



Lombard Street

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The collapse of the world's financial markets has resulted in intense examination of how to restructure and reform regulation for banking, securities, insurance, and other parts of the financial services industry. Various regulatory proposals are already being circulated in academic and public policy circles. Governments around the world are considering reforms. The conversation and decisions surrounding these proposals will fundamentally impact how financial services is structured and conducted across the globe throughout the 21st century.

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From the Editor

We are pleased to present excerpts from Judge Richard Posner's new book, *The Failure of Capitalism: The Crisis of '08 and the Descent into Depression*.

Posner is not an expert on financial markets or their regulation. He's not a finance professor, nor an economist by training. He hasn't been a regulator either. Posner is a judge of the Seventh Circuit Court of Appeals based in Chicago. His opinions, which he writes himself, are some of the most widely cited in the judicial system. He is a prolific writer on varied topics from sex to terrorism.

Most importantly, for the current debate, Posner is one of the founders of the important discipline of law and economics which has revolutionized legal thinking, and the direction of judicial decision making, by showing how economics can provide deep insights into how the law does and should work. His career has been built on a certain faith—hardly blind—in the important role of markets—and capitalism generally—in advancing economic growth and prosperity.

Thus, when Judge Posner concludes, as he does but with more nuance than the title suggests, that capitalism failed and that the government must play a significant role in regulating financial markets, any serious person must take notice and consider his arguments and evidence carefully. In the end almost everyone will disagree with something in Posner's short and rapidly produced book.

— David Evans

For more information about contributing to Lombard Street, please contact info@finreg21.com

Book Excerpt: A Failure of Capitalism

By Richard A. Posner, Circuit Judge, US Court of Appeals

The world's banking system collapsed last fall, was placed on life support at a cost of some trillions of dollars, and remains comatose. How could it have happened after all we've learned from the Great Depression? In these excerpts from his latest book, noted author and jurist Richard A. Posner presents a concise and non-technical examination of this financial disaster and the stumbling efforts to cope with it.

Excerpted from A Failure of Capitalism: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION, by Richard A. Posner, published by Harvard University Press Copyright © 2009 by the President and Fellows of Harvard College

The Underlying Causes

Conservatives do not agree that the economic emergency is a failure of the market to internalize the costs of an economy-wide catastrophe. They argue that the cause was government. They point to legislative pressures on banks to facilitate homeownership by easing mortgage requirements and conditions, to which could be added the deductibility of mortgage interest payments and interest on home equity loans, along with real estate taxes, from taxable income and the repeal in 1997 of capital gains tax on most resales of residential property.

I examine some of the legislative pressures later. For now it is enough to note that small-government conservatives, at least those who were in power, were happy with these policies—President Bush pushed homeownership as a cornerstone of the “ownership society” that he advocated as part of his political philosophy of “compassionate conservatism”—until a governmental scapegoat was needed to explain the depression. The housing bubble and the risky lending practices could have been prevented by more aggressive regulation and the elimination of tax benefits for homeowners. But the absence of these or other preventive measures was the result not of too much government but of too little: not of intrusive, heavy handed regulation of housing and finance but of deregulation, hostility to taxation and to government in general, and a general laissez-faire attitude, “conservative” in a currently prevailing sense of the word. Conservatives wanted taxes to be lower rather than higher and regulation to be lighter. They considered markets

to be self-regulating, from which it followed that bubbles, risky lending, defaults, and other market perturbations would be self-correcting unless the government interfered. (In an older sense of “conservative,” risky lending, risky borrowing, heavy indebtedness, bubbles, and speculation would have been thought antithetical to a conservatively managed economy.) There is an illuminating analogy to industrial pollution in capitalist society. Suppose government provides no remedies at all (whether judicial or administrative) against harms from pollution. Then rational profit-maximizing producers, in deciding how much to pollute, will not consider the effects of their pollution on people with whom they have no actual or potential contractual relationship (as they do with their workers). Yet when those effects are taken into consideration the social costs of pollution may exceed the cost savings from not doing anything about it.

If government refused to do anything about pollution, one could call its refusal a “cause” of the pollution if one wanted, but a more illuminating formulation would be that the government had failed to do anything about pollution caused by industry. Similarly, the social costs of a recession or depression are external to the rational self-interested decision-making of financial institutions because nothing an individual firm can do will avert such an event. The aggregate self-interested decisions of these institutions produce the economic crisis by a kind of domino effect that only government can prevent—which it failed to do. That was a grave government failure, which allowed a failure of the financial market to produce disastrous consequences for society as a whole. The roots of the failure lay in widespread dissatisfaction, beginning in the 1970s, with public-utility and common-carrier regulation, and other forms of economic regulation as well, including the regulation of banking and investment. The economists who inspired the deregulation movement were not macroeconomists and did not differentiate between banking and other regulated industries, such as railroads and airlines. They were not alert to the macroeconomic implications of competition in banking; and macroeconomists, as we shall see, thought that the problem of depressions had been solved.

