

RETHINKING FINANCIAL REGULATION

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- “history first occurs as tragedy, then repeats itself as farce.”
- economics : constructs of rationality, optimization and equilibrium, and statistical testing of hypothesis
- The Central Problem of Depression was solved

- Assumptions of Rational behaviour applied to Financial markets
- Past Justification of Regulation based on Market Failures
 - Information failures
 - Adverse selection in credit markets
 - Opportunistic behaviour
 - Moral hazard
- Decision making was by Rational Agents

Rethinking rationality in Financial Markets

- The efficient markets hypothesis
- first, decision-making cannot be systematically biased
- biases are not correlated across the participants
- systematically correlated biases will be eliminated by rational arbitrage.

- No place for Bubbles
- financial asset markets always fully reflect all available and relevant information,
- adjustment to new information is virtually instantaneous
- participants are at least as good at price forecasting as is any model that a financial market scholar can come up with
- Empirical Evidence: misalignment between asset prices and economic fundamentals for long periods

- noisy-trader framework
- not consistent with EMH.
- theory has *normative* intents rather than a positive description of reality.

rethinking on the foundation of investor behaviour: Alternative Paradgims

- *instrumental rational choice theory,*
- *Other Dimensions:* observance of social norms,
- motivation for normative conformity,
- Prestige, irrespective of the direct profit
- heuristics, frequently relying on mental short-cuts and rules of thumb.
- over-optimistic;
- have limited willpower and limited self-control;
- and that people are 'boundedly' rational, in the sense that they have limited information-processing powers.

- decisions are myopic and seldom have long run consequences been worked out in arriving at them.
- three heuristics when making judgements under uncertainty (Tversky and Kahneman 1974) :
 - **Representativeness**
 - **Availability**
 - **Anchoring and adjustment**

- choices among risky prospects exhibit several pervasive effects that are inconsistent with the basic tenets of expected utility theory.
- underweight outcomes that are merely probable
Certainty effect
- **isolation effect**, leads to inconsistent preferences
- Overconfidence During upswings
- Panic during down swings
- Herd behaviour
- Irrational Exuberance

- limitation of the assumption of arbitrage (Royal Dutch Shell case)
- perverse incentives created by the Originate to Distribute model.
- over relied on Credit rating agencies
- “influenced by availability and representativeness heuristics, investors replaced rigorous credit controls and valuation mechanisms with over reliance on credit ratings.”

Macro foundations: **KYNES AND MINSKY**

- solved the problem of the business cycle spurred by the prosperity in the mid-1960
- endogeneity of cyclical instability and of the transitory nature of the institutional underpinnings of financial markets.
- investment decisions based upon the *expected returns* based on the Marginal efficiency of investment and the long run rate of interest.

- Thus expectations played an important, if not a central, role in this framework.
- Major features of the Keynes-Minsky approach:
 - future uncertainty, the formulation of expectations, the importance of confidence, and volatility.
 - financial market will inevitably be affected by waves of optimism and pessimism
→MEI calculations → Volatility

- The Retreat from Keynes to a more mainstream approach: Monetarism
- Excessive government intervention is harmful: Inflation with unemployment
- what drives the waves of overconfidence and panic that cause and perpetuate crises.
- MINSKY : Hedge finance is expected to dominate in a healthy economy in equilibrium. However, this stable liability structure degenerates into an unstable speculative and Ponzi system.
- periods of prolonged prosperity due to the availability of cheap credit → Overconfidence → ponzi financing → off load assets → asset price meltdowns.

- rational self-interest or cognitive limitations?
- regulation of Banks and financial markets was not based upon regulating the *behaviour* of investors and borrowers
- *informational* imperfections of financial markets.
- Crises embedded not in the nature of Market imperfections per se,
- behaviour of economic agents

. TOWARDS A NEW ORTHODOXY?

- flaws and frictions to with individual behaviour
- more pragmatic approach to regulation?
- Geneva Report, NYU-Stern Report, De Larosiere Report and Turner Review :
- behavioral shortcomings that hinder the optimal market clearing conditions proposed in efficient market hypothesis.

- current financial regulations tend to encourage Minsky type pro-cyclical risk taking behavior
- Herd behaviour → correlated behaviour → Systemic risk
- micro-prudential concern is about individual risk
- macro-prudential with common, herd behaviour, and with shifts in generalized attitudes to risk

- In the end its about individuals, their Motives and Attitudes.
- Regulation must not be aimed at both the micro-foundations of such behaviour as well as at the macro level.
- Financial Systems are at cross roads because the very profession of economics is at a cross road.
- Much would depend upon the path economic theory takes from here
- "flaws-and-frictions economics will move from the periphery of economic analysis to its center."

