OPINION | APRIL 23, 2010

Back to Basics on Financial Reform

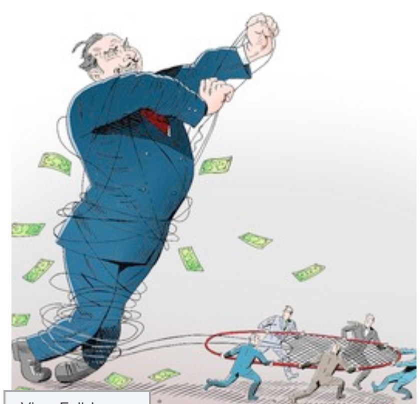
The case for limiting leverage and regulating derivatives is overwhelming, but that doesn't require a new 1,300-page law.

By NIALL FERGUSON AND TED FORSTMANN

A "trilemma" is like a dilemma, only there are three things to choose from and you can have just two. The current debate over post-crisis financial regulation suggests we face such a trilemma: We can choose any two of the following, but not all three: 1) efficient capital markets 2) no bailouts to big banks and 3) a depression-free economy.

From the 1980s until 2007, we essentially opted for one and two. Financial markets operated with more freedom than at any time since the 1930s and the Federal Reserve stood ready to cut interest rates if asset prices tanked. But the idea that big banks might be able to get new capital from the Treasury was scarcely even contemplated. Choosing one and two resulted in a global financial and economic crisis worthy of the name depression.

In the aftermath, congressional Democrats are claiming that we can have three out of three. In effect, the bill introduced to the Senate by Christopher Dodd purports to prevent future depressions without sacrificing the efficiency of our financial markets or committing taxpayers to future bailouts of the banking system. This trifecta is not credible.



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Either the bill really does imply future bailouts, as Republicans argue. Or, as seems more plausible to us, it is going to introduce such a wide range of new financial regulations that the efficiency of our capital markets will be significantly diminished.

The public today is in no mood for light-touch regulation. It knows Wall Street has become largely a giant casino creating bets whose only purpose is to create fees for itself—with the difference that taxpayers are expected not only to bail out the casino's biggest losers but also to endure misery in the form of lost homes, lost jobs and lost savings if the casino inadvertently triggers a depression. The charges brought against Goldman Sachs by the Securities and Exchange Commission confirm this view.

Whether or not there is any basis for the SEC's claim that it misled investors, the key point is

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that the synthetic collateralized debt obligation (CDO) at issue was nothing more than an elaborate wager on the future price of some mortgage-backed securities—a wager with as much economic utility as a gigantic bet on a roulette wheel or a horse race. Facilitating such bets has become a huge part of the business of the world's biggest banks.

For most of the past 20 years the explosive growth of the derivatives market—the total notional amount of derivatives outstanding in June last year was $604.6 trillion—was immensely lucrative for bankers and those who invest in bank stocks. But it increased the instability of the global financial system. And taxpayers have paid a heavy price since the system all but collapsed in late 2008.

The case for some kind of regulation of the derivatives market is overwhelming. There was never a good reason for treating credit default swaps and their ilk differently from commodity futures, which are standardized and traded on exchanges. The lack of market transparency and efficient competition in these instruments indicates that much of the profit made in the current, "over-the-counter" market is simply vigorish extracted by the financial bookies. History shows that competitive markets where standardized products are traded for low commissions do not spontaneously arise. They have to be created.

The problem is that Congress is not content to address this problem alone. On the contrary, the common characteristic of the two bills currently under discussion is their staggering length (both exceed 1,300 pages) and complexity. The nightmare possibility arises: Could the proposed cure turn out to be just another symptom of the same disease? As the rules become ever more convoluted, so the opportunities for the unscrupulous increase—and the efficiency of the financial system as a whole decreases.

There is a widespread but erroneous belief that the financial crisis has its origins in deregulation dating all the way back to the late 1970s. Therefore any steps to restore the pre-Reagan regulatory system are to be welcomed. This is really bad financial history.

First, in the more controlled capital markets of the 1970s, borrowers generally paid more for their loans because there was less competition. Lousy managements were protected from corporate raiders. Savers earned negative real interest rates because of high inflation. Deregulation—such as lifting restrictions on the interest rates banks could pay and charge—and financial innovation delivered real benefits for the U.S. economy in the 1980s and '90s.

Second, it is not at all clear that our crisis was exclusively caused by a failure of regulation as opposed to a failure of monetary policy. A very large part of the responsibility for the housing bubble and bust lies with the Federal Reserve, which underestimated the extent to which inflationary pressures had relocated themselves from consumer prices to asset prices. This was a near-term error of the period 2002-2004. It has nothing whatever to do with deregulation and everything to do with defective monetary theory.

Third, the crisis of 2007-2009 originated in one of the most highly regulated sectors of the financial system: the U.S. residential mortgage market. The mortgage originators, the government-sponsored enterprises that dominate the securitization process, the commercial banks—these were scarcely institutions ignored by Congress over the years. On the contrary, Washington constantly tinkered with the system in a misguided campaign to increase home ownership. That campaign ended in tears.

Still, it took extraordinary forces to turn a subprime bust into a global financial crisis. The key forces were excessive leverage on and off bank balance sheets, and derivatives that allowed massive but opaque side bets on the future value of U.S. homes. And it was these two factors that magnified (and exported) the losses in the mortgage market; legislators should focus on them. Instead, both the House and Senate bills are packed full of scatter-gun regulations that owe more to the prejudices of legislators than to a rational assessment of what actually went wrong.

The best example (there are many) is a provision in the bill passed by the House last year creating a mechanism to police banker compensation—before we even have the results of the bill's projected study on "whether there is a correlation between compensation structures and excessive risk taking."

By all means let us regulate the derivatives market—beginning with a reform that makes it a real market. And let's clamp down on excessive bank leverage. But let us not believe we can abolish both bailouts and depressions, other than by creating another layer of government regulation. That would be to impale ourselves on the horns of a trilemma.

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Printed in The Wall Street Journal, page A17

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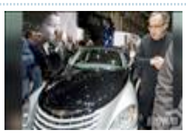

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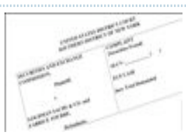

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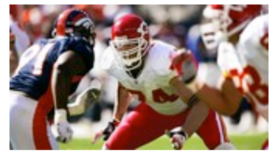

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