

It is difficult to overstate the gravity of the financial and economic crisis which the world now faces. Almost all the developed economies are now in recession, or on the edge of it, and the most recent economic indicators suggest that this recession will be more severe than any experienced since the Second World War. While the major emerging markets like China and India continue to grow, they are also slowing down quickly. So the world faces the prospect of outright recession in developed economies and significantly below trend growth elsewhere. The consequence will be rising unemployment everywhere, with the associated social and political tensions. The global growth dynamic which has lifted many of the world's poorest people out of poverty over the last 20 years has stalled.



The crisis is so serious that it clearly justifies fundamental re-thinking about the way in which national governments, and the international institutions to which they are affiliated, carry out their tasks of overseeing the global economy and, particularly, of regulating financial markets.

THE CRISIS AND ITS CAUSES

Arguably we are still too close to the origins of the crisis to develop a fully articulated theory of why and how it emerged. A good and careful explanation of the origins of the financial crisis, which summarizes our current understanding, can be found in a paper published in November 2008 by the Brookings Institution.¹ The authors' summary is that:

“The financial crisis.... had its origins in an asset price bubble that interacted with new kinds of financial innovations; with companies that failed to follow their own risk management procedures; and with regulators and supervisors that failed to restrain excessive risk taking”.

It now seems clear that following the recovery from the dotcom bubble at the beginning of this century monetary conditions and liquidity became very loose. That in turn contributed to a bidding down of risk premia, so that investors were investing in risky assets at returns which did not reflect the uncertainties behind those investments.

Why was liquidity so loose? That remains highly disputed territory. Some argue that the principal failure was that the monetary policies failed to restrain liquidity growth, what one commentator has called “the great failure of central banking”.² Others argue that interest rate policy was not obviously too lax, but that regulators failed to require banks, in particular, to retain adequate reserves

1 The Origins of the Financial Crisis. Baily, Litan and Johnson. Brookings Institution Initiative on Business and Public Policy. Fixing Finance Series – Paper 3. November 2008.

2 The Great Failure of Central Banking. Stephen Roach, Fortune. September 2007



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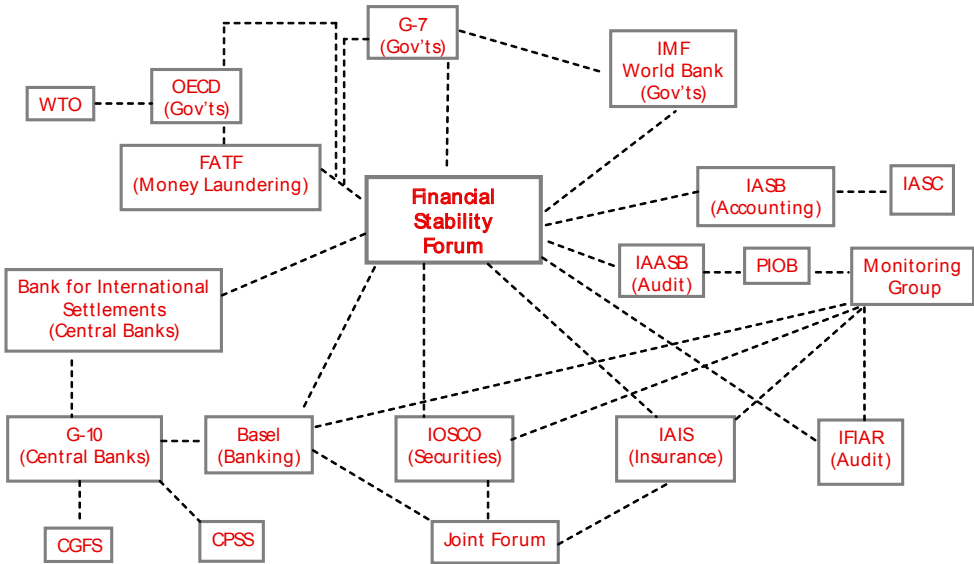
in the upturn, to protect them against losses in the downturn. In other words, regulatory policy was pro – rather than counter cyclical.

A further strand of analysis maintains that the underlying cause can be found in the so-called “global imbalances”. Some Western economies, notably those in Anglo-Saxon countries, were over-consuming. In both the US and the UK household debt as a percentage of GDP rose to previously unheard of levels, and savings rates fell close to zero in both cases. At the other extreme the savings rate in China reached 40% GDP. China’s huge trade surplus was balanced by enormous trade deficits in the US and some other countries. Many economists argued that these imbalances could not persist, though most believed that the unwinding would be less dramatic and less damaging than it is turning out to be. The central issue here is the extent to which the crisis has revealed flaws in the international regulatory architecture, flaws which must be corrected if we wish to reduce the risk of similarly damaging crises emerging in the future.

