.

Structure of the module

A common procedure in financial courses is to begin the study of financial products with bank deposits as ‘simplest’ case:

Assume fixed (zero) interest.

Initial simplifying assumption of no default risk.

Then move on to variable-value products – funds, etc.

However, once default risk is taken into account, banks become the most *complicated* financial market to analyse.

As is now being seen.

We therefore here begin with fund management:

Provides case of ‘pure’ / clear-cut delegation.

Allows plausible assumption of extreme asymmetry of information.

We then proceed to other financial markets where these simplifying assumptions are no longer plausible, and both the contractual and informational structure become much more complicated. The order will consequently be:

- Fund management
- Insurance
- Capital market
- Intermediation in general
- Banking

The Core principles of bank management

Conventional / traditional / ‘**mono-tasking**’:

Deposits in, loans out.

1. Liquidity management.
2. Asset management.
3. Capital adequacy management.
4. Liability management.

Remains basic.

BUT no longer the only or even main source of profit.

- Now increasingly → ‘**multi-tasking**’:
- **OBS** activities / **diversification** / merging of activities of banks and **nbfis**.
- From asset management to **liability management**.
- From ‘**mono-**’ to ‘**multi-tasking**’.
- Increased **competition**.
- Increased **risk**.

Outcome of three interlinked processes:

- Deregulation.
- Innovation.
- Globalisation.

1. DEREGULATION.

Need for regulation: particular significance of banks for the economy:

- Payments system → all economic agents have relations with banks.
- Sheer scale.
- Money creation process, etc.

Two strands of deregulation:

- Removal of government restrictions.
- Removal of self-regulatory restrictions.
 - i.e. Established from within banking / financial sector itself:
 - e.g. Agreements among building societies on interest rates, etc.

Three phases.

Note: Not same timing or even sequence in different countries:

- (i) Decisive blow to traditional framework.
- (ii) Ending sharp distinction between banks and nbfis.
- (iii) Allowing increased competition within financial sector and from outside it.

Deregulation Phase (i) Decisive blow to traditional framework.

Ending 'traditional' / 'mono-tasking' structure of sector.

- Asset side: Lifting quantitative **controls** on banks' **assets**.
- Liabilities side: Lifting ceilings on **interest rates** on **deposits**.

UK:

Began early:

'Competition and Credit Control', 1971.

Lifted credit restrictions.

Associated with very loose monetary policy / 'Barber boom'.

Subsequent backsliding – 'corset' – deposits at BoE to restrain growth of MS.

But by early 1980s all exchange and credit controls ended.

US:

'**Regulation Q**' (imposed in 1933):

Limited interest rate payable on deposits.

Not lifted till 1982.

Note: Traumatic effects of 1930s US bank failures.

→ Deregulation *came later than in UK*.

Very significant effects on international finance.

Variable rate lending.

1970s:

Volatile interest rates.

Inflation.

→ Banks increasingly allowed to issue variable rate loans.

e.g. Linked to LIBOR (London Inter-Bank Offer Rate).

> 'Stuck' with unprofitable loan rate.

Variable rate lending → banks could now liability-manage.

→ Stock of loans could become determined by demand.

→ **Near-horizontal credit supply curve!**

→ Great **expansion of banks' balance sheets**.

Also: Reduction in Capital:Asset ratios.

Exposure to greater risk.

From asset management to liability management.

Asset management of **post-war decades:**

- Large public sector (war) debt.
- Readily tradable.

Quantitative controls → 'traditional' situation maintained:

Liabilities side: Largely **passive** supply / customers' deposits.

Assets side: **Active** adjustment of balance sheets.

From 1970s:

Banks **actively create liabilities** / borrow from other banks / '**money markets**'.

Preview of globalisation: UK CCC but US maintained Q:

→ impelled move of US banks into Eurodollar market.

Deregulation Phase (ii) Ending sharp distinction between banks and nbfis.

UK: Banks and **building societies**:

1980s: banks allowed to compete in mortgage market.

1986: building societies allowed to compete in market for consumer credit.

i.e. both allowed to **compete in each others' markets**.

US: Once again, **much restrictive legislation** of 1930s **remained** in force till late, but:

1980s: some competition with 'thrifts' allowed.

1999: banks allowed more freedom to compete in investment banking, insurance, etc. (Repeal of Glass-Steagall.)

Deregulation Phase (iii) Allowing increased competition within financial sector and from outside it.

Within financial sector:

nbfis → new kinds of financial services.

e.g. online banking – Egg, etc.

→ new kinds of nbfis competing with traditional banking.

Firms from **outside financial sector** enter financial services market:

UK: Tesco, Marks and Spencer, Virgin, etc.

US: Not only retail firms but also industrial:

e.g. General Motors.

General Electric's financial arm → 1/3 of its revenue!

