<u>Financial Regulations: More the merrier?</u>

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Introduction

The global economic meltdown of 2008 -was it the result of massive ignorance shown by regulators during the booming economy or a part of economic fluctuation cycle?The banks and various financial institutions became unable to perform their core business activities and went short in lending money to individuals and businesses which resulted in reduced liquidityand jeopardizing the global financial system.Various economists have prescribed remedies for these financial calamities.But without the analysis even the seemingly correct recommendations will not prove to be credible.

The rationale behind bringing new regulatory frameworks is to insulate the investors and stakeholders from malpractice adopted by financial institutions but the degree of deregulation and vulnerabilities of policies may provide these institutions to subvert the regulations.It is difficult to say precisely that financial regulation is the panacea for all the problems which financial systems may face.

A brief history of regulation and how deregulation came:

The regulatory structures came into dominance with the creation of Fannie May in 1938 by Roosevelt in order to make a centralized institution for mortgage lending , as number of banks and mortgage companies were issuing subprime loans for promoting the home ownership .The limited growth of economy forced governments to consider regulation as an obstacle for economy .In 1978 deregulation started , when the airline deregulation act was signed by the then president Jimmy Carter and with that deregulation replicated as a fire to take various sectors of economy such as energy , telecommunication and financial services.The intent was to achieve high growth with fewer regulations.

Effects of deregulation:

Alan Greenspan released counterparty supervision which allowed banks to keep a close watch on their trading partners and breaking down the restriction of Glass Steagall act(1933) , Graham –Leach-Bliley act was legislated allowing commercial and investments banks to do things which they were restricted to do, for example consolidation of various types of financial institutions.These reforms made various impacts on the financial industry -

1.Firms were allowed to build new financial instruments and services.

2. Consolidation of inefficient firms leading to efficient ones

3. Options available to investors and businesses increased in such a way where an investor is unaware of where is he investing.

Deregulation resulted in new technologies based on financial engineering and new institutions were formed such as hedge funds and equity firms which developed advanced but resulted in various flawed mathematical models for portfolio optimization. Risk managers did not account for the degree of correlation between the defaults of various asset classesinstead the models assumed that these individual asset classes possessed the inherent independence and have zero correlation. The mortgage backed securities (underlying on junk assets) were sold as high rated tranches and default swaps were issued against these securities.

Looking backwards - Post crisis analysis of deregulation:

The deregulation was intended to have more growth but the analysis of adverse impacts,which deregulation, could bring was not done properly. There was a lack of anticipation which could be summarized as –

- No attention was given to stability of economic stability
- Misjudgment on the part of risk managers and the contrary implications of complex derivatives.
- No proper measures were thought of for the situations if big institutions fail primarily described as "Too-Big-Too-Fail".
- The amount of turmoil that would be developed in the global markets due to the exposures of these institutions in various countries.
  The $786B trouble asset relief program knows as TARP was released by US congress in order to provide liquidity to frozen credit markets and restore the investor's confidence in banks.

Leading to re-regulation:

The collapse of one of the most sophisticated financial system of the world made the taxpayers huge costs.The regulatory policies became ineffective and financial institutions became indulged in the practices of moral hazard.The credit default swaps issued by AIG, contained the vulnerability of being insured by anyone with the payment of small premium , which would then insure the individual in case of default of the asset which he does not even own.Result was - AIG went under the huge defaults, requiringthe government to intervene and take 80 percent stake in the behemoth of insurance industry .It was felt that government intervention was inevitable in order to mitigate the recessionary effects and revamping the economy. This global economic collapse destroyed many trillion dollars and to deal with this aftermath of crisis, regulators proposed the 2010 Doff frank law and Volker law in order to prevent the next crisis.

Is more the merrier?

Statistics show that 15 major regulations were issued in last fiscal (2011) according to the office of management and budget (a major regulation has economic effect of at least $100M).But again,is more the merrier? May be not.For example take a hypothetical reform in the banking system where investment banks have to insure themselves against the possible downturns or bailouts for an amount of $ 1B with a premium of $ 100M. It may not be a difficult task for banks to engineer the situations where they can easily claim $1B.So a default conditionfor bank and capital injection by the government would be almost similar.

Prevention of crisis with proper regulations:

Existing regulations would have been sufficient , provided the cash on balance sheets of banks and cash lent by them was proportionate but the amount of loans disbursed went beyond 100 % to the value of deposited money , so maybe this would never have happened**.**Even the Sarbanes Oxley act enacted in 2002 in order to bring new reporting and disclosures could not forecast the financial crisis of 2008.This forces us to analyze the prospective cost and benefits of any new regulatory framework. In this context it is worth mentioning the Prof. Raghu ram Rajan who argues that there is a need for a regulatory system that is immune to booms and bursts modeled as “cycle proof regulation”.

New regulatory frameworks must be subjected to rigorous qualitative and quantitative analysis as well otherwise they could do more unintended harm instead of doing good. The cost effective regulations are needed which should be stringent enough to control the financial firms during the possible downturns and should restrict them lesser when they strive for positive growth. Instead of raising the permanent capital, cheap contingent capital should be raised in good times in order to back future troubles. Financial firms may insure themselves by purchasing collateralized insurance by firms which are leveraged to allowed limits.

Conclusion:

Governments tend to over-regulate the financial systems aftermath of crisis of this massive scale.Governments should recognize that near zero interest rates and fiscal stimulus are not the effective instruments to bring economies on the tracks of continued growth. Global regulatory bodies should be established which can admonish the institutions to invest in overleveraged markets and encourage them to invest in emerging economies with increased transparency. Financial systems with **Not-More-Not-Less** regulations have the potential of generating positive growth prospects and can operate a sustainable economy rather than providing an economy which is derailed at regular intervals with a cycle of growth and recessions.