Lessons from the Last Financial Crisis and the Future Role of Institutional Investors

by

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The dynamics of the financial crisis were driven by underpricing of risk and lack of transparency, which led to a loss of confidence when the bubble finally burst. Crisis resolution involved massive government interventions that caused a permanent transfer of losses to the public sector as well as sovereign-debt crises that may involve painful solutions. Letting banks fail is a necessary disciplinary factor, but this requires a well-defined “game plan” which did not exist in the crisis. Regulatory reforms underway aim at restoring confidence, but they may hamper the long-term potential of institutional investors. Nevertheless, institutional investors should still be able to provide risk capital – except for perhaps pension funds, which have been weakened by demographic developments. Finally, improving governance and reducing excessive risk-taking are important but challenging tasks. More active and involved shareholders could further these goals, but such participation will be hard to achieve. Therefore, transparent bonus and remuneration plans are perhaps the most important initiatives for preventing future systemic financial crises.

JEL Classification: G01, E6, G1, G2, G3.

Keywords: Financial Crisis, financial reforms, institutional investors, pension funds, long-term investment and saving, corporate governance.

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I. Lessons learned

1. The dynamics of financial crises

During the 15 years prior to the major financial crisis of 2008, the world witnessed a long period of falling risk premiums in the financial markets. Measured risk also declined, and investors seeking higher yields increased their appetite for risk. As reported yields rose, and measured risk fell, bubbles began to form in many markets. This obviously applied to the equities markets, but also, and especially, to the real estate markets. Remarkably enough, this was virtually a global phenomenon.

When the asset bubble began to burst, financial institutions worldwide had to concede that the value of loan portfolios was being strongly eroded. The new realisation was that it was hard to identify precisely how the residual risks were distributed. Greater use of financial instruments and the development of sophisticated financial techniques added to the uncertainty and the lack of transparency. Which institutions were left holding the toxic assets? This again led to a fatal negative spiral, with a loss of confidence in the individual financial institutions and the entire market. Liquidity in the markets dried up completely, and on a global scale the first real worldwide crisis in the financial system since the Depression of the 1930s became a reality.

2. Stabilisation phase

A general characteristic of this crisis was the massive involvement of governments and central banks. With the exception of Iceland, in no country were systemically important financial institutions allowed to fail. This required massive support from governments and central banks. The methods differed – massive capital injections to major banks and investment banks in the US and the UK, extensive guarantees for all banks’ debt in other countries – but the objective and purpose was the same: to protect the viability of the financial system. As a consequence, the risk was absorbed (for a time at any rate) by governments, and the markets were swamped with inexpensive central-bank credit. An ironic aspect is that the crisis of 2008 was in particular caused by excess liquidity and cheap credit, but the solution (at least in the short term) seemed to be even more liquidity and even cheaper credit.

Restoring of financial confidence led to a permanent transfer of losses to the public sector, as the private sector’s risk takers were bought out. In more polemical terms: profits from the excesses of the preceding period were privatised, while the losses were socialised. This is hardly a model that is tenable in the long term. Having said that, there was little inclination among political decision-makers to try out the alternatives: allowing the financial system to fail. The real economy is far too dependent on a well-functioning financial system for that to be allowed to happen.
3. Allowing for a “decent” bank crash

Bank failure is a necessary disciplinary factor

If individual banks, and especially the largest of them, cannot be allowed to fail – and the essence of a market economy is that any privately-owned company must be allowed to go bankrupt – there is no fundamental disciplinary factor in the financial system. If there is an implicit government guarantee for the banks, the taxpayer is left with the tail risk. Bank shareholders and depositors are given a free put option by the State. It is vital to financial stability that this put option is priced, and that the banks and their customers and shareholders come to pay for it. Otherwise, we can sit back and wait for the next bubble to burst.

A well-defined “game plan” is required

The key requirement is that there is a complete, well-defined “game plan”. In a banking crisis, time is even more valuable than money. If a financial crisis is looming, the speed at which the authorities intervene is vital. A clear division of means and roles is just as important. To avoid “moral hazard” it is important that shareholders and other liable capital owners are in the front line when the losses are distributed, but also that major holders of senior debt know and accept the risk of a “hair cut”.

4. Sovereigns

The financial crisis increased fears of a sovereign debt crisis

In several countries, the financial crisis led directly to increased fears of a sovereign debt crisis. Examples are Greece, Ireland and Portugal. In Ireland’s case, a very large and inflated banking sector was fully guaranteed by the Republic of Ireland, and the enormous negative equity in the banking system was thereby “nationalised”. In addition, large public-sector deficits cast doubt on the sustainability of government finances. In the affected countries, this was not only due to the financial crisis and the collapse of the banking system. The spotlight was also turned on the general sustainability of government finances in light of demographic developments that would increase, among other things, future pension-system costs and government expenditure on healthcare.

Painful decisions to deal with unsustainable debt levels may have to be made

The crisis of confidence in sovereign debt becomes especially pressing when it becomes clear that the real interest burden on these sovereigns far exceeds the expected future real growth rate. In such a situation, there is the prospect of an untenable debt collapse. This is the mechanism that has been so destructive for a number of euro-area member States during the past year. In this light, it is an open question whether the traditional means of support from the IMF and the core EU member States are anything more than a postponement of some painful decisions. These decisions can involve restructuring of the debt, or debt rescheduling, either full or partial.

II. Future regulation

Reform initiatives to reduce the risk of future financial crises

After the crisis, a large number of global initiatives have been launched to reduce the risk of a future financial crisis and collapse. The purpose is to make the financial system more resilient and to prevent future financial crises from creating strong negative real-economic consequences. The intention has quite simply been to boost confidence in the financial system. The initiatives include
efforts to establish Basel III, Solvency II, the Frank-Dodd financial reforms in the US, and the EU’s regulation of the market for derivative financial instruments.

The major question, however, is whether these initiatives will function as intended. A general aspect of the regulatory adjustments is higher requirements for capital and capital of better quality. This in itself strengthens the institutions affected, but at the heart of the most recent financial crisis was the collapse of “near-bank” institutions. “Shadow banking” becomes even more attractive when the official banks are subject to tighter capital requirements. Much of the regulation that has already taken place, and expected future regulation, is aimed at “near banking”, but regulation is not without its costs. Higher capital requirements, etc. lead to credit contraction, which in itself has negative consequences for the real economy.

### III. Institutional investors’ contribution to ensuring growth and financial stability

The regulation of institutional investing is currently also subject to considerable changes. The overall trend has been to consider the entire financial system as one single entity, and to treat identical activities in a uniform way, independently of the legal packaging. The principle is that, for example, a loan to a company must be subject to the same capital requirements and valuation, regardless of whether the loan is granted by a life insurance company, a bank, or another financial entity. The objective is naturally to prevent regulatory arbitrage.

The Solvency II framework, among other things, entails that all assets and liabilities must be marked to market. In many countries it will be a fundamental break with the past if non-commercial entities, such as pension funds and cooperative societies engaged in life insurance, are also to be subject to mark-to-market regimes. In such cases, the institutional investors’ capacity for risk will be solely dependent on the ratio of their liabilities to free reserves/equity, possibly supplemented with backing from external sources – for example company sponsors or the labour-market parties.

Critics of the Solvency II regulation regarding institutional investors point out that in this sector, too, this regulation will lead to a lower capacity for risk due to the higher capital requirements. It is also feared that strict capital requirements based solely on market values will lead to “short-termism” and “herd behaviour”.

In my view, this criticism is justified in the sense that external events such as stock-market crashes simultaneously reduce reserves and thereby investors’ capacity for risk. Everyone therefore seeks to reduce risk at the same time, thereby exacerbating market volatility. On the other hand, precisely this same eventuality will make it extra attractive to hold surplus reserves in order to cope with increased volatility. In the long term, therefore, higher capital requirements are hardly likely to have any negative impact on either capacity for risk or the scale of market fluctuations.
The alternatives to solvency-based capital requirements (based on market values) do not seem attractive: The use of “smoothing”, for example, will in practice make it impossible to hedge the liabilities that have been exposed to smoothing as a “smoothed” asset cannot be bought in the market at a “smoothed” price. In the same way, using historical prices, for example, for assets and liabilities would muddy the situation. Using another analogy: this is like switching the light off if you don’t like what you see.

However, even in a mark-to-market regime, institutional investors can contribute substantially to future growth. They can so because, in contrast to banks, they are rarely exposed to the risk of a “run” on the institution. This makes it possible for institutional investors to invest in illiquid assets with a long horizon. As providers of long-term savings, these investors can therefore make a key contribution to restructuring and developing our society – nationally and globally – by investing in sectors with high long-term returns.

The fact that pension systems today appear to have weakened globally compared to the 1990s, and are therefore less able to be suppliers of long-term venture capital, is only in small measure due to new regulation. The weakening of pension systems is more due to the fact that, historically, very generous pension commitments have not been supported adequately enough by pension contributions. An increase in life expectancy augments the pressure on pension systems, regardless of whether they are private-sector or public-sector schemes.

In many countries, the pressure on pension systems has led to the closure of defined-benefit schemes in both the public and private sectors. Instead, the workforce has been offered regular savings schemes, often as fully individualised plans. In general terms, there has been a shift from lifelong pension products to regular savings accounts. This entails the individualisation of both investment and life-expectancy risk. Based on fundamental welfare considerations, the expediency of this can be questioned; in addition, the individualisation of investment decisions weakens pension savings’ ability to support and finance long-term investment in growth and employment.

IV. Corporate governance and stewardship

Institutional investors typically invest on behalf of current and future pensioners. They thus hold “fiduciary responsibilities”. For a minority shareholder, acting as a good owner – i.e. engaging in overall discussion of appropriate strategies with the company’s top management and influencing the composition of top management – is a “public good”. The individual minority shareholder cannot internalise the possible benefits, as these are enjoyed by all shareholders, while the minority shareholder itself bears all the costs of an activist corporate governance policy. Atomistic ownership of large stock-exchange-listed companies therefore entails the considerable risk that investors will act as short-term, unengaged investors rather than as owners. One consequence can be that large companies without a dominant owner to promote good corporate governance on behalf of all shareholders will in real terms be taken over by managements that act solely in their own interest. This leads to an overwhelming risk of “moral hazard”, whereby top management, via opulent
bonus and remuneration plans, rewards excessive risk-taking and takes over an increasing share of the company’s profits.

In this light, a number of political initiatives at the global level must be welcomed. In addition to higher equity requirements, the requirement for transparent bonus and remuneration plans and prior approval of these plans at the companies’ annual shareholder meetings are perhaps the most important initiatives to prevent future systemic financial crises. There is little doubt that excessive risk-taking in the financial sector in the years up the crisis – in addition to the macroeconomic pro-cyclical excesses – also originated from a failure of governance. In reality, this led to the privatisation of the profits of a small group of players – and the socialisation of the subsequent massive losses. Today, many countries are still struggling with the consequences.