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To: Study of Deposit and Insurance Guarantees

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Re: Brief Comments on Regulation and Insurance

These brief comments are based on limited study of the Savings and Loan problems in the U.S. during the 1980s, press accounts of the HIH and FAI problems in Australia, discussions with property valuers who have been much affected by rising PI premiums and some background on loan underwriting from study at the University of Wisconsin in Real Estate and Urban Economics. Also, my PhD dissertation topic was a model of office market cycles, motivated by the large losses due to the office supply glut of the early 1990s. Had those losses been larger (coinciding, perhaps with a major world downturn), they might have threatened to wipe out bank capital (instead of merely destroying a portion of bank capital, causing a bank contraction and a recession). This more severe scenario could have led to bank runs and the need for depositor guarantees to maintain the financial system. Essentially, the following are a set of biases and opinions arising out of this experience in real estate finance over the last 25 years.

1. Deregulation is not all it is cracked up to be. Regulation of financial institutions (banks, insurance companies, housing lenders) came about as a result of long and painful experience during the century leading up to the Great Depression of the 1930s. Essentially the lesson was that competition among financial institutions leads to serious moral hazard problems. Competition for market share leads to premium cutting (insurance) or spread narrowing (depository/lending institutions) so that the least sound institutions tend to grow during good times. During normal times, competitive pressures push profits below long term required profit levels needed to weather bad times. This is the nature of markets—they tend to base prices on short turn cash flows, not long run viability. Agency problems worsen lack of foresight—the lending officer will have been promoted or switched jobs before the bad loans (or policies) come home to roost. Importantly, institutional cash flows allow unsound business practices, indeed, reward them, for long periods of time. The bad drive out the good when it comes to financial prudence. Consumers trust the experts who set prices for loans or insurance premiums—they are unable to protect their interests because of imperfect information. When the test comes in bad times, the aggressive, successful, but imprudent institutions may have dragged most of an entire financial intermediation industry into insolvency. Regulation requiring prudent practices and adequate reserves, and involving a strong eye for fraud, self-dealing or conflicts of interest proved effective in stabilising financial institutions and, in general, served society well. During the 1980s, what could be called an ideology of misguided free market economists gained the upper hand. Instead of recognising that some institutional regulatory frameworks serve to increase market efficiency (especially in the long run), they were convinced that all regulations reduce efficiency—an untrue

position, even a nonsensical one since all markets must operate in some institutional regulatory framework (enforcement of property rights at a minimum and some kind of currency regime). Some deregulations have worked well, especially in the short or medium term and mostly in non-financial businesses like airlines (changes in competition may give a different long run result however). However, many other dergulations (especially in finance and accounting) have led to big problems and huge losses not only of funds invested by little old ladies, but also of economic growth and efficiency. It is not efficient when an HIH goes broke or Lloyds gets in serious trouble or office buildings stand empty.

2. In the case of banks, avoiding conflicts of interest and ensuring capital adequacy are key issues. Less than five years after repeal of the Glass-Steagal Act in the U.S., a 1930's law that prohibited banks from selling securities, Citigroup and others were found to have seriously misled investors due to conflicts of interest and lent imprudently (for example to WorldCom), benefited insiders and generally screwed up both banking and securities markets. Citigroup, in essence, bribed Worldcom executives who were bringing them profitable IPO and acquisitions business, while touting unsound investments to naïve investors. The fact that companies at the centre of world finance engaged in such damaging practices suggests that it is essential to have regulatory and legal frameworks to prevent trouble.

3. In the case of insurance, it is essential that reserves that seem perhaps too large in good times be maintained against the 911s or major earthquakes that can inflate claims to unforseen levels. Trends such as increasing litigation and size of awards for damages can inflate the tail of insurance claims. Again, regulation is the key.

4. Prevention of losses is far more effective than trying to decide who pays for them.

5. The comment of previous studies that badly designed guarantees are worse than no guarantees at all is very relevant. With moral hazard already a problem it may be better to take our medicine rather than to allow the system to get worse. The problem is that guarantees give more money to the bad lenders/insurers who have created the problem. "Regime change" (changes in management) should be part of any bailout of an institution.

