REGULATION: CURBING GROWTH

MAGNUS LIND OF NORDIC FINANCIAL SYSTEMS BELIEVES A LITTLE LESS REGULATION AND MORE INSTABILITY IS A LOW PRICE TO PAY FOR A HEALTHIER FINANCIAL SOCIETY.

Nordic Financial Systems (NFS) recently carried out a global survey on organisational change and shared service centre (SSC) initiatives among treasuries[1]. The main conclusion was that treasuries fear the trend that banks are becoming increasingly reluctant to offer different kinds of loans to finance their operations. Key to this finding was the perception that new regulations are enforcing that trend. Here, we describe how the present regulatory frenzy may create an inefficient financial sector, making the larger corporations risk averse, and so affecting the prosperity of business and society.

The primary role for treasury is to ensure availability of cash in all situations. To do so, there must be sufficient channels for raising cash and currently treasuries use several banks for funding. However, if each bank demands that the company buy other services as a condition, the company is forced into depending on only one or at most a small number of banks. The US Association of Financial Professionals (AFP) found in its Credit Access Survey[2] in March 2003 that more than 50% of the respondents from large companies said they had been denied credit or had their terms changed after refusing to purchase other financial services offered by the banks. The lack of competition among banks creates a situation where few banks adapt to the true needs of the client, but instead develop products and services not demanded. Thereafter, the banks have to 'educate' the customers as to why they should procure these products.

Let's consider why banks exist in the first place. They manage the payment system and are experts when managing financial risk. In this context, they are only vehicles for creating growth and wealth, which is the basic requisite for any welfare system. Banks must not exist just for their own purpose and therefore regulators must regard the existence of banks from a growth perspective. Growth is created when we find new ways of manufacturing and delivering goods and improving the way in which we do things – thought of as 'innovation'. Innovation is, by definition, doing things differently and in ways never tried previously. However, if you do things in a different way, you are seen to be taking a risk, and sometimes that risk is too high and the innovator defaults.

'IT MUST BE POSSIBLE TO LET A BANK GO BANKRUPT IN ORDER TO CREATE A 'SURVIVAL OF THE FITTEST' CULTURE'

THE CULTURE OF RISK TAKING. Essential to the vital growth of the economy is a society that embraces and is tolerant to risk-taking. Society must regard risk as a necessity for prosperity and wealth creation, and develop efficient supporting structures, of which the financial system is merely one component. Banks must be forced to compete and develop competence for assessing and managing financial risk and at the same time develop competence to get paid for taking on that risk. This means that any bank not competent enough must be made redundant.

'MOVING FORWARD, WE WILL INCREASINGLY WITNESS SURVIVAL OF THOSE WHO CONFORM AND WHO ARE OBEDIENT'

In addition, the basic sponsors of innovation are not the venture capitalists, nor the banks, but the customers, and very often the early adopters are the large companies that trust the innovator by taking the risk of using its products and services. Regulators and politicians must allow this risk component, instead of creating a risk-averse system that will affect the willingness of the sponsors to take on risks and so decrease innovation and growth. But do the regulators realise this, are they aware of the consequences of their social engineering? And, more importantly, how accountable are they? Many would argue that they are accountable only to a limited degree. Will the Basel Committee[3] face trial if its regulations create a credit crunch or reduced risk appetite, and will Mr Sarbanes and Mr Oxley be imprisoned and made responsible for their Act, if it makes the larger companies less inclined to support innovation? And how can this be proven?

In Sweden, there is a model that curbs entrepreneurship, innovation, growth and the wealth of the nation. Thirty years ago, Sweden was one of the richest countries in the world based on GDP per capita. Today, it is one of the poorest in Europe but still continues to indulge in hostile and prohibitive fiscal and other legislation that has proven to be effective in decreasing innovation activities to low levels. I would therefore argue that regulators and politicians can be responsible for wealth destruction.

