THE GLOBAL CRASH:

Why Regulators Resist Reforms

Introduction

In the polemic and post-mortems that have followed the global financial crisis, the central bankers and financial regulators have been frank about their professional performance. The principal United States banking supervisor, for example, has described considerable weaknesses in her country's regulatory set-up and warned that 'the widespread economic damage has called into question the fundamental assumptions …that have directed our regulatory efforts for decades'..[1] Her counterparts in the United Kingdom have been equally candid about their failure to recognise the mismatch between regulatory protocols and market realities.[2]

These shortcomings have not undermined the political credibility of leading monetary officials, however. In the wake of the crisis, they have retained a powerful influence over national policy which has been reconfirmed in striking terms. The incoming Obama administration, for example, was quick to publicly endorse 'the expertise and powers' of the Federal Reserve Board as 'indispensable for preventing and managing financial crises'. The new Secretary for the Treasury added that 'the programs it has initiated since the onset of this crisis have played a critical role in helping to contain the damage to the broader economy'.[3] The British Parliament confirmed the reappointment of the Governor of the Bank of England in mid-2008 in equally fulsome terms. '[His] skills, qualities and experience… will be greatly needed and tested', it declared, 'in facing the challenges… arising from the current market turmoil and from anxieties over inflation'.[4]

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[1] Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, testimony on Modernizing Bank Supervision And Regulation before the Committee on Banking, Housing and Urban Affairs, U.S. Senate(19 March 2009) URL: http://www.fdic.gov/news/news/speeches/chairman/spmar0319.html

[2] 'Memorandum from the Financial Services Authority (FSA)', House of Commons Treasury Committee, *Banking Crisis*, Vol. II Written evidence (HMSO: HC 144–II, March 2009), pp. EV 456-7 especially. URL: http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144ii.pdf

[3] 'The Role of the Federal Reserve in Preserving Financial and Monetary Stability: Joint Statement by the Department of the Treasury and the Federal Reserve' (23 March 2009) URL: http://www.treas.gov/press/releases/tg66.htm

[4] House of Commons Treasury Committee, *Re–appointment of Mervyn King as Governor of the Bank of England Tenth Report of Session 2007–08*, Vol. I (London: HMSO HC 524-I, June 2008), p. 4. URL: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/524/524.pdf

The survival of American and British monetary officials, together with the existing policies and protocols of these central bankers and financial regulators, owes a great deal to a remarkable political and professional consensus in the two countries on the overriding merits of free markets and the dangers of state involvement in business. Despite wholesale destruction of wealth in the last two years, neither their governments nor their business communities believe that financial deregulation has become unaffordable. With this consensus has come a ‘culture’ among monetary officials which has shaped regulatory outlook and behaviour in the United States and the United Kingdom.

This paper seeks to explore this outlook and behaviour through examining the published record of the central bankers and financial regulators describing and defending the decisions which they took during the current decade. It opens with a description of the methodology employed in the paper and the underlying economic assumptions. The analysis focuses first on the dominant role of the United States and the United Kingdom in the world’s financial services, partly because of their market leadership but also because of a powerful Anglo-American ‘culture’. As global financial services boomed, freedom from regulation and other state interference came into fashion almost everywhere in the final two decades of the previous century, which made the onset of the global crisis in 2007 all the more traumatic.

The presentation explains how the Anglo-American ‘culture’ contributed to the onset of the global crisis. It predisposed policy makers to underestimate new sources of instability. Monetary officials failed to comprehend how radical changes in the business models of American and British banks had increased their vulnerability. They also ignored the lessons of the Asian financial crisis and the major market crashes and corporate scandals in the early years of this century. The paper then explores the links between regulators’ decisions and market failures. It concludes with a discussion about the regulators’ response to contemporary pressures for reforms.

A Simple Model

This paper adopts a simple methodology. No attempt is made to offer an alternative regulatory model. The focus, instead, is on delineating the main preconceptions and policy constraints which can be shown to have shaped both regulatory policy and enforcement. The analysis links these ‘cultural’ factors to major regulatory challenges to show why a specific policy decision was taken and how its subsequent defects have been explained by the officials responsible. In this way, policy decisions and their implementation can be linked to the economic environment and prevailing market conditions, so that a realistic assessment of the performance of the regulatory system can be achieved. The paper also illustrates the collective Anglo-American nature of the world’s dominant regulatory arrangements by illustrating how closely matched has been the thinking of officials in Washington and London.

In seeking to identify the principal features of this ‘culture’ and their relevance to the global crisis, the analysis will rely, almost exclusively, on the public accounts of their stewardship given by senior American and British monetary officials themselves. These central bankers and financial regulators are engaged in a constant and extensive dialogue with the financial services industry, the wider business community and opinion makers. They also have to account for themselves in considerable detail before congressional and parliamentary forums. This public record, which involves analyses of considerable technical sophistication as well as more 'political' presentations, allows the monetary officials' outlooks, priorities and responses to events to be examined in considerable detail, both during the global crisis and in the preceding decade.

This material presents the work of the American and British central banks and regulatory bodies as leading officials wish themselves to be seen and without being edited by the media or filtered by political or academic commentators. It may be objected that this public record must be misleading because it excludes any account of the policy-making process and the political, commercial and personal pressures that were involved. In reality, no problem of self-censorship and self-serving presentations by leading officials has been encountered, as will be evident from the presentation which follows, as well as from the accompanying paper ("Global Crash: Fatal Decisions – Four Case Studies in Financial Regulation') which reviews four case studies of monetary officials' policies.[5] Indeed, they can be seen with hindsight to have given a host of hostages to fortune by their candour over the years. In addition, these same officials are the largest source of published revelations about how regulatory failings created the business environment which led to the global crisis.

The Intellectual Consensus

This paper does not attempt to present a critical review of the economic theory that has underpinned central banking and financial regulation in the United States and the United Kingdom.[6] There has never been a shortage of academic 'non-believers', and their ranks have been increased since 2007. One prominent academic involved in British central banking, for example, has complained that 'current macroeconomic research has had little to say about bank lending, financial instability and house and asset price bubbles…[and has] pointed monetary policymakers in the wrong direction'.[7]

The reality is that economics did not seem to offer a convincing model defining the optimal regulatory arrangements. These would have to ensure a flourishing banking industry that achieves an effective balance between risk-taking and institutional stability and that also supplies the funds for maximum economic growth while

[5] Not that these dangers can be excluded entirely. In an account of its response to the financial crisis, for example, the Securities and Exchange Commission stated: 'Charged Fannie Mae and Freddie Mac with accounting fraud in 2006 and 2007 respectively, and the companies paid more than $450 million in penalties to settle the SEC's charges'. Only a careful reader would have to followed the links shown to other webpages that revealed both actions related to offences committed in 2004 or earlier and were thus unrelated to the current crisis.'SEC Actions During Turmoil in Credit Markets' 12 March 2009 URL: http://www.sec.gov/news/press/sec-actions.htm

[6] For a good example of economic research which supports the conclusion that that 'government actions and interventions caused, prolonged, and worsened the financial crisis', see John B. Taylor , 'The financial crisis and the policy responses: An empirical analysis of what went wrong', NBER Working Paper Series Working Paper 14631 (January 2009), p. 27. URL: http://www.nber.org/papers/w14631

[7] Professor David Blanchflower, Monetary Policy Committee Member, 'The Future of Monetary Policy' (March 2009), pp. 1, 9. URL: http://www.bankofengland.co.uk/publications/speeches/2009/speech382.pdf

safeguarding its depositors.[8] There has not even been general agreement about the contribution which banking makes to the development process.[9]

Nevertheless, an academic consensus has been overwhelmingly in favour of the key principles on which the prevailing Anglo-American regulatory 'culture' has been based. 'The absolutely dominant intellectual conventional wisdom [worldwide] of the years running up to 2007', a senior British official has explained, was 'confidence in the ideas that markets were self correcting' together with a conviction that ' it was not the role of regulators to interfere with what the market did'. Officials should be not concern themselves with financial market innovation no matter how menacing 'the explosion of sub-prime lending' on the grounds that market excesses are 'self-correcting'.[10]

This world view began with a commitment to financial liberalisation.

