Discussion of "New Deal Financial Acts and the Business of Foreign Debt Underwriting: Autopsy of a Regime Change"

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Main Hypothesis of the Paper

- In the 1930s, there was a major regime shift in global financial markets (especially foreign government debt) triggered by financial regulation (New Deal)
- The new regulation moved the system from one resting on **certification by prestigious private intermediaries** to one dominated by public intervention (e.g. through multilateral governmental financial institutions)
- From an incentive perspective, the new system is inferior to the earlier system
- Hence, this is a paper about **regulatory failure**

Main Hypothesis of the Paper

- Analysis proceeds in three steps:
    1. **Old regime** (until 1931): Private intermediaries act as **certifiers** in the foreign government debt market and mitigate information problems through **reputation**
    2. **New Deal regulation** destroys the old regime by ...
        (i) ... reducing reputable capital,
        (ii) ... increasing liability and thereby making reputable capital "more cautious"
    3. Evolution of a **new regime** with a markedly reduced scope of investment banking and increased public intervention

Overall Assessment

- In response to financial crises, political discussions focus on **market failures**
- There is a tendency to replace private activities by **public intervention** (hard to reverse)
- This paper stresses that **regulation** is also subject to **failure**, especially if it is not tailored to the true causes of the problems
- Therefore, the paper is not only interesting from a historical perspective (which it certainly is!), but it is also extremely topical and important for current economic policy
- The main hypothesis is thought-provoking, bold and convincing

Main Hypothesis

The Old Regime of Certification

New Deal Financial Acts

Crowding Out and Crowding In

Conclusion

The Old Regime of Certification - How the Benchmark Model Worked (London: 1820 – 1914)

- Markets for foreign government debt are fraught with problems of asymmetric information
- Prestigious banks solved information problems by ...
  - ... **monitoring** borrowers and penalizing borrowers for misbehaving
  - ... acting as **crisis managers**
- Important prerequisites of **certification**: **Capital** and **prestige** (reputation):
  - Capital was pledged as **collateral** for sovereign debt
  - Prestige/reputation (implying future rents) deterred banks from misbehaving

How New York Replaced London (1900 – 1931)

- Success was reinforcing and strengthened the position of market leaders $\rightarrow$ Tendency of regime to persist
- So how could New York replace London?
- 3 factors:
  1. Growth of US economy (**capital**)
  2. Development of prestigious banking houses in the protected US market (**prestige**)
  3. Political restrictions in the London market (**weakening of incumbents**)

The Value of Certification

- Foreign government debt issues managed by prestigious banks **outperformed** those from other underwriters
- Hence, certification seems to have delivered significant value, especially in the sovereign debt market
- Argument: Due to **enforcement problems** in sovereign debt, signalling and control are particularly important in the foreign government debt market

The Old Regime – Comments

- Paper stresses importance of (delegated) **signalling** and **control** in foreign government debt markets
- These are typical responses to **adverse selection** and **moral hazard problems**
- But: Adverse selection and moral hazard are of less concern in sovereign debt markets
- **Enforcement** is key! (Willingness to pay rather than ability to pay, see Eaton/Gersovitz/Stiglitz, EER 1986)
- Certification argument rests strongly on models for corporate debt
- Unresolved question: How did banks solve the **enforcement problems** that they encountered in dealing with foreign governments?

The Old Regime – Comments

- Typical responses to enforcement problems in sovereign debt markets:
  1. Exclusion from **future credit** (Eaton/Gersovitz RES 1981)
  2. **Direct sanctions:** Interference with debtors' international transactions and transfer (Bulow/Rogoff AERPP 1989, JPE 1989)
- Prestige and (maybe even more!) the prominent market position of bankers may have been very important in these respects
- Small number of international creditors banks with large market shares makes it easier to have a **credible threat** towards the debtor country:
  - Threat of exclusion from future credit is only credible if no other creditor extends credit (easier to maintain with smaller number of banks)
  - Direct sanctions are more painful if banks have larger market shares

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New Deal Financial Acts

- 3 important components:
  1. Separation of investment and commercial banking (**Glass-Steagall Act**)
  2. High standards of disclosure (**Securities Exchange Act**)
  3. Increase in underwriters' civil liability (**Amended Securities Act**)
- How did these changes destroy the old regime?

