“Financial institution failures are a fact of life and little can be done to stop them”: an evaluation of the recent proposals for reform of financial market regulation in the United States and Europe

Domenico Ferrari, New York University
“Financial institution failures are a fact of life and little can be done to stop them”: an evaluation of the recent proposals for reform of financial market regulation in the United States and Europe

***

Table of Contents

1. Introduction p. 1
2. The current financial crisis: origin and development p. 3
5. The future of financial markets regulation p. 6
6. Conclusions p. 7

***

1. Introduction

The current economic situation, with worldwide markets plunging and an unprecedented credit crunch undermining the future world’s economic growth for several years, shows us with clarity how fragile and unstable the financial markets can be.

We have been astonished witnesses to the federal rescue of Fannie Mae and Freddie Mac following the sub-prime crisis, the bankruptcy of Lehman Brothers, the sales of Bear Stearns and Merrill Lynch and the takeover of AIG by the U.S. Federal Reserve to avert its bankruptcy.

Nowadays, under the pressure of the uncertainty and chaos characterizing the global financial markets, the statement “financial institution failures are a fact of life and little can be done to stop them” seems true, more than ever.

We are watching, as Roger Altman correctly pointed out, modern history’s greatest regulatory failure.\(^1\) The globalisation, for a long time, has been analyzed only with reference to the global supply chain for goods and services. The digital technology shortened the distances between countries and revolutionized the global supply chain, allowing people to engage in business with one another across the globe, with each nation bringing its comparative advantage to the table of world commerce.\(^2\)

---

1 Roger Altman, “Modern history’s greatest regulatory failure”, Financial Times, September 17, 2008.
However, the globalization has not limited its impact to the supply chain: it has also seriously affected the development of the global financial markets. The new technologies have allowed a volume of financial transactions which could not be foreseen just few decades ago. The interaction between financial operators and markets, with the related *know-how* spill-over, induced an increasing sophistication of such markets, with the continuous creation of brand new financial products and services.

At the same time, globalization makes the financial markets even more fragile and unstable than before, because now they are deeply linked and dependant upon each other’s performance.

In addition to the traditional banking system, new sophisticated financial operators appeared in the global markets: securities firms, investment banks, mortgage finance companies, hedge funds.

Unfortunately, the sophistication acquired by the global financial operators, and strengthened by globalisation, has not been acquired also by the public regulators, whose reaction to the new developments has been totally inadequate.

The degree of leverage taken on by the financial institutions during the past few years is totally unacceptable. Until the current international financial crisis, the global trend has been toward deregulation: the removal of government restrictions on the freedom of financial markets.

In an attempt to enhance competition, and for the fear of being left behind by less regulated and more competitive financial markets, the newly developed financial system has not been subject to any prudential supervision, and mainly left to its own self-regulation. Needless to say: the consequential lack of transparency was stunning.

Even in the traditional field of banking supervision, the development of a coordinated international regulation (in particular: the Basel Accords) seemed to be totally focused on the creation of an international “level playing field” for the enhancement of international competition, more than prudential supervision.

In particular, both Basel I and Basel II disciplined minimum capital requirements for banks, without taking into account any other important ground for prudential regulation (especially control of liquidity, the lack of which seems now to be one of the main causes of the current credit crunch).

The current financial meltdown, direct consequence of the lack of adequate regulation, will have a huge impact on the future of the world’s economies in the following years.

Governments, learning from their previous mistakes, are now trying to reform the financial markets and to implement a new, more efficient regulatory framework for financial institutions. The effectiveness of such proposals to solve the current crisis, and their impact on the future of financial regulation, will be the subject of the following paragraphs.

---

2. The current financial crisis: origin and development

As pointed out in the previous paragraph, one of the causes of the current credit crunch has been an unforeseen lack of liquidity in the financial markets.

During the last few years, the indebtedness in the United States has reached unexpectedly disproportionate, and risky, levels. Such indebtedness, both private and public, was financed by a huge flood of foreign capital.

It was probably foolish to pretend that the globalisation could be financed through the indebtedness, and the consequences of such an idea have been terrific. At the beginning of the current year, the markets began to understand, with mounting panic, that the debt-driven consumer boom experienced by the United States in the last decade was becoming unsustainable.

Financial troubles started from the mortgages crisis, with repayment problems arising for loans backed by mortgages issued by borrowers with a low credit rating (so-called subprime mortgages). The crisis had severe implications for highly complex credit chains arisen from the securitization and resale of highly risky subprime loans, through special purpose vehicles.

The fall of the subprime market caused the crisis of the U.S. government-sponsored agencies Fannie Mae and Freddie Mac, which were then rescued by the U.S. Treasury through a huge nationalisation (which had no precedents in U.S. history), in an attempt to stop the financial meltdown. Unfortunately, the end of the troubles is yet to come.

Confidence in the interbank market has already been broken, due to the lack of transparency and to the uncertainty related to many Banks’ risk exposure in the subprime market. Such a crisis of confidence caused extensive liquidity restrictions.

