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Oops! Unintended Consequences of Fixing Financial Regulation

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FINANCIAL REGULATION CYCLES OVER MANY YEARS, ALTERNATING BETWEEN PERIODS OF LENIENCY AND TIGHT CONTROLS. In Summer 2010, as the Wall Street Reform and Consumer Protection Act (also known as Dodd-Frank for Senator Christopher Dodd and Representative Barney Frank) was signed into law, the world has clearly moved from an era of increasingly self regulation and laissez faire economic principles toward a more highly regulated environment. Regulation is a lagging indicator, traveling to politically induced extremes before being pulled back toward the center as conditions change.

WHAT CAUSED THE FINANCIAL CRISIS

The recent financial crisis will be studied to death in the future, but the primary drivers can be captured in a few broad categories.

- **Culture:** Firms, individuals and regulators all believed they understood the risks accepted. Skeptical voices with contrarian thoughts were shut out of the conversation.
- **Accountability:** Investors outsourced their due diligence responsibility.
- **Incentives:** Financial incentives encouraged mortgage originators to sell, investment banks to securitize and regulators to defer to internal models.
- **Exposures:** Assumed diversification benefits were proven incorrect as tail risks occurred.
- **Leverage:** Entities that borrow are forced to sell when markets move against them.
- **Systemic risk:** When markets are stressed there are no buyers and a liquidity crisis puts the entire financial system at risk.

It is impossible to predict which specific risk will create a crisis, but a leading indicator always seems to be someone saying "It's different this time." Risk models that use only historical data are not flexible enough to adjust. A successful financial system will work in concert with the regulatory framework to set up a fair and transparent market where those interested in reducing their risk find someone willing to be paid to accept the risk.

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By allowing firms to fail it encourages them to experiment. If firms are too big to fail, resources are diverted to lobbying to maintain the moat and increase barriers to entry. Creative destruction might seem like an oxymoron, but it is necessary for capitalism to thrive. There must be oversight that kicks in when products become overly popular, both internally at companies and within the industry.

By 2006 banks were focused on growth with limited risk analysis or due diligence, individuals were spending beyond their means, and government provided incentives for home ownership through low interest rates and loose credit standards. Reduced oversight created a perception that Government Sponsored Entities and large banks were "too big to fail," encouraging the cycle to continue. This combination of risks caused the system to freeze up when defaults rose above expectations.

NEEDED: CONFIDENCE IN THE SYSTEM

Regulation of the financial services industry should cast a broad net so no risk falls through the net. Its main job is to create confidence in the system itself. When confidence leaves the market, liquidity dries up and the market can't operate efficiently. Everything else it does supports this overriding fact. Transparency, peer review, and maintaining a fair marketplace are key components of this strategy. The Dodd-Frank bill will set the tone of the regulatory environment for years to come. There are many things right about the new regulatory framework, but there are potentially unintended consequences as well. Some that could reduce confidence in the system are described below.

- **Proprietary trading**: The so-called Volcker rule does not clearly define proprietary trading, allows banks to manage assets while using performance-driven compensation and does not limit the leveraged position of

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assets purchased within the 3 percent limit. Creative bankers will evade the spirit of this regulation if yet-to-be written rules don't tighten constraints.

- **Regulatory arbitrage:** Transparency should improve with standardized derivative products on an exchange, but regulatory arbitrage will still allow creative products to flow to the loosest regulator as happened with credit default swaps. Principle-based capital requirements calculated at the holding company level, and auditors with teeth, are needed to avoid a repeat with a different complex security. Coordination between regulators through a patchwork that focuses on only one part of the financial services market (e.g., banks, insurers, securities) will each have conflicting motivations. Consistently strong regulation is unlikely to result.
- **Systemic risk:** The Financial Stability Oversight Council (FSOC) will struggle to effectively manage systemic risk due to its politically based reporting structure. With the chair being the Secretary of the Treasury politics will be high on the agenda. The FSOC also does not address the "enablers" that bought the assets without proper due diligence. Just as drug dealers would not exist if there were not drug users, suppliers of financial instruments have no market without buyers. The legislation does not address future systemic risks that are not purely financial. Examples include pandemics, natural disasters or technology gone wild. Interactions between risks, including funding sources, should be measured quantitatively and questioned qualitatively. When multi-line companies have few insiders who really understand how a multitude of risks interact, how can we expect regulators to do any better? Will the new "super regulator" for systemically important firms be up to the challenge? And if they are, why continue to support other, now redundant, bureaucracies?
- **International cooperation:** The Office of National Insurance will be formed to provide a unified front internationally. How this group will interact with the NAIC is not clear. Each group is incented not to work with the other from the start as a form of self preservation. If there is over-regulation then risks will move offshore, much like the XXX reinsurance market has. While some have suggested that the ONI have an Office of the Actuary, a better place for this role is beneath the FSOC so as to address risks in all types of financial institutions.
- **Lobbying:** Regulators and Congressmen get much cozier with industry when lobbyists are involved. One suggestion would be for lobbying arms of companies accepting government aid to be greatly reduced or eliminated. The major risk in this legislation is that the lobbyists will drive the remaining bureaucratic rules making, leaving holes and arbitrage opportunities throughout.

