Memo to: Oaktree Clients

From: Howard Marks

Re: On Regulation

I've been asked why there weren't any memos during the twelve weeks between September 9 and December 1. Lack of ideas? Writer's block? Carpal tunnel syndrome? CIA posting? The answer is "none of the above." I was putting the finishing touches on a book, *The Most Important Thing: Uncommon Sense for the Thoughtful Investor*. It pulls together all of the strands of my philosophy into what might be thought of as a super-memo. It will be published in late April and I hope you'll let me know what you think.

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In the 3½ years since the financial crisis surfaced in July 2007, there has been extensive discussion of the part deregulation played in creating it, as well as the need for increased regulation to prevent the next one. The release last month of the report of the Financial Crisis Inquiry Commission reawakened the debate. Thus I'm often asked nowadays how I feel about regulation and what I think the future holds in that regard.

<u>The Swing of the Regulatory Pendulum</u>

I've written before that attitudes toward regulation follow the same pendulum-like swing as most other aspects of market behavior. They oscillate not only in response to events in the economic environment, but also because neither total regulation nor total deregulation produces an entirely satisfactory answer. As in so many things, there's no perfect solution.

A great source on the subject is *Wall Street Under Oath*, a 1939 book on the causes of the Great Crash of 1929 written by Ferdinand Pecora, who was counsel to the Senate committee investigating the crash and later a New York State judge. I first read it about twenty years ago, and I brought it out of storage in 2007. It is a typical polemic, assigning blame and touting regulation pursuant to what I assume were the author's philosophical/political biases (see page 4).

Pecora describes a Wall Street that, up to and including the 1920s, was like the Wild West. Bankers and brokers were out to make money for themselves; their behavior was largely unregulated; and conflicts between their interests and those of their clients were widespread and disregarded. In particular, according to Pecora, disclosure standards were non-existent.

These facts combined with other causes to produce a market crash of epic proportions; widespread losses; a drying up of capital; deflation; and a massive depression with a resulting increase in unemployment to 25%. Unsurprisingly, fingers were pointed at the prior administration and political power shifted to believers in an activist role for government. The most lasting result was the enactment of laws that governed the financial system for decades and in many cases still do: the Securities Act, the Securities and Exchange Act, and the Glass-Steagall Act. Thus the 1930s saw a massive swing of the pendulum in favor of regulation.

The next several decades on Wall Street were – perhaps thanks to the impact of those laws – a relatively placid period. This led to a view that, with rare exceptions, market participants are well-behaved by nature. Further, steady growth with only moderate dips caused a perception of an inherently benign and productive economy that could achieve even more if only the regulatory shackles were loosened. After President Carter deregulated the transportation industry in the late 1970s, the door was open for much of the regulatory apparatus built in the early part of the century to be relaxed. Ronald Reagan, whose famously free-market views coincided with a period of peace and prosperity, led the deregulatory charge. We saw a similar turn in Britain under the leadership of Margaret Thatcher; the collapse of the USSR and a resounding victory for capitalism; and the ascendance of free market adherents Alan Greenspan and George W. Bush.

With the economy and financial system generating prosperity, people wanted more of the same. And with manufacturing in decline, we relied heavily on the financial sector for an increased contribution to GDP, job creation and standards of living. The prevailing view was that the less regulation we had, the more productive business and finance could be. And what was there to be feared from an unregulated economy, anyway? The result in the past decade, according to a great newspaper quote that sadly I can't locate, was "the kind of regulation you get from an administration that doesn't believe in regulation."

Thus, coming full circle from the 1930s, starting in 1999 we saw revocation of Glass-Steagall; elimination of the up-tick rule limiting short sales to instances when stock prices were rising; a pivotal decision to exempt derivatives from regulation; increased permitted leverage at investment banks; and starvation of regulatory agency budgets. These developments were followed by the global financial crisis of 2007-08. Coincidence or causality?

<u>Free Markets Are Dangerous – Regulation is Essential</u>

The free-market, capitalist system runs on self interest and the desire for profit. We need regulation to ensure those things are kept within reasonable limits. Thus the goals of financial regulation are roughly as follows:

- to limit risk, especially risk to the overall financial system,
- to restrict the concentration of economic power,
- to protect customers, especially "the little guy,"
- to prevent error, fraud, misrepresentation and theft, and
- to democratize finance and make it a tool of social policy.