The huge cash infusions which followed, made by the central banks of the United States and the European countries, were useless, because such a solution was unsustainable considering the magnitude of the crisis. As a consequence, the crisis of confidence in the financial markets spread, the securities markets plummeted through the floor, and the current credit crunch resulted, as clearly explained by Christian Kellermann.4

We have already seen some of the consequences: the fall and rescue of Bear Stearns, the bankruptcy of Lehman Brothers, the crisis of A.I.G.. However, the final extent of the impact that the credit crunch will have on the real economy is still impossible to be fully foreseen.

It is quite clear that, while their own funding dries up, the survived financial institutions will be much more cautious in extending credit to other firms and businesses. Access to credit will be much more difficult than in the last years, and the growth will slow down in the whole world.5

---

Obviously, both the United States and the European Union, being highly affected by the current financial meltdown, are approving bailout packages to face the crisis, as well as examining proposals of reform for financial regulatory frameworks which have proved to be totally ineffective.

3. **Proposals for reform of financial markets regulation: the United States**

The credit crunch caused at least two major interventions in the U.S. financial regulatory system.

First of all, the U.S. Congress approved a $700 billion financial rescue plan, giving flexibility to the U.S. Treasury as for the implementation of the plan itself.

A huge debate is currently going on in the United States as to what the wisest way would be to implement the financial rescue plan. In particular, the original idea of the Treasury Secretary Henry Paulson, to incorporate a publicly-held “trust corporation” which will buy out the distressed assets of the financial institutions affected by the crisis, was criticized on the ground that the taxpayers would pay the price of the investment bankers’ mistakes, giving rise to a huge “moral hazard” problem. Many commentators are suggesting that the focus should be on the creditors’ side, through the implementation of a restructuring plan where part of the debt is forgiven in exchange for equity or warrants.

However, a different intervention proposal, addressing the financial meltdown, focused on the long-term scenario, is more interesting for our purposes.

In particular, the rise of the international financial crisis has been used by the U.S. Treasury as an opportunity to launch a *Blueprint for a Modernized Financial Regulatory Structure*: basically a proposal for a massive reform of the U.S. financial regulatory framework. Most of the Treasury’s proposals are not strictly related to the current market turmoil, but the latter represented a great chance for successfully launching the project, considering that it has always been very difficult in Washington, under normal circumstances, to make significant institutional reforms.

The U.S. Treasury proposal presents a series of short-, intermediate- and long-term recommendations for a reform of the U.S. regulatory structure.

The long-term recommendation, which is the most important in terms of regulatory policy, is to create an entirely new structure of regulation, shifting the focus from a functional-based approach to an objective-based approach.

In particular, the U.S. Treasury believes that an objective-based framework would improve regulatory effectiveness, leading to an optimal regulation.

The new structure would consist of a market stability regulator, which would be the Federal Reserve empowered with additional functions to prevent systemic risks, and focusing on the overall supervision of the market. In addition, a newly created

---

prudential regulator would focus on “moral hazard” problems created by financial institutions benefiting of government guarantees, and a business conduct regulator would protect consumers’ interests in the market.

The regulatory reform proposals in the United States have not been, however, the only response to the financial meltdown: similar steps have been undertaken also by the European Union countries, as described in the following paragraph.

4. Proposals for reform of financial markets regulation: Europe

The European response to the international financial crisis has been quite different from the United States’ approach.

In particular, the European countries agreed to implement a rescue plan which provides for European governments buying substantial stakes into banks to boost their finances and guarantee interbank lending until the end of next year.

In substance, the European plan is a broader application of what the British government just implemented, by taking control over two British major banks: HBOS and Royal Bank of Scotland.

While the U.S. plan is focusing on the problem of mortgage-backed securities, the European rescue plan is much more focused on the liquidity problem, since banks are not willing to lend to each other in this environment of panic, giving rise to a huge liquidity crisis.

In addition to the above-described interventions, the financial meltdown has given the occasion, also in Europe, to consider the limits and failures of the current financial regulatory framework, and to raise proposals for its comprehensive reform.

European Parliament member Daniel Daianu recently commented: “in this crisis, we experience a massive failure of both, regulation and supervision. Therefore it is vital that we improve both”.

Accordingly, the European Parliament voted by large majority in favour of an initiative report with proposals for the future structure of financial markets supervision: the so-called “Lamfalussy framework”. The report calls for a stronger commitment of national supervisors to European objectives, for a stronger role of the European Central Bank System in the coordination of the market supervisors and for measures to make the securitisation process more transparent.

The Lamfalussy framework could be a possible basis for an integrated, developed system of supervisory authorities. Such authorities would supervise the full range of financial services that in the medium-term should be covered by a single European financial market supervisory authority to be created. In fact, specifically European problems with regards to financial markets are strictly related to the European integration process.

In particular, the integration of European financial markets implemented in Europe led to gaps in supervision, inefficiencies and possibilities for legal regulatory arbitrage,
because the regulatory structure remained inadequate with regard to both the level of integration and the size of European financial markets.