- With financial liberalisation, the economy as a whole enjoys faster growth because constraints on lending are reduced which means easier access for investors to bank finance.
- By definition, the retreat from controls on bank lending will encourage risk-taking and increase the potential for financial institutions to fail and for bank runs to occur.
- But gains from faster economic growth will more than compensate for the occasional crises even when they have 'severe recessionary effects'.[11]
- In any case, markets are best left to regulate and discipline the banks and investors are better placed than regulators to understand how sound or otherwise a financial institution is.[12]
- Economic growth is best promoted by monetary stability, and appropriate monetary policies will keep recession at bay and maximise prosperity.[13]

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[8] This finding reflects a study of the principal regulatory issues in the light of data gathered from 107 countries at the end of the previous century presented in James R. Barth, Gerard Caprio, Jr., Ross Levine, 'Bank Regulation and Supervision: What Works Best?', NBER Working Paper Series Working Paper 9323 (November 2002), pp. URL: http://www.nber.org/papers/w9323.

[9] For a summary of the key issues, see Sanghoon Ahn and Philip Hemmings, *Policy Influences on Economic Growth in OECD Countries: An Evaluation of the Evidence,* Economics Department Working Papers No. 246 (Paris: OECD, 2000), pp. 41–3.

[10] Lord Turner, Financial Services Authority Chairman, House of Commons Treasury Committee, *Banking Crisis*, Vol. I Oral evidence (HMSO: HC 144–I, March 2009), pp. EV280, 281. URL: http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144i.pdf

[11] The analysis in support of this conclusion supported by data derived from 60 countries relating to crises which occurred between 1980 and 2002 is presented in Romain Ranciere, Aaron Tornell and Frank Westermann, 'Decomposing the Effects of Financial Liberalization:Crises vs. Growth', *National Bureau of Economic Research Working Paper 12806* (December 2006) URL: http://www.nber.org/papers/w12806. But it is only proper to record that central bankers acknowledged the very heavy costs that financial crises could inflict on an economy. *e.g.*, David Clementi, Bank of England Deputy Governor, 'Banks and Systemic Risk – Theory and Evidence', Bank of England Conference (23 May 2001). URL: http://www.bankofengland.co.uk/publications/speeches/2001/speech130.htm

[12] For an evidence-based presentation in favour of the market's wisdom, see Mark J. Flannery, 'Using Market Information in Prudential Bank Supervision: A Review of the U.S. Empirical Evidence', *Journal of Money, Credit and Banking*, Vol. 30, No. 3, Part 1 (August 1998), pp. 297-8.

[13] The classic expressions of this outlook came from Ben S. Bernanke as a governor of the Federal Reserve Board in 'On Milton Friedman's Ninetieth Birthday' (2 November 2008) URL: http://www.federalreserve.gov/boarddocs/speeches/2002/20021108/default.htm; 'the Legacy of Milton

- In consequence, inflation targeting will prove 'the best policy framework for promoting wider economic prosperity and stability'.[14]

On the basis of such research findings, minimalism seemed the best approach to financial regulation. The policy conclusions that followed included

- reliance on market forces as a safer and more effective strategy than government oversight; and
- priority for monetary rather than financial stability.

The regulators had two further, quasi-academic preconceptions about financial crises with important policy implications (which will be challenged both in the analysis that follows and the accompanying paper).

- Financial crises are unavoidable, even in advanced economies, 'especially while maintaining a dynamic and innovative financial system'.[15] As a result, regulators cannot be held responsible if a crisis occurs.
- Financial crises tend to have little in common, which makes their occurrence hard to predict and their origins difficult to comprehend.[16] As a result, recent experience is not a good guide for substantial changes to regulatory policies and protocols.

An Anglo-American Affair

This consensus originated in the United States and the United Kingdom and forms the foundation for a regulatory 'culture' among their monetary officials. The two countries' central bankers have a strong sense that they share regulatory practices and problems, and they adopt similar public stances on major issues. This common frame

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and Rose Friedman's *Free to Choose*' (24 October 2003) URL: http://www.federalreserve.gov/boarddocs/speeches/2003/20031024/default.htm.

[14] The Bank of England denied that 'the *Inflation Targeting* regime… imposed a straightjacket on central banks including ours by setting too narrow a remit'. Sir John Gieve, Deputy Governor, Bank of England, 'Seven lessons from the last three years', (19 February 2009), pp. 13-4. URL: http://www.bankofengland.co.uk/publications/speeches/2009/speech377.pdf

[15] Washington and London have used almost identical wording on this issue, although in the British case, the bank closures since 2007 were without parallel since the nineteenth century. Ben S. Bernanke, Chairman, Federal Reserve Board, 'Financial Reform to Address Systemic Risk', Council on Foreign Relations (10 March 2009). URL: http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm. House of Commons Treasury Committee, *Re–appointment of Mervyn King as Governor of theBank of England Tenth Report of Session 2007–08*, Vol II Oral and written evidence (London: HMSO HC 524-II, June 2008), p. EV4. URL: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/524/524ii.pdf

[16] David Clementi, Bank of England Deputy Governor, 'Banks and Systemic Risk – Theory and Evidence', Bank of England Conference (23 May 2001). URL: http://www.bankofengland.co.uk/publications/speeches/2001/speech130.htm. THis view is shared by one of Hong Kong's most experienced regulators after a extensive survey of evidence from the last century. But his finding is challenged by an impressive essay in the same volume. Andrew Sheng, 'Bank Restructuring revisited' and Geoffrey P. Miller, 'Banking Crises in Perspective: Two Causes and One Cure', in Gerard Caprio, Jr *et al.* (eds), *Preventing Bank Crises: Lessons from Recent Global Bank Failures* (Washaington: The World Bank, 1998), pp. 280, 325.

of reference is not the outcome of the so-called 'special relationship' between American and British political leaders or the result of shared political and strategic interests. Furthermore, the collective 'culture' persists despite considerable differences between the political and institutional arrangements for overseeing monetary and financial affairs.[17] This common outlook survives, regardless of changes in national leadership or ruling party (notably the 2008 elections in the United States).

This Anglo-American 'culture' consists of a set of shared attitudes and preconceptions which, it will be shown, shape regulatory behaviour to a remarkable degree and reduce the differences between the two countries' policy decisions on major issues to a very low level. Even the choice of rhetoric employed by those responsible for monetary and financial affairs is strikingly similar, as will be evident from the analysis that follows. In other fields, it would be tempting to argue that the United Kingdom has no choice but to accept the United States' leadership and adopt its agenda. In the case of financial services, such an explanation will not do. In financial services, the two countries compete on relatively equal terms. Only in respect of this industry could a Bank of England official claim without sounding ridiculous that Americans feared British competition in 2007.[18]

This 'culture' begins with a firm belief in the virtues of free market forces. This assumption has gained increasing international credibility because of the growing trend over the last 30 years, even among socialist countries, to dismantle state controls and liberalise both domestic markets and the foreign trade and investment sectors. Governments which have abandoned state direction of their economies have achieved sustained growth at extremely high levels, especially in Asia. The period also saw the transformation of advanced economies into post-industrial societies, relying on their service sectors to generate their own wealth and on emerging and transition economies for manufactured products.

A key element in the shared Anglo-American 'culture' is the market reality: their enormously successful financial services industries. The United States and the United Kingdom led the international trend towards deregulation, and their financial sectors boomed. The two countries dominate world financial and securities markets, and they are the largest exporters of financial services. They have enjoyed exceptional profit opportunities thanks to worldwide economic growth over the last three decades. But 'cultural' factors have also played a substantial part in the success of their financial services. New York and London have the biggest concentration of regulatory expertise, and they have become the arbiters of world best practice, with which other countries must confirm. Thus, American and British firms have the additional and market-enhancing advantage that, increasingly, they operate internationally within a 'culture' zone originally designed for their convenience.

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[17] On these differences and their significance, see Howell E. Jackson, 'An American Perspective on the U.K. Financial Services Authority: Politics, Goals & Regulatory Intensity', Harvard Law School Discussion Paper No. 522, 08/2005, pp. 4, 12 especially. URL: SSRN-id839284[1].pdf

[18] 'Over the past few months there has been renewed talk of London overtaking New York as the world's leading financial centre. And it has reflected fears in the US as much as self congratulation in this country'. Sir John Gieve, Bank of England Deputy Governor, 'The City's Growth: The Crest of a Wave or Swimming with the Stream?', London Society of Chartered Accountants (26 March 2007), p. 2. URL: http://www.bankofengland.co.uk/publications/speeches/2007/speech306.htm

The Anglo-American advantage has been reinforced by the absence of serious rivals to its 'cultural' as well as market dominance. The European Union, in theory, could offer an alternative system, but European countries have split the management of monetary affairs. Monetary stability goals are set centrally, while fiscal policies and financial stability remain the responsibility of member governments whose priorities are national rather than European or global. Thus, market dominance means that the American and British financial authorities are able to impose a large measure of harmonisation of regulatory goals and behaviour – if not the political and legal rules and practices – on the day-to-day oversight of global financial business.[19]

Until 2007, this discipline seemed to be a natural consequence of how global markets brought 'financial integration and capital mobility'.[20] The assumption was that Anglo-Saxon regulatory practices would work equally well anywhere regardless of cultural and institutional differences.[21] The danger seemed small that imitation of Anglo-Saxon models would open global capital markets to the malignant as well as the benign features of American and British financial behaviour. On the contrary, the message from Washington and London was that their standards of excellence would ensure global stability. American and British regulators claimed to have studied the impact of increasingly esoteric and exotic products in their financial markets and to have found the risks involved to be limited and acceptable.[22]

For example, the Enron scandal offered abundant evidence of how blind the market and its supporting institutions (accounting firms, in particular) could be to the real worth of a major corporation. In response, American regulators pledged a commitment to greater watchfulness on the part of the banking industry.[23] Subsequent events showed that, in practice, the underlying weaknesses had not been eliminated. But for the foreign clients of the world's largest financial markets in New York and London, the Federal Reserve Board commitment to better corporate performance seemed close to a regulatory guarantee that Anglo-Saxon financial institutions would operate to the highest standards of prudential management.

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[19] Beth A. Simmons, 'The International Politics of Harmonization: The Case of Capital Market Regulation', *International Organization*, Vol. 55, No. 3 (Summer, 2001), 592-5.

[20] Darryl Crawford, 'Globalisation and Guanxi: The Ethos of Hong Kong Finance', *New Political Economy*, Vol. 6, No. 1 (2001), p. 47.

[21] James R. Barth, Gerard Caprio, Jr., Ross Levine, 'Bank Regulation and Supervision: What Works Best?', NBER Working Paper Series Working Paper 9323 (November 2002), p. 1. URL: http://www.nber.org/papers/w9323

[22] A typical example of such reassurance to the world at large was an American central banker's detailed review of financial innovation which advised that 'the potential for the new instruments and techniques [*i.e.*, mortgage-based and other derivatives] to produce instability has been overestimated'. Roger W. Ferguson, Jr., Federal Reserve Board Vice Chairman, 'Financial Engineering and Financial Stability' Annual Conference on the Securities Industry, American Institute of Certified Public Accountants (20 November 2002) URL: http://www.federalreserve.gov/boarddocs/speeches/2002/20021120/default.htm

[23] Richard Spillenkothen, Director, Division of Banking Supervision and Regulation, Federal Reserve Board, 'Oversight of investment banks' response to the lessons of Enron' in testimony before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, U.S. Senate, 11 December 2002. URL : http://www.federalreserve.gov/boarddocs/testimony/2002/20021211/default.htm

Taken by Surprise

The global crisis was an abrupt and unexpected reversal of the sustained but stable growth that had seemed to be norm for the new century. From the 1990s, the leading economies had appeared to have put behind them a long period of monetary instability during which regular inflationary and budgetary setbacks disrupted growth. They now enjoyed a prospect of unbroken prosperity glowingly described in an official, post-crisis British report.[24]

> The period since the economic downturn of the early 1990s, which affected almost all developed countries, came to be known as the 'great moderation' in the United States and the 'great stability' in the United Kingdom… characterised by low and stable global inflation, as well as high and stable global real GDP growth over the past decade.[25]

Initially, American and British officials refused to believe that this 'golden' age had started to crumble. In the second quarter of 2006, financial institutions began 'to liquidate portfolios to meet margin calls or solvency requirements', which caused significant funding problems. The Bank of England linked this trend to mounting competition in financial markets 'to stay ahead of, or keep up with, the pack [which] stretches risk management systems in the process'. Nevertheless, no special response was deemed unnecessary because of officials' deeply-held conviction that the markets were self-correcting.[26]

In the following year, market failures and corporate collapses began, which have proved enormously costly for their citizens, both as investors and as taxpayers. British financial regulators lost half of the ten major banks under their supervision. In the United States, the costs of the first government rescue programme could be described only in epic terms.[27]

> The $700 billion TARP program alone is worth more, in inflation-adjusted dollars, than the combined cost of the Hoover Dam, the Panama Canal, the first Gulf War, the Marshall Plan, the Louisiana Purchase, and all of the moon missions. Multiply that ninefold, and you have the current running total of the federal government's economic rescue programs.

The financial disaster which began in 2007 was made all the more traumatic because this was a crisis that should not have happened. Never had the defences against worldwide financial instability and global recession seemed so strong. The world monetary system now enjoyed a general freedom from inflation and rapid economic expansion. This achievement had reinforced the consensus among advanced and

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[24] House of Commons Treasury Committee, *Financial Stability and Transparency Sixth Report of Session 2007–08* (London: HMSO HC 371, March 2008), p. 9. URL: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/371/371.pdf

[25] House of Commons Treasury Committee, *Financial Stability and Transparency Sixth Report of Session 2007–08* (London: HMSO HC 371, March 2008), p. 9. URL: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/371/371.pdf

[26] The trend was a well below the levels which had led to crises in 1987 and 1998, the Bank of England concluded. Sir John Gieve, Bank of England Deputy Governor, 'Financial System Risks in the UK – Issues and Challenges' Centre for the Study of Financial Innovation Roundtable (25 July 2006), pp. 6, 8-9. URL: http://www.bankofengland.co.uk/publications/speeches/2006/speech280.htm

[27] Christopher Cox, SEC Chairman, Joint Meeting of the Exchequer Club and Women in Housing and Finance (4 December 2008). URL: http://www.sec.gov/news/speech/2008/spch120408cc.htm

emerging economies hat markets were more efficient than governments in fostering sustained and stable economic growth and in ensuring a better deal for consumers in terms not only of prices but of quality and choice. As an additional reassurance, agreement had been established among the world's central bankers on the regulatory measures that would minimise the risks of institutional failure and contain potential contagion across individual countries.

Central bankers in Washington and London took credit for creating the monetary environment which allowed the expansion of world imports by 180 per cent from 1990, while world GDP rose by 80 per cent.[28] They expressed satisfaction in the way their banking systems proved their ability to withstand severe strains from changing trade patterns, sharp swings in business cycles and direct threats to national survival.[29]

> The last decade has seen some big and unanticipated changes. Since 1999, oil prices have risen from below $20 a barrel to over $70 a barrel, the US Fed funds rate has varied between 1% and 6.5%, and the stock market has experienced its post dotcom boom, bust and recovery, with the FTSE All Share falling from its 2000 high of over 3200 to below 1660 in 2003 before now recovering to over 3400. We have seen 9/11 and the onset of a new form of international terrorism, the explosive growth of new financial instruments and new players to exploit them, and we have seen the emergence of China and India into major forces in the world economy.

An Accident Waiting to Happen

This outlook had an important policy implication because in the background, radical and, in retrospect, retrograde changes were taking place in the business models of the American and British banking industries. What was to prove the most damaging shift got underway in the United States. Here, the direct link between the banker and the borrower was being broken with the emergence of 'originate-to-distribute' model. Arguably, without this innovation, the sub-prime mortgage business would have been confined to the American market, and its collapse in 2006 would not have been followed by the extensive contamination of the global banking system.[30]

The serious consequences of this model for banking supervision were not widely recognised. Before the advent of the 'originate-to-distribute' model, a bank loan almost always created a deposit with the bank, which created an identity between depositor and borrower. Thus, banking supervision traditionally had been able to operate on an assumption that what is good for the borrower is also good for the depositor. Under the 'originate-to-distribute' model that identity of interest could no longer be taken for granted. Now, the borrower's relationship with the bank became

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[28] Sir John Gieve, Bank of England Deputy Governor, 'The City's Growth: The Crest of a Wave or Swimming with the Stream?', London Society of Chartered Accountants (26 March 2007), p. 9. URL: http://www.bankofengland.co.uk/publications/speeches/2007/speech306.htm

[29] Sir John Gieve, Bank of England Deputy Governor, 'Uncertainty, policy and financial markets' Barbican Centre (24 July 2007), p. 4. URL: http://www.bankofengland.co.uk/publications/speeches/2007/speech321.htm. Earlier, in making similar comparison of this sort, another British central banker had quoted Alan Greenspan, then Federal Reserve Board Chairman. Sir Andrew Large, Bank of England Deputy Governor, 'Convergence in Insurance and Banking: Some Financial Stability Issues', Mandarin Oriental Hotel (12 June 2003), p. 6. URL: http://www.bankofengland.co.uk/publications/speeches/2003/speech196.htm

[30] Antje Berndt and Anurag Gupta, 'Moral Hazard and Adverse Selection in the Originate-to-Distribute Model of Bank Credit' (November 2008), p. 1. URL: ssrn-id1290312[1].pdf

limited and specialised. Typically, the bank sells a mortgage to a client with whom it has had no previous customer relationship and about whom, therefore, the bank has far less information as to credit-worthiness than traditionally would be the case. (In the sub-prime mortgage industry, the bank offloaded the extra risk involved by selling on the loan to a third party which had even less direct knowledge of the borrower.)[31]

Securitisation aggravated this process, transforming the model from 'originate and distribute' to 'acquire and arbitrage', whose disastrous consequences for the world's financial markets have been summed up by a leading British official.[32]

> … credit intermediation [now] meant passing through multiple trading books in banks, leading to a proliferation of relationships within the financial sector. This 'acquire and arbitrage' model resulted in the majority of incurred losses falling not on investors outside the banking system, but on banks and investment banks themselves involved in risky maturity transformation activities. The explosion of claims within the financial system resulted in financial sector balance sheets becoming of greater consequence for the economy, with financial sector assets and liabilities in the UK and the US growing far more rapidly as a proportion of gross domestic product than those of corporates and households.

A different but no less radical transition was taking place in the United Kingdom. Once again, the direct link between the banker and the customer was being weakened, but this time on the deposit rather than the lending side. As in the United States, British 'commercial banks followed the path of investment banks'. A high priority was given to 'expansion of proprietary trading' and 'the funding of long-term assets in short-term wholesale markets'. The transformation of British banking behaviour was extraordinary, declared the Governor of the Bank of England.[33]

> Forty years ago, the clearing banks in London held around 30% of their assets in short-term liquid instruments. [In 2009] that liquid assets ratio is about 1%. For the major UK banks, almost 25% of customer loans are now funded by short-term borrowing in wholesale markets. At the turn of the new century it was close to zero. This was the distinctive feature of the contemporary British model of banking. Distinctive it may have been; sensible it was not.

Once again, the consequences of this major change in the business model were to prove disastrous. As the global crisis got under way, the fragility of this business model could not be disguised. Investors lost confidence followed by depositors, and two of Britain's largest banks were brought down, Britain's chief central bankers lamented, together with all the property-related firms which had acquired bank status in the last two decades of the previous century.

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[31] This analysis draws heavily from Antje Berndt and Anurag Gupta, 'Moral Hazard and Adverse Selection in the Originate-to-Distribute Model of Bank Credit' (November 2008), p. 1. URL: ssrn-id1290312[1].pdf

[32] 'Memorandum from the Financial Services Authority (FSA)', House of Commons Treasury Committee, *Banking Crisis*, Vol. II Written Evidence (HMSO: HC 144–II, March 2009), EV 457 URL: http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144ii.pdf

[33] Mervyn King, Governor Bank of England, 'Finance: A Return from Risk' (17 March 2009), p. 4. URL: http://www.bankofengland.co.uk/publications/speeches/2009/speech381.pdf

The Earliest Warning

The regulators' failure to respond to these dramatic transformations of American and British banking can be attributed to officials' scepticism about the merits of state interference with free markets that was the current economic wisdom. Their preference for non-interventionism seemed to have been vindicated by the robustness of the global financial system and the sustained momentum of world economic growth in the wake of the Asian financial crisis of 1997-98.

But opinions about that earlier financial shock altered, and Asian export-led growth and booming foreign reserves came to be viewed as a mixed blessing. American and British see the 'growth of significant global imbalances over the last decade' – particularly from 'newly emerging countries, like China' – as a major cause of financial instability.[34] There are two versions of this explanation. The first is more comprehensive.

The Anglo-American rationale for shifting a share of culpability to the Third World and to China in particular involves the official analysis of why their financial markets took the road to disaster. The breakdown in the expected good sense of the markets is attributed to 'the ex-ante excess supply of global savings over investment, which pushed real interest rates on safe assets to historically low levels, reinforced by loose monetary policy'.[35]

> This 'savings glut', as Chairman Ben Bernanke christened it, was in part the result of high national savings rates in some Asian emerging economies, especially China, which despite high investment rates, chose to export capital rather than import it, as standard theory would lead one to expect... One factor behind the high level of savings by the emerging market economies was their experience during the 1997-8 Asia crisis, when several countries were forced to tighten policy sharply in the face of a 'sudden stop' of capital inflows from abroad. Thereafter, a strategy of relying on domestic savings to finance investment and the accumulation of a substantial war chest of foreign reserves looked more appealing.

But this version of Asia's involvement in the global crisis is incomplete. Unexplained is the most striking market failure in the prelude to the global crisis: the inability of the American financial system to accommodate free flows of capital from overseas. The net volume of foreign savings received by the United States quadrupled as a share of GDP from 1995 to reach around 6 percent of GDP in 2006. Properly invested, these

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[34] Alistair Darling,MP, Chancellor of the Exchequer, House of Commons Treasury Committee, *Banking Crisis*, Vol. I Oral evidence (HMSO: HC 144–I, March 2009), p. EV366. URL: http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144i.pdf. It should be noted that there is a less compressed and more objective listing of the external factors: 'Large current account surpluses accumulated in the oil-exporting countries, Japan and some other east Asian developing nations, while fiscal and current account deficits grew in the US, UK and some members of the Eurozone' 'Memorandum from the Financial Services Authority (FSA)', House of Commons Treasury Committee, *Banking Crisis*, Vol. II Written evidence (HMSO: HC 144–II, March 2009), p. EV 456. URL: http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144ii.pdf

[35] Charles Bean, 'Some Lessons for Monetary Policy from the Recent Financial Turmoil', Deputy Governor , Bank of England, Conference on Globalisation, Inflation and Monetary Policy (22 November 2008), pp. 2-3. URL: http://www.bankofengland.co.uk/publications/speeches/2009/speech368.pdf

inflows would have been highly beneficial, the Chairman of the Federal Reserve Board has explained. The mortgage market welcomed the foreign funds, and they fuelled a housing boom. 'Unfortunately, much of this lending was poorly done', he has admitted, with 'little or no down payment by the borrower or insufficient consideration by the lender of the borrower's ability to make the monthly payments'.

Regulatory intervention could have corrected this mismanagement, the Chairman has admitted, but the American regulatory system was not up to the task.[36] The market, left to its own devices, was unwilling to halt the imprudent lending. On the Federal Reserve Board's own analysis, incompetent bank lending and defective regulation combined to transform a benign inflow from overseas into toxic assets which exported contagion via world markets. But there was another regulatory failure. 'The global imbalances were the joint responsibility of the United States and our trading partners' America's chief central banker has stated, but not enough effort was made to resolve the situation 'although the topic was a perennial one at international conferences'.[37]

Asian Experiences

Well into the global crisis, central bankers have begun to recognise important parallels between current Anglo-American challenges and the Asian financial crisis. Indeed, one official has suggested that the principal difference between the present and the earlier situations 'is that the crises of the 1990s were regional, whereas the current crisis has become global.'[38] This recognition is belated but significant because the Asian experience did not previously receive the attention it deserved from American and British monetary officials.

Several sources of instability that contributed to the downturn in Asia's fortunes at the end of the last century were to emerge emerged as prominent features of the current global crisis. In the 1990s, financial institutions took a highly optimistic view of new Asian profit opportunities. They were particularly attracted by China's liberalisation programme, and the country became the largest recipient of foreign direct investment.[39] Many foreign bankers preferred to dispense with the costs and complexities of undertaking rigorous due diligence in China especially when investing via 'international trust and investment corporations' (ITICs) and similar bodies. (These had been established with special exemptions from normal state controls so that they could help to accelerate economic development.)[40] Foreign banks had assumed that since the ITICs were established directly by the central and

[36] Chairman Ben S. Bernanke Federal Reserve Board , 'Four Questions about the Financial Crisis' (14 April 2009) URL: http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm

[37] Ben S. Bernanke, Chairman, Federal Reserve Board, 'Financial Reform to Address Systemic Risk', Council on Foreign Relations (10 March 2009). URL: http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm

[38] Ben S. Bernanke, Chairman, Federal Reserve Board, 'Financial Reform to Address Systemic Risk', Council on Foreign Relations (10 March 2009). URL: http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm

[39] An excellent summary of China's domestic and international financial situations in this period is Nicholas R. Lardy, 'The case of China', in Chung H. Lee (ed.), *Financial Liberalization and the Economic Crisis in Asia* (London: Routledge Curzon, 2003).

[40] A good summary of the ITICs, their history, role and problems can be found in Solomon Smith Barney, *Fixed Income – Local Government ITIC Credits*, 26 November 1998.

local governments, their ownership and control gave them the status of government borrowers, which would relieve their foreign partners from the burdensome controls on foreign investments.

In late 1998, the government declined to authorise a rescue of the Guangdong International Trust and Investment Corporation whose liabilities were estimated at over USD4 billion.[41] Foreign bankers now discovered that insolvent ITICs were not regarded as state entities under Chinese law, and loans advanced other than in the full compliance with state exchange control regulations were at risk.[42] The Chinese government's insistence on strict respect for the law was underlined in the then Prime Minister's response to overseas lobbying on behalf of the foreign investors.[43]

> "If Chinese companies cannot afford to pay their debts, they must apply to the People's Bank of China and court to be made bankrupt," Zhu said. "The Chinese Government will protect the rights and interests of foreign creditors according to the law."

Disregard for the importance of due diligence was not confined to investments in China. Earlier in the 1990s, the entire region had been hailed as an 'economic miracle'.[44] Its glittering performance had offered the promise of large profits and attracted substantial inflows of foreign investment.[45] International banks showed a considerable appetite for assets throughout South and East Asia with little regard for the risks involved. But the profits proved fragile and, often illusory as a World Bank survey of 5,550 public-listed corporations in nine East Asian economies covering the period 1988-96 demonstrated.[46]

> Ex-post, it has become clear that the operational performance of East Asian corporates was indeed not as stellar as many had thought and in fact involved investment with high risks... This poor performance and risky financing structures of East Asian corporates were, however, not notably featured among observers writing on East Asia prior to the financial crisis. Quite the opposite, East Asian corporates were considered an important contributing part of the East Asian miracle and were generally viewed upon as very competitive and adept at exploiting new market opportunities, and consequently attracted considerable amounts of foreign capital.

Asian entrepreneurs were not the only parties responsible for the collapse of Asian economies in 1997-98. No less alarming was the way in which 'even the most sophisticated operators in global financial markets' were prepared to go on lending 'well after the increased risks in the region were generally apparent'. The increasing use of structured derivatives by global banks was identified as contributing to this perverse behaviour. In the aftermath of the Asian financial crisis, these products were identified as a serious threat to financial stability in terms that foreshadowed their

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[41] *Financial Times*, 28 January and 22 April 1999.

[42] For a good contemporary overview of the ITICs affair and its business and banking ramifications, see Faith Keenan 'Finance: Picking up The Pieces', *Far Eastern Economic Review*, 6 May 1999.

[43] Prime Minister Zhu Rongji, *China Daily*, 17 October 2000

[44] World Bank, *The East Asian Miracle. Economic Growth and Public Policy* (New York: Oxford University Press, 1993), pp. 1-2.

[45] This topic is analysed in some depth in *Managing Capital Inflows in East Asia* (Washington: World Bank, 1995). See also Manuel Guitián, 'The Challenge of Managing Global Capital Flows', *Finance and Development*, June 1998.

[46] Stijin Claessens and Simeon Djankov, 'Publicly-Listed East Asian Corporates: Growth, Financing and Risks', Paper Presented to Regional Conference on Asian Corporate Recovery: Corporate Governance, Government Policy (World Bank, 15 March 1999).

later role in the making of the current global crisis.[47]

> It is the role of most derivative packages to mask the actual risk involved in an investment, and to increase the difficulty in assessing the final return on funds provided' for the primary lenders and for market regulators. The incentives motivating such [products] provide little support for the common belief in the self-regulating nature of private capital markets in terms of risk assessment or of their ability to allocate capital efficiently.

Ignoring the Past

The lessons of the Asian financial crisis were largely ignored,[48] as were other serious shocks to financial markets in the following decade even when they involved scandals closer to home. During the 1998 downturn in Asia, the United States faced a serious emergency with the collapse of LTCM. This firm 'received generous terms from the banks and broker-dealers that provided credit and served as counterparties, even though LTCM took exceptional risks', the Chairman of the Federal Reserve later observed, because investors, 'awed by the reputations of LTCM's principals, did not ask sufficiently tough questions about the risks that were being taken to generate the high returns'.[49] As he highlighted this lesson from the past in 2006, the dire consequences of the continuing regulatory tolerance of such imprudence were about to cause an even bigger shock.

The Enron collapse was another scandal that central bankers and financial regulators declared they regarded as a serious warning. Nevertheless, a senior regulator was to complain in 2009 that little had changed. 'The same off-balance sheet-vehicles were permitted beyond the reach of prudential regulation, including holding company capital requirements', and a similar failure as in the Enron case to ensure that financial products did not undermine the safety and soundness of financial institutions.[50]

The reluctance of monetary officials to learn from experience is an important element in the Anglo-Saxon regulatory 'culture'. Their resistance was based on a conviction that financial emergencies would be followed by excessive measures by governments

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[47] The analysis in this paragraph, together with the accompanying quotation, is drawn from J. A. Kregel, 'Derivatives and global capital flows: applications to Asia', *Cambridge Journal of Economics*, Vol. 22, No. 6 (November 1998), pp. 678, 679, 690.

[48] Among the regulators' challenges acknowledged in the Asian financial crisis which were to prove no less menacing in the current global crisis were the quality of corporate information and the severe pressure on bank credit triggered by sharp falls in share prices. Alastair Clark, Executive Director Bank of England, 'Accounting Standards and International Financial Markets', Institute of Chartered Accountants in Banking, Dublin (3 May 2000) URL: http://www.bankofengland.co.uk/publications/speeches/2000/speech84.htm; David Clementi, Bank of England Deputy Governor, 'Banks and Systemic Risk – Theory and Evidence', Bank of England Conference (23 May 2001). URL: http://www.bankofengland.co.uk/publications/speeches/2001/speech130.htm

[49] Significantly, while he pledged that 'authorities should (and will) try to ensure that the lapses in risk management of 1998 do not happen again', he warned that this 'systemic risk' could not be eliminated: 'To try to do so would likely stifle innovation without achieving the intended goal'. Ben S. Bernanke, Federal Reserve Board Chairman, 'Hedge Funds and Systemic Risk' Financial Markets Conference, (16 May 2006): URL: http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm

[50] Sheila C. Bair, Federal Deposit Insurance Corporation Chairman, testimony on Modernizing Bank Supervision And Regulation before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (19 March 2009) URL: http://www.fdic.gov/news/news/speeches/chairman/spmar0319.html

to regulate financial affairs. The improved prudential supervision, these officials argued, would prove more costly to the economy in the long run than the danger of financial collapses.

The impact of this outlook on policy was serious. Past crises were regarded as dangerous guides to the future. 'It is not uncommon to see legislators and regulators rush to promulgate new laws and rules in response to market breakdowns', Alan Greenspan insisted, 'and the mistakes that result often take decades to correct'.[51] The British view, as expressed by the Governor of the Bank of England, echoed Greenspan.[52]

> After another twenty years or so, memories of the Panic of 2008 will have faded', asserted 'and the regulations put in place in its wake will no doubt be seen as old-fashioned, inhibiting of the potential of the City, and as ripe to be swept away as was the Glass-Steagall separation of commercial and investment banking in the United States a few years ago.

Thus, as the cautionary lessons of the past were ignored, policy-makers and regulators favoured an early dismantling of the remedies introduced to overcome the instability which corporate mismanagement and financial misjudgement have created in the past. This tendency is still very much in evidence as the American and British officials responsible for dealing with the emergency conditions created by the global crisis argue that the measures taken should be regarded as interim remedies and that restraints on the market that should be removed as early as possible.

Market Virtues

The accompanying paper offers four case studies of the way that American and British central bankers and financial regulators identified potential threats to stability but decided not to act on the grounds that markets should be trusted. This behaviour reflected a deeply-entrenched belief in the sound judgment of markets and their ability to impose whatever discipline was necessary to achieve efficiency and integrity. The belief in the superiority of this collective good sense was and remains a deciding principle in the Anglo-American regulatory approach.

After his retirement, Alan Greenspan, the doyen of British as well as American central monetary officials,[53] revealed that his reluctance to regulate was inspired not by a perception of markets as wise or virtuous but, rather, by the belief that they were beyond human control, which made financial regulation an empty pretence. 'Markets have become too huge, complex, and fast-moving to be subject to twentieth-century

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[51] Alan Greenspan, *The Age of Turbulence: Adventures in a New World* (New York: Penguin Press, 2007), pp. 375-6.

[52] But note that earlier in this speech, he had declared: 'We must ensure that an institutional memory is maintained so that the lessons from the crisis are not forgotten and those impediments to excessive risk-taking are not swept away once memories of the crisis recede'. Mervyn King, Governor Bank of England, 'Finance: A Return from Risk' (17 March 2009), pp. 4, 15. URL: http://www.bankofengland.co.uk/publications/speeches/2009/speech381.pdf

[53] For a post-global crisis the British regulators' sense of Greenspan's influence, see Lord Turner's evidence in House of Commons Treasury Committee, *Banking Crisis*, Vol. I Oral evidence (HMSO: HC 144–I, March 2009), pp. EV280, 281. URL: http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144i.pdf

supervision and regulation', he declared, 'This globalized behemoth stretches beyond the full comprehension of even the most sophisticated market participants'.

Greenspan also believed that markets recovered best from crises when left alone by governments 'rebalance'.[54]

> Today, oversight of these [financial market] transactions is essentially by means of individual-market-participant counterparty surveillance. Each lender, to protect its shareholders, keeps a tab on its customers' investment positions. Regulators can still pretend to provide oversight, but their capabilities are much diminished and declining…. Since markets have become too complex for effective human intervention, the most promising anticrisis policies are those that maintain maximum market flexibility – freedom of action for key market participants such as hedge funds, private equity funds, and investment banks. .. Regulation by its nature, inhibits freedom of market action, and that freedom to act expeditiously is what rebalances markets.

As a result of this sort of thinking, regulation itself was identified as a serious source of financial instability, which should be opposed. For example, in a discussion of the risks that followed the rapid growth of hedge funds, the Federal Reserve warned in 2006 of the capacity of financial markets to erase the pain of previous crises and to seek to evade market discipline once more, aided and abetted by over-generous credit from banks and other sources. American regulators, nevertheless, declared their opposition to any form of 'prescriptive regulatory regime' on the grounds that, 'by creating moral hazard in the marketplace, it leaves the system less rather than more stable'.[55]

Thus, on the eve of the global crisis, American and British central bankers were united in their conviction that the fate of banks and other financial institutions must be decided not by the state but by the market. The Chairman of the Federal Reserve Board was particularly anxious in 2005 to dispel the notion that it would automatically 'prevent the failure of a large, highly interconnected financial firm' despite the disruption that the financial system and the broader economy might suffer in consequence. The consequences of regarding some firms as 'too big to fail' would be dire.[56]

> … it reduces market discipline and encourages excessive risk-taking by the firm. It also provides an artificial incentive for firms to grow, in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having implicit government support. Moreover, government rescues of too-big-to-fail firms can be costly to taxpayers, as we have seen recently. Indeed, in the present crisis, issue has emerged as an enormous problem.

Government intervention was not entirely ruled out, declared the Bank of England in 2006, but should only be contemplated 'to avoid serious disturbance' to the national

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[54] Alan Greenspan, *The Age of Turbulence: Adventures in a New World* (New York: Penguin Press, 2007), p. 489.

[55] Ben S. Ben S. Bernanke, Federal Reserve Board Chairman, 'Hedge Funds and Systemic Risk', Federal Reserve Bank of Atlanta Financial Markets Conference (16 May 2006) URL: http://www.federalreserve.gov/newsevents/speech/bernanke20060516a.htm

[56] Ben S. Bernanke, Chairman, Federal Reserve Board, 'Financial Reform to Address Systemic Risk', Council on Foreign Relations (10 March 2009). URL: http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm

economy.[57]

> … the authorities cannot and should not be expected to intervene with a support package every time a bank – even a large one – gets into difficulties. The cost of such an interventionist approach, in terms of market discipline and fiscal burden, would be substantial. And it would in all likelihood compromise the efficient provision of financial services and inhibit the exit of weak firms from the industry.

Regulators in Retrospect

Monetary officials are willing to concede that the current global crisis was foreseeable. Even the threat from mortgage-based securities should have been evident to both the market's professionals and its regulators well before 2007. The failure of monetary officials to respond to the ample warnings signs is astonishing. British monetary officials admit in retrospect that they were wrong to assume that they could rely on 'full, complete, and efficient markets' to manage the risks created by the new financial products.[58] 'In fact, most of the underlying causes of the crisis [had] attracted attention from economists, central banks, international financial institutions and regulators', the Bank of England has since confessed. However, 'regulators could never prove that the risks they identified would crystallize', central bankers assert, while 'central banks and the IMF discussed the imbalances for so long that some came to believe that they were crying wolf'.[59] American monetary officials make a similar complaint. The international regulatory community was at fault in believing that global financial institutions operating in global markets could safely operate with significantly lower capital requirements thanks to 'diversification and advanced risk management practices'.[60]

But the fundamental cause of the catastrophe was more humdrum: a reluctance to enforce the law. American officials admit in retrospect that they had considerable legal powers to halt the malpractices and mismanagement which destabilized financial markets (notably in relation to mortgages). 'For various reasons, these powers were not used effectively and, as a consequence, supervision was not sufficiently proactive'.[61]

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[57] Ian Bond, Head of Financial Crisis Management Division, Bank of England, 'Managing a Bank-specific Crisis: A UK Perspective', BBA workshop on managing a bank-specific crisis, (26 October 2006), p. 3. URL: http://www.bankofengland.co.uk/publications/speeches/2006/presentation061026.pdf

[58] See, for example, the lucid summary of financial engineering techniques in Nigel Jenkinson (*et al*), Bank of England Executive Director Financial Stability, 'Financial Innovation: What Have We Learnt?', Reserve Bank of Australia Conference on Lessons from the Financial Turmoil of 2007 and 2008, '(14-15 July 2008) p. 8. URL: http://www.bankofengland.co.uk/publications/speeches/2007/speech321.htm speeches351.htm

[59] Mervyn King, Governor Bank of England, 'Finance: A Return from Risk' (17 March 2009), p. 15. URL: http://www.bankofengland.co.uk/publications/speeches/2009/speech381.pdf

[60] heila C. Bair, Chairman, Federal Deposit Insurance Corporation, testimony on Modernizing Bank Supervision And Regulation before the Committee on Banking, Housing and Urban Affairs, U.S. Senate(19 March 2009) URL: http://www.fdic.gov/news/news/speeches/chairman/spmar0319.html

[61] Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, testimony on Modernizing Bank Supervision And Regulation before the Committee on Banking, Housing and Urban Affairs, U.S. Senate(19 March 2009) URL: http://www.fdic.gov/news/news/speeches/chairman/spmar0319.html

The central bankers and financial regulators argue that their resistance to official intervention represented political realities. They believe that their minimalist approach to regulation reflected the majority view in most countries. Public opinion would have opposed regulatory efforts to improve the regulation of the banks as 'constraints on the growth and profitability' of the industry and 'a tax on the success of the investment banking community', a British official claimed, while a more liberal regulatory régime was identified in 2007 as an important asset in London's rivalry with New York.[62] The politicians and the public would have opposed any regulatory innovations that reduced this competitive advantage.

End of an Era?

The global crisis seemed to discredit the vision of markets spontaneously correcting their excesses and disciplining wayward participants, and 'the autumn of 2008 marks the end of an era'. [63]

> After a generation of standing ever further back from the business of finance, governments have been forced to step in to rescue banking systems and the markets. In America, the bulwark of free enterprise, and in Britain, the pioneer of privatisation, financial firms have had to accept rescue and part-ownership by the state.

For this unhappy end to decades of liberalisation, the laisser-faire mentality of central bankers and financial regulators had much to answer.

In the United States, investor and depositor confidence was shaken to a degree that was almost without historical precedent, an American central banker has reported, and dramatised by 'the inability of Bear Stearns to borrow even against U.S. government securities [which] led to its collapse'.[64] Decades of optimism about the financial markets' ability to generate prosperity were replaced by scepticism. Long-standing assumptions about the market's collective good sense were being discarded, and disillusionment, if not despair, was the dominant sentiment at every level in 2009.[65]

> Investors of all stripes – sovereign wealth funds, large long-only institutional investors, private equity sponsors, hedge funds, and retail investors – are searching for new rules of asset allocation and appropriate risk premiums in an uncertain and unusual economic environment.

The case against the 'invisible hand' and the free operation of market forces was made equally powerfully by an official British report.[66]

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[62] Mervyn King, Governor Bank of England, 'Finance: A Return from Risk' (17 March 2009) URL: http://www.bankofengland.co.uk/publications/speeches/2009/speech381.pdf

[63] 'A Short History of Modern Finance, *Economist*, 16 October 2008.

[64] Elizabeth A. Duke, Federal Reserve Board Governor, 'Credit availability and prudent lending standards', testimony before the Committee on Financial Services, U.S. House of Representatives, (25 March 2009) URL: http://www.federalreserve.gov/newsevents/testimony/duke20090325a.htm

[65] Kevin Warsh, Federal Reserve Board Governor 'The Panic of 2008', Council of Institutional Investors (6 April 2009) URL: http://www.federalreserve.gov/newsevents/speech/warsh20090406a.htm

[66] *The Turner Review A regulatory response to the global banking crisis* (London: Financial Services Authority, March 2009) pp. 45-6. URL: http://www.fsa.gov.uk/pubs/other/turner_review.pdf

> In the past, an important school of thought has argued that market discipline can play a key role in incentivising banks to constrain capital and liquidity risks... But a strong case can be made that the events of the last five years have illustrated the inadequacy of market discipline: indeed, they suggest that in some ways market prices and market pressures may have played positively harmful roles…A reasonable conclusion is that market discipline expressed via market prices cannot be expected to play a major role in constraining bank risk taking, and that the primary constraint needs to come from regulation and supervision.

Articles of Faith

From 2007, ample evidence had accumulated that markets are neither self-correcting nor self-regulating. But the principle that the market must be left free to decide the fate of banks and other financial institution remained an article of faith at the heart of Anglo-American 'culture'. This resilience in the face of a calamitous gap between policy and performance has been put in context by an American official. Financial liberalisation won its credibility during a long period of prosperity, he notes, in which 'articles of faith accumulate'. 'Some of these understandings are strong and enduring and well grounded;' he observes, 'others, more problematic or misplaced; others still, properly and promptly discarded'.[67] In this case, the 'misplaced' articles of faith are protected by officials who, as this presentation has already shown, chose not to take action against threats to market integrity and stability out of a confidence in the operation of free markets which the global crisis has shown to be wholly unjustified.

As the Bush administration was coming to an end in 2008, regulators warned that 'events have called it into question' the benefits generated by free and competitive markets. The public, therefore, should be left in no doubt that massive rescue operations launched by the government should be recognised as temporary measures and 'there has to be a deliberate design to eliminate them'.[68] This commitment to the market did not alter as President Obama took office. The essence of our financial system is to let people take chances with their money', a senior official declared, 'and to enjoy most of the benefits and to endure most of the pain associated with taking those risks'. 'From a policy perspective', she went on, the goal must be 'to let financial entities fail if they make bad decisions', regardless of their size.[69]

For central bankers, the concept of moral hazard was sacred, and they must retain their freedom to let financial institutions fail. The Chairman of the Federal Reserve Board used virtually the same wording in 2009 as he had done in 2005 to reject any obligation to save even the largest banks. His one concession to the global crisis was the admission conceded that for the time, he was firmly pledged to rescue any financial institution whose downfall might cause 'further serious destabilization of the

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[67] Kevin Warsh, Federal Reserve Board Governor 'The Panic of 2008', Council of Institutional Investors (6 April 2009) URL: http://www.federalreserve.gov/newsevents/speech/warsh20090406a.htm

[68] Christopher Cox, SEC Chairman, Joint Meeting of the Exchequer Club and Women in Housing and Finance (4 December 2008). URL: http://www.sec.gov/news/speech/2008/spch120408cc.htm

[69] A saving clause was added: 'If we cannot afford to have them fail, then they should be regulated so as to prevent imposing systemic risk'. Ethiopis Tafara, Director, Office of International Affairs, SEC, 'A Few Observations Based On International Regulatory Conversations', CESR Conference (23 February 2009) URL: http://www.sec.gov/news/speech/2009/spch022309et.htm

financial system'.[70]

As the crisis in the United Kingdom intensified in 2008, the Bank of England fought strenuously for the right to allow banks to go out of business 'to encourage prudent behaviour by others'.[71] British monetary officials seem to have triumphed. A parliamentary investigation into the collapse of British banks described banks as 'special' organisations, 'similar in some ways to utility providers'. Nevertheless, its report stated, 'banks should be allowed to "fail" so as to preserve market discipline on financial institutions'. It was essential, the report added, 'to ensure that its framework for maintaining financial stability does not provide free insurance to banks' or a guarantee that no bank would be allowed to fail.[72] Moral hazard remained the regulators' gold standard.

Political leaders and monetary officials agree on a need to reform regulatory policies and practices. In theory, the Anglo-American regulatory 'culture' recognises that 'supervision (looking at the individual institutions and markets) and the systemic factors involving concentrations, inter-relationships and behaviour in relation to the system as a whole' must both be regarded as 'an essential element in the provision of financial stability oversight'.[73] But the two are not of equal weight, and 'systemic' risk is regarded as the more urgent priority, as the Chairman of the Federal Reserve Board indicated in a 2009 discussion of regulatory reforms.

He believed that that 'strong and effective regulation and supervision of banking institutions' is not enough to reduce system risk. What is required, he argued, was the much vaguer goal: 'reforms to the financial architecture, broadly conceived' and regulation of 'the financial system as a whole, in a holistic way, not just its individual components'.[74] The lack of precision was understandable. As a British report had noted a little earlier: 'There is no consensus about what financial stability means, how it should be measured and how the balance should be struck between the pursuit of a financial stability objective and other public policy objectives'.[75] The implication is that a radical departure from the minimalist regulatory approach of the past is unlikely.

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[70] Chairman Ben S. Bernanke, Federal Reserve Board Chairman, 'Financial Reform to Address Systemic Risk' Council on Foreign Relations (10 March 2009) URL: http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm

[71] Mervyn King, 'Banking and the Bank of England' (10 June 2008), pp. 3-4. URL: www.bankofengland.co.uk/publications/speeches/2008/speech347.pdf

[72] But note the criticism of the Bank of England for invoking moral hazard in the same report: 'We are unconvinced that the Bank of England's focus on moral hazard was appropriate for the circumstances in August [2007]. In our view, the lack of confidence in the money markets was a practical problem and the Bank of England should have adopted a more proactive response. House of Commons Treasury Committee, *The run on the Rock Fifth Report of Session 2007-08*, Vol. I (London: HMSO, HC56-I, January 2008), pp. 43, 74, 77. URL: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf

[73] Sir Andrew Large, Bank of England Deputy Governor, 'Financial Stability Oversight, Past & Present', London School of Economics (22 January 2004), p. 19. URL: http://www.bankofengland.co.uk/publications/speeches/2004/speech212.htm

[74] Ben S. Bernanke, Chairman, Federal Reserve Board, 'Financial Reform to Address Systemic Risk', Council on Foreign Relations (10 March 2009). URL: http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm

[75] House of Commons Treasury Committee, *Banking Reform Seventeenth Report of Session 2007–08* (London: HMSO, September 2008 HC 1008), pp. 100-2. URL: http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/1008/1008.pdf

Conclusions

The basic Anglo-Saxon regulatory 'culture' has demonstrated remarkable powers of survival. The essential principle of a self-regulating market reinforced by moral hazard has not been overthrown, although there has been a debate about whether or not the largest banks would be allowed to fail. Conventional wisdom has continued to accept that increased regulation would handicap innovation and thus do more economic damage than the closure of a mismanaged financial firm. Thus, the prevailing regulatory policies and procedures are unlikely to shift very dramatically in the immediate future. There is also a general sentiment in both the United States and the United Kingdom that such radical measures as are unavoidable should be regarded as temporary and discarded as early as possible.

Monetary officials continue to exert significant political influence, which gives them considerable control over the reform process. They continue to believe in the merits of a market-driven system and to regard instability as the price to be paid for growth in the financial sector. The principal threat to financial stability is identified as the leverage exerted by the very large, multinational firm which has multiple financial businesses operating in several regulatory and legal jurisdictions. So the priority is systemic risk.

By contrast, monetary officials do not accept that 'too many banks had made too many rotten individual-loan underwriting decisions'.[76] They are not convinced that prudential supervision to minimise unsound and unlawful business practices would make a significant contribution to financial stability. The analysis presented here, together with the case studies in the accompanying paper strongly suggest that it was the quality of the lending in the sub-prime mortgage market that did the damage, rather than the securitisation and sale worldwide of these loans. Similarly, it was conflicts of interest rather than complex mathematical models that proved the downfall of the rating agencies. But perhaps the greatest damage was done by the regulators who regarded themselves as redundant where free markets prevailed – even in the face of clear evidence that markets were malfunctioning.

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[76] A British official will concede no more than 'there was some of that'. Paul Tucker, Bank of England Deputy Governor Financial Stability, 'The Turner Review Conference' (27 March 2009) URL: http://www.bankofengland.co.uk/publications/speeches/2009/speech384.pdf