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Due Diligence: Here a Regulator, There a Regulator, Everywhere a Regulator

By L. Burke Files, DDP, CACM, President Financial Examinations & Evaluations, Inc. (01/02/2015)

How did we come to this? How did we come to this oppressive weight of regulations and regulators?

I did some high end sleuthing and plied my subjects with wine, fatty food and cigars to loosen their lips and tell me the real story. I learned from this expensive research that at no time did any banking or finance professional say, "I want tons of rules and regulations and enforcer nannies with whips and bad attitudes." At least I think most said no... so again how did we get here?

Lets look at their view, the government's regulatory point of view. They see the; 1907 Knickerbocker crisis, 1929 Wall Street crash, 1974 oil embargo and collapse of Bretton Woods, 1987 Black Monday, 1986-89 S&L crises, 1997 Asian crisis, 2001 Dot com crisis, 2008 subprime lending crisis, and the 2009 European Sovereign Debt crisis. All were very serious events. The 1980's S&L crises saw over 1,700 institutions closed, 400 billion wiped off balance sheets at a cost of 160 billion, with 130 billion coming from taxpayers. In one crisis, the banks and S&Ls lost more money than they had ever made in history!

Now there are many theories as to what caused the crises, but I think all of the central theories of interest spikes, borrowing short term and lending long term, poor oversight, bad auditing, and good ole fraud are all correct. As in most crashes and red faced moments, many elements come together to precipitate a disaster. In that sense these crises were no different than others and neither was the response.

I have lived through the S&L crisis and six other crises. And after all of those crises, and the ones before, the government has passed a new set of laws that are promulgated into regulations in order to ensure that "It (it is vague term for a crisis)" will never happen again.

The response to any crisis is always the same. It starts with finding blame. Someone or some group of institutions must be blamed, properly vilified, then hauled out before the public eye and properly flogged by angry politicians whipped into an angry froth. These floggings are now called Hearings or Special Committee Reports. The agents of the crises are now banned or regulated out of existence. The public taxpayers' money is tasked to support the private markets. Those systems deemed essential are given state support since it is all so reasonable and reassuring that essential things are state supported. After all they are essential.

The problem is that after each crisis, laws are passed in response to the crisis but these laws are not passed after careful consideration. These ill-considered post crises laws that are passed in frothy haste become part of the permanent regulatory landscape. These laws are spawned from panic driven ideas, swirled in with the underlying aim of reducing risk in the market place, and protecting the voters. The legislators are asked by the news reporters what they are going to do about the crises, and by golly they know they must be seen as doing something. Action over substance is often their motto, if not their guiding principle.

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Financial regulations are born from a crisis. We owe the very creation of these laws to the crises that have occurred.

Unfortunately, in passing many of these laws, they attempt to remove an important feedback mechanism, called losses or fiscal pain. Pain is an essential feedback mechanism in life to let you know you are doing something wrong or you are injured. If something is painful then your attention to the pain will cause an appropriate action. If we remove the pain of touching a hot stove, how much more damage could we do to ourselves?

This is the same with investors. If they loan their idiot cousin Mallory US$1,000 because she promised to pay back US$2,000 in 10 days, and the loan is never paid back, it is likely they will never lend the idiot a dollar again. Now assume after the loan goes bad, they can run to a legislator and be bailed out by money taken from everyone else (taxes). The pain is removed and so is the important feedback mechanism of lending to "Mallory the idiot". With the pain of a loss removed you try it again to see if you can double your money this time at casino Mallory! If you win, great, if you lose you go back to the taxpayers. The regulations have become a bit of a fiscal anesthetic, the risk has not been removed – only the feedback mechanism.

Now that the public is numb with money, and the government is there to bail out the numb wallets – the governments have a right, in fact a duty, to protect themselves from the misbehavior of the participants in the financial markets. The governments pass the laws and promulgate the regulations – not to protect the public, but to protect themselves from having to bailout institutions that misbehave.

Since governments are spending money on bailing out bad banks, and are still doing so today, they need to collect tax revenue. According to the IMF, the worlds' biggest banks in 2011-12 benefited in the form of cash and explicit government subsidies to the tune of US$630 Billion.

