

THE TELMARC GROUP, NOTES NO 51
**EUROPEAN CONTROL OF WORLD FINANCIAL
MARKETS: A DECLARATION OF WAR?**¹
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The change in Administrations in a few days will present an interesting set of challenges for the United States internationally. It appears as if France and Germany, with the assistance of that globetrotting man-about-town Tony Blair have conspired to knock the United States from its perceived perch as leader of the world's economies. They have had meetings with other world leaders and have come to an agreement amongst themselves that at the April meeting of the Group 20 Summit in London that they will put to the US a new world order to oversee the financial markets, and to form, unilaterally and in a manner to their choosing, a now global financial regulator. In many ways this move can cause more damage to the US economy than multiple al Qaeda attacks.

In this White Paper we review what little may be known of their proposal and then we lay out what we see are the current misgivings in the financial community. Then we make some recommendations. Clearly this will be Hillary Clinton and President Obama's first and possibly one of their greatest challenges.

The issue is that the world press covers this extensively but the US press fails to present what the others have done. The Washington Post lightly reviews the meeting and says that Merkel's comments were suggestions. The NY Times barely discusses the meeting. In contrast in the NY Times that day they spent three full pages discussing the gray squirrel problem in England, also known as the US squirrel we all see in New York City and feed in the park, and presented recipes on how to prepare the US squirrel! The Germans have declared financial war on the US and the NY Times is praising the British for cooking a US icon, the gray squirrel²!

There are two issues we wish first to focus on. The first is the difference between the US coverage and the foreign coverage, namely the major US Papers, the NY Times and the Washington Post, both fail totally to present what truly was said, which we feel is a material difference and is a breach of their duty to their readers. Second, we wish to assess what was said by Merkel and Sarkozy, as reported by the foreign press, and to demonstrate that what their intentions are represents a true threat to the US economy. Let us begin with the NY Times.

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² <http://www.nytimes.com/2009/01/07/dining/07sbox.html?ref=dining> and <http://www.nytimes.com/2009/01/07/dining/07squirrel.html?ref=dining>

The New York Times in its coverage via an AP feed stated³:

"January 8, 2009: Sarkozy, Merkel, Blair Call for New Capitalism: By THE ASSOCIATED PRESS: Filed at 1:58 p.m. ET PARIS (AP) -- The leaders of France and Germany appeared to put disagreements over economic policy behind them Thursday, calling on the U.S. to join global efforts to address the financial crisis.

French President Nicolas Sarkozy, leading a two-day conference with former British Prime Minister Tony Blair on the future of capitalism, said the crisis has shown that no country can go it alone on economic policy. "In the 21st century, there it is no longer a single nation who can say what we should do or what we should think," he said. German Chancellor Angela Merkel said the system "cannot continue as it is" and called for better-regulated financial markets. European leaders will meet in Berlin before the G-20 summit in London to decide a common approach as global leaders gear up for a second meeting on the global financial crisis, Sarkozy said. Measures will be taken at the G-20 meeting in London on April 2, Sarkozy promised, saying "we cannot accept the status quo." He called for closer cooperation on economic policy, saying: "We should discuss how each of us is managing his currency, his interest rates." The leaders of France and Germany have differed in the past over how much government support Europe's economy needs. "

In contrast to the coverage in England, Singapore, New Delhi and Dublin, which covered Merkel's and Sarkozy's threats to the US, of which none of the US newspapers even got close to presenting, the NY Times merely alludes to some meeting via an AP feed. Yet there were threatening words from Merkel and Sarkozy as understood by all other press. We will cover them herein. They are, in many ways, a declaration of war against the United States!

The NY Times article ends with a quote from Tony Blair which is chilling for what it says and for what it implies:

"Blair called for a new financial order based on "values other than the maximum short-term profit." "The greatest entrepreneur I had the chance to meet was passionate about what he had created, not what he had accumulated," he said."

This may be meaningful for a Franciscan where there has been a vow of poverty, chastity and obedience, but an entrepreneur does not get into a business solely for the fun of creating! Rewards, especially financial rewards, are a strong motivator. I am always concerned about the motivation of converts; they are like ex-smokers, always trying to get others aligned to their new religion.