Glass-Steagall Act

- Crowding out of securities affiliates of commercial banks **reduced competition** in the underwriting business and increases investment banks' market share
- But: Investment banks were **prevented from taking deposits** if they wanted to avoid regulation/supervision
- Problems of giving up deposit business:
  - Deposits were a crucial feature of **relationship banking**
  - Relationship depositors could offer support during crises
  - Banking relationship provided useful current account information
- Problems of becoming subject to supervision:
  - Forced disclosure destroys business model relying on proprietary information
- Consequence: Investment banks were also driven out of the underwriting business

Security Acts

- **Disclosure of information** implies loss of comparative advantage in information acquisition
- **Increased liability** makes underwriting less attractive and reduces incentives to act as crisis managers

New Deal Financial Acts – Comments

- Consequence of regulation: Several major players were driven out of the market
- Reputable capital could not easily be replaced by newcomers
- Breakdown of sovereign debt market is probably **not** due to the **direct effects** of New Deal Financial Acts on the underwriting business in sovereign debt (e.g., disclosure rules are of minor importance there)
- Only the new **liability rules** directly affected the attractiveness of the sovereign debt business
- **Corporate** investment banking became much less attractive, and the effective closure of sovereign debt markets may have been a **by-product** of prestigious banks' decision to abandon corporate investment banking

Did Regulation Destroy Reputation?

- Idea: The very fact that banks were regulated destroyed their reputation and prestige
- Question: Was prestige reduced because banks had performed poorly or because they were (wrongly) accused of having misbehaved?
- Evidence on relatively good performance of bankers is convincing
- Effect on sovereign debt market should not be overstated because investors could observe bank performance
- It is not clear that investors share public scepticism towards financial elites
- Regulation may even increase trust in banks
- But: Regulation made it more difficult for prestigious banks to **differentiate** themselves from other market players (and thereby earn rents)

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Crowding Out of Private Capital

- Result of regulation: Prestigious banks no longer wanted (and were able?) to act as certifiers
- New business model:
  - Role of investment banks was reduced to that of a (not information-intensive) **market maker**
  - Sharp increase in competition (lower barriers to entry)
  - **"Default puzzle"**: Defaults are no longer concentrated in less prestigious houses
  - In the corporate securities market, **covenants** were used to deal with increased liability
- Breaking-up of banking relationships (followed by and possibly causing an increased number of defaults in the corporate sector)

Crowding Out – Comments

- Why did banks from **other parts of the world** not take over the underwriting business, just as the United States had from Britain before? (Glass-Steagall was U.S.-specific)
- Why was the (domestic) corporate securities market not affected in the same way as the sovereign debt market?
  - New regulation should have affected the underwriting of corporate securities even **more strongly**
  - But: Moving losses to the issuers through covenants works with corporate securities, but not with sovereign debt due to **enforcement problems**
  - **Demand-side factors:** Was there any demand for foreign government debt, given the default experience and the political climate?

Crowding In of Public Capital

- Reconstruction of long-term relationships was neither feasible, nor desired
- Government (and quasi-public institutions, FBPC) took over responsibilities from "inept" banks in debt restructuring
  - No involvement of banks
  - Involvement of investment banks with "skin in the game" may have been more efficient
- Increasing public intervention in international financial markets, culminating in the formation of the Bretton Woods institutions
- New regime: "Investment banks do the selling, rating agencies do the assessing and the IMF does the troubleshooting"

Crowding In – Comments

- Is the modern role of investment banks really restricted to brokerage?
    - Modern underwriters (or underwriting syndicates) take on the **distribution risk** of securities
    - Lead managers typically carry largest part of the risk
- Nevertheless, there clearly has been a **shifting of risk** from private to public agents (with corresponding incentive effects)
- While the New Deal may not be the only explanation for this development, it seems to have contributed to it in a very significant way

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Conclusion

- Insightful and thought-provoking paper with important policy implications
- Some arguments rely (too) strongly on models of **corporate debt** neglecting the specific characteristics of **sovereign debt**
- Paper certainly contains many **lessons for today**
  - The replacement of private activities by public intervention is dangerous because it removes private responsibility, which distorts private incentives
  - Before carrying out hasty reforms, the real culprits of the crisis have to be identified
- For discussion: What has the paper to tell us about the inglorious involvement of Goldman Sachs in Greek sovereign debt management?

Thank you very much for your attention!