Financial Reform: A legitimate function of government?

by John Wiesner

"Does it make sense to have a chief risk officer of, say, the United States of America, whose role it would be to manage/mitigate this risk?"

A prior fundamental question, less practical in its root, is whether or not it is a legitimate function of government to regulate financial institutions. The answer can guide how any new checks and balances should be developed to mitigate future financial disruption. At the same time as these questions are being considered, statements are being made that no institution should be "too big to fail,"which implicitly points to answers.

This essay will first speak analogically about government function, then relate those analogies to our current crisis.

Driving on the right side of the road is more than just a convention in this country, it is the law. Does it need to be the law? When vehicles moved much more slowly, when walking was the most common method of moving around, there may not have even needed to be conventions about "going to your right" when passing by an on-coming person. Clearly there is no morally right or wrong answer about driving on the right side or the left side of the road, as we see parts of the world that have the exact opposite convention. However, it is arguable whether or not someone should decide what the convention should be. The point here is not which direction is correct, the point is whether or not it is a legitimate function of government to make that determination.

When people primarily walked, there was not as much danger of injury if there was no convention, but as technology has made transportation so much faster, and thereby increased the risk of harm when people collide, it seems that a convention is at least good, if not necessary.

If everyone driving a vehicle had to re-decide which direction to go every time they approached an oncoming vehicle, accidents would abound and people would drive more slowly. Transportation would therefore be slower, dangerous and far less efficient. Technology has at least made the need for a safer convention necessary.

It seems fairly self-evident that it is a primary function of government to protect its people. Therefore, it does not seem outrageous to argue that it is a legitimate function of government to have passed laws dictating on which side of the road people should drive. Even though there may well have been a time when a government's dictating on what side you pass by an oncoming ambulatory would have been considered over-reaching, the increased risk of harm due to technology seems to make the case that the government should dictate a convention by law, and enforce that law.

Just as technology has made transportation both more efficient and more dangerous, so likewise has technology made our financial world more efficient, but also more dangerous to all in the event of a crisis. Everything moves much more quickly throughout the world. Collisions of two entities, "accidents" such as AIG or Lehman, have a much bigger impact than they would have had a century ago. Our global economies and monetary systems are as interconnected as a fine Swiss watch, and it seems that a grain of sand can threaten to halt the whole system.

That begs the second analogy, that of a clock. Many centuries ago water clocks existed that kept time "well enough." They were very large, not very precise, and not very efficient. Now we have highly efficient, and highly accurate watches and clocks. A water clock would hardly have been affected by a grain of sand getting into it, but a grain of sand can halt and even destroy a fine Swiss watch. The in-

Financial Reform: A legitimate function of government? *by John Wiesner*

creased efficiency and precision of the Swiss watch makes some level of protection, some "guard" if you will, necessary; hence the glass face cover.

Similar to glass face covers on watches, our financial system needs safe guards and protections. Further, it may very well be a legitimate function of government to dictate certain norms, such as driving on either the right side or the left side of the road, for financial transactions.

Leveraged derivative transactions are much like 800 horsepower engines in a vehicle. They are a very useful tool, but they can also be a weapon by which the operator could harm both himself and others if he does not use them properly.

Should the government outlaw either leveraged derivatives or 800 horsepower engines? Of course not. None-the-less, it would be preferable to be certain that those who use leverage have a sufficient mastery of the tools so that they are less likely to hurt someone by misuse. So there may well be an argument that it is a legitimate function of government to regulate the financial world.

The push toward centralized clearing and open market trading can provide some of these safeguards without much government intervention. Centralized clearing gives a for-profit industry the incentive to watch for systemic risk. Centralized clearinghouses need not be a government agency, but it seems that not enough financial institutions availed themselves of centralized clearing before the crisis. If a safe convention does not arise naturally from the market place, it might be necessary for the government to dictate the norm, by law.

Open market trading can help users avoid hurting themselves. If there is enough open competition, it is less likely that a misinformed buyer will systematically over pay for an instrument. One-off OTC transactions leave open the possibility that one party or some oligopoly can systematically over-charge for certain instruments, if for no other reason than that there is not enough competition to shed light on the real value of the instrument. Having access to a wider liquidity pool can at worst only increase the depth of the market; more likely, it will provide the opportunity for price improvement. This practice of price discovery can actually make the whole environment safer for all the users, without government intervention. But again, if entities do not avail themselves of these better conventions, it may be necessary for a government to force the issue, due to its duty to help protect the people.

Centralized clearing and open markets can help mitigate the pain of future defaults of financial institutions. The domino effect of a series of individual counter-party relationships is diffused by centralized clearing. It seems almost childish to say that mutualization of risk has great value in an essay for an audience that is primarily composed of actuaries. The entire existence of the insurance industry is predicated on that one fact. Nevertheless, financial transactions should likewise be mutualized. They could have been and still have not been. So it may be necessary to actually state the obvious: large financial institutions need to mutualize their counter-party risk through exchanges and into centralized clearinghouses.

The free-market natural evolution has not brought about this correct convention, at least not effectively enough; and so governments, legitimately, are now demanding this convention…by law.

Financial Reform: A legitimate function of government? *by John Wiesner*

This legislation begs the next question, should governments actually be the overseeing body of the risk? Should the government actually run the centralized clearing of all financial transactions? I say "NO!"

A government-run centralized clearinghouse would not have the incentive to work with the financial institutions to foster creativity, and would probably just slow down the whole economy. A non-governmental central clearing entity wants to both stay in existence and to foster new business of its mutualized members. In this way, provided that the financial institutions are willing to subject themselves to one another's mutualized risk, the government's role can be no more than dictating that this practice must be done, without actually having to do the work for people.

Going back to the driving analogy, I believe it is important that we all drive on one side of the road, and I agree that it is a legitimate function of government to enact, and even enforce, such a rule, but I do not think that the government should actually drive the vehicles for us.

The government should allow institutions to fail if they either do not properly manage their own risks, or even if they simply are not competent enough to profit. The large institutions' thinking that they are too big to fail has caused them all to have an arm's race of risk-taking, just to stay ahead of their competitors who think the same way. Giving ALL institutions the possibility of failure should help collective curb the overactive risk-taking that we have seen in past decades.

Combining both the legitimacy of government regulation on how to mutualize counter-party risk and the real possibility of failure for large institutions should help mitigate overactive risk-taking. Keeping the actual job of mutualizing that risk at exchanges and central clearing houses, rather than within some new government agency, should likewise leave open the possibility of profit, innovation and free capitalism.

John Wiesner is the risk management strategist at Chicago Board Options Exchange in Chicago, Ill. He can be reached at *wiesner@cboe.com*