Paper Five

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Financial Regulation: So what do we do now?

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In April of this year the G7 finance ministers, worried about growing financial turbulence, endorsed the approach to regulation presented to them in a report from an eminent group including the Chairman of the UK's Financial Services Authority, the President of the Federal Reserve Bank of New York, and the Chairman of the US Securities and Exchange Commission[2].

The report began with an honest recognition of past failure: "A striking aspect of the turmoil has been the extent of risk management weaknesses and failings at regulated and sophisticated firms".

There followed a series of detailed recommendations, the essence of which was embodied in three core themes: greater transparency, greater disclosure, and stricter risk management by firms. In other words, nothing new. The Committee were repeating the tired trinity that has defined financial regulation for the past three decades. The trinity failed, and without a new approach the regulators will fail again.

That failure had two closely related origins: regulation failed to keep up with the institutional changes that in thirty years have transformed financial markets; and the regulators accepted that firms had the technical skills, expressed in their mathematical risk models, to manage risk better than the regulator could.

Thirty years ago most loans, to businesses and to individuals, were made by banks, or specialist institutions such as building societies. The deregulatory fervour of the 1980s changed all that. Credit markets became "dis-intermediated", that is instead of banks acting as intermediaries between savers and borrowers, the markets took over. Borrowing is now packaged into securities that are sliced and sold through a myriad of financial intermediaries. Investment banks, like Lehman Brothers, Merrill Lynch and Goldman Sachs, are (or were) at the centre of this process, taking on massive amounts of debt relative to their capital base (i.e. becoming highly leveraged) in order to deal profitably in the complex web of markets. Guiding their operations are their mathematical risk models, statistical models that measure the riskiness of their operations against patterns of past market behaviour. The firms claimed that they could manage risky markets, *and the regulators swallowed that claim.* Faith in transparency, disclosure, and risk management by firms is at the heart of the financial regulation today.

Yet at the same time it is generally accepted that a core purpose of financial regulation is to mitigate *systemic* risks, like a global credit crunch. Such risks are externalities, their cost to the economy as a whole is greater than the cost to firm whose actions are creating the risk. But if regulators focus on risks that are recognized by firms already, and neglect systemic risk, why do we need regulation at all, other than to enforce best practice? Firms will manage their risks well enough, using systems that are inevitably (and properly) market sensitive.

The flaw is that in the face of *systemic* market failures even the most transparent market is inefficient. In financial markets risk is mispriced, with consequences that are all too evident today.

So what can be done to tackle “systemic” risks?

First, regulators must begin to base their approach on the system as a whole. For example, whilst financial firms are encouraged by supervisors to conduct thousands of stress tests on their risk models, few are conducted by the regulator on a system wide scale. If it possible to have system-wide stress tests on the impact of Y2K, or of avian 'flu, why not on liquidity? The regulator should conduct system wide stress tests of those scenarios most likely to produce systemic stress - such as a 40% drop in house prices. The information gleaned in this exercise should feed into regulatory measures that might be quite different from those suggested by the risk management of an individual firm. After all, banks end up concentrating their resources in places where their *individual* risk management systems tell them, erroneously, they are safe. In the past couple of months the Federal Reserve has started to run such systemic tests.

Second, financial institutions must be required to undertake pro-cyclical provisioning, raising their reserves in good times and using those reserves as a cushion in bad times. The rules determining these reserves would be quite different from those governing the regulatory capital that financial institutions are required to hold today. That capital is a charge, not a buffer. Since the firm must hold a certain capital reserve to be allowed to operate, it cannot use that reserve to tide it over in bad times. The provisioning requirements should be based on the health of the economy as a whole, so capturing systemic strength and weakness. A policy like this has been pursued in Spain, where, despite the massive real-estate crisis the banks have so far remained strong. Astonishingly, the Spanish system is being dismantled because it is not in accord with market based international financial accounting standards.

Third, financial regulation must escape from its present focus on the nature of institutions – commercial banks are regulated differently from investment banks, hedge funds are not regulated at all – and concentrate instead on function. For example, targeting regulation on highly leveraged institutions, whatever their formal legal status, is an important step in this direction. Many years ago the only significant highly leveraged institutions were commercial banks. Today, leverage is a characteristic of firms throughout the financial system, whether they are deposit taking banks, investment banks, hedge funds, mutual funds, private equity firms or insurance companies. There is no such thing as safe leverage. It is this leverage that threatens market gridlock in a disintermediated financial system. Regulation must switch from an institutionally-defined approach to a functionally-defined approach as a vital component of systemic regulation. It’s the potential spread of pollution that matters, not the legal entity of the polluter.

The fact that the FSA is a comprehensive regulator means that the UK is particularly well placed to implement these changes. In the US, with its segmented regulators, it will be more difficult. Perhaps an overarching Federal Regulatory Commission would be the answer. But most important of all, domestic and international regulators must abandon the tired trinity, and focus now on the systemic risks generated by today's financial markets. The next time you hear a regulator arguing that greater transparency is the answer, you will know that he or she doesn't understand the question.

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[2] "Enhancing Market and Institutional Resilience", Financial Stability Forum, Basel, April 2008 (www.fsforum.org)