Regulate in haste…!

Kevin Davis
Commonwealth Bank Chair of Finance, University of Melbourne
Director, Melbourne Centre for Financial Studies
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Times of financial turmoil, like now, tend to lead to calls for increased regulation. Often those calls are heeded, and new or changed regulation introduced without the perceived problems and suggested solutions having been subject to adequate analysis, consultation, articulation, or design of effective implementation processes.

Our recent experience has certainly shown up some gaps in the regulatory framework. In the financial sector, there is ongoing interplay between regulation and innovation, and continual reassessment of regulatory arrangements is required.

But “act in haste, repent at leisure” is a maxim as relevant to redesign of regulatory arrangements as it is in other walks of life.

Three reform proposals recently advocated and emerging out of the recent turmoil illustrate well the need for detailed consideration rather than knee-jerk reactions.

Two of them arise from the share price instability supposedly caused for some companies as a result of substantial margin lending and stock lending positions by corporate insiders (and others).

One proposal is that stock lending by corporate insiders and superannuation funds should be banned – because it facilitates short sellers whose actions depress the company share price. This simplistic reaction overlooks the fact that the stock lender receives cash (or other) collateral helping them to maintain their long position in that stock rather than selling it themselves to generate needed cash.

Put slightly differently, those corporate insiders may not have been able to purchase the stock, pushing up its price, if they had not been able to acquire cash for the purchase either by stock lending or through margin loans. While there are clearly some problems with stock lending arrangements in Australia, proposals to ban it for certain groups because it helps short sellers depress the price are on shaky ground.

A second proposal is that required corporate disclosures should include information about substantial margin loan or share lending positions of directors and management. Here, we need to ask: what is the purpose of the disclosure requirements?

Margin loans and share lending by insiders tells us something about their personal financial position and attitude to risk taking (which may be of interest to investors!), but very little about the *fundamental value* of the company. Thus if the purpose of disclosure is to assist investors determine a fair value for the stock, it is not clear what requiring such disclosure would achieve.

But clearly, such disclosure would be relevant for identifying possible forced-sale price points, and quite valuable for those wanting to ‘trade on the trading”. What that achieves in terms of social and economic efficiency is far from clear, and there are already examples (such as when the SFE removed broker ID’s from the limit order book in 2004) where providing information which might assist disequilibrium trading strategies is presumably thought to be undesirable.

In a similar vein, Prime Minister Rudd recently announced a review of the case for increased disclosure by investors of positions in equity derivatives such as contracts for difference (CFDs) and equity swaps. The motivation appears to be a concern that market players can establish significant hidden positions of economic interest in companies,

Some equity derivatives provide an indirect, currently undisclosed, ownership position, possibly warranting disclosure. But CFDs and equity swaps are not of that ilk. Their use generates exposure to the company’s stock market fortunes, and is used by investors to hedge as well as to speculate.

Disclosure requirements for these two instruments (other than for corporate insiders, where it should be mandatory) are probably redundant.

First, they tell nothing about potential ownership stakes.

Second, exposures taken in these markets show up as price pressures in the physical market – because these are two-sided transactions. Either there is a balance between long and short speculators and hedgers, or market makers (arbitrageurs) will hedge their net exposure by purchases or sales in the underlying stock.

A third example is suggestions emanating from both academicia and industry that a government agency be established (*AussieMac*) which would issue low risk (government guaranteed) bonds and acquire high credit quality home loans from Australian lenders. The laudable objective is to restore much needed liquidity to financial markets, such as for residential mortgage backed securities (RMBS).

One problem is inconsistency with government competition policy which requires any government trading enterprise to pay a fair value for any government guarantee received, And, at a practical level, the current liquidity problem reflects market’s inability to decide on a fair value for the underlying risk.

A more fundamental issue is that the proposal appears largely redundant. The RBA’s willingness to accept RMBS (including those constructed in-house by banks) as collateral in repurchase agreements (repos) achieves a similar effect. The private sector can off-load mortgage backed securities in exchange for more liquid government securities.

There may be arguments for "tweaking" the RBA's current arrangements, such as expanding the range of institutions able to enter such repos for competitive neutrality reasons. Increasing the agreed term of repos would also assist market liquidity.

These types of changes are, arguably, more easily implemented and involve less distortion to the financial sector than *de novo* establishment of a new government sponsored entity. Rapid action is desirable to restore normal liquidity to financial markets. But having a single liquidity tap (the RBA) able to be adjusted as needed, rather than adding a second one (the Aussie Mac) which is permanently turned on (or dripping) would appear to be a more efficient solution

In all of the cases discussed here, it is vital that the sources of perceived problems are carefully analysed, so that all potential solutions are identified, discussed, and subjected to rigorous cost-benefit analysis. Otherwise, there is the risk that "regulation by reaction" will create more problems than it solves.