

SHIFT

**The tectonic plates
of the FINANCIAL**

**LANDSCAPE are
shifting under our feet.
Where are the major
fault lines, and what
will be left standing?**

BY CHRISTOPHER WRIGHT

For German billionaire Adolf Merckle, the world had become an unbearable place. A casualty of the global financial crisis, Merckle effectively signed away control of his empire (120 companies acquired over 40 years), left his office, and threw himself in front of a moving train. His suicide is emblematic of the pain and wreckage the crisis has strewn across every continent.

Governments around the world have taken bold and unprecedented action in response to the crisis—bailouts, coordinated rate cuts, massive stimulus packages, nationalizations, deposit guarantees. Such interventions would have been inconceivable just a short time ago. Yet doubts are expressed daily that these efforts will all be enough to avert disaster. Wild swings in the market have led many investors to keep record amounts in cash.

The tectonic plates of the financial landscape we thought we knew are shifting under our feet. Global finance will never be the same after this crisis. The financial leadership of the United States is being challenged, capitalism is under assault, industry structures are realigning, and (all agree) more regulation is coming.

CHANGING U.S. ROLE

The crisis has obliterated U.S. leadership in global financial matters, a chorus of critics has asserted. “The U.S. will lose its status as the superpower of the world financial system. This world will become multipolar,” German finance minister Peer Steinbrück declared in September 2008. “In the 21st century, there is no longer a single nation who can say what we should do or what we should think,” French President Nicolas Sarkozy added in January 2009.

The United States was already in decline, according to this school of thought. The war in Iraq, the military and economic rise of China, and the U.S. recession mean that America can kiss its dominance in world affairs goodbye. U.S. financial giants have been smashed to pieces or otherwise humbled, bringing an abrupt end to New York’s iconic status as the world’s preeminent financial center. Investment returns will be lower going forward, causing major headaches for

the retirement funding of U.S. Baby Boomers. The selective ban on short selling has foreign investors factoring political risk into their calculations about the United States for the first time in modern history. Now for the coup de grâce—the current crisis will leave the United States so weakened that it won’t even be able to provoke another international financial crisis worthy of the name ever again in the future.

With the collapse of U.S. hegemony would come the end of U.S. dollar dominance. According to the weak form of this argument, the U.S. would no longer be able to obtain easy credit from the rest of the world, an arrangement that had been possible only because of the dollar’s unquestioned status as the world’s reserve currency. Stronger forms of the argument have the euro supplanting the dollar as reserve currency to some degree and some observers predicting a full-blown collapse of the dollar when inflation spins out of control from over-stimulation of the U.S. economy.

The end of U.S. dominance also would portend big changes in multilateral organizations, including the World Bank and International Monetary Fund. Indeed, the process has already begun, with the expansion of the November 2008 “Summit on Financial Markets” from the G8 to the broader Group of Twenty (G20). The G20 decided to include more emerging economies in its Financial Stability Forum (or FSF, a group established in 1999 and composed of senior representatives of national financial authorities). But some observers expect China, for example, to take a broader role at the IMF in exchange for making foreign reserves available to recapitalize other countries.

Others envision different scenarios. Rather than marking the start of the Asian century, the crisis may instead elevate the Gulf Arab states to new heights as the most important investors in the world. Other candidates for new prominence on the world financial stage include a resurgent Russia. Indeed, Russian prime minister Vladimir Putin summed up the view of many international observers when he said, “Trust in the United States as the leader of the free world and the free economy, and confidence in Wall Street as the center of that trust, has been damaged, I believe, forever.”

But forever is a long time. The crisis may leave the United States in a better relative position than many thought at first. The jury is still out on the ultimate effects of the crisis, and a verdict will not be returned for five or more years,

according to Stephen Roach, chairman of Morgan Stanley Asia in Hong Kong.

Roach acknowledges the challenges to U.S. leadership arising from the crisis. The United States has in recent years become a debtor nation with a paltry savings rate and an economy driven by an unsustainable consumption binge propped up by asset bubbles. “A lot of what we’ve taken for granted in the American hegemonic model is now being challenged and dismantled,” he says.

