IN CASE OF CRISIS BREAK GLASS

EDITOR – MARTHA POON
Weren't you there when finance married the concept of crisis? Economists, financial journalists, politicians, regulators, social activists and academics all bore witness to the nuptial. Alan Greenspan gave the bride away on 23 October 2008 when he admitted before US Congress that he'd found a flaw in his governing ideology. All financial crisis analyses pursue a single question – What went wrong in the financial system?

In her book Anti-crisis (Duke University Press, 2013) anthropologist Janet Roitman examines the stakes of thinking in terms of crisis. She points out that diagnosing “what went wrong” assumes strong basic knowledge of how things operate, in practice. And yet, when the markets seized up half a decade ago, we were shocked to find out how little we understood about the global system of finance. From no income no asset loans to collateralized derivative obligations, from Lehman's infamous Repo 105 to the mechanics of the shadow banking sector – it is only as a result of the global choke up that we discovered this incredible network of financial mechanisms.

There is no denying that crisis is a productive concept. If anything, that's Roitman's major observation. Her concern is that crisis-thinking might be a false friend to researchers because it neutralizes curiosity while participating in discursive conversation. It seems to me this point is worth considering, especially in the field of risk and regulation. Everywhere we turn, the world seems to be in a state of exception. Is it possible we’re saturated by a single concept? Could there be other ways of confronting the actual crisis? Economists, financial journalists, politicians, regulators, social activists and academics all bore witness to the nuptial. Alan Greenspan gave the bride away on 23 October 2008 when he admitted before US Congress that he'd found a flaw in his governing ideology. All financial crisis analyses pursue a single question – What went wrong in the financial system?

Having explored how we came to live in a world where governments self-discipline to please creditors and citizens gamble to support themselves and their communities, this issue then asks – What can we foresee for ourselves in the future? In the remaining essays, Sabine Montagne unravels the legal underpinning of our enduring trust in pension funds, while special contributor Helaine Olen reports on the growing gap between the expectations of American workers and the actual performance of their defined contribution plans. Kim Sain and Christian Huber remind us of an episode of pension mis-selling in the 1980s, in the UK. Financial innovation changes the work life of financial professionals, just as it does social experience. Last but not least, you will find the executive summary of Michael Power, Simon Ashby and Tommaso Palermo's research report. Risk culture in financial organisations. The full 103-page document, available on CARR's website, examines the organisational position of the risk function inside financial institutions.

Martha Poon
Editor, R&R

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In the social sciences and the popular press, crisis texts are a veritable industry. Crises are posited with such astonishing frequency that I recently felt compelled to investigate why so many authors are drawn to this argument.

Instead of debating whether it’s appropriate to label this or that situation a crisis, I ask questions about the significance of crisis as a working concept. What is a crisis? What does crisis signify? What intellectual labour does it perform when it is invoked to tell a story? It seems to me that we should be more aware of the consequences of using crisis as a tool for thinking.

In my book, Anti-crisis (Duke University Press, 2013), I discuss how crisis narratives structure thought and shape political responses. After reviewing its long history, Anti-crisis concludes that the term “crisis” is a blind spot in social scientific thinking. What I have found is that crisis is not simply a way of naming events, it’s a conceptual distinction or observation that generates meaning. Once we call something a crisis we begin to engage in a series of logically interconnected steps that unleashes a characteristic pattern of reasoning. The pattern is familiar and it can be comforting, but it is neither original nor is it innovative.

The point of departure for all crisis-based analyses is one basic question: What went wrong? From the get-go, the claim to crisis demands that we search for the origins and root causes of failure. The answer to what went wrong is invariably that we have deviated from the proper course of action because of alleged distortions in what human beings know and the way they do things in practice.

This built-in relationship between crisis and distorted knowledge is very important. When analysts call something a crisis, they are claiming to observe a chasm between what people are doing, and what they should be doing to conform to reality or to ethical practice. This requires the observer to portray the events they are witnessing as a fictitious, erroneous or illogical departure from reality. A financial crisis, for example, signifies a gap between economic value grounded in material fact, and hypothetical judgments or misguided evaluations of risk levels or prices.

A crisis is also a statement embedded in a philosophy of time. Crisis accounts present a diagnostic of the present through which an analyst identifies a disjunction between what we know and our ability to move forward according to a desired path. As the etymology of the Greek word krisis signifies, crisis is the moment when one must make a pivotal decision to change course. Therefore, when someone claims that we are in crisis, they are both demanding a moment of truth and demarcating an opportunity to revert to the proper course of history.

The collapse of credit markets is a prototypical example of how crisis thinking is deployed to explain the significance of human events. In 2008 it was revealed – or so it is alleged – that financial markets had been diverted or corrupted in pursuit of false value. Housing booms became speculative bubbles, structured products became toxic assets, risk pricing became a delusion of despairing. Numerous commentators have argued that a correction, boosted perhaps by the appropriate interventions, offered hope of re-establishing or relocating some more genuine or fundamental value. A dizzying array of authors have enthusiastically pursued this premise, producing what US banking editor Tom Braithwaite at the Financial Times called a “tannum of crisis analysis” (2011).

The resulting narratives are all structured as a quest for the “roots”, “origins” or “causes” of what went wrong in credit markets. If you look closely at these accounts you will find that financial crisis advocates share a similar concern with unearthing a History from which we have become alienated because of some inadequacy in our own knowledge. In their own words, Michael Lewis seeks to reveal the “secret origin”, Robert Skidelsky the “deeper causes”, David Harvey the “underlying contradictions”, and Bethany McLean and Joe Nocera the “hidden history”, of how a seemingly more desirable development of capital markets became distorted.

I am confident you recognize the story of financial crisis. Now follow me closely while I show you its pitfalls.

Crisis is a term that operates by drawing a comparison. To posit a crisis we must ask – Crisis as compared to what? Crisis means that a judgement has been made by which the present is deemed to be at odds with an alternative and more normal situation. This alternative state is actually a preferred state of affairs because the idea of “normal” is a subjective evaluation. Every person, every community, and every polity does not refer to “normal” in the same way. This is why crisis stories provide generic accounts that are fuzzy. What happened? What is happening? How are financial systems being engineered? Researchers ignore basic empirical questions when they speculate and debate how finance has gone wrong.

