

Essay

Good Regulation is Good Governance 101

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In 1925, at the time that Britain reverted to the gold standard, Winston Churchill, then Chancellor, said that he would like to see 'finance less proud and industry more secure.' The move was criticized by economists for overvaluation of the British Pound; but the quote was prescient and is especially relevant today, when the hubris of the financial markets has fractured the global economy so excessively.

Course correction so far has relied on bailouts. Instead what is immediately needed is the observance of good governance in regulation and in the long term, a restructuring of the regulatory architecture. Key to this is the recovery of ground lost by the regulator in ensuring market integrity, reinforcement of the currency of financial markets viz., trust, and deliverance of market stability which will help the underlying economy and the society at large. In sum: ensuring good regulation through good governance. This is the challenge before regulators today.

The impact and import of the global financial crisis can be judged by two simple numbers: global market capitalization and GDP growth. (source - the World Federation of Exchanges www.world-exchanges.org data.worldbank.org), They grew from \$17.1 trillion and \$27.5 trillion in 1990 to \$ 64.5 trillion and \$ 63.2 trillion, in 2007 respectively. A year later, market capitalization had almost halved to \$ 33.5 trillion while GDP growth fell from over 5% to 3% in 2008 and -0.5% in 2009.

The crisis that surfaced in 2007 has already peaked twice, in 2008 and 2011, and is far from over. In every analysis, financial market regulators have been accused of sleeping at their desks, held captive by the industry, remaining benign as the party went on and even abetting the excesses both wittingly and unwittingly.

The Indian caste system provides a useful prism through which to analyze the global financial markets boom from the early 1990s till the bubble burst and the crisis unfolded. The caste system comprises the *Brahmins* as the priestly classes at the top, the *Kshatriyas* as warriors and kings, the *Vaishyas* as merchants, and the *Shudras* or lower castes at the very bottom. Pre-2007 would have revealed a disordered system. Instead of the regulators and governments being the *Kshatriya* warriors who protected the investor and the kingdom (system), and the banks and broker-dealers being the *Vaishya* facilitators or middlemen of the marketplace,

- Bankers, governments, central banks and regulators became the *Brahmins*
- Corporations became the *Kshatriyas*
- Markets, broker-dealers and hedge funds became the *Vaishyas*
- Investors, consumers and citizens became the *Shudras*

How did it get this way?

Bankers, or *Vaishyas*, upgraded to Brahmin status by positioning themselves as 'advisors' to nations, their governments, central banks and corporations. The latter acted as willing partners to bankers, with laws and rules that furthered the interest of bankers. Corporations, supported by banks and an advantageous policy framework which legitimized crony capitalism, led globalization by expanding their operations both organically and inorganically.

Vaishyas, apart from middlemen, also mean 'seducers.' Aided by technology, broker-dealers created a complex set of products (derivatives, synthetics) that created frenzied trading activity and lulled everyone into believing all was well with the world. Later, Warren Buffet described those derivatives as weapons of mass economic destruction. Regulators, not wanting to stifle innovation, allowed these products to thrive with tissue-paper-thin regulations. Governments in the U.S. and Europe were willing partners as they found the all-round stock wealth creation, notwithstanding its skewed distribution, beneficial to pursue their lavish spending policies and create a facade of general well being. Those policies helped them soar to the peak of the caste system, where they sat, unwilling to examine the system crumbling below them.

Investors and consumers, who should have been at the top of the system, became the garbage bin of products

that were neither suitable nor needed. No one cared, anyway, as long as they could keep spending and keep up the illusion.

A few instances stated below best highlight the key events that caused the crisis and the role played by the financial market caste system.

- **Bankers** in the U.S. lobbied hard with Washington for the repeal of the Glass-Steagall Act in 1999; it allowed them to conduct commercial banking (backed by federal deposit insurance) and investment banking (high-risk proprietary trading) activities on the same balance sheet. The upside of high returns was earned by the banks, but the downside of high risk was paid by the government. Profits were private and losses, public.