INNOVATION VS INSTABILITY. An interesting conclusion is delivered by David Birch from Arc Analytics, a research and consulting firm in Waltham, Massachusetts, US, which has been studying innovation and entrepreneurship since 1983. Birch is convinced that, while the large corporations decrease the number of employees, the fast-growing innovative companies, known as the 'gazelles', hire[4] – therefore making themselves the basic wealth creators. Interestingly, Birch states that the gazelles are extremely unstable, and the distance between failure and success is paper-thin. Since the gazelles are supposed to create the largest portion of growth, this implies that growth in itself is unstable. The only way to ensure stability is therefore to create conditions for as many gazelles as possible to try to succeed or indeed fail.

With this perspective, it is surprising how the regulatory environment is developing. For instance, why is the Basel Committee so focused on creating financial stability, and why is it so important? How does that self-imposed ambition relate to the desperate need for sustained growth to support society? The conclusion must be that we do not need a stable financial system; we need an effective system that creates room and incentives for innovation, while at the same time endorsing risk-taking. An effective financial system is a system that has the competence to properly assess financial risk, combined with the competence to get paid for taking on such risk.

Developing regulations with standard risk valuation principles and close ties between supervisors and banks do not create an efficient system. The financial institutions must, instead, assess risk in uniform ways – this will create a lack of competence in the system and avoid the risk of bankruptcy. If you do not risk bankruptcy you will not make that extra effort and will therefore not achieve true competition. This will conserve a financial system that is reluctant to take on balance sheet risk. This system will be stable, banks will not disappear and directors of banks will have an easier life, competence will not be necessary, instead good relations with supervisors will be.

WHY DOES SOCIETY ALLOW THESE DEVELOPMENTS? Is it because there is a lack of options, or is the task to fight the regulatory tide too immense? It must be possible to let a bank go bankrupt in order to create a 'survival of the fittest' culture. If one does not risk loosing everything, why make the extra effort? Will the necessary restructuring of the global banking service sector ever take place? Is it dangerous with a defaulting bank, and can we avoid the 'Herstatt' effects without decreasing competition in the financial sector? There are several interesting initiatives in this area that encompass the combination of keeping the deposits insured while still maintaining the risk for the bank to default. For instance, the Shadow Committees in Europe[5] and the US[6] have launched several ideas that promote more market discipline.

Despite these and other options, the Basel Committee is successively moving away from market discipline solutions to favour those where the supervisors and the banks collectively agree on how to manage risk. This system will create grounds for corrupted relationships, while standardising financial risk management and creating increased streamlined behaviour. This, in turn, will increase the risk of systematic errors. Moving forward, we will increasingly witness 'survival of those who conform and who are obedient'.

Sarbanes-Oxley adds to this scenario by reducing the risk of uncertainty the executive management is prepared to take. It forces the business to be predictable and a safe bet, but how will it affect the company's role as main sponsor of innovation? If we can prove that bad policies create decreased growth and wealth, we can also sentence the responsible parties, so why do we not implement a Sarbanes-Oxley Act on the regulators and politicians, forcing them to take the consequences of their decisions?

We have to conclude that regulation has to be driven by the overall objective of society: growth and wealth creation. If this requires less predictability and more instability, this is a low price to pay. It is time to end the ambitions of central planning and social engineering and time to let innovation flourish.

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Notes

[1] *Copies of this survey can be requested by emailing info@nfs.se.*

[2] *Credit Access Survey: Linking Corporate Credit to the Awarding of Other Financial Services,* March 2003, Association of Financial Professionals – www.AFPonline.org.

[3] Basel Committee on Banking Supervision – www.bis.org/bcbs/index.htm.

[4] *Slump? What Slump?, Fortune* Small Business, Sunday 1 December 2002 – www.fortune.com.

[5] The European Shadow Financial Regulatory Committee (ESFRC) (The Centre for European Policy Studies) – www.ceps.be.

[6] Shadow Financial Regulatory Committee (American Enterprise Institute for Public Policy Research) – www.aei.org.