

// Regulation: the price to pay

With the London G20 meeting having only given guidance to the future of regulation of the financial system, much of the detail remains to be filled in. Although highly regulated banks were at the heart of the current problems, world leaders appear to want more of the same. The issues at stake and possible solutions were given an airing at both the Alfi conference and a roundtable on 10th March organised by the American Chamber of Commerce and Prim. So what caused the crisis and what needs to be done?



Yves Mersch, Governor, Luxembourg Central Bank

"Financial instruments don't have original sin; a simple mortgage can be dangerous."

The list of scapegoats in the current crisis appears to be endless, with press and politicians looking for an easy answer. "The argument goes that if you ban the 'bad' people, companies, derivatives, products then this crisis will not happen again," noted Avinash Persaud of the consultancy Intelligence Capital Ltd speaking at Alfi. "But this is wrong," he continued "it is the behaviour that repeats itself with every crash that needs regulation."

// Bubbles the main cause

This behaviour, he argued, was excessive borrowing and that this is easy to spot. So when a credit bubble appears it is the regulators' job to burst the bubble. Complex instruments amplified the boom, but it was the simple fact of carefree lending and borrowing that was the root of the problem. "Finan-

cial instruments don't have original sin," he quipped, adding: "a simple mortgage can be dangerous." Mr. Yves Mersch, Governor of the Luxembourg Central Bank speaking at the Amcham/Prim event agreed. "The fundamental issue was excessive leverage which was facilitated by high liquidity, low interest rates and financial innovation." In response to this, regulators were looking in the wrong direction, he said. "Supervision was too legalistic and the macro-prudential view was missing." Like consumer price inflation, asset price inflation carries dangers.

// Common sense needed

Sir Michael Rake, chairman of British Telecom told Amcham/Prim that rules were probably not the answer. "Rules based regulation had been at fault in 1929 and we have to be careful not to stifle innovation as the financial system remains important for wealth creation." He reminded the audience that the panic over Enron led to the attack on the accountancy professionals, the destruction of Andersen and introduction of the expen-

sive and infective Sarbanes-Oxley legislation.

As an example of where things went wrong he pointed to credit rating agency's naive reliance on historical models and a lack of common sense being applied to new products. But if there were prescriptive new rules, ways would be found to circumvent these. "Light touch is not the point, smart is the point," he insisted.

// Regulators can't keep up

The consensus was that it is naive to expect regulators to know what is going on. After all, the world's largest banks have supervisors working on the spot in head offices, but this did not prevent the bust. Dr. Jon Danielson of the London School of Economics told the Amcham/Prim conference that asking regulators cope with all the data hedge funds might throw at them was like trying to "drink from a fire hose." Unlike the regulations which govern the rules of the road, he said, financial institutions are just too complex to keep track of on a micro level.

- Excessive lending was at the heart of the boom/bust
- Regulators are fallible
- Whatever the rules, mistakes will happen the conditions exist
- Next boom is far away: we have time - to get things right
- More regulation appears likely
- ...so sensitive supervision will be more highly prized
- Only regulate if the system or consumers are at risk

"Supervision was too legalistic and the macro-prudential view was missing."

// Tread gently

Governments have promised waves of regulation over the next two/three years but Danielsson recommended they take their time. "There is no hurry to solve the next crisis; we are busy sorting out the current problems. Let's take time to get regulations right – but the cost of hasty over reaction could be high."

Jean-Marc Goy, of the CSSF set out some dos and don'ts for the future regulatory set up. First he listed what we don't need: "Over regulation should be avoided. All financial innovation should not be discouraged but we need appropriate risk management." Blowing the trumpet of his own organisation he said: "we hear the need for principles and we at the CSSF like to think we are pragmatic." Basically he felt there was no need for fundamental change of Luxembourgish and EU supervisory systems. He added that prudential supervision has been improved since the October 2008 law which has strengthened CSSF and Central Bank cooperation.

// We do need

Goy was in favour of greater international cooperation with supervisory bodies, stopping short of having a formal multi-national supervisor with all the bureaucracy that would entail. This idea appears to have been adopted by the G20. Whilst in general opposed to excessive change, he felt there was room for changes on three levels. Capital adequacy rules require tightening he said as both the Basle I and II systems have been shown to have failed. Again, this is widely accepted. He called for the appointment of several non-executive directors to the boards of credit rating agencies and rules to avoid conflicts of interest. Remuneration systems should discourage excessive risk he said, with earnings based on long term performance.

Avinash Persaud reckoned there would be a strong move towards reinforced national



Sir Michael Rake, Chairman, British Telecom

boundaries regarding regulation, particularly as individual country tax payers have stepped in to rescue banks. This will mean little appetite to rescue foreign operations. He also argued that although the global business cycles are linked there are distinct national circumstances that require different policy responses.

// Hedge funds do good

There is a feeling that the crisis is being used as a pretext to fight old arguments, whether this be to attack low tax financial sectors or to squeeze the likes of hedge funds. Standard investment funds are breathing a sigh of relief they are escaping a regulatory backlash from the credit crunch, while greater hedge fund supervision is even welcomed by some in the industry.

Persaud is not so sure. "I would not regulate hedge funds because I would not have them sold to the general public," he remarked. "There is only the need to regulate if there is systemic risk or for consumer protection reasons. So if a hedge fund is large, has substantial leverage and has a strong co-relation to the financial system then I would regulate. However a small, specialised fund should not be hampered." He pointed out that there is no evidence that alternative assets have caused problems in this crisis, rather hedge funds are performing a vital task of relieving banks of toxic assets. "Liquidity requires

people to take risks and buy at the bottom of the market," he continued. "Pension funds should not be doing this but institutional investors should be allowed."

// Softly-softly G20

From the G20 communiqué, this message appears to have got through. The leaders of the world's largest countries spoke of extending "regulation and oversight to all systemically important financial institutions, instruments and markets. This will include, for the first time, systemically important hedge funds."

On other items too, the communiqué does not read like a manifesto for over regulation. The global Financial Stability Board would provide an early warning system through which measures would be discussed. There is more talk of "principles on pay". The strongest language comes regarding capitalisation: "In future, regulation must prevent excessive leverage and require buffers of resources to be built up in good times." In other words, there appears no desire to stifle the global financial system; just what Luxembourg's financial sector wants to hear.

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