- The Club of Banks (the Basel Committee) maintained that **sovereign debt** was 'zero risk' and, therefore, exempt from capital provisioning by banks. This resulted in a potent combination where governments (particularly southern European), aided by cheap funding, indulged in lavish social programs and banks, not worried about credit worthiness, earned from unchecked lending.

- The Basel Committee endorsed the use of '**credit rating agencies**' to help assess the extent of risk to determine the proportionate capital required. But there were no restrictions on related businesses like advisory and consulting that could endanger their independence in credit rating, no mechanism put in place for a public agency to audit their rating processes and no review of the fine print that gave them no liability. The banks and credit rating agencies forged a symbiotic relationship leading investors such as pension/mutual funds and individuals into believing that the ratings were well-founded and grounded in good faith.

- A major regulatory change that **increased leverage** and, therefore, increased firm and systemic risk, was the waiver for select large institutions to use their in-house risk model for determining asset value and capital provision. This April 2004 SEC proviso completely ignored the learning from the 1998 Long Term Capital Management collapse from excessive leverage. Driven by profit motives, pressures of quarterly financial reporting and greed for executive bonus, these firms ignored conservative principles of valuation and allowed themselves borrowings as high as 50 times net worth. If a firm is levered 50:1, then a mere 2% fall in markets would wipe out its net worth.

- **Letting firms fail** is as integral to the principles of capitalism as the opportunity to succeed. But this did not happen. Regulators adopted differential and inconsistent standards to treat different firms differently and thwarted this very principle. Of the five big firms which benefited from a diluted net capital ratio rule and were subject to high stress in the crisis, Lehman Brothers went bust, Bear Stearns and Merrill Lynch were taken over by JPMorgan and Bank of America and Morgan Stanley and Goldman Sachs converted to banks to give them access to central bank funds and deposit insurance.

- **Central Banks** played their part to cause the crisis. A founding principle of the 'Euro', that was consistently flouted from Germany to Greece, was that member-countries would maintain their fiscal deficit to 3% of GDP and total debt within 60% of GDP. The European Central Bank had neither the will nor the wherewithal to inflict punishment or enforce discipline. In emerging markets like India and China, regulators have been known to take a 'kind' stance when banks have fallen short of minimum capital adequacy ratio on a self-serving notion that such 'grace' period allows a bank to self-correct. This mis-belief portends another Japan-like scenario where the economy is recovering from the history of bad loans from banks to corporations for a decade now.

- In order to assuage the sections of the population that did not benefit from the economic boom, the US government, in the late 1990s, authorized Government Sponsored Enterprises – Fannie Mae and Freddie Mac – to acquire and refinance such mortgages and thus created the sub-prime excesses. This licensed 'throwing caution to the winds.' Subprime customers were encouraged to borrow more notwithstanding their inability or disinclination to repay, or their lack of understanding of the fine print in the product. With no brakes in the system, the crash was inevitable when the underlying asset value of home prices fell and the subprime borrowers default rose.

- Far from public view and regulatory scrutiny was a parallel system causing the crisis. A Club of Broker Dealers (International Swaps and Derivatives Associations Inc - ISDA) facilitated the **OTC market** for derivatives trading. Since all trades and settlements were done bilaterally and not market-wide, the OTC market did not use the margin-based clearing and settlement systems for risk management prevalent in stock exchanges – and therefore, the extent of the risk embedded in the OTC markets remained hidden from the regulators.

Thus, much like the caste system, the upper castes protected themselves and furthered their interest. Those of the lower castes were compromised or ignored.