INTERNATIONAL FINANCIAL REGULATION

The “system”, if it can be described as such, which oversees international financial markets is certainly more a product of evolution than of intelligent design. It is based on a delicate balance between supranational entities and national governments. Unlike in the trade arena, where countries sign up to international agreements in the WTO, and cede jurisdiction over the policing of those agreements to a supranational body, in the financial arena there is no such model in place. The international bodies which do exist to set global rules, for example the Basel Committee which sets capital reserve ratios for banks, depend on voluntary agreements by their members, who commit to implementing those agreements in their home countries on a “best endeavours” basis. There are no multilateral sanctions on those who do not follow those agreements. (The main enforcement mechanism is that

Global Committee Structure - A Regulator's View



Source: Adapted with permission from Sloan and Fitzpatrick 'The Structure of International Market Regulation', in *Financial Markets and Exchanges Law*, OUP, 2007

countries may refuse to allow banks which do not meet international standards to set up branches there. But this is a difficult sanction to apply in the face of political pressure).

Furthermore, the system is built on an old fashioned subdivision of financial markets into three sectors: banking, securities, and insurance, which no longer reflects the reality of international financial markets. The result of that three-legged arrangement, combined with the existence of a wide-range of international bodies with different and overlapping responsibilities, is a highly complicated network of institutions and committees which lack obvious logic and structure. The system as it currently stands has been described in "Global Financial Regulation: The Essential Guide" by Davies and Green.³ The simplified picture of the global network can be found at Exhibit A.

One striking feature of the organisation chart in Exhibit A is that all the boxes are connected by dotted lines. In other words, there are no obvious hierarchical relationships between the different groupings. While the G7 Finance Ministers have, in theory, sat at the top of this pyramid in recent years, they have not taken an active and interventionist role in financial regulation, taking up individual issues typically only in crisis conditions. One consequence is that the system has responded very slowly, if at all, to changing circumstances in financial markets. For example, the Basel accord on bank capital was diagnosed as inadequate in the mid 1990s. It took 10 years to devise Basel 2 which was instantly redundant at the point it was introduced in 2008. Indeed the Federal Reserve has not yet switched to Basel 2 and may never do so.

The roles of the international financial institutions, the IMF and the World Bank, in this structure are also somewhat unclear. The principal functions of the IMF and the World Bank are to monitor compliance with international codes and standards, on the one hand, and to assist countries to meet those standards on the other. In addition, the IMF in particular is charged with monitoring global financial stability. The BIS performs a similar function in parallel. Both of them, in different ways, produced warnings about global imbalances and financial risk taking in the years leading up to the "explosion" in the summer of 2007. But those warnings were not hard wired into the regulatory system, and produced no concrete consequences in the form of tighter capital regulation. A good description of the pre-crisis analyses can be found in the Annual Reports of the Bank for International Settlements in 2007 and 2008.⁴

These weaknesses in the regulatory architecture have now been well understood by governments across the world. They were at the heart of the agenda for the G20 Summit in November 2008 in Washington. The fact that the Summit was convened on a G20 basis pointed to another problem: the unrepresentative nature of the bodies regulating the international financial system, whose composition reflected the financial world as it used to be, not as it now is. One early decision by that Summit was that the key institutions and committees must be re-balanced to bring the new financial powers into the core decision making processes. The Summit also set in train a number of work streams on detailed regulatory issues which will produce recommendations in time for the second G20 Financial Summit in London in April 2009.⁵

But there is a danger that this detailed work may mask some of the fundamental issues which now need to be addressed by both political and economic decision makers. This paper argues that there are 7 interlocking sets of issues which, together, shape the debate.

3 Global Financial Regulation: The Essential Guide. Howard Davies and David Green. Polity Press 2008.

4 www.bis.org

5 Declaration of the Summit on Financial Markets and the Real Economy. 15 November 2008.

1. THE ROLE OF MARKETS

In an unusual mea culpa Alan Greenspan said before Congress that his main failure had been to place excess reliance on the ability of the management and shareholders of major financial firms to act effectively in their own interests. "I made a mistake in presuming that the self-interest of organisations, specifically banks and others, was such that they were best capable of protecting their own interests".⁶ Is the Greenspan diagnosis correct, and has the crisis revealed fundamental flaws in the market mechanism? Have financial instruments become too complex for even those who invest in trade in them to understand the risks to which they are exposed? Are there fundamental flaws in the intellectual framework which market participants use to try to understand financial market dynamics – the efficient market hypothesis and its intellectual descendants? If there are such weaknesses, how should they be corrected? Are different forms of governance required for financial institutions if the traditional principal/agent model does not deliver satisfactory outcomes?