However, the United States still has a huge lead over other countries in the world. “I don’t expect the gap to be closed,” he says, “but the gap will narrow” as a result of the crisis.

Robert Jenkins, chairman of the Investment Management Association and chairman of F&C Asset Management (both based in London), holds a similar view. “The U.S. is not in decline,” Jenkins says. “Rather, a number of other nations are in the ascent. The gap is closing.” He points out that the standard of living in China and India is rising “both in absolute terms and relative to the U.S.,” a development he describes as “cause for celebration, not hand wringing.”

The United States may be hurting from the crisis and recession, but greater pain is being felt in countries that focused on exporting to the United States.

As home to a number of such export-led economies, Asia has grown spectacularly in the past 30 years, yet these markets may not do so well going forward. “Asia has a lot of heavy lifting to do to validate the optimism of the so-called Asian century,” Roach says. “Most important, it needs to change the structure of its economy from one that is overly reliant on exports to one that’s driven more by internal private consumption.”

China will assume a larger role in multilateral institutions in terms of dues paid and voting rights, according to the consensus view, yet is unlikely to use its stockpiled funds to recapitalize beleaguered financial institutions elsewhere. In December 2008, Lou Jiwei, the chairman and chief executive of the China Investment Corporation, said China has no appetite for such a venture after sustaining heavy losses on previous investments in the Blackstone Group, Morgan Stanley, and Barclays. Thus far, China has not been aggressive in using its new position in the multilateral institutions to set the agenda or influence policy. This approach is consistent with the country’s traditional stance of keeping a low profile in international affairs when no direct national interest is at stake.

“Leadership” and “decline” are relative terms. The crisis also exposed housing bubbles in Spain and the United

Kingdom (occasioning the nationalization of Northern Rock), frothy stock prices in India, and losses in European banks that have exceeded total losses in U.S. banks. The IMF had to come to the rescue of Iceland and Pakistan. Russia suffered when oil prices collapsed. China had to pour massive stimulus into its economy to prevent unemployment from reaching politically destabilizing levels. (“It is like keeping a river in flood so that you cannot see the rocks below,” as one observer colorfully put it in the *Financial Times*.) Meanwhile, U.S. Treasuries retained their safe-haven status (prices up, yields down).

For better or worse, financial leadership is still the United States’ to lose. Judging by events thus far, it will take more than the current crisis for that to happen.

INDUSTRY STRUCTURE

The way business is being done in the financial industry is changing as a result of the crisis, but the impact will vary for asset management firms, investment banks, and hedge funds.

ASSET MANAGEMENT FIRMS One structural change wrought by the crisis has been to accelerate the convergence of traditional asset management and hedge fund techniques, according to Jeb Doggett, CFA,

partner at Darien, CT-based investment management consulting firm Casey Quirk. Clients are now more willing to untie managers from benchmarks and allow them to use all the skills and insights they possess, such as shorting or international investing. Moreover, outcome-oriented approaches that focus on the liability to be funded (e.g., lifecycle products) will increasingly call on managers to employ

a broader set of capabilities (consulting, insurance, risk engineering) that now currently reside in different organizations. Kevin Quirk, founding partner of Casey Quirk, believes that investment firms with different core competencies will need to partner with each other in some way (combining strong products with strong distribution networks, for example) to remain competitive in the more challenging environment ahead.

INVESTMENT BANKING The demise or transformation of such big-name investment banks as Lehman Brothers and Goldman Sachs has led some to conclude that investment banking as a business model is dead. Unlike commercial banks, which benefit from a perception that governments will step in to stop a run on deposits, investment banks can be brought down with a rumor. Reportedly, rumors swirled

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around all the recently affected investment banks, contributing to their bankruptcy (Lehman), absorption by another company (Bear Stearns, Merrill Lynch), or application to become a commercial bank (Goldman Sachs, Morgan Stanley). Some observers believe that investment banking, while not completely dead, will face stronger headwinds in coming years because such firms lack access to a reliable funding base, such as deposits, and do not provide a safety net for investors (deposit insurance), making investment banks less competitive. Finally, because shotgun marriages are not the happiest, it is not outside the realm of possibility that an acquired firm, such as Merrill Lynch, could be spun out some day and regain its independence.