THE FRANCO-GERMAN THREAT

At a meeting on January 8, 2009, Sarkozy of France and Merkel of Germany took a unilateral position in preparation for the April 2009 meeting of the G 20. This position

³ <http://www.nytimes.com/aponline/2009/01/08/business/AP-EU-France-New-Capitalism.html>

was less one of a specific program than of a threat against the United States, a declaration of financial war if one likes, that said that the US must comply with whatever they in their wisdom devise as the new rules for the control of the financial community. The New York Times did not carry this story in this manner.

In the January 8, 2009 Guardian said of this meeting⁴:

"The leaders of France and Germany today issued a stark warning to Washington and the global financial community that Europe would lead the way in restructuring the global financial system and ushering in a more "moral" form of capitalism. Appearing to set aside recent disagreements over how to handle the economic downturn, Nicolas Sarkozy, the French president, and Angela Merkel, Germany's chancellor, presented a united front in their efforts to reform a system they said had led to "unprecedented instabilities". "

The Guardian article continues:

"Twelve days before the inauguration of Barack Obama as US president, Sarkozy gave a characteristically frank verdict on the role of the US in future negotiations."Let's be clear: in the 21st century it is no longer a single nation who can say what we must do, what we must think," he said, adding that Britain's place in the economic discussions was with her European allies "and not just with the US". Speaking at a conference in Paris on the future of capitalism, the leaders of the EU's powerhouse member states agreed on the need to make long-term changes to the old financial order, which Sarkozy said had been "perverted" by an "amoral" form of unbridled finance capitalism....

Here Sarkozy is setting up this old order which he sees as a pure America creation as the amoral enemy to be attacked. He is doing what every individual does when laying plans for an attack; he demonizes the entity which he will have as an enemy. The article continues:

...Hailing the "return of the state", the right-wing market liberal said he hoped a more responsible model of global finance would emerge from the wreckage of the current crisis. Merkel, also a centre-right conservative, said she would "react very strongly" if attempts were made to block tighter regulation. "Once everything is going better, the financial markets will tell us, you politicians don't need to get involved because everything is working again," she said. "I will stay firm, we must not repeat the mistakes of the past."....

Merkel is throwing the gauntlet down at the financial players by her term "react strongly". We of course remember all too well the German "react strongly" response from years gone by; Poland, Czechoslovakia and the like.. The article continues:

"... Calling for the creation of a new economic council to run along the lines of the UN Security Council, the chancellor said she was also in favour of a sustainable economy

⁴ <http://www.guardian.co.uk/business/2009/jan/08/europe-financial-regulation>

"world charter" which would set out new rules for long-term financial management. "No country can act alone in this day and age, not even the United States, however powerful they may be," she said. Former prime minister Tony Blair, also speaking at the conference, agreed it was "utterly crucial" for far-reaching reforms to be carried out ..."

This story got significant coverage as well all around the globe, except perhaps in the US as discussed. From the Shanghai Straits Times⁵:

"Jan 8, 2009 Push for world financial reform PARIS - FRANCE'S President Nicolas Sarkozy and Germany's Chancellor Angela Merkel called on Thursday for new rules to govern world finance in the wake of the global economic collapse. Welcoming international experts to a conference on the future of capitalism in Paris, Sarkozy said governments should have the bones of a new system of regulation ready before April's Group of 20 summit in London. Ms Merkel came with an idea of her own - a powerful new economic council at the United Nations to oversee the financial markets. Both leaders urged the United States not to stand in the way of tighter controls on world financial markets, which they blamed for the crisis battering the global economy. 'I've always in my political life been a supporter of a close alliance with the United States but let's be clear - In the 21st century, a single nation can no longer say what we must do or what we must think,' Mr Sarkozy said. "

Merkel wants the UN to manage financial markets. The UN cannot even manage traffic flow at 42nd and 1st Avenue and she wants them to manage financial markets! The last sentence clearly lays down the threat as was not recorded in the AP release of the NY Times. He alleges that this is all the US fault!