Regulators deserve a fair share of the blame for this outcome. Most regulators can be charged with:

- ignoring investor protection and relying on disclosure and caveat emptor
- not learning from prior experiences in new policy formulation that created both firm and systemic risks
- encouraging innovation in products with no checks or balances
- working on incomplete or approximate information while managing a crisis
- having a continued belief in efficient market hypotheses without cross-verification to understand what is simmering below the surface

For regulators to immediately recover lost ground, the caste system of the markets must be put back to its original order, where investors and stakeholders are at the top of the heap, where the market intermediaries are sent back where they belong – as facilitators or Vaishyas – and where regulators and governments are once again the warriors, charged with investor and system protection. This will ensure market integrity, reinforce trust - the main currency of stable financial markets.

Getting there requires new thinking on governance structures. Good governance rests on four pillars:

- Stakeholder protection
- Prudential regulation
- Systemic risk management
- Orderly dismantling

As a first step towards **stakeholder protection**, financial market regulators would do well to learn from other industry regulators. For instance, in the pharmaceutical industry, regulatory approval validates all new drugs as effective and safe if the benefits outweigh the risks and make them, therefore, suitable for public consumption. The Food & Drug Administration *approval process* requires multiple levels of clinical testing and the process takes five to eight years. Similar is the rigour in the approval of a new automobile design or a residential building: human lives depend on this.

By this yardstick, as Paul Volcker told bankers at a seminar on Future of Finance Initiative in 2009, the last useful innovation in finance was the ATM machine. Financial market regulators would do well to bring on board standards of ‘*appropriateness and affordability*’ and review the framework for the on-going oversight of financial products to these standards.

Secondly, advisors must be subject to stringent compliance requirements and held accountable for investment recommendations and selling practices. Investor protection is best achieved when the interests of manufacturers, distributors and advisors of financial products are aligned behind the investor – neither ahead of nor alongside.

Third, minority shareholders need protection. In emerging markets, regulators have photocopied the Western rules that protect the shareholders from management, even though their challenge is different. There management is the majority shareholder in family promoted enterprises and hence minority shareholders need protection. Boards of corporations must be accountable for their fiduciary obligations.

Prudential regulations on risk management must focus on the specific nature of the institution. Banks, which enjoy the status of public trust in most countries, must put in greater safeguards in exchange for the privilege of continued access to funds from the central bank and the continued guarantee of its customers' deposits. The practice of allowing banks across the world to engage in both deposit-taking activities which enjoy state guarantees, and proprietary trading on the same balance sheet, must end. Regulators, in turn, must be alert to tracking the liquidity and solvency of these banks. Broker-dealers need to 'mark to market' open positions on universally accepted conservative principles and ensure that such exposure is backed by adequate capital. For all of the above, prudential regulations must enforce the principles to ensure compliance in spirit - and not just in form that mere 'rules' can permit.

While regulators like the U.K.'s Financial Services Authority (FSA) have clear principles of regulations, their eastern counterparts focus more on specific rules. This results in elaborate compliance structures which focus on form over substance. And in these countries, violations seldom attract a penalty of over \$100,000 and are often arbitrary, resulting in violators getting away and investors getting hurt. This structure must be replaced by one which reduces the cost of compliance but substantially increases the cost of non-compliance, and serves as a deterrent.

The third pillar of governance requires regulators focus on systemic risk management. Reform must be brought to the OTC markets, the credit rating agencies and sovereign debt.

(a) The recent crisis exposed the vulnerability of OTC markets and their lack of transparency in outstandings and embedded risk. Today, the larger markets in New York, London, Mumbai, Hong Kong and Singapore use technology to process millions of transactions and ensure best execution. Clearing corporations have risk management systems to track exposures on open positions, levy margins and unemotional resolution of failed trades by foreclosure or auction.

But this fireproof mechanism was circumvented by the OTC market, whose members settle between themselves and not the wider market. Their existence is akin to building subways and footbridges for pedestrians to cross roads with heavy traffic, but turn a blind eye to those who choose not to use them. Plus the errant pedestrian may well cause a car to avoid him/her only to run into another car and set off a series of car accidents. That is systemic risk – where the actions or non-actions of a firm or a small set of firms may cause a system-wide problem. Regulators must transition bilateral OTC markets to the more transparent market-wide clearing and settlement systems.