We must not ignore the costs of regulation. Some market failures cannot be corrected at a cost less than the social cost of the market failure, and it is best to ignore them. But are depressions such a market failure? They are not, even if we could be confident that a depression would occur only once every eighty years (this year is the eightieth anniversary

of the stock market crash of October 1929), and of course we cannot be. The Great Depression of the 1930s inflicted horrendous costs, quite apart from the suffering inflicted on tens of millions of Americans, not to mention—since it was a global depression—more tens of millions abroad. Among the costs, as conservatives should take note, were the excesses of the New Deal. And without the depression there might have been no Nazi Germany and no World War II. The costs of the present depression may include a swing to excessive regulation, a politically as well as economically unhealthy dependence of business on government largesse (I give an example later, involving Citigroup), a huge loss of economic output, an immense increase in the national debt, a high inflation rate, a decline in U.S. world economic power, a weakening of the nation's geopolitical power as the country turns inward to address its economic problems, and increased political instability in many parts of the world. It may turn out that if the asset-price bubbles of the last decade are subtracted from measures of economic growth, the U.S. economy will be adjudged to have been stagnant—that rather than being productive during this period, Americans were living on borrowed money.

Why a Depression Was Not Anticipated

As in the lead-up to the attack on Pearl Harbor, so in the lead-up to the financial crisis that struck in September 2008, most competent analysts disagreed that the economic prospects were as dire as Roubini and the other “Cassandras,” “alarmists,” “Eeyores,” and “prophets of doom” (notice the absence of a neutral term for someone who warns of disaster—there is no noun “warner”) were contending. For all the reasons I have mentioned, most people, even most experts, were unlikely to be persuaded by the doomsters. But it is unforgivable that the government, though alerted by them beginning in 2005 to the signs warning of a possible economic catastrophe, did not deploy its formidable resources to study the issue in depth. The explanation may be the absence of a machinery (other than the market itself) for aggregating and analyzing information bearing on largescale economic risk. It is a machinery the Federal Reserve and the Treasury Department could have created, and presumably would have had they not been overconfident that another depression could be prevented more or less effortlessly even after a financial crisis hit, just by a lowering of interest rates.

Little bits of knowledge about the shakiness of the U.S. and global financial systems were widely dispersed among the staffs of banks, other financial institutions, and the regulatory bodies, and among academic economists, financial consultants, accountants, actuaries, rating agencies, mortgage brokers, real estate agents, and business journalists. There was no financial counterpart to the CIA to aggregate and analyze the information—to assemble an intelligible mosaic from the scattered pieces. More precisely, no agency assumed that role, though the Federal Reserve, the Treasury Department, or even the President’s Council of Economic Advisers might have done so. Much of the relevant information was proprietary and therefore shielded from journalists and academics. Investment banks, hedge funds, mortgage originators, and other financial firms conceal information about business strategies that might help competitors, and avoid, as far as the law permits (and sometimes farther than it permits), disclosing adverse information about the firm’s prospects. Even the regulatory agencies lacked access to much crucial information about the financial system, because of limitations on their authority that were thought appropriate in an era of triumphal deregulation.

Lacking authority to regulate the new derivatives, financial regulators could not force disclosure of information that might have revealed how risky the financial system had become. At its peak, the market in credit-default swaps was larger than the entire U.S. stock market (though that is misleading, because swaps are largely offsetting—if an insured event comes to pass, the liability of the issuer and the claim of the purchaser should cancel, as in my A-B example in Chapter 2). And because the issuers of the swaps, unlike conventional insurance companies, were not required by law to maintain adequate (or for that matter any) reserves, there was no protection against the kind of run that brought down AIG, leaving the buyers of the swaps uninsured. Home financing was regulated, but by different agencies from those that regulated banks; hedge funds were barely regulated at all.

What We Are Learning about Capitalism and Government

Capitalism will survive the current depression as it did the Great Depression of the 1930s. It will survive because there is no alternative that hasn’t been thoroughly discredited, which wasn’t as clear in the 1930s. It is clear now. The Soviet, Maoist, “corporatist” (fascist Italy),

Cuban, Venezuelan, etc. alternatives to capitalism are unappealing, to say the least. Yet capitalism may survive only in a compromised form—think of the spur that the Great Depression gave to collectivism. Spawned in the depression, the New Deal ushered in a long era of heavy-handed government regulation of the economy; and likewise today there is both advocacy and the actuality of renewed regulation and an impending increase in the size of government. Hence, the importance of the question whether government may have been responsible for the current crisis. For if so this would be a powerful argument against reregulation—against the new New Deal that liberal economists like Paul Krugman and Joseph Stiglitz are dreaming of—though not an argument that would have much political traction during the present emergency.

I have already indicated my doubts that the government bears the basic responsibility for causing the depression. As far as one can judge on the basis of what is known today (obviously an important qualification), the depression is the result of normal business activity in a laissez-faire economic regime—more precisely, it is an event consistent with the normal operation of economic markets. Bankers and consumers alike seem on the whole to have been acting in conformity with their rational self-interest throughout the period that saw the increase in risky banking practices, the swelling and bursting of the housing bubble, and a reduction in the rate of personal savings combined with an increase in the riskiness of those savings. The market participants made plenty of mistakes, but that is par for the course. Whenever has it been different? Economic life is permeated with uncertainty. The media are having a field day exposing instances of financiers' malfeasance, misfeasance, folly, and seemingly egregious extravagance. Sometimes they misunderstand what they denounce. An example is the thunder of criticism of John Thain's \$1.2 million redecoration of his office suite when he became CEO of Merrill Lynch, months before Merrill Lynch's swoon into the arms of Bank America. Companies that raise billions of dollars, some of it from immensely wealthy investors, have a legitimate business interest in decorating their quarters in a manner apt to impress such investors. The financial crisis was indeed the consequence of decisions, some mistaken, by financiers. But the mistakes were systemic—the product of the nature of the banking business in an environment shaped by low interest rates and deregulation rather than the antics of crooks and fools.

