Taxpayers will fund another run on the casino

By John Kay

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Fannie Mae and **Freddie Mac** were probably the world's most heavily supervised financial institutions, subject to a specialist agency, the Office of Federal Housing Enterprise Oversight. The office employed 236 people at the time of its last annual report. OFHEO did not fail because it was understaffed or not well informed about Fannie Mae's activities, but because it lacked authority. The entire staff earned less in aggregate than Franklin Raines, the aggressive chief executive who masterminded Fannie's expansion.

Like Martin Wolf, I yearn for a world in which regulators would moderate the inherent instability of the financial system. But my yearning is tempered by modest expectations of what regulation can achieve. Martin's realism, which I share, acknowledges that public expectations are much higher and politicians will claim to respond to these expectations. But the politicians will fail. The next financial crisis will be different in origin and the rules that will be introduced to close the doors of today's empty stables will prove irrelevant.

It is easy to assert that the solution to any market failure is better regulation. If regulators were all-knowing and all-powerful; if they were wiser than the chief executives but willing to do the job for a fraction of the remuneration awarded to such executives; if they understood what was happening in the dealing rooms of **Citigroup**, **Merrill** or **Lehman** better than Chuck Prince, Stan O'Neal, or Dick Fuld; then banking regulation could protect us against financial instability. But such a world does not exist. Market economies outperform planned economies not because business people are smarter than civil servants – sometimes they are, sometimes not. But no one has enough information or foresight to understand the changing environment, so the market's messy processes of experiment and correction yield better results than a regulator's analysis.

In an imperfect world, the simple rules that Martin seeks have unanticipated and counterproductive consequences, as with the reserve requirements imposed under the Basel agreements. Reserve ratios were transformed from an internal discipline of prudent management to an external burden to be evaded when possible. Because these rules distinguished different asset categories, they opened the doors to regulatory arbitrage, fuelling the explosion of securitisation, which is at the root of current problems. Capital requirements proved ineffective in preventing banking failures and as soon as crisis struck, they proved counterproductive, forcing banks to constrain good lending to meet regulatory obligations. The proposed solution – of course – is further refinement of the regulations – to legislate against structured investment vehicles, to supervise the categorisation imposed by rating agencies and to introduce counter-cyclical reserve requirements.

In our debate in London last week, Martin used a forceful metaphor to describe the impact of the development of financial conglomerates – a utility is attached to a casino. The utility is the payments system that enables individuals and non-financial companies to go about their everyday business confident that they can make and receive payments, and lend and borrow to finance normal transactions. That activity needs to be protected from the consequences of the booms and busts that are an inevitable concomitant of securities trading in volatile markets.

There are two routes to this result. One is to separate the utility from the casino. Narrow banking prevents conglomerate institutions from relying on the assets of their unsophisticated customers as collateral for their highly sophisticated trading. Another approach regulates the casino sufficiently to ensure that failure there cannot jeopardise the utility. This latter outcome is not feasible and to come close to achieving it would end financial innovation.

The industry will successfully resist both the ring-fencing of everyday banking and the meaningful regulation of trading operations. Martin and I both recognise that in the next crisis, as in this, the taxpayer will step in to fund the casino in order to protect the utility.

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