WHAT KIND OF FINANCIAL REGULATION FOR THE 21ST CENTURY?

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The financial instability hypothesis is a model of a capitalist economy which does not rely upon exogenous shocks to generate business cycles of varying severity. The hypothesis holds that business cycles of history are compounded out of (1) the internal dynamics of capitalist economies, and (2) the system of interventions and regulations that are designed to keep the economy operation within reasonable bounds.

Hyman P. MINSKY, *The Financial Instability Hypothesis*, Working Paper n°74, May 1992

Analysis of major financial institutions' collapse during the latest financial crisis has allowed us to identify five ingredients that are always present in such affairs and always combine to create an explosive cocktail. The troubles experienced by Northern Rock, Royal Bank of Scotland, Lehman Brothers, Anglo Irish Bank and Allied Bank - to only cite the best known - involved on each occasion a power-hungry and authoritarian leader (Richard Fuld at Lehman, Sean FitzPatrick at Anglo Irish Bank) motivated by an insatiable need for social recognition and obsessed by the desire to unseat the current leader (Goldman Sachs, in this instance). A second distinctive element was the failing of internal governance systems, particularly the boards of directors, which on each occasion showed themselves to be incompetent and subservient. Under these conditions, firms' almost unlimited ability to access cheap short-term funding at less than 2% was a massive encouragement to indulge. For many, this involved an asset whose safe reputation they found reassuring, to wit, property. Others went too far offering direct loans to developers (the two Irish banks) or private borrowers (i.e. Northern Rock's mortgage loans). Lastly, others' problems stemmed from their purchase of certain classes of securitized property assets (i.e. Lehman's subprime and similar investments). With such assets generating yields 5 or 6% above funding costs, banks geared up massively on credit, with some inflating their balance sheets to more than 30 times their equity capital. The abuse of the credit system helped to transform a bull property market between 1998 and 2003 into a real bubble between 2003 and 2006 without regulators acting. This nonchalance was either a question of principle (the Fed has never tried to burst asset bubbles; the Bank of England was very proud of its light and even limited regulation); a poor distribution of tasks amongst regulators (in the UK between the FSA, Bank of England and the Treasury; the US Fed did not monitor the investment banks); or connivence with the institutions that regulators were supposed to control (as was the case in Ireland).

An efficient theory of financial regulation should be grounded in a lucid postulate of the invariability of human nature in general, and of financial executives in particular (cf. recent insights from the field of evolutionary psychology). It is relatively improbable that people's nature has evolved significantly over the past few decades. Moreover, there is nothing wrong with this, since actors' greed has always been and will always remain one of the most powerful engines driving capitalist progress. Once you have set aside the utopia of Marxist

thinking (like the nationalisation of banks) or Luddism (the prohibition of a number of innovative and useful financial practices like junk bonds or securitisation), the best way of avoiding future financial failure consists firstly of applying rules of internal governance found in codes of good practice (the first of which was the 1992 Cadbury report), whose first prescription is to build a board of directors comprised of members who are both competent (i.e., capable of understanding the particularly complex issues that financial establishments face and doing much more than serving as good accounting auditors) and truly independent (i.e., capable of arguing with the group executive). Secondly, the authorities must require financial institutions to diffuse high-quality information, including full fair value to shareholders and money market lenders so they can evaluate the risks that the company is taking. Lastly, external regulators must replace the lax Anglo-Saxon regulation that we experienced over the past decade with a new kind of regulation is both adaptive and intelligent. Today, the real risk resides in an excess of unsuitable regulation, one consequence of the knee-jerk legislative reaction to the crisis. Suffocating financial institutions under a mountain of paper and useless and costly procedures will not stave off the danger and in fact only succeed in hobbling the credit markets. The capitalist system will adapt, as it has always done. It remains that the winners of the 21st century will not be those countries that are against capitalism or propose a different form thereof, but those that have been able to adapt the most efficient (thus most competitive) regulation, one based first and foremost on principles and practices and not on rules and validation processes that are purely procedural in nature.