Difficult issues in financial regulation for financial stability

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Abstract

This article explores some of the difficult issues in financial regulation for financial stability. Noting the lack of prior academic work in the topic, this article presents a discussion of some difficult issues in financial regulation for financial stability. Some of the difficult issues include: the difficulty in breaking too-big-to-fail financial institutions into small insignificant parts; the difficulty in regulating executive compensation in the financial sector without limiting the ability of financial institutions to attract and reward executive talent; the difficulty in instilling strict financial regulation and supervision without limiting the ability of financial institutions to exploit emerging profitable opportunities; the difficulty in ensuring that financial institutions increase lending during a recession or in bad times; the rarity of having a female CEO and Chair in a major financial institution; the difficulty in making central banks independent from the influence of the federal government; the difficulty in making financial institutions become relevant in the ever-changing digital technology environment; and the difficulty in preventing financial institutions from taking excessive risks when strict regulations are loosened under a light-touch regulatory regime. The implication of the findings is that financial regulation for financial stability is not an easy task. There will be issues that financial regulation can address, and there will be issues that financial regulation cannot address. Acknowledging that such difficulties exist on the path to financial stability is the first step to addressing these issues.

Keywords: financial regulation, financial stability, bank supervision, crisis, central bank, banks, financial institutions, financial innovations, banking and finance.

JEL Code: G21, G28.

1. Introduction

This article explores the difficult issues in financial regulation for financial stability. It explores some of the dilemma that financial regulators face in regulating the financial system and in promoting financial stability. It also proffers some solutions to the identified issues while showing how complex the issues are even when there is a possible solution. A lot of academic studies have analyzed the importance of financial regulation for financial stability (see, for example, Santos, 2001; Brunnermeier et al, 2009; Goodhart et al, 2013; Armour et al, 2016; Ozili, 2018; Kim et al, 2020). But, surprisingly, little work has produced an account of the difficult issues which financial regulators face in regulating and stabilizing the financial system.

It is important to identify and understand the difficult issues in financial regulation. Studying the difficult issues in financial regulation for financial stability will help policy makers to understand the limits of financial regulation. Policy makers, and financial regulators, need to understand not only the issues that hinder the better execution of financial regulation towards financial stability, they also need to understand the issues in the financial sector that cannot be addressed using policy tools. These issues should stir up debates, and lead to many suggestions on how to address them. This article will show the difficult issues and how complex they are, which in turn will help financial regulators to think more deeply about these issues.

This article adds to the financial stability and regulation literature in the following way. This paper contributes to the understanding of the complexity of financial regulation for financial stability. Secondly, the article contributes to the literature by drawing attention to the need to exercise caution in implementing policies for financial regulation and stability. This is because not every issue in the financial sector can be address using policies or other tools of financial regulation.

The rest of the article is structured as follows. Section 3 presents some of the difficult issues in financial regulation. Section 4 presents the conclusion.

2. The Difficult Issues & Solutions

2.1. Breaking too-big-to-fail financial institutions into small insignificant parts

A difficult issue: Breaking too-big-to-fail financial institutions into small insignificant parts is a difficult issue because financial institutions like monopoly power. They know that when they are too big to fail, they will be bailed out by the government when they are in crisis (Stern and Feldman, 2004). For this reason, financial institutions have an incentive to become bigger and increase market share. They can lobby regulators when given the opportunity (Yadin, 2015; Lambert, 2019), and they can spend a large amount of money to fight regulation and reform that seek to reduce their monopoly power in the financial sector.

Proposed solution: In the case of banks, for instance, one way to break too-big-to-fail banks into small insignificant parts is to divide large banks into smaller financial institutions. Many banking scholars support this idea such as Marsh (2011) and Brox (2009). Bank regulators can break too-big-to-fail banks into small insignificant parts by requiring too-big-to-fail banks to separate their core banking business from their non-core banking business, and move their non-core banking business under a separate non-bank corporate structure. This will reduce the size of too-big-to-fail banks and keep them smaller.

Another option is to use a 'revoke-and-reinstate' licensing regulatory action. Under this approach, the regulator can revoke the license of too-big-to-fail financial institutions, and immediately reinstate their license with a new license that limit the scope of activity which a too-big-to-fail financial institution can engage in. The aim of this approach is to significantly reduce the size of large financial institutions by decreasing the number of activities they are permitted to do. This approach will ensure that too-big-to-fail financial institutions carry out only a limited amount of permissible activities, thereby, reducing their systemic exposure and ultimately reducing their size in aggregate terms.

Another approach to reduce the size of too-big-to-fail financial institutions is to introduce a super-spreader tax. This option was suggested by Economist Sheri Markose. A super-spreader tax is a special tax levied on too-big-to-fail financial institutions as a penalty for being systemic (Markose, 2012). The logic behind a super-spreader tax is that too-big-to-fail financial institutions are a significant source of systemic risk to the financial system. This is because the collapse of a too-big-to-fail financial institution can trigger the collapse of other financial institutions in the financial system (Barth et al, 2012; Ozili and Arun, 2018). Therefore, it makes sense to require too-big-to-fail financial institutions to pay a surcharge or a fee as a penalty for making the financial system riskier due to their too-big-to-fail status (Markose, 2012).

Under a super spreader tax regime, large too-big-to-fail financial institutions will pay a higher super-spreader tax while the relatively smaller too-big-to-fail financial institutions will pay a lower super-spreader tax. The benefit of the super spreader tax is that it will discourage too-big-to-fail financial institutions from aspiring to become even bigger. Another benefit of imposing a super-spreader tax is that it would give too-big-to-fail financial institutions an incentive to become smaller in size and less systemic. It will also discourage smaller financial institutions from seeking to become too-big-to-fail in the future.

A complex issue: Opponents of breaking too-big-to-fail banks into small insignificant parts argue that doing so will have socioeconomic and macroeconomic consequences. Firstly, it can lead to loss of jobs in the financial sector when large financial institutions begin to shut down their subsidiaries in order to reduce their size. It could also lead to the shutdown of subsidiaries in foreign countries. Consequently, it may be difficult for such financial institutions to re-enter a foreign country in the future after shutting down their operations in the foreign country. Secondly, breaking too big to fail banks into small insignificant parts can send a bad signal to existing and potential investors. It can lead to the impression that policy makers, or regulators, are against business expansion and economies-of-scale activities in the financial sector. It can lead to capital flight from the financial sector to other sectors of the economy.

2.2. Regulating executive compensation in the financial sector without limiting the ability of financial institutions to offer competitive pay to attract executive talent.

A difficult issue: Regulating executive compensation without limiting the ability of financial institutions to offer competitive pay to attract executive talent is a difficult issue. Financial institutions do not want regulation that restrict their ability to offer competitive pay to attract and reward executive talent. They will oppose regulatory restrictions on executive compensation. Regulating executive compensation is a very difficult issue because it can make talented executive staff leave the financial sector in search for competitive pay in sectors where executive compensation is not regulated. Regulating executive compensation not only affects executive management, it also affects low-level employees. This is because, once low-level employees know that executive compensation is regulated, they will feel that they won't be compensated very well when they exceed performance targets due to regulatory controls on compensation. As a result, low-level employees will be discouraged from pursuing a long term career in the financial sector, thereby, triggering a mass departure of workers from the financial sector.

Proposed solution: Some financial regulators can take some bold step to regulate executive compensation in several ways. One, financial regulators can monitor current executive pay using information from past executive pay. Financial regulators can monitor executives' past pay packages, including option and stock holdings, in order to detect current compensation arrangements that encourage excessive risks, which may be indicative of excess compensation (Bebchuk and Spamann, 2009). A second option is for financial regulators to assess the justification of executive pay (Bebchuk and Spamann, 2009). To do this, financial regulators need access to information about the level of debt, number of shares and options held by senior executives (Bebchuk and Spamann, 2009). Thereafter, regulators can assess the sensitivity of executive pay to increases and decreases in the value of assets of financial institutions. If executive pay is too protected from downside risks, regulators should upwardly adjust their assessment of the risks posed by the financial institution, and demand additional reassurance from the financial institution in the form of additional capital or otherwise (Bebchuk and Spamann, 2009).