Financial markets are built by groups of human agents out of distinct designations, decisions, determinations, and contexts. Somebody is doing something somewhere over a period of time to make subprime loans, rate changes and waves of foreclosures happen. We need to know more about how quants design financial models or rating agencies develop new risk measures; how accounting boards set up standards and investment bankers do analyses. We need to observe how risk managers deploy scenarios and pundits debate possible outcomes; how central bankers conduct rate operations that get written into swap agreements.

There are so many anti-crisis questions for which we need answers because I simply don’t buy that mortgage rates reset themselves or that housing prices fall spontaneously. When were these extensive debt markets created and how did the banking system become so leveraged? At what point did we come to see a mundane occurrence like deflation as truly exceptional? When does a credit asset become a toxic asset and how do we distinguish the former from the latter? When does real estate equity become reconfigured as a debt burden?

The most elusive question of all is: Why crisis now? When did crisis begin? How can we be certain a crisis has obtained?

My argument is that financial markets are not produced by some naturally unfolding history gone amok, nor are they the result of efforts to place that housing price fall spontaneously. When were these extensive debt markets created and how did the banking system become so leveraged? At what point did we come to see a mundane occurrence like deflation as truly exceptional? When does a credit asset become a toxic asset and how do we distinguish the former from the latter? When does real estate equity become reconfigured as a debt burden?

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DSK STANDS FOR SELF-DISCIPLINE

Before “DSK” was shorthand for scandal, it was the name of a French sovereign bond. The acronym was first used by the French headquartered La Monde in December 1997 to report on a debt instrument named after Dominique Strauss-Kahn, then France’s Minister of Economy and Finance. In the presence of an assembly of Paris stock market agents, Strauss-Kahn proudly announced the launch of this acronym. The very first to index France’s rate of inflation. In the UK, this category of bond is called a lien because the interest rate paid by the borrowing country is linked to inflation.

The DSK bond was tailored to meet the appetite of creditors – especially big institutional investors like life insurance companies, pension funds, savings and investment banks – for secure investments and in monetary affairs. Inflation-indexed bonds not only reward specific economic conditions, they neutralize the institutional conditions under which policy measure to achieve low inflation conditions can be made. Linkers or inflation-indexed bonds are deliberately shaped by treasurers as a signal that disciplined will be exerted on public finance. They further signal that arrangements institutionalizing the economic policies that suit the preferences of market actors will be put in place.

Debt management practices can certainly neutralize governments, but my research suggests these practices are neither the result of a naturally occurring theory nor of political neutral options. The DSK is part of a long term process in which governments are willingness to self-discipline with regards to public spending, money creation and inflation control in order to make their debt more attractive to global investors.

The threshold was an administrative device that performed multiple roles. It secured resources where the value was assigned by the state, and gave the central public administration the opportunity to directly control monetary supply and credit distribution. Reforms that occurred during 1960s were deliberately designed to neutralize the Treasury’s role in monetary affairs, because its tools were accused of feeding inflation. According to Jean-Yves Haberer, a young technical advisor to the French minister of finance who directed the operationalization of these reforms, the main object was “to gradually take the treasury department to be a borrower, that is to say, to ask itself questions of a borrower such as the cost of borrowing and the debt burden services”.

To “put the debt in the market” was to force the state to live in a real market for funding.

Since societal conventions appear to be more easily manipulated than contractual debt obligations, states are concretely disciplined on their social policies, public spending and monetary control by market techniques. It is somewhat ironic that high civil servants in the treasury who are supposed to fund state activities promote innovations like DSK bonds. Yet the budgetary cost-cutting measures endlessly discussed in the US debtor ceiling debate and the European and Greek debt crisis, barely scratch the surface of how deeply debt instruments reshape the agency of the state, impose reforms, reform the state’s goals, and reconfigure relationships between creditors, citizens and economic policy.

In sovereign debt markets, the letters DSK still stand for self-discipline.

Reference


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The political will to meet specific economic objectives which are attractive to capital investors is written into the bond itself.
Slate governments across the United States are scrambling to expand legal gambling. In the past year, Massachusetts passed a bill allowing three casinos and a slot machine parlor, in Ohio opened three new casinos, and Rhode Island, North Carolina, and Maryland approved new gambling venues. This year promises fever-pitched campaigns to legalize gambling in New Hampshire, Georgia, Kentucky, Texas, and to expand gambling in Florida, Illinois, and Pennsylvania. In New York, Governor Cuomo hopes to establish seven Las-Vegas style casinos on non-Native American land.

Just as they did during the recession of the early 1990s, legislators in cash-strapped states are looking to commercial gambling as a way to raise revenue by raising taxes. Spurred by vigorous lobbying and the pressure of fiscal urgency, they are paying little attention to the potential human costs of partnering with gambling interests.

At a casino industry trade show I attended in 2008, a panelist approvingly told his audience: “States are responding to what other states are doing, there’s a lot of border anxiety. It’s an arms race.”

The most lucrative “arms” at stake in the race to raise revenue from gambling are modern slot machines. The devices—which typically feature video screens instead of mechanical reels, buttons instead of handles, and accept player loyalty cards instead of coins—have become familiar to gamblers around the world. Known as “video lottery terminals” in Canada, “pokies” in Australia, and “fruit machines” or “jackpot machines” in Britain, they have become the international cash cows of the gambling industry. In the US they generate upwards of three quarters of gambling revenue; even in so-called destination-resort casinos, they bring in twice as much as all other games put together.

But the machines are noteworthy for more than their extraordinary revenue performance. Slots are commonly misperceived as an innocuous form of gambling because they offer relatively low stakes, are easy to play, have historically been popular among women and retirees, and outwardly resemble youth arcade games. In fact, the opposite is true. Studies by a Brown University psychiatrist, Robert Bresan, have found that individuals who regularly play modern video slots become addicted three to four times faster (in one year, versus three and a half years) than those who participate in traditional forms of gambling like cards or sports betting. Bresan calls these machines “the most virulent strain of gambling in the history of man.”