The current financial crisis clearly shows that the aims of an integrated European financial market (such as efficiency, risk diversification, stability and the provision of liquidity) cannot be reached if an efficient European supervisory structure and adequate regulation of complex investment companies are not implemented.

5. The future of financial markets regulation

It is particularly difficult to predict the future trends of financial markets regulation, following the economic meltdown and the international credit crunch produced by the failure of the current financial regulatory framework.

The recent proposals for reform were presented prior to the start of the most serious global economic crisis experienced since 1929, and could be seriously affected by the developments of this instable economic situation.

However, even assuming that the proposals for reform of the regulatory framework in the United States and Europe will be implemented as currently envisaged, the overall effectiveness is still difficult to predict.

The United States’ proposal is ambitious and could lead to positive outcomes. The idea of shifting the focus from a functional-based approach to an objective-based approach could give more flexibility to the system, allowing the regulators to implement more specific and effective actions in the pursuit of the relevant objectives, in a world where financial institutions tend to interact and operate on a broad basis, and the distinction based on different functions could be outdated and ineffective.

However, such an ambitious proposal presents more than one problem in its concrete implementation. First of all, a key issue will be the effectiveness of the positive interaction among different regulators, which will be crucial for coordinating examinations and activities impacting on financial institutions.

Such a coordination among regulators could be extremely difficult, if we consider that the different regulatory agencies in the United States, even if they have very similar functions in certain areas, have very different regulatory philosophies.

In addition, the reform of the regulatory role of the Federal Reserve, as envisaged by the current proposal, is also problematic. On one hand, it gives the Federal Reserve much more responsibility in the area of systemic stability. However, on the other hand, the same is given less supervisory capacity, because on a day-to-day basis its supervisory powers will be given to different regulators. Such an imbalance could seriously jeopardize the effectiveness of the new role envisioned for the Federal Reserve.

The future of regulation of financial institutions in Europe is not as easily predictable.
The integration of the European financial market did not lead to the creation of a single, truly integrated regulatory framework, despite the efforts for a positive harmonization among the European countries.

Gaps and inefficiencies in supervision are still a concrete problem in Europe: the Lamfalussy framework is a good starting point, but much more has to be done for the creation of a truly integrated European regulatory framework.

The proposal for the implementation of a new European financial market directive, setting up binding rules for the member States in relation to balance sheets and reporting obligations, the regulation of the rating sector and the conditions for institutional investors, should be seriously taken into account in pursuing the aim of an increase in the stability of the financial markets.

The current financial crisis proved, on a worldwide basis, that a solid financial market architecture is not a competitive disadvantage, but on the contrary, as correctly pointed out by Christian Kellermann, a competitive advantage for all the financial markets actors.9

However, the definition of concrete, effective steps aimed at improving the current regulatory framework is much more difficult, and subject to much more debate, than the determination of general principles of regulatory policy.

6. Conclusions

The analysis of the current financial crisis, and of the measures which are going to be adopted by the United States and the European countries in order to limit its detrimental effects, shows that uncertainty and risk will still dominate the financial markets.

The international credit crunch showed, dramatically, the limits of the current regulatory framework, and will lead to a broad revision of the regulatory policies everywhere.

The recent international trend toward deregulation, which seemed to be the future path for the worldwide financial sector,10 has been completely overthrown by the upcoming events. Now, it has to be hoped that the panic of governments to stop the crisis will not lead to an excess of regulation.

In fact, regulation is always about making trade-offs, especially when considering costs and benefits.11 The intensity of regulation and supervision which prevents any possible failure would most probably be excessive, because the costs would outweigh the benefits.

As a consequence, the statement “financial institution failures are a fact of life and little can be done to stop them” is probably correct, also considering the continuous and increasingly rapid, change of the world economy.

9 Christian Kellermann, ibidem.
It is certainly impossible, even for an extremely efficient regulator, to successfully predict every future development, and consequential risk, on the financial markets.

However, when a new failure happens, we have a chance to understand something more about the previous mistakes, to concretely improve legal certainty and to make some additional step on the path for reaching an optimal regulatory framework.

The current economic crisis, notwithstanding its disastrous consequences, taught us, *inter alia*, that capital requirements are not enough without liquidity control; that in the future, credit risks should only be allowed to be structured and resold if a minimum proportion of the relevant economic interest is kept by the issuing institution; that it would be useful to introduce a system of minimum reserves in terms of financial and tangible assets.

Occasional regulatory failures should be considered as the inevitable cost of implementing a truly effective system of regulation.

It is true that little can be done to stop financial institution failures: regulation and supervision will always have a limited role, and they will never be able to eliminate all possible risks in a financial market which is, necessarily, characterized by risk.

However, it can be done, and it has to be done, much more to improve our regulatory and supervisory frameworks, in order to reach an optimal level of regulation which would be mostly effective and, at the same time, cost-efficient.
REFERENCES:


