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FINANCIAL INNOVATION: REGULATOR'S NIGHTMARE

Towards More or Just Better Regulation?

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Abstract

Financial markets have changed markedly after the Lehman crash both in the U.S. and in the European Union, there are more and stricter regulation in place. A full world economic recovery is not coming soon, however, even with financial markets recovering. More alert watchdogs alone cannot do wonders in sluggish output figures but can bring more stability and an assurance to avoid future meltdowns. The paper argues that more and better regulation is needed to prevent the world economy from further catastrophic financial events. The main thrust of reasoning is that there is no more such a thing as national banking so effective international supervision is a must. The overwhelming might of multinational bank call for multinational oversight. There is a danger though that hastened regulation, can be overdone, while not preserving the proper incentives to create and ease credit under the generally sluggish growth conditions and let funds flow globally where most wanted. The main target of global regulation should be not just the global banks but, more emphatically, the large national business-cycle related key net saver and borrower countries, respectively. Creating new rules such as Basel 3 is the first step in this direction. The world does need a much better global financial oversight, which is not necessarily more, but better, by any measure.
Keywords: Lehman crisis - financial market - financial regulator - internationally mobile capital - global banks - use of derivatives - securities - credit-rating - Basel-3 - LCR (liquidity coverage ratio) EFA (European Financial Authority).

JEL: E44, E60, E62

I. Introduction

What are the clear benefits, of financial globalization? There are many. As was described by great many authors who have been long established in the related international finance literature, Fisher (2001), Froot-Rogoff(1995), Krugman–Obstfeld(2000), Pugel (2002), the better international distribution of excess funds between net savers and net borrowers, both private and public, measurable welfare gains are produced due to lower equilibrium interest rates. Larger markets, more customers do mean lower margins and bigger volumes, just as in the case of a large domestic banking institution. Small open economies can benefit a great deal from financial liberalization, however, new types of concerns emerge with respect to the macro-stability and maintaining the flow of funds in both public and private debt markets, Magas (2012). The most obvious benefit of financial globalization for countries in urgent need of fresh financing is associated with the availability of more private funds, true, not necessarily at a better price, and with the fact that funds can arrive much more rapidly than from state-related sovereign sources or global financial institutions, such as the IMF or the World Bank. True, there may be a steep price to be paid to get the speed. At the same time, speed my handsomely pay off.

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Cross border banking opens up new opportunities and new types of risks, of course, to determine the just manageable global risks and strike a good balance is anything but easy. Global banks, however did manage to expand their business rapidly, and have created a completely new environment for regulators.

With the spread of modern technology to gather, store and generate information about non tangible but engineered financial products (derivatives) that do not have a traditional market value, one that can be easily measured against its utility (weighing its profitability against its risk), there is new world and indeed a new division of labor being formed that neither Adam Smith nor his successors could have foreseen. The financial innovation market for these derivative products is growing rapidly, both on futures and options exchanges and in private sales, which tend to be more complex and more lucrative, at least for a while. In this new world, the art (not science) of valuing shares may be getting harder because of changes in the nature of the economy, creating even greater scope for bubbles to form. When the bulk of a company's assets were physical and its markets were relatively stable, valuation was more straightforward. Now growing proportions of a firm's assets-brands, ideas, human capital-are intangible and often hard to identify, let alone value. They are also less robust than a physical asset such as a factory.[1] This new, very innovative partly IT-related, complex market development has increased the difficulties of assessing risk and value, especially in a global context.

Still, as long as risk remained concentrated within a country and largely its banks, its financial regulators should have been able to keep tabs on it. The trouble with today's global pool of capital is that regulators may be out of their depth. Does a global financial system need a global regulator? We suggest it does.

II. TOWARDS MORE OR JUST BETTER REGULATION

Is the American model to be copied?