2. FINANCIAL INNOVATION.

3 interlinked forces of demand and supply:

- (i) **Instability** of financial environment.
→ **DEMAND** for innovations.
- (ii) Increasing sophistication of **regulation**.
→ **DEMAND** for innovations.
- (iii) **Technological** developments.
→ **SUPPLY** of innovations.

(i) Instability of financial environment.

1970s: Wide, **volatile** and highly unpredictable swings in:

- Interest rates
- Exchange rates
- Inflation.

[See diagrams in Mishkin chapter 1, etc.]

→ **DEMAND** for new financial instruments to **hedge** against risk:

- Forward foreign exchange contracts.
- Currency futures.
- Currency options.
- Interest rate swaps.

Definitions: see *Oxford Dictionary of Finance and Banking*.

Previously: **Balance sheet adjustments** as response to risk:

e.g. Manage ‘**gap**’ in **interest-sensitivity** and/or **duration** between assets and liabilities.

But now: Massive **scale** of financial transactions:

Far outweigh transactions for trade!

- even **narrowest of margins** → substantial profit opportunity
- proliferation of new specialised instruments
- BS adjustment largely **superseded** as response to risk.

(ii) Increasing sophistication of regulation.

Necessary with **markets of great complexity:**

Largely structured *precisely* for ‘loophole-mining’!

‘**Regulatory arbitrage**’.

i.e. relocation in less strictly regulated countries.

‘**Regulatory arbitrage**’ and global finance:

US banks tightly-regulated (Regulation **Q**, etc.)

→ from late 1950s shift to London, etc.

To operate ‘**off-shore**’.

→ ‘**Eurodollar**’ and other ‘**Eurocurrency**’ markets:

- Banks hold currency outside its country of origin.
- Now used for non-European currencies as well.

Shows **interlinkage**: deregulation, innovation and **globalisation**.

(iii) Technological developments.

Four ‘waves’ (**Schumpeterian?**) → increased **SUPPLY** of innovations:

(1) Application of **computers** in banking:

- Computerised **accounts**.
- Also other financial sector institutions, e.g. Rating agencies.

(2) **Telecommunications** / computers in customers’ money management:

- Statement print-outs, etc.

(3) Banks and nbfis build computerised **files on customers**

- → tailor services / **marketing**.

(4) **Electronic payment** methods / cash management techniques:

- Credit cards, Automated Teller Machines (ATMs), etc.
- Unit debit card clearing cost 7p < cheque 35p

3. GLOBALISATION.

Globalisation of banking has paralleled:

- Globalisation of financial system.
- Growth of MNCs in general.

Globalisation: ‘Pull’ and ‘push’ factors.

Prime example: Expansion of **US overseas banking.**

‘Push’ (as already seen):

- Regulation in home country, i.e. US:
- Historically tight restrictions.
- (See also Mishkin ch. 10 on inter-state banking.)
- Restrictions on funding (Regulation Q, etc.)
- Earlier deregulation in London.
- → Expansion of Eurodollar market.

‘Pull’:

- US banks follow their customers abroad:
- Expansion of **US MNCs** into post-war Europe.
- US banks → Europe to serve these.

Once in Europe, started tapping into:

- Host-country sources of funds.
- Demand for banking services, etc.

Three strands of globalisation process:

- (i) Creation of overseas bank **networks**.
e.g. Citibank, Barclays.
- (ii) **Mergers / takeovers** of overseas banks.
- (iii) **Alliances:** ‘strategic’ / equity-based.

Relaxation of capital controls → growth of UK’s **foreign asset exposure:**

| 1983 | 1988 | 1993 | 1998 | 2003 | 2006 |
|-------------|-------------|-------------|-------------|-------------|-------------|
| 85.8 | 99.4 | 184.9 | 338.5 | 1637.4 | 3094.6. |

Securitisation.

Has **increased pace** of globalisation of banking.

- Banks (and other lenders) **unload assets** onto securities market.
- Mortgages, car loans, etc. → increasingly *marketed*.

‘Asset Backed Securities’ (ABS).

- These securities then further sliced and packaged:

‘Securitised Investment Vehicles’ (SIVs).

Interlinked with **disintermediation:**

- Much of banks’ assets is no longer ‘mediated’.
- Managed by specialised / highly speculative nbfs.

Need for **harmonisation in regulation**.

- Another globalisation issue.
- Response to increased cross-border financial activity

EU; **Basle** agreements / directives:

Aims:

- **'Passport'** for financial services.
 - Mutual recognition of supervisory authorities.
 - Common standards in accounting, etc.
- **Convergence** of banking systems.

Summary:

From asset management to **liability management**.

From **'mono-'** to **'multi-tasking'**.

Increased **competition**.

Increased **risk**.

Outcome of three interlinked processes:

- Deregulation.
- Innovation.
- Globalisation.