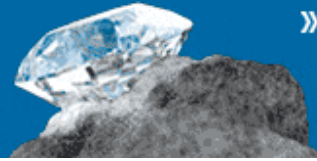


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FINANCIAL NEWS

Financial reforms taking too long

Roy C Smith

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Nineteen months after the rescue of [Bear Stearns](#), and despite the surprise reversal in the case of [Lehman Brothers](#), the too-big-to-fail guarantee of liabilities of large financial institutions is still out there in the market.



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The guarantee has been free to the institutions as the governments have not yet charged or required special capital reserves in exchange for it. Government support of these institutions has been very valuable to them as they have worked themselves out of the crisis and explains much of the sharp rise in the prices of their stocks and bonds.

US Treasury Secretary [Tim Geithner](#) has repeatedly said rules would be introduced to restrict “Tier-1” banks (the new term for too-big-to-fail institutions) through tighter leverage, liquidity and capital ratios, but these rules have yet to appear.

Geithner and [Federal Reserve](#) Chairman [Ben Bernanke](#) may be waiting for their legislative proposals to be enacted before installing the rules but it now seems unlikely that any new financial reforms will be passed by the end of this year.

Not only are these delayed by the slow progress of healthcare legislation now engaging [Congress](#), there are growing disagreements over the content of the financial reforms that may further slow things down.

In March Geithner announced a package of reforms that contained consumer protection and

regulation of derivatives, hedge funds, rating agencies and executive compensation in addition to measures to control systemic risk. The systemic risk measures are by far the most important but some of the others, especially bankers' compensation, are getting most of the attention.

There also may be a divergence within the administration over the right approach to dealing with systemic risk that could further hold things up.

[Paul Volcker](#), the respected former Fed chairman and a [President Obama](#) adviser, has appeared before Congress urging that the scope of any implicit federal guarantee be narrowed to banks alone, disavowing any such guarantee for other financial institutions such as investment banks, insurance companies or investment companies.

Thus the moral hazard of a government safety net would be limited to a relatively small number of important banking institutions rather than have it extend all over the place.

In exchange for the safety net, Volcker would have the banks return to being low-risk public utilities, no longer permitted to engage in such non-banking activities as proprietary trading, commodities or hedge funds. Those non-bank financial institutions no longer entitled to the safety net would have to manage themselves more prudently as there would be no assurance of a government bailout if they got into trouble.

Before Bear Stearns this was the government position on non-banks but, as we have seen, some firms got into trouble anyway and the state felt compelled to assist them. Volcker wants to go back to the way it was before, with the non-bank regulators stepping up to control their charges more rigorously.

The Geithner proposal takes a wider view, and accepts the implicit guarantee might apply to any Tier-1 institution, but seeks to contain the risk by applying tough new restrictions on capital, leverage and liquidity to both banks and non-banks. If the risk is sufficiently suppressed by the rules, then the probability of the safety net being used is reduced accordingly.

Geithner wants the notion of an implied federal guarantee to be dismissed by the market because the systemic risk, now to be under rigorous control, will have disappeared. Geithner may also believe that the stringency of the new regulations will provide incentives to large institutions to downsize their balance sheets and/or spin off their riskier businesses so as no longer to be regarded as a Tier-1 firm.

This might happen in some cases but control of systemic risk will still depend on the US Government's ability to install and enforce effective new rules for a variety of different types of institutions. This is a tall order – regulators have a poor record of preventing crises through their enforcement of rules.

Further, the Geithner proposal requires that Congress give new powers to the Government to take over non-banking financial institutions and that this power be vested in the Fed, subject to oversight of a committee of senior officials. There is a lot of reluctance in Congress to increasing the Fed's regulatory powers or to trust it to monitor and control a variety of new, complex, non-banking risks which just recently successfully eluded its scrutiny.

Most likely, a compromise between the two approaches will be struck and the Treasury and the Fed will have to live with whatever the new law turns out to be. Until then, no one can know what the new rules will be, when they will appear or what Tier-1 firms should do to adapt to them. It may also be that European and other authorities are waiting to see what emerges in the US before finalising their own rules, knowing that systemic risk control can work only in a global context.

Once new rules are adopted we can hope that much of the world's riskier financial businesses will be removed to outside the systemic risk barrier, into smaller, more expendable units. That would be good for the implied safety net and the moral hazard that goes with it. The riskier stuff would return to the broad institutional pool of financial assets made up of firms that do not comprise systemic risk but are free to take whatever risks they like.

This pool of sophisticated, institutionally managed capital is vast – even now it is valued at more than \$130 trillion – and its investment preferences and ability to move rapidly have been the stuff of bubbles and panics. We have had two such bubbles in the past decade and surely will have more in the future, but if the risk is removed from systemic institutions then the burden of bubbles will not be on the banking system or on the taxpayer.

This is of course what we need, but we need it sooner rather than later.

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