As I learned from interviews with hundreds of gambling addicts and game designers over nearly two decades of fieldwork on the US gambling industry, the particular addictiveness of modern slot machines has to do with the solitary, rapid, continuous wagering they enable. It is possible to complete a game every three to four seconds, with virtually no delay between one game and the next.

To my surprise, the vast majority of those I interviewed harbored no illusions of winning big; instead of playing for the jackpot, they played for what some call “the zone” – a trance-like state of absorption that can suspend the pressures and anxieties of everyday life. Some players become so caught up in the interaction with the gambling machine that their awareness of space, time, and monetary value fades.

“The consistency of the experience that’s described by my patients is that of numbness or escape,” Robert Hunter, clinical director of the Problem Gambling Center in Las Vegas, told me in an interview. “They don’t talk about competition or excitement – they talk about climbing into the screen and getting lost.”

“Time on device” is the gambling industry’s term for a mode of machine gambling that is loss absorbing and euphoric in that about maintaining a hypnotic flow of action—a mode that is especially profitable for casinos.

“Our best customers are not interested in entertainment,” acknowledged a slot machine designer from a company now owned by International Gaming Technology (IGT), the nation’s largest slots supplier. “They want to be totally absorbed, get into a rhythm.”

So-called problem gamblers are known to contribute a grossly disproportionate percentage of slot machine revenues—30 to 60 percent, according to a number of government-commissioned studies in the United States, Canada, and Australia. But problem gamblers aren’t the only ones whose finances and well-being are at stake in the bid to expand machine gambling. “Over-spending and/or losing track of time or money occurs for the majority of regular players,” a 2011 Canadian report found. While casinos and governments may campaign for “responsible gaming,” the evidence suggests that the bulk of their gambling revenues derive from such overspending.

As the psychologist Mark Dickerson explains, the way that modern slot machines configure gambling activity “reduces the player’s ability to maintain a sequence of informed and rational choices about purchasing the next game offered.”

“How can they expect people to gamble responsibly?” commented a video poker addict following a Gamblers Anonymous meeting in Las Vegas, “when they build machines that make them behave irresponsibly?”

Surely, civic leaders looking to close budget gaps can find more ethical alternatives than capitalizing on such devices.

“It’s time we asked the modern gambling machine what is often asked of consumer products like cigarettes, guns, and junk food: Might the product and its design be partly to blame for the problem?”

The American Gambling Association, the lobby group for the US gambling industry, says no: addiction need not be people, not machines. Yet industry members invest a great deal of their money and energy in the effort to influence consumers’ behavior through technology, design. At trade conferences, they make no secret of their aims: How to turn casual gamblers into regular gamblers, how to keep them playing longer and spending more money; how to take the taint of one at the 2005 industry trade show – to “Build a Better Mousetrap.”

To this end, over the last decade slot designers have focused on developing low-denomination “dribble-feed” games that take gamblers’ money slowly and grant them a steady flow of small wins along the way – just the kind of design that can put players into the zone that addicts describe. These “high hit frequency, low volatility” games allow players to bet on multiple paylines simultaneously such that they frequently “win” back a portion of their total bet, although they are steadily losing the audiovisual feedback they receive from the machine is identical to that of winning. Kevin Marangan and Mark Dixon at the University of Waterloo found that gamblers’ brains do not distinguish between actual wins and these “false wins”.

Despite the gambling industry’s oft-repeated claim to be the most highly regulated industry there is, the agencies around the world tasked with approving its new slot models perform no tests to determine how technological innovations like false wins might harmfully affect players. There are no consumer protection guidelines in place — in the US or elsewhere — to evaluate the addictiveness of game characteristics such as wagering speed, use of credit rather than coins, and the ability to play for extended periods without interruption. More often than not, regulatory agents describe themselves as working in partnership with industry innovators.

“When is the industry too entrenched, provides too large of a tax base, and the lobby is just too powerful? If you do create a regulatory loophole, guys like us will drive a truck through it.”

Legislators in any jurisdiction seeking to expand the availability of gambling machines as a way to bolster government budgets should be wary of inviting financial dependence on devices whose design is widely misunderstood, poorly regulated, and, for millions, addicting.

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Spread betting is an unusual name for a financial product. A spread bet is a contract made between a trader and a spread betting company based on the movement of prices of those markets. When a spread bet is placed on the platform of a spread betting company, the company automatically becomes the counterparty of a bet. The business operates similarly to High-street bookmaking where the bookmaker takes the opposite side of fixed odds bets on horse races, sports events and political elections, even though spread bet odds are not fixed. The relationship reflects a particular power dynamic where risk is sold as a consumer product on terms set by a profit seeking enterprise.

Spread betting is a mature market in the UK where it has been growing for almost 40 years. Based entirely on the internet, the UK saw an increase in the number of spread betting companies and for a share of this technological boom. The risk appetite of betting firms, especially the smaller ones, increased as a result of competitive pressure. Despite growing competition, IG, the oldest running and largest spread betting company in the world represents 44 per cent of the market volume, and serves as a yardstick of the industry’s health. In May 2013, IG registered a net trading profit of £361.9 million, a slight slowdown from 2012 but still up £27.6 million from 11 years ago. Given the nature of the product it sells, the company’s reported revenue is higher following periods of increased volatility as in 2008, 2009, and more recently July 2013. According to the Financial Times, over June, July and August, the FTSE 250 group reported sales of £38m, up £82m in the same period a year earlier.

Widespread access to the internet and the rise of electronic trading systems have made it possible for firms to market spread betting contracts to pools of traders and wannabe traders that exist outside the closed network of financial professionals. But technology isn’t the whole story behind the rapid rise of this industry in attracting investors’ money. The emphasis on the democratising powers of digital infrastructure overshadows the fact that spread betting was not always considered a legitimate form of investment which could be regulated by the Financial Conduct Authority (FCA). What really paved the way for investment capital to flood into this market was the industry’s ability to take advantage of a series of regulatory opportunities.