If ethics, self-regulation, personal responsibility, respect for risk and a sense of limits could be counted on, we wouldn't need much in the way of regulation. But, sadly, they can't.

Since the profit motive can lead financial institutions to aggressive risk taking, error and even misdeeds, regulation is counted on to prevent these things. There's also concern that individuals' self-interest might drive them to actions that collectively might injure their companies and society.

Free markets do a great job of allocating economic resources – especially on average over the long run – but the interim fluctuations produced by miscalculation can be intolerable and have to be modulated. This makes regulation indispensable. **Bottom line: the financial system can't be entrusted to untrammeled free markets.**

<u>Regulation is Imperfect and Harmful – Free Markets Do It Best</u>

On the other hand, regulation is too imperfect to be relied on. (Thanks to "Soggy" Sweat for this dialectical approach – see "All that Glitters," December 17, 2010.) It's easy to write hard-and-fast rules, but rules sometimes impose undue costs or restrict activity in undesirable ways. And their specificity often makes them capable of being circumvented. Because financial institutions are intent on innovation, rules rarely keep pace and regulators usually find themselves playing catch-up. Rule-writing is reactive: rules are written in response to the last problem, not to foresee and prevent the next one, which invariably is different. In addition, regulators lack the financial motivation that drives those who can profit from getting around regulations and exploiting loopholes.

Since rules become outdated and circumvented, it might be preferable to regulate through principles. In other words, rather than numerical limits and defined borders, regulations might be written in general terms to produce adherence to ideals and policy goals. But regulating this way requires that judgments be made, and regulators are rarely accorded the license required for judgment-making. Imagine the second-guessing, legal appeals and phone calls to congressmen that would follow an individual regulator's decision that a financial institution's actions have violated vague principles . . . especially during a halcyon period when the warned-of consequences are slow in coming.

Principle-based regulation requires not only flexibility that is hard to build into and nurture in bureaucracies, but also significant business acumen, perspicacity and foresight. The evidence is *prima facie*: very few people saw the risk posed by sub-prime mortgages and structured mortgage products, and certainly not the regulators. And no one I know of – regulator or otherwise – foresaw the effect these things would have on banks, money market funds and the commercial paper market.

Why didn't regulators say a word about rating agencies' dispensing many thousands of triple-A ratings to structured mortgage vehicles? Why were the highly regulated banks ground zero for the consequences of the financial crisis, while unregulated hedge funds were relatively unscathed? I just can't imagine that regulators will ever have the ability to fully anticipate the consequences of changes in the fast-developing financial system, or to foresee the development of new problems for which rules and responses have yet to be drawn up. Here's how Peter Sands, chief executive of Standard Chartered, was quoted in the *Financial Times* of January 27: "It is not clear why some regulators who were there before the crisis should believe they now have all the right solutions."

What regulator would have been able to make a difference in protecting our financial institutions (and the overall economy) from the developments of 2004-07? And given how valuable his skills would be in the private sector, how long would he have remained a regulator? No, it just doesn't make sense to expect government employees to safeguard the financial system. **The conclusion is inescapable: responsibility for the safety of the financial system can't be delegated to regulators.**

<u>The Origin of Attitudes</u>

In December I wrote of gold that it's like religion: either you believe in it or you don't. I think something very similar can be said about regulation of business and the economy.

Liberals who champion an expanded role for government tend to be pro-regulation, while conservatives favoring laissez-faire policies and limitations on government will argue against it with vehemence. Democrats generally like an activist government: that's what makes them Democrats. Republicans don't.

Those partaking in the benefits of economic growth tend to favor free-markets and oppose further regulation, since they're happy with things the way they are. The reverse is true for those who are failing to participate and those working in the public sector . . . although there are millions of exceptions on both sides. Businesspeople who trust the economy to perform for them generally oppose regulation, while members of labor want it to prevent their being taken advantage of by management and the owners of capital.