In Reuters India the issues was presented as⁶:

"PARIS, Jan 8 (Reuters) - France and Germany said on Thursday Washington was no longer able to impose its views on other major powers and they hoped incoming U.S. President Barack Obama would listen to them at a summit on overhauling the financial system. French President Nicolas Sarkozy and German Chancellor Angela Merkel said they would push for a more regulated form of market capitalism when G20 leaders meet in three months, and European states would meet within weeks to seek common ground. "We as Europeans do not have to wait until we have spoken with the United States to develop our views," Merkel told a news conference with Sarkozy, when asked how Obama's team felt about her belief in a "social market economy". "We develop views that we contribute to the discussion and I am hopeful that they will not fall on deaf ears," she added.

Merkel said she would not repeat errors she had made in the past, such as failing to push through tougher regulation of hedge funds on an international level. She also put forward the idea of an 'economic council' to work alongside the U.N. Security Council. The European G20 leaders would meet in Berlin in the weeks ahead to prepare for the

⁵ http://www.straitstimes.com/Breaking%2BNews/Money/Story/STIStory_323675.html

⁶ <http://in.reuters.com/article/asiaCompanyAndMarkets/idINL822160220090108>

April summit in London, Sarkozy said, adding that the United States should not be allowed to dominate the talks in London. "

Merkel wants a socialist economy with a new form of regulation. Again the Sarkozy words also are threatening, this time slightly differently, but he and Merkel are clearly declaring war!

In contrast the Irish Times in an article entitled, "**Grandstanding by Sarkozy fails to dispel economic worries**" presents a balanced view when it states⁷:

"Despite Nicolas Sarkozy's bravura performance on the world stage, there was an authoritarian drift in his domestic policy, writes Lara Marlowe THE ENGLISH words will and determination don't quite convey the aggressive force of the French term volontarisme, inevitably associated with President Nicolas Sarkozy. Whether it was his 80-day courtship and marriage of Carla Bruni, the relentless pursuit of a second Irish referendum on the Lisbon Treaty or the way he tackled the global financial crisis, Sarkozy showed plenty of volontarisme in 2008. "

"Behaviour that would have grated in other circumstances suddenly became inspiring, as when Sarkozy insisted that George W Bush would have to agree to a crisis summit because, "Europe demands it. And Europe is going to get it." The downside of Sarkozy's volontarisme was a commensurate hunger for power. Sarkozy attempted, but failed, to secure the presidency of the euro group for himself until 2010. In France, he took unilateral decisions regarding the curriculums of primary schools, dictated the schedule of debates in the National Assembly and put public radio and television stations directly under his control."

It appears as if the Irish get what Sarkozy is saying and trying to do. They voted against the socialist EU proposal and Sarkozy assumed he would just fly across the waters and educate these illiterate farmers. Sarkozy perhaps may have forgotten, perhaps since he is Hungarian and not French, that it was the Irish in the sixth through the tenth centuries who educated the Franks, both Merovingians and Carolingians, and without that education they most likely would still be wandering barbarians. In addition the Franks are ironically the ancestors of both the French and the Germans, Asterix notwithstanding.

The Financial Times of London stated⁸:

"President Nicolas Sarkozy and Chancellor Angela Merkel yesterday warned the US and the banking industry not to thwart European efforts to tighten financial regulations this year. In a blunt message to Barack Obama, the incoming US president, the leaders of France and Germany made clear that the European Union was determined to set the agenda for the G20 summit in London on April 2.

⁷ <http://www.irishtimes.com/newspaper/world/2008/1229/1229728601431.html>

⁸ <http://www.ft.com/cms/s/0/d3eeba2c-dd76-11dd-930e-000077b07658.html>

The summit of leading and emerging economies will discuss ways of strengthening the architecture of global financial regulation, as well as prudential supervisory and accounting standards. "In the 21st century, there is no longer only one country that says what we should do and think," Mr Sarkozy told a Paris conference on capitalism and ethics. "We will not accept any return to a single way of thought." He said later that Mr Obama's agreement for a regulatory overhaul would be "so much the better", but was not indispensable. ..."

