

Should We Just Re-Regulate or Totally Restructure Banks?

Many solutions are being offered to solve the current economic crisis. But rather than merely adding to the costs and complexities of regulatory governance, the answer needs to address the long-term challenges of the industry.

Many sources have been blamed for causing the current banking crisis, including Congress, federal and state regulators, the credit-rating agencies, and the CEOs of the giant banks themselves. As various governmental interventions in the marketplace seem to fail to solve the problem, the number of solutions being suggested appears to grow as quickly as the hope for an immediate, short-term solution vanishes.

While Federal Reserve Chair Ben Bernanke spurns talk that the U.S. banking industry will be nationalized, fear that it might occur has been blamed as the trigger for significant drops in the stock market. Surprisingly, various think tanks and industry representatives continue to push for an ever larger, yet still vague, governmental presence in the financial services industry, while some view the bailouts of AIG and Citigroup as essentially federal takeovers and, combined with the conditions placed on the recipients of

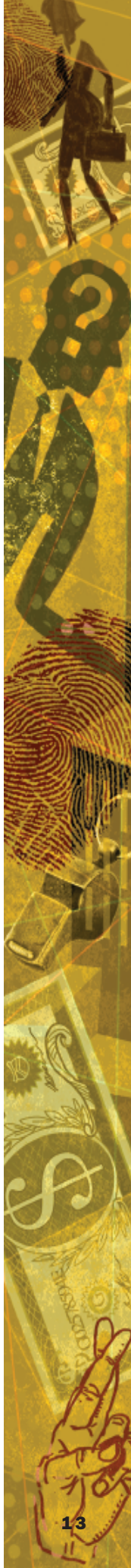
Troubled Asset Relief Program (TARP) funds, as virtual nationalization. Other countries have initiated significant government involvement with their banking industries.

One of the extreme governmental interventions was proposed by the Squam Lake Working Group on Financial Regulation, a think tank affiliated with the Center for Geoeconomic Studies of the Council on Foreign Relations. The group published a white paper in February 2009, *A New Information Infrastructure for Financial Markets*, that calls for a new regulatory regime for gathering and disseminating financial market information. Based on the premise that neither firms nor regulatory agencies have had sufficient information in the past, the paper proposes a new infrastructure to collect and analyze adequate information from all financial institutions. The purpose of this program is to bolster the government's ability to foresee, contain, and, ideally, prevent disruptions to the overall financial services industry.

The paper's recommended requirements for information collection include quarterly reporting of asset positions and risks, a stan-

dardized process to measure asset valuations and risk exposures, sharing of information among regulatory agencies, release of such information to the private sector after an unspecified time lag, and regulator preparation of an annual "risk of the financial system" report. The information is expected to be detailed enough to allow regulators to identify significant counterparties of derivative positions, and aggregation of all the information is considered necessary to provide proper regulatory oversight.

A number of questions and downsides immediately come to mind in evaluating the paper's recommendations, which essentially call for increasing the cost and regulatory burden on financial institutions to design and operate a system to collect such information and on the government to provide the regulatory analytical and intervention infrastructure. First of all, such a proposal ignores the place of the marketplace as a regulator. The consequences of taking risk must be borne by those deciding to take on those risks, not by taxpayers. Failure needs to be punished rather than increasing the moral hazard of allowing government



bailouts to insulate risk takers from damage. Government bureaucrats don't have a sparkling reputation for managing whole industries, let alone individual enterprises. With all its faults, the U.S. system of capitalism has still resulted in the highest standard of living in the world.

Second, such an extensive new regime for gathering and disseminating facts ignores the current structure in place to inform investors, creditors, and the general public. It's hard to believe that the needs of regulators would differ so greatly from existing users of financial information. If the existing information structure is inadequate, then the disclosure aspects of U.S. Generally Accepted Accounting Principles (GAAP) should be modified, and auditors should be required to enforce them better.

Further, the paper fails to address the questions of validation and assurance. If audit firms aren't currently providing effective assurance that companies are disclosing their financial risks appropriately, such as the risk of having to sell at fire-sale prices or the risk of counterparty collapse, then the public accounting profession should be brought to task. A knee-jerk reaction toward more expensive and more intrusive governmental regulation isn't the solution for a lack of information.