MOVING FORWARD

There is no shortage of guilty parties that helped to create the recent financial crisis. Everyone played a part. Individuals took on risks they had little chance of surviving financially, financial institutions became originators and/or enablers accepting the ultimate risk positions, and regulators and rating agencies provided the alcohol at the party when their job was to take the punch bowl away.

A complete list of systemic risks is impossible to create, but an attempt must be made at the federal level to continually update the list and not give in to political pressures. A systemic risk regulator must be independent of the political process, with offices throughout the country to better understand regionally important issues. Emerging risks should be considered, utilizing experts to identify, coordinate, and develop a game plan to address them. A national chief risk officer, with staff, would improve coordination across and between risk silos.

The insurance industry is currently performing a live case study of regulatory reform as the NAIC implements its program for risk-focused examinations. Unfortunately there has been wide variation in the way states are performing these exams. They have tended to be audit based and not the forward-thinking partnership they could become. RFEs should focus as much on risks likely to increase in future audits, bringing in outside risk experts to do this, rather than trying to have internal staff competent in audit work evolve into risk managers through a few hours of training. It is a different skill set. This will hurt the NAIC's efforts to remain the primary insurance regulator if they do not anticipate the next big risk.

Financial institutions must continue to develop their enterprise risk management process. Those who do it well will have a competitive advantage. By identifying their unique risks and consciously choosing the ones they accept based on consistent analysis, a strategic planning process will evolve and improve over time. This will help firms manage their risks, mitigating or avoiding specific risks by choice.

Financial institution regulators need to consider emerging risks and build scenarios that show how they might interact with the current financial system. The focus on developing such a framework should be on the skill set needed rather than on industry. This group should be comfortable with numbers and projections, with a healthy skepticism for what others are saying. This group should be involved in regulation of all financial institutions, from credit cards to insurance to investment banks. A single profession does not own these risks, and all professionals with standards and professionalism requirements should be allowed to participate. Actuaries create models that consider potential events and challenge those same models with common sense. This helps the profession provide honest feedback around work done by others with credibility based on mathematical knowledge and experience in the financial space. Many actuaries are also forward thinkers and can help develop solutions that consider emerging risks. The actuarial profession should be included in this risk management regulatory group, and some actuaries will have the experience and communications skills to lead such a team.

All regulation has unintended consequences. To be sure, creative products are already on the drawing board designed around the new regulatory framework. How will this change the financial landscape? Will it be as drastic a change as the last time regulations tightened in the 1930s, or did a culture shift drive most of those changes? Only when individuals pay the final bill of the recent crisis will we know the answer to that. With interest rates held low and deficit spending ingrained in entitlement programs and bailouts, it is likely that there will be more bumps in the road before smooth sailing returns. ■

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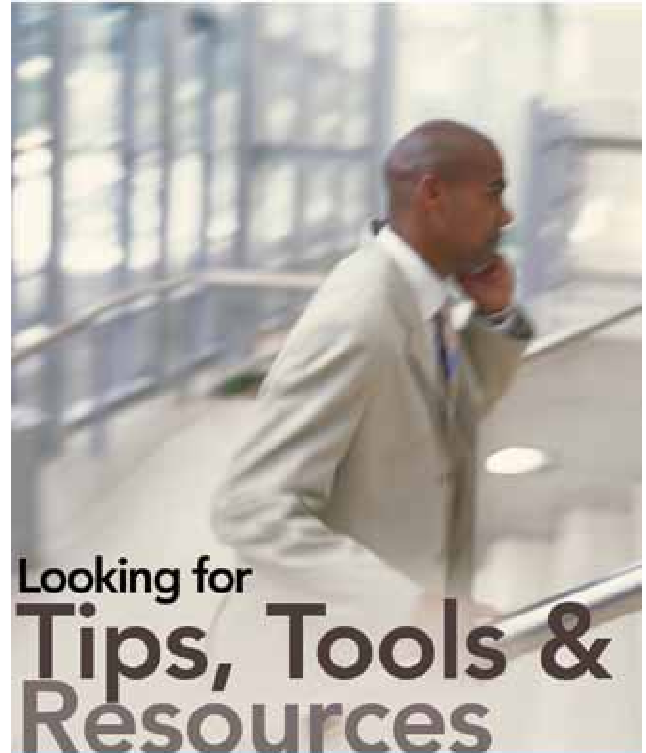

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