In the last sentence Sarkozy is clearly is threatening Obama. Again, we wonder why none of the main stream press has taken to this at all. In a way this is a real and present danger to whatever Obama wants to do with his spending of a trillion dollars. The Financial Times continues:

"...Ms Merkel told the conference that she would "react very strongly" if the financial community tried to block government efforts to tighten regulation."Once everything is going better, the financial markets will tell us, 'You don't need to get involved, you the politicians, because everything is working again,' " she predicted. "I will stay firm. We must not repeat the mistakes of the past." "

In startling contrast the report in the Washington post states⁹:

"PARIS -- The leaders of France and Germany appeared to put disagreements over economic policy behind them Thursday, calling on the U.S. to join global efforts to address the financial crisis. French President Nicolas Sarkozy, leading a two-day conference with former British Prime Minister Tony Blair on the future of capitalism, said the crisis has shown that no country can go it alone on economic policy. "In the 21st century, there it is no longer a single nation who can say what we should do or what we should think," he said. German Chancellor Angela Merkel said the system "cannot continue as it is" and called for better-regulated financial markets. "

She did not just call for a better regulated market she threatened the United States, as did Sarkozy with two things. First that the US would no longer dominate the financial markets and second that Germany and France would establish the rules of play. This is a clear and unvarnished demonstration that the Washington Post and the other US newspapers fail, by neglect or deliberately, to understand what this threat truly means. It is a declaration of war against the United States! They want to unilaterally set standards in a way and manner which will benefit them and them alone and to do so in a purely socialist manner. The risk is that the Obama Administration either does not see this for what it is or worse agrees to usurp any and all US pre-eminence in this area.

THE SERVICE INDUSTRY

I once worked with a fellow named Val Podmolik, and he told a story his father who was a plumber. He would go into a person's home who had a backed up toilet, see that

⁹ http://www.washingtonpost.com/wp-dyn/content/article/2009/01/08/AR2009010800918_pf.html

it was just a simple blockage problem, then use the plunger to solve the problem, and then sit there and have a smoke and read the paper for an hour. Then he would come out, showing a functioning toilet and hand them a large bill which they gratefully paid. When Val asked his dad why he did this he replied that if he went in, solved the problem, and came out, he would never get paid what he would if he stayed in there for an hour. This was not an hourly scale issue, rather it was a perception on the part of the homeowner that there was some magic going on and that true magic took time. Val said that was when he understood the true nature of the service industry. It was not what you did but how you did it! You spent more time, even if it was not necessarily required, just to keep the patina polished.

The Financial industry is a major player in the service business, it simply takes people who have money and want a return, such as pension funds and others and finds people who need the money and put the two together for a fee. It was like when Disraeli wanted to buy the Suez canal from the French and to protect it from the Turks and Russia and he went to Rothschild and obtained the money, not from the Bank of England, for that would have taken too long. The Rothschild's could get the money overnight, relatively speaking. Thus it is relationships, established over many years that make the financial service industry function.

Another element is their ability to make money on transactions. Whether it is as a market clearer in the broker business or as the middlemen in the financial markets or raising capital they get paid no matter what when the transaction occurs. They do not take a position in the transaction they only effect its happening. This worked well until the Glass Stegall Act was repealed in the Clinton Administration. Since then these entities started taking positions, leveraged positions, and this is when things went south. This is when they left the service business and became a principal.

BASIC FACTS ABOUT THE FINANCIAL INDUSTRY

There is certain basics observation of the financial services industry that one should note before even addressing new and improved regulation. We list them as follows:

1. Motivated by Greed. Every banker I have ever met is fundamentally motivated by greed, abject greed. This is reinforced by the compensation mechanism in financial companies. They do not create anything, they merely transfer value from A to B. they broker a deal. For that they make money. On the other hand, hedge funds managers may hold onto investments thus taking a risk with their shorts and longs. Their investors think highly enough of them to give them large amounts of equity as well as large amounts of compensation and the US Government think highly enough of them to compensate them the same as an entrepreneur who creates jobs and value with a very low capital gains taxes. The tax code sees no difference between value transfer and value creation.

2. Regulation always looks backward, there always exists a regulatory lag. The classic example of backward looking regulation has been the FCC. The SEC is now facing the

same issue. Technology and technique is changing so quickly, and morphing so quickly that any regulation proposed today may very well be arbitrated on the morrow.

