Financial reform: A start, but only a start

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Speculation and greed were at the heart of the global financial collapse. Reforms of financial regulation have gone some way to curbing their impact, but a lot more still needs to be done.

The collapse of global financial institutions that began with the meltdown of sub-prime mortgages in the US spread virally and devastated the lives of millions. At the height of the crisis, most economically developed countries felt forced to bail out the big banks in an effort to save what remained of their own national financial machinery. Often, those rescues came with few strings attached.

Ironically, when governments eventually did attempt to impose regulation, they found virulent opposition from the very institutions they had rescued. The result today is a smorgasbord of redress that, taken together, is as yet more aspirational than concrete. Still, it represents a start and, in many ways, a good start. But justice demands that we do more, and that every step be taken to prevent a recurrence.

What still needs to be done? To answer that, it helps to think about the root causes of the meltdown. These were, first, speculation and second, greed. Both are difficult, but not impossible, to fight. Knowing how they came to be gives us the tools.

An unexpected result of the dominant theory covering financial asset management, Modern Portfolio Theory (MPT), is the growth of speculation.

Under MPT, in essence, risk reduction equals performance enhancement. By touting diversification as key to reducing risk, MPT promulgates the concept that risk can be mitigated through means other than due diligence and prudence. Accepting a premise that risk can be reduced through the purchase of “assets”, such as commodity indexes or the collateralised debt obligation (CDO), fiduciaries peeled funds away from stocks and bonds, replacing them with economically useless and dangerously speculative products.

The scale of this transfer was, on a combined basis, massive. One of the most notorious examples is the synthetic CDO, which contains derivatives that themselves are tied to debt assets. In other words, the backing is theoretical in the extreme. By 2001, these had grown to an $80 billion market. That year, American Express took an $826 million loss from CDO operations, an amount equal to over 10% of the overall market. Moody's announced that 58% of the synthetic CDO pools it rated had exposure to WorldCom, Enron and Global Crossing, three famous companies then exposed as having scandalously failed to properly account to shareholders. Still, speculative fervour continued. By 2007, half a trillion dollars were in such investments. MPT trumped even Moody's warnings easily.

The secondary cause of the crisis was compensation structures that encouraged greed. Hedge fund founders being allowed to collect profits on other people's investments led to an ethic that was corrupting to the person and destructive of capitalism. It hasn't ended. In spite of all that has transpired over the last two years, managers with expertise in all sorts of new vehicles continue to be sought after and handsomely rewarded for success, fuelling greater greed-and speculation. Further, CEO compensation plans backfired. What began as a tactic to encourage corporate leaders to work to grow a company's value, and thereby benefit society and equity owners of the company, has devolved into a personal wealth attainment ploy.

What's changed so far in financial regulation? In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act addresses a broad range of structural issues. The act sets out the framework for constructive reforms. It establishes a Federal Insurance Office within the US Department of the Treasury, an inter-agency working group between several agencies (to provide a study), an Energy and Environmental Markets Advisory Committee, an office of the Investor Advocate within the Securities Exchange Commission (SEC), and the Bureau of Consumer Financial Protection. In other words, several new entities that might themselves create regulations have been born; it is a path, not a destination.

A few aspects of the act appear to address those two root causes of the global financial crisis-speculation and greed. The SEC has the authority to grant a pathway for investors who wish to nominate directors by allowing investors to place nominations on the ballot. If this authority is used, then it might allow shareholders to address a secondary cause of the meltdown, the greed factor and CEO compensation. Further, the SEC Investor Advisory Committee is now a permanent body. With this new status, it might press more strongly for expanded disclosure requirements (an important tool for watchdogs), as the less formal predecessor organisation has. Again, these are paths, not destinations.

Basel III, with its more global reach, seems to be trending towards greater specificity and impact than the US approach. To date, the Basel Committee raised the minimum common equity level of banks and set a counter-cyclical buffer, to be imposed by regulators as needed, containing risk-weighted assets. The real work is due by year-end and is expected to address the speculative nature of investing quite directly.

Anticipating that Basel III does transpire, we can expect to see leverage ratios lowered and standardised, which would directly reduce the opportunity for banks to over-extend the balance sheet. The Basel Committee, made up of members from 27 economically developed nations, includes representation from the United States. Because a core purpose of the committee is to harmonise banking regulations, this poses an excellent opportunity to address speculation. But Basel III is a banking organisation and, unfortunately, many hedge funds or other independent asset managers are beyond its reach.

The developed economies have laid out a path toward protection from another financial meltdown. But we have yet to walk it and, as we do, we must be deliberate. Even stronger steps than those already taken are possible. We are beginning to hear calls for an alternative financial asset management theory. This is beyond the scope of regulation. But regulators can begin to address the fiduciary standards whereby MPT thrives. Why not legislate an explicit duty of loyalty to the society in which the body of the beneficiary lives? After all, the beneficiary's financial well-being would not be well served by investments that bankrupt his fellow citizens.

In the meantime, regulators can try to reduce speculation. One idea began in 1972 when Nobel Laureate economist James Tobin suggested that even a small tax on currency spot conversions would slow speculation. Perhaps it is time to revive and expand the idea. Charging fees on gains from holding periods of less than 60 seconds would also dampen the velocity of trading. It is easy to argue that these ideas are absurd, but the cost of not taking bold action has risen to the trillions, when measured by losses the crisis created.

The response to the financial collapse thus far has been to establish new frameworks, and these are potentially of enormous importance. It is now up to those who hold the reins to seize the opportunity and both build the important protective structures so recently begun, and dismantle the root causes of the crisis: frameworks that encourage rampant speculation and boundless greed.

Recommended links and references

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