

Commentary: Get Ready for a Systemic Global Regulator

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On March 26, 2009, Treasury Secretary Timothy Geithner testified before the House Financial Services Committee, chaired by Congressman Barney Frank, to describe the Administration's proposals to reform the regulation of financial services. Earlier in March, the Financial Services Authority (FSA), the SEC's counterpart in the United Kingdom, produced "The Turner Review." Lord Turner is the current head of the FSA and his Review describes the UK Administration's proposals to reform their regulatory system. Secretary Geithner and Lord Turner each proposed the institution of a "systemic regulator."

The timing of these proposals is no accident. Each of them was released in anticipation of the meeting of the G-20 in London on April 2. As Secretary Geithner pointed out, systemic regulation requires global cooperation. Lord Turner has gone so far as to propose a "college of regulators" to accomplish this global cooperation, something like the Committee of European Securities Regulators (CESR) that advises the European Commission in the EU. For what it's worth, the European Commission's latest consultation, following on the heels of the de Larosière report, proposes to replace CESR with a true regulatory organization that would have rule-making and adjudicatory authority. If history is any guide, a global college of regulators can be expected to evolve into a global regulator in the fullness of time.

The Turner Review, which can be downloaded from the FSA's website, makes for mighty interesting reading for anyone interested in the origins and evolution of the current financial crisis. For one thing, Lord Turner provides a very persuasive analysis, backed up with data, presented at a level that can be comprehended by the sophisticated lay reader, as compared to the technical economic analysis that anyone other than an economist struggles to understand. More to the point, Lord Turner explains the crisis as a failure of regulation, demonstrating a level of candor shocking to an American reader used to more prevarication by regulators and politicians.

For some time, I have wondered how it is that commercial and investment banks ended up in so much trouble over defaulted sub-prime mortgages. Many banks were basically a front office for mortgages and other loans, bundling them up into pools and selling the resulting mess to investors as "asset-backed securities," a process Lord Turner calls "securitization." The process effectively removes these

assets from the balance sheets of banks, freeing up their capital for more loans. This should have made the banks more secure because the losses should have struck the investors who ended up with the securities, rather than the banks who produced them. While some of these loans may have been stuck in the banking pipeline, it is difficult to understand how this would have caused so much carnage.

It turns out that banks were selling asset-backed securities with their left hand, and buying asset-backed securities with their right hand. These operations were conducted by different desks. The securities were sold by the banks' investment banking operations, and bought by trading desks. Moreover, the amount of capital required to hold unsecuritized loans by a bank was greater than the amount required to hold a position in the resulting asset-backed securities on the trading desk. The theory was that there was a ready market for securities, whereas loans were difficult to sell. The banks, and their regulators, assumed that a liquid market for securities would always exist, and imposed lower capital requirements for securities positions.

The situation was exacerbated by the fact that no one regulator was in a position to understand what was going on. Financial services companies, particularly in the United States, but to some extent everywhere, tend to have different regulators. And, the regulatory focus tends to be different. While banking regulators tend to worry about capital requirements and excess leverage, securities regulators are focused on sales practices. Insurance company regulators focus on the ability of an insurer to satisfy its policies. Hedge funds, meanwhile, are generally unregulated or at most, regulated by securities regulators with a relatively light hand, at least when it comes to concerns about leverage. Certainly, no one regulator was charged with the duty of thinking about the amount of leverage building up in the system.

The actual numbers are quite revealing. While consumer and government debt increased somewhat, debt within financial services institutions exploded between 2002 and 2007. Since financial services are intended to provide financing to consumers and industry, the build up of leverage within the system was an aberration. Lord Turner calls this process harmful rent extraction. You might think of it as a systemic Ponzi scheme, where money is being raised from investors to pay other investors, rather than to finance some industrial project that will hopefully generate enough profits to pay back the financiers with interest. Of course, there is no Charles Ponzi in this case; instead, many institutions each acting in their rational best interests, but without collaboration, end up unknowingly and collectively playing the same game.

Lord Turner doesn't really blame market participants for the resulting calamity. He agrees that compensation structures might have contributed somewhat to the crisis by providing too much incentive for investment bankers to create and sell all sorts

of exotic financial products to institutional investors. But, he puts this down as a minor factor, rather than a major cause.

The problem, as Lord Turner sees it, is that regulators were too willing to defer to the market to properly allocate resources on the misguided belief that if financial products were not socially desirable, their creators would lose money and stop producing them. The problem is that each company operated in a vacuum where the only rational thing to do was to keep producing products on the assumptions that the market was valuing them properly and there would always be a liquid market. When these assumptions proved to be incorrect, the entire house of cards collapsed.

The solution proposed by Secretary Geithner and Lord Turner is the institution of a systemic regulator. All systemically important financial players would report their activities to this regulator. In turn, the regulator would have the power to apply the brakes when things are getting out of hand.

This proposal is startling in its ramifications. Investment bankers do not generate products by dreaming about them in their office. They respond to the needs of their customers. So, when an investment banker has a horde of hungry clients eager to obtain a derivative or debt instrument with certain characteristics, the systemic regulator might prevent its sale because of "system-wide consequences." This will take profits right out of the mouths of investment banks. If experience is any guide, they will scream bloody murder.

Moreover, this authority will extend across the board – to banks, broker-dealers, insurance companies, pension funds, mutual funds and hedge funds greater than a certain size. Suppose that the systemically significant size of a hedge fund is determined to be \$50 million, the size proposed in the Hedge Fund Transparency Act sponsored by Senators Grassley and Levin. Presumably the systemic regulator will have the power to deny the application of a hedge fund wishing to cross the threshold when this is deemed necessary for systemic purposes. In plain English, this means that the fund will be required to turn away investors, or perhaps redeem out existing investors.

Put as simply as possible, the systemic regulator must have the authority to curtail on a case-by-case basis otherwise lawful transactions among willing buyers and willing sellers when necessary to limit leverage within the financial system. This amount of market intervention is unheard of in the United States and would be a novelty in most of the industrialized world.

Lord Turner is aware that the systemic regulator will be under extreme pressure. For that reason, he proposes that the regulator will also have a lot to say about who is employed at positions of responsibility within financial services firms. In theory,

this is because the regulators need to know that the people running these firms have financial competence, as well as being persons of good character. But, the dark side of this is that managers who have demonstrated a bit too much financial creativity need not apply. Presumably this control over employment decisions will extend to all of the institutions under the control of the systemic regulator.

The systemic regulator will therefore have God-like powers, at least insofar as the financial services industry is concerned. This brings to mind the words of James Madison:

“If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.”

We have a bit more experience with the Constitution than Madison did when he wrote *The Federalist No.51*. In the US system, we oblige the government to control itself by subjecting regulatory agencies to the control of Congress, who must answer to the voters. No other result is consistent with the Constitution. This also means that the decisions made by the systemic regulator will be influenced by the inclinations of certain members of Congress sitting on powerful committees. These include decisions as to which firm will make a profit selling some securities product, which hedge fund will be permitted to grow, and who will be employed at a systemically important institution.

We expect to have quite a bit more to say about systemic regulation in future articles. For now, suffice it to say that the institution of a systemic regulator, which appears to be a train leaving the station, will have a profound effect on the financial services industry. Stay tuned.

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