Opinion: Suggestions for the financial sector

By Rex Ghosh

As the world closes in on the three-year mark of the beginning of the global financial crisis, I believe it's not enough to rely on new regulations to prevent future disasters – a fundamental change in mindset is required.

The global financial crisis, marked by the bankruptcy of Lehman Brothers in September 2008, has taken an enormous economic, financial, and social toll.

In the United States and abroad, regulations, laws, and practices are being changed to help ensure that such crises do not recur. But these regulations – running to the thousands of pages – are enormously complex. It may be years before they are all adopted and absorbed into the daily lives of those in the financial sector. The real prevention rests in the notion that leaders need to work toward changing the very culture of the sector to rely on more fundamental and basic practices based in prudence and responsibility.

I would like to see the financial sector learn the following lessons:

· For the Federal Reserve – Central banks such as the Fed should not only look at goods price inflation, but also at important asset prices, such as the stock market and housing sectors. It also needs to be more mindful of lending and credit booms, especially in the face of weakening credit standards. That's what paved the road to hell three years ago. We do not want to repeat that option again. Traditional monetary policy tools (like the Fed's interest rate) may need to be bolstered by counter-cyclical capital requirements (requiring banks to hold more capital in "boom" times).

· For Banks – Boring is good. Banks should get used to being a much smaller proportion of the economy, like it was before the 1990s. Bankers should also be aware of credit and counterparty risks. They need to know who they're doing business with, know to whom they are lending and not rely solely on credit ratings.

· For Regulators – They need to watch the kids and the cookie jar. They should not count on banks to manage their risks prudently. They should think seriously about "tail risks" – just because something has not happened before, such as a nation-wide decline in house prices, doesn't mean it cannot happen in the future.

These are not incredibly difficult precepts. The short answer is that the Fed needs to broaden its view of what constitutes inflation, banks need to look past the paperwork and avoid risk, and regulators need to realize their jobs don't end with the passage of new rules. For every regulation created, there are 50 new ways created to get around it. We need to realize that the practices of the past won't go away until we match the letter of the regulations with the culture of the financial sector.

Rex Ghosh received his A.B. in economics from Harvard University, MSc. in development economics from Oxford University, and his M.A. and Ph.D. in economics from Harvard University. He has taught at Princeton University and Georgetown University. He is the author of several books on international economics and numerous articles in professional journals.