3. New Entrants always look forward, finding ways and means around and over regulatory obstacles. The new entrants of late have been the hedge funds and the mortgage lenders. The opportunity was created and after a short while they managed to seek the advantage and follow it. The mortgage lenders, facilitated by the GSEs such as Fannie and Freddie were Government facilitated "drug addicts" and "Drug Dealers" who managed to seek out the helpless and sell them toxic products. True one should be responsible for what one agrees to, and the acquirer of these toxic products are as much to blame as the sellers, as one sees in the Drug markets, but we generally seek out the dealers rather than just the users.

4. Typically the financial intermediaries make money by being a middle man and providing a service. Holding assets like a bank has not been their forte. The mortgage sellers are examples of those not taking custody as were all the mortgage backed securities. It created multipliers in the financial markets allowing for explosive expansion but it at the same time allowed for extensive fraud.

5. Unregulated Financial Transactions always have led to disaster. The Financial Entities such as hedge funds and the independent mortgage companies, all lacking any transparency, will take steps to maximize their own gains independent of any long term stability of the financial markets. We look no further than Madoff.

6. Independent Financial Assessors always manage to have or develop conflicts of interest. As the accounting firms in Enron and WorldCom had accounting and consulting businesses, and these two businesses created internal conflicts and problems with the overall business, so too do we see the rating agencies having developed a conflict in their missions and this resulted in a compromise in their prime mission of providing rating results which were truthful.

7. Laws are Existing but are not Enforced. It is not that we do not have the laws, it is that we have no enforcement of them. Fraud is a well established civil and criminal statute. Just where are all those mortgage sellers who perpetrated fraud?

8. New "Products" are produced which lack substance, transparency and validation; they are merely just new games of chance not creators of value. The whole issue associate with CDS, credit default swaps, which are in reality just insurance policies, is akin to insuring every bet at Las Vegas. Consider the Black Jack Table. If every player purchases a CDS at each draw of a card then everyone would be covered for every bet. But netting out the best, we know there will be a winner and lots of losers. We can statistically calculate on the long term what we need to charge for the CDS swaps here. However of the market just goes away, and if we have priced these based upon some underlying asset value then we may have substantially greater losses. This is the problem with the assumptions. As we have said before, "if elephants had wings..."

ROUBINI'S "SHORTCOMINGS"

The financial markets *bête noir*, Nouriel Roubini, had published in March 2008 a paper listing the ten issues regarding the reform of financial regulation in a world financial market¹⁰. We summarize and rephrase the Roubini Shortcomings here:

1. The system of compensation of bankers and operators in the financial system is flawed. It is a source of moral hazard in the form of gambling. He argues, as do we, that the primary shortcoming is that the bankers are compensated highly for relationships not results. Especially they are not compensated for the results on the time horizon of the deals. Thus their judgment is clouded by the lack of full temporality of their actions.
2. Current models of securitization (the “originate and distribute” model) has serious flaws as it reduces the incentive for the originator of the claims to monitor the creditworthiness of the borrower. Namely as we also state above, the do the deal and pass it on. The entire mess about securitized mortgage obligations is a prime example of a hot-potato strategy of making money and taking no risk.
3. Regulation and supervision of banks and the lighter – on in some cases such as that of hedge funds non-existent – regulation and supervision of non-bank financial institutions has led to significant regulatory arbitrage: i.e. the transfer of a large fraction of financial intermediation to non-bank financial institutions...This is our factor on the creation of non-regulated financial institutions such as the sellers of mortgages, a creation of the law not just of the market. These could be eliminated with the stroke of a pen.
4. Regulatory and supervisory regimes have moved in the direction of emphasizing self-regulation and market discipline rather than rigid regulations. This is less an issue of the law as much as it is of the enforcement of what is already on the books.
5. Basel II agreement has shown its serious flaws: capital adequacy ratios that procyclical and thus inducing credit booms in good times and credit busts in bad times; low emphasis on the importance of liquidity risk management; excessively low capital requirements given the serious financial risks faced by banks; excessive reliance on internal risk management models; excessive role given to the rating agencies and their ratings. This is Basel II, and if we look at what Sarkozy and Merkel is saying their view is to junk that and go to a Basel III which is much more onerous. If Basel II does not function as per Roubini, even before operative, how can we deal with a Basel III and what will that uncertainty do to the markets already in a fragile condition¹¹.