Another study recommending increased governmental regulatory effort was published in January 2009 by the Group of Thirty (G30), a nongovernmental think tank of senior financial experts and prominent academics led by Paul Volcker, former Federal

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Reserve chair. Titled *Financial Reform: A Framework for Financial Stability*, the study notes the important role that mutual trust plays in the effective functioning of financial services intermediaries. Trust, of course, depends on a strong ethical culture.

The study's list of systemic flaws causing the current crisis includes weak credit appraisal and underwriting standards, extreme and sometime unrealized credit concentrations, misjudged maturity mismatches, the wildly excessive use of leverage on and off balance sheets that's often embedded in little-understood financial products, and unwarranted and unsustainable confidence in uninterrupted market liquidity. These causes demand total restructuring of the banking industry, not just adding new laws and more regulation on top of the existing pile. As is the

case with all controls, true reform must be built into the system. It can't consist of only add-ons.

In addition to recommending an overhaul of regulatory and governmental oversight, the G30 paper recommends that "institutional policies and standards must be strengthened with particular emphasis on governance, risk management, capital, and liquidity." What this means is that risks must be as transparent as possible to the relevant stakeholders in financial institutions. The more opaque the risks being taken, the more difficult it is for stakeholders to ascertain if there's reasonable balance between risks and expected rewards. Transparency is essential to maintaining the trust necessary for effective and efficient markets.

The G30 paper also recommends that organizations maintain a business (and ethical) culture that promotes discipline and a focus on long-run performance. Responsibility for this begins at the top—the board level—and must permeate throughout the firm. According to the study, if the complexities of governing and managing the global conglomerate financial services giants are too extensive because their disparate businesses are so diverse, "the argument for reducing the size and complexity of these organizations becomes relevant." The events at AIG almost exactly fit the description of a small unit away from headquarters whose actions brought down the largest insurer in the world.

In other words, G30 believes that in view of the aftereffects of the repeal of Glass-Steagall, legislation should be considered to require commercial-bank-holding

companies to divest their insurance and investment banking operations. Accountability and transparency—two ethical characteristics much needed in today’s frightening economy—can be achieved much more easily and effectively in less complex, less diverse, smaller financial firms.

Additional recommendations in the G30 study to mitigate the current financial crisis include enactment of pending accounting changes requiring on-balance-sheet recognition of many current financial products that are now off-balance-sheet. Transparency would be enhanced. Further, the study calls for badly needed reform of the framework used to determine credit ratings. Significantly, there is no current contractual relationship between the credit rating agencies and those who use the ratings. Consequently, rating agencies have so far escaped accountability in the courts for the quality of their ratings. Because the issuers of financial products being rated can “shop around” for the most favorable rating before engaging the rater, the resulting phenomenon is similar to Gresham’s Law (low-value currency drives out high value). Professional accounting ethics prohibit—or at least discourage—audit clients from shopping around among different firms for the most favorable interpretation of accounting principles.

The G30 paper summarizes the need for what it calls a “comprehensive overhaul of the national and international financial systems.” This means ethical requirements, not just more direct governmental action. Such an approach is greatly preferable to other piece-

meal initiatives, which are likely to add regulatory costs and complexities that outweigh their benefit.

The undesirability of direct regulatory intervention by the government is exemplified by the actions that are keeping AIG in what is essentially a holding pattern. Bailout funds (with their accompanying rules) have escalated to \$173.3 billion—with no exit strategy or end in sight. The often stated cause as “regulatory failure” rings hollow. As described in the December 2008 column, we shouldn’t only blame a “huge regulatory loophole” for the AIG fiasco, as Bernanke told the Senate. We must also consider the fact that the AIG audit committee, its board of directors, PricewaterhouseCoopers, and many in AIG’s management failed to do the jobs they have been tasked by law to perform.

Private-sector solutions, such as strengthening aspects of the Sarbanes-Oxley Act to restructure the banking environment, should be considered for solving the long-term challenges of the industry before adding on costly bureaucratic regulation. **SF**

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