

thinkpiece

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Something Must Be Done! Sir Humphrey writes: Lessons for Financial Regulation

Richard Hobbs

Summary

- The author explores the government's response to the financial crisis. He warns that drastic, politically expedient intervention that is seen to be "doing something" risks stifling competition while failing to address the underlying causes of the crisis.
- As we have seen, regulatory failure carries high political costs, even though "zero failure rates" are difficult to achieve in reality. This amplifies the need for intervention that is stronger, more prescriptive and restrictive, regardless of how effectively thought through it may be.
- Closer examination of the financial crisis itself indicates the cause to be not so much the regulatory system itself but the extreme gearing of capital and the regulatory authorities' understanding of the firms being supervised. Yet many of the resulting regulatory interventions have not addressed those underlying causes.

CII Introduction

Recent years has witnessed statements by governments the world over vowing to learn the lessons from the credit crunch by creating a more rigid financial regulatory system. However on the eve of a general election in the UK, it might be worthwhile remembering that being seen to be "doing something" for its own sake can be a dangerous proposition, even if it might be considered politically acceptable.

In this thinkpiece, Richard Hobbs takes a timely look at the recent past in financial regulation and warns that governments should perhaps take a more prudent and cautious approach rather than introducing sweeping regulatory changes simply to sate the thirst of public retribution.

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It is no fun being a regulator when things go wrong. The cry goes up *where were they?* But the system is not designed to achieve “zero-failure.” Zero failure is actually chimerical in a society relying on free markets since some capital would have to sit around substantially unutilised which makes no sense for its owner. So there will be failures and the regulatory regime is set up to try to ensure that there are just enough not to be too many, thus sustaining confidence in the system and markets.

That deals with idiosyncratic risk but when risk and failure become systemic an even louder cry goes up. Behaviours quickly become political. The political architects of the system point to the regulated. The regulators point to the regulated. The regulated point to each other. Expert commentators quickly begin the post-mortem which looks bad for all the aforementioned. Defensive behaviours quickly set in. It is said that surgeons are more likely to recommend surgical interventions to their patients’ conditions than other kinds of specialists and the reverse is true. Hence legislators legislate and regulators regulate as the solution to any given problem. So the response to a regulatory failure such as the credit crunch and banking crisis of 2008 is to have more legislation and more regulation.

The risk is that, under the media spotlight, action, any action is considered politically more acceptable than thought if that thought leads to the conclusion that comparatively little needs to be done.

So strong is this phenomenon that it is the subject of political satire. In the episode of the famous BBC television series *Yes Minister* entitled “Party Games”, there was the political imperative: we must do something; this is something; therefore, we must do it. The authors easily secured that this faulty logic quickly descended into farce. I have always found this episode instructive in the analysis of public policy. Its present custodians might do well to reflect on whether it may have some application in the current frenzy. The risk is, however, that under the media spotlight, action, any action, is considered politically more acceptable than thought if that thought leads to the conclusion that comparatively little needs to be done.

The specifics of the current crisis are worthy of a little scrutiny. In his excellent paper “Fixing Regulation,”¹ Clive Briault points out that the main studies² make between them 167 recommendations for changes to regulatory regimes across the world. If every

¹ Published by the Centre for the Study of Financial Innovation (CSFI), ISBN 978-0-9563888-0-3

² The Financial Stability Forum, International Monetary Fund, European Union, US Treasury and the UK Financial Services Authority

recommendation was as good as every other this would represent excellent productivity. The reality, however, is that the crisis is not likely to have had 167 causes so 167 remedies seems too many. As Karl Snowden has argued so eloquently previously in this series,³ markets need as little regulation as is feasible to enable them to provide society with economic prosperity.

It is odd that banks were allowed to create structured investment vehicles and other conduits which, when push came to shove, were reliant on the regulatory capital of the parent bank: a triumph of legal form over economic substance.

Closer examination suggests there may have been very few root causes, perhaps to the extent that, had the regime in force at the time been operated rigorously, then current regulatory standards would have been sufficient. Two factors stand out as contributors. First, the extreme gearing of capital that finally caused markets to lose confidence in the paper issued by some banks. Second, it is a fundamental aspect of regulatory supervision that the regulatory authority understands the entity it is supervising, particularly its structure and scale. It must do so to make sense of the capital ratios it is enforcing. If the entity is effectively larger than it purports to be then the denominator of the capital fraction is under-stated. It is odd, therefore, that banks were allowed to create structured investment vehicles (“SIVs”) and other conduits which, when push came to shove, were reliant on the regulatory capital of the parent bank: a triumph of legal form over economic substance.

An equivalent oddity is the way internal models were allowed to be used to price credit risk when reliable data was not available to populate them, or the reference period was shorter than the credit risk cycle for which a contract was being priced. This latter practice is akin to a windstorm underwriter pricing his contract on his loss experience in the last hurricane season. He would be rightly run out of town.

It is received wisdom that the Basel 1 Accord hard-wired capital requirements to a degree that restricted the rate at which banks could contribute to overall economic prosperity. That the bankers themselves lobbied for the introduction of internal models in Basel 2 is not in itself an indictable offence; interest groups have a right to make representations but it is indicative of how their minds were running; higher gearing was on the cards. Had internal models been policed more rigorously then less credit could have been formed. Ultimately, the crisis for the banks in question was one of capital not liquidity.

³ Karl Snowden, [Financial Regulation: What Good Really Looks Like?](#), CII *Thinkpiece* No.31 (November 2009).

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No doubt a crisis is a good opportunity for the authorities to introduce some new techniques they were saving up for the next convenient legislative opportunity but it should be possible to identify which measures are intended to solve which problems. Of the 167 recommendations, which ones address SIVs and internal models? If they do not address either, what do they address and why?

Fortunately, the insurance sector has largely escaped the direct consequences of this regulatory storm, though not the resultant

recession. The most obvious parallel is Solvency 2 which now has the unfortunate conceptual parentage of the Basel 2 Accord. However, it is not the use of internal models per se that let us down; rather it was their inappropriate use. Fortunately, risk pricers in insurance keep better data to populate their models and the test of the implementation of Solvency 2 is whether it facilitates more accurate risk pricing, not whether it drives up capital requirements for an industry that did not suffer systemic failure.

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Richard Hobbs was recently appointed as Board Director of Lansons' newly rebranded Public Affairs and Regulatory Consulting practice. He founded Beachcroft Regulatory Consulting in 2002. Previously he worked in the Insurance Directorate of the Department of Trade and Industry as the Director responsible for the reconstruction of the Lloyd's insurance market and was Head of Life and Pensions at the Association of British Insurers.

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[Financial Regulation: What Good Really Looks Like?](#) by Karl Snowden (Published 10 November 2009)

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One of the top reads in Whitehall and Westminster last year was the Thaler & Sunstein book that described how to “nudge” customers towards making “better” choices on complex subjects. In this third article in our series on insurance and risk, provides one perspective on nudge theory, exploring its potential rewards and risks.

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