The new order

Executive summary

■ The scale of the carnage in the credit markets and the resulting taxpayer-funded bank bail-outs has made radical changes to the regulatory regime inevitable. Risk creators must pay for the state underwriting the business, and the supervisory architecture must focus on remedying root causes rather than just adding more layers of compliance.

EDDIE FOGARTY EXPLAINS WHY, IN THE WAKE OF THE FINANCIAL CRISIS, WE NEED A MORE FOCUSED, RELEVANT AND EFFECTIVE REGULATORY REGIME – AND WHY THE BANKS WILL HAVE TO BEAR THE COST.

With so much regulation, standards and compliance in place, how can the financial markets disaster ever have happened? Yet given the size of the losses that will now have to be paid out of general taxation for decades to come, few people will argue against introducing more regulation. But more of the same is not the solution. Much of the present regime is simply not focused, relevant or effective. Too much pro forma regulation and compliance has created an inability to see the wood for the trees, and contributed to regulatory failure.

To find solutions, we need to look forward rather than backward. Playing the blame game is futile, but let's indulge ourselves just a little – after all, the blame is so richly deserved that the opportunity is irresistible. Undoubtedly, many factors led to the financial crisis but a root cause has been reckless lending and balance sheet growth, fuelled by extravagant remuneration within the banking community – not by all, but certainly by far too many. Blaming the disaster on financial innovation, mispricing of risk and other seemingly complex factors is disingenuous: individuals were allowed to parade themselves as geniuses when in fact they were being foolish and reckless, and now they walk away from losses that exceed the GDP of many countries, in many cases with handsome pensions.

SPREADING SOME NEW COMFORT BLANKET OF REGULATION OVER THE MARKET AS A WHOLE WOULD BE TO PUNISH ALL FOR THE SINS OF THE FEW, AND IN ANY CASE WOULD NOT BE EFFECTIVE.

There have been too many rogue bankers. Consequences must follow, primarily for the banking community. We see now that large banks carry an implicit state guarantee. Most business does not enjoy this privileged position. Bankers cannot expect master of the universe-style remuneration in the good times, plus the option of a state bailout when things go wrong. The much used argument of the need to reward talent looks paper-thin in the light of the complete failures that have been witnessed. Credit institutions in particular must be the focal point for stronger, more effective regulation.

TOO BIG TO FAIL Taxpayers should not be left with no option but to bail out banks. Shareholders and lenders have to know that they – and not the taxpayer – carry the risk. Of course, this is easy in theory but more difficult in practice. To overcome the practical difficulties, it may be necessary to have a restriction on absolute size, so that each bank is small enough to be expendable.

There will always be a concern that allowing one bank to fail will have a domino effect, but unless there is some exit mechanism we are effectively accepting that the banks should have a state guarantee. If that is the position, then the reality of that guarantee should be recognised. No private enterprise should have the benefit of a free state guarantee. When called on, such guarantees result in a huge transfer of resources from the public sector to the private. The economic pricing for this guarantee should be made explicit and paid by all entities whose lending or risk-taking has the financial benefit.

This would mean that the guarantee would be funded on an ongoing basis, not just if and when required, thereby creating a reserve fund and, more importantly, charging a margin that reflects the public cost of private risk taking. It is not sufficient that private costs alone are covered in financial transactions, we have also to ensure that external, public costs are also paid. Environmental regulation adopts the principle that the polluter pays; financial regulation must adopt an equivalent principle of the risk creator

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pays. This analogy is especially apt, since in many cases we are dealing with toxic assets.

FAILURE OF REGULATION It is clear that regulators failed to regulate effectively. It is no defence to say that this crisis was unprecedented or unforeseeable. A primary purpose of regulation is to look ahead, to consider what can go wrong and to take preventive measures. What caused the credit crunch was not a meteorite from outer space but a predictable consequence of reckless balance sheet expansion. We are entitled to expect financial regulators to be able to identify this, rein it in and curb things like 100%+ mortgages, in the same way we would expect the fire authority to ensure that petrol is not used to extinguish fires.

But to say the crisis has been caused by lax or light-touch regulation misses the point. There has been no shortage of regulation; the problem is that it has been generalised and unfocused. There needs to be a stronger sense of first things first. Priorities, not routines, must be the focus. Those priorities need to be actively and constantly reviewed and managed. The letter of the law needs to take a back seat to the intended result of the law. The new supervisory architecture needs to focus on remedying the root causes, not merely to add layers to an ineffective existing system.

This will be a huge challenge for regulators. It will require a step-change in approach, process and expertise. Individuals on the front line will need to exercise – and be able to exercise – much greater judgement and discretion. They will need to be supported at the institutional level. All of this will cost more. My proposition is that those who create and profit from the risk creation must foot the bill.

National borders mean little in financial markets. Large financial institutions are global or regional, but supervision, even within the EU, is national. In this situation, regulators can only see part of the picture and get an incomplete view. There is now a proposal for an EU-wide system of financial supervision. In addition, new areas, such as the regulation of credit rating agencies, are being considered.

This makes sense, but the EU must ensure effectiveness and relevance. MiFID-style directives running to over 250 pages add to compliance overload and certainly do not result in putting first things first. In practice, they can be a distraction from those priorities for both the regulator and regulated and lead to a robotic focus on complying with compliance. A pruning of existing regulation and compliance to get back to essentials would be well justified.

CREDIBILITY OF FINANCIAL STATEMENTS UNDERMINED As with regulation, no one can say that we did not have enough accounting standards. But they seem to have been useless in the run-up to this crisis. How can it be that accounts supposed to set out a true and fair view failed to recognise or disclose the losses that have now been revealed? Clearly, the credibility of bank annual reports and financial statements has been severely dented. Financial statements appear to have been entirely backward-looking exercises, whereas a forward-looking approach is essential for financial balance sheets.

Auditors were also too complacent and ineffective. An auditor is expected to be a watchdog not a bloodhound, but we did not get a growl or even a yelp as bank lending went out of control and assets were loaded onto balance sheets at unsustainable values. Just as regulators could not see the wood for the trees, so accountants and auditors seem to have been lost in their accounting standards.

In the same way as there is a risk of just more regulation, there is every chance that we will get more accounting standards. But more is not necessarily better and some of this standard-setting goes on for so long it can take on the appearance of a self-serving exercise. The IAS 39 financial instruments standard and accounting for derivatives is a case in point. There needs to be a real-world dimension. Standards and standard-setting for financial information coming into the public domain has to serve the public interest. Standards cannot be pet projects for the accounting profession, and the whole process needs to be sharpened up, or effectively regulated.

Banks caused the financial crisis and must now accept the greatest share of the costs of the heavier supervision it will generate. The out-of-control bonus culture must be ended and reward-for-failure exit packages outlawed. Regulators need to be much more focused on priorities and avoid pro forma regulation. The steps to be taken now have to be genuinely effective in addressing the root causes of the problems. Spreading some new comfort blanket of regulation over the market as a whole would be to punish all for the sins of the few, and in any case would not be effective.

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