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Collaborating in a Meritocracy and Post-Crisis Reform

Sarah Paterson^{*}

Abstract: It is tempting to see the defensive reaction of the finance industry in Britain to the recent financial crisis as something new; a sign of an industry which has developed a rotten culture of self-interestedness and a devil-may-care attitude to the consequences of its actions. This paper argues that in fact the reaction is a familiar one in the historical record, continuing a long-run debate between the industry and the British authorities on responsibility for liquidity and capital crises. Whilst the details of the debate have changed as the market has changed over time, the contours of the general debate are clearly visible from the end of the nineteenth century to the present day. The paper suggests that what is new is the difficulty of mediating the debate in a more meritocratic age, when the soft controls of patronage, class and deference have largely fallen away. It argues that more law and more regulation will not achieve real reform, if it does not reflect the values of those it seeks to control. Instead, it suggests that we must develop ways to encourage collaboration between market participants and the authorities within modern, merit-based systems.

Keywords: Reputation; Financial regulation; Financial crisis

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I. INTRODUCTION

This paper is concerned with three types of liquidity. First, it is concerned with “funding liquidity”; that is the availability of funding from the finance industry for the productive economy and between the members of the finance industry themselves, in each case to facilitate business and investment. Secondly, it is concerned with “market liquidity”; that is the availability of active, widely-held markets in which to trade financial instruments to permit the rapid employment or realisation of funds. Finally, it is concerned with “emergency liquidity”; that is the availability of finance to smooth funding and market liquidity cycles. The paper argues that, although there has been a fundamental shift in the sources and uses of funding and market liquidity and therefore of the causes and nature of periodic dislocations in funding and market liquidity in Britain over the last two hundred and fifty years, there has always been debate between the finance industry on the one hand and the government and the central bank (as representatives of the wider public interest) on the other about the role and responsibilities of the finance industry in providing liquidity to markets, so that a thread of common disputes can be identified throughout the historical record. To this extent, as Mark Twain is supposed to have said, history does not repeat but it rhymes.

Nonetheless, the paper illustrates how certain shared values across British society made (admittedly uneasy) cooperation between the finance industry and the government and the central bank possible before the so-called “Big Bang”.¹ It argues that in many ways these shared values were a function of a society based on class and patronage, and so the paper is not a nostalgic call for a return to a previous era. But the financial crisis has revealed that the post-Big Bang finance industry has not solved the problems of the old British financial system without risking stability, or provided a solution to the long-run decline of productivity in the British commercial sector by building London as a financial centre for the world, or equalized standards of living amongst the British population by facilitating borrowing as a credible alternative to redistributive policies or driving economic growth. Nor did modern monetary policy or economic theory prove equal to preventing the crisis (although it arguably did better in containing it). Thus we are faced with big questions, and it is in this context that the paper argues that building an ever greater legal and regulatory edifice to hold the finance industry unequivocally to account for liquidity booms and busts (including in legislating for the finance industry to provide emergency liquidity) lulls authorities into a false sense of security, emphasizes the “us” and “them” narrative increasing intergroup hostility and, overall, decreases the prospect of fundamental structural change to take account of the lessons of the Great Recession. It is an effective

¹ Comprehensive reform of the way in which the London Stock Exchange operated, launched on Big Bang day, 27 October 1986

response to a public outcry that “something must be done”, but we should not be fooled into thinking that it has provided a complete solution. The paper thus joins a small but growing body of literature suggesting the need to think about how government and regulators, on the one hand, and market professionals, on the other, can collaborate in modern, meritocratic society to develop views of how the financial system should be working and about how it could be restructured to produce genuine change.

The paper proceeds as follows. First, certain themes in the debate about the interests of the finance industry and the wider public interest from the middle of the nineteenth century until the 1980s are identified. Next, the paper explores how certain cultural and social values across members of the finance industry, government and the central bank nonetheless made uneasy cooperation possible. The paper then examines the emergence of the same themes in the context of post-financial crisis debate, but explores why the debate is harder to mediate in a more meritocratic era. Finally, the role of the legal and regulatory response is examined. The paper then concludes.

II. THE POLITICS OF FINANCE BEFORE “BIG BANG”

A. THE VIEW FROM THE AUTHORITIES

In the history of the relationship between the state and the financial sector, a recurrent theme has been that a lack of discipline amongst financial institutions produces the busts (and the preceding booms) in funding and market liquidity, so financial institutions should bear the cost of resolving them. As early as 1839, when a rapid downturn in the US economy produced contagion effects in the UK, the Bank of England’s response was to take “ostentatious disciplinary action” against firms of any size which had been active in trade and finance with the US.² In one of two influential pamphlets published before the Bank Charter Act of 1844, the pressure in the money markets was blamed on excessive speculation in foreign securities by the banks of the day.³ Later, severe dislocation in the textile, coal and steel industry was blamed on the post-war boom in credit.⁴

Linked to this point, but distinct from it, is the so-called moral hazard concern. A moral hazard problem arises when a series of protections incentivises reckless lending and trading behaviour, precisely because protection is in place. Thus any sense that the central bank stands ready to provide emergency liquidity to a troubled financial institution increases the risk that the financial sector will

² D Kynaston, *The City of London: Volume I A World of its Own 1815-1890* (Pimlico 1995), 107

³ F Capie, ‘British Financial Crises in the Nineteenth and Twentieth Century’, 12–13 in N Dimsdale and A Hotson (eds) *British Financial Crises Since 1825* (Oxford University Press 2014)

⁴ RC Michie, *The City of London: Continuity and Change, 1850–1990* (Macmillan, Hampshire 1992), 119

behave in a reckless and undisciplined fashion.⁵ The theory of financial market regulation prescribes that, to avoid moral hazard risk, legislation should spell out clearly the conditions on which the central bank will provide funding to distressed institutions without government consent.⁶ This also has a long pedigree. It was first reflected in English law in the Bank Charter Act of 1844 which broadly provided that the Bank of England would provide funding liquidity to a bank suffering a temporary liquidity shortfall but not a bank whose liabilities were judged to exceed its assets: public (taxpayers) money should not be spent on a hopeless concern without government approval because it is the fiscal, and not monetary, authorities who should decide to use public money in this way. Thus in his account of the Barings crisis of 1890, Kynaston identifies that when the Prime Minister, Lord Salisbury, offered to provide the necessary fiscal support for the Bank of England to break the legislative limits on support, the Governor of the day apparently resisted on the basis that “reliance on such letters was the cause of a great deal of bad banking in England”.⁷

This concern for moral hazard has been particularly acute at times when government and central bankers have been frustrated by the apparent irrationality of markets. Besides the well-known market liquidity bubbles of the South Seas Company and tulips,⁸ there are plenty of examples of market liquidity booms in the history of the City of London from the “Kaffir” boom and bust at the start of the twentieth century, to the rubber boom of 1910.⁹ Each boom has spawned its own scandals. Kynaston tells us that such was the scale of the scandal caused by the so-called Brush boom around the advent of electrical lighting in the 1880s that market and funding liquidity for the electrical industry, and concerns loosely related to it, was tight for thirty years,¹⁰ and from the market liquidity boom of the 1920s cites a stockbroker who recalled that there was “even a concern whose main object was said to be the extraction ... of essential fats from the content of hotel dustbins” and notes that “during this period practically any rubbish could be sold”.¹¹ A particular scandal followed Clarence Hatry who was sentenced to fourteen years penal servitude for his share promotion almost a century before a LIBOR trader was to face a prison sentence of a similar length.¹² Insider dealing

⁵ RM Lastra, *Legal Foundations of International Monetary Stability* (Oxford University Press, Oxford 2006), 115

⁶ Ibid.

⁷ D Kynaston, *A World of Its Own* (n 2), 432

⁸ See JK Galbraith, *A Short History of Financial Euphoria* (Penguin, London 1994)

⁹ ME Murphy, ‘The English Approach to the Distribution of Securities’ (1941) 14(4) *The Journal of Business of the University of Chicago*, 373

¹⁰ D Kynaston, *The City of London Volume II The Golden Years 1890-1914* (Pimlico 1996), 462

¹¹ D Kynaston, *The City of London: Volume III Illusions of Gold 1914-1945* (Chatto & Windus, London 1999), 138-139

¹² B Eichengreen, *Hall of Mirrors: The Great Depression, the Great Recession, and the Uses – and Misuses – of History* (Oxford University Press, Oxford 2015), 112-113 and “‘Libor Scandal’: Former City Trader Tom Haynes Gets Fourteen Years for Rigging Rates’ *The Telegraph* 3 August 2015 (although the latter’s sentence was subsequently reduced to 11 years)

was rife (it was not outlawed in Britain until the 1980s),¹³ the practice of bond washing, originally started between the wars, was denounced as nothing short of a fraud on the Inland Revenue,¹⁴ and the increase in Bank rate in the late 1950s was accompanied by significant scandal that certain members of the establishment had profited from being tipped off. The Bank of England suffered a formal Parliamentary investigation after the Poseidon boom of 1970 (nickel mining),¹⁵ and the decade spawned larger-than-life figures such as Jim Slater and Tiny Rowland.