Laissez-faire capitalism failed us, but government allowed the preconditions of depression to develop and wreak havoc with the economy. And its responses to the crisis were late, slow, indecisive, and poorly articulated. The responses also created “moral hazard” (the tendency to engage in risky behavior if one is insured against the consequences of the risks’

materializing). They did this by eliminating the limits on federal deposit insurance of bank deposits and by extending that insurance to checkable accounts in money market funds, but more important by bailing out failing firms deemed “too big to fail”—an incentive for corporate giantism and financial irresponsibility (which go hand in hand because the difficulty of controlling subordinates grows with the size of an organization). The government gratuitously disrupted the operations of hedge funds by limiting short selling—at the height of the banking crisis the Securities and Exchange Commission forbade short selling of financial stocks. And by substantially increasing the federal deficit, the government’s responses to the crisis are sowing the seeds of a future inflation. But of these criticisms, the main ones—the creation of moral hazard and the planting of the seeds of a future inflation—concern the unavoidable side effects of any effective measures to limit a depression.

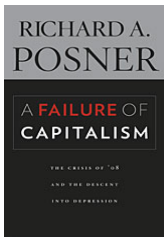
Conclusion

What is inexcusable is the failure of the Federal Reserve and other economic agencies within the federal government to have prepared contingency plans for the possibility, remote as it seemed, that a crumbling of the banking industry would set the stage for a depression. When the financial crisis hit in mid-September 2008, the government was unprepared and responded with a series of improvisations that did avert the most catastrophic imaginable consequences of the crisis but could not avert a depression. The improvisations were bumbling, incoherent, poorly explained; the President seemed absent, so far as attending to the economy was concerned, during the critical period. Even now, four and a half months after the crisis hit, the government has no coherent plan of recovery. In the absence of such a plan, it is, or soon will be, trying everything at once—flooding the economy with money, which may not work, as I argued in Chapter 5; trying to restore output and employment by massive deficit spending, which may not work either; bailing out the banking industry—or perhaps confiscating much of it (“nationalization”) (odd how saving the industry and swallowing it are discussed in the same breath); reforming the regulatory framework and as part of the reform perhaps consolidating the myriad agencies that have a piece of the financial regulatory pie; and relieving mortgagors of some of the burden of their mortgages. All are measures with strengths and weaknesses that cannot be gauged in advance; all suffer from having to be adopted without having been thought out in advance; some, such as regulatory reform, are overly ambitious. And doubtless there is

more to come. The atmosphere is electric with proposals for economic recovery—so many that the government may lack the intellectual resources to evaluate them.

I am not a forecaster. I do not know when the recovery from this depression will begin. But if it begins tomorrow, the trillions of dollars that the government has spent to speed recovery, and the restructuring of banking and its reform that will bring in their train untold problems and uncertainties, will overhang the economy for years to come, as when an expensive treatment cures a deadly illness but leaves the patient debilitated.

About the author



Richard Allen Posner is currently a judge on the United States Court of Appeals for the Seventh Circuit in Chicago. He helped start the law and economics movement while a professor at the University of Chicago Law School; he currently serves as a senior lecturer at the Law School. Posner is the author of nearly 40 books on jurisprudence, legal philosophy, and several other topics. He is considered to be one of the most respected judges in the United States and one of the most cited legal scholars of all time.

A Failure of Capitalism can be purchased from [Harvard University Press](#).

The Enforcement Problem with Regulation Reform

By Arthur Long, Financial Institutions Group, Davis, Polk & Wardwell

In addressing regulatory challenges posed by the financial crisis, a central question will be how much effort should be allocated to creating new rules for financial institutions and how much effort should be allocated to enforcing existing ones. To date, the principal focus has been on the creation of new rules – new rules on mortgages and predatory lending, new rules reorganizing the federal financial regulators, even new rules returning banks to the Glass-Steagall era. At the same time, government's efforts to refine programs intended to unfreeze the banking and credit markets have continued at a rapid pace, which has contributed to the number of new and changing rules for financial institutions.

Not nearly enough attention has been paid to enforcement issues, which will be extremely significant, particularly in the months to come right after any new rules are finalized. What are some of the pitfalls of new rulemaking and what will implications will new rules have for regulatory enforcement going forward? My principal reservation about creating new rules stems from the currently charged political environment, in which competing interests are asserted with inadequate restraint.

When enacting more and more legislation is a primary goal, the clash of competing interests can end up undermining desired outcomes. There is no better example of this than recent experience with the Troubled Asset Relief Program (TARP)'s Capital Purchase Program. As conceived, the Capital Purchase Program seemed to be a reasonable response to the events of the fall of 2008. Because of the difficulties posed by constructing a workable program to purchase troubled assets from bank balance sheets, TARP money was instead allocated to shoring up bank capital in the hope that such increased capital would spur lending. But because the national economic outlook severely darkened after the Lehman Brothers bankruptcy, TARP money did not bring with it an expansion of lending – banks generally followed another desired path and instead chose to reduce balance sheet risk.

