Regulation and Seismic Results

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The financial industry is one of the most, if not the most, regulated industries in the world. Now, post the "GFC" (Global Financial Crisis), more and more regulation is coming. It also covers a much larger group of businesses in the industry than ever before. The U.S. Congress passed a law for financial industry regulation, that has been met with mixed reactions from all sides. Governments around the world are rushing to create "stability" within the financial world. Certainly out of genuine concern, but also out of political necessity to do something to show they are doing something about something that already happened, so that the something does not happen again.

The fact is, it happened before and will happen again. It will not be for the same reasons, because governments will have a whole different set of structures that amazingly fail to protect the investor of the future. Will the financial industry be any less "greedy" after heavy additional regulation? Will grandma and grandpa gain greater profitability or any additional real security in their investment? The simple answer is that a bad deal is a bad deal, no matter how much regulation you lay on top. The regulations force structures and costs onto deals that are inherently non-economic. Finally, these structures, which are government-imposed only, prepare the investor and set the stage for the next crash.

For the last 20 years, manufacturers and other industries developed a totally different structure and process of doing business. Unencumbered by regulatory structures and systems, they moved, "at the speed of business", as one logistics firm advertises. In the meantime, financial institutions and the industry in general were stuck in the governmental regulations and limitations to adapt to the new environment. The GFC has more to do with the disconnect between the financial industry and the "real" economy than many economists care to admit.

Blame who you like, but people forget that mortgage-backed securities went bad because the borrowers could not pay the mortgage. Those people could not pay because they lost their job in the industrial U.S. Midwest. The problem spread across the U.S., and the financial guarantee, insurance from AIG, could not handle the massive loss of jobs and non-payment of mortgages.

Many of the mortgages that failed were part of a special program to encourage home ownership created by the federal government of the U.S.; it was part of the Community Reinvestment Act. Housing was being created where the people were, not where the jobs were being created. Businesses were sailing, while the financial structures, more focused on governmental regulations, could not change to properly support the new business model. The rift that came was of seismic proportions.

In a New York Times article, this premise is turned into an attempt to create a Richter scale for the financial world. One of the noted leaders in this process is Didier Sornette, Director of the Financial Crisis Observatory. No, not in Palo Alto, California, but at the ETH in Zurich. The global financial fault lines are far different from the geologic fault lines, but an analogy is much deeper than one first thinks. "Great earthquakes shape landscapes", says Dr. Sornette in the article. "Great crashes shape regulation, the perception of risk and the psychology of people." It is not surprising that the new regulations mark the largest change in the regulatory world since the Great Depression of 1929. Pressure builds up over time until the system, or fault lines, make a radical shift.

The U.S. Congress, after the Crash of '29, passed the Securities Act of 1933 and 1934, creating the Securities and Exchange Commission and starting the ball rolling towards the GFC. All the regulations in the world did not stop people like Bernard Madoff. Deals that were bad deals 5 years ago will still be bad deals 5 years from now, whether they are issued under Ucits 3, or, by then, Ucits 25 regulations.

There is certainly a need for regulation of the industry and the legislation after the Great Depression was much needed, but the reaction of governments this time will be critical to determine how financial institutions and the industry will be able to adapt to new economic processes and systems. A plane flies through the air with wings that are flexible. It is simple physics. Following that example, this time around, less is more.

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