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OpEd

Better slow than sorry

June 30, 2010, Financial Post – Finn Poschmann

In 2009's G20 meetings in London and Pittsburgh, participating governments spoke of the urgent need for collective action to restore the global economy's functioning by spending "stimulus" money in record amounts, and to agree on speedy regulatory reforms that would restore stability to the financial marketplace.

Last weekend in Toronto, the urgent language remained in the summit communique, yet the direction had changed sharply. Rather than commit to further deficit spending, wildly beyond the means of governments to finance in the near term, G20 members declared victory in generating global recovery and agreed to pare back their overspending.

The G20's leaders and finance ministers seem to have taken a lesson from Greece's paroxysm in the sovereign debt market. The pace of Greece's recent overspending, and its apparent inability to slow it, led risk spreads on Greek to debt to rise earlier this year to 1,000 basis points (it now sits near 700). The fact many European banks had used Greek debt as collateral to backstop their own borrowings transmitted Greek risks quickly and widely through financial markets -- which, the Bank of Canada pointed out in its financial stability report last week, remain more unsettled than they were at the end of 2009. Clearly something about the G20's past approach was not working well.

The change in direction also happened because of pressure from Canada's negotiators, who worked within the context of a federal political commitment to return Canada's fiscal stance to balance in the next few years. This is a practical and moral victory for Canada.

And, in what is also a practical and moral victory for Canada, consensus on the direction and speed of financial sector reform has evaporated. A global bank tax, or a tax on financial intermediation, was off the table in Toronto before it got on. That is good, because when the aim of policy is in part to improve the conditions for lenders and borrowers, it would have made little sense to make more costly and more rare the transactions -- trades in risks -- that support lending and borrowing activity .

On financial regulation, the G20 instead violently agreed to present plans at the group's next meeting, in Seoul: plans that would describe the sort of capital adequacy schemes, which will apply to most financial institutions, and which members might implement over the years that follow. The communique's language is charmingly vague: The new rules will be phased in over a "transition horizon" that reflects "different national starting points and circumstances." That is for the best, because the concerns of regulators in the U.K., France and the U.S., for instance, hardly reflect the needs of the Canadian market.

To be sure, the vagueness about what will be the capital adequacy rules and when they may bite imposes costs. Banks that do not know how much capital they will need to reserve in future will be more stingy than otherwise in their dividend policy, with at least short-term costs for their millions of shareholders. Those same banks will be uncertain about how much lending they will be able to commit in future, and that will make their lending more conservative today, which in turn will slow decisions about business investment.

That this uncertainty imposes a cost today is a problem. It is a better problem to have, however, than to more quickly have certainty about regulation that is too restrictive, retarding growth when it is sorely needed, or regulation that is simply misguided.

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Which of these categories applies to the financial reform bill currently struggling through U.S. Congress is hard to say. While the White House has been pushing hard, it is unclear, owing to Monday's death of Senator Robert Byrd, whether the legislation will pass before summer recess. If it did, it would amount to quick action. But in many ways the legislation combines quick action with uncertainty: Implementation looks to involve a long phase-in period, and no one knows for now how broadly new rules will apply. Special scrutiny is in store for financial institutions that are believed to impose systemic risk, but which institutions those are will be decided by council in future, and regulations will be applied at the discretion of the regulator.

The 2,000-page bill will impose aspects of what is known as the Volcker rule, after former Federal Reserve chairman Paul Volcker, who is advising President Obama on financial market regulation and would like to see banks that take deposits do less investment banking. Deposit-taking institutions will be sharply limited in the amount of capital they can devote to private equity investment, which means they will be doing less investment on their own accounts. The Volcker rule's heart is that banks' deposit-taking function is put at too grave a risk when those banks also engage in investment banking functions.
Mr. Volcker's view is that given a chance, corporate managers will simply take on too many risks, putting not just themselves and their shareholders at risk, but depositors and the broader financial system. That this has happened in the past is inarguable. It is also inarguable that future crises will happen. What is less clear is whether legislation and regulation like this will prevent them or will instead suppress growth and innovation.

For instance, the commercial paper and mortgage market collapses in the US in 2007 and 2008 did not happen because retail bankers engaged in investment banking. One key cause, perhaps the single most important one, was the failure of the designers, issuers and buyers of mortgage-backed securities to adequately contemplate what would happen if housing prices in regional markets, rather than showing their usual offsetting booms and busts, instead simultaneously fell together. It was a mistake made by many, including regulators.

That leads to the more generic question why legislators and regulators would be more likely than managers and shareholders to make shrewd choices about the sorts of risks they may take on. They may do so, but it is an odd starting point.
For instance, between 1988 and 2007, owing in part to deregulation, Canadian banks drastically expanded the range of activities they took on, including investment banking, and financed much activity off of their balance sheets. Not surprisingly, the risks to which these institutions were exposed increased, but so too did their returns. The reason, as suggested by forthcoming research to be published by the C.D. Howe Institute, may be that corporate managers (yes, supported by a reasonably sound regulatory system) learned adequately to manage those risks, for the most part, and thereby protected shareholders' earnings. That financial institutions in Canada did not implode in 2008 seems likely to be a product of market incentives doing exactly what they should do.

What will happen in the U.S. is uncertain. And readers will note that markets yesterday were showing a lot of disdain for uncertainty. What seems clear, however, is that a Volcker rule for Canada is for the moment not called for. What's more, Canada's G20 delegation deserves congratulations for slowing the contagion of bad regulation, and persuading many other participants to shift their potentially destructive course.

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