There is a suspicion that the lack of discipline, moral hazard risk, sheer irrationality and scandals of the markets are all symptoms of an industry out only for itself, with no regard for wider obligations to the rest of society. For much of the twentieth century there was a concern that the finance industry put its own interests above financing the British economy.¹⁶ Frequent comparisons were drawn with the German banks,¹⁷ and reports pointed to a sector with no regard for the greater public good. A source of particular criticism was the City of London's focus on overseas lending,¹⁸ whilst in the second industrial revolution British industry repeatedly complained of a lack of capital.¹⁹ The twentieth century British banking sector was stable but it was also inherently uncompetitive, relying on what were essentially fixed rates of interest and operating in a cartel-like fashion.²⁰ The banking industry did not acquit itself well in various moments of national crisis,²¹ in the interwar years the Big Five clearing banks were criticized for their approach to reorganization and reconstruction of British industry,²² and in 1931 it was alleged that the banks had talked down the national economic situation resulting in the fall of the Labour Government.²³ The Macmillan Committee on Finance and Industry famously reported, in 1931, a credit gap for

¹³ Kynaston, *The City of London: Volume IV A Club No More 1945-2000* (Pimlico, London 2002), 455 (discussing Slater Walker)

¹⁴ Kynaston, *A Club No More* (n 13), 80–81. Bond washing is the practice of selling a bond before a coupon is paid and buying it back immediately after the payment in order to avoid paying tax on the coupon

¹⁵ *Ibid.*, 405

¹⁶ Michie (n 4), particularly the summary at 3–11

¹⁷ G Jones, *British Multinational Banking 1830–1990* (Clarendon Press, Oxford 1993), 223

¹⁸ E Green, *The Making of a Modern Banking Group* (St George's Press, London 1979), 68 notes "World trade, in total value, trebled between 1875 and 1913, and Britain's foreign investment reached about £4,000 million by 1913 in comparison with £5,500 million invested abroad by France, Germany, Holland, Belgium and the United States of America put together. For the London-based British banks, here was an opportunity to capture a large share of the financial business which accrued from trade expansion and overseas investment"

¹⁹ For a list of complaints, see M Ackrill and L Hannah, *Barclays: The Business of Banking 1690–1996* (Cambridge University Press, Cambridge 2001), 90–91

²⁰ *Ibid.*, 105–106

²¹ See, for example, R Roberts, 'How We Saved the City', 99–101 in N Dimsdale and A Hotson (eds) *British Financial Crises Since 1825* (Oxford University Press, Oxford 2014)

²² Kynaston *Illusions of Gold* (n 11), 417

²³ P Williamson, 'A 'Bankers' Ramp'? Financiers and the British Political Crisis of August 1931' (1984) 99 (393) *The English Historical Review* 770–866

small firms wishing to raise long-term finance of under £200,000,²⁴ and there were suggestions that the British banks did not have the expertise to assess the prospects of large businesses in new sectors of the economy.²⁵ In the 1950s, the Radcliffe Committee noted particular funding gaps for agriculture and small business,²⁶ in 1966 the new Prices and Incomes Board conducted an investigation into banks' profits,²⁷ and in 1971 the Bolton Committee pointed to an acute lack of knowledge amongst financial businesses of the financial services available to them.²⁸ Matters reached their apogee in 1973 when the Labour Party published a Green Paper proposing nationalization of the banks,²⁹ but even the Thatcher government felt no love for them, imposing a £400m levy on the clearing banks in 1981.³⁰ Meanwhile, the membership rules of the London Stock Exchange, restrictions on non-members and fixed commissions meant that it "was able to survive, and even thrive, though its charges were considered high, entry was restricted and regulations prevented jobbers obtaining from non-members the capital required to fulfil their functions properly as market makers".³¹

Coupled with this sense of a self-centred industry, undeserving of help from the polity, there is a repeated sense of an elitist group out of touch with the rest of the country. Augar recounts, "A well-meaning merchant banker at a staff Christmas Party, on hearing that one of his typists lived 'on an estate in Romford', replied, 'How splendid. Do you keep horses there?'"³² Writing in his diary at the time of the banker's ramp the Governor of the Bank of England noted, "At Bank till 9. Dined at Basque restaurant with Peacock, Grenfell. Lafitte 1917".³³ The single most important qualification in the City of London was connections: it was said of one successful participant that "he rowed for Oxford and was a friend of Augustus John",³⁴ and of another that he possessed a "... remarkable knack of getting rich people with whom he dined or shot or spent his Saturdays to Mondays, to invest or speculate through his firm".³⁵ Most merchant bankers maintained a country estate for shooting and fishing,³⁶ and their lives had very little in common with those of most of the rest of the country. Ingham tells us that when Lord Cowdray was asked how he had avoided being caught up in the

²⁴ Ackrill and Hannah (n 19), 91; G Ingham, *Capitalism Divided? The City and Industry in British Social Development* (Macmillan Education Ltd, Basingstoke, Hampshire 1984), 198

²⁵ Ackrill and Hannah (n 19), 93

²⁶ Green (n 18), 56–58

²⁷ Ackrill and Hannah (n 19), 162

²⁸ Green (n 18), 64

²⁹ Kynaston, *A Club No More* (n 13), 478

³⁰ *Ibid.*, 589

³¹ Michie (n 4), 138

³² P Augar, *The Death of Gentlemanly Capitalism: The Rise and Fall of London's Investment Banks* (Penguin, London 2008), 34

³³ Kynaston, *Illusions of Gold* (n 11), 238

³⁴ *Ibid.*, 300

³⁵ *Ibid.*, 324

³⁶ *Ibid.*, 347

scandals of the 1970s with the likes of Jim Slater he replied, “Quite simple. I only lent money to people who had been at Eton”,³⁷ and scholarship in the 1960s held these aristocratic pretensions of the financial class responsible for a marked division in British capitalism between finance and domestic industry.³⁸

Tied up with this sense of an arrogant elite who deserved what it got was a long-run sense that making or moving money was not in and of itself socially useful. In the debate at the start of the nineteenth century about the extent to which the banks preferred overseas investment to domestic concerns there was more than a little sense that this served only a rentier class flourishing on its investments.³⁹ Kynaston’s account has frequent references to the lower worth of money to production in the inter-war years: from a City man turned farmer “I like the feeling that the production of food is useful and honourable”,⁴⁰ from a clerk in a City firm, “except that the department was able to make a substantial contribution to the profits of the firm, I find it difficult to persuade myself that we were doing anything particularly constructive or helpful in these very disturbed times”,⁴¹ and from a retired City hand, “I did not like banking which consists essentially of facilitating the movement of money from Part A where it is to Part B where it is needed”.⁴² In a later period the case for low interest rates was to be advanced because we “... must be ... on the side of the active producer against the passive investor”,⁴³ and an account written in the 1960s struck a rather depressing tone, “After spending two months talking to people in the City, I felt oppressed and dispirited by its narrowness and bleakness, the quasi-sexual fascination with money concealed behind large layers of humbug, and the sheer boredom of it”.⁴⁴ Kynaston tells us of comments after the Lornrho affair in the 1970s that “The truth is that much of the City’s spectacular growth has been created out of thin air”.⁴⁵

We also find evidence of concerns for a short run approach throughout the history of finance in Britain. One of the main criticisms of the approach of the safe, stable British clearing banks to financing industry in the latter part of the nineteenth century and the early part of the twentieth century was that they took a short term view of the firm’s prospects, were focused on marketability and risk and had very little appetite for supporting management’s longer term vision. They were accused of refusing to make any efforts to understand industrial techniques or problems,⁴⁶ and of refusing long term finance in favour of short term finance

³⁷ Ingham (n 24), 139

³⁸ For a useful review of the literature *ibid.*, 19–32

³⁹ Kynaston, *The Golden Years* (n 10), 385

⁴⁰ Kynaston, *Illusions of Gold* (n 11), 53

⁴¹ *Ibid.*, 101

⁴² *Ibid.*, 332

⁴³ JH Wood, *A History of Central Banking in Great Britain and the United States* (Cambridge University Press, Cambridge 2005), 298

⁴⁴ Kynaston, *A Club No More* (n 13), 197

⁴⁵ *Ibid.*, 479

⁴⁶ Kynaston, *Illusions of Gold* (n 11), 39

by way of overdraft,⁴⁷ so that successive government initiatives sought to fill the vacuum left by this short term approach.⁴⁸ After the Macmillan Report had identified a serious gap in industrial funding there was even discussion of a *Banque D’Affaires* for Britain. The short termism debate launched another investigation in January 1977 in the form of the Wilson Committee.⁴⁹ And Ingham has highlighted how a shift to institutional portfolio investment in shares in Britain, and the existence of a deep secondary market for shares, reduced the need for concern with supporting the long-run profitability of any particular industrial concern.⁵⁰

B. THE VIEW FROM THE FINANCE INDUSTRY

The finance industry has traditionally reacted to political rhetoric by highlighting the role of the authorities. Witnesses at the Committee on Banks of Issue in 1840 blamed the early nineteenth century financial crisis not on the profligate activities of British banks in the US, but rather on the approach of the Bank of England to its banking and note issuance functions.⁵¹ The commercial and financial crisis of 1847 was thought to be not only a consequence of the railway boom, but also of the aggressive discounting policy of the Bank of England.⁵² At the turn of the century the boom in West African mining shares suited the Imperialist ambitions of Joseph Chamberlain, then British secretary of state for the colonies.⁵³ In the early twentieth century debate about the City of London’s overseas investment activities, the finance industry pointed to the extent to which other governments took an active role in supporting the promotion of industrial concerns when compared with the distinctly *laissez-faire* British attitude.⁵⁴ Michie highlights the number of new issues before 1931 which were based either on fraud or poor business judgement, and argues that a failure to regulate the market so that a poorly informed, rapidly growing investor class suffered significant losses made it difficult for industrial companies to raise capital later.⁵⁵ Far from being a “bankers’

⁴⁷ Although the bank histories also suggest that banks continuously rolled over short-term overdrafts rather than call in loans which would likely result in liquidation and low or no recoveries, early examples of a practice which we would today call ‘amend and extend’ or, more pejoratively, ‘amend and pretend’ — see Ackrill and Hannah (n 19), 94–95; A Offer, ‘Narrow Banking, Real Estate and Financial Stability’, 160 in N Dimsdale and A Hotson (eds) *British Financial Crises Since 1825* (Oxford University Press 2014); Michie (n 4), 119

