

Corporate foibles

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With trust in short supply, the accountability mechanisms of financial regulation need rethinking

Effective and efficient capital markets depend on confidence in financial institutions, the regulatory apparatus, and, ultimately, trust between market participants and financial intermediaries. Trust, like liquidity and solvency, is now in very short supply, and confidence has evaporated. This has prompted the former chairman of the US Federal Reserve, Alan Greenspan, to assert that we are facing "the biggest financial crisis since the end of the Second World War".

The collapse of Northern Rock in the UK and Bear Stearns in the US, and the difficult issues raised by margin lending here in Australia, clearly demonstrate the failure of existing accountability and regulatory mechanisms. It is unwise to engage in structural reform in the midst of a crisis. At the same time, it is clear that continued reliance on emasculated conceptions of accountability, based on enhanced transparency underpinned by legal rules, has become exceptionally problematic.

In the past three months I have interviewed senior policymakers and practitioners in Sydney, London and New York as part of a major project on the future of financial regulation. The view from the bridge suggests that navigating safe passage through the partially submerged financial minefield cannot occur without a total rethink of the

purpose of regulation.

One Wall Street senior investment banker proclaimed that the model and diagnostic tools used to evaluate performance simply no longer fulfilled their purpose. "The system is fundamentally broken," he says. A similar view prevails in London, which is widely regarded as having the most responsive regulatory framework and the lightest touch - a regime that, until the crumbling of Northern Rock, was held up as a paragon of effectiveness. John McFaul, the chairman of the influential Treasury Select Committee, bemoans the fact that risk management systems collapsed under the weight of a financial services industry that engaged in "an act of collective

madness".

Psychosis is an easy but ultimately misleading diagnosis. The herd-like behaviour of investment and commercial banks was, in many ways, a rational response to a flawed system of material and ideational incentives. These incentives have become embedded at a global level, irrespective of the specific form of particular regulatory regimes. Just as rules can easily be worked around, a retreat to principles cannot guarantee probity, as the increase in market manipulation in the London market makes painfully clear.

In the US, the destructive civil war in the Democratic Party has unleashed a dangerous admixture of race and ill-thought-out economic populism. The presidential race is fuelling protectionist feeling at precisely the same time that the country requires incoming investment. And while the Labor government in Australia retains its post-honeymoon glow, like a vacation tan it will inevitably fade. The extent to which margin lending was mis-sold is likely to trigger a far-reaching review of whether the current system of oversight is sufficient to curtail egregious lending practices. In the current global climate, rhetoric is no substitute for sound management and strategic vision.

At a broader level, it remains to be seen whether the deterioration of underwriting standards, particularly in the US, was criminal. It is apparent, however, that reputational defence strategies centre on the failure of lower-level employees to adhere to stated corporate policy. This will not wash. Indeed, if this approach gains traction the opportunity to deal with the underlying cause of the problems now besetting global markets will be lost.

It is imperative that the regulators and the regulated reach agreement on what constitutes ethical conduct, and that this understanding permeates the sector. It is also necessary to restructure and recalibrate specific preventative, detection and deterrence mechanisms. This requires, in turn, recognition that the current regulatory paradigm itself needs to be redesigned.

Australia has already made some advances in reforming the governance of capital markets. the Australian Securities and Investments Commission has embarked on a strategic review. It is designed, in part, on a calculated decision that reducing the regulatory burden can only be justified in circumstances where the polity has confidence in the integrity of key institutional actors. The objective is to clarify regulatory objectives and the mechanisms used to achieve them.

A solution cannot be imposed; nor can it be left to the market. It has to be negotiated. Business

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integrity requires placing ethics at the heart of operational decision-making in demonstrable ways. While there is always the risk that the system will be gamed, in reality there is a common understanding at a global level that no other credible option remains.

As a board member of an international investment bank put it to me recently: "We need to build a system based on first-order normative principles; to do otherwise is to rearrange the deckchairs on the Titanic." Sound advice.

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