Crisis reveals need for new regulatory mindset
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Australia's financial sector has been relatively isolated from the sub-prime crisis, but overseas best-practice financial regulation has changed and will change more before the dust settles.

The crisis has brought a dramatic expansion in official support to keep the financial sector functioning. The lender-of-last-resort facility, traditionally confined to banks, has now been made available to a wider group (including entities not under prudential supervision), against a broader range of collateral and for longer maturities.

Support went beyond the provision of additional liquidity. The stance of US monetary policy has been dramatically adjusted, primarily to support the financial sector.

Earlier notions of "moral hazard" have been drastically revised. It used to be thought that if institutions were "bailed out", they would be less careful in the future. Taxpayers' money was put at risk only after the shareholders' equity had been extinguished. If depositors were fully protected, we used to think that they would be less fastidious in their placements, and intermediaries would be too ready to expand by eager bidding for deposits. But moral hazard has had to play second fiddle to the pressing need to shore up the financial sector. In the case of the two casualties so far - Northern Rock and Bear Stearns – the shareholders were left with some (admittedly greatly reduced) equity.

The Humpty-Dumpty of the old regulatory mindset cannot be put back together again. A more robust *core* financial sector will have to be built, tough enough to withstand normal cyclical shocks with less assistance.

What are the elements of this new order?

First, a redefinition of the enlarged core financial sector for which the authorities take systemic responsibility, combined with an explicit quarantining of this from the non-core segment. This core needs to comprise the predominant suppliers of credit and key market institutions: the intermediation process must be guaranteed even in adversity. Investors in the non-core sector should be warned, loudly and constantly, that the safety of their money is not assured.

Quarantining requires financial entities to be either fully within or fully outside the protected/supervised sector. We still need fringe financial intermediaries which will provide risk capital for uncertain ventures, but these suppliers needs watertight separation. The various entanglements (SIVs, implicit guarantees and so on) must not straddle the core and non-core sectors.

Second, once this core sector is defined, it needs to be properly supervised. This means a rethink of "light touch" supervision (some call it "soft-touch"), which saw nothing wrong at Northern Rock, just before it hit the wall.

Next the vulnerability to sudden illiquidity needs to be addressed. An old-fashioned liquidity requirement should be brought back, to offset the distortions created by the authorities' readiness to accept lower quality assets as collateral for emergency lending. If mortgage-backed assets or credit-card debt are really homogeneous as to risk and other characteristics, they should be traded on an exchange, rather than over-the-counter, so that a real market with depth and resilience exists. Idiosyncratic assets should remain with the originator (or the riskiest tranche should remain) so that proper credit assessment is made. Otherwise, risk capital should be provided outside the core institutions, where caveat emptor (and caveat lender) applies.

The credit process is inherently procyclical. Euphoria occurs during the upswing, clouding both borrowing and lending decisions. Asset price increases expand the collateral base. Non-performing loans (NPLs) decrease, distorting risk assessment.

Prudential supervision should work hard to offset this. Capital and liquidity requirements might be varied over the cycle, built up in the expansionary phase when the seeds of later problems are sown. General provisions for NPLs should similarly be built up in the good times (which will require rejigging of accounting and taxation rules). Loan-to-valuation ratios and required margin limits could be shifted over the course of the cycle. Collateral could be valued at its average over a run of years rather than at current value, to offset its pro-cyclicality.

The main mindset change here is that prudential supervisors should accept that their task goes beyond the micro-economics of individual institutions, and needs to address macro-prudential issues.

Third, monetary policy also needs reconsideration: the origins of financial crises are usually found in poor macro-policies. The US mortgage debacle is a product of the excessively low interest settings in the years following the “tech-wreck” in 2001.

Alan Greenspan argued that central banks could not identify asset bubbles and could not prevent them even if they did. In any case bubbles didn’t do much harm and could be mitigated by active monetary policy when they burst. This created the “Greenspan put” - the belief that the Fed would always save the financial sector by sharply cutting interest rates. It has, but this is a trick that loses its magic with repetition. The head of Deutsche Bank “no longer believes in the market’s self-healing power.”

Finally, risk assessment needs root-and-branch rethinking. Clearly the conflict of interest within rating agencies must end, with these incompatible functions put in separate entities. It’s hard to see how the new Basle II rules can rely on such ephemeral commercially-driven assessments. Notions that risk can be diminished through diversification may make sense with idiosyncratic risk, but systemic risk is by its nature strongly correlated and needs to be assessed differently. There also needs to be a fundamental recognition that risk assessment based on day-to-day volatility (even when embedded in a sophisticated “black box”) misses the “black swans” at the tails of the risk distribution curve, and these are the ones that matter.

Remuneration policies needs to align incentives with sustainability, without richly reward failure as well as success.

Financial markets, understandably, want as few regulatory constraints as possible. They laud financial innovation as the driver of wealth creation. They have been a powerful lobby for “light touch” regulation. Sarbanes-Oxley is a reminder of the dangers of overreaction. But if we can’t allow evolutionary natural selection to work, and instead need the authorities to step in during every downturn to rescue the weakest institutions, then we need a more activist view of financial regulation.

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