Only unpopular reform will make system safer
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These days, regulators are always bloodhounds chasing greyhounds.

Now that the triage stage of the global financial crisis is ending, attention is turning to preventing a repeat of the disaster. But as the trauma recedes, so too does the appetite for the deep reform that is needed, especially in the United States.

The Obama administration understands that crises are opportunities for reform, but the recent US reforms are timid. While stronger capital and liquidity requirements are foreshadowed, these will have to be imposed on an industry that has shown itself to be singularly adept at avoiding costly capital impositions.

The crowd of competing regulators has been reduced by one, but responsibility is still spread among four federal regulators, not to mention state authorities. The Federal Reserve maybe given a specific mandate for systemic supervision but it has no new policy instruments and its primary objectives are still price stability and employment. While there is a new-found interest in avoiding asset price bubbles, no one has yet suggested precisely how this can be done.

More can (and no doubt will) be done to strengthen the role of regulators, but their position is intrinsically weak. They can't act decisively until failure is manifest. As Bank of England governor Mervyn King has put it, regulators are like a church whose congregation attends weddings and burials but not the sermons in between. With the fast pace of financial innovation, regulators are always bloodhounds chasing greyhounds.

If it is hard to devise a set of rules to constrain the behaviour of individual institutions, then part of the answer is to make the financial sector more robust structurally. The current structure has evolved largely according to the dictates of the market. The Efficient Markets Hypothesis (EMH) encouraged the presumption that the market should be left alone for greatest efficiency.

Reminded of the costs of a serious financial crisis, we may now be more ready to treat the financial sector in the same way that we treat other community risks, such as road safety and air travel. Structures are designed with the specific realisation that there are potential risks that justify preventive measures, even at some cost to simple notions of efficiency.

The structure of finance is critical because of interconnections. Problems in one part trigger problems elsewhere, such as bank runs and counterparty risks. As well, there are elements that are vital to the smooth functioning of the economy, where the government has an obligation to ensure that a minimum standard of service is maintained. These elements include a safe repository for the public's liquid assets, credit to keep businesses going, and payments services to facilitate transactions. Keeping these services going involves government-backed deposit insurance and "lender of last resort" support for banks' liquidity.

The taxpayer bears the risks of assuring that these basic functions operate smoothly, so there needs to be intrusive supervision with robust design requirements for the providers of these services.

A modern universal bank – HSBC or JPMorgan Chase – not only provides these essential basic functions, but takes on a variety of other risks that should not be underwritten by the taxpayer. Investment banking, underwriting capital issues, brokerage, issue of derivatives and proprietary trading have aspects that have been likened to a casino, with the wagers being about future price movements. The essential basic functions should be separated from the casino.

An overdeveloped fear of "moral hazard" (that the promise of protection would make managers too risk-prone) has made regulators reluctant to identify (or even acknowledge) that there were some institutions that would be protected from closure. If we could build the basic structure of the financial sector from scratch, it would be better to acknowledge that some banks are "too big to fail", and quarantine their key banking services into stand-alone institutions. Contingency plans could be prepared for the restructure of troubled systemic institutions (management changed, shareholders and unsecured creditors given a "haircut", depositors protected) without triggering systemic failure or encouraging moral hazard. And then, for the remainder of the financial sector, "buyer beware" warnings should be prominent, explicit and acted on.

Regrettably, in many countries (including the US) it may not be feasible to restore this kind of division between banks and investment banks. Crisis-induced consolidation has actually worsened the "too big to fail" problem. Financial markets will resist such reform, not only because it would constrain expansion, but because it is in their commercial interests to be able to bring their non-systemic risky operations within the official safety net.

The crisis also reminded us that market prices don't just respond to external "news": they also have their own internal unstable dynamic. An initial modest shock provokes reactions that exacerbate falls in asset prices. As asset prices fall, strong balance sheets turn weak, collateral has to be topped up, liquidity dries up, credit margins blow out and ratings are downgraded. These are exacerbated by excessive leverage, margin loans and derivatives. The downward price spiral feeds on itself.

Perhaps the most important problem revealed by the crisis was the unhelpful political economy of prudential regulation. Regulators in many countries do not have the political backing to carryout their unwelcome tasks of constraining exuberant markets and excessive risk taking. In part, this is because these risks are so rewarding for bank managers and shareholders. As well, it is a mindset issue: the dominance of the EMH stripped the regulators of an intellectual rationale for intervention. If the market is always right, any interference will be inefficient. Just as pernicious, in some countries such as the US, was the conflicted relationship between financial markets and the legislature.

None of these reforms will be popular with the finance industry. But the taxpayer, lumbered with the huge cost of the dismal performance of the sector, is entitled to demand a safer financial structure.

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