⁴⁸ Including an effort to recapitalise and reorganise the Lancashire cotton industry; the Securities Management Trust (1929); the Bankers Industrial Development Corporation (1930); the Special Areas Reconstruction Association (1936); the Industrial and Commercial Finance Corporation; the Finance Corporation for Industry; the Industrial Reorganisation Committee (1960s); the National Enterprise Board and Equity Capital for Industry (1976)

⁴⁹ Kynaston, *A Club No More* (n 13), 541

⁵⁰ Ingham (n 24), 74–78

⁵¹ Wood (n 43), 78–79

⁵² Capie (n 3), 12–13

⁵³ J Schneer, *London 1900: The Imperial Metropolis* (Yale University Press, 2001), 73–74

⁵⁴ Kynaston, *Golden Years* (n 10), 394

⁵⁵ *Ibid.*, 116–118

ramp”, scholars have shown that in 1931 on the central issue of the need to defend the gold standard politicians “agreed with, or at least acquiesced in, the views of the bankers”.⁵⁶ In the financial crisis of 1932 excessively protectionist policies adopted by many nations came under the spot light. Post-war credit expansion was blamed not only on lending policies but also on government’s unwillingness to control public spending and over-confidence in tighter monetary policy controls (in part as a result of the sometimes inconsistent objectives of full employment and price stability).⁵⁷ The lack of investment in British industry after the Second World War was attributed in part to taxation policies and direct government intervention in the capital markets,⁵⁸ with a particular focus on the incentives created by the taxation regime to create larger firms, and the consequences for small business,⁵⁹ and many of the actions and investments of the bodies set up by government to promote investment turned out disastrously.⁶⁰

The role of the Bank of England as part market participant, part the bankers’ bank has also come under repeated scrutiny. Until the early nineteenth century, the Bank of England was a commercial competitor to the banks.⁶¹ Indeed, until the 1825 crisis it had a monopoly on joint stock banking in England. In the second half of the nineteenth century it adopted a convention of discounting the acceptances of firms of one of its directors.⁶² As Britain began to move to a system of fractional reserve banking, and the Bank of England discussed where the banks’ reserves were to be held, attention was drawn to the fact that the Bank of England “was a competitor in every day banking life as well as saviour in times of crisis”.⁶³ In the 1930s, when it could no longer seriously be said to be a competitor with the banks, it was accepted that the Bank of England’s role included maintaining the stability of financial markets through open market operations.⁶⁴ These open market operations continued after nationalisation in 1946. The Bank thus regularly intervened in the money markets, and guarded its own institutional power “just as jealously as it defended the coincident and related demands of the City”.⁶⁵

Related to this issue is the fact that it is not always easy for bankers or politicians to identify what will start a market or funding liquidity crisis, even if it is comparatively easy to blame it solely on the financing industry in the immediate aftermath in order to detract attention from other possible causes. Schnee recounts how few foresaw the sudden fall in South African mining stocks in 1900, precipitated by British defeat at Magersfontein in the Boer War, and the even

⁵⁶ Williamson (n 23), 777; Ingham (n 24), 37; 171

⁵⁷ Wood (n 43), 306–310

⁵⁸ Michie (n 4), 120–123

⁵⁹ Ibid., 124–125

⁶⁰ Ibid., 127–128

⁶¹ Green (n 18), 2

⁶² Ibid., 118

⁶³ Kynaston, *The Golden Years* (n 10), 41

⁶⁴ Kynaston, *Illusions of Gold* (n 11), 226

⁶⁵ Ingham (n 24), 132–133

harder to anticipate effect on restaurants, the retail meat and beer trade.⁶⁶ In the 1907 crisis Natty Rothschild wrote that he could not describe the global financial crisis or “account positively of what has taken place and still less in any way to forecast the future”.⁶⁷ In the run up to World War I the assassination of Archduke Franz Ferdinand had no obvious effect on the financial markets, and a sharp downturn was only precipitated by Austria’s ultimatum to Serbia on 23 July 1914.⁶⁸ The precise causes of the 1930s financial crisis in Britain (and indeed further afield) continue to remain obscure, notwithstanding decades of research. In the late 1930s it was the City’s very rationality which seems to have held it back from determining what was coming in the 1940s,⁶⁹ and in inquiries in the decade after the war into whether powerful figures had been tipped off about a rise in bank rate it became clear how few in the market had thought about the bank rate rather than the risk of devaluation.⁷⁰ During the post-war inflationary boom the authorities found it hard to determine what sorts of bank credit to restrict.⁷¹ In the early 1960s, there was widespread concern in Europe about the developing Eurodollar Market “which was under no central bank control and in which quite small firms were handling enormous sums of money”,⁷² but the Bank of England resisted the temptation to intervene to London’s considerable advantage.⁷³ In contrast in the 1970s the British government did take action to control the commercial property sector but with disastrous consequences for the so-called secondary banks.⁷⁴

Not only does the finance industry feel that authorities will always shine the spotlight on them in order to divert attention from public failures, there is also a repeated sense that the authorities turn on practices which were known about and, implicitly at least, accepted once public opinion becomes aware of those practices and turns against them. There is some suggestion that the refusal to bail out Overend Gurney in 1866 followed from a breakdown of trust between the house and the Bank of England when the latter refused to rediscount the former’s bills of exchange, and Overend responded by attempting to engineer a mini-run on the Bank of England.⁷⁵ In 1931 Lord Kyslant and his adviser, Harold Morland of

⁶⁶ Schneer (n 53), 84

⁶⁷ Kynaston, *Golden Years* (n 10), 443

⁶⁸ Roberts (n 21)

⁶⁹ Kynaston, *Illusions of Gold* (n 11), 453

⁷⁰ Kynaston, *A Club No More* (n 13), 94

⁷¹ *Ibid.*, 68

⁷² *Ibid.*, 283

⁷³ Jones (n 17), 322 noting that London branches of foreign banks did not require separate capitalisation, the Bank of England had a flexible approach to foreign currency operations with non-residents, there were no reserve requirements or maturity constraints and there was no Glass-Steagall Act to separate commercial and investment banking

⁷⁴ M Reid, *The Secondary Banking Crisis 1973–1975: Its Causes and Course* (The MacMillan Press Ltd, London and Basingstoke 1982)

⁷⁵ M Flandreau and S Ugolini, ‘The Crisis of 1866’, 80 in N Dimsdale and A Hotson (eds) *British Financial Crises Since 1825* (Oxford University Press, Oxford 2014)

Price Waterhouse, stood trial for charges which turned on whether the secret transfer of hidden reserves was acceptable; common place practice leading one commentator to state “If he was guilty then most of the chairmen of large public companies would today be in custody”.⁷⁶ In the 1950s so called “bond washing” appears to have been tacitly accepted by the authorities.⁷⁷ There is also a sense within the financial community that in the unsteady years which follow a liquidity crisis, punishments for finance professionals are out of proportion with the scale of the harm which they have individually caused. Indeed, the relationship between the responsibility of the individual for the harm caused, and the wider responsibility of the time in which he or she was working, may not be easy to determine.⁷⁸

There is also a sense of frustration that the role the finance industry performs in providing liquidity to markets is not understood. The City of Glasgow crash in 1878 (and the Barings crisis in 1890) produced decisive regulatory responses around the publication of financial information, but also may have resulted in the unduly conservative lending practices of British banks which were to come under scrutiny for so much of the twentieth century.⁷⁹ The banks reacted angrily to what they saw as “speech after speech from our legislators of which the purpose has been to set class against class and to represent the interests of capital as antagonistic to the welfare of the people”.⁸⁰ There was a general feeling that the contribution of finance to economic growth was not understood: in particular, the role of the finance industry’s international business in generating “invisible” earnings which became a major element in Britain’s balance of payments;⁸¹ its role in creating employment by building an intermediated financial centre in London through which international investment (as opposed to purely domestic capital) flowed;⁸² and the range and complexity of the sources of its earnings.⁸³ After the war, the delay in getting vital commodity markets going again was partly blamed on the instinctive dislike of futures by the government of the day.⁸⁴ The banks pointed to the consequences of active investing in industry for the German banks in 1931,⁸⁵ and the consequences of direct intervention by government in distorting the operation of the British financial system.⁸⁶ And at the time of the Wilson

⁷⁶ Kynaston, *Illusions of Gold* (n 11), 231

⁷⁷ See n 14 and accompanying text

⁷⁸ J Black, ‘Learning from Regulatory Disasters’ LSE Law, Society and Economy Working Paper Series WPS 24–2014 December 2014, 5

⁷⁹ Kynaston, *A World of its Own* (n 7), 333

⁸⁰ Kynaston, *Golden Years* (n 10), 498

⁸¹ Michie (n 4), 23; 25; Ingham (n 24), 40–41

⁸² Michie (n 4), 110; Ingham (n 24), 35

⁸³ Ingham (n 24), 35–36

⁸⁴ Kynaston, *A Club No More* (n 13), 3; Michie (n 4), 137

⁸⁵ Michie (n 4), 119

⁸⁶ *Ibid.*, 89; 113

Committee in the 1970s the London clearing banks doubted that there really was pent up demand from industry for long-term bank finance.⁸⁷

This different perspective on the role of finance perhaps also explains why successive generations of finance professionals have felt that they justify their elite status in society. In the days of the hereditary finance elite in the City of London, the hereditary leaders at the tops of firms took their paternal role seriously, providing job security and, it appears, a generally happy working environment for hundreds of employees.⁸⁸ Cassis provides an example of a rich private banker's generosity in Lord Hillingdon who regularly invited the employees of Glyn's bank to cricket matches at his country house.⁸⁹ The paternalism was balanced by regular interference in the lives of employees, imposing restrictions on when they could marry and where and when they could drink,⁹⁰ but there was a general acceptance that a lucky few had been able to live above everyone else.⁹¹