A third option is to prioritize stronger corporate governance. Financial regulators can focus on strengthening corporate governance rather than imposing direct regulatory restrictions on executive compensation. Financial regulators can introduce corporate governance reforms that align the design of executive pay arrangements with the interests of common shareholders of financial institutions. Four, financial regulators can leave executive compensation untouched. They can stop trying to fix the excess executive compensation problem and let the markets fix the problem (Murphy and Jensen, 2018; Hurt, 2011).

A complex issue: Even if executive compensation is regulated, there will be regulatory loopholes that allow financial institutions to offer excess compensation. For this reason, it might be better for financial regulators to refrain from interfering with private compensation contracts, and allow the markets to fix the executive compensation problem. But the market itself is imperfect, and there will continue to be excess pay sometimes. Market discipline can provide a check-and-balance on excessive pay and can also address the worst abuses of compensation packages (Markham, 2007).

2.3. Instilling strict financial regulation and supervision without limiting the ability of financial institutions to exploit emerging profitable opportunities

A difficult issue: Strict financial regulation and supervision can limit the ability of financial institutions to take advantage of available profitable opportunities (Brunnermeier et al, 2009). The fear of sanctions or heavy fines under a strict regulatory and supervisory regime can discourage financial institutions from pursuing emerging profitability opportunities. When financial institutions are unable to freely pursue emerging profitable opportunities, they are likely to report low profits due to regulatory restrictions, and persistent low profit is an indicator of financial instability (Bouzgarrou et al, 2018). This will become a serious concern to financial regulators when many financial institutions report persistent low profits.

Generally, there are two broad types of financial regulation, namely, 'capital regulation' and 'activity restriction' (Djalilov and Piesse, 2019; Noman et al, 2020). Activity restriction is a type of regulation that prohibit regulated financial institutions from carry out, or participating in, certain financial transactions or business activities. The argument in support for activity restriction is that since moral hazard encourages risk-taking, banks that are allowed to engage in more activities naturally have more incentive to take more risk to increase profit (Boyd et al., 1998). Therefore, higher levels of activity restriction can reduce banks' risk and profit (Gonzalez, 2005; Pasiouras et al., 2006; Agoraki et al., 2011; Wang and Sui, 2019). Activity restriction is used by regulators in many countries (Noman et al, 2020), even though it is considered to be unsustainable in the long term. Many studies show evidence that higher bank activity restriction is associated with financial instability [see, for example, Barth et al. (2004), Laeven and Levine (2009), Ashraf (2017), Li (2019)]. In contrast, capital regulation ensures that financial institutions have sufficient and high quality capital that can absorb unexpected losses that arises from the risk-taking activities of financial institutions (Santos, 2001; Ozili, 2017). Currently, capital regulation has been adopted in many countries and is promoted by the Basel Committee for Banking Supervision (BCBS).

Proposed Solution: One way to instill strict regulation and supervision without limiting the ability of financial institutions to exploit profitable opportunities is to introduce strong capital regulation, not activity restriction. Capital regulation is a better approach because it ensures that financial institutions have sufficient capital to absorb unexpected losses without creating externalities in the financial system (Brunnermeier et al, 2009). Capital regulation allows financial institutions to pursue emerging profitable opportunities and focus on risk-adjusted returns or profits (Gaganis et al, 2015). Under a capital regulation regime, financial institutions can carry offer a wide range of risky activities provided that they have sufficient risk capital to absorb any resulting losses. Capital regulation does not stop financial institutions from exploiting profitable opportunities, rather it makes financial institutions stronger and safer while taking more risk. When compared to activity restriction, activity restriction does not allow financial institutions to freely pursue all available profitable opportunities in the business environment especially when certain business activities have been banned by regulators.

