Should Taxpayers Pay For Future Bank Failures?

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At the 14 March 2011 APEC Financial Regulators Training, Bangkok, Thailand

Good Morning, ladies and gentlemen

My remarks are about financial regulation in general. But where it is relevant to the banks here in Thailand, it is my own opinion. It is not in any way the position of the Financial Institution Policy Committee of which I am a member.

We meet here in Bangkok barely 3 years after one of the biggest financial crises in history, and quite soon after the official report by the National Commission on the Causes of the Financial and Economic Crisis in the United States which came out in January.

It is interesting to note that the Report issued by America's official enquiry body pinned the blames not on chances nor on accidents, but squarely on the people involved.

The people that they blamed included the commercial bankers that concentrated too much on risk taking, the mortgage originators that did not control the quality of the borrowers well, the investment bankers that put together products that were far too complicated, the traders of financial products that looked only to yearly bonuses without due care for long term results, the securities analysts that failed to adequately identify the risks and the rating agencies that misled people in their assessment of the risks of complex products.

But the biggest blames were reserved for the American financial regulators.

The Federal Reserve was criticized for failing to set the minimum quality standard for mortgage borrowers, allowing the practice of no-document loans, unproven sources of income, multiple speculations on many houses at the same time, and the high and unsustainable loan-to-value ratios.

The securities regulators were criticized for failing to adequately supervise the rating agencies and for allowing the investment banks to operate at too high the levels of leverage.

This is probably not the end of official reports. There may be more to come with regard to events in Ireland, and the investigation into Royal Bank of Scotland is still on-going.

As a financial regulator myself, I can't help feeling that the criticism was a bit harsh. The main cause to all crises is the macroeconomic conditions that allowed the gigantic bubbles to build up. And this is not the remit of financial regulators.

Anyhow, enough of the past, it is now the time to look to the future. The future does look set to be more secure because there are so many financial regulatory reform measures being proposed in the Dodd-Frank Wall Street Reform and

Consumer Protection Act, and by international forums such as G-20, Financial Stability Forum and IOSCO.

Many of them are designed for the more sophisticated transactions and are therefore not much relevant yet to most emerging markets where transactions are of more simple structure and are less complicated.

However, there are some very important issues that all markets should consider, and especially the emerging markets. What are they?

First is the problem of shadow banking. In the advanced markets, banks set up numerous Special Purpose Vehicles. They sold a lot of assets to these SPVs, securitized the assets and removed them from the banks' balance sheets.

However, for many of the transactions, even though the legal structure provided no recourse back to the banks, in reality the banks often had no choice but to step in when the products got into trouble.

The banks did not hold capital for the assets that they had put into these SPVs. They had capital only for the assets that still remained on their balance sheets. So in the end, when they were forced to take responsibility for the assets in the SPVs, they had to be bailed out by the government.

The lesson from the advanced market is that regulators must ensure that banks have adequate capital to support their shadow banking activities.

However, in most emerging markets, banks do not yet do much securitization. So is it right for the emerging market regulators to feel comfortable about this?

In my opinion, they could be wrong. Emerging market banks may still have a lot of hidden liabilities from shadow banking.

Banks in emerging markets are allowed to sell investment products to the public through their retail counters. All the investment products are packaged by securities companies that are the banks' affiliates.

They sell only products from their affiliates, and nothing from their competitors. Savers that walk into each bank are therefore offered products exclusively from one single group. Why is it a problem?

If a saver is offered investment products from various sources, he/she will have to make comparison. He/she will have to compare not only the rates of return but also the risks of capital loss. To the saver, it will clearly be an investment decision. It will be clear that the risk of capital loss belongs to the saver.

Instead when the saver is offered products only from the bank's affiliates, there is high risk that the savers may wrongly perceive all the products that they buy to be the banks' own risk.

The lesson learnt in the advance markets is that when panic set in, some banks were forced to cover losses to investors who bought into their SPVs. They were

forced not by law, but by circumstances. They had to do so to prevent panic from spreading to their other operations.

