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It is often said that the two motives driving the financial industry are Greed and Fear. In the current crisis, all the failures of the financial controls which can be identified in retrospect have a common element: in every case, the controls were absent or ineffective, and allowed « greed » to overcome « fear » in the financial institutions involved.

Greed overcame fear in the case:

-of the lenders in the American mortgage market who lent to insolvent borrowers then sold the loans without recourse

-of the investment banks who structured and sold securities based directly and indirectly on these loans, and sometimes parked them in off-balance sheet structures,

-of the rating agencies, who rated the securities on the basis of dubious models

-of the investors, including the proprietary trading desks of banks, who bought the securities on the basis of these ratings, and leveraged them with short-term funds.

What could or should regulators have done to avoid these excesses and the financial crisis?

First, let us keep in mind that the regulators of every financial activity - banking, insurance, fund management, capital markets, - are all national institutions, not international bodies. They have to control financial activities which are completely international: one of the banks with the largest exposure to the US mortgage market is a Swiss bank. International coordination of regulators works (at Basel for banks, the International Organisation of Securities Commissions, IOSCO, for capital markets, etc.) but these bodies can only issue recommendations and rely on national regulators to implement them. Furthermore, many national regulators supervise only one category of financial institutions, banks, brokers or insurance companies, for instance, while more and more products involve several sectors, for instance Mortgage backed securities.

I will focus on banks and credit, not only because it is my area of experience, but also because credit has been and will be at the heart of every financial bubble. And banks used to be the sole source of credit. They are not any more.

In classical financial theory, banks have to be regulated to the extent that they take deposits from the public, and therefore benefit from a public good, which is trust. Banking regulation has therefore focused on deposit taking institutions. And, at least in a number of countries (including the United States), banking regulations left out market funded financial institutions which do not take deposits from the public. This includes investment banks and mortgage banks, the two main players in the subprime crisis. Clearly, there is no longer a Chinese wall between customer deposits and financial markets, and most commercial banks are largely dependent on financial markets for their funding. This means that the first policy change that is needed after this crisis is a revision of the scope of banking regulations in every major country, beginning with the United States.

Still, having a unified regulator for all financial activities (as the Financial Services Authority in Great Britain) is neither necessary nor sufficient. The key control is that of credit at all its stages, and the control of banks in all their activities, including securitization, proprietary trading, asset and liability management, liquidity management. In many cases, the changes needed in terms of banking regulations are already being worked on within the framework of Basel II. But again, the implementation of changes in banking regulation will have to be done country by country, which is a more realistic approach than seeking the creation of a supranational regulator, and probably also more desirable. In the case of the United States, substantial legislative changes are needed to revise the structure of financial regulation, and they should be a priority of the next administration.
As for central banks, they have demonstrated that they can avoid a systemic crisis by coordinated and strong actions. But as much as they can be effective firefighters, they cannot replace regulators as gamekeepers. The real challenge for future monetary policy is the coordination between central bankers and financial regulators. When central bankers see the first signs of a financial bubble, when asset prices start to inflate beyond reason, they cannot, and possibly should not, try to stop asset price inflation through monetary policy. They should be in a position to make sure that financial regulators do their part. Otherwise, the entire economy would be made to suffer if monetary policy is the only tool that can be used to correct the inadequacies of financial regulation.