The connection between the business model of spread betting and that of gambling runs deep. Spread betting easily did start out as a bookmaking business in 1964, when Coral Index, spearheaded by stockbrokers and capitalised by bookmaker Joe Coral, was the first spread betting company registered under the 1960 Betting and Gaming Act. The act’s relaxed legislation was meant to legalise betting outside the racecourse but its flaws also provided attractive new business opportunities. In contrast to the higher cost of futures trading and the regulatory limitations imposed on the futures markets at the time, companies could now offer to trade on future prices with a more flexible regulatory framework. In the 1980s, spread betting was a newer device for trading futures-type contracts without the constraints of conventional financial regulation.

In its earliest days, spread betting was a risky business to operate. By taking the opposite side of the bet, Coral Index was literally betting against its punters. What would happen if many of its clients went right at the same time? Inevitably, Coral hit a bad run at some point losing all of its original capital. Despite having lost a lot of money and the financial backing of Joe Coral, the company carried on until 1981 when it was sold to Ladbrokes which was itself acquired by IG three years later.

IG’s original business model was somewhat different. The company, started in 1974, offered spread bets on gold, but only when it could hedge the position it had against its customers in the market. It offered a 50/50 profit or loss to its customers by locking in the spread – commission fee – included in the buy and sell side price of a spread bet. IG gradually diversified its breadth of bettable assets, as well as indices like the FTSE as well as the Dow Jones, because it was able to hedge risky positions held in those assets in the relevant futures markets.

While the City of London adopted the hedging tools at hand to improve its business model, IG and its competitors – Ladbrokes Index won the case and since then spread betting has been regulated as a financial product. The use of hedging combined with little competition meant that profits would come mainly from the spread – commission fee – included in the buy and sell price of a spread bet. IG gradually diversified its breadth of bettable assets, as well as indices like the FTSE as well as the Dow Jones, because it was able to hedge risky positions held in those assets in the relevant futures markets.

IG bought over in 1981 and City Index which started much later in 1983 – were still officially operating under betting legislation. The spread bet’s status as a gambling product changed with the Big Bang financial deregulation in the UK in 1986. Eager to facilitate futures trading at the time, the Conservative government included a clause which would prevent a futures contract from being interpreted as a wager, unenforceable under the Gambling Act of 1845. This regulatory detail was a window of opportunity for spread betting companies.

City Index led the way. In a case known as Leslie v. City Index, the firm took one of its customers to court in 1991 for debts accrued after the 1986 financial crash. For City Index, litigation was a means to an end: it wanted the ruling by the courts to establish that spread betting qualified as an investment under the meaning of the 1986 Financial Services Act. City Index won the case and since then spread betting has been regulated as a financial product. Although spread betting no longer falls under betting legislation it does retain one essential trait that marks it past as a betting product: the winnings remain free from capital gains tax. An important advantage against other taxable forms of financial investment, the tax-free perk is one of the spread bet’s unique selling point to investors, even though it only applies to UK tax payers.

The tax-free perk is one of the spread bet’s unique selling point to investors, even though it only applies to UK tax payers.

Claire Loussouarn explains how a gambling instrument became a popular and mainstream investment product in the UK.

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CARR RESEARCH

OUR TRUST IN PENSION FUNDS

Socio-economist Sabine Montagne examines our trust in the US model of financing retirement.

When Europeans decided to reform their retirement systems in the 1990s, they took the American model of retirement financing as their major point of reference. The defining feature of the American system is that financing is shared between a public federal regime, and a private complement in the form of a pension fund. Instituting this feature in continental Europe was the primary objective of reformers during the decade of stock market euphoria that marked the 1990s.

Curiously, the effectiveness of this model has not been questioned following the market crash of 2001 or 2007, despite a series of social and economic blows suffered in the United States. What is more, the model continues to relentlessly insinuate itself into the institutional make up of continental European countries.

How can we understand this persistent belief in the virtues of the pension funds? Since the advantages of this model have proved inoucuous from a number of economic of vantage points, I have felt compelled to search for the alternative reasons that make it an attractive configuration. What is it about pension funds that makes them so hard to resist?

Macro-economic constraints and institutional interests have no doubt nourished the wave of reform on how social protection is financed. These forces have created a groundswell that is not easy to stop, even when reformers are confronted with contradictory arguments grounded in compelling empirical evidence that new solutions aren’t working. This principle alone, however, is not enough to account for the persistence of this belief.

The trust organizes management around two principles: first, the financial form. What I have discovered is that this idea is far more stubborn than the economic assumptions woven into the very fabric of pension funds that, so long as they remain taken for granted, inhibit empirical evidence that new solutions aren’t working. This principle alone, however, is not enough to account for the persistence of this belief.

The trust is essentially a procedural guarantee. It is not in any way constructed to guarantee a substantial level of financial performance that would assure a certain quality of retirement.

In privileging the trust as an entry point for my study, I have placed the question of pension funds’ legitimacy within the history of juridical economics. The idea is that pension funds inherit from the trust, a special legal form that is as distinctive as the contract or the corporation. The trust is unique to Anglo-American culture and possesses no exact equivalent in other places such as France. Over the course of time, jurisprudence as engendered a corpus of juridical rules, and has also constructed a veritable model of financial comportment that regulates all relationships within the chain of investment. The trust, therefore, is not only a specific juridical status of Anglo-American law, but its demands permeate the everyday practices of the financial world surrounding it. The trust is key to understanding the contemporary organisation of the pension industry.

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Behind this fable there is something else at work beyond the convergence of constraints and interests that explains the fierce adherence to the American model. There is a force that even the current institutional collapses are unable to shake off. We must, therefore, seek to understand the assumptions woven into the very fibre of pension funds that, so long as they remain taken for granted, inhibit an internal critique from developing.

That conviction in pension funds’ legitimacy by a guardian on behalf of a minor, it thus constitutes a guarantee that the management of the pension industry’s “efficacy” is a juridical structure called “the trust”, a special legal form that is as distinctive as the contract or the corporation. The trust is unique to Anglo-American culture and possesses no exact equivalent in other places such as France. Over the course of time, jurisprudence as engendered a corpus of juridical rules, and has also constructed a veritable model of financial comportment that regulates all relationships within the chain of investment. The trust, therefore, is not only a specific juridical status of Anglo-American law, but its demands permeate the everyday practices of the financial world surrounding it. The trust is key to understanding the contemporary organisation of the pension industry.