Is the American model to be copied? Not necessarily, but it offers a good a deal of wisdom and market experience. Who regulates Citigroup, the world's largest and most diverse financial institution? With its operations in over 100 countries, selling just about every financial product that has ever been invented, probably every financial regulator in the world feels that Citi is, to some degree, his problem. America alone has the Federal Reserve, the Securities and Exchange Commission, the Commodities and Futures Trading Commission, the New York Stock Exchange, 50 state insurance commissioners and many others. Yet, in a sense, nobody truly regulates Citi: it is a global firm in a world of national and sometimes sectoral watchdogs. The same is true of AIG, General Electric Capital, UBS, Deutsche Bank and many more.

Might that be a good thing? It has become fashionable to think of regulators as Shakespeare's „caterpillars of the commonwealth, creatures who, far from adding value, get in the way of the market". Naturally, not everyone shares this opinion. All the same, it seems clear that much of the dynamism in global finance during the past three decades has been due to fewer regulations on the movement of capital, particularly across borders, and on what can be done with it. For the most part, money is now free to flow wherever an opportunity presents itself, and has generally done so, leaving everybody better off than with heavy regulation.

Leaving capital free to move where it could earn the highest return also showed up over-costly or misplaced regulation: the money simply went elsewhere. For instance, because Japan prohibited the use of derivatives, options in Japanese securities were traded in more accommodating Singapore. As Japan gradually eased these restrictions, some of the offshore business shifted back to Tokyo. In general, competition for capital has encouraged countries to improve their regulation to appeal to mobile capital-although some, such as Malaysia, have resisted this pressure, and continue to impose controls on cross-border capital flows.

Strikingly, there has been no race to the bottom in regulation. Behind every great market there is good regulation-whether by a government agency or by the market participants. Internationally mobile capital has tended to reward regulation that protects investors and minimizes privileges for market insiders. Broadly speaking, this has led to a convergence of regulation around common international standards, but this process is by no means complete, particularly for investment products sold to personal investors. The day when a global firm can sell the same simple stock market-index fund anywhere in the world remains a long way off.

[1] As Enron showed, a reputation for trustworthiness, and the market value resulting from it, can vanish in a moment. The dotcoms pushed this valuation challenge to extremes, often expecting investors to put a price on profits that would not be forthcoming for many years, and would be derived from business models and intangible assets such as brands that had not yet been created.

America remains reluctant to allow European securities exchanges to apply their trade via screens in America, even though technically this is now easy to do. „Outrageously protectionist stance, as it is seen by European regulators.

Given the political difficulties, the idea of a single global regulator is not on any serious agenda. That may be just as well: competition among regulators has some benefits. What is on the agenda, at least of the regulators in countries open to international capital, is to ensure that good information is available about the state of global markets and about financial firms' global operations. The FSA, for example, is able to regulate only Citigroup's British activities, but it will have a much better chance of doing it well if it knows enough about the health of the firm worldwide. Information is already flowing more freely between different national regulators. Multinational institutions such as the International Monetary Fund, the Bank for International Settlements and the Financial Stability Forum all play a useful part in this, but it is bilateral communication between national regulators that matters most-and the global financial system is nowhere near as transparent to national regulators as it should be.

One reason is that no global consensus exists on what exactly should be regulated. For instance, in Britain reinsurers are regulated by the FSA, but in their home markets Munich Re and Swiss Re, the world's largest reinsurance companies, are mostly unregulated. Non-financial firms with big financial operations do not fit comfortably into the current regulatory framework anywhere. Enron, which has been plausibly described as an investment bank or hedge fund with an energy business on the side, was not regulated in America. In Britain, the firm itself was not regulated, but its financial subsidiaries were monitored by the FSA. There are big question marks over who regulates the growing number of firms now transforming themselves into financial behemoths, modeled on GE with its huge GE Capital operation. Hedge funds and other highly leveraged institutions are regulated lightly in most countries, and not at all in America. A proposal by a presidential working party for tougher regulation of hedge funds, prompted by the collapse of Long-Term Capital Management, was unexpectedly blocked for many months in Congress at the time. Now, hedge funds are no exceptions.