6. Quick action is important. Had the U.S. regulators shut down the problem S&Ls and minded the regulatory store better, the S&L losses would have been far smaller (perhaps 10% or less of actual losses) and many useless vacant buildings prevented. Generally when problems develop, there is a pattern of warnings being ignored and regulators failing to take timely action when problems first appear.

7. This suggests that regulators and industries regulated have to be kept independent of each other—regulators are often captured by the industry regulated. Methods are needed to prevent payoffs (through future employment or whatever) to regulators. We need honest government because government plays roles that require trust and honest dealing.

8. There are larger implications for the economy. Deregulation in the 1980s led to too much money seeking too few valid projects. This led to the office space glut in the

U.S., Australia and other countries. There was considerable destruction of capital in this process, as the cash flows of the buildings will never recover their costs.

9. There is probably a larger economic issue related to income distribution. Keynes expected rates of return on capital investment to fall as capital stocks increase, as they do during periods of prosperity (just look at how much profit the banks book if you doubt this story). Often, decision makers who allocate capital (fund managers, bankers, insurance companies) are loath to accept falling returns, so they diversify instead into areas where risks are greater. The fact that others do the same, leading to over investment, exacerbates the risks. Overcapacity often results, leading to operating losses and write-downs of capital values.

10. There are therefore three interrelated issues: guarantees, regulation and macroeconomic stability. Macroeconomic stability is favoured, I believe (following Hobson, Ely, Keynes and others who sought to respond to Marx's theory of capital accumulation followed by capital destruction) by policies that redistribute wealth. Much as owners of wealth hate to pay them, taxes on the wealthy and redistribution to investments in human capital of the poor, public infrastructure and public goods (like knowledge) help prevent capital destruction. The problem, as Keynes showed, is that demand becomes inadequate to justify further investment, interrupting the circular flow of income, when too much money is in the hands of investors and too little in the hands of consumers.

11. Japan had de facto guarantees by its refusal to make banks recognise bad loans. The moral hazard problems are made more serious by the failure of regulatory frameworks. In the U.S., deposit guarantees were in place for over 40 years before they caused a problem. Free market ideologues claimed moral hazard due to guarantees was the problem when in fact the S&L debacle did not occur until S&Ls were deregulated in 1980-82.

12. Deposit guarantees are about protecting the assets of small savers (there is no way to protect all assets, it is an uninsurable risk). If guarantees are put in place, they certainly must be capped and effectively capped. In the U.S., deposits in banks and S&Ls were only guaranteed to $100,000, but loopholes allowed savers to have multiple accounts and hence escape the cap. One guarantee of a limited amount per individual (or their trusts or companies) is all that can be provided. And even these guarantees require additional legs to stand on—adequate regulation to ensure solvency of financial intermediaries and macroeconomic management capable of maintaining a relatively stable economy.

13. A world at peace would help as well. Major risks to the world economy come from the possibility of nightmares like nuclear terrorism or nuclear war or biological war. Conflict resolution, social justice, population control and peace are the long-term roads to stability.

14. A major problem with insurance is that it is actually nonsense to think one can quantify the risks. The question of who bears risk is therefore likely to be 'everyone' in one way or another. If government steps in to guarantee policyholders, surely that means all of us bear the excess unquantified risk. That might be a good idea to help an economy recover from disaster, but needs to be coupled to regulation, credible, swift

and sure criminal penalties for malfeasance by insurance executives, capital at risk at all times by those who underwrite risks (no good attracting business based on the guarantees—the intermediaries have to have money at risk or they have no incentives (even perverse incentives) to do the job right. Guarantees need to be capped so the insured bear some of the unexpected losses. And there should be in the package an idea of who pays for it. If there are contingent government liabilities, at the same time we should pass contingent tax legislation to raise the money.

The gist of these comments is to say that guarantees, regulation, economic management, the legal system and the business system all interact in complex ways so that considering guarantees without considering all the other issues means the system that is designed leaving out these related issues could malfunction. The answer regarding guarantees is “it depends” on the context created by these other issues. A well designed system will never need to use guarantees, even if it puts them in place, and will pay attention to the distributional consequences of guarantees, using them to protect the poor and middle class to a limited degree, rather than trying to protect the institutions and the rich who cannot be insured since market fluctuations are too big to be fully insurable.