

# Financial Regulatory Reform: Is America the Next Greece?

**China New Finance Magazine (Beijing)**

**June 2010**

**Dr. E. Ted Prince**

Founder and CEO  
Perth Leadership Institute  
[www.perthleadership.org](http://www.perthleadership.org)

## **The Reforms Will Not Work**

America has put the world through a major economic stress test that almost became a catastrophe. After intense public pressure the US Government is now moving to reform the American financial system. My opinion: financial reform is badly needed; the reforms will be passed by Congress but will fail to prevent future economic crashes in the US. Furthermore they will mark the beginning of the end of US global financial dominance.

We cannot view healthcare reform and financial reform in the US as being separate and unconnected issues. The healthcare reform in the US is in conflict with the financial reform. Financial reform purports to reduce financial system risk. However healthcare reform increases it by massively increasing fiscal deficits. The real reason for the financial reform is to provide the US government with political capital that it lost in passing healthcare reform so that it can improve its chances in the November 2010 elections.

What I call the “over-developed countries” (the “ODCs”), the most important of which is the US, are approaching a series of major economic crises in which their massive fiscal deficits will lead to their long-term demise. Financial regulation is not taking aim at the right target. The real problem is not just the private sector in the US and the developed countries. It is their public sectors and governmental agencies, the irresponsible fiscal behaviors of these public sectors and the sophisticated methods they have adopted to conceal these problems by manipulating governmental statistical systems. Unless this problem is fixed, no financial reform can be successful, either in the US or in any other country.

## **Proposals Look Great, But What About Execution?**

At first blush, the reforms hit all the right notes. The package of measures includes major new regulation of financial companies and financial markets. The banks must increase their capital. There will be more transparency in the markets for derivatives and exotic financial instruments. The US government’s role as a backstop in case of system failure is now finally crystallized and formalized. There are regulations to protect consumers and investors from rapacious traders and investment banks. There are numerous other policy initiatives which, surely, must make the US financial markets a vastly better and safer place to be.

But even the package as proposed contains some warning signals to those experienced in the ways of government and politicians. I used to work in government. When we didn’t want to actually do anything about a problem, but we wanted it to appear like we were doing something, we would propose a study of the problem. When you do a study in government, nothing happens. That is because all parties are represented, there is no consensus and therefore nothing is

decided. Vested interests start lobbying the politicians who are persuaded to do nothing. And this all takes a lot of time so gradually the public gets bored with the issue and it just dies a natural death with nothing actually happening.

The package of reforms several proposals for studies. These include, amongst others:

- To study what to do about Fannie Mae and Freddie Mac, the two Federal housing agencies that arguably created the whole mortgage mess.
- The Treasury to re-examine capital standards for banks
- The SEC and the CFTC to create a report about who regulates what.

So we can be pretty confident that nothing much will happen in these areas or any other areas, particularly with the mortgage agencies. Yet the mortgage agencies are the biggest financial liability for the US Government with trillions of dollars in liabilities. At one stroke, this stratagem enables the biggest liability problem in the US to be shelved.

Experienced government analysts also know that there is certain language that usually means that the government agency can take action according to its own discretion. This language is typically of the form "They [particular government agency] are urged to do {a particular good thing}" This language typically is interpreted to mean that either the agency can water down the measure, or not do anything at all. Many of the measures include language of this kind. For example one "urges" the SEC take actions to include transparency in the markets and to include its regulation of credit-rating firms. Notice that this language does not say that the agency "must" do something. It merely recommends that the agency do it, meaning that the agency is free not to do it if it can devise apparently credible reasons not to do so. Many of the proposals that are in front of Congress are of this form. In some cases the agency may indeed do something. In other cases we can be sure it will not.