HEDGE FUNDS The death of the hedge fund as a viable business model has also been proclaimed. While hedge funds seem unlikely to disappear completely, major changes are occurring. The ranks of hedge funds thinned by 4 percent last year, and some predict that the total number will fall by half before the end of 2009. Consolidation may produce two tiers—large multistrategy hedge funds capable of serving institutional investors and small boutiques that appeal primarily to high-net-worth individuals—squeezing those stuck in the middle.

Some surviving hedge funds are swearing off leverage entirely (or had their bankers do it for them), while others are deemphasizing highly leveraged small-arbitrage strategies. Fees are coming down, with the 2-and-20 model (2 percent management fee plus 20 percent of profits) giving way to mandates and fees at half the price.

Illiquid assets are being split off into special vehicles with longer lock-up periods to slow investor redemptions. “That’s become, very quickly, a new paradigm in the hedge fund industry,” Quirk says, adding that clients will adjust to the longer lock-ups just as they have in the past for direct real estate and private equity. Quirk also predicts that hedge fund performance fees will be restructured to reflect the term of the investment, paying out like private equity when the investment is realized instead of by calendar year. Hurdles and caps are likely (for example, no performance fee unless a minimum threshold is met, with a maximum imposed to discourage excessive risk taking). In these and other ways, in Quirk’s view, the interests of hedge funds and their clients will become better aligned.

Increased regulation of hedge funds, a near certainty after the US\$50 billion Madoff scandal, could include registration, greater transparency in holdings, independent third-party administrators (who value assets and prepare investor statements), mutual fund-like borrowing ratios, strengthened whistle-blower programs, higher taxation (at regular income tax rates instead of capital gains rates), restrictions on offshore tax deferrals, and more due-diligence requirements for funds of funds. The days when hedge funds could say, in effect, “We’re math geniuses—just give us your money and don’t ask any questions,” may be numbered.

OTC-EXCHANGE COMPETITION With crisis comes opportunity. Exchanges are poised to take business (credit default swaps and other contracts) away from the OTC market. According to one line of thought, the lack of transparency and central clearing in OTC markets emboldened Bear Stearns, Lehman Brothers, and AIG, aggravating the crisis. Margin calls would have prevented the build up of excessive counterparty risk.

In late December 2008, the Liffe futures exchange began clearing credit default swaps through LCH Clearnet in London. In the United States, regulatory approval is pending (as of this writing) for two different CDS clearinghouse ventures, one led by the CME Group and the other by the Intercontinental Exchange (ICE). Meanwhile, NASDAQ is moving into interest rate swaps.

Despite such developments, central clearing, whether arranged through exchanges or among OTC participants themselves, is not likely to be a panacea. A central counterparty can help to absorb losses if a dealer fails but cannot prevent the injudicious use of leverage or eliminate all performance risk. In fact, if the clearinghouse is not adequately capitalized or well managed, it can create new risks, concentrating them into a single point of failure.

CAPITALISM IS DEAD, LONG LIVE CAPITALISM!

“Le laissez-faire, c’est fini.”

So declared French president Nicolas Sarkozy, who was among those proclaiming the death of capitalism shortly after the crash. More specifically, it is the supposed “American-style” or “Anglo-Saxon” form of capitalism—caricatured as unbridled faith in free markets and an allergic reaction to any government interference whatsoever in the economy—that has come under assault.

Of course, this world view is an oversimplification. The truth of the matter is that the United States, the United Kingdom, and most other developed markets have had mixed economies for decades—complete with transfer payments, subsidies, progressive taxation, government-sponsored enterprises, and government regulation of business. In modern times, no *laissez-faire* economy has ever truly existed outside the pages of a textbook.

Even so, capitalism has “lost credibility, not just in the United States, but around the world,” says Adam Lerrick, professor of economics at Carnegie Mellon University in Pittsburgh, PA, and visiting scholar at the American Enterprise Institute based in Washington, DC. He points out that the Europeans, who have been calling for more constraints on financial firms for years, are saying “We told you so” while China, Brazil, and India argue that the United States and World Bank were wrong to push developing countries so hard to liberalize their economies.

