

3. The financial industry and its regulators

[The functions fulfilled by the regulatory departments:

- 1) gathering information to identify potential risk
- 2) monitoring and preventing systemic risk
- 3) managing bad assets - protecting against the risk of a bank run

I first mentioned some personal experience of the relationship between the financial world and its regulators.

My first encounter with regulators was when working for a consultancy firm in the Netherlands on a risk management project where my company was installing a new piece of software. I had asked the project to be stopped until I had found the source of a major calculation error. Attending a cocktail party organised by the bank I had been approached by a man who had asked me if I knew him. I said I didn't. He had replied by saying his name which I had recognised as being that of one of the top executives of the firm. He had added: "But I do know who you are: you are the man who is a nuisance because he is putting everything on hold".

I had answered him that it was our duty to submit to the regulator figures that could be trusted. This angered him even more: he looked at me and he said: "You don't understand at all, my dear friend: I will tell the regulator: 'These are the figures' and that will be the end of the story, there won't be a peep. This is the way things work, young man!" and he left.

I derived the conclusion that there was a power balance and that that top banker had explained to me that it was skewed in his favour.

In more recent years, working in the risk management department at CountryWide in California, I would be part of a group of people who would be told: "Look, this is a letter the regulator has sent us. Can you come up with something we may answer?" Ultimately, we would look at the answer to be sent. There was never any implication however that we would change our behaviour and properly address the issues raised as needing redress, only

that we needed to find a way the answer and write a letter which would sound reassuring to the regulator: it was nothing but a writing-up exercise!

If the regulator remained consistently unhappy with us the answer would be “regulator arbitrage”: we would change our legal status so as to move to a more complacent regulator. So with CountryWide we moved from the OCC (Office of the Comptroller of the Currency) to the OTS (Office of Thrift Supervision).

Some authors claim that there is a risk of overdramatizing the relationship regulator / regulated by talking of "regulator capture", suggesting erroneously that the power balance is in every case in favour of the financial industry. The fact is, they say, that regulators may have conflicting purposes and therefore views.

A case was in the news in October 2014 when Carmen Seggara who had worked for the New York Fed was fired for being too blunt. She had recorded dozens of hours of conversations showing how lenient the regulator was towards Goldman Sachs in this instance. There was nothing so blatant though as what I had experienced myself on the regulated’s side.

The dominant view since the 1970s is that regulation should be light, the regulator should be benevolent and permissive. For instance, Alan Greenspan at the head of the Federal Reserve rejected governor Gramlich's suggestion to intervene in the subprime crisis. In a prior case, he had rejected Brooksley Born's suggestion to regulate derivatives; she was in those years head of the CFTC (Commodities and Futures Trading Commission).

Illustrative cases:

1) The Financial Accounting Standards Board and "just value"

The initial incident took place on 12 March 2009 and the outcome on 2 April 2009.

How do you value an asset? One options is "Book value" i.e. the price you paid.

Accounting categories for debt instruments:

"Trading" and "Available for sale" should be marked-to-market.

"Held for investment" should be marked-to-model which Warren Buffett once called "marked-to-myth".

In 2006 FASB, in standard 157, had promoted "just value": all financial instruments should be marked-to-market.

But in 2009, marking-to-market would have suggested that numerous firms were actually insolvent.

A congressional committee, the House Financial Services Committee summoned FASB on March 12 to have the standard changed. There was a violent argument associated with threats from congress people.

There was some resistance on FASBS' board: some members resigned rather than comply, but the 157 standard was modified on 2 April, which led to a 5% rally on the international stock exchanges.

2) the "LIBOR scandal"

The incidents had taken place in 2008 but the "scandal" proper took place in the Spring of 2012 when a heavy fine was imposed on Barclays, the British bank.

The LIBOR (London Interbank Offered Rate) are a set of market (floating) rates applying to financial instruments labelled in American dollars but issued outside the United States.

The rates are quoted daily by 16 banks as being the rates which are demanded from them by other banks when they borrow from these.

There is an incentive for banks to quote lower figures than the actual ones because there is a risk premium encapsulated within the rate: telling that the rate demanded from you is rising is revealing the world that mistrust in you as a trustful borrower is rising. It is also exposing yourself as a bank to possible bets by competitors on your downfall (through

Credit-Default Swaps). This happened in particular to the investment banks Bear Stearns in March 2008 and Lehman Brothers in September 2008.

On the 27 June 2012, Barclays is fined 365 million euros.

Bob Diamond, CEO of Barclays, asked by an investigation committee, claims that Paul Tucker, vice-governor of the Bank of England (central bank) had encouraged him in 2008 to lower the quotes, he had added that people high-up, in government, were telling him to advise so.

Jerry Del Missier, Chief Operating Officer of Barclays, on July 17, before the same committee, said he was not surprised by the injunction as it was the only reasonable thing to do to save the financial industry.

It turns out that in this case, the so-called "invisible hand" that protected the markets against implosion got heavily penalized because although it played its part according to expectations, rules had been breached.

3) North Carolina and the subprime crisis

In 1999, North Carolina passed a law forbidding all practices which allowed subprime loans. The Mortgage Bank Association moved in to oppose a spreading of the law to other states. The argument to support the opposition was that prohibiting these practices amounted to racial discrimination. It turned out to be the reverse, as revealed by a study.

The MBA invested 500 million dollars in such lobbying.

Canada had a law for the whole country similar to that of North Carolina.

The people at the head of the Mortgage Bankers Association were responsible for the subprime crisis.

4) High Frequency Trading and the issue of opacity

There is a premium for being fast on the stock exchange. Exchanges became electronic in the 1990s.

40% to 60% of transactions currently are performed by computers having strategies for buying and selling; the so-called "algorithms".

The peak of the flash-crash of 6 May 2010 took place over 14 seconds only.

Computers allow mapping the market much more completely than was the case when operations were manual. Indeed, by voiding most operations, the algorithms manage to build a very complete picture of supply and demand on a particular stock market: they probe the market for potential buyers and sellers and get something like a 3-D view of the market.

The regulators don't have the resources necessary for monitoring so many operations.

Why has the regulator been so lenient on HFT although it introduces so much opacity on the markets?

Probably because it allowed to prop up, boost, the stock markets, reconstituting households' savings which had been dramatically depleted by the depreciation of housing.

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It looks like there exist "revolving doors" between the regulatory departments and the financial industry.

Instances are known of regulators having invested considerable effort in changing rules, then joining the company that most benefits from the fact that these rules had been modified.

- Robert Rubin, the American Secretary of the Treasury, who repealed in 1998 the Glass-Steagall Act which was preventing Citicorp from merging with Travelers, the insurance company, then immediately joining Citigroup which had resulted from the merger. Rubin would ultimately become CEO of Citigroup.

- Wendy Gramm, who as head of the CFTC deregulated the energy sector, then joined the board of Enron, the company that most benefited from the deregulation.

How to prevent "regulator capture"? By following the suggestion of Luc Coene, Governor of the Belgian National Bank of capping compensation of bankers.