The finance industry also repeatedly reminded government that financial institutions are ultimately private institutions with responsibility to their shareholders and investors: in other words, responsibility to the community is a function of the state. Reading Kynaston's history we can track this from the early days of discussion about a fractional reserve banking system, "if we each of us say we will maintain sufficient gold reserves of our own, then we assume a responsibility to the community which is not properly ours, and we relieve the Bank from responsibility which is theirs",⁹² through the debate about the role of the banks in lending after World War I, "If the State came in and forced the Banks to lend a lot of money wrongfully then it must take responsibility",⁹³ to the twentieth century debate about lending to industry when the banks repeatedly pointed out that the work was simply not profitable,⁹⁴ and the view of the 1970s that "What all these critics ignore is that the financial services industry in all its aspects, whether it be life assurance, unit trusts, pension funds, savings banks, and even the Stock Exchange, came into being to provide a service to investors. That is the origin and that is still its central purpose".⁹⁵ Michie highlights the number of new concerns before 1931 based either on poor business judgement or outright fraud,⁹⁶ and the problems of over-capacity in major export industries like coal, shipbuilding, mechanical engineering, cotton, and woollen textiles after the war which meant they lacked profitability and, consequently, adequate security for

⁸⁷ Ingham (n 24), 68

⁸⁸ Ackrill and Hannah (n 19), 343–344

⁸⁹ Y Cassis, *City Bankers, 1890-1914* (Cambridge University Press, Cambridge 1994), 135

⁹⁰ Ibid., 136

⁹¹ T Pikkety, *Capital in the Twenty-first Century* (The Belknap Press of Harvard University Press, Cambridge, Massachusetts and London, England 2014), 416

⁹² Kynaston, *Golden Years* (n 10), 588

⁹³ Kynaston *illusions of Gold* (n 11), 7

⁹⁴ Ibid., 136

⁹⁵ Kynaston, *A Club No More* (n 13), 532

⁹⁶ Michie (n 4), 116–117

banks or attractive investment opportunities for the capital markets.⁹⁷ Ingham points to the low marginal efficiency of investment caused by “a combination of inefficient management and recalcitrant labour”.⁹⁸ Ackrill and Hannah suggest that Thatcher’s levy on the banks in 1981 may have been motivated, in part, by a refusal of the banks to take on export credit guarantee risks on an uneconomic basis.⁹⁹

Moreover, the regulated sector points to the need to understand the role of largely unregulated institutions in the provision of credit. In the rapid expansion of credit after the 1847 financial crisis banks placed their reserves “on call” with the City of London’s bill brokers who used them in turn to finance commercial bills, keeping dangerously low level of reserves themselves. Ultimately this led to the third biggest financial crisis in Britain in 20 years when Overend Gurney failed, leading to a major credit panic.¹⁰⁰ At the start of the nineteenth century, lack of capacity in the British banking system led to the growth of the company promoter, whilst the London money market financed the speculative investment activity which those promoters encouraged.¹⁰¹ In the 1950s, clearing banks were allowed to buy into the almost entirely unregulated hire purchase sector,¹⁰² and in the 1970s they lent heavily to the so-called secondary banks which over-extended into commercial property resulting in a major crisis.¹⁰³ From the end of the 1950s, restrictions imposed in New York and Tokyo drove the growing Eurobond market to London where it developed outside the highly restricted world of the London Stock Exchange.¹⁰⁴

In the attribution of blame game, the industry also points to the extent to which all liquidity crises are partly psychological and therefore, implicitly, not anyone’s fault. In his masterly work on the American depression Kennedy describes how “psychological perception counted as heavily as the accountants’ computations in shaking confidence in the banking system”.¹⁰⁵ Kynaston recounts repeated instances of banks becoming troubled by rumours as a result of an isolated incident.¹⁰⁶ It was common to react with fear to the discovery that the house was being “discussed” or “talked about”. In the 1847 financial crisis, when the Bank Charter Act of 1844 was suspended, it was not ultimately necessary for the Bank of England to exceed its lender of last resort functions because the very

⁹⁷ Ibid., 118–119

⁹⁸ Ingham (n 24), 65

⁹⁹ Ackrill and Hannah (n 19), 259

¹⁰⁰ N Dimsdale and A Hoston, ‘Financial Crises and Economic Activity in the UK since 1825’, 48 in N Dimsdale and A Hoston, ‘Financial Crises and Economic Activity in the UK since 1825’

¹⁰¹ Kynaston, *Illusions of Gold* (n 11), 34

¹⁰² Kynaston, *A Club No More* (n 13), 102–3

¹⁰³ Ackrill and Hannah (n 19), 198; Cappie (n 3), 21; Reid (n 74)

¹⁰⁴ Michie (n 4), 139–140; Ingham (n 24), 51–54

¹⁰⁵ Kennedy, *Freedom from Fear: The American People in Depression and War 1929–1945* (Oxford University Press, Oxford 1999), 67

¹⁰⁶ See, for example, the experience of London City & Midland Bank during the troubles of Brunton Burke Kynaston, *Golden Years* (n 10), 492

fact that the government issued a letter permitting such a relaxation was of itself enough to stop the crisis. Kynaston tells us that Disraeli compared the situation to the liquefaction of St Januarius's blood, "the remedy is equally efficient and equally a hoax".¹⁰⁷ At the time of the Overend Gurney crisis again it was the suspension of the Bank Charter Act which allayed the panic.¹⁰⁸ We are told that in 1890 "... it was not until the public were assured that the Government and the Bank of England had been equal to the crisis ... that men began to look up and take courage".¹⁰⁹ More recently, the virtual collapse of the Eurodollar and Eurobond markets in 1974 appears to have been forestalled in part by reports from a meeting of central bankers in Basle that they would bale out commercial banks.¹¹⁰

C. MEDIATING THE DEBATE

Yet, notwithstanding the uneasy nature of the relationship, from the first Barings crisis onwards in Britain there was a conversation about these different perspectives and a long era of co-operation between government, the Bank of England and the merchant and clearing banks. This is seen in the 1890s "lifeboat" for Barings itself (albeit after confirmation of its long-term viability), with the Bank of England putting up the first million pounds and the joint-stock banks all contributing. At the start of the nineteenth century Rothschilds accorded significant support to Brunton Bourke on the basis that "in times like these if you can prevent a grain of sand or two from interfering between the axle and the wheel, you may succeed in removing all danger of great disturbances".¹¹¹ In the summer of 1911 the Bank of England coordinated the "dramatic if low-profile rescue" of the Yorkshire Penny Bank, with the joint stock banks subscribing £2m of new working capital and a guarantee fund headed by the Bank of England.¹¹² In 1913 the Bank of England was able to steer the market through the bankruptcy of the Indian Specie Bank and the ensuing crisis in the silver market.¹¹³ In 1918, when a period of intensive consolidation in British banking led to monopoly concerns and the threat of litigation, the banks were able to avert it by agreeing to submit all major proposals to the Treasury and the Board of Trade (at a time when the US was imposing break-ups and branching bans after investigation into US banking trusts).¹¹⁴ In 1922 the Bank of England was able to mastermind the

¹⁰⁷ Kynaston, *A World of its Own* (n 7), 160–161

¹⁰⁸ Dimsdale and Hotson (n 100), 73

¹⁰⁹ Kynaston, *Golden Years* (n 10), 38

¹¹⁰ Kynaston, *A Club No More* (n 13), 501–502

¹¹¹ Kynaston, *Golden Years* (n 10), 439–440

¹¹² *Ibid.*, 533–534

¹¹³ *Ibid.*, 582–583

¹¹⁴ Green (n 18), 4; Ackrill and Hannah (n 19), 69–70, although the clearing banks scenting an opportunity to win international finance business from the merchant banks, refused to release gold stocks to help the Bank of England in the crisis of confidence at the start of the war, see J Foreman-Peck, *A History of the World Economy* (Hemel Hempstead 1995), 168 cited in Ackrill and Hannah, 79 fn 97

takeover of Huths by Koning Bros.,¹¹⁵ in 1923 the acquisition of Cox & Co by Lloyds,¹¹⁶ in 1929 it persuaded the “Big Three” clearing banks to put up £2.6 million to save Banca Italo-Britannica (contributing £250,000 and agreeing to accept sterling acceptances placed on the London market),¹¹⁷ and in 1931, when a fraud in the Brussels office of Lazards resulted in a loss of £6m, a combination of a loan from the Bank of England, support from the firm’s parent and an agreement to close foreign offices saved the day.¹¹⁸ The 1930s also saw an extended operation to rescue the Anglo-South American Bank, in which the main clearers contributed up to £1m each, “almost certainly an entire loss”,¹¹⁹ and a contribution from National Provincial to further assistance by the Bank of England to Lazards.¹²⁰ In 1935 a “gentlemen’s agreement” was brokered to reduce speculation in gold and foreign exchange,¹²¹ followed by a series of agreements between the discount houses and the clearing banks;¹²² RBS was persuaded to shelter Glynn Mills;¹²³ Westminster Bank provided vital help to Schroders;¹²⁴ and the Bank of England mustered significant support to brokers even “those who had been gambling and those who were really not entitled, on their financial position, to receive such assistance”.¹²⁵ In 1951 Barclays assumed responsibility for the failed Ideal Bank at the Bank of England’s request.¹²⁶ Before 1958 Britain’s major clearing banks gave assurances that they would not attempt to enter hire purchase business as part of a general attempt to squeeze the post-war credit boom,¹²⁷ and in the 1960s the banks were once again asked to restrict their lending.¹²⁸ In 1973 The English Co-operative Society agreed to absorb the Scottish Society provided a syndicate of English and Scottish banks underwrote some of the losses,¹²⁹ foreshadowing the relatively open-ended ‘lifeboat’ for the secondary banking sector (notwithstanding doubts about the systemic risk arguments which supported it).¹³⁰ As Ackrill and Hannah put it, “Consensus and convergence rather than conflict and coercion prevailed”.¹³¹