¹⁰ <http://media.rgemonitor.com/papers/0/Nouriel-RegulationSupervisionMarch08.pdf>

¹¹ See Basel I discussion by Allen <http://pages.stern.nyu.edu/~lallen/mortgage.paper.pdf> if this is what happened in Basel I then a proposed Basel II at this time could result in a global meltdown.

6. Conflicts of interest and informational problems that led the rating agencies to rate – or better mis-rate – many MBS and CDO and other ABS products as highly rated are well known and recognized. This is also a reiteration of what we have said before. The rating agencies are held harmless in the current regulatory environment. Although it may be onerous, why are not the same terms of Sarbanes Oxley applied to them? Criminal penalties have a true chilling effect on most people, Madoff excluded.
7. There are fundamental accounting issues on how to value securities, especially in periods of market volatility and illiquidity when the fundamental long term value of the asset differs from its market price. The current “fair value” approach to valuation stresses the use of mark-to-market valuation where, as much as possible, market prices should be used to value assets, whether they are illiquid or not. This as we have also said is a major issue. The mark to market rules truly created chaos.
8. Financial markets have become less transparent and more opaque in many different dimensions. The development of new exotic and illiquid financial instruments that are hard to value and price; the development of increasingly complex derivative instruments...Indeed, again as we have argued in previous White Papers with the hedge fund industry holding so great a fraction of the nation's and world's investment and the fact that they do so in total obscurity leads to both uncertainty as well as opportunities to manipulate markets.
9. Ninth, what are the appropriate institutions of financial regulation and supervision and the system of such regulation and supervision in a world of financial innovation and globalization?
10. Reforms of financial regulation and supervision cannot be done only at the national level as regulatory arbitrage may lead financial intermediation to move to jurisdictions with a lighter – and less appropriate - regulatory approach....This is the Merkel and Sarkozy platform, on one hand, the regulatory arbitrage issue is a valid one, but on the other hand the tight fisted salute to doing her way or no way will just throttle the markets. Some form of continuing accommodation to minimize market regulatory arbitrage is essential but again as we have stated above the regulatory environment often solves yesterday's problem, it has a regulatory lag, and never seems either to catch up or ever look forward.

These Roubini Shortcomings are in many ways what we have phrased in our own analysis of the issues, but in a different manner. Using these two views we can hopefully address some suggestions.

RECOMMENDATIONS

There have been a plethora of studies regarding the regulation of financial markets¹². For example regarding the Basel Accords in the CATO Paper by Oatley, the author writes:

"But there is a potential for harm that arises from the interaction between the unintended consequences of financial regulation and the glacial nature of international decision-making. This interaction could indeed create a less safe banking system.

The Basle Accord's Unintended Consequences

Regulation always has unintended consequences, and these consequences often push regulators further away from, rather than closer to, their goals. This has certainly been the case with the Basle Accord. The accord imposed an eight-per-cent minimum capital requirement on internationally active banks, but it required additional capital for loans that are considered more risky. The accord established four risk categories, assigning a zero risk weight to governments of nations in the Organization for Economic Cooperation and Development (oecd), a 20 percent risk weight to oecd banks and non-oecd governments, a 50 percent risk for mortgage lending, and a 100 percent risk to all other loans...."

He continues:

"The risk classification scheme also offers incentive for banks to engage in regulatory capital arbitrage. When capital requirements are not based on a standard like the probability of insolvency, banks can often restructure their portfolios in order to reduce their regulatory capital requirements without reducing their risk. By securitizing assets, banks can unbundle and repackage risks to transform on-balance sheet assets into off-balance sheet assets that fall into lower risk weight categories.

While reliable information on the scale of regulatory capital arbitrage is not available, the Federal Reserve has estimated that securities used to engage in regulatory capital arbitrage account for more than 25 percent of total assets of the United States' ten largest banks. In several individual cases, those securities account for close to 50 percent of total assets. The problems created by regulatory capital arbitrage pertain less to the off-balance sheet assets and more to the onbalance sheet assets ..."