A second problem, at least in foreign eyes, was and is still is that America has too many different regulators. Whereas Britain has merged its numerous financial regulators into a single authority, and several other countries around the world are moving the same way, America continues with its plethora of different regulators for different parts of the financial-services industry. It seems doubtful that any of them has a good overview of what is happening in America's financial system as a whole-though the Fed claims it gets all the information it needs, one way or another. During the Clinton administration, regulation often took place on the golf course between Mr. Greenspan, Arthur Levitt, the chairman of the SEC, and Robert Rubin, the Treasury secretary. Today, it gets more official arrangements. All the same single foreign regulators would find it easier to resolve cross-border issues with a single American counterpart.

Some American regulators defend their multiple systems, despite the considerable duplication it entails, mainly on the ground that regulatory competition keeps them keen and lean. Certainly, the superiority of the single, consolidated regulator has yet to be proved. According to a report CSFI (2010) by the Centre for the Study of Financial Innovation,, There is a pervasive mood of discontent in the City with the ESA: people find it bureaucratic, intrusive and insensitive." Still, the current division of labor among the different American regulators is hard to justify. Why, for instance, should the SEC oversee trading on stock exchanges and the CFTC trading on futures exchanges when the regulatory needs of all exchanges are essentially the same? And why is insurance regulated not federally but at the state level, mostly by elected insurance commissioners? Nobody really thinks this makes sense, but the system survives because each regulatory body has its own supporters in Congress. In some respects, an inefficient regulatory system suits powerful financial firms. The Glass-Steagall laws, which kept banks, investment banks and insurers separate, survived a dozen attempts in Congress to scrap them-until 1998, when Travelers, an insurer, merged with Citibank, which immediately ended its expensive lobbying against abolition. They went soon after. Many in the US Senate thought, especially after the Enron collapse, that a single regulator along FSA lines would be good for America's capital markets, but for a major change to take place, it will need a bigger crisis than Enron to make it happen. It did, with not much delay, The Lehman crisis in 2008 did the job, so did the Dodd–Frank Financial Act, which has reformed the entire U.S. system for the satisfaction of almost all players, true the product is lengthy, and it is incorporated into twenty five hundred pages of new legislation.

So far America's cumbersome regulatory system does not seem to have retarded the development of its markets, but in the long run it may prove costly, particularly if-and it is a big if-the European Union succeeds in fully integrating its capital markets and introducing appropriate regulation. America has long boasted of having the most efficient capital markets in the world, and to date that has broadly been true. But its unwieldy system of multiple regulators could become a competitive disadvantage should Europe develop a

better, less costly regulatory mousetrap. Indeed, it is possible that pressure from the EU will help to consolidate American regulation. Under a forthcoming EU directive, any financial conglomerate operating within the Union will have to choose a main EU regulator who will he responsible for global supervision of the firm. In practice, the European regulator for the big American firms, such as Goldman and Citi, will probably delegate by requiring the firm to nominate one of the American regulators as its „co-coordinating regulator", which would become a de facto single national regulator for the firm.

Even if the infrastructure for effective global regulation were in place, huge challenges would remain. Some are of an intellectual sort. „ How much failure should a regulatory system allow?" a question so often heard. To supply an answer is not simple, beyond saying it should be more than zero, and less than would cause system-wide collapse. Others in the regulator business reckon that the ideal would be „a trickle of little problems, to keep people aware of the risks''. It may be a tribute to American regulation that Enron was actually allowed to go bust, and luckily this does not appear to have had system-wide consequences. The Lehman crisis ended in a different scenario. Some countries might have tried to organize a rescue; indeed, even the Fed has a reputation for keeping alive firms that should have been allowed to die. Understanding whether the level of risk is getting too high has become harder now that so much risk is being transferred out of the banking system. Many worry that regulators and financial firms alike are better at judging the relative riskiness of different instruments, institutions and counterparties than the total risk in the system. We agree, there is a lot of weight in this argument.