The trust is essentially a procedural guarantee. It is not in any way constructed to guarantee a substantial level of financial performance that would assure a certain quality of retirement.

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DO-IT-YOURSELF RETIREMENT

How are Americans faring with their 401(k)s? Author Helaine Olen reports from New York.

"For retirement, the answers are 4-5-1-1," proclaimed Tyler Mathisen, then editor of Money magazine in 1996. "Feel sure that someday, like a financial Little Engine That Could, we'll pull us over the million-dollar mountain all by itself."

For this sentiment, and others like it, Mathisen was soon rewarded with an on-air position at financial news network CNBC, where he remains to this day.

As for the rest of us? We were had.

The United States is on the verge of a retirement meltdown. The culprit? That same thing Mathisen celebrated: the 401(k), along with the other instruments of do-it-yourself retirement.

Not only did they not make us millionaires as advertised, promoted the idea that ma and pa saver could invest their way to riches, we ignored warning of trouble. As early as 1986, Karen Ferguson who was then, as she is now, the head of the Pension Rights Center, warned in an op-ed published in the New York Times, "Many of the workers have nothing to spare from their paychecks to put into a voluntary plan."

In 1989, economist Tavis Ghilarducci, who is now at the New School, called the do-it-yourself retirement system an "an abyss" at a congressional hearing.

Everyone Thought They Could Get Rich

What Americans think of today as the natural retirement landscape began as a few technical changes to the tax code in the late 1970s. These changes were meant to allow high earners to receive a greater chunk of their salary on a tax deferred basis. However, the Reagan administration decided that companies should be allowed to offer the new set-aside to all their workers. It didn't take the corporate bean counters long to figure out the new 401(k) was a gravy train for the financial services sector.

The leakage rate is now close to 25 per cent. People find it almost impossible to put money aside in this environment. The American savings rate hovered around 10 per cent in the late 1970s and early 1980s. Today, it is a little more than 1 per cent.

As a result, innovations that promise to improve our retirement situation never seem to work out quite as planned. Take a look at what happened when companies began to adopt automatic enrolment plans for 401(k)s, which forces people to opt-out of retirement plans instead of filling out papers to join up. Yes, the number of people contributing to deferred contribution accounts increased, but not did what industry insiders call the "leakage" rate – that is, the number of people borrowing against or withdrawing the money in their accounts, if the money isn't repaid, the consumers must pay additional penalties for accessing it.

The leakage rate is now close to 25 per cent.

The Gravy Train

So, why does this situation persist? Well, for that you can blame the great bull market of the twentieth century.

Just as Americans were beginning to grasp how self-funded retirement mechanisms, like Dow Jones Industrial Average took off. From a low in the 1930s of under 10,000 in early 2000, 20 billion by the greatest amount ever recorded. College costs have tripled since the early 1980s. The amount of money students are borrowing to pay tuition bills all but doubled from 2006 to 2012 to $1.1 trillion. Lately, economists have been warning and patients are increasingly responsible for ever greater amounts of their medical expenses – credit reporting agency Transunion recently claimed an astonishing 22 per cent rise in out-of-pocket hospital expenses over the past year.

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At the same time, costs of things Americans can't do without continue to rise. College costs have tripled since the early 1980s. The amount of money students are borrowing to pay tuition bills all but doubled from 2006 to 2012 to $1.1 trillion. Lately, economists have been warning and patients are increasingly responsible for ever greater amounts of their medical expenses – credit reporting agency Transunion recently claimed an astonishing 22 per cent rise in out-of-pocket hospital expenses over the past year.

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Think about this for a moment. The retirement industry is actually admitting it doesn't have a viable business model if it needs to put its customers first.

The truth is this: the concept of a do-it-yourself retirement can't work. To expect people to save up enough money to see themselves through a 25- or 30-year retirement is a dubious proposition in the best of circumstances. Yet, this is the system instituted in America which allows hunters in the financial sector to prey on ordinary people with little knowledge of sophisticated financial instruments and schemes. And the mainstream US media, which increasingly relies on the advertising dollars of the personal finance and investment industries, perpetrates this expensive lie to an unsuspecting public.

When combined with stagnating salaries, rising expenses and a stock market that did not perform like Rumpelstiltskin and spin straw into gold, do-it-yourself retirement is guaranteed to lead future generations of Americans into financial insecurity. It's unlikely to work any better for Europeans.

Helaine Olen is the author of Pound Foolish: Exposing the Financial Secrecy and Injustice in Your Retirement and Financial Future. This piece has been adapted from a piece previously published on iMoney and Salon.com.
The evolution of financial services regulation in the UK has repeatedly drawn on scandals as justification for regulatory change. However, the connection between scandals and regulation is not straightforward.

Throughout an in-depth analysis of policy documents, reports, media articles, professional statements and prior research from 1986 to 2012 (cf. Soin & Huber, 2013), we identify four phases of regulation in UK retail financial services. Each phase is characterised by the coexistence of four competing approaches to regulation: the practitioner-based, the state-based, the market-based and the risk-based approach. These phases existed in different combinations, but in each phase, one prevails. We show how advocates of the different regulatory approaches, fuelled by scandals, engaged in fierce competition, and we explain how the perception of these failing approaches had led to financial regulation in its current form.

The Financial Services Act (1986) resulted in the implementation of a regulatory framework that had a largely self-regulatory element and consisted of a two-tier structure. Regulation of securities and investments was delegated to a lead regulator; the second tier consisted of a number of smaller organisations that were responsible for overseeing the major areas within the financial services sector.

In the early stages of regulation (1986-1988), the dominant approach was “practitioner-based, state-bailed out regulation.” In these years, it was perceived that there was a better understanding of the markets than the regulator and state controls were seen as excessive, unnecessary and disruptive. At the same time however, advocates of state-based regulations were challenging practitioner understandings by suggesting the need for regulation in the name of investor protection.