Even captains of finance who have benefited handsomely from capitalism are starting to sound like unreconstructed

Marxists. In their view, capitalism fails at producing public goods (e.g., a clean environment), channeling greed, distributing wealth, or dealing with economic crises.

Those who are newly disappointed with capitalism are in part feeling the pain of their own unrealistic expectations. The business cycle has not been repealed, nor can it ever be. Financial markets do not reliably deliver projected returns on a regular schedule, even if widely used normal-distribution risk models imply otherwise. Moreover, financial crises are inevitable in a capitalist system and cannot be prevented in their entirety.

Despite its flaws, capitalism, with its predilection for private economic activity, has brought more prosperity to more people in more places than any other system. According to the annual Index of Economic Freedom produced by the Heritage Foundation and the *Wall Street Journal*, countries that have a greater degree of economic freedom are demonstrably more prosperous than countries in which private property rights have less protection and the government overburdens the economy.

Periodic scandals and crises are the price paid to maintain the goose that lays the golden eggs. “You can set up a system that will never have a financial crisis,” says Lerrick, “but it won’t grow very fast either—that’s the trade-off.” He cites the former Soviet Union as a case in point. As Winston Churchill famously observed about democracy and government, capitalism may be the worst way to organize an economy, except for all the other ways that have been tried.

No country has responded to the crisis by ditching its private markets or replacing them with a centrally planned command economy, nor would any be likely to do so. No G20 communiqué has urged such a drastic step, so private ownership of the means of production will for the most part remain the cornerstone of the world’s major economies. The question now is how capitalist systems will adapt and go on.

Those who favor expanding public activity at the expense of private activity likely will make great political strides in the next few years. If so, more regulation and redistribution of income will follow. Devotees of the private sector and individual liberty will be dismayed, but this episode would not be the first time that public policy has taken a left turn after a crisis. In response to the Great Depression in the United States, the capitalist system was modified with the addition of New Deal social spending, government jobs programs, and regulation of the financial sector. The U.S. Securities and Exchange Commission (SEC) was created in 1934 to regulate securities trading and disclosure requirements.

Proposals from capitalism’s progressive critics include “community capitalism” and corporate social responsibility (CSR). Community capitalism emphasizes employee stock ownership and worker democracy. The CSR movement, a more recent development, is steadily gaining mind-share in corporate circles. German chancellor Angela Merkel will take her fight for a “social market economy,” which emphasizes

the role of all stakeholders, to the next G20 summit.

The problem with such developments, as Lerrick sees it, is that such an approach would require companies to go beyond maximizing shareholder value and focus instead on the politically correct cause of the day (“going green”), which would entail a number of conflicting objectives.

The cultural marketplace had begun to provide alternatives well before the crisis hit. In the United Kingdom, more than two dozen banks already offer sharia mortgages or other Islamic-inspired financial products. In India, “Dharma capitalism” unapologetically seeks profits but tempers materialism with higher values derived from Indian philosophy.

Nor are all the voices of criticism coming from outside capitalism and the investment industry. Vanguard founder John Bogle, for example, has written against materialism and greed in his 2008 book *Enough*, arguing for a return to the “moral capitalism” of the 18th century.

Bogle is not the only one asking capitalism to return to its roots. A lot of post-crisis commentary is to the effect that capitalism became too skewed toward finance in recent years and should redirect talent and capital back to the “real” or “productive” economy. As Sarkozy later said upon further reflection, “What happened was a treason of the values of capitalism. The market economy itself is not called into question.”

Shifts in underlying values may be somewhat amorphous, but there will be nothing subtle about the regulatory response to this crisis. Deregulation, it is widely proclaimed, did not work. New legislation has been promised by the U.S. Congress and the Obama administration. In addition, the G20 is expected to outline regulatory proposals at its April summit in London.