At the same time, the fact that public funds were involved drew greater legislative scrutiny of executive bonuses within the financial community, driven by an adverse public reaction to the amounts received. Public anger was ultimately channeled into what many in the industry considered to be punitive legislative proposals capping executive pay. The net result was to create suspicion on the part of the financial industry, parts of which continue

to need public assistance in some form, against public assistance as a matter of principle. In the same vein, the asserted immigration policy behind the TARP requirements for H-1B visas was not necessarily congruent with a policy of rapidly restoring banks' fiscal health.

Similar pitfalls could crop up in efforts to rationalize and further empower the nation's banking regulators. In a charged political environment, the core competencies of regulatory agencies may be obscured by their perceived stands on issues that resonate with sections of the country and their representatives, such as foreclosure relief. The results of enacting new rules in such circumstances may be counterproductive: a banking agency whose mission has historically been limited may find itself with new powers but with inadequate resources to wield such powers effectively, all because the agency has put to the forefront one or more popular policy proposals. This is hardly a recipe for increasing the safety and soundness of the nation's banking system.

What we learned from SOX

Another consequence of new rule creation is the consequent diversion of resources – monetary, systems and human capital – into compliance with the new rules. On this score, experience with the US Patriot Act of 2001 and the Sarbanes-Oxley Act of 2002 is highly instructive: both required the financial community to make considerable compliance efforts in the years immediately following their passage. Although it is difficult to say with certainty, the fact is that financial institutions, like all corporations, have to ration their resources. Herculean efforts in elevating compliance in these areas almost certainly had the effect of reducing time spent in other important ones. A similar truth applies to the nation's financial regulators themselves, whose resources are currently stretched extremely thinly. Diverting resources to new rule enforcement, therefore, may result in inappropriate attention being paid in other key areas, such as monitoring credit quality and other factors directly related to a bank's health.

The enforcement of existing rules, by contrast, if properly constrained, does not raise the same risks. In the current crisis, weakness at the nation's banks was joined contemporaneously by a rise of investor frauds and Ponzi schemes, some of the oldest tricks of the criminal trade. Such schemes were clearly punishable under existing laws, and in the case of Bernard Madoff, suggested to relevant regulators. No new rules would have been necessary to respond to these abuses, but rather a more considered allocation of resources to investigating and prosecuting them. Investigations and prosecutions under existing legislation were precisely aligned to the evils at issue.

Banking institutions in particular are subject to a wide range of rules, many of which allow bank regulators considerable enforcement discretion. Banks are regularly examined and rated in key areas: capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk. As the Government Accountability Office recently pointed out, banking regulators have a variety of tools to address risk management weaknesses:

- Citing weaknesses in supervisory letters or examination reports,
- Meeting with senior management, and
- Requiring corrective actions to be taken and policies and procedures adopted.

In addition, a weakness at a subsidiary bank can call the bank holding company's "financial holding company" status into question, thus preventing the growth of certain holding company businesses until those weaknesses are corrected.

What are some principles for the proper enforcement of existing banking laws and regulations?

First, because banks and bank holding companies are subject to such a wide variety of laws, and because regulatory resources are constrained, regulators should concentrate on the key areas implicated by the current crisis – capital, liquidity, and risk management among them. Such concentration has not always been the standard. For example, if you research public bank regulatory enforcement actions earlier in the decade, you will find a large number of almost identical actions requiring banks to undertake additional compliance measures with respect to currency transaction reporting and suspicious activity filings, including, in many cases, requiring the bank in question to investigate its historical records and determine whether additional reports should have been filed with law enforcement.

The principal reason for these enforcement actions was perceived weaknesses in the regulators' approach to anti-money laundering before September 11, 2001 (which generated considerable after-the-fact congressional criticism). But it is not clear that the regulators' "new" approach produced tangible benefits in anti-money laundering compliance, and indeed, the "new" approach may have detracted from supervision in other important areas, like risk management.

Rules versus institutional goals

Second, in terms of enforcing existing rules, thought should be given to whether certain competing rules may have actually have a tendency to undermine the most important functions at a banking institution. For example, bank regulations require banks to set aside reserves for loan losses, and permit banks some discretion in setting those reserves because predicting future credit losses is a matter involving a certain amount of judgment. In the past, the Securities and Exchange Commission, acting under its enforcement powers, has suggested that certain banks' loan reserving practices resulted in manipulated financial statements because the size of loan loss provisions taken has a direct effect on the amount of net income the banks report. By taking large reserves when profits are high, a bank can smooth its earnings over time. However, given the recent past, when the economy rebounds, banks should not be influenced to take an unduly liberal approach to loan reserves because of SEC concerns about their year-over-year financial statements.

So too, under the Community Reinvestment Act (CRA), banks have an obligation to meet the credit needs of low- and middle-income communities. In using their examination powers in the current environment, however, bank regulators should consider whether particular institutions have recently inappropriately sacrificed credit quality to CRA concerns and act accordingly when undertaking CRA evaluations.