So where does all of this money come from? Simple, the money comes from us and the governments need more money. The need for more tax revenue is the entire reason behind the OECD's FATF, The Patriot Act, and FATCA. Revenue needs to be recognized and once recognized it will be taxed.

So we have laws and regulations from nine major crises in my life time, each with their own regulators, to numb wallets to reduce risk and supposedly stabilize the financial markets, coupled with income recognition laws and regulations, to pay for the consequences of the legal and regulatory anesthetic. The regulators through less than thoughtful actions are the sources of the contagions as well as the addictive medicine for symptoms, no cures, just addictive pain killers.

There is also a serious cultural divide between the government regulators and the financial industry with their bankers. It is how different they think. It is a matter of fact that the members of government and the regulators tend to be liberal arts majors and very few have ever made something of value, such as creating a business or worked for themselves. They have always been the ones getting the paycheck and not the ones making the money to be able to meet payroll. They are risk and pain adverse and active seekers of security.

The leaders of industry, are as a rule, aggressive, are creators of value and are risk seekers. They live by their skill and wits and not everything they do is precisely calculated to succeed. They are not numb to pain or risk – which they experience every day of their careers. Pain is the feedback mechanism needed for them to understand where not to go. It is a real and big chasm of vastly differing thought processes to bridge.

So what happens…?

I watched the NASD in the 1970 and 1980 promulgate more and more regulations because of some real issues with fraud. They did not attack the fraudster so much as increase the regulatory burden on all broker dealers so that the fraud would never happen again. The NASD continually increased the regulatory burden and reduced the compensation available to small broker dealers. The small broker dealers were the primary sources of VC back in that time. The NASD killed the small independent Broker through regulatory burdens and caps on earnings. There was a great consolidation to the larger firms, as they could spread the cost of regulation over so many more productive units. Funny, the NASD was run by members of larger firms!

Today, I see no small IPOs. The small firms needing capital now go to private parties and private funds. If they do well, the private funds do well. The power of selection and the profits are ever more concentrated. All IPOs are from much more mature companies with the wealthy individuals and private funds harvesting a bulk of the profits of the success of the company upon the flotation. The very laws put in place to protect the average investor are directly responsible for the concentration of wealth.

The same is happening to banking.

The smaller banks suffer the same burden as the larger banks. They are greatly restricted on the types of investments made. In fact, they are actively skewed toward Tier One type capital, which is general sovereign debt or top rated securities. The banks have stopped most lending to small to medium sized entities. The regulators waste too much of the banks productive time going through loan portfolios and asking questions of the banks judgment for the banks to bother to accept the risk and burden of the regulator. Will the regulations and regulators do to small banks what they did to small broker dealers in the 1980s? That is currently the trend.

The regulatory burden is too great and is causing entirely too much economic friction. It has become a one-way mandate by regulators. In fact, a bit of research has shown almost no challenges to the regulators' opinions have been filed. The only two challenges that I am aware of in the US - the banks lost. I am more or less certain that with the current weight of regulations, financial institutions cannot do any business without some violation of regulations every day and with regulators becoming permanently ensconced in banks, banks will take fewer and fewer risks.

So what has been the response to the impact of regulatory caused market disruptions?

The old venture capital IPO has been replaced with centrally controlled venture funds and crowd funding (the positives or negatives of crowd funding remain to be seen).

The banks are consolidating to deal with the high costs of regulations, lending less and less, we are losing the small local bank and the lending function is being replaced by the 'shadow bankers'.

Part of this Due Diligence column is to suggest solutions. We do need some government regulation to provide for a level and honest commercial field, not to pick winners or losers and certainly not to back losers. Regulations need to be reduced if we wish to save the small banks and lenders. If we do not, keep coming with the regulations and do not forget to support critical fiscal infrastructure by bailing them out a few more times.

Regulators need to think about what they are tasked to do. They have become the bureaus of 'Make Wrong' toward their charges – the confrontational relationship has been established and it is bad, for both sides.

The regulated need to do better too. A few of the fines handed out in the last year were deserved, but that is in itself insufficient. The shareholders take a bath but management gets to stay? People need to lose their jobs and feel the pain of their bad choices – both management and shareholders, not just the shareholders

Regulations are a great deal like music and musical instruments. Well-coordinated, and in the right amount, they can be uplifting. Uncoordinated and with too many instruments– the audience will just plug their ears and walk out.