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## A new rulebook for financial regulations

By James M. Stone | February 5, 2009

SINCE insufficient regulation is considered a contributor to the 2008 financial crisis, one might expect that better regulation will soon be implemented to prevent a recurrence of the bubble. However, those who supported the extreme deregulatory policies of the last 20 years - respected free-market theorists as well as many large campaign contributors who gained from the permissive policies - remain powerful and may be able to block any effort. They will surely contend that increases in regulation should be minimal, that the "fruits of financial innovation" must be protected, or that what is needed is better regulators rather than more government.

It is time for those who believe we have tasted enough of the fruit of reckless finance to offer an agenda for regulatory change. What is needed is neither an industrial policy substituting political preferences for the invisible hand nor a new ocean of paperwork. Instead, we should think about financial regulation as mainly a set of prohibitions on harmful practices, more a rulebook than a bureaucracy.

Here is a checklist of subjects for the debate agenda.

**Leverage.** The 2008 crisis couldn't have occurred if regulators had heeded the most obvious lesson of the Great Depression. Speculators buying stocks on loose margin helped create a bubble in equity prices that burst in October 1929, and tore the fabric of the economy. Since then, it has been understood that excessive leverage in financial markets is hazardous to participants and bystanders alike. Leverage for common stock investors was limited after that time to around one-to-one, but few if any leverage limitations were applied to the new derivative instruments that emerged in the last 20 years. By 2008, banks and brokers were leveraged as much as 30-to-one. A financial institution with that much leverage is necessarily jeopardizing itself and its counterparties. Far tighter leverage restrictions are needed, and, for banks, that should include restrictions applied to large loan customers, including hedge funds.

**Complexity.** A substantial share of the damage in 2008 was caused by stunning overuse of derivative securities such as credit default obligations and securitized mortgage tranches. Some of these instruments were so convoluted that they can not be unwound without congressional help, and their risk profiles can't be parsed by Wall Street's brightest bankers. These are examples of the "financial weapons of mass destruction" Warren Buffett warned about years ago. Policymakers should consider forbidding any insured institution from trading derivatives too complex for risk analysis and limiting the menu to instruments collateralized with modest leverage, traded on exchanges, or approved as contracts of insurance.

**Cyclical Robustness.** Institutions of finance used to help the country get through inevitable economic cycles. Profits from good years were retained as capital in banks and brokers, thus available to cushion the lean years. By shifting much of their risk and reward to hedge-fund clients, banking institutions inadvertently moved profits into businesses that sent them home in personal compensation - forfeiting the cushion. Then, as banks and brokers grew increasingly envious of their clients' economics, they ramped up their own leveraged trading activities to mimic the hedge funds . . . and supercharged compensation to compete for talent. Regulation should assure that cyclical gains are not paid out in compensation by a taxpayer-backstopped financial sector.

While we shouldn't be quick to assign blame to individuals for accepting the pay they were offered, the notion that the good years belong to the management and the bad years belong to the taxpayers deserves a deep burial.

**Scale.** Congress has gone too long without debate on the basic questions of anti-trust policy. Policymakers used to wonder if bigness could indeed be badness. In recent decades, however, consolidation in the financial sector

has gone largely unchallenged. Some in government seem to think huge scale is actually a public benefit; others accept it as an irresistible force. It is neither. Most of the giant firms taxpayers are bailing out were small fractions of their current size and market shares a few decades ago. Some degree of consolidation may have been justified by underlying economics, but it is time to ask if the scale of the troubled behemoths serves anyone well. It is fair to query whether any firm can be too big to fail without being too big to manage or whether financial companies with inexhaustible lobbying budgets are compatible with pluralist democracy.

Nobel Laureate Joseph Stiglitz has said that when "a firm is too big to fail . . . it should be broken up." Congress and the president should force an examination of the question and reconsider its 1999 repeal of the Glass-Steagall Act, which had long separated banks from brokers.

**Sales Practices.** Irresponsible mortgage lending also played a role in the crisis. Much of the harm was done at the point of sale, where families were encouraged to take on obligations only marginally realistic even in good circumstances and impossible to honor in a declining economy. Documentation grew ever weaker as the bubble enlarged, just when it needed strengthening. Well-meaning but exaggerated public policies to favor home ownership contributed to this problem, as did securitization that allowed sloppy underwriting analysts to pass off the risk bearing to others, but some measure of blame belongs to downright ugly practices. In the first 50 years after 1929, securities regulators established an admirable tradition of sales oversight, including broker-dealer licensing and testing, suitability rules, and compliance and conduct examinations. These standards were weakened in recent years and never matched in mortgage origination or derivative sales.

A uniform high standard of protection is presumably what Harvard law professor Elizabeth Warren was seeking when she called for a Financial Product Safety Commission. Government needs to take a fresh look at sales practices in the financial service industry and raise the bar throughout.

**Disclosure.** The least controversial pillar of financial regulation should be the requirement of full disclosure. Sadly, even the simple principle that financial institutions should reveal their metrics to a public dependent on their soundness was diluted in the tide of deregulation. The emerging hedge-fund industry was subjected to virtually no reporting requirements, and banks were permitted to pack liabilities into opaque special-purpose entities omitted from balance sheets. Some policymakers were fooled into thinking that less than full disclosure was a new global imperative or that there were no widows and orphans to protect in sophisticated markets. It should be clear by now that pension investments and the ability of a financial failure to catalyze more general economic maladies justify intervention even by the widows-and-orphans standard. The coming regulatory reform should restore maximum transparency as the inviolable objective of financial reporting, and large debtors and counterparties of guaranteed institutions should be subject to the same standards as the institutions themselves.

This is not a call for an industrial policy, for red tape, or for nationalization of the financial sector. It is a common-sense call to prohibit behaviors that produced a terrible outcome. The crisis we find ourselves in, one that will scar millions of American families, never needed to occur. The turn in the real estate cycle that fomented the crisis would have been manageably absorbed had adequate regulation of financial institutions been in place all along. The regulatory cure implied here may seem Draconian to those who profited from under-regulation, but it is no larger than the harm that regulation's laxity has engendered.

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