The opportunity to contest the practitioner-based, self-regulatory approach came in the form of the pensions mis-selling scandal of the late 1980s. As part of the wider deregulation of the sector, and endorsed by the government of the day, retirement annuity plans were replaced by personal pension plans. Individuals could now choose whether (or not) to join or leave their company scheme (with employer contributions) or switch to a private scheme with only minimal contributions. While these new pensions provided more flexibility, they also created a situation where many people were persuaded by financial advisers to leave perfectly respectable occupational pension schemes and invest the lump sum into a personal pension.

The heart of the problem lay in the commission-based reward system: Financial advisers were only paid when they sold, which induced hard selling in the industry and financial advisers saw this as an easy opportunity to maximise their commission income. However, regulatory investigations revealed that most people were likely to be worse off when they retired than they would have been if they had stayed in the company pension scheme. And, as events and investigations progressed, it became clear that nearly all companies had engaged in these mis-selling practices.

The perceived lack of a credible response from practitioners seriously damaged the dominance of practitioner-based regulation and self-regulation was deemed ineffective. This proved to be a pivotal moment in the early in-cumulation of retail financial regulation in the UK. Actors who made sense of the pensions scandal as being tightly linked to overall financial regulation, reaching far beyond advice on pensions, quickly gained power. The scandal and the associated perception of the failure of regulation as such, started to cement itself in both the minds of actors and the general public. Although the structures didn’t change, the way they operated did as a result of actors making sense of the scandal. As it turned out, the pensions mis-selling scandal was not convictedly addressed until 1997.

In the second phase of regulation (1988 – 1993), the pensions mis-selling scandal was still being used as part of the social construction of regulation. Scandals were equated to the “failure” of financial regulation. And as a new version of regulation was proposed, one that was based on ideas around customer “choice” and “competition”. This approach formed the foundations of the third phase of regulation – the market based approach (1993-1997). From 1993, the market-based approach was extended to incorporate the notion of risk. There was a commitment to maintaining cost-effective regulation as well as a dedication to maintaining consumer protection. The two-tier regulatory structure was abolished and replaced by a single super-regulator – the Financial Services Authority (FSA).

During this phase, the pensions mis-selling scandal was still a hot topic. Scandals, it appeared, were not exclusive to one group of actors and struggles emerged between the various regulatory bodies who offered competing assessments of the on-going pensions scandal.

Scandals do not speak for themselves but can be used by many different actors. In this case, the pension mis-selling scandal came back to haunt the advocates of the state-based approach. Supporters of the market-based approach to regulation turned their own arguments against them by connecting the scandal to deep-seated issues about the way in which financial products had been sold. By 1991, several of the regulatory agencies’ views of what constitutes successful financial regulation faced dissension by other actors – like the government – and soon the market-based approach would become the prevalent way of thinking about financial services regulation.

Events changed dramatically with the collapse of global financial markets in 2007. The complex reasons for these events – the paralysis of the regulatory agencies, the paralysis in the markets and the paralysis in inter-bank lending – meant that there were no quick fixes. However, the unraveling of these complexities and the instances of bad practices that subsequently emerged (eg, the fixing of LIBOR), resulted in another reconfiguration of the regulatory approach. Past events like the mortgage endowment mis-selling scandal and newer events like the collapse of Keynesia in 2009, the payment protection insurance mis-selling scandal of 2011 and the mis-selling of interest rate swaps in 2012, were being re-construed as failures of regulation that demanded a change in the regulatory approach and the structure of the regulator. The days of “light touch” regulation and “over deregulation” were over. As one author put it, “the potential for the impact of the economic crisis unfolded, we have radically changed our regulatory approach” (FSA, 2011, p.3).

Since 2012 there has been a return to a two-tier regulatory structure and in retail financial services, the paradigm has swung to an approach based on “heavy weight intervention” and “intrusion” at the product design stage (FSA, 2011, p.3). What future financial regulation holds is unclear, but certainly there will be further changes; and future and past scandals will be used as a vehicle for these changes.

To conclude, we are not suggesting that scandals are not “scandalous” – frozen markets and bad advice on pensions do have very real consequences. However, scandals play a special role in financial regulation as they can be selectively drawn upon by actors to argue for new forms of regulation. But in order to work in anyone’s favour, scandals need to be conceived of as important. As we argue elsewhere (Soin & Huber, 2013), the evocation of scandals is not the only catalyst for regulatory change. They are, however, a powerful means by which actors can mobilise their preferred changes in financial regulation.

References

Kim Soin is an associate professor of accounting and management at the University of Exeter Business School.

Christian Huber is a lecturer at the Helmut Schmidt University – University of the Federal Armed Forces in Hamburg, Germany.
It is widely agreed that failures of culture, which permitted excessive and uncontrolled risk-taking and a loss of focus on end clients, was at the heart of the financial crisis. Many official reports, analyses, commentaries and blogs go further to focus on the cultural dimensions of risk-taking and control in financial organisations, arguing that for all the many formal frameworks and technical modelling expertise of modern financial risk management, there was an underlying lack of the social dynamics of risk-taking within financial organisations, including a failure to fully appreciate the motivations and ethics of decision-makers.

From this point of view, we regard the explosion of interest in risk culture in financial organisations since 2008 as being symptomatic of a desire to reconnect risk-taking, and related management and governance processes, to a new moral narrative of organisational purpose.

The primary aim of our research, extending over 18 months and involving several banks and insurers in the United Kingdom, was to discover and analyse how the risk culture change agenda was taking shape inside different organisations. From this grounded and bottom-up point of view we decided to define risk culture in advance but to observe and understand its manifestations within organisations. We interacted mainly, though not exclusively with personnel from the risk function. While this may be seen as limiting the generalisability of our results, it was clear to us at an early stage that risk culture change programmes were being led by risk functions and that the reappraisal of the organisational footprint of risk management was at the centre of these programmes. We supplemented this approach with a formal survey of CII and CIMA members and also engaged, for comparative purposes, with personnel from two non-financial companies – an airline and a large industrial company.