REGULATION 2.0

Proposals for reform have multiplied like rabbits. Reformers want to

- limit the use of leverage,
- curb innovations in new instruments,
- require securitizers to retain exposure to the instruments they create,
- require more balance sheet disclosure of derivatives and risk positions so lenders can more easily identify weak borrowers,
- give regulators more discretion to prevent banks from pursuing business models that pose systemic risks,
- consolidate off-balance-sheet activities (such as special investment vehicles, or SIVs),
- prevent banks from creating off-balance-sheet entities entirely (as the Bank of Spain did before the crisis began),
- raise capital requirements in general and adjust prudential reserves as needed to put the brakes on rapid loan growth,

- require banks to salt away billions in “generic provisions” in good times to prepare for bad (the Bank of Spain does this),
- require banks to invest a portion of borrowed funds in safe low-yielding assets to stay liquid,
- encourage market participants to more actively monitor bank risk by requiring more subordinated debt in bank capital structures, and
- make regulations more adaptable so regulators can more easily respond to changing conditions (e.g., accelerate the move to principles-based regulation).

Unfortunately, the government, even with “enough” rules and enough bureaucrats to enforce them, cannot make the world a totally safe place. The record does not warrant such faith:

- U.S. regulators probed Bernard Madoff’s firm eight times in 16 years but failed to uncover the biggest Ponzi scheme in history.
- The U.S. Federal Reserve Board, Fannie Mae (originally part of a government agency), and the SEC were specifically created in response to previous financial crises but failed to prevent later crises. Indeed, it has been argued that the Fed’s prolonged easy-money policy after the 2000 bubble collapse and 9/11 contributed to the current crisis and that previous Fed rescues (e.g., Long-Term Capital Management) created a moral hazard, leading directly to subsequent imprudent conduct on the part of firms anointing themselves “too big to fail.”
- Fannie Mae and Freddie Mac, institutions at the epicenter of the current crisis, were chartered and overseen by the U.S. Congress. Fannie was pressured by the highest levels of government in 1999 to loosen underwriting standards and boost subprime mortgage activity, which the mortgage giant did, despite predictions at the time that a bailout would one day become necessary.
- Lehman Brothers CEO Richard Fuld’s certifications of financial statements under the much-vaunted Sarbanes-Oxley Act, passed in response to the Enron–WorldCom generation of scandals, did nothing to deter the reckless behavior that led to Lehman’s demise.
- In a classic illustration of the law of unintended consequences, moves by regulators to strengthen banks in developed countries caused capital to flee from emerging markets, causing great damage there.

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- Prior to the failure of Northern Rock in the United Kingdom, the bank appeared to have adequate capital as measured according to the U.K. regulatory framework.
- Spectacular fiascos at BCCI, Barings Bank, and Société Générale—now seemingly forgotten in the wake of even more spectacular failures—left observers asking, “Where were the regulators?”

Where indeed. Deregulation is widely excoriated at the moment, but history provides ample testimony to the imperfections associated with government intervention. With the pendulum now swinging back toward more government oversight, the limitations of re-regulation will become apparent soon enough, if history is any guide.

INTERNATIONAL LEVEL After the crisis hit with gale force, there were calls for a “global SEC,” an über regulator with global enforcement powers to keep the world’s financial system in good working order. The idea was abandoned after China and the United States objected that a global enforcer would infringe on national sovereignty. Moreover, it was pointed out, a global authority could only regulate to the lowest common denominator (i.e., only that which the most permissive country would allow), hardly a recipe for efficacy.

Attention has shifted to other proposals, one being better coordination between the IMF, FSF, and G20 to provide an early warning system of threats to the stability of world markets. But without a global enforcer, warnings can go unheeded if individual countries decide that an activity that happens to increase systemic risk would be in their best interest.

International “harmonization” of national regulation has also become a popular topic. In April 2008, the FSF made 67 recommendations for rendering regulatory frameworks more consistent among countries with respect to prudential oversight, use of credit ratings, and responses to stress in the financial system.

But harmonization is difficult to achieve in practice. In Europe, the most tightly integrated group of countries on earth, cross-border financial regulation is still a matter of cooperation and attitudes differ widely. France and Germany are more highly regulated, while looser sentiments prevail in Switzerland, Luxembourg, the United Kingdom, and Ireland.

Also, harmonization can never produce complete uniformity in rules, because local conditions vary and individual countries have differing capacities for implementation. Without some semblance of uniformity, regulatory arbitrage can occur. As a matter of systemic risk, if one country has

a strong regulatory environment, it will make little difference if another does not. When faced with new regulation, some aggressive firms will simply move their registrations to less-restrictive jurisdictions, and potential threats to world financial stability will remain.

