

FIXING FINANCE

1. WHY REGULATION?



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Preface

The collapse in Ireland's economic fortunes has been a dreadful blow. It has adversely affected our reputation as a well run economy with sound public finances, a good business climate and ahead-of-the-curve policies for the attraction of foreign investment. For individuals throughout the country it has had severe effects on income, security and well being.

The surge in unemployment since 2007 indicates that a heavy burden has fallen on lower-income groups, and deprivation on that score will most likely increase. Young working families have been hardest hit. Many have large mortgages and insecure income made ever more vulnerable by the forces of globalisation and the growing scarcity of jobs for life. While Keynesian economics and common decency would suggest that this is a time for enhanced budget measures to compensate the unemployed and their dependants, the condition of the Irish government's finances is so dire and the need to control spending so compelling, that the implementation of such counteracting measures will not prove possible.

The rich too have lost hugely. Their financial losses have spilt over to the banks and from there to shareholders and the taxpayer. The value of residential property has fallen by 40%, development land by over 60%, Irish bank shares have fallen by 80% and more. Pension funds and bank shareholders have suffered massive losses.

Many of us expected a significant downward adjustment in property prices. A few economists and economic journalists warned of the really serious consequences if the property collapse fed into the banking system. But the extent and speed of the decline has taken most by surprise. In space of an alarmingly few years, Ireland has fallen from top of the world economy beauty parade to bare qualifier. The evidence shows that Ireland's most respected institutions including the Central Bank, the major Irish banks, the Department of Finance, and the ESRI among others failed to grasp the massive danger to the economy posed by the property bubble. This failure is all too understandable but it is painful to admit. The key issue now is not to spend too much time in regret or in attributing blame, but to work out a strategy to extricate ourselves from the recession and from the escalating debt burden and to start the process of restoring the economy to health.

There were two separate contributors to Ireland's troubles. One was the collapse in the global banking system, beginning in the US subprime mortgage sector and rapidly spreading through Europe and the world economy. We in Ireland were in good company in failing to see this coming