I think our attitudes in this regard are highly correlated with those of our parents and largely a function of the time and place we grew up in. They can be altered through exposure to opposing points of view, but I think most people's attitudes toward regulation stem far more from upbringing and circumstances than from analytical and intellectual processes. Attitudes toward regulation, like politics, are largely hereditary and change slowly if at all.

<u>Reconciling the Two Positions</u>

It's my belief that because both free markets and regulation are imperfect – and because of the strength of people's political and philosophical biases – we will never settle permanently on either a completely free market or a thoroughly regulated system. Any position will prove merely temporary, and the pendulum will continue to swing toward one end of the spectrum and then back toward the other.

- Scandals and crashes will cause a cry for regulation.
- Regulation will curb the excesses and punish the wrongdoers, discouraging repetition.

- The environment will calm, and economic progress will become the rule.
- Memory of the events behind the demand for regulation will fade.
- Free-marketeers will gain sway, and they'll argue that we could do even better if the system were deregulated.
- Regulation will be eased.
- Risk-taking and misdeeds will rise.
- Scandals and crashes will occur anew.
- Pro-regulation forces will regain influence, and free-marketeers will be in the doghouse.
- And the pendulum will swing back toward regulation.

There will never be total, lasting agreement on either complete regulation or totally free markets. **Importantly, however, it might well be the case that compromise between the two has the most dangerous consequences.**

- In the decade leading up to the crisis, politics favored home ownership and liberal mortgage availability. These forces, combined with unregulated mortgage securities markets, gave rise to excessive lending, exaggerated demand for mortgage securities (given the illusion of safety), and thus artificially low mortgage rates and loose terms.

- Which bailout recipients remain the biggest sinkholes, without any real chance of repaying the government's investment? The answer is Fannie Mae and Freddie Mac, the government-created mortgage agencies: supposedly private enterprises whose operations were distorted by a tacit federal guarantee. They engaged in uneconomic behavior, advancing the policy goal of making home ownership available to people who couldn't afford it, and accepting vast risk on the basis of inadequate capital because they (and their lenders) had no fear of loss.

- Legislators turned regulation over to the private sector by putting credit rating agencies in charge of financial institutions' investing standards, giving commercial organizations excessive imprimatur. Financial temptation pressured them to drop their standards, and when they succumbed, the previously sacrosanct triple-A rating became a meaningless label.

- Having witnessed the rescue of the banks and the financial system, we now have a system where free-market rewards will continue to motivate risk taking and no one believes the ultimate price – meltdown – will be demanded of too-big-to-fail institutions that take it too far. A free-market mechanism undercut by moral hazard may perform adequately 95% of the time, but it will pose terrible risks in the remainder.

The real bottom line is that since both free markets and regulation are imperfect, our financial systems will continue to be imperfect. They will work well for us most of the time, although not perfectly, and they will be subject to bubbles and crises every few decades (hopefully not more often).

The Recent Experience

Think about the last few years: the depth of the financial crisis, the pain it caused, the blunders (or worse) that were behind the crisis, the financial sector bailouts it necessitated, and the acrimony they elicited from a Main Street feeling left to fend for itself. Then add in a White House and Congress controlled by Democrats, with their leaning toward government involvement in the economy. Certainly this was a formula for a powerful upswing in regulation.

In this context, I'm surprised that we haven't seen much more government activism. The new financial regulations are mild and constrained, in my opinion. Increases in financial institution capital requirements and controls over executive compensation have generally been more moderate in the U.S. than in Europe. No one has gone to jail (or even been subjected to heavy fines) as in the Enron/Adelphia era. And there have been no punitive increases in taxes on "the rich."

And yet there have been enough steps toward regulation for their limitations to be manifest. One of the primary components of last year's new financial reform law was the so-called Volcker Rule, under which banks can no longer risk their capital on trading and investing for their own account. The bankers I meet with rail against the extent to which this will interfere with their ability to serve their customers and lay off risk. They further complain that actions inherent in market-making can be hard to distinguish from Volcker Rule violations. Where do positions held for trading and hedging stop and prop trading start? Think about Goldman Sachs's bets against subprime mortgages:

- Did they hedge Goldman's long positions in mortgages?
- Did they lessen the risk in Goldman's overall portfolio?
- Were they bets against Goldman's clients?
- Or did they enable Goldman to take positions that served its clients and otherwise engage in client facilitation?

I'd guess the answer is "all of the above." Clearly, however, a market maker can do far more to provide liquidity if it is allowed to hedge through offsetting positions.

Mortgage shorts also shored up Goldman's finances and made it one of the least needy financial institutions. Which would we like to have more of, Goldman Sachs or Lehman Brothers, which plunged into mortgages and derivatives without significant risk control and consequently went bankrupt? And yet Goldman's actions have been vilified and proprietary investing has been outlawed.

On February 6, a front-page *New York Times* story indicated how difficult it is to rein in free-market forces and self-interest. Although Washington pushed financial institutions to compensate executives through stock grants in order to align interests with shareholders (and mandated it at the very top), the article described non-mandated employees' success in hedging their shareholdings and thus sidestepping exposure to the risks affecting their companies.

> “Wall Street is saying it is reforming itself by granting stock to executives and exposing them to the long-term risk of that investment,” said Lynn E. Turner, a former chief accountant at the Securities and Exchange Commission. “Hedging the risk can substantially undo that reform. . . .”
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> More broadly, critics say, the practice of hedging represents another end run around financial reform.
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> For example, new rules that cracked down on debit card fees have led several big banks to eliminate free checking. Firms also plan to make up missing revenue by adapting their businesses to the tougher new regulations on derivatives and trading with the banks’ own capital.

The *Wall Street Journal* of February 18 provided another example:

> In November, Barclays PLC quietly changed the legal classification of the U.K. bank’s main subsidiary in the U.S. so that the unit would no longer be subject to federal bank capital requirements. . . .
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> The maneuver allows them to escape a provision of the financial-overhaul law that forces the pumping of billions of dollars of new capital into the U.S. entities, known as bank-holding companies.
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> “It’s just not worth it to have all that capital trapped” in the holding company, said a New York lawyer who is advising banks on how to restructure.
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> The moves are the latest example of how banks are scrambling to cushion the impact of new laws and rules around the world.

The article went on to illustrate how a patchwork system can be evaded through regulator-shopping. By deregistering its subsidiary as a bank-holding company, Barclays escaped regulation by the Federal Reserve Bank, which would insist on greater capital. Instead its units now fall under the FDIC and the SEC, which will impose no such requirement.

The bottom line as far as I’m concerned is that you can enact a law or rule and tell businesspeople precisely what to do, but you can’t make the economy or companies comply with policies and social aims. Regulations are limited in their scope and effect, and like a balloon, when you push in one place, self-interested behavior pops out in another. As these articles indicate, **those who enact regulation sometimes get it right at first glance, but they’re rarely able to anticipate and control the response of those being regulated or the second-order consequences of the rules.**

Errors and misdeeds will occur as long as imperfect, self-interested humans stray into excessive risk-taking. And as long as these things lead to bubbles and resulting crashes, the willingness to dispense with regulation and rely on free markets will never be complete, regardless of regulation's limitations.

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I believe a free market is the best decision maker, causing financial resources, labor and intellectual capital to flow where they are most valuable and thus have the potential to be best rewarded. But the ride will be bumpy – by necessity – and some of society's goals will go unfulfilled. Of course, those who favor limits on government involvement in business argue that financial and market regulation shouldn't be a vehicle for implementing social policy.

The collapse of the USSR shows the limits of a thoroughly controlled economy. On the other hand, it's likely that China's impressive accomplishments over the last decade have been aided by the fact that its economy is controlled, such that the movement of resources can be centrally mandated in the short run. China's purposefulness is impressive, and China likely would have accomplished less if it had to work entirely through free-market forces. Would we trade our system (and results) for theirs? Will our answer be the same in twenty years? And will China remain the same, or once the highly regulated system has raised standards of living, will people insist on freer markets as well?

The debate will inevitably go on:

- What system is most likely to produce the results we seek? In the last few years we've seen calls for regulations to require "prudent" mortgage lending and prevent "excessive" compensation. What system is best able to define these amorphous terms and produce these results?
- How will economic goals be integrated and balanced with society's other priorities, and should they be?
- How will laissez-faire economics and financial regulation coexist, and what will be the consequences?

These questions will never be answered conclusively. The swing of the pendulum will continue unabated.

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