Third, in enforcing existing rules, bank regulators should take a more focused approach to the "too big to fail" problem than is being currently suggested by some critics of Administration proposals. Noting the conundrum that in addressing the "too big to fail" issues posed by Bear Stearns, Washington Mutual, Wachovia and Merrill Lynch, the bank regulators increased the size of JPMorgan Chase, Wells Fargo and Bank of America, these critics have argued that such systemically significant institutions should be broken up and effectively made to operate on a public utility model. It is not at all clear, however, how such a legislatively mandated break-up would be effected, nor what the effects of such a break-up would be on a financial system that has moved more and more to a universal banking model.

On the other hand, existing rules under Section 3 of the Bank Holding Company Act, allow for growth by acquisition to be checked if a bank holding company's financial and managerial resources are not satisfactory. Until bank balance sheets and risk management systems perform better, the Federal Reserve Board could make this a standard with sharp teeth. Outside of the acquisition context, the quality of bank balance sheets is regularly reviewed by the regulators, who have the authority to push institutions to dispose of problem credits and assets. Current rules also empower regulators to influence a banking

institution's capital structure by taking the view, for example, that the institution relies too little on core capital elements and too much on hybrid capital.

To call attention to the enforcement of current rules is not to suggest that all reform legislation is currently undeserved. Substantial arguments have been made that the lack of mortgage broker regulation and of formal controls over systemically significant financial institutions and the risks they pose contributed significantly to the current crisis. And so, to some degree, there is room for Congress to act. But Congress can also act appropriately by recognizing the extent of laws currently on the statute books and the conflicts that those laws and their underlying policies at times impose for financial institutions. Congress can also act appropriately act by considering whether regulators have the resources to comply with their current legislative mandates and granting additional resources when necessary; this too is also a worthy legislative goal.

About the author



Arthur Long is a member of Davis Polk & Wardwell's Corporate Department, practicing in the Financial Institutions Group. He advises domestic and foreign banking organizations on the regulatory implications of mergers and acquisitions transactions; private equity and fund investments; new financial products, including derivatives; compliance and enforcement; bank insolvency issues; and, in the case of foreign banks, establishing U.S. branch and other offices.

Bridging the Gap between Rating Reliance and Reliability **By Viktoria Baklanova, Senior Director, Fitch Rating Fund**

Despite the implementation of the Credit Rating Agency Reform Act of 2006, five subsequent rulemaking initiatives, and the recent panel discussions among regulators, investors, prominent scholars and representatives of the CRAs shepherded for the U.S. Securities and Exchange Commission (Commission), the investing public still believes there is more to do to restore confidence in the beleaguered US financial regulatory system. Rating performance in the areas of structured credit during the last two years has shaken investor confidence to its core.

On top of that, poor rating performance coupled with rating process weaknesses uncovered by the Commission's extensive 10-month examination of three major CRAs in July 2008 have raised additional questions of both CRA ratings reliability and the fallibility of the rating process. All of this, in turn, calls into question the appropriateness of using credit ratings as part of the regulatory process.

It is not unusual, historically,, for busts and market failures to increase CRA scrutiny. The major piece of CRA regulation, the Credit Rating Agency Reform Act of 2006, was promulgated in the wake of the Enron debacle and the subsequent Internet /Telecom bust. At the time, investors felt cheated by CRAs because Enron carried an investment grade rating from the major CRAs days before filing for bankruptcy. The current focus on CRAs is likely to produce another quite costly regulatory regime. This is due to two reasons: an unprecedented number of downgrades of structured credit securities, and the perceived CRA failure to foresee the credit crisis. As an internal ratings industry saying goes, you can never spend enough money for due diligence; yet, more regulation doesn't necessarily ensure greater reliability.

A long history of credit rating

CRAs have been in the business of assessing the creditworthiness of debt securities for more than a century, long before the Commission was established by the Securities Exchange Act of 1934 to protect interests of investors in the wake of the Great Depression. Since 1900, John Moody & Company has published *Moody's Manual of Industrial and Miscellaneous Securities*. Standard & Poor's traces its origin to the publication of *Henry Varnum Poor's History of Railroads and Canals in the United States* in 1860.

The other firm that later was merged with the Poor's, the Standard Statistics Bureau, was formed in 1906 by Luther Lee Blake. In 1941, *Poor's Publishing and Standard Statistics* merged to form the Standard & Poor's Corporation. Fitch Publishing Company, which later became Fitch Ratings, was founded by John Knowles Fitch in 1913. Located in New York City, the Fitch Publishing Company began as a publisher of financial statistics known to its customers, including the New York Stock Exchange as *Fitch Bond Book* and the *Fitch Stock and Bond Manual*.

This long-standing history of the three largest CRAs emphasizes their core strengths in fundamental credit analysis. Corporations, in borrowing money, commit themselves to a certain level of future cash outflow. To meet the commitment, the corporations have an expected, but unfortunately uncertain level of cash inflow, which is to be applied against the obligations.

Fundamental rating analysts are trained to decipher off-balance sheet entities, operating leases, pension obligations and put them back on balance sheets to have a complete picture of a company's total financial claims. Analysts also consider timing of the debt coming due and treat short-term debt obligations as especially dangerous: if the future of the company gets clouded even for a moment, short-term lenders leave quickly. Rating statistics, which includes rating assignments, upgrades, downgrades, rating withdrawals and defaults, have been accumulated over many decades by the major CRAs and used to gauge rating performance. Rating default and transition statistics have also been used as a model input to back-engineer the credit quality of structured credit securities.