In the emerging markets, in future when panic sets in, banks will most likely be forced to do the same. Just like in the advance markets, the banks will find out that their capitals are way inadequate when it is far too late.

Second is the problem of counterparty risks. It was found in the advance markets that over-the-counter derivative trading could be a major source of systemic risk.

If one bank fails, and if it has large counterparty balances with other banks, the bank that fails can drag down other banks.

The reformers therefore recommended that as much derivative trading as possible should be moved onto exchanges with central counter party facility, where the balances between the banks can be safely netted off.

Again in most emerging markets, banks do much less derivative trading than banks in the advance markets. So is it right for the emerging market regulators to feel comfortable about this also?

Take the example of Thailand. Risk management in foreign currencies is mostly done through forward contracts. These are custom made. It therefore led some bankers to argue that there is no need to set up a market for standardized futures contracts. Because no one will use them!

But they are wrong. If a standardized FX futures market does exist, the bid and offer in this market will automatically be lower than what the banks currently charge their clients through forward contracts.

When a futures market is available, customers can achieve lower costs. They will automatically break down as much of their needs as possible into standardized futures, leaving only the small amounts that they cannot do so in the old form of forward contracts.

The only people to lose out will be the banks who can no longer dictate their prices. The people to benefit will be today's bank customers.

Because central clearing reduces systemic risks, regulators should impose substantially higher risk weights on the counterparty balances that remain outside the exchanges.

Third and probably the most important problem is who should pay for bank failures. When the Asian crisis broke out, Asian governments generally ended up paying for the bank failures out of the general taxation, directly or indirectly. In this financial crisis, all other non Asian governments also did the same.

This approach imposes a big burden on the tax payers. The innocent mass was made to pay for the mistake of the few. So for tomorrow's bank failures, should this continue?

Emerging market regulators cannot be complacent. Even though there are various measures to strengthen bank capitals through Basel 3, numerous other rules and early warning system, banks will still fail. This could be because of fraud, neglect or the overlook of hidden risks and shadow banking as mentioned above.

The Swiss banking authority is pushing Swiss banks to issue a special category of bonds i.e. contingent convertible bonds (nicknamed CoCo bond) that will behave like debt in normal time, paying high coupon.

But when the banks' core capital fall below a percentage, say 7%, or when the regulator judge the banks to be close to collapse, these bonds will be converted into equity. In the case of Credit Suisse, the regulator will require it to carry an extra 9% of capital in such bonds.

These bond holders, and not the general tax payers, will pay for the banks' failure.

In the US, if major banks fail tomorrow, the Dodd-Frank Bill allows the government to levy from the remaining banks to cover the costs. It may seem odd to force the surviving banks, the good banks, to pay for the cost of the failed bank, the bad banks, but it is the surviving banks that benefit the most from the authority stepping in to save the system.

So here, the banking industry, and not the general tax payers, pays for the bank's failure.

The rule for bank failure should be set in advance. It should be drawn up in normal time. Because I have seen from experience that when panic sets in, all banks will be considered, as Mervyn King, Governor of the Bank of England said, too important to fail.

In Thailand, there is another peculiarity. Banks here are allowed to issue bills of exchange to walk in customers. These BEs are not capital market products that are normally issued in big lots with proper underwriting and market making. For all intent and purposes, these BEs are bank deposits. But in Thailand, banks do not pay deposit insurance levy on BEs.

This has encouraged the banks to issue substantial amounts of BEs. And this trend will continue and grow.

And even though legally they are not covered by deposit insurance, when panic sets in and when all banks are too important to fail, they automatically become additional costs to the public.

Emerging market regulators must plan today for bank failures that will happen tomorrow. If they do not, they will again automatically impose the burden on the general tax payers, the innocent bystanders.

And in future no tax payer should ever forgive them for that.

Thank you.