¹¹⁵ Kynaston, *Illusions of Gold* (n 11), 70

¹¹⁶ Jones (n 17), 239–240

¹¹⁷ Jones (n 17), 233

¹¹⁸ Kynaston, *Illusions of Gold* (n 11), 228

¹¹⁹ *Ibid.*, 359 – although Lloyds refused to be involved see Jones (n 17), 241

¹²⁰ *Ibid.*, 360

¹²¹ *Ibid.*, 387

¹²² *Ibid.*, 390

¹²³ *Ibid.*, 391

¹²⁴ *Ibid.*, 393

¹²⁵ *Ibid.*, 427

¹²⁶ Ackrill and Hannah (n 19), 119

¹²⁷ Green (n 18), 87, noting that “Although banks in both Scotland and England were keen to take similar interests in hire purchase concerns, the Governor of the Bank of England was adamant in his disapproval”

¹²⁸ Ackrill and Hannah (n 19), 161

¹²⁹ *Ibid.*, 199

¹³⁰ *Ibid.*, 207–208

¹³¹ *Ibid.*, 119

A number of reasons account for this. First, the conservative nature of the market meant that it was easier to monitor,¹³² and when problems did arise they were of a scale and simplicity which could realistically be handled through private and public cooperation. Second, the Bank of England ceased to compete commercially with the banks on the same scale.¹³³ Third, the banks preferred cooperation to legislation and, over the course of the century, saw increasing risks of the latter if they failed to deliver the former.¹³⁴ Fourth, the banks gradually “grouped themselves in an exclusive club, reluctant to admit outsiders and intensely respectful of each other’s sphere of influence”,¹³⁵ a club which new entrants craved to join and which in turn made it easier for the Governor of the Bank of England to exercise his powers of “moral suasion” (metaphorically represented by the raising of his eyebrows).¹³⁶ Fourth, it was possible for situations to be resolved behind closed doors, so that contagion could be contained.¹³⁷

Fifth, although much of the market was a fundamentally uncompetitive oligopoly, the Bank of England appeared to accept that as a price of a strong and stable banking system, whilst bankers “secure in their cartel” for the most part “did not resent this informal interference and sometimes valued it”,¹³⁸ so that there were mutually reinforcing benefits from co-operation.¹³⁹ But, it is suggested, most importantly of all there was no “cult of youth”,¹⁴⁰ but rather a general culture of deference,¹⁴¹ in which the Bank of England had undeniable gravitas,¹⁴² and various gentlemanly codes, values and ideals such as secrecy which both sides of the debate observed.¹⁴³ As Schneer puts it, gentlemanly capitalists “largely controlled [the City’s] key financial institutions ... Imbued with certain aristocratic values and ideals — duty, honour, Christianity,¹⁴⁴ love of sport and adventure, to list a few — they composed the very class which over centuries had come to dominate Britain’s government. Naturally, then, City and government

¹³² Flandreau and Ugolini (n 75), 85–88

¹³³ Kynaston, *Golden Years* (n 10), 154

¹³⁴ *Ibid.*, 201; 531

¹³⁵ *Ibid.*, 268

¹³⁶ Kynaston, *Illusions of Gold* (n 11), 68; See also Flandreau and Ugolini (n 75), 88–89

¹³⁷ As Ackrill and Hannah (n 19) identify at 65, until 1970 no British bank was required to publish details of its reserves nor figures for its actual profit

¹³⁸ *Ibid.*, 106

¹³⁹ Turner also points to the role of the banks in holding large amounts of government debt as the *quid pro quo* for this tacit agreement see: J Turner, ‘Holding Shareholders to Account’ in N Dimsdale and A Hotson (eds) *British Financial Crises Since 1825* (Oxford University Press 2014)

¹⁴⁰ Kynaston, *Illusions of Gold* (n 11), 311

¹⁴¹ For an example, see Ackrill and Hannah (n 19), 360 describing Martin Taylor, who became CEO of Barclays in 1994, and who at the Financial Times had been “one of the ‘teenage scribblers’ whom bankers and politicians alike complacently undervalued in the more deferential 1970s”

¹⁴² As Kynaston puts it, “Ultimately the City obeyed the Bank of England because its leaders had been inculcated in the virtues of a hierarchical society and it barely occurred to them not to do so” *A Club No More* (n 13), 202. Ackrill and Hannah (n 19), 115 describe it as a “partnership modified by deference”

¹⁴³ Ackrill and Hannah (n 19), 107

¹⁴⁴ Although there was also a significant Jewish minority amongst the investment bankers

cooperated”.¹⁴⁵ In other words, shared social, cultural and educational backgrounds (public school and Oxford or Cambridge) meant that there were certain values shared by both the members of the finance market and the members of government and the members of the central bank, so that the gap between the values of the City and the values of wider society was not unbridgeable.¹⁴⁶ These values continued to dominate the narrative, and made conversation and cooperation possible between these upper class men notwithstanding rhetoric, in what was a “class conscious and only slowly changing society”.¹⁴⁷ As we shall see, this was to change profoundly in the Big Bang world.

III. THE POLITICS OF FINANCE AFTER THE BIG BANG

A. THE NEW ORDER

Many commentators have told the story of how the elements of this market which enabled it to cooperate on some level with government and the central bank also brought about profound change in its structure.¹⁴⁸ The market was, essentially, uncompetitive: a closed shop which was able to prevent competition in rates and which ultimately can hardly be said to have served the customer.¹⁴⁹ Eventually the arrival of Wall Street firms ushered in a new order in the City of London: recruitment on the basis of merit replaced patronage;¹⁵⁰ education became a prerequisite;¹⁵¹ serious prejudices such as gender bias which had thrived in an essentially uncompetitive industry began to be dismantled;¹⁵² professionalism was a prerequisite which did not speak of being a player and not a gentleman; long

¹⁴⁵ Schneer (n 53), 71

¹⁴⁶ Ackrill and Hannah (n 19), 120 fn 31 and accompanying text

¹⁴⁷ Ackrill and Hannah (n 19), 86

¹⁴⁸ See, for example, Kynaston *A Club No More* (n 13); Augar (n 32); Ackrill and Hannah (n 19)

¹⁴⁹ Ackrill and Hannah (n 19), 69 “If a tighter banking oligopoly could reduce competition and raise sustainable long-run profits, the acquiring banks’ shareholders might yet benefit. Fortunately for them (though arguably less happily for the banks’ customers), as we shall see, this condition was fulfilled”

¹⁵⁰ The banking histories of the twentieth century reveal the age of patronage. See, for example, Ackrill and Hannah (n 19), 63 noting that when Robert Barclay retired from the board in 1910 he was a sixth generation descendant of the founder and his son took his place; 76 noting that between the wars “the advice to schoolboys was still that, to get [such a] [clerk’s] position in a clearing bank, connection or an introduction was more effective than an application for what were still unadvertised, but attractive, positions”; 79 noting “most ‘really big positions’ were filled not by ordinary staff but by ‘suitable’ sons and nephews”; 123 noting that “even in 1962 four of the meritocrat Edwin Fisher’s five immediate successors were descendants of the families which had once owned the constituent parts of the bank and the fifth was the son of an earlier meritocrat chairman” and that F.C. Goodenough “blatantly promoted his son as heir apparent”

¹⁵¹ Cf Ackrill and Hannah (n 19), 79 “Some branch managers were ... wary of juniors who aspired to qualifications they themselves lacked, while it was not obligatory for ‘family’ entrants destined for the top to sit ... exams. Formal qualifications might help promotion within or between branches, but family connections were the path to local head offices, local boards and, for the more able, the board of directors itself”.

¹⁵² Ibid., 345–346

hours and an “eat what you kill” mentality replaced customer loyalty (and complacency);¹⁵³ and finance became considerably more complex and less conservative. Competition, globalisation and technological innovation squeezed profits on many traditional areas of bank business and reduced the role of market connections in winning business. The market adapted by focusing on transactions and transaction fees, the role of leverage in improving returns and the reduction of transaction costs by restricting monitoring, improving tradability, encouraging diversification and developing hedging techniques to reduce risk on default. This, in turn, necessitated the hiring of a new breed of mathematically literate bankers who were attracted away from other careers in science and technology by the promise of very high remuneration packages and the chance to indulge in some serious mathematical wizardry.

For some time, the modern and innovative financing techniques appeared to have solved the gaps in liquidity for British markets and to have dismantled the uncompetitive and collusive structure of its financial sector, without jeopardizing the strength and stability of the system. This was all the more the case as Britain moved to a service sector economy, in which the finance industry undeniably provided employment and contributed to tax receipts and the old concerns for the financing of industrial production to promote growth began to diminish. Financial institutions borrowed short at low rates to finance the acquisition of assets packaged into longer term deals at higher rates. Much of the banks’ funding liquidity came from the interbank and wholesale funding market rather than market liquid government securities and deposits. Hedging techniques were developed to match fixed term/fixed rate lending and increasingly financial institutions encroached on each other’s products and geographical spheres. The road was not entirely smooth: the 1970s saw problems for some banks in foreign exchange; in the 1980s and 1990s many well-known companies and institutions made mistakes in derivatives trading; and increased bad debt losses and regulatory capital charges continued to put pressure on banks’ returns.¹⁵⁴ However, the real day of reckoning came when, notwithstanding their apparent depth, global reach and diversification, the short term funding markets (notably the interbank market and the commercial paper market) seized up completely once serious concerns about the quality of the assets which had been financed took hold.¹⁵⁵ Once this happened one of the principal things which provided investors with confidence, market liquidity, disappeared increasing concerns about default.¹⁵⁶ This was particularly acute because some investors invested in the first place not on the basis of a proper investment appraisal, but rather because they were confident that

¹⁵³ Ibid., 374–375

¹⁵⁴ Ibid., 228

¹⁵⁵ H Davies, *Can Financial Markets Be Controlled?* (Polity Press, Cambridge, England and Malden, USA 2015), 1–2

¹⁵⁶ A McNally, *Debtanator* (Elliot and Thompson, London 2015), 48

a liquid market would always exist which would enable them to sell their investment.¹⁵⁷ Modern finance realised that many apparently unrelated risks were, in fact, closely correlated.