Accordingly, one of the fundamental assumptions in rating such securities is that the credit performance of structured securities, including securitization and collateralized debt obligations (CDOs), is similar to that of corporate securities. An apparent weakness of such an assumption and subsequent failure of structured credit securities to perform at par with corporates has driven regulators not only to review the entire CRA business, but focus more rigorously on the issues pertinent to the rating of structured securities.

This boils down, in simple English, to the question, "Are all AAA credit ratings the same?" In an attempt to alert investors to important distinctions between corporate and structured securities, CRAs may be required to disclose the models, methodologies and key assumptions on which they base their ratings, as well as to differentiate the ratings of more complex products by adding a specific symbol.

A question of performance

The question of a rating performance is the cornerstone of the ongoing debate on how to improve the reliability of credit ratings. The investment public and regulators are both advocating for accurate credit ratings, which they expect to correctly reflect credit risk of a particular issuer or a specific security. It is worth noting that an accurate rating is not necessarily stable. Quite counter intuitively, credit ratings that accurately and timely reflect underlying fundamentals and market sentiments are increasingly unstable. Worsening credit environment and liquidity generally push ratings down while periods of economic expansions and ample liquidity push ratings up. In fact, according to Moody's statistics of rating upgrades and downgrades, the number of downgrades rises in proportion to upgrades during cyclical downturns and the ratio reverses itself in the periods of an economic boom.

In addition, the rating transition from an investment grade to a speculative grade usually entails a loss of favorable lending treatments for affected entities such as margin calls on available credit lines and other tougher borrowing covenants. Eventually, the solvency of such a borrower might be questioned. This effect is known as "credit cliff" -- when a potentially accurate, but unstable rating causes chain events leading to the market disruption. The pro-cyclical nature of credit ratings assigned by CRAs has been researched in Howell E. Jackson's *The Role of Credit Rating Agencies in the establishment of Capital Standards for Financial Institutions in a Global economy* and in *Regulating Financial Services and Markets in the 21st Century* by Elis Ferran and Charles A.E. Goodhart.

While a rating derived from current market observations and trading data may accurately reflect changes in credit quality of the issuer, the rating also has a potentially damaging effect if CRA rating triggers are incorporated into governing documents. The glaring example of such damage is the gigantic chain of credit events stemming from credit deterioration in the relatively contained fringe market of subprime residential mortgage-backed securities. This is precisely the opposite of what is considered one of the major goals of financial market regulation -- to ensure stability and orderly function of the financial markets. If the markets get what they want -- that is, timely and accurate CRA ratings -- the flip side is an undesirable reliance on such ratings in a form of rating triggers that threaten the safety and soundness of the financial system.

One proposal to bridge the gap between reliance and reliability is to establish regulatory control over the integrity of the process, analytical independence and proper management

of the conflicts of interests. That is where the CRA regulatory discourse is currently focused, including the recent Commission's roundtable. The government utility business model for CRA as a way to manage a particular conflict of interest arising from the issuer-fee business model appears very topical, given the current trend towards a heavier government hand in financial market regulation. The government-run CRA model envisions a CRA directed by a government and mainly funded by issuers paying a fee (or a tax) on issuance or outstanding debt. This option is theoretically appealing because the ratings are perceived as a "public good."

Ratings v. "opinions"

This option raises serious practical issues with respect to analytical independence. It is not difficult to foresee the government having a natural interest in protecting the "national champions" or companies in which the government has a direct financial interest. Moreover, changing the business model is not going to improve the ability of CRA analysts to anticipate the timing and severity of cyclical economic downturns and account for those changes in the rating assessments. In the current crisis, the independent projections of GDP growth and housing market dynamics made by disinterested economists on staff of government and supra-national organizations turned out just as inaccurate as opinions of analysts employed by the private sector, including CRAs.

An equally important legal issue to consider is the inconsistent treatment of credit ratings by various market constituents and courts. While investors and regulators treat, or would like to treat, credit ratings as an accurate measure of credit risks, courts define them as "opinions." Rating agencies themselves consistently define credit ratings as "opinions" of relative creditworthiness. Accordingly, a government-sponsored CRA or a government-funded CRA via a public tax on outstanding debt is likely to perpetuate the existing ambiguity and even encourage investors' undue reliance on credit ratings assigned by such CRAs due to perceived regulatory approval.

A credit rating is a snapshot of issuer's relative credit worthiness, which, as claimed by the CRAs, carries certain predictive qualities. However, the accuracy of such a prediction cannot be guaranteed or otherwise ensured by regulation. Investors should be educated about the limitations of credit ratings methodologies and the cyclical nature of the rating process itself. A review of rating methodologies and assumptions related to the initial rating assignment, credit monitoring criteria, conditions of the rating changes should be a part of such education.

In addition, the burden of dispelling credit rating illiteracy should be placed upon both CRAs and regulators themselves. If a complex adjudication process that results in conveniently short and deceptively simple rating symbols is revealed, investors might then be discouraged from excessive reliance on credit ratings. To limit systemic risk posted by a vicious circle of rating trigger-based lending covenants and margin requirements, banks and other regulated entities should also be discouraged from using CRA ratings in lending documents. Rather, regulated institutions should be required to focus on old-fashioned fundamental credit research, due diligence and knowing their clients.