COLLEGE OF SUPERVISORS The communiqué from the November 2008 G20 summit called for greater and more formalized collaboration between regulators in different countries regarding the health of particular internationally active financial institutions. Ethiopis Tafara, director of the Office of International Affairs at the SEC affirms the “college of supervisors” idea as a sensible response to the fact that major players are globally active while regulatory powers are nationally bound. “The only way to square that circle is for the regulators also to be globally active through coordination,” Tafara says.

The “college of supervisors” concept is not new and has been in use for at least 20 years. Such colleges have been established under the Basel II framework and in the European Union. More details on the G20’s initiative will be presented at the next summit in April.

Tafara anticipates the establishment of 30 such colleges, one for each of 30 systemically significant financial institutions. The main regulators from the principal countries involved will confer on an institution’s operations and financial condition in an attempt to get ahead of problems that could have global implications. Colleges will be convened to share information, alert international peers of problems in bank operations in other countries, arrive at common judgments about risk positions and other systemic concerns, and produce recommendations for home agency consideration. The hope is that a composite view will provide a better window into the health of the institution than each regulator could derive on its own.

This is a good approach, in Tafara’s view, despite the fact that colleges will lack their own enforcement powers. Regulators can and will make the colleges work, he believes, because it’s in each country’s interest to have a complete and accurate picture of how an important institution’s affiliates are faring abroad. Activities beyond the border can have negative consequences for economic well-being at home. “Self-interest,” notes Tafara, “is a pretty powerful thing.”

SYSTEMIC RISK Many hopes (in the U.S. Congress and elsewhere) are being pinned on the still fuzzy and untested notion of regulating systemic risk at the national level. Great swathes of financial activity, such as hedge funds, OTC mortgage-backed securities, dark pools, and credit default swaps, have begun to rival regulated entities and markets in size but without comparable transparency or rules. Some proposals would place all systemically important activities, present and future, under regulatory oversight or control, regardless of the type of instrument or firm.

“Regulatory gaps” between agencies have also attracted much attention in recent years. (For example, see the U.S. Treasury Department’s March 2008 “Blueprint for a

Modernized Financial Regulatory Structure.”) Financial stability is potentially threatened when new kinds of entities or instruments arise or when existing entities depart from their traditional roles (e.g., hedge funds speculating in oil futures, AIG writing credit default swaps). “Shadow banks,” “near banks,” and other vestiges of a “second financial system” fall between the regulatory cracks. The new thinking is to take an integrated approach for banking, insurance, securities, derivatives, and beyond to identify and manage risk systemically. A systemic risk regulator would, under various proposals, register and approve new products, supervise prudential ratios, mandate public reporting of newly important institutions and instruments, and deflate asset bubbles. Such a regulator would not merely talk about “irrational exuberance” but actually attempt to do something about it.

The U.K. Financial Services Authority (FSA) is the prime example of a trend toward a single national regulator, according to Vincent Reinhart, resident fellow at the American Enterprise Institute and former director of monetary affairs at the Federal Reserve. Under most proposals, the Federal Reserve would be the agency regulating systemic risk in the United States. In Reinhart’s formulation, the Fed would become the “FDA” of the financial system. It would test new financial products in a way analogous to the way the U.S. Food and Drug Administration tests new drugs and monitors them for ill effects in clinical trials before clearing them for general use. “Ideally, you rethink regulation from the ground up,” Reinhart says. “If all we do is build upon the existing edifice, we may only be compounding inefficiencies.”

At the same time, Reinhart recognizes there are big problems associated with attempting to regulate systemic risk. “To begin with, no one has defined to universal satisfaction what systemic risk is,” he says, adding that, having failed to define it, “it’s hard to come up with measures that would be predictive.”

Any definition will necessarily have many working parts covering, among other things, leverage, liquidity, risk concentrations, and sensitivities to market prices and economic conditions. Several metrics, some of which have successfully identified market stresses in the past, have been suggested, including aggregate asset/liability mismatches, sovereign debt default probabilities, and rates of change in asset prices. Reinhart lists credit spreads (e.g., the TED spread, which is LIBOR over Treasuries), credit default swap rates, equity option values, trading volumes, and bid–ask spreads. He also refers to relatively recent academic work exposing vulnerabilities in interbank payment linkages (e.g., the Watts and Strogatz network model, as published in the journal *Nature* in 1998).