In the March 2008 US Treasury Report on Financial Regulation they state:

¹² See <http://www.gao.gov/new.items/d0832.pdf> ; <http://www.gao.gov/new.items/d0561.pdf> ; <http://media.rgemonitor.com/papers/0/Nouriel-RegulationSupervisionMarch08.pdf> ; <http://www.cato.org/pubs/regulation/regv23n4/oatley.pdf> ; also the US Treasury Report on what it recommends for regulatory reform issued in March 2008 <http://www.ustreas.gov/press/releases/reports/Blueprint.pdf> also see ; http://web.mit.edu/polisci/research/singer/Copelovitch_Singer_JOP_10_08.pdf

"Prompting this Treasury report is the recognition that the capital markets and the financial services industry have evolved significantly over the past decade. These developments, while providing benefits to both domestic and global economic growth, have also exposed the financial markets to new challenges. Globalization of the capital markets is a significant development. Foreign economies are maturing into market-based economies, contributing to global economic growth and stability and providing a deep and liquid source of capital outside the United States."

These developments are pressuring the U.S. regulatory structure, exposing regulatory gaps as well as redundancies, and compelling market participants to do business in other jurisdictions with more efficient regulation. The U.S. regulatory structure reflects a system, much of it created over seventy years ago, grappling to keep pace with market evolutions and, facing increasing difficulties, at times, in preventing and anticipating financial crises....

The high levels of delinquencies, defaults, and foreclosures among subprime borrowers in 2007 and 2008 have highlighted gaps in the U.S. oversight system for mortgage origination. In recent years mortgage brokers and lenders with no federal supervision originated a substantial portion of all mortgages and over 50 percent of subprime mortgages in the United States. These mortgage originators are subject to uneven degrees of state level oversight (and in some cases limited or no oversight). However, the weaknesses in mortgage origination are not entirely at the state level. Federally insured depository institutions and their affiliates originated, purchased, or distributed some problematic subprime loans. There has also been some debate as to whether the OTS, the Federal Reserve, the Federal Trade Commission ("FTC"), state regulators, or some combination of all four oversees the affiliates of federally insured depository institutions...

"After evaluating these options, Treasury believes that an objectives-based regulatory approach would represent the optimal regulatory structure for the future. An objectives based approach is designed to focus on the goals of regulation in terms of addressing particular market failures. Such an evaluation leads to a regulatory structure focusing on three key goals:

- *Market stability regulation to address overall conditions of financial market stability that could impact the real economy;*
- *Prudential financial regulation to address issues of limited market discipline caused by government guarantees; and*
- *Business conduct regulation (linked to consumer protection regulation) to address standards for business practices."*

The Report recommends several types of regulators:

1. *Market Stability Regulator* – The Federal Reserve The market stability regulator should be responsible for overall issues of financial market stability.

The Federal Reserve should assume this role in the optimal framework given its traditional central bank role of promoting overall macroeconomic stability.

2. *Prudential Financial Regulator* - The optimal structure should establish a new prudential financial regulator, PFRA. PFRA should focus on financial institutions with some type of explicit government guarantees associated with their business operations
3. *Business Conduct Regulator* - The optimal structure should establish a new business conduct regulator, CBRA. CBRA should monitor business conduct regulation across all types of financial firms, including FIs, FIDIs, and FFSPs. Business conduct regulation in this context includes key aspects of consumer protection such as disclosures, business practices, and chartering and licensing of certain types of financial firms
4. *Federal Insurance Guarantee Corporation* - The FDIC should be reconstituted as the Federal Insurance Guarantee Corporation ("FIGC") to administer not only deposit insurance, but also the FIGF (if one is created and valid reasons to leave this at the state level exist as discussed in the report). The FIGC should function primarily as an insurer in the optimal structure.