It is highly unlikely that CRA rating will be abandoned as some market observers suggest. In fact, quite the opposite view is coming to the forefront of the debate: that during times of instability the need for well-informed opinions only increases. Given the continuing need for these opinions, regulators from around the world are on a long-term mission to come up with a comprehensive set of rule that would govern the process around CRA registration and ongoing oversight of their business activities. This has resulted in CRA regulation that will eventually move away from a reliance on market-based regulation and high-level principles.

The on-going financial market crisis serves as a strong-enough reason to justify a more pervasive level of CRA regulation, not only in the U.S., but globally. Last month the European Parliament adopted a CRA regulatory framework that includes a mandatory registration for CRAs operating in Member States, compliance with business conduct rules, corporate governance standards and surveillance regime whereby regulators will supervise registered CRAs. The adoption of the regulation will have to be monitored over the next years in order to determine its effectiveness in protecting investors and improving financial market efficiency. Regulators should also be aware of the hazardous side of regulatory licensing of the rating business and take steps to discourage excessive reliance of investors and regulated entities on CRA ratings.

The views and opinions expressed in this article are those of Ms. Baklanova and are not intended to, and do not represent, the opinions, views or policies of Fitch Ratings or the Fitch Group.

About the author



Viktoria Baklanova is senior director at the Fund and Asset Manager Rating Group of Fitch Ratings in New York. Viktoria is responsible for rating money market funds, bond funds, and other public investment vehicles. She is a PhD Candidate at the University of Westminster Law School.

How Technology Can Revitalize Financial Services Innovation and Minimize Risk

By Margaret Weichert, CEO, The Morgan Weichert Group

Non-bank innovation in the financial services sector has traditionally been viewed with caution by both regulators and banks. Both legitimately fear the introduction of undue and potentially destabilizing risk into the financial sector. The question of risk is particularly important now while the economy remains fragile and sluggish and the extent of systemic risk introduced by earlier innovations is still unclear.

For banks, there is an added concern: That non-bank technology innovations threaten to disintermediate legacy bank technologies that evolved over time and at great expense. Consequently, as banks and regulators begin to contemplate the future, it is important to consider how technology might revitalize and improve the financial services sector.

The dawn of the World Wide Web not only created a new channel for activities like shopping and bill paying, it also created new markets, including auctions, music and video downloads, and new advertising models. These new activities required new payment methods, new customer service capabilities and new communication methods. And although banks ultimately went online, non-banks like Amazon, PayPal, CheckFree and even Wal-Mart were the early Internet pioneers. These players simplified customer experiences, streamlined processes, reduced customer costs and created new business and payment models that customers embraced. They also reduced artificial complexities associated with regulations and risk and underwriting models created for the physical world. Instead of replicating physical world experiences, they created simple, intuitive and easily accessible financial experiences.

New risk models

Today, new Web technologies and business models are creating new risk underwriting models such as Prosper and Pay Rent, Build Credit (PRBC) that offer both regulatory challenges and opportunities. Prosper, Zopa and other “P2P lenders” allow individuals to underwrite loans, in theory democratizing credit. However, when individuals began losing money -- often without understanding why -- regulators, including the SEC, stepped in. Now regulated, these players provide an interesting, Internet-driven competitive force to

traditional lending that may cause the banks themselves to innovate. Since each of these players use non-traditional, Internet data sources to “score” consumer credit and give consumers a greater number of lending options, banks may be forced to do likewise to compete.

For example, PRBC and other new Internet companies are attempting to use non-credit bureau data, including data from social networks, to improve credit underwriting for thin file and no file customers. Rather than competing with banks, these players in most cases would like to work with banks to help them reach new customer segments without increasing overall risk. This type of “win win” innovation may help banks expand revenues even as margins shrink due to regulatory pressure.

In the current, risk-adverse environment, risk officers and regulators are challenged to learn from these technology and risk innovations to find better, more predictive underwriting vehicles. Particularly as many consumers are struggling to free themselves from excess credit, risk models that incorporate non-traditional elements may be extremely important in the near future. Even learning from the mistakes and failures of these innovations may provide critical insight for next generation risk models.

Web 2.0

The term “Web 2.0” came into widespread use in 2004 after Tim O’Reilly hosted a conference that focused on technology companies that had “come back” from the 2001 dot-com collapse to establish new capabilities leveraging the Internet as a platform. Classic Web 2.0 solutions share several common traits: openness, interconnectivity, decentralization, customization, and they are democratic. Wikipedia, Facebook, Blogger, Twitter, and YouTube enable anyone to publish content, connect that content to relevant networks and customize their Internet experiences. RSS Feeds, Google Local and Mobile Phone applications enable consumers to customize where and how they interact with the Internet.

Prior to the recent banking crisis, many banks were starting to experiment with Web 2.0 capabilities while non-banks -- especially in financial management and investments --- forged ahead aggressively to create stickier, customer friendly solutions. Google, Amazon, Apple, and PayPal each combine Web 2.0 capabilities with financial services to make the customer experience simpler and more relevant.

Some in the banking industry fear that stepped up privacy regulation might also restrict banks from participating in open Web 2.0 forums and data mining. If this were to occur, banks could end up as low-profit “utility players” while Web 2.0 companies establish more-profitable relationships with customers based on information-rich, customer specific offerings, like tailored investment recommendation, savings plans, and even unique discounts on savings goals (e.g. trips, cars, etc.). At the same time, the banks may find technology partners eager to collaborate with them to access their existing customer networks. For example, several data aggregation/personal financial management companies (Mint.com, Wesabe, Yodlee), would be very interested in accessing bank data to learn more about customer preferences.