An alternative, though perhaps complementary hypothesis is that the fundamental problem lies in the way in which states seek to regulate markets.

2. THE FUTURE ROLE OF THE STATE

For years it has been fashionable, certainly in the major financial markets of London and New York, to downplay and even denigrate the role of the state in financial markets. Regulators were widely considered to be a tiresome inconvenience, at best, and central banks were often seen as monetary policy authorities only. Even in the months leading up to the outbreak of the crisis, financial firms thought the major risk to their business was "excess regulation".⁷ But we have now seen that in crisis conditions financial markets, and the main institutions within them, depend entirely on the state for their continued existence. Almost all the major financial institutions of the Western world would have collapsed without the provision of huge sums of liquidity by the central banks, and many of them now owe their survival to direct capital injections by the governments, and to the expansion and strengthening of government-based deposit guarantee schemes which have prevented retail bank runs.

It is once again understood that financial markets, and especially banks, depend on the existence of what Paul Tucker of the Bank of England has described as a complex "social contract" between them and the state.⁸ Banks undertake the fundamentally risky process of maturity transformation, turning sight deposits into long term loans. They could not do so on the scale needed to support a dynamic economy without two essential underpinnings: a deposit guarantee scheme (whether funded by the banks themselves or not is less crucial than the fact that it is underpinned by statute) and the availability at times of stress of potentially unlimited liquidity from the central bank. Those two aspects of state support allow the banks to take risks. But the state cannot allow unlimited risk-taking. Otherwise, banks would have little incentive to control their risks as when things go well they will make high profits and when the market turns down the tax payer will bail them out. So, to exert some control over risk-taking governments impose prudential regulation on the banking system which imposes a requirement on banks to hold capital reserves at a certain level.

6 Testimony to the House Representative Oversight Committee. 23 October 2008

7 Banking Banana Skins 2006. David Lascelles. Centre for the Study of Financial Innovation. www.csfi.org

8 Remarks by Paul Tucker at a Chatham House Conference on "The New Financial Frontiers" 29 April 2008. www.bankofengland.co.uk

It is now clear that all elements of this “social contract” need to be re-thought. Deposit-guarantee schemes have not been generous enough to prevent bank runs. The normal ways in which central banks provide liquidity to the system have proved wanting and had to have been revised several times during the crisis. Prudential regulation has failed adequately to constrain risk-taking. The intensity of that regulation will clearly have to be stepped up in the future. To do so will, however, be costly. Requiring banks to hold higher reserves, and more liquidity, will impose costs on them which will be passed on to customers. So governments cannot with impunity make their banking systems “safe”. That will in turn constrain economic growth. Determining where the new balance should be struck will be a very delicate process.

Robert Solow, the 1987 Economics Nobel prize-winner, argues for a fundamental change: “I would like to see a regulatory system aimed at insulating the real economy from financial innovations insofar as that is possible. That may require limits on the freedom of actions of commercial banks”⁹

And there are even more serious problems to address under this heading. Some governments, notably in the US and the UK, now have sizable shareholdings in some of their banks. Is it desirable that the state should hold equity stakes in banks? International experience would suggest that state owned banks are often inefficient and loss-making. But having taken an equity stake, how easy will it be to withdraw, and on what terms should the government withdraw? While the Government does own a stake in a bank, what influence should it have on the bank’s lending policies, and on its remuneration? Some of these, perhaps, are short term questions, but there is an urgent need for a coherent intellectual framework within which to address them.

3. BALANCING LEGITIMACY AND EFFICIENCY

It is now widely accepted, certainly by the G20 Summit, that the legitimacy of the international regulatory bodies needs to be strengthened, in other words new members from the major developing countries must be included. But we know from experience that broader membership of international bodies can lead to inefficiency and stasis. Committees with 150 members will rarely make decisions. How will that balance be struck in the future? Which emerging markets need to be brought in? How to choose between them? Do G7 countries themselves need to reduce or consolidate their own representation? Why, for example, can the EU not be represented by one voice?

4. THE GLOBAL/NATIONAL BALANCE

Some have argued that repeated malfunctions in the international financial system point to the need for a global regulator, perhaps a world financial authority.¹⁰ So far nation states have not been prepared to cede authority over their financial systems to a global body, however governed. This position contrasts markedly with the arrangements for international trade, where the WTO is able to enforce trade agreements. Does the latest crisis alter the balance of argument on this central question? Might there be a case for some kind of supranational authority with an enforcement arm, to ensure that countries meet internationally agreed standards on a continuing basis? Might nation states gain sovereignty in one sense, by ceding responsibility to a body which can conduct global oversight more effectively than any individual state?

