Re-regulation will fail to curb bankers' worst excesses

FinancialTimes.com
By John Plender
May 27, 2009

Bankers are, by common consent, dangerous. If the risk of a re-run of the current financial debacle is to be avoided, it is vital that those who play with the most dangerous capital market instruments should be thoroughly disarmed by watertight regulation. Yet so persuasive is Wall Street in the policy dialogue that we are now witnessing re-regulation with a banker-friendly face.

Consider, first, the over-the-counter (OTC) derivatives markets, the opaque multi-trillion dollar Sargasso Sea where so much systemic risk resides. This is a huge source of profit to the biggest banks, and an equally huge source of loss to the taxpayer when toxic derivatives blow a hole in balance sheets, as at Lehman Brothers and AIG.

The obvious way to curb this dangerous activity is by forcing such business onto formal, fully transparent exchanges. This would be tough for the banks, because exchange-traded derivatives are standardised, commodity-type products that generate a fraction of the returns available in the OTC market - to which taxpayers could very fairly respond, so what?

Yet the recent reform proposals from Tim Geithner, US Treasury secretary, surprised even bankers by opting for a much less draconian set of measures involving no more than a clearing house, a not very demanding measure of transparency, and a scale of capital charges that merely tries to steer business towards regulated exchanges.

Clearly, some very effective lobbying has been going on. For, as Christopher Whalen, a banking analyst, argues, in spite of the appearance of reform, the proposals leave the OTC market in the hands of large derivatives dealer banks. Terms such as innovation, productivity and competitiveness are being heard again in Congress in connection with arguments that OTC derivatives manage risk, rather than create it. The same language can be heard in London, which handles a greater volume of derivatives business than Wall Street.

Then there is the case of the remarkably unstressful stress tests, which showed that US banks needed no more than $75bn of fresh equity. Yet the methodology in the stress test report is open to question. Lucian Bebchuk of Harvard University points out that the report's estimate of $600bn aggregate losses takes into account losses arising from non-payment, but not discounts related to mark-to-market values.

This approach, adds Mr Bebchuk, overlooks a substantial amount of economic damage imposed on banks by the crisis because it fails to estimate the economic losses on troubled assets with post-2010 maturities. Here, then, is a case of old-fashioned regulatory forbearance, which encourages the survival of zombie banks in the same way that the Japanese authorities did during Japan's lost decade.

Consider how quickly the suggestion that the Glass-Steagall Act should be recalled was dismissed. Consensus seems to be building that Glass-Steagall's firm dividing line between commercial and investment banking is inappropriate in a world where the banks' large corporate clients still require the supposed benefits of securitisation.

Similarly, splitting the system between narrow banks investing depositors' money in very low risk assets and broad banks investing uninsured deposits in higher risk assets appears to have little traction in the policy debate.

This is not just a triumph of lobbying on the bankers' behalf. It also reflects the difficulty politicians face in grappling with the immense complexity of modern financial markets. To offer an alternative to what the experts prescribe requires confidence, even when you know that the experts have just wrecked the financial system. That is why so much of the re-regulatory effort will come via the blunt instrument of the Basle capital regime.

Of course, the shape of the financial system will not be exclusively dictated by regulatory reform. There is also a market response, which will ensure that many of the more toxic financial instruments will not come back. That said, it is beginning to look as though the re-regulated US financial system will have more in common with the system of the past 10 years than many bankers would have dared hope just months ago. Taxpayers be warned.