The opportunity for risk managers across the industry is to understand both the promise the potential risks of these capabilities. For example, openness and lack of centralized control in social networks has potential to compromise customer privacy and security since some social spaces thrive on sharing personal data. At the same time, many of the most successful Web 2.0 companies, including PayPal, have incorporated network feedback ratings to enhance risk management and make customers even more safe.

Mainstream wireless technology

In addition, the prevalence of WiFi, the emergence of WiMAX and wireless infrastructure improvements today give consumers and businesses the reliability and confidence they need to trust wireless devices for more than just communications. Over the last three years mobile financial applications have gone mainstream, with mobile alerts, mobile banking, mobile remittances and mobile financial management all gaining traction. Banks and non-banks alike have played key roles innovating in this space. Traditional banks have led the way in mobile banking, mobile security and financial alerts. Non-banks, like Mint, Wesabe and Obopay, have played leadership roles in mobile financial management and money transfer capabilities.

Given the breadth of mobile applications in the market, the regulatory environment is exceedingly complex. The Federal Communications Commission (FCC) regulates telecommunications providers, while the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and state regulatory agencies each regulate banking services. State laws around money transfer add further complexity and securities laws related to financial advice add further potential complications. All the complexity notwithstanding, consumers and businesses are adopting new mobile services at increasing rates, making it imperative

that banks, regulators and non-banks work together to reconcile the possibilities of this technology with the prudence the general public expects.

Authentication and Customer Security

Evolution of electronic channels and customer data proliferation also drove innovation in authentication, encryption and security. For example, the Secure Electronic Transaction (SET) protocol was developed in 1996 for the Internet by a Visa and MasterCard consortium, which also included GTE, IBM, Netscape, RSA and Verisign. That solution failed to gain adoption, because its cost and complexity outweighed its perceived benefits (especially for consumers and merchants). Instead, most retailers chose Secure Socket Layer (SSL) protocols to protect transactions, and relied on usernames and passwords for site authentication. Similarly, early attempts by NACHA, the Electronic Payments Association, to require public key infrastructure (PKI) for Internet transactions were rejected by the market and ultimately replaced with the simpler WEB rule. In both cases, market dynamics and customer convenience were key to establishing standards. Traditional rule-making entities, banks and regulators played relatively small roles in setting these standards.

Later attempts by industry insiders to enhance authentication and security also had mixed results, underscoring the difficulties of driving innovation via regulation or rules. Visa, MasterCard, and JCB implemented 3-D Secure protocols as added security for online credit and debit card transactions. In the US, these programs achieved minimal adoption, primarily because they interfered with the customer checkout experience. Another attempt includes the 2005 Federal Financial Institutions Examination Council (FFIEC) guidelines for multi-factor authentication for Internet transactions. The guidelines were intended to drive banks to stronger, multi-factor authentication. However, because the guidelines were not specific, many banks were unclear about how to comply. In addition, the costs to implement strong solutions were high, some estimated at \$15-30 per customer.

Although insiders struggled to find a “silver bullet,” technology players continued to innovate. RSA and Verisign successfully established token-based solutions for businesses. Cyota, PassMark and Arcot worked directly with banks and others to identify and implement customized retail authentication and security solutions. Bank of America’s Site Key is an example of a bank partnership with a technology company (PassMark). That solution enhances authentication without hindering the customer experience. Other banks, like Standard Charter, partnered with solution providers like Arcot to beef up behind-the-scenes security.

Today, the competitive technology environment continues to drive innovation, much of which will benefit banks and keep customers and their data safe. Regulators still face challenges since no single standard has emerged, and even industry-standard “audits” and “protocols,” like the Cardholder Information Security Program (CISP) from Visa are hard to monitor and do not fully protect against security breaches. And yet, an entire industry of security-oriented technology and service firms has sprung up to help firms comply with new security standards, while also helping Visa and the regulators monitor compliance. Furthermore, given that the “fraudsters” are some of the most innovative players in financial services, this is one area where partnerships between banks, non-banks and regulators are truly critical. Historically the role of regulators in innovation was to set standards, many of which were proved unworkable in the marketplace. In the future, banks, technology companies and regulators should work together to understand the key security priorities; create incentives to solve those problems; and work with non-banks to ensure that technology and service companies can reasonably implement the appropriate solutions.

Conclusion

As banks and the economy emerge from the current financial crisis, innovation will be critical. A recovering economy, increased global competition, and increased fraud/security threats will demand better solutions. Since technology players are not as limited by the current economic crisis, they will play an important role in jump starting innovation. Consequently, the challenge and the opportunity for banks and their regulators will be to work in partnership with technology innovators on customer-enhancing innovations, without sacrificing safety and soundness or risking consumer privacy, security or financial well-being.

About the author



Margaret Weichert is the Founder and CEO at The Morgan Weichert Group, LLC, a financial services consulting firm. Weichert recently served as the eCommerce/ATM Business Planning and Analytics Executive at Bank of America (BAC), with responsibility for strategy, innovation, business development, business intelligence and analytics for eCommerce, ATM and mobile channels