9 Interview with the Financial Times. 16 December 2008

10 Global Finance at Risk. The Case for International Regulation. John Eatwell and Lance Taylor. Polity Press 2000

5. INTERNATIONAL REGULATORY INSTITUTIONS

The crisis has focused attention on the continuing uncertainty about the appropriate role for the International Monetary Fund in particular. Should the IMF itself become a kind of financial regulator? At present its role is limited to a general financial stability oversight function, together with some monitoring of compliance with international standards. Should the IMF take over more responsibility in this area, or is the Financial Stability Forum, with its broader membership including regulators in nation states themselves, a more appropriate body?

There is a particularly difficult version of this question within the European Union. The decision making structures of the EU in relation to financial markets are, if anything, more complex than those which operate globally. (Exhibit B). Although the single financial market has been in operation for over 15 years, and financial firms authorised in one country can operate across the European economic area, the crisis has revealed incompatibilities in the domestic regulation of banks which has caused serious problems elsewhere. The most dramatic example is the problems created in the UK and the Netherlands by Icelandic banks, using an authorisation in Reykjavik to bid aggressively for deposits from retail savers. When those banks ran into difficulty, the Icelandic Central Bank was unable to back them and the British Government had to step in. Can this and other problems in Europe be resolved without the creation of a single regulatory authority in the European Union to sit alongside European Central Bank? Without such a body, is there not a risk that the single financial market process will go into reverse, with – as has happened at times during the crisis – individual countries pursuing “beggar my neighbour” policies to protect their domestic institutions? Are we about to see the single financial market go into reverse, with EU member states asserting jurisdiction over local entities of firms head-quartered elsewhere in the EU?

In a recent report for the Centre of European Policy Studies Karel Lannoo has argued that the EU should now establish a European Financial Institute, on the model of the European Monetary Institute which was the forerunner of the European Central Bank. The EFI should set out a roadmap for the creation of new central authorities for the regulation of major pan-European institutions at least.¹¹ The EU have asked a “wise men” group, under Jacques Delarosière, to explore the future of European regulation.

6. HOW “TOUGH” SHOULD REGULATION BECOME?

It is easy in the midst of a crisis created by exaggerated risk-taking in the financial sector to argue that regulation must be tightened for the future. But, as we have pointed out, tighter regulation is not costless. It comes with a high price tag for firms and consumers in the form of raised costs of borrowing. How do we determine where to set the balance in future between financial stability and risk taking?

In the case of insurance companies, as with banks, there are similar issues related to solvency. Tighter solvency rules look attractive, but will significantly reduce the returns for long term investors. And in securities markets countries have variously intervened to prevent short-selling and in some cases leveraged trading, in stressed market conditions. But those restrictions are likely to have adverse long term consequences for the cost of capital. Again, determining where the balance should be struck will be a delicate question in the future.

11 Concrete Steps Towards More Integrated Financial Oversight: The EU's Policy Response to the Crisis. Karel Lannoo. Centre for European Policy Studies. 1 December 2008. www.ceps.eu

7. THE BORDERS OF REGULATION

The fundamental justification for prudential regulation of institutions has remained broadly unchanged for some time. Governments typically regulate investment managers or deposit takers who receive funds from retail investors or depositors. They apply lesser regulation to investment banks who operate principally in the wholesale markets, and institutions investing entirely on behalf of professional investors or institutions, like hedge funds or private equity firms, have been largely outside the regulatory framework. Certainly they have not been subject to capital regulation. But in the midst of the crisis some important changes have been made to what we might call the “regulatory frontier”. Specifically, the main US investment banks have become bank holding companies, able to take retail deposits and with privileged access to the Federal Reserve. It is likely that, as a consequence, those investment banks will be able to take fewer risks than before, and their leverage will be significantly reduced. As a result proprietary trading activities are migrating from those institutions into unregulated hedge funds. In those circumstances, is the regulatory frontier now in the right place? Should hedge funds, and perhaps the major private equity firms, be subject to greater regulatory oversight, if it is possible that their activities will be on such a scale in the future as to generate risks for the financial system as a whole?

Another set of institutions which have been broadly outside the regulatory net are credit rating agencies. There are new legislative proposals in the European Union to impose a European regulatory framework on those agencies. But does it make sense for there to be different regulatory structures in the European Union and the US on essentially the same firms? Would it not be preferable to reach a global agreement on where the regulatory frontier should be drawn?

CONCLUSION

The crisis has challenged many of the assumptions which have underpinned the regulatory system. The consequences of the financial meltdown will increasingly affect ordinary working people over the coming months. That in turn, will focus political attention, and perhaps popular anger, on actions of the firms and regulators who are seen to be responsible. So the task of re-engineering the system for the future is urgent. And politicians will need a new language to explain their responses to a sceptical public.