A complex issue: The preference for capital regulation by policy makers does not mean that more capital regulation is always better. In fact, requiring financial institutions, such as banks, to keep too much risk-capital can be harmful to banks because it can limit their ability to create new loans from existing capital when more capital is tied down by regulation. For this reason, there is need to determine the optimal level of regulatory capital that is needed to keep financial institutions safe. The optimal regulatory capital is one that (i) protect banks from downside risks, (ii) allow banks to pursue risky activities, and (iii) does not limit banks' ability to create new loans from shareholders' capital.

2.4. Ensuring that financial institutions increase lending during a recession

The rational response of financial institutions, or lenders, during bad times is to reduce the size of credit in order to reduce their overall exposure to credit risk in bad times. They often do this by increasing interest rate on new loans, or an outright refusal to lend to some businesses or business sector during bad times. Reducing credit supply in bad times will worsen the economic situation of businesses and individuals.

A difficult issue: Ensuring that financial institutions increase lending in bad times or during a recession is important because it helps to stimulate growth towards economic recovery. The difficult issue is how to make financial institutions increase lending in bad times and during recessions. In other words, how can regulators make lenders to act irrationally in bad times by lending more in the presence of high credit risk during a recession? Even shareholders will expect lenders to reduce credit supply in bad times in order to reduce the potential for losses that could deplete shareholders' capital.

Proposed solution: One way to make financial institutions increase lending in bad times and during a recession is to give explicit/implicit government guarantees on new loans issued by financial institutions in bad times. Once implicit or explicit government guarantees have been granted to formal lenders, they will have an incentive to increase lending during bad times, and hope that the government will pay back some or all of the resulting non-performing loans which the government had guaranteed if the loans go bad.

But such explicit and implicit government guarantees given to financial institutions, or lenders, can create three problems. The first problem is that the profit generated from such lending is shared privately by financial institutions while the cost of the crisis is borne by the public since the government is guaranteeing bad loans using taxpayers' money. The second problem is that large lenders, such as big banks, tend to enjoy the advantages of implicit or explicit guarantees to a greater extent than small lenders. The third problem is that the fact that the government is implicitly or explicitly guaranteeing new loans in bad times could signal to the markets that the new loans issued in bad times are already bad on arrival and are of low quality once issued. As a result, money market and capital market lenders will be unwilling to lend to borrowers that are benefiting from the such guarantees or will lend to them at a premium.

Another option is to impose a 'total loan to total funding ratio' (LFR) as a regulatory requirement. Regulators can require lenders to keep a high LFR regulatory requirement during bad times. The advantage of this approach is that it can make lenders increase lending in bad times since a high LFR in bad times will mean that lenders must give out more loans from the deposits or funds they receive in bad times. This approach also creates two unique problems. The first problem is that, in order to meet the high LFR ratio, lenders may prefer to extend additional credit lines to existing corporate customers instead of issuing new loans to new customers during a recession. They will not issue loans to new customers because they want to reduce credit risk. The second problem is that instead of issuing new loans to new customers in bad times, lenders can rather choose to reduce the amount of loans issued and significantly reduce deposits or the funding they receive in bad times in order to meet the LFR target. The third problem in requiring lenders, such as banks, to keep a high LFR in bad times is that it assumes that lenders will receive more funding or deposits in bad times from which it can lend from. The problem is that the number of deposits in banks tend to be lower in bad times as customers prefer to hold cash as a precaution in bad times rather than keep it as deposit in a bank.

2.5. Having both a female Chair and female CEO in a major financial institution is rare.

In recent times, the representation of women on the board of many financial institutions is growing. Today, a good number of Fortune 500 finance companies have a female Chief Executive Officer while other finance companies have a female Chairperson. This is indeed a good thing! Generally, both men and women do well in corporate leadership (Perryman et al, 2016; Green and Homroy, 2018; Ozili, 2020). The literature on female leadership show that women do well in business, and the firms they manage perform very well (see, for example, Lückerath-Rovers (2013), and Bennouri et al, (2018)). The finance literature also show that female CEOs are more conservative in managing risk than male CEOs (see, Yang et al, 2019; Ozili, 2020), while male CEOs take more risk in search for high profits than female CEOs (Elsaid and Ursel, 2011; Faccio et al, 2014).