The problem has been brought to the fore by the technology bubble, and the fear, recently reborn, of a wider American equity bubble. Do regulators know when a bubble has formed and the financial system is becoming dangerously imbalanced? Probably not with enough certainty to base policy on. What is clearer is that aggregate risk ebbs and flows with the economic cycle, credit officers tend to lend too much in good times, heating up the economy, and then cut back too much in a downturn, making things worse. One way to get round this would be to require banks to set aside higher amounts of capital during economic booms than during recessions, to make risk-taking less pro-cyclical. How much capital financial firms should set aside against risks going wrong is the trickiest decision international regulators have to make. Since 1988, big banks have been abiding by the Basel capital regime, which links the amount of capital they have to hold in reserve to the riskiness of the loans they make. However, the categories of risk are too undifferentiated: banks have to set aside as much capital against a loan to Microsoft as to a dotcom tide, or as much against a loan made to Brazil or, as one to South Korea. Banks have also discovered ways to use derivatives and other securities to allow relatively risky loans to qualify for a low-risk, low-capital treatment. Regulators fear that a large part of the growth in the use of derivatives and securitization by banks may stem from evasion of regulatory controls. The fear is more than justified we can also add.

III. Is Basel-3 the solution?

Basel-3, a more sophisticated version of risk-based capital rules, is now in the pipeline. It is meant to apply not only to big banks but to all banks worldwide, and to all investment firms in the EU. There is also talk of an Insurance Basel before long. But Basel-3 has met with considerable opposition, partly because it is too complicated, partly because some countries disagree over how much capital should be set aside against some sorts of loans. Germany wants a lower capital requirement for loans to small businesses, for example, because hank loans are their traditional source of funding. The launch of the new regime, originally scheduled for 2012, has already been delayed until 2014, and even that may prove to be optimistic. Meanwhile, the banks are operating with a capital regime that does not work as intended, but may be lulling regulators into a false sense of security.

In determining regulatory capital, Basel-3 would give an even more important role to credit-rating agencies such as Moody's and Standard & Poor's. How good their ratings are is the subject of much debate. In the sovereign risk front, well this was clearly confirmed over the recent downgrades of the U.S. government debt itself, or the floating of downgrades of many good sovereign debts such as France or Belgium. As an alternative, banks will be encouraged to use their own in-house credit ratings. But regulators still mistrust the use of quantitative credit-risk models to set regulatory capital. They need better techniques and better data, especially in Europe. Many big banks already use quantitative models to assess how much capital they need to set aside against portfolios of marketable securities. These 'value at risk' - (VAR) models typically measure the most the firm could lose in a day, judging by past performance, but they tend to underestimate the frequency with which really bad days occur. There have been half a dozen 'perfect storms' in the market in the past decade, during which VAR calculations proved useless in predicting losses. Stress-

testing portfolios against imaginary perfect storms remedy some of the weaknesses. But modeling credit risk in this way is much harder, not least because data about past credit performance are scarce.

Another market-based system of regulation has also received some attention. If banks issue short-term subordinated debt that is traded every day and has to be refinanced regularly, and can stay in business only as long as the debt is refinanced, then the market will in effect regulate the bank. Lenders will not finance a bank they think is in risk of default. Alas, the only country to have tried it so far has been Argentina, where the government's fleecing of the banking system after its debt default rather spoilt the plot. Regulators are only too aware that the sheer complexity of the financial system imposes practical limitations on what they can do. Increasingly, they have to rely on the private sector to assist them in their regulatory task. They simply do not have the capacity to find out what risks are being taken inside a large international hank unless it tells them.

The consolidation in the banking sector may be increasing the risk of the financial system in other ways.[2] The new global dilemma, and with it the real danger, that the risk originally taken on by the capital markets will eventually find its way back into the banking system. Much of the risk-transfer apparently being undertaken may be an accounting ruse, designed to escape regulatory capital requirements without truly shedding the risk. And if insurers are unable to meet their liabilities and go bankrupt, the banks may be caught short of needed reserve funds. It is safe to assume that much of the unwanted risk assumed by the banking sector may end up in the hands of less sophisticated investors, including some of the individuals now being targeted by the financial-services firms. They may be taking on this risk unwittingly. Nobody knows how those individuals might react if they found out, or how this would affect the economy as a whole. They might feel poorer and less inclined to spend, which could inflict the sort of damage on the economy and the banking system fears.