A familiar pattern then arose: banks and other financial institutions unable to fund themselves in the short term market were forced to liquidate assets which rapidly achieved fire sale prices (or were not saleable at any price) and to call in loans from other institutions, depositors became concerned about the safety of institutions and runs on deposits follow.¹⁵⁸ A classic liquidity and capital crisis rapidly developed. Whilst the derivatives markets should have gone some way to maintaining confidence that protection was in place if the underlying assets defaulted, derivatives turned out to be far from a panacea and, it transpired, actually exacerbated some aspects of the liquidity crisis as collateral securing open positions fell in value, and as it transpired that banks had funded many players through the derivatives market without requiring the posting of sufficient margin, in each case leading to swingeing margin calls.¹⁵⁹ In short, the hedging which the derivatives provided for a defaulting book was more limited than it had appeared in stable markets, and it became clear that this had led many financial institutions to miscalculate the overall risk of their book.¹⁶⁰ A familiar game of blame and recrimination followed.

B. THE VIEW FROM THE AUTHORITIES

A dominant theme of the post-crisis rhetoric has been that a lack of discipline amongst financial institutions lies at the route of the problem. In the immediate aftermath of the 2008 financial crisis, blame was attributed to bankers who took loans advanced to low income borrowers at variable interest rates and low starting rates for the purposes of purchasing houses, packaged them together and resold them as a high quality product. Rising interest rates meant that borrowers could not reset their loans at the end of the initial borrowing period so that many defaulted. Worse, the finance industry had (largely through developments in derivatives) created a spider-web of interconnected but opaque relationships so that no-one could be sure who had what exposures to these loans. The rest of the story is well known.¹⁶¹ Commentators have also focused on the moral hazard problems of the crisis, pointing to what appears to have been an implicit

¹⁵⁷ What Keynes called a “liquidity fetish”; see A McNally (n 156), 47–48. For a general discussion of the role of influences on behaviour other than credit assessment see J Black, ‘Reconceiving Financial Markets – From the Economic to the Social’ 13(2) (2013) JCLS 406–407

¹⁵⁸ CM Reinhart and KS Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton University Press, Princeton and Oxford, 2011), 144

¹⁵⁹ Davies (n 155), 40; Katharina Pistor, ‘Toward a Legal Theory of Finance: Retheorizing Law & Finance’ (2012) Available at: http://works.bepress.com/katharina_pistor/ 17, 14–15 and 29

¹⁶⁰ D Awrey, ‘Toward a Supply-Side Theory of Financial Innovation’ (2013) 41(2) Journal of Comparative Economics

¹⁶¹ The literature is voluminous. See, for example, Reinhart and Rogoff (n 158), 213; Davies (n 155), 30; Eichengreen (n 12)

assumption in the market that governments would bail-out financial institutions, leading to increasingly reckless lending behaviour.¹⁶² In other words, the assumption of lender of last resort support for banks and other financial institutions enabled them to borrow cheaply, fuelling excessive leverage in the finance sector, and enabling many financial institutions to operate with very low levels of liquidity.¹⁶³

Regulators puzzle over the extent to which economically rational markets can lend on terms which seem entirely decoupled from the credit fundamentals on which they are apparently based.¹⁶⁴ Furthermore the loan market has seen a growth in so-called “covenant lite” loans, in which only a single financial covenant is provided, triggered only if further debt is incurred (and, often, subject to other ratio floors) and layers of exceptions are included in other covenants allowing the borrower to increase leverage substantially over the life of the loan almost by stealth.¹⁶⁵ And the recent boom and bust has, of course, produced its own impressive list of scandals.¹⁶⁶ So a deeply moral narrative regretting the apparent absence of judgment and common sense has once again been part of the rhetoric. The after-party has also come to focus on a finance industry concerned only for itself with no regard for the greater good or its social responsibility, albeit that in its modern guise it is a loose collection of individuals each batting for him or herself rather than a gentlemanly team of the nineteenth and twentieth century batting only for its side. Thus it is that Paul Tucker, the Bank of England’s Deputy Governor for Financial Stability has called for a social contract between banks and the rest of society.¹⁶⁷

Moreover, the modern cult of “meritocratic extremism”¹⁶⁸ has done little to dispel the sense of the detachment of the lives of the financial community from the fourth estate. First, the meritocracy is something of an illusion, merely replacing the need for the right sort of family tree with a need for the right sort of education. Secondly, only those with the intellectual ability have the capacity to enter the “meritocratic” elite.¹⁶⁹ Thirdly, the financial rewards seem excessive to many outside the financial sector. Ultimately a small, extremely wealthy

¹⁶² See, for example, P Coggan, *Paper Promises: Money, Debt and the New World Order* (Penguin, London 2012); P Augar, *Reckless: The Rise and Fall of the City* (Vintage, London 2010), 59; A Admati and M Hellwig *The Bankers’ New Clothes: What’s Wrong with Banking and What to Do About it* (Princeton University Press, Princeton and Oxford 2013); Eichengreen (n 12)

¹⁶³ Davies (n 155), 38 and Reinhart and Rogoff (n 158), 145

¹⁶⁴ Federal Reserve Bank Leveraged Loan Guidance

¹⁶⁵ See investor letter to AFME high yield board available at <http://clamo.ftdata.co.uk/files/2015-02/24/AFME%20Investor%20letter%20%20-%20FINAL%20VERSION.pdf> (last accessed 26 November 2015)

¹⁶⁶ D Awry, W Blair and D Kershaw, ‘Between Law and Markets: Is there a Role for Culture and Ethics in Financial Regulation?’ (2013) 38 *Delaware Journal of Corporate Law* 191–245

¹⁶⁷ H Wilson, ‘Banks Need New Social Contract Says Tucker’ *The Telegraph* 30 June 2011; Davies *Can Financial Markets Be Controlled*, xiv

¹⁶⁸ Pikkety (n 91)

¹⁶⁹ M Fleurbaey *Fairness, Responsibility and Welfare* (Oxford University Press, Oxford 2008)

educational aristocracy emerges which appears to have very little in common with the rest of society. The debate over the social usefulness of much of what the finance industry does has also been reignited with passion and vigour after the financial crisis by, amongst many others, Piketty in his celebrated work, Kay (who appears to conclude that a great deal of what it does do is of no social use at all) and insightful comment on the crisis by Mian and Sufi.¹⁷⁰ In particular, the twenty-first century has seen ever-greater focus on the short termism debate. As the British Business Bank attempts to provide vital funding to small and start-up businesses after the financial crisis we are reminded that there is nothing new under the sun.

C. THE VIEW FROM THE FINANCE INDUSTRY

For its part, after the crisis the finance industry has pointed to the role of the authorities within it. The pension mis-selling scandal of the 1990s was in part a response to the call of the Conservative government of the day to promote personal pensions and their portability.¹⁷¹ The report into the failure of the Royal Bank of Scotland suggested an unwillingness to look too closely at the business of the bank for fear of jeopardizing London's place as a major financial centre (with all the consequences for GDP and tax which that would have).¹⁷² The British government was delighted by the expansion in credit which enabled more in the population to buy a home,¹⁷³ and there was a tendency to explain away rising housing prices notwithstanding the link between housing price bubbles and financial crises.¹⁷⁴ As the ability of economic growth to deliver a better standard of living for those at the lower and lower-middle end of the income scale was called into question with a rapidly ageing population,¹⁷⁵ and the declining working class meant that political parties were increasingly forced to fight on the electoral middle ground so that they doubted public tolerance for heavily redistributive policies,¹⁷⁶ there was an understandable political allure in dynamic and innovative debt markets to facilitate consumer borrowing (and spending) to resolve inequalities in standard of living.¹⁷⁷ At the same time, Government policy encouraged investment in debt, leading to unsustainable debt levels throughout

¹⁷⁰ Piketty (n 91); J Kay, *Other People's Money* (Profile Books 2015); A Mian and A Sufi, *House of Debt: How They (and You) Caused the Great Recession, and How We Can Stop It Happening Again* (University of Chicago Press, 2015)

¹⁷¹ Ackrill and Hannah (n 19), 369

¹⁷² Black, 'Learning from Regulatory Disasters' (n 78), 8

¹⁷³ Davies (n 155), 15–16 and 90–91

¹⁷⁴ Reinhart and Rogoff (n 158), 212

¹⁷⁵ F Fukuyama *Political Order and Political Decay: From the Industrial Revolution to the Globalisation of Democracy* (Profile Books 2015), 443 "In all developed countries, the costs of end-of-life care have accelerated faster than the overall rate of economic growth, and they are on their way to becoming the single largest component of government spending"

¹⁷⁶ *Ibid.*, 400–401

¹⁷⁷ *Ibid.*

the economy,¹⁷⁸ placing excessive faith in price stability as the goal of monetary policy to ensure the basic stability of the financial and economic system,¹⁷⁹ together with a better understanding of overcapacity and stock control to tame the business cycle. Piketty has “absolutely no doubt” that the increase in inequality contributed to financial instability in the US because the lower and middle classes needed to borrow in order to increase their purchasing power and “unscrupulous banks and financial intermediaries, freed from regulation and eager to earn good yields on the enormous savings injected into the system by the well-to-do, offered credit on increasingly generous terms”.¹⁸⁰ But as Kynaston put the finance industry perspective on responsibility (writing rather presciently long before the 2008 financial crisis) “If Politicians fail to challenge the assumptions of bankers that — ultimately ... is their responsibility”.¹⁸¹ Once again, if politicians did not entirely agree with the bankers’ assessment they seem to have acquiesced in it on the basis that “this time is different”.¹⁸² There have also been serious questions about the specific involvement of the Bank of England, given the number of hats which the central bank must wear.¹⁸³