The paper by Copelovitch and Singer raises many significant issue of a coordinated global regulation¹³. The mere differences in central banks and their structures present an almost insurmountable barrier. The different structures of central banks presents, in many ways, a country by country evolved creation and yet to establish an international regulatory environment would demand a reconciling of all of these institutions, a near impossible task as proposed by Merkel and Sarkozy¹⁴!

Thus our recommendations are as follows:

1. **Financial Markets Must be Regulated to the Extent that Financial Fraud is the Prime Focus, the Investors Should be allowed to bear Risk:** It is not the goal of the Regulator to eliminate risk. Indeed that is always an element of a market and concomitant with returns. Fraud on the other hand is a criminal act and the Regulators should take actions to militate against that.
2. **Property is Real and Should be Protected:** The Transactions in the Financial Markets have the nature of property transactions, even if partitioned and disaggregated for more efficient market dynamics such as one finds in mortgage pools. There is nothing inherently wrong with a mortgage pool as long as the true property interests are preserved. To preserve them the chain must be traceable and the partitioned and disaggregated interest must have a

¹³ http://web.mit.edu/polisci/research/singer/Copelovitch_Singer_JOP_10_08.pdf

¹⁴ One needs look no further than the battle between President Andrew Jackson and the backers of the Bank of the United States during Jackson's administration. This was a central bank and it led almost to a civil war within the backers and those opposing such an entity.

means of reconciling all interests in an ongoing basis. This is both a legal and accounting issue.

3. **Transparency is Essential:** All Financial Markets open to the Public must be transparent. In the world of the Accredited Investor for example the investors have access to the financials and details of their investment, albeit risky. The transparency must be real. Again in the world of Accredited Investor it is the Accounting Firms duty to present valid results, the transparency being provided via the accounting firm. In the hedge fund the same applies. In the case of mortgage backed securities it in a sense if the rating agency. There then is a fiduciary duty applied to this reporting.
4. **Disclosure:** Transparency means access and accessibility. Disclosure means taking the additional step and providing information whether require or not so that the investor and those in the investor food chain have any and all information material to the investment for the life of the investment. In this category is also the mark to market issue. As Roubini has stated he believe that this mark to market must be modified. It is a cumbersome and problematic issue. It possibly adds to market volatility but studies in some later period will only determine this.
5. **Responsibility:** The major problem is one of responsibility. With Sarbanes Oxley there is an over concern on signing reports and the like. I was Chairman of an Audit Committee of a public company when Sarbanes Oxley came out. I went through all the issues and I finally left all boards just to avoid the personal risk. Not that anyone would commit a crime but one knows that a criminal threat is a Damocles sword that gives one much more clarity than a simple civil suit. Thus criminal claims against violators should be extensively implemented and prosecuted.
6. **Professionalism:** The Regulatory Agencies must be professional. In the U.S. today there are problems. At the top political levels one get political appointees and these come with their baggage. At the bottom levels many take low paying Federal jobs with the intent of using that as a stepping stone to a better paid job at a law firm of the like. The net result is the best leave and the mediocre stay. In the middle, the career employees are no match for the best the financial throws at it. Thus there must be a fundamental change in the professionalism and compensation. The transition of such an organization is a difficult problem. Yet it is a spy versus spy game. Wall Street will not become saints if we have a professional staff, it will just morph into a different form with the same DNA.
7. **Disaggregation:** There are so many types of financial instruments and there will undoubtedly be many more that it is necessary that they be disaggregated. The bundling of them together and the use of them to leverage each other leads to an unstable situation. Value of any one is difficult and values of leveraged types, one piled upon another, is impossible. Thus they

should be held in disaggregated entities with individual transparency and disclosure and the ability of the Regulators to assess each for fraud.

8. **International Agreements are Necessary to Avoid Arbitrage Resulting in Financial System Loss of Integrity not Financial Gain:** Merkel and Sarkozy have a point, but so do Basel I and Basel II. There are processes. The world does not need a common system. It needs transparency and disclosure and it needs the ability to allocate responsibility for criminal acts and to prosecute across borders. If one violates a French criminal act and one resides in the US the French should be able to prosecute. The French should not be able to dictate to the U.S. how business is done in the U.S. This is what Sarkozy and Merkel believe is their prerogative. We believe that such an action would result in irreparable harm to financial markets.