There is a real threat that it might accelerate itself through the reverse multiplier. Still, as long as risk remained concentrated within a country and largely its banks, its financial regulators should have been able to keep tabs on it. The trouble with today's global pool of capital is that regulators may be out of their depth, their national jurisdiction. In this sense, there is an obvious need for global regulation. At the same time, it seems clear that much of the dynamism in global finance during the past three decades has been due to fewer regulations on the movement of capital, particularly across borders, and on what can be done with it.

For the most part, money is now free to flow wherever an opportunity presents itself, and has generally done so, leaving everybody better off than with heavy regulation. One should add, in the general case with normal behavior.4[3]

IV. Conclusions

We should restate our crucial points.

Behind every great market there is good regulation - whether by a government agency or organized by the market participants. Following the severe financial crises both in the U.S. and in Europe over the last four years, it became clear to address the need for a shift to better international regulatory environment. Internationally mobile capital has tended to reward regulation that protects investors and minimizes privileges for market insiders. Broadly speaking, this has led to a convergence of regulation around common international standards, but this process is by no means complete, particularly for investment products sold to personal investors.

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[2] Consolidation has cut down the number of big market participants. In 1995, 20 banks in the United States accounted for 75% of foreign exchange transactions; by 2001, the number was down to 13. What is certain is that financial firms, especially on Wall Street and in the City of London, love derivatives, and have hired an army of mathematicians and physicists to work as „financial engineers", creating complex new derivatives to shill risk around the financial system. Credit derivatives already have a nominal value of almost $1 trillion, up from around $100 billion five years ago. They were forecast to top $3 trillion by 2011. The nominal value of over-the-counter derivatives now exceeds $100 trillion, 60% of which is handled by a mere five dealers, including two giants, J.P. Morgan and Citigroup. Derivatives and other tools of financial engineering can be used to manage risk better by hedging positions and transferring unwanted risk to a counter-party, which is what banks say they mostly use them for. However, those tools can also be used to increase risk, perhaps by a big margin, and there is a growing danger that this will be done accidentally.

[3] In this context, mention must be made of how a natural scientist views the world of modern financial markets, and ask the question more often heard: „*Why do so many people cling so hard to the notion of efficient markets*?" Emanuel Derman of Goldman Sachs, one of the growing number of former physicists working in investment banking, puts this notion in perspective. In finance, he says, you are playing against people, who value assets on the basis of their feelings about the future. „*These feelings are ephemeral, or at best unstable*." What a simple way to portray the complex reality. as quoted by. U.S. Weekly Analyst, Goldman Sachs, March 24. 2002.

The day when a global firm can sell the same simple stock-market-index fund anywhere in the world remains a long way off. The sovereign debt market experienced major setbacks due to the leading ratings agencies' poor record of getting it right early on and sending proper market signals globally to firms and individual with money saved, who is and who is not a good future risk.

Given the serious political difficulties, the idea of a single global regulator is not on any serious agenda neither in the G-20 context, nor in the EU. That may be just as well: competition among regulators has some benefits. What is on the agenda, at least of the regulators in countries open to international capital, is to ensure that good information is available about the state of global markets and about financial firms' global operations.

Understanding whether the level of risk is getting too high has become harder now that so much risk is being transferred out of the banking system. The problem has been brought to the fore by the technology bubble, and the fear of a wider American equity and real estate bubbles. Do regulators know when a bubble has formed and the financial system is becoming dangerously unbalanced? We may repeat: probably not, with enough certainty to base policy on. What is clearer is that aggregate risk changes and flows with the economic cycle.

Another old lesson to be repeated: is that credit officers tend to lend too much in good times, heating up the economy, and then cut back too much in a downturn, making things worse. One way to get around this would be to require banks to set aside higher amounts of capital during economic booms than during recessions, to make risk-taking less pro-cyclical this was helped by the recently eased terms - as defined by the Basel-3 - on the LCR, liquidity coverage ratio required by banks on their daily operations. If this was internationally required, it would be all the better. Initiatives in this regard should come from the regulators of the largest key players of the American markets. The same goes for Europe and for its new institution, the EFA, the European Financial Authority. We need better rules not just more. Large and small open economies, their private and public sectors will sure benefit from them.

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