A difficult issue: It is common to see a male CEO and male Chairperson in the same financial institution. But it is rare to find a major financial institution that has a female CEO and a female Chairperson (i.e. head of the company Board). Having both a female Chair and CEO in the same financial institution is difficult to see in major financial institutions, and it is hard to understand why this is happening. Here are my thoughts on why this might be happening! Could this be happening because financial institutions have not thought about the possibility of having both a female CEO and female Chair in the same company? Or, could this be happening due to the need to balance the gender distribution in leadership such that a gender is the CEO and another gender is the Chairperson? Or, could this be happening because of the historical patriarchal dominance of men over women in business that makes it difficult to have a wholly female leadership in large finance organisations? This phenomenon raises more questions than answers?

2.6. Making central banks independent from the influence of the federal government

In theory, central banks ought to be independent from the influence of the federal government, and from any other political influence so that the central bank can conduct monetary policy in a way that is consistent with the statutory objectives of the central bank. Many scholars have advocated for central bank independence, for example, Walsh (2011), Goodhart and Lastra (2018), Bodea and Hicks (2015), de Haan et al (2018), and Tucker (2020).

A difficult issue: in practice, it is difficult to make the central bank fully independent from the influence of the federal government. This is because the central bank governor is appointed by the President or the Head of federal government. This practice makes it difficult for the central bank to completely reject or oppose directives from the federal government even when the directives are inconsistent with the statutory objectives of the central bank. The challenge is to find a way to make the central bank attain a reasonable level of independence with minimal interference from the federal government.

Proposed solution: One way to make a central bank attain a high level of independence is to allow the bankers' association elect the central bank governor. This way, the elected governor will be a competent person, who is familiar with the workings of the financial system and the economy, and who is free from undue political influence. Another suggestion to make the central bank become independent is to enact legislation that makes it very difficult for the federal government to remove or suspend the incumbent central bank governor purely on grounds of policy disagreements. Legislation should allow that the central bank governor finish his/her tenure, irrespective of any grievances the federal government may have against the central bank governor or the operations of the central bank.

A complex issue: While attaining central bank independence is important, there is a price to pay for attaining full central bank independence. An independent central bank can become too powerful, and refuse requests from the federal government to intervene in areas of the economy that are outside the statutory duties of the central bank. Also, an independent central bank can resist any pressure to make necessary interventions in the economy during crises. The independent central bank can insist that its primary role is to promote price stability at all times, and that it will not extend its duties outside the goal of price stability, irrespective of whether there is an economic crisis or significant risks to financial stability. The implication is that the independent central bank may not prioritize economic recovery and preserving financial stability during a crisis; rather, the independent central bank may most likely prefer to pursue price stability only.

2.7. Making traditional financial institutions become relevant in the ever-changing digital technology environment

The rapid increase in digital finance innovations in the financial sector has led to concerns that the core competitive advantages of traditional financial institutions are being eroded by disruptive innovations led by technology companies and Fintech agents. The risk is that the Fintech businesses operating in the financial eco-system, who are constantly seeking market share, will steadily erode the core competitive advantage of traditional financial institutions. As a result, traditional financial institutions will have to make tough choices if they are to remain competitive in the digital age.

A difficult issue: The difficult issue is how to make traditional financial institutions become relevant in the midst of ever-changing digital finance innovations. Traditional financial institutions need to find ways to cope with the threat posed by disruptors, such as RegTech in the regulatory sector, LendTech in lending markets, InsurTech in the insurance sector, PayTech in the payments sector, TradeTech in the investment and trading markets.