(b) Credit rating agencies must pass the litmus test of independence and the rating process must be subject to periodical regulatory audit to ensure high quality standards in internal systems. Other businesses, such as consulting and advisory, which generate greater incomes but potentially threaten independence or create conflicts of interest, must be structurally dismantled.

(c) Challenge the Holy Grail of sovereign debt. A sovereign is just another borrower and its credit standing must be assessed on the basis of fiscal deficit, exchange rate stability, extent of debt and debt servicing capability – present and future. Regulators must force sovereigns to borrow at public auction to ensure that the price discovered – the cost of borrowing – is established by a transparent process and subject sovereigns to the same market discipline as a private borrower.

The last pillar of effective governance requires regulators to recognize the necessity of failure and the orderly dismantling of firms in the event of a systemic breakdown. Of course, the prerequisite is an effective systemic risk management mechanism. Should a firm or a group of firms cross the threshold and pose systemic risk, regulators must mandate measures ranging from recapitalization to suspension of individual businesses, to permitting takeover or shutdown as may be appropriate. Just as in an extreme cases of diabetes, a part

of the body to be amputated to extend life, so firms on the brink of failure can be mitigated by a series of measures initiated at different triggers and control the impact of their crash on the system.

These are all immediate measures to save the system from sinking further. To keep the system robust in the future and lower the risk of further crises, it is necessary to build a sound architecture for a global regulatory framework. In the developed world, there exists a clear separation of legislative, executive and judicial functions. But in a number of emerging markets, financial regulators combine all three powers without the benefit of checks and balances. Regulators exercise their powers arbitrarily, and have allowed regulatory capture either by government or markets. Notwithstanding upright and effective executives at the helm of some of these regulators, the systemic solution is to limit regulators to executive and administrative functions with limited subordinate legislative capability.

The improved regulatory architecture should provide for a check on the propriety of regulatory policies and internal processes of administration. Government audits of regulators should go beyond financial transactions review and ensure accountability on policies and their implementation. Judicial functions, to hear and adjudicate cases on civil and criminal matters, are best left to the courts with relief provided through an appellate structure. It would be against the principles of natural justice to have the regulator be the prosecutor and judge.

Indian lyricist, Javed Akhtar, recently tweeted: 'A conqueror from west to east is great, like Alexander. And from east to west is a tyrant, like Chengiz Khan.' Till the crisis, the supremacy of the Western regulatory framework went unchallenged and became the norm for emerging markets. Now regulators from the East have demonstrated far higher standards that are worth emulating. For instance, in 2008, save for the three major markets of Hong Kong, Singapore and India, most countries banned 'short sales' in one form or another. But no regulator was held accountable for the efficacy of the ban. The Australian regulator introduced a series of measures under Future of Financial Advice (FOFA), delinking investment advisors from product manufacturers and places direct accountability to investors on the suitability of their advice. In 2009, the Indian regulator abolished entry loads on mutual funds that made the product less expensive and more transparent. Risking unpopularity, the Indian central bank, in 2005-07, took a number of credit control measures to real estate, equity and consumer goods financing and helped contain the excesses that other countries witnessed. To learn and emulate, regulators need to shun the natural Occidental bias against the Orient.

The economic boom which preceded the financial crisis coincided with the period when capitalism began enjoying virtual monopoly status - after the fall of state-sponsored socialism in the Soviet Union and Eastern Europe in the late 1980s. The financial crisis and the damage caused lend credence to the allegation that capitalism has been hijacked by the cronies and the corrupt. Much like the old caste system, a select few have disproportionately benefited, with scant regard to fairness and equity.

To extricate capitalism from this crisis and restore not only financial market democracy but also world order, regulators need to reboot, re-ignite and honour principles of good governance.