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## Seven habits that finance regulators must acquire

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*"Simply stated, the bright new financial system - for all its talented participants, for all its rich rewards - has failed the test of the market place."* Paul Volcker, April 8 2008

Paul Volcker is the giant among contemporary central bankers, both literally and figuratively. He it was who had the moral courage to crush inflation as chairman of the Federal Reserve between 1979 and 1987. When Mr Volcker speaks, people listen. What he had to tell the economic club of New York last month was well worth listening to.\* His summation, cited above, was so devastating, because so true.

Mr Volcker noted that this crisis is not unique. On the contrary, "today's financial crisis is the culmination, as I count them, of at least five serious breakdowns of systemic significance in the past 25 years - on the average one every five years. Warning enough that something rather basic is amiss." Those who do not heed such warnings are fated to suffer something yet worse.

So what is to be done? There is a part of me - quite a large part, in fact - that says: "Forget regulation: it will never work. Apart from normal laws against fraud, let the financial system live and die by the laws of competitive markets. If businesses fail, let them simply go down, with all their shareholders, customers and employees. Meanwhile, we will remind users constantly of the dangers."

I suspect this approach might give us a better financial system than the one we have today. But it is one we cannot have because governments will not dare let us, as experience with Northern Rock and Bear Stearns has reminded us. The public, governments feel, must be protected from banks and banks must be protected from themselves. Finance is deemed far too important to be left to the market.

Given this, regulation will need to be radically reconsidered, unless, as Mr Volcker points out, we are comfortable with a substantial financial crisis every five years or so. However great the lobbying power of the financial sector, it will surely be unable to preserve a licence to commit havoc on such a scale, particularly when, as he also remarks, "it is hard to argue that the new system has brought exceptional benefits to the economy generally".

So far tighter regulation is desirable in the longer-run interests of the industry itself, let alone the public's. What, then, should such regulation look like? Here I would like to analyse what I see as the fundamental issues. I am influenced in doing so by an excellent recent paper from Nouriel Roubini of New York University's Stern Business School.\*\*

So here are seven principles of regulation. I call them the seven "Cs".

First, coverage. Perhaps the most obvious lesson is the dangers of regulatory arbitrage: if the rules required certain capital requirements, institutions shifted activities into off-balance-sheet vehicles; if rules operated restrictively in one jurisdiction, activities were shifted elsewhere; and if certain institutions were more tightly regulated, then activities shifted to others. Regulatory coverage must be complete. All leveraged institutions above a certain size must be inside the net.

Second, cushions. Equity capital is the most important cushion in the financial system. Also helpful is subordinated debt. If Bear Stearns had had larger equity capital, the authorities might not have needed to rescue it. Capital requirements must be the same across the entire financial system, against any given class of risks. But there must also be greater attention to the adequacy of that other cushion: liquidity.

Third, commitment. The originate-and-distribute model has, it is now clear, a huge drawback: originators do not care sufficiently about the quality of loans they plan to offload on to others. They do not, in Warren Buffett's phrase, have "skin in the game". That makes for sloppy, if not irresponsible or even fraudulent lending. Originators should be required, therefore, to hold equity portions of securitised loans.

Fourth, cyclical. Existing rules are pro-cyclical. Capital evaporates in bad times, as a result of write-offs, thereby forcing contraction of lending, worsening the economic slowdown and further impairing assets. Mark-to-market accounting, though inherently desirable, has a similar effect. One solution could be to differentiate between target levels of capital and a lower minimum level. Institutions that have minimum capital in bad times would only be required to aim for the higher target level over an extended period.

Fifth, clarity. Lack of information, asymmetric information and uncertainty are inherent in financial activities. These are why they are vulnerable to swings in collective mood. The transactions-orientated financial system is particularly vulnerable, because information has to flow freely across arms-length markets. So a big challenge is to generate as much clarity as is possible. One issue is the calamitous recent role of the rating agencies and the conflicts of interest under which they operate.

Sixth, complexity. Excessive complexity is a significant source of lack of clarity. It is particularly damaging, as we have seen, to the originate-and-distribute model, because markets in complex securitised products may, at times, seize up, forcing central banks to become "market makers of last resort", with all the difficulties this entails. One possibility then is to insist that all derivatives be traded on exchanges.

Seventh, compensation. On this I can do no better than quote Mr Volcker: "In the name of properly aligning incentives, there are enormous rewards for successful trades and for loan originators. The mantra of aligning incentives seems to be lost in the failure to impose symmetrical losses - or frequently any loss at all - when failures ensue." Whether regulators can do anything effective is unclear. That this is a challenge is not.

John Maynard Keynes wrote of an eighth "c". He argued that "when the capital development of a country becomes a byproduct of the activities of a casino, the job is likely to be ill done". He had a point. Features of a casino will always be present in a financial system that performs the essential functions of guarding people's savings and allocating them where they can do most good.

Regulation will always be highly imperfect. But an effort must still be made to improve it.

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