Measuring systemic risk will require the collection of more data from an expanded universe of institutions ranging from insurance companies to off-balance-sheet SIVs (special investment vehicles that administer asset-backed securities).

The inability of large institutions at present to compile their own comprehensive risk positions, counterparty exposures, and liquidity information in a timely fashion has been noted in industry self-studies. Still, it would be desirable, Reinhart says, to have risk exposures and balance sheet fluctuations of individual firms on a frequent, perhaps daily, basis. But such information is unobtainable because of lags in reporting and legitimate concerns about business secrets. Particularly in markets that undergo rapid changes in strategy, available information can quickly become obsolete, leaving systemic regulators always one or more steps behind the curve.

Even where information can be collected, resistance to reporting it to the government can be expected. For the government to have a complete picture, hedge funds, for example, would need to report their assets under management, leverage, and portfolio holdings as well as to identify their credit counterparties and investors. Some funds would go out of business or move to less onerous jurisdictions rather than reveal their secrets. To protect proprietary investment strategies, a compromise approach could collect coded or aggregated data from prime brokers without identifying particular hedge funds.

Even if the data problems were solved, a more fundamental problem would remain: The indicators that predicted the last crisis might not predict the next. Having a reporting framework based on what happened the last time leaves open the possibility that new imbalances will go undetected because no one is looking in the right place.

Moreover, regulatory agencies will inevitably make mistakes. In March 2008, then-SEC chairman Christopher Cox told the media that the agency had “a good deal of comfort” in the capital levels of Bear Stearns and four other major Wall Street firms. This was a few days before Bear Stearns collapsed.

Regulators have been faulted for failing to recognize asset bubbles in the past. There is no reason to believe that future regulatory performance will be any better. In some instances, they may act too forcefully to shut an incipient asset bubble down, putting an unwarranted damper on markets and the economy.

Another problem is deciding whether and how to announce a systemic concern. A candid public statement from the systemic authority might spook investors and precipitate the very event sought to be avoided. If, on the other hand, regulators only worked behind the scenes to resolve

problems, they would lay themselves open to charges of undue secrecy and failure to alert the public. Steering a middle course—issuing a report that is less than forthright—might not be enough to make people aware of the danger. In England, Canada, and Europe, central banks regularly issue financial stability reports discussing current risks in world markets. Each report, according to Reinhart, is a delicate balance reflecting the inherent tension between too much and too little disclosure.

Suppose a regulator’s report sounds the all clear but a financial disaster occurs shortly thereafter. Reinhart wonders whether or not, in such circumstances, the agency would become too aggressive in trying to fix the problem (e.g., excessive central bank lending leading to other problems). It’s also possible for the agency, not wanting to admit that it missed the first signal, to remain in denial too long, reducing the chances for effective action. One may legitimately ask whether a similar

motivation led Fed officials to maintain their long-held position that the subprime mortgage mess would remain confined to the housing sector and not spill over into the general economy.

Finally, green lights from systemic risk regulators might have soporific effects, lulling investors and institutions to sleep with the comforting thoughts that an all-wise and all-knowing government is watching over them. Some market participants may become oblivious to real risks

that remain in the system, and others more susceptible to moral hazard might even begin taking unfounded risks of their own.

Regulating systemic risk is an ambitious and untested undertaking. These are uncharted waters infested with imprecise metrics, data-collection problems, and the fallibility of human beings. “You’ve got to wonder if this is a case in which good intentions are running ahead of what’s possible,” Reinhart says.

Be that as it may, the rush to re-regulate is on, and more rules of all kinds are coming. But while regulation might reduce the frequency and severity of financial crises, it will not eliminate them entirely. Financial stability is not the only value that rulemakers must weigh in the balance. Competing policy considerations, including growth, innovation, competitiveness, and freedom, will eventually return to the fore, and the pendulum will swing in the opposite direction once again. ▀

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