

How to Make the Financial Giants Behave

By Tom Petri
and Bert Ely

The collapse and rescue of Long-Term Capital Management has raised concerns about secretive, unregulated and enormously leveraged pools of hot money that threaten the world financial order.

Some have suggested more Government regulation of financial institutions — that is, finding a Govern-

ment cat to look after the mice. But these rodents are agile. They can simply scurry to another country without cats. After all, global markets rely on the free flow of capital.

More important, the Government would require that every guarantor company find a group of other companies to insure its own liabilities under the system before the contract takes effect. This would create a strong web of financial groups insuring one another, should a few run into problems.

The key to this plan is that although it would be voluntary, there is incentive for all parties to take part. If, for example, a bank or hedge fund is able to line up guarantors, it would then be solid enough to receive the highest ratings from Moody's and Standard & Poor's, and would be able to raise capital more cheaply. This would more than offset the cost of the contract fees it would have to pay.

And since the guarantors would have their own money at risk, the Government could delegate to them responsibility for overseeing the company's safety and soundness. The company would thus escape "one-size-fits-all" Federal oversight and could negotiate its own regulation.

What's in it for the guarantors? They make money right away from the contract fee without putting up any capital. All they initially offer is a guarantee to step in if things go bad.

This brings us to the devils of the moment: hedge funds. What if they decide they don't want any part of these contracts? Hedge funds have to get their money somewhere, and any potential lenders would probably have

ment cat to look after the mice. But these rodents are agile. They can simply scurry to another country without cats. After all, global markets rely on the free flow of capital.

An alternative is to find a way to entice financial companies to behave responsibly without imposing Government regulations that might cause them to flee or to find ways to circumvent the system.

We propose a system in which a financial company (a bank, brokerage company, insurance firm, money market fund, or even a hedge fund) would voluntarily negotiate a contract with a large group of other parties

(banks, pension funds, endowments, corporations and the like) under which that group would guarantee the company's liabilities should it find itself overwhelmed with losses. In exchange, the group of guarantors would charge the company a fee; the more risky the company's investments, the higher the fee.

But what would insure that huge losses by a bank, for example, wouldn't wipe out one or more of its guarantors? First, as part of the contract, the guarantors would be able to hire an accounting firm or other independent watchdogs as confidential monitors of the bank's actions. The

Hedge funds could police themselves.

their own contracts with guarantors. Those contracts would no doubt include penalty clauses for institutions lending to a hedge fund that is leveraged at 25 or 100 times its capital. The cost of this penalty would be passed along to the hedge fund in higher interest rates, limiting its borrowing.

In addition, a bank's guarantor institutions would quash any loans it might make to hedge funds that didn't open up their balance sheets, no matter how many Nobel laureates might be plotting the fund's strategy.

Our proposal would create incentives for financial companies to monitor and guarantee one another in a far more rational way than Government could hope to do by itself. And it is the only way we can hope to regulate multinational financial conglomerates that no single government can control.

All it would take is for enough financial companies to draw up these contracts — about 3 percent of the financial industry — for the benefits to start showing up. Eventually their competitors would follow suit, and we could spare ourselves further disasters like the Asian banking crisis and the Long-Term Capital mess.

Tom Petri is a Republican member of the House of Representatives from Wisconsin. Bert Ely is a financial consultant.

Letter-to-the-Editor
October 9, 1998

Response to OP-ED
October 5, 1998

Hedge Fund Protectors

To the Editor:

Tom Petri and Bert Ely (Op-Ed, Oct. 5) are right that more Government regulation is not the way to avoid debacles like the collapse of Long-Term Capital Management. However, their proposal for a chain of financial guarantors ignores important points.

As a former member of a large pension fund company, I worked with independent auditors as well as regulators. These organizations are ill equipped to evaluate the risks involved in today's advanced strategies.

Financial gurus like the Nobel laureates at Long-Term Capital are inventing new strategies every day. Their complexity often provides a competitive advantage in the race to exploit inefficient markets.

Unless potential guarantors can accurately assess the risks being taken by a financial institution, Mr. Petri's and Mr. Ely's "strong web" could easily become a row of dominoes.

FRED MASLIN
San Francisco, Oct. 5, 1998