Our desk research of academic and practitioner literature on risk management, management control, culture and safety issues suggested strongly that risk culture is a way of framing issues of risk and culture in organisations, and not a separate construct. In addition, risk culture is itself a composite of a number of interrelated factors involving many trade-offs. We approached the research with a number of additional prior assumptions:

- Risk culture is not a static thing but a continuous process, or processes, which repeats and renews itself, but may be subject to shocks.
- Risk culture will be a mixture of formal and informal processes. The former are easy to observe, the latter are harder to observe since they involve a myriad of small behaviours and habits which in aggregate constitute the state of risk culture at any one point in time.
- We do not assume that an organisation necessarily has a single risk culture and we accept that risk cultures may be trans-organisational. Conceptually we would prefer to speak of “risk cultures” which may be unevenly distributed within organisations (eg, retail as compared with investment banking) or across the financial industry as a whole (eg, insurers as compared with banks).

The most fundamental issue at stake in the risk culture debate is an organisation’s self-awareness of its balance between risk-taking and control. It’s clear that many organisational actors prior to the financial crisis were either unaware of, or indifferent to, the actual trade-off or risk profile of the organisation as a whole. A combination of control functions being ignored or fragmented, and of revenue generating functions being given star status, rendered the actual trade-offs involved in this balance institutionally invisible, both internally and externally, until disaster struck.

For this reason, the prescriptions arising from our research essentially point towards reconnecting the organisational capability to make visible, as well as to understand and accept or change, the actual control-risk trade-offs. Many practitioners now advocate this in terms of organisational clarity about the nature and extent of risk appetite and we observe that this plays a large part in many risk culture reform agendas.

Our research reveals that, underlining this fundamental question of culture, our participant organisations were also grappling with several other significant trade-offs as they sought to address risk culture. Unlike a number of consulting frameworks, we do not regard one side of the equation as necessarily, “our culture”, and the other as “their culture”. Rather they provide a conceptual framework, arising out of our data, which allows us to describe the variety of approaches by our participant organisations.

These trade-offs also provide a way of framing some challenges that CROs, CEOs and Boards need to consider.

The swing back to the centralisation of risk management

Our research suggests that the risk culture debate is symptomatic of a desire to make risk and risk management a more prominent feature of organisational decision-making and governance. The pendulum has swung towards an increase in the centralisation of risk management within financial organisations. This is understandable given the events of 2007-9. We observe three interrelated dimensions of this shift.

- Greater structural formalisation of a “three lines of defence” model.
- The creation of new risk oversight units and capabilities.
- Increased attention to risk information consolidation and aggregation.

Underlying this general change in the regulatory and organisational climate are a number of specific trade-offs which define and are fundamental to the way organisations think about and seek to act upon their risk cultures. We have documented the variety of ways in which organisations have consciously and uncannily addressed these six trade-offs, often mixing approaches. We outline some key challenges for CROs, CEOs and Boards arising from these trade-offs.

We regard the explosion of interest in risk culture in financial organisations since 2008 as being symptomatic of a desire to reconnect risk-taking, and related management and governance processes, to a new moral narrative of organisational purpose.

Risks, regulation, Winter 2013
Between risk and control? We observed that the clarity and enforcement of trading limits was regarded as a core feature of risk culture across all our participating organisations. However, we detected subtle differences in approach and attitude to limits. ‘Sandbox guardians’ (a phrase used frequently) limits and related risk management policies and rules unintentionally become a system in their own right. Specific organisational inclinations to one way or another were strongly influenced by their own histories and collective memories of bad practice. From the comparator airline, it also became apparent that the propensity to invest in knowledge of risk is a risk appetite and risk culture issue.

Risk culture challenges for CROs, CEOs and Boards

• How do you ensure that the risk function is focused primarily on supporting business decisions?
• Do you know which areas of the business are ‘gold-plated’ in terms of risk management and control?
• When risk limits and tolerances are changed, is the risk function a leader or a follower in this decision?
• Do you understand the appetite for acquiring risk knowledge in your organisation?
• Have you ever discussed internally the implications for risk-taking and/or for your desired level of risk appetite of acquisition strategies, in particular if you plan to buy entire teams from other organisations?

Internal change or the use of advisors?

Under pressure to engage in some kind of risk culture change programme, many organisations have to make decisions about whether to use advisors or not. We discerned a difference between consulting sceptics and enthusiasts. The former had a mixed set of attitudes: a recognition that change processes must be owned internally to be effective over time; scepticism about formal survey instruments in the market; and a feeling that advisors were primarily selling regulatory compliance. Enthusiasts were also mixed: some were driven by regulation, others sought leverage to develop new performance management systems with a risk component. And advisors themselves found risk culture a problematic consulting object. They were generally dissatisfied with existing approaches and recognised the need for a mix of skills. They were also searching for new ways to advise on decision-making processes.

Risk culture challenges for CROs, CEOs and Boards

• Do your organisation essentially have respect for advisors? Are you open to advisory propositions?
• Do you have processes to discuss the kind of expertise you may need, internally and externally, to progress risk culture change?
• Do you have an appetite for benchmarking with external entities? If yes, what have you done about it?
• Have you ever approached the topic of risk culture in meetings attended by people from both HR and Risk? If you are a member of Risk, do you have access to raw data from internal staff morale surveys? Or customer satisfaction surveys?

• Is your organisation open to exchanges with research organisations like universities?
• Are you sure of the reasons? If so, what was the last time there was such an exchange?

Own risk culture or regulatory culture?

Regulation has undoubtedly been a driver of risk culture change programmes. Risk culture features in many regulatory speeches. We found that attitudes to regulation were mixed: frustrated organisations talked about excessive documentary demands; how regulation was interfering with business decisions, and how it was crowding out attention to the softer dimensions of risk culture. Co-operatively developed organisations accepted the new regulatory climate and sought to work with this more actively. A key issue is whether financial organisations understand the extent of the regulatory footprint on their business. The trade-off between their own approach to risk culture and that of the regulator is not even visible to many organisations. It also became apparent to us that there is a regulatory sub-culture in the sense of a network spanning parts of regulators, parts of financial organisations and parts of advisors who share common values. This network needs more research into its characteristics.

