

## Financial WMDs and the regulators

By C K G Nair and M S Sahoo, Last Updated: Nov 07, 2008, 12:16:00 AM IST

### Synopsis

Regulators must know the implications of organisational structures, products and practices of market participants.



Suddenly we have a new ⚡⚡⚡ planetary crisis⚡⚡⚡. The financial ⚡⚡⚡ tsunami⚡⚡⚡ struck the world with a force never seen in history; even the pace of the Great Depression of the 1930s was less dramatic, thanks to geographical barriers and technological limitations of the times.

The financial over-innovations, some of which Warren Buffet termed as weapons of mass destruction, have achieved a scale of global destruction in hours what the real sector over-ambitions could not even dream of in centuries! From state-of-the-art to ⚡⚡⚡state of nature⚡⚡⚡ could be a realistic description of what

happened to the Wall Street recently.

Interestingly, the neo-liberals who escalated unbridled high finance to its hallowed status have identified the culprit, the NINJA (no income, no job, no assets) loans! A handsome \$1.4 trillion worth(less) of it ⚡⚡⚡ housing loans to the ⚡⚡⚡bottom of the pyramid⚡⚡⚡, which became NPAs ⚡⚡⚡ while conveniently camouflaging in the footnotes the many an unknown trillion dollars worth of securitisation in the form of CDOs and many other exotic three letter pet names that have overnight became four letter nightmares.

If it was only \$1.4 trillion, the answer to the crisis would have been so easy ⚡⚡⚡ a write-off of a maximum \$1.4 trillion plus interest (in any case all the loans would not be NPAs). Like the farm loan waiver of India, which the neo-liberals criticised ad nauseam, which was indeed a master policy stroke that supports the notion ⚡⚡⚡the poor need grants, not loans⚡⚡⚡.

So, it is not the original home loans to the poor that were toxic, but the complex products that were mounted over them through greed-based financial engineering models; through over-securitisation and complex product innovations.

The ♦♦♦masters of the universe♦♦♦ were experts in alchemy (reminding the magical world of Gabriel Garcia Marques); in converting poor loans into AAA-rated instruments to be gulped up by the high finance agents everywhere. After all, they had to show ♦♦♦value addition♦♦♦ to support the astronomical pay and perks they commanded.

But why and how could the ♦♦♦greed merchants♦♦♦ take the world for a flight of fancy. This is episode two of the story ♦♦♦ the (in) action of the many empowered, autonomous regulators. Free from the democratic compulsions of elected governments they were to seek behaviour modification through appropriate incentive structures, identify stress points in time and take remedial action without fear or favour.

But alas, did they do that, or did they get over-awed by the beauty and complexity of the products evolved by the Wall Street? The flight of fancy presented by the Icarus was so alluring that the regulators forgot that even Daedalus objected to his son♦♦♦s wax-winged flight to the Sun.

While setting out to listen the ♦♦♦Sirens song♦♦♦ in the sea of liquidity, low inflation and high growth, the regulators, like Ulysses, ordered not only their own tying up to the mast of the ship but also their blindfolding and that too with no instructions to untie and remove the blindfold after passing the island of the Sirens. Now when the Sirens have some, there is no one left to free Ulysses from his self-ordered ordeal!

George Stigler talked of ♦♦♦regulatory capture♦♦♦ four decades ago when the regulators were not even independent in the modern sense. He warned that the regulators would gradually come to champion the cause of the regulated rather than the consumers, whom they are supposed to protect.

It is a regulatory capture of a greater magnitude that happened now when they not only supported the conflict-of-interest-ridden organisational structures and product over-innovations but also lightened the regulation and oversight of these entities and their activities.

It is indeed part of the behaviour modification agenda of the regulators that they need to look at the business models of finance entities for the potential conflict of interest. When an entity or related entities engage in multiple businesses ♦♦♦ as an agent of the buyer and seller; an adviser to investors as well as proprietary trader; as advisers as well as traders; raters as well as business seekers ♦♦♦ all are riddled with conflicts.

Identifying these conflicts and avoiding emergence of such entities are a first line defence of the regulators against possible systemic collapse. When one puts so much emphasis on know your client (KYC), doesn♦♦♦t the regulator have to know the entity and its business as well?

Regulators need to know the product churns out of the market. It is not that all the financial innovations, like that in real science, are economically and socially productive. Financial entities seeking greater profits will build new structures that would boost their bottom lines.

No harm. Sometimes products make entry in plain vanilla form but soon take on complexities. It is for the regulators to put them through the prism of economic and social value addition before allowing them entry to the market.

Any sign of toxicity, potential systemic concern, should be nipped in the bud like ♦♦♦terror futures♦♦♦ mooted by the Pentagon in the aftermath of 9/11. If there are knowledge gaps, only those products they understand should be cleared ♦♦♦ nothing will happen to the world if some of the financial innovations with unknown implications are prevented, but the opposite can be quite disastrous.

Remember the size of the potential moral hazard. Markets used to mock at the mention of moral hazard as a reason for discipline and the governments used to hate accepting its existence. But look what has now befallen many a countries. Moral hazard bigger than some of the big economies! Ultimately states, even in the most free markets, cannot fail its people and systems, while markets have only big profits and pay packets at stake.

It goes well for the regulators to remember this dictum and plan a regulatory game through well set principles. Like a chess master who sees many a moves in advance, regulators must know the implications of organisational structures, products and practices of market participants and ♦♦♦front-run♦♦♦ the financial Frankensteins rather than becoming their worshippers dazzled by their innovations.

A relaxed or self-tied up, or captured regulator joining the flight of the Icarus would only heighten the moral hazard rather than reducing it.

*(The authors are with the Union ministry of finance and Sebi respectively.)*