Furthermore, although the broad pattern of the crisis is understood, many specific aspects of how it was triggered and how it spread are not. In an excellent account of the effects of the crisis in the repo market, Dimsdale and Hotson conclude, “The process whereby contagion shifted from the repo market to the interbank market is not exactly clear and it may never be established unequivocally”.¹⁸⁴ Coupled with this is a sense both that the authorities turned against practices which were implicitly known about, and that the scale of the punishment visited on individual bankers is out of all proportion with their role. It is a neat coincidence that both Clarence Hatry and the City trader Tom Hayes (involved in LIBOR rigging) received prison sentences of 14 years, in the case of the former in January 1930 and in the case of the latter in 2015.¹⁸⁵ Whilst the finance industry feels it has no option but to invest, leading to Chuck Prince’s now infamous comment, “As long as the music is playing, you’ve got to get up and dance”,¹⁸⁶ the authorities can also be reluctant to act in case they cause growth and investment to stall prematurely,¹⁸⁷ and there is speculation over what the authorities did and did not know about scandalous practices during the crash.¹⁸⁸ In the modern debate about the social usefulness of the finance industry, market

¹⁷⁸ McNally (n 156)

¹⁷⁹ Ibid., 28

¹⁸⁰ Piketty (n 91), 296

¹⁸¹ Kynaston, *Illusions of Gold* (n 11), 240

¹⁸² Reinhart and Rogoff (n 158), 213

¹⁸³ H Wilson, ‘Bob Diamond Claims BoE’s Paul Tucker told Barclays ‘to lower’ LIBOR rate’ 3 July 2012

¹⁸⁴ Dimsdale and Hotson (n 100), 46

¹⁸⁵ See n 12 and accompanying text

¹⁸⁶ M Nakamoto and D Wighton, ‘Citigroup Chief Stays Bullish on Buyouts’ Financial Times 9 July 2007

¹⁸⁷ Davies (n 155), 48

¹⁸⁸ H Wilson, ‘Bob Diamond Claims BoE’s Paul Tucker told Barclays ‘to lower’ LIBOR rate’ 3 July 2012

participants point out that when we think about the “rentier class” we are thinking too of insurance company and pension fund money which belongs to all of us.¹⁸⁹

When real challenges with the pre-big bang model of UK financing, notably the lack of a scientific approach to monetary or economic issues,¹⁹⁰ a lack of competition and a general complacency and lack of innovation ushered in a new order, members of the new world saw themselves as more meritocratic, cleverer and with shared values based on rational economic principles rather than the cosy world of the past, worthy of high salaries because they have been “selected on the basis of their intrinsic merits rather than birth or background”.¹⁹¹ At the same time, they work ferociously long hours in a generally more serious atmosphere and an internally competitive culture which offers little by way of job security.¹⁹² Many have selected a career in finance solely for the financial reward which it brings, and if that reward were to be removed may well pursue a career in another field of science or technology. Thus the intellectual finance elite which has emerged sees itself just as entitled to greater rewards than the rest of society as the gentlemanly capitalists who preceded them did, but this time based on merit rather than birth. The 2008 financial crisis is also in many ways the mirror image of the nineteenth and twentieth century concerns for protecting investors’ returns. This time, rather than cautious lending products delivering safe returns but holding back growth, many innovative but risky maturity transformation products were developed. However, in both cases the motivation was ultimately to deliver the type of profits for the private institution’s shareholders and investors which they demanded.¹⁹³

The need to bring an unviable financial institution to a soft landing is often described as a “too big to fail” problem: that a financial institution has become too large to be regulated or controlled but too large to be allowed to fail. In fact, it is better thought of as a “too significant to fail normally” problem, and history shows that all sorts of financial institutions, big and small and within and outside the regulated sector, can have systemic effects or assume critical functions. At the present time there is a (regulator encouraged) growth in so-called alternative lenders filling the gap left by the contracting bank sector. Leverage is at the heart of the investment model for many of these lenders, adding to capital provided by their investors with money borrowed from banks.¹⁹⁴ We have been here before: driving lending into a sector which is largely unregulated (because it has rich, sophisticated investors which do not need protection and does not accept deposits from the public) but which is interconnected with main stream regulated financial services. Many of those within the regulatory net are frustrated that the net is tightened, but not widened. And we have repeatedly seen the critical importance

¹⁸⁹ Davies (n 155), 19

¹⁹⁰ Kynaston, *Illusions of Gold* (n 11), 323

¹⁹¹ Piketty (n 91), 334

¹⁹² Ackrill and Hannah (n 19), 374 “A nice safe job in a bank, for many decades the hope of many parents for their offspring, no longer was so safe”

¹⁹³ See, for example, G Tett, *Fool’s Gold* (Abacus, London 2010)

¹⁹⁴ P Augar, *Reckless* (n 162), 69

of psychology in this crisis: take, for example, the decision to announce the Northern Rock guarantee;¹⁹⁵ the disastrous consequences of Chancellor Merkel and President Sarkozy's statement in Deauville that governments in crisis would make bondholders a take-it-or-leave-it offer;¹⁹⁶ the controversial "whatever it takes" words of Mario Draghi;¹⁹⁷ and the febrile atmosphere was rather brilliantly captured in Andrew Sorkin's "Too Big to Fail".¹⁹⁸

D. MEDIATING THE DEBATE

The contours of the debate outlined in the first part are therefore clearly visible in the modern debate. On the one hand the authorities lay the blame for the liquidity and capital crisis firmly at the door of the finance industry on the basis of a lack of discipline; moral hazard risk; irrationality of markets; scandal; a lack of regard for wider social responsibility; an elitist culture; a lack of useful contribution; and a short term approach. On the other hand, the finance industry points to the role of the authorities in the boom; the particular role of the central bank; the ease with which the authorities seek to shift blame; a sense of turning on practices which were implicitly known about; disproportionate punishment for individuals; frustration that the role of finance in the modern economy is not understood; justification for high reward based on merit; the consequences of driving finance into the unregulated sector; and the psychological aspect of financial collapse. However, whereas in earlier eras these issues marked the contours of a conversation, in the modern era the two sides are ranked against each other in something of a bitter, silent feud.

Many factors make the debate harder to mediate in the twenty-first century. First, of course, there is the sheer scale and complexity of the finance market.¹⁹⁹ Secondly, increasing globalisation and diversification of the market have made it increasingly difficult to control.²⁰⁰ And thirdly, notwithstanding the criticisms of it, the late twentieth century and early twenty-first century market is a more regulated place designed to create a "level playing field" between different groups so that the previous anti-competitive advantages of co-operation have largely disappeared.²⁰¹ But (it is suggested) most important of all is the wider gap between the values of the finance industry and the values of wider society. The new market players share

¹⁹⁵ Eichengreen (n 12), 181

¹⁹⁶ Ibid., 350–351

¹⁹⁷ Ibid., 372

¹⁹⁸ A Sorkin, *Too Big To Fail: Inside the Battle to Save Wall Street* (Penguin, London 2010)

¹⁹⁹ A process that had started in the 1970s with the move towards universal banks providing comprehensive financial services, see Green (n 18), 82 and continued with the development of modern, innovative financing services after the Big Bang in Britain in 1986

²⁰⁰ Ackrill and Hannah (n 19), 211 (noting the overlaps between what had formerly been the distinct businesses of clearing banks, merchant banks and others, so that the clearly defined groups of earlier eras began to disappear)

²⁰¹ Ibid., 212

a common background but this time university economic courses and not social and cultural family and public school backgrounds, emerging with shared values focused on self-interested economic rationality and certainly without deference towards an established institution or, more generally, age. They share a common identity based on “articulation of a clear integrative ideology”.²⁰² Thus the institutions, and the individuals within them, are shamelessly in competition with one another down to the last penny: there are no Marquis of Queensbury rules here, instead one fights solely to win and no- holds-barred is definitely the way.²⁰³ So in 1984, when the potential failure of Johnson Matthey Bankers threatened the London gold market, no “Lifeboat” could be put together and the Bank of England was forced to fund a bail-out itself,²⁰⁴ in 1992 the Bank of England was unable to maintain Britain’s place in the Exchange Rate Mechanism in the face of sustained attacks by currency speculators notwithstanding spending £15bn to support sterling in the markets,²⁰⁵ and in 1994 (in part as a result of its financing arrangements) no second rescue could be coordinated for Barings, notwithstanding serious concerns at the time that the failure would have systemic consequences.²⁰⁶ When Northern Rock presaged a more general collapse in British banking in 2007, there was no contribution from other British banks or building societies, and where banks did step in, as in the case of the takeover of HBOS by Lloyds Bank plc, litigation has followed.²⁰⁷ The obvious exception to this story, the rescue of Long Term Capital Management coordinated by the US Federal Reserve, is outside our account because it took place in the US but, in any event, the LTCM story is hardly one of collaboration and respect: the definitive account of its fall highlights the extent to which trading against LTCM by the banking community in the period before its rescue at the very least contributed to its demise.²⁰⁸

It is perhaps not surprising, then, that the post-crisis response has been comprehensive legal and regulatory reform to protect taxpayers’ money. Indeed, this is precisely the response which we would expect if we come to doubt the ability of norms of behaviour to resolve issues. Detailed macro-prudential tools have been developed to enable the authorities to slow asset bubbles and restrict credit expansion, thus avoiding crisis; increased levels of deposit insurance have been implemented; new attempts (for the UK) or renewed attempts (for the US) to ring fence critical banking functions from other, more speculative, financial

²⁰² This term is borrowed from F Fuyuyama (n 175), 325, used there in a very different context to describe the development of an entrenched Indonesian identity but, it is suggested, apposite here in describing the identity which has emerged in the finance industry

²⁰³ The Marquis of Queensbury rules were a code of generally accepted rules in boxing rings in London in the nineteenth century