Risk culture challenges for CROs, CEOs and Boards

• Does your organisation genuinely respect the public objectives of the regulatory function? Do you have positive “regulation conversations” internally? How often? Who is participating in such conversation (e.g. business, risk, compliance, senior or junior members of staff)?
• Do you push back and challenge the regulator? If not, do you know why not?
• If you think regulatory demands for documentary evidence are excessive, do you have a clear conception of what you would require in the absence of regulation?

• Do you have ways of tracking the extent to which regulation is “inside” your organisation? Do you have any processes to track the impact of regulation on work habits and internal attitudes to risk? Would you like to know?

Leverage on behaviour: ethics or incentives?

Behaviour modification is another key issue for risk culture change programmes. We noted two generically different approaches to behavioural risk. The first we call ethics or mission-based. It involves renewed corporate narratives for focusing on clients and respect for internal control processes. Interestingly, risk management is being re-positioned as a carrier of organisational ethics. In contrast, organisations also invest in disciplinary and incentives-based levers with greater short term purchase over behaviour in the form of risk metrics within the performance management system.

Risk culture challenges for CROs, CEOs and Boards

• Do you understand where in the organisation the behaviour change is most necessary? If not, how will you get it?
• Which combination of levers is most likely to be effective in bringing about that change? Is such combination different in different parts of the organisation (e.g. functional areas or hierarchical levels)?
• How are you monitoring and measuring “respect” for internal control and risk management?

Conclusions

Despite the apparent cynicism of the general public, our research demonstrates that financial services firms are engaged in extensive programmes of internal reform with a view to changing their culture of risk-taking and control.

The different trade-offs which emerge from our data are not mutually exclusive. Issues about the authority of risk expertise; the extent of interaction between risk and the business; the clarity of risk appetite; the use of advisors; the commitment to ethical change; and whether regulation casts a more significant shadow over risk culture than is commonly acknowledged are all connected. At the same time organisations implicitly choose a balance between longer term, organic processes of cultural change and shorter term, more engineered and visible levers over behaviour. Our report also suggests that the TLD model, which has been promoted as a solution to the financial crisis, should be looked at more carefully and critically for its side-effects.

Any research report is limited in time and space, by its methods and by data availability. It is part of the culture of financial organisations that they are not naturally open to external researchers and we have been unusually fortunate in our participant organisations for the access they have afforded us, for their trust in our processes, and for their candour in interacting with us. This report is very much by them for the public good.

We hope that our study will provide additional awareness of the complex challenges facing CROs, CEOs and Boards who genuinely wish to influence the cultural conditions under which risk-taking and control activity happens in their organisations. Our principal prescription is that there is a need for financial organisations to be aware of the many trade-offs we have identified – including what kind of relationship to have with the regulator – to monitor them, and to make explicit decisions about them where possible, rather than allowing them simply to happen to the organisation. When it comes to risk culture, our report suggests that it is not only the level of risk-taking which was deviant in many organisations. It was also the lack of this organisational self-knowledge and the authority to act upon it.

We have provided a number of questions arising from our work as a pathway to this awareness. But we have not sought to position our work as another advisory offering. The fact that the questions we pose are not easy to answer in a familiar practical way does not mean that they are not important. Indeed, we think they require the closest consideration.

The full report of Risk Culture in Financial organisations is available here: www.lse.ac.uk/researchAndExpertise/units/CARR/pdf_Final-Risk-Culture-Report.pdf
CARR News

Madalina Busuioceanu’s book, European agencies: law and practices of accountability (Oxford University Press, 2012) was referenced extensively by the Advocate General of the Court of Justice of the European Union, Niko Jakubovic, in his formal opinion before the Court on case C-270/12 (12 September). The case is a UK challenge to the emergency powers of the European Securities and Markets Authority (ESMA), one of the EU’s key financial services regulators, to intervene in the financial market members state in order to regulate or prohibit short-selling.

Julien Etienne presented a paper titled “How regulators learn corporate bad news” at the Law & Society Annual Conference. She was an invited speaker. She was an invited speaker at the ESRC sponsored conference on “Architecture, governance, and state failure: the relevance of algorithms” [vimeo.com/69641360]. She attended an ESRC sponsored conference on “Bureaucratic dynamics through ratings” at the SASE Annual Meeting held at University of Milan (27-29 June).

Mike Power and Tommaso Palermo presented final report of ESRC project “Risk Culture in Financial Organisations” with Simon Ashley (Prysmly) at the Old Library, LSE, before an audience of 150 (30 September).

CARR Seminars 2013

Prof Mike Power and Dr Tommaso Palermo, LSE
Date: 5 November 2013
Time: 1 – 2.30 pm
Venue: KSW 3.01

Risk culture in financial organisations

Prof Gerry McGahee, Warwick Business School
Date: 19 November 2013
Time: 1 – 2.30 pm
Venue: KSW 3.01

Reactivity and reactions to regulatory transparency in medicine, psychotherapy and counselling

Dr Jenny Andersson, Sciences Po
Date: 3 December 2013
Time: 1 pm – 2.30 pm
Venue: KSW 3.01
Forging the future. The origins and spread of predictive expertise.

CARR Events

Mike Power and Tommaso Palermo presented final report of ESRC project “Risk Culture in Financial Organisations” with Simon Ashley (Prysmly) at the Old Library, LSE, before an audience of 150 (30 September).

CARR Publications

Building European Union capacity to manage transboundary crises: Network or lead-agency model?
Avian Bird, Madalina Busuioceanu and Martin Groenleer, Regulation & Governance, DOI: 10.1111/reg.12033

Working for Europe? Socialization in the European Commission and Agencies of the European Union
Serin Szmerenyi, Madalina Busuioceanu and Martin Groenleer, Regulation & Governance, 2013, DOI: 10.1111/1467-9299.2012.02103.x

Risk, interest groups and the definition of crisis: the case of volcanic ash

Political Science Research Methods in Action
Martin Lodin co-edited with Michael Brutur, Basings Stockholm, 2013

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