Proposed solution: One way to make traditional financial institutions become relevant in the ever-changing digital technology environment is to require financial institutions to focus on developing distinctive capabilities in certain segments of the market where they can maintain sustainable competitive advantage in the financial ecosystem. Another way to make financial institutions become relevant in the ever-changing technological environment is for financial institutions to re-engineer the way they do business by creating a new strategy of digitalisation in their business model. Adopting digital technology in their business model will help them gain high visibility in key markets, and could lead to increase in activity in all digital channels owned by traditional financial institutions. Traditional financial institutions will also need to constantly re-engineer the digital component of their business model in response to changing digital technology.

A complex issue: Making traditional financial institutions become relevant in the ever-changing digital technology environment has the consequence of crowding-out the new Fintech players from the market. This is because the Fintech players may find it difficult to gain customers that are already served by traditional financial institutions. It can also discourage new Fintech entrants from joining the financial ecosystem. Furthermore, the need for financial institutions to re-invent themselves through digital innovations is not without problems. It may be difficult for financial institutions to keep up to speed with the ever-changing digital technology landscape. Some financial institutions, due to their small size, may be slow in adopting digital technology and the cost of upgrading digital technology infrastructure may be very high. This can put small financial institutions at a competitive disadvantage, and make them vulnerable and attractive for hostile acquisition by rivals.

2.8. How to instill light-touch regulation without creating incentives for excessive risk taking

A difficult issue: Whenever regulatory rules are significantly relaxed or loosened – making them lighter on financial institutions – the unintended consequence is that financial institutions will have an incentive to take more risks in pursuit of higher profits. This creates a difficult problem for financial regulators. Regulators need to find a way to discourage financial institutions from taking excessive risk when regulations are relaxed.

Certain economic conditions require regulators to relax or loosen strict regulations. For example, during a pandemic or economic crisis, regulators may need to loosen credit rules to allow financial institutions increase lending to critical sectors of the economy in order to boost productivity and to support economic recovery in such times. Regulators often have to grapple with the possibility of excessive risk-taking by financial institutions after strict regulations are loosened.

Proposed solution: One way to adopt light-touch regulation without creating incentives for excessive risk-taking is to ensure that all agents of financial institutions have a skin-in-the-game. There should be personal liability for losses that arises from taking excessive risks. This will make financial institutions become cautious when taking excess risks.

A complex issue: Adopting this approach is more complex than it seems. This is because, to have a skin-in-the-game, the corporate veil must be lifted so that risk-takers can be disciplined even though they are acting in the interest of the financial institution. But this approach is complicated because taking disciplinary actions on agents of financial institutions can send a bad signal to employees and financial markets, and can discourage talented employees from seeking opportunities in certain segments of the financial sector especially in the trading and investment sub-sectors.

3. Conclusion

This paper offered a discussion about the difficult issues in financial regulation for financial stability. Some of the identified issues include: the difficulty in breaking too-big-to-fail financial institutions into small insignificant parts; the difficulty in regulating executive compensation in the financial sector without limiting the ability of financial institutions to attract and reward executive talent; the difficulty in instilling strict financial regulation and supervision without limiting the ability of financial institutions to exploit emerging profitable opportunities; the difficulty in ensuring that financial institutions increase lending during a recession or in bad times; the rarity of having a female CEO and Chair in a major financial institution; the difficulty in making central banks independent from the influence of the federal government; the difficulty in making financial institutions become relevant in the ever-changing digital technology environment; and the difficulty in preventing financial institutions from taking excessive risks when strict regulations are loosened under a light-touch regulatory regime.

The implication of the findings is that financial regulation for financial stability is not an easy task. There will be issues that financial regulation can address, and there will be issues that financial regulation cannot address. Acknowledging that such difficulties exist on the path to financial stability is the first step to addressing these issues. Should more financial regulation be introduced to address these issues? I doubt. Should financial regulators do nothing about these issues because they are difficult? I don't think so. Perhaps, some of the difficult issues identified in this paper can be resolved by careful regulatory policy design, provided there is a good formal relationship between regulators and regulated financial institutions.

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