²⁰⁴ Kynaston, *A Club No More* (n 13), 656

²⁰⁵ Ibid., 750

²⁰⁶ Ibid., 762–765

²⁰⁷ T Wallace, ‘Lloyds Shareholders Launch £350m HBOS Lawsuit’ *The Telegraph* 22 July, 2015

²⁰⁸ R Lowerstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (Fourth Estate, London 2002), 186–187

activity are under discussion; bail-in tools to recapitalise banks with long-run viable businesses caught up in the temporary liquidity crisis of the time have been introduced; new margining and clearing requirements for the derivatives industry have been developed and increased capital requirements have been imposed to enable banks to withstand a crisis. There has also been a focus on insolvency law, with the introduction of a series of special resolution powers in the Bank Recovery and Resolution Directive (henceforth BRRD, implemented in the UK through amendments to the Banking Act 2009) for use where an institution has been judged by the authorities to be unviable but its failure might otherwise jeopardise financial stability, interrupt the provision of critical functions or affect retail depositors. In particular, in many cases emergency liquidity will be required in order to implement these resolution tools in the form of short-term bridge financing or the provision of guarantees, or additional capital may be required. The question then arises as to who is to be responsible for the cost of these measures to “resolve” an otherwise unviable institution? The authorities have resoundingly answered that this funding should come from the finance industry. Both the Key Attributes and the BRRD state that financing arrangements should be in place to ensure that funds are available for such purposes without the need for recourse to public funds. Ultimately the political message is clear: the finance industry is now responsible for the costs of stabilising the financial system in a financial crisis, including legislatively-backed measures to bring unviable institutions to a gentle stop.

This legal and regulatory edifice appears to be intended as a conclusive response to the crisis, obviating the need for debate between the authorities and the finance industry of the lessons of the crisis. But we must fear that much of it is a chimera. First, whatever the rhetoric around private sector responsibility, the potential scale of a financial system crisis, and the unique role which government can play in stemming it, means that we can never be assured that the taxpayer will not need to contribute. Crucially, in times of tightening liquidity asking financial institutions for too hefty a contribution may merely deepen the contraction of credit and heighten the risk of contagion, whilst pre-funding involves the highly inefficient capture of precious capital. We cannot rule out financial crashes in which private resources are unequal to the scale of the collapse. If we needed reminding of the possible contagion effects of institutional failure, we have had many reminders during the crisis. Moreover, Rogoff and Reinhart have suggested that the bail-out costs for the authorities may not be as significant as other effects such as a long term reduction in tax receipts.²⁰⁹ In other words, the need to get the economy moving again needs to stay in focus as well as the need to protect it.²¹⁰

²⁰⁹ Reinhart and Rogoff (n 158), 142; 163–171; and 231–232

²¹⁰ And this, of course, was a major lesson of the Great Depression; Ibid., 146

As Piketty puts it, “rapid execution is the principal strength of the monetary authorities”.²¹¹

Secondly, we must be wary about the ability and willingness of the authorities to use macro-prudential tools during a period of growth. So it is that as post-crisis regulation begins to bring about the apparently desired contraction in bank lending, authorities are indecisive in slowing the expansion of credit in the unregulated sector in the “cheap money” environment, dither over their approach to lending on loose terms, and begin to encourage financing techniques such as securitisation which were at the heart of the crisis. At the time of writing, collateralised loan obligations, designed to increase market liquidity so that an investor need worry less about the risk of default, are making a rapid comeback.²¹² In turn, the loans in which CLOs invest have few covenants, tested only if the borrower wishes to take an action and not on an ongoing basis and subject to myriad exceptions (so-called “covenant-lite” loans), so that one of the principal private mechanisms for restraining credit expansion no longer operates. Many of the leveraged loan structures of the pre-crisis period have successfully refinanced (often at remarkably low rates) in the high yield bond market. Despite the dangers, regulators are slow to intervene because CLOs and the bond market are filling the vacuum in the availability of finance left by the retreating bank sector. At the same time, there is increasing focus in Europe on attracting significant levels of foreign capital, notwithstanding suggestions in the literature of a correlation between rapid capital inflows, asset price inflation and financial crises,²¹³ and banking monopolies are being relaxed to enable the shadow banking system to enter the market. At the same time, whilst the regulatory net is tightened on those within it, there has been little attempt to cast the regulatory net wider.

Finally, we must be concerned for a legal and regulatory system which is imposed upon the financial industry but which is ultimately only one part of the institutional framework and which the industry does not appear to accept. The comprehensive legal and regulatory response seems likely to increase distrust between the finance industry and the government. The finance industry does not trust the government to reach decisions which take account of what they regard as their legitimate interests, and so is not willing to participate in the reform process, and government appears to endorse that view by the strength and single-mindedness of its regulatory and legislative response and failure to acknowledge any contributory responsibility. As Fukuyama puts it, the government becomes “walled off” from the citizens of the finance industry.²¹⁴ As a result, the finance industry does not assist government in the process of understanding what has gone wrong, and where it can withholds compliance with the formal rules, increasing in turn government’s distrust of the financial community and

²¹¹ Piketty (n 91), 552

²¹² McNally (n 156), 48

²¹³ Reinhart and Rogoff (n 158), 157–158

²¹⁴ Fukuyama (n 175), 511

strengthening its commitment to coercion. Nonetheless, deviations remain difficult to detect, so that ultimately many of the reforms lack a credible enforcement mechanism. Moreover, as Douglass North puts it, “All organized activity by humans entails a structure to define the ‘way the game is played’”,²¹⁵ and that structure is made up of institutions which comprise formal rules, informal norms and their enforcement characteristics. Central to the formation of the formal rules (to some extent) and the informal constraints (to a great extent) are beliefs — “both those held by individuals and shared beliefs that form belief systems”.²¹⁶ Here is the rub: there is no evidence of an ideological shift in the finance market. Indeed, the industry appears to remain committed to individualistic competition and remuneration, funding liquidity provided by interbank and wholesale counterparties, the packaging of debts into financial instruments which are easily tradable reflecting greater concern for market liquidity than investment assessment, a focus on portfolio investing rather than monitoring, easy access to credit by the shadow banking system to provide liquidity to markets as the banks retreat, and a misplaced faith in diversification notwithstanding the correlations which appear in modern, linked markets between risks which would have been regarded as entirely unrelated in previous eras. As a result, it seems unlikely that the informal constraints within the finance market will change significantly, or the way in which they are enforced. These informal constraints would seem to be more important in shaping behaviour within a market than the formal rules. And so, notwithstanding the enormous legal and regulatory effort, it is difficult to believe that the fundamental incentives in the finance market have changed.

What is needed instead is some method of gently encouraging both sides in the debate to collaborate more constructively to assess how the financial system should provide liquidity to markets and to develop ideas on how it could be restructured to produce genuine change. There is a small, but growing body, of literature focusing on this need to think about collaboration in modern, individualistic, merit-based systems. In political science, Francis Fukuyama has contributed an influential study on the role of trust in prosperity.²¹⁷ Alan Morrison and William Wilhelm have recently considered trust in the context of developments in investment banking,²¹⁸ and social psychologist Dacher Keltner has proposed that success in the twenty-first century will require collaboration rather than coercion.²¹⁹ This paper joins this embryonic research in suggesting that

²¹⁵ DC North, *Understanding the Process of Economic Change* (Princeton University Press, Princeton N.J. 2005), 61

²¹⁶ *Ibid.*, 96

²¹⁷ F Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (Penguin Books, London and New York 1995)

²¹⁸ AD Morrison and WJ Wilhelm Jr., ‘Trust, Reputation and Law: The Evolution of Commitment in Investment Banking’ (2015) 7(2) *Journal of Legal Analysis* 363

²¹⁹ D Keltner, *The Power Paradox: How We Gain and Lose Influence* (Allan Lane 2016)

the next stage in adaptive efficiencies for modern economies will be to discover how some of the collaborative benefits of personal, patronage-based systems can be adapted and adopted in the context of meritocratic and merit based ones.

This is not to say that there is no role for formal rules or formal means to compel compliance with them. But it is to question, perhaps heretically, whether the ideological heart of the post-crisis response should be more regulation to impose more responsibility on the finance industry. It seems clear that we need to embrace some form of institutional change, and that that must go beyond changes to formal rules, but whilst we have done quite a good job of identifying what is wrong with our current system, we are still some way off knowing how best to change it. In order to work that out, we need to find new ways to work together. If we do not, to refashion the words of an earlier commentator in an earlier time, we might start to wonder whether we are judging the merit of new regulatory measures solely by the extent to which they offend the finance community,²²⁰ so that there will be no ground-up genuine change, and the leviathan regulatory reforms we have built will gradually be dismantled in more prosperous times.

IV. CONCLUSION

This paper has argued that the broad contours of the debate about the role and responsibility of the finance industry after the crisis can be traced throughout the history of modern finance. But it argues that the debate was easier to mediate in the class-based, uncompetitive markets of the past when certain shared norms incentivised cooperation. It should certainly not be read as a defence of laissez-faire. Anyone who has familiarised herself with the historical record cannot fail to appreciate the frauds and excesses which emerge if the industry is left off the regulatory leash. Yet regulation and legislation will never deliver genuine change if a different belief system endures within the market. It is for this reason that there is a pressing need for dialogue and debate between the finance market and the authorities which, somewhat paradoxically, may become less and less likely the more regulation and coercion are employed as methods of driving the reform agenda. The emerging question is this: how can the best of the cooperation and collaboration which was a feature of the cartel-like, patronage based systems of the past be adapted for the competitive, merit-based systems of the present? This paper has sought to frame the question. The next stage of the research project will be to suggest some tentative answers.

²²⁰ See the words of Moley in response to Roosevelt's speech in Madison Square Gardens in 1936, "whether he wasn't beginning to feel that the proof of a measure's merit was the extent to which it offended the business community" quoted in Kennedy (n 105), 282