And there are some other more specific issues that the measures do not address. For a start, they do not map out a specific path to address the problem of the ratings companies. These companies were instrumental in causing the economic meltdown through ratings that were simply false. The ratings companies created ratings for mortgage and other companies based not on their intrinsic value but on the basis of attracting clients and revenues for the ratings companies. It is an open secret that what the ratings companies did was fraudulent but the measures in the reforms do nothing to address this inherent conflict. Even now, US government agencies including the Federal Reserve make ratings from these companies a necessary component for selling financial instruments in the US markets. This is one of the more incredible gaps in the reform measures.

Nor do the reforms address what to do about Fannie Mae and Freddie Mac, other than setting up a "study" to look at the problem. Yet these agencies were also instrumental in causing the economic mess by over-promoting subprime mortgages. And they are still doing this even now. The fact is that both major US parties, but particularly the Democrats see these agencies as being instruments of social policy, as a redistributive financial mechanism, not as an economic mechanism. These two agencies have massive, off-balance sheet liabilities that endanger the US economic system both now and in the future. The proposal for a study shelves this problem yet again. We can be confident that these two agencies will play a prominent role in causing the next US economic crisis.

This is all a huge pity. The US does need financial reform and it needs many of the things that it proposes. But, as I will show below, the reforms will not work because fundamentally they take the wrong approach. And also because they are taking place in what is fundamentally the wrong financial and political environment not only in the US but globally in the developed countries.

## **We Have Seen This Movie Before**

But there is worse. There have already been a series of financial regulatory reforms in the US in the past 10 years, based on a similar approach that did not work. After the technology bust of the early 2000s the US Congress passed the Sarbanes-Oxley ("Sarbox") law that was designed to prevent future economic crashes based on risky market behaviors. This law imposed major new regulations on public companies and strengthened auditing and compliance in them. In so doing it greatly increased the costs of doing business, particularly for small public companies.

Sarbox did not prevent the recent Great Recession. There is a school of thought, to which I belong, that says this law actually helped create the crisis. It did this by making market participants over-confident in the belief that with increased audit and compliance laws, the level of market risk had actually been reduced to the point that an economic crisis could never occur again. Clearly, whatever one believes, Sarbox did not prevent the recent economic problems. Yet the current package of financial reforms is based on the same premise that more regulations, laws, compliance and government oversight will prevent future financial crises.

In fact Sarbox not only did not prevent another financial bust, it also created many other problems. It made it more difficult for a company to go public. It made it more difficult for smaller public companies to raise capital. It led to large companies gaming the compliance system by using legalistic methods to hide liabilities in off-balance sheet entities. It led even the audit companies to approve transactions that should not have been approved – for example Ernst and Young approving clearly fraudulent transactions by Lehman Brothers just before it failed. It led to a reduction in foreign companies going public in the US because of the onerous and expensive compliance procedures they would have to adopt by going public in the US. Not only were Sarbox financial reforms unsuccessful in achieving their main objective, they also led to a severe deterioration in the overall financial environment in the US, making it less competitive in the global financial marketplace.

Sarbox is a lesson in the law of unintended consequences. Often regulators and leaders impose regulations and laws that have the opposite effect in practice to what was intended by them. Sarbox was meant to prevent future economic crises. However it probably actually made them more likely. Sarbox was meant to make the financial environment more attractive by making it safer. In fact it led to deterioration into the US financial climate and to many overseas companies avoiding the US to operate and go public in more attractive financial environments.

The current financial reforms look suspiciously to me like Sarbox. I think there will be some major unintended consequences of the reforms if they are passed. For one I think it will discourage financial innovation in the US and will lead many US financial companies to leave the US. It will lead to many innovative financial professionals to go to other countries where they can be more free to pursue financial innovation. It will result in a lower rate of formation of financial companies and less competition in the financial markets. Many other companies will take less risk and this will lead to lower returns in the US as a whole. Companies will spend more effort in gaming the regulations so that they appear to be in compliance with the new reforms, even when are not in compliance with their spirit, which was what happened with Sarbox.

As a result more capital and more financial expertise will move away from the US to other countries. The countries they will move to will be those that have less regulated environments and which encourage financial innovation. I don't know who they will be, but they could include countries such as Israel, Singapore, Dubai, the Baltic counties such as Estonia and Latvia, possibly even China if it does the right things. But the bottom line is that the proposed financial reforms are likely to the beginning of the end for US financial market dominance. They will mark a transition where that dominance is assumed by one or more other countries that take advantage of this opportunity to create better financial environments that allow for more innovation within an appropriate risk environment.

## **Treating Symptoms, Not the Disease**

The fundamental problem of the financial reform is that it focuses on treating symptoms, not the disease. The fundamental problem in the US financial system is that most market players take the view that it is perfectly acceptable to make money even if it makes most people worse off, even including bankrupting their own company. As long as behavior can be made to appear legal, it is acceptable.

Just as China's innovation problem actually has its roots in its education system, so America's financial problem also starts in the US education system, and particular in the system of business education at the graduate level. The root cause is education at the MBA level. This system teaches financial engineering focused on manipulating numbers to get the right result rather than in creating true value for everyone.

The US financial system has a legalistic and formalistic bias that encourages risky behavior as long as it can be made to appear legal, that is, in compliance with legal regulations. Since private sector lawyers are almost always better than government lawyers in the US, this encourages financial companies to game the system. They know that if the government takes legal action against them, they can win in court even if the spirit of their actions is wrong. And if they look like they might lose, then they can lobby the politicians to get a change in the laws.

Nowhere in the regulatory measures is any proposal to address the root of the problem, which is risky behavior and its encouragement by the US system of business education. Even though a new discipline of behavioral finance has emerged in the last few years that addresses this issue at the academic level, almost no schools in the USA teach behavioral finance. The US reforms focus on legal and compliance measures, not on behavioral approaches, education, and training in values that would discourage taking risky, antisocial behaviors. Until financial reform focuses on behavioral rather than legal approaches the overall system cannot be fixed or even improved. Any reform will eventually be gamed by its players and the same financial problems will recur.

The result, therefore, of the reforms, is that the sum is less than the parts. Keynes called this the error of composition. This is the error of believing that a lot of good things makes the sum of them even better. In fact, often the reverse is the case.

In the case of the reforms, more is worse. The reforms should have taken a behavioral approach based on education and cultural values and buttressed it with minimal legal support. Instead it has gone the other way, assuming that behaviors can never be changed and relying on a command and control approach that bureaucrats love. These rarely work in complex systems like the US financial system. Until we tackle the problem of self-seeking behaviors at their source, we can never change the situation by brute force.

## **Private Sector Bad, Public Sector Even Worse**

But there is something even more fundamental that will prevent the current proposals from being effective in the long-run. That is the problem of public sector financial reform. The package of reform proposals does not even come close to tackling this particular issue.

The first problem is government spending which is increasing rapidly in the US. The rate of increase in spending in the US is unsustainable and it will eventually force up bond yields. This will reduce the effectiveness of the financial sector by crowding out private investment, and lead to less capacity by the US government to act as a backstop against the type of economic failure we had in the last two years. Even if the financial reforms do allow the US government a formal role in acting as a backstop to failed financial institutions, they can have no impact if the US government lacks the financial capacity to step in to save the banks. Legal backing is no use if the financial strength is not there.

Another driver of public sector spending is the public sector mortgage agencies whose real and massive liabilities are not included in official government liabilities. Another is the unfunded pension liabilities of both the federal government and also the State and local governments in the US. They have run up massive fiscal deficits that are not counted in the official statistics on government debt and liabilities. Lately new regulations have allowed us to know how much they are but they are still not counted as part of government debt. Furthermore almost all government agencies in the US use optimistic assumptions to hide the real level of liabilities they have on their books.

Why do they do this? Because the liabilities are to union members and these unions have lots of political power and so can vote against any political leaders who want to do what is right, that is include them in their official government liabilities.

Why should this be seen as part of financial system reform? Because if we prevent busts in the private sector (which this article thinks is not possible with these reforms anyway) it won't stop the public sector moving towards a massive bust. But this time, you can't bail out the government because there is no government behind the US government to clean up the mess. In other words, the even bigger bust we need to prevent is a fiscal blowout by the US public sector – both federal, State and local.

In fact, viewed from this perspective, the US is just another Greece in the making. Not this year or even next, but at some time. The US has the same fundamental problems as Greece and many other European countries where massive debt has accumulated in the public sector but where creative accounting has obscured what is really going on. Of course Greece is just one example but there are similar problems of pension and other debt that is not being recognized in the countries of the European Union as well as in the US.

I like to call this the problem of the Over-Developed Countries, or ODCs. ODCs are developed economies where short-term thinking has become so endemic that statistical systems have been manipulated so that the true liabilities are now known. This is especially true of retirement liabilities. Politicians and public sector leaders do not want them recorded so that those who do not benefit from such retirement benefits are not aware of the scale of the problem and so do not know to punish their leaders for allowing this problem to continue.

The ODCs include the US and many of the countries of the European Union. Some of the EU countries, just like the US, have been manipulating their financial results so that they are in compliance with EU rules. This is why we are seeing such financial problems right now in Europe.

In Europe it is much clearer that the real and fundamental problem is the public and not the private sector. Indeed these countries are similar to many US investment banks that set up separate off-balance sheet entities in order to conceal debt which would have put them out of compliance with regulatory rules. The market has belatedly realized that the European countries are all a fiscal time-bomb that at some stage will explode. The market is saying that the real risk problem is with the governments of these countries, not their banks and financial institutions.

In most of these countries a combination of overspending on welfare programs, pensions and health care has led their public sectors to be essentially bankrupt. However their leaders have successfully concealed this situation both from their own citizens and, until now, financial analysts. All of the European countries, even including Germany and France, have been manipulating their statistical systems for years to conceal their true financial state. This is why Germany and France defeated a proposal from the EU Secretariat some years ago to set up an independent watchdog to monitor the statistical systems of the EU countries.

The US has the same disease in the public sector. The biggest concealed disaster to date is the pension systems for unions and public workers which are underfunded by trillions of dollars. To this debt we will soon need to add health care costs for a vastly expanded health care system.

The liabilities of these retirement systems especially for public employees dwarf the liabilities that are incurred in any economic crash by the private sector.

But the US government is not touching this one because it is too explosive politically. It owes its union supporters a favor so this problem will not be touched in the current regulatory reform. The current package of proposals could be passed in its entirety but this would not impact the unfunded pension problem and the fiscal deficits that are looming in the future for both the US and many other ODCs.

In many ways this resembles health care reform. Health care reform has massive social benefits but huge negative economic and financial consequences. Most of these negative consequences have been deliberately obscured because if the public really understood what they were and the consequences for succeeding generations, they would not support the reform. Financial reform in the US is deliberately ignoring the issue of government fiscal deficits because this would result in many current political leaders being voted out of office in the forthcoming November 2010 election. The current package of reforms is politically very positive for the Democratic government because people are angry about the bailouts of the banks and the current US government will benefit in the elections from being seen to be punishing the banks.

### **Health Care Reform Undermines Financial Reform**

This raises another major issue. The US Government has just passed the health care reform. This will lead to massive spending increases. We need to recognize that health care reform is in fundamental conflict with the current financial reform.

Financial reform aims to cut risk in the overall financial system and to raise capital reserves. However health care reform raises financial risk by creating massive spending increases and adding to fiscal deficits in an environment where there is little or no incentive for consumers to curb their own demand for health care.

As we see clearly now in Europe, public sector over-spending eventually leads to spillover effects in the overall financial system including a huge rise in risk premiums. This is one reason why ODCs get to be that way; their spending on health care, if not accompanied by fiscal discipline and good consumer financial behaviors, leads to increasing fiscal problems. This is the situation of France and most of the old members of the European Union with the exception of Germany, which alone in the EU is not an ODC.

It is significant that the US public has been generally more opposed to health care reform than in favor. This almost certainly reflects the recognition by the US public that health care costs under the reformed system will be unsustainable and lead to higher taxes and other fiscal problems. Only 22% of the US public approve of the job that the US Congress is doing. Some of this reflects a general dissatisfaction with the political bickering between the two main parties which stalls any chance of good government. But some of it also reflects the belief by the US public that the US Government and Congress are not good steward of taxpayers' monies and that they are creating a high-level of long-term financial risk.

Significantly, the US public ranks fiscal laxity by the US government and Congress as being the single biggest problem in the country. In other words, the US public recognizes the huge risks which are building up in the US financial system even if the US Government and Congress do not. Health care reform is a key part of that increased risk.

Viewed from this perspective, the US government is pushing financial reform because it is popular with the public and will help it in the elections later this year. This is also why it is taking legal action against Goldman Sachs, even though Goldman actually helped save the US financial system itself by managing to succeed where almost all other US investment banks had failed. Pushing this issue of financial reform will help it counter-act the lack of popularity of health care

reform and hopefully lead US voters to forget their concern about the fiscal problems of the health care reform. The proof of the pudding will be in the eating. The big issue now is how hard the US government will push financial regulation after the election has been held, or even if it will push it at all once the elections are over.

### **The Bottom Line – Conventional Thinking Leads to More Conventional Busts**

Individually there is almost not one proposal in the financial reform proposals that I would disagree with. Almost all look great. Viewed in isolation they should work really well.

But life is not a textbook. Things usually don't work the way they are intended. Existing social and political interests work to keep things the same way they were before. And if you change laws and regulations but you don't change behavior, educational systems and culture, you won't get reform.

Sure reform is difficult especially the reform of the world's largest financial system. And sure you have to start somewhere. But you have to look at the lessons of the past. These are not hopeful. Recent financial reform has failed and this set of reforms is taking the same approach as the last set of reforms, stressing laws over changing behaviors. The only difference this time is that many more regulations are being proposed. That is not a good sign.

And the reforms do nothing to reform public sector financial systems and spending, which are probably the biggest problem of all. Public sector methods of measuring their financial performance and results will not change, nor the public sector's spending practices. Even if private sector risk goes down, which I personally doubt, the US public sector's risk is still rising rapidly, probably beyond European levels.

And not only the risk profile of the US public sector is rising rapidly. The risk profile of all the public sectors of the ODCs is also going up. That means the global risk from public sector financial systems is rising at the same time. That means overall higher global financial risk, no matter how much reform the developed countries carry out within their private sectors.

And health care reform, apparently not connected, actually makes things worse. With one hand the US government reforms claim to reduce private sector financial risk. But with the other hand, health care reform actually increases overall risk significantly by increasing public sector risk. If private sector risk does not actually decrease significantly as a result of the reforms, which I believe is the case, then overall system risk will go up significantly in the US and globally. In that case we can expect to see significant fiscal risks in the developed countries at the same time as their private sector risks are going up too.

Of course mine is not the usual view in the US. Most people think that reform is badly needed and will work. But that is exactly what the experts and the public said about Sarbox 8 years ago and both the public and the experts were absolutely wrong. Only three years ago the experts said that a recession or economic catastrophe was impossible. Beware the experts and think for yourself. You might reach a far better judgment if you ignore the experts.

*Dr. E. Ted Prince, the Founder and CEO of the Perth Leadership Institute, located in Florida in the US has also been CEO of several other companies, both public and private. He is the author of 'The Three Financial Styles of Very Successful Leaders (McGraw-Hill, 2005) and numerous other publications in this area. He is a frequent speaker at industry conferences. He works with large corporations globally on leadership development programs and coaches senior executives and teams in the area of financial leadership. He holds positions of Visiting Professor at the University of Florida in the US in its Graduate Business School and also at the Shanghai University of Finance and Economics in China.*

