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G20 Summit: The Need to Regulate Short-Termism

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At the G20 summit coming up in Toronto on 26-27 June, leaders are expected to focus on how to avoid a repeat of the recent global financial crisis. However, the IMF's recommendations fail to address a key issue -- short-term incentives that encourage bankers' risky behaviour.

HOW SHOULD we regulate banks so as to avert a recurrence of the recent global financial crisis? In advance of the upcoming G20 summit in Toronto, the International Monetary Fund has proposed a new global tax on financial institutions roughly in proportion to their size, as well as a tax on banks' profits and bonuses. These proposals have received a mixed response from the G20 presidents and finance ministers: the United States and the United Kingdom are strongly supportive while others whose banking systems successfully endured the crisis, including France, Germany, and Canada, are opposed. What explains this mixed response, and does it point to the need to consider alternative regulatory remedies?

Short- vs. Long-Term Incentives

High-income countries share much in common with regard to the sophistication of their financial systems. There is, however, a crucial differentiating attribute that explains why some contributed to, or went relatively unscathed by, the crisis: the long- or short-term focus of bank managers. Where managers focus more heavily on short-term earnings benchmarks, they face incentives to take on greater risk. Two potentially self-reinforcing attributes of countries' financial systems contribute to this focus: (1) the concentrated or diffuse ownership of the financial institution; and (2) the extent of self-regulation allowed by the government.

Where ownership is more diffuse – that is, numerous shareholders own a stake in the firm without a majority owner – managers' pay is explicitly tied to the company's share price performance. Quarterly earnings updates tell the shareholders how the company is doing, so managers focus their efforts on

meeting, or exceeding, these tri-monthly reports. Consider the effect this has had on Goldman Sachs since it went public in 1998.

Goldman used to profit primarily by serving the ongoing needs of its clients, such as raising capital, trading blocks of stock or providing merger and acquisitions advice. This strategy forced Goldman's bankers to be "long-term greedy" — a phrase coined by a former senior partner, Gus Levy. Now, however, Goldman focuses on "making markets" for its trading "counterparties". Goldman's bet against the mortgage market was constructed in just two months at the end of 2006 and the beginning of 2007, and made the firm a profit of nearly \$4 billion in 2007. Closing a multibillion dollar merger or underwriting a bond issue can take months, if not years, and result in a fee in the millions or tens of millions.

The Extent of Self-Regulation

As a result of this new focus, only one of the seven Goldman professionals grilled by senators in the US hearings is, or ever was, a banker — the people who actually meet with clients and help shape their long-term futures. In 1998, John L. Thornton, a former president and co-COO of Goldman Sachs, feared that taking the company public would lead to financial rewards being measured in months instead of lifetimes. It appears that he was right.

Where financial institutions heavily influence regulatory oversight, their short-term focus is likely to go unchecked. Independent government oversight that looks out for the public's long-term interest is necessary to moderate the risk-enhancing activities that occur in response to firms' short-term incentives. We can observe this by comparing the regulatory systems of Canada, the US and the UK.

In all three countries, diffuse ownership of banks predominates. In Canada, banking oversight is concentrated in a single body — the Office of the Superintendent of Financial Institutions — which actively monitors the country's banks, and whose regulatory guidelines are more heavily oriented towards protecting banks and their depositors rather than investors. This regulatory bias has led Canada to implement a more stringent leverage ratio, stricter capital requirements, and more conservative lending rules compared to the US. Close monitoring is made easier by the fact that six banks dominate the financial sector.

In the US, regulations are heavily informed by industry professionals, and the banking system is highly fragmented. As a result, financial institutions not only have more influence over the kinds of rules that are made, but also search for ways to circumvent them. In the UK, although the banking system is highly concentrated, financial institutions have also been able to self-regulate in order to ensure competitiveness.

Addressing Short-termism

The financial institutions of the US and UK are at the far end of the spectrum, with diffuse ownership and regulatory oversight biased in their favour. France and Germany are closer to the other end, with concentrated ownership and heavy government oversight. Thus, it is not surprising that they are at odds over the IMF's proposals. In the middle is Canada, with diffuse ownership and active, independent government oversight. Canada mixes the two approaches, and is seen as an enviable banking system for its capacity to weather financial crises. These include the 1930s, the S&L crisis of the 1980s, and the recent Great Recession; Canada has had only two bank failures while the US has had over 12,000. Yet, it remains competitive in global markets.

Current proposals that focus on taxes in proportion to bank size, or too-big-to-fail regulations, do not address the underlying short-term incentives that bank managers face. Canada's financial system is dominated by six banks yet is among the safest in the world. Taxing pay likewise fails to address the

underlying short-term incentives – bankers will continue to make risky bets despite the level of taxation on their income (just like taxes on winnings at a casino do not seem to be much of a deterrent to gamblers). Proposals should address the short-term incentives that bank managers face, and/or ensure that government regulators moderate bankers' short-term focus by having greater independence from the industry.

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