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Comments on Regulating the New Financial Sector
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The Center on Capitalism and Society is an ideal venue to discuss how we can emerge from the global financial and economic crisis.

Nevertheless, the present long period of disturbed financial market conditions is a particularly difficult environment in which to initiate fundamental reform of the architecture of financial regulation, for three reasons. First, the crisis has fundamentally transformed the structure of the international financial system. Over the past seven months, the stand-alone investment banks here in the United States have disappeared or transformed themselves into bank holding companies, blanket guarantees have been granted to banking systems in many countries, and governments have taken massive capital stakes in major banks in their jurisdictions. It is hard to discern exactly how the regulatory environment should be reformed to incorporate such profound structural changes. Second, these same seismic shifts have suddenly resulted in a high degree of government involvement in key segments of the financial services industry in many countries. As a result, the prospects for reaching agreement on internationally consistent financial regulation are actually weaker than they were seven months ago: deep government involvement means that politicians must satisfy their own domestic constituents that their taxes are well spent. And achieving reform that will durably enhance financial stability is even more of a challenge given the third factor: although the global financial system is almost fully integrated, the architecture of its regulation— if you can call it an ‘architecture’ — is highly fragmented across different countries, and different financial institutions and markets. These factors, which make reform of the global architecture of financial regulation so difficult at the present time, are also what make it so imperative to achieve it.

In these circumstances, the knee jerk reaction in many quarters — “let’s regulate everything” — is exactly the wrong one. First, it is not feasible to regulate everything: provided the regulatory environment is appropriate and internationally consistent, risk-taking is most efficiently done by market participants who will lose financially if their bets turn out wrong. Second, even if regulating everything were feasible, it would be a terrible idea. The first principle of regulation is that the need for it arises where there are *externalities* that have a deleterious impact on the allocative efficiency or stability of markets.

Therefore, in order to determine how a restructured and less crisis prone financial system should be regulated, we must start by determining what are the weaknesses in the current regulatory system that contributed to the current global meltdown. Next, we must do a triage to determine which of these weaknesses private sector participants will henceforth have a risk-adjusted profit incentive to redress on their own (perhaps with a little gentle regulatory prodding); and finally which of them are truly externalities -- market failures -- that need to be mitigated by enhancements in regulation.

Of course, as everyone appreciates, the most essential form of regulation in a capitalist economic system is the broad legal framework that defines obligations under freely-negotiated contracts and provides for redress for adversely affected parties whenever there is a failure to honor a contract.

Beyond the need for this comprehensive framework of laws and practices governing the behavior in financial markets, I think there are two primary reasons for implementing measures of

financial regulation. The first is to redress major market failures in the financial system. One key externality that has adversely affected the soundness of the global financial system over the past decade or so results from the fact that financial markets have not been ‘pricing-in’ the level of overall financial system risk, or the changes in it. For example, market-based measures of implied volatility generally declined over the whole period 2002-06 at the very time when systemic risks were building up. Because these overall systemic risks were not reflected in market prices, competitive pressures limited the degree to which financial risk managers took account of changes in the level of aggregate financial system risk in managing their own balance sheets. The build-up of aggregate leverage in the upswing of the credit cycle during 2002-06 should have caused all financial institutions to progressively increase their capital cushions and strengthen their liquidity as asset prices boomed. And in recent months the converse may have been true: since Lehman Brothers failed, markets appear to have been pricing in more systemic risk than is actually in the system, particularly given that most banks as well as a number of key non-bank financial institutions have been brought under the umbrella of government support in many countries. Clearly, in managing their individual balance sheets, participants in financial markets typically do not accurately “price in” system-wide stability risk as it rises or falls. In a weakly regulated financial system, competitive pressures actually work to prevent them from doing so.

The second key rationale for regulation in the financial system is to redress asymmetries in information, mainly the informational asymmetries that arise between sophisticated institutional market players and retail customers. In our modern financial system the complexity of contracts (insurance policies, derivatives, structured products, even residential mortgages) is such that retail customers are unable to accurately recognize risks without regulatory ‘clear-language’ guidance and sanctions for market abuse. Here regulatory intervention is needed so that uninformed retail customers can better understand the risks they are running.

The internationally fragmented structure of regulation aggravates both these externalities by increasing the incentive to move risks to the least-regulated segments in the international financial marketplace. I believe that these two general principles should be borne in mind as we contemplate fundamental reform of the architecture of financial regulation. So, let me close by listing three key areas where I believe these principles should be applied to find regulatory answers to financial system weaknesses.

First, new regulatory measures are needed to assure more timely and accurate public disclosure of the values of financial instruments, and to ensure that these valuations are consistent across firms at a given point in time. Two types of regulatory initiatives are needed to achieve this goal: 1) There must be full convergence to a single internationally-accepted set of high-quality financial reporting standards and guidance for all financial and non-financial corporations; and 2) these regulations should be translated into a regulatory and supervisory structure that is consistent across different institutions and market segments, as well as across countries.

Second, over an appropriate time frame, measures should be taken to gradually build up the capital adequacy of banks and other systemically-important financial institutions. Capital is the ultimate shock absorber in the financial system.

Third, we must devise new ways to ensure an internationally-consistent architecture of financial system regulation and supervision. For example, we can't have different rules for capital adequacy or liquidity management in different countries, and the same applies to many other key areas of regulation. The fact that the UK FSA allowed British banks to hold a significantly lower capital cushion relative to Basel regulatory minima appeared to give a competitive advantage to its banks in the upswing of the credit cycle but turned out to be an 'Achilles heel' that made the UK banking system more vulnerable once the credit cycle turned.

I believe these are three obvious areas where weaknesses reflect externalities and coordination failures in the private sector; and where there is therefore a solid case for regulatory initiatives to make the global financial system more robust.

So, I come full circle to the point I made at the beginning: A global financial system demands enlightened and globally-consistent regulation. This will be a tall order. And since we are graced with the presence of Finance Minister Lagarde on this podium let me say how much I hope that the Declaration of the upcoming G20 Finance Ministers meeting will send a very clear message that maintaining open and contestable markets, and implementing internationally-consistent regulation and supervision, will be the *sine qua non* for achieving a global financial system that is less prone to severe periodic crises.