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Column: Rebuilding the pillars

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Serious academic researchers are, generally speaking, averse to doing two things—comment upon a yet-unfolding event in a timely manner; and organise themselves into a large team to come up with research output that provides a comprehensive view of a phenomenon. That is why the recent volume on the financial crisis by the finance department of the New York University's famed Stern School—Restoring Financial Stability—deserves special applause. A large and leading finance school and a short subway ride from Wall Street itself, Stern's leadership in the matter is hardly surprising. But it is not alone. Wharton, for one, already has a course on the crisis and is likely to come up with an edited volume soon.

It is important to understand why an academic treatise on the subject should stand out amidst the reams that are being devoted worldwide to the subject. To quote from the foreword by the Stern deans "...we present here a set of views that are at once informed, carefully considered and debated, independent, and focused exclusively on public interest."

While lucidly and accessibly propounded, the diagnosis of the Stern faculty does not throw too many surprises. Policy documents like the Turner Review discussed in this column recently have held pretty much the same factors responsible—global imbalance, overly soft interest rate regimes by central banks led by the Fed, financial innovation gone astray through securitisation and massively leveraged near-banks. It adds governance failure at major financial institutions—cash bonuses egging financial executives on to take massive risks—and explicit or implicit government guarantees to the list of culprits.

The prescription for a new architecture is perhaps of greater interest. The volume identifies four principles that should guide the new system. Presciently, it starts off with fixing executive pay rather than with any specific asset market problems. Greater disclosure and transparency of compensation; longer stock holding periods and stricter forfeiture rules; and a multi-year bonus pool linked to firm performance in both directions, from which cash out can happen only in a staggered manner. It is important to remember, institutions do not make risky or dumb decisions, their executives do. To make institutions behave, curb greed at the executive level.

Fair pricing of government guarantees and ring-fencing their access come next. For instance, deposit insurance should be priced on the basis of the health of the insured and premiums should be collected on a continual basis. The investor function of government-sponsored enterprises like the Fannie Mae and Freddie Mac should end—they should only securitise assets.

Addressing counter-party risks in derivative markets follows. The solution is to have more, not less, trading in these assets. Large standardised markets such as credit default swaps (CDS) and related indexes on exchanges with centralised counterparty-cum-clearinghouse facilities. Other instruments like CDOs and CLOs should at least trade with a clearinghouse mechanism to better assess the systemic risks of large institutions. OTC markets should be made more transparent and have closer regulation to prevent insider trading and market manipulation. The regulator needs to don the garb of a coordinator or market-maker for these to happen. Off-balance-sheet items of banks need to come under closer regulatory focus and regulation needs to be more comprehensive in its coverage of bank activities to be effective.

Finally prudential financial regulation must be aimed at reducing systematic risk with one regulator for large, complex financial institutions (LCFIs) whose mandate would include the assessment of the systemic risk of these institutions and its possible contribution to the downside risk of the economy. Regulatory constraints for LCFIs would be determined on the basis of this assessment and they would be made to pay for their risk profile in the form of higher capital requirement, taxes and/or mandatory insurance. Financial institutions need to internalise the cost of the risk they create for the entire system.

The professors give the Fed a good overall grade with a suggestion of discriminating among recipients of its liquidity injection. The US Treasury—pre-Obama—fared less well. The troubled assets relief programme (Tarp) was hesitant, ill-specified and took too long to come, and the Treasury missed the opportunity of providing short-term loan guarantees and recapitalisation. In comparison, the UK scheme was much better conceived. Finally, they suggest more direct government action in the housing market space and advise caution in extending the bailout outside the financial sector.

Even in desperate times, there is need, perhaps more desperate than ever, for careful thought preceding action. Violations of one or more of the four principles, identified in very early 2009, have already been at the heart of several furors in the months since. The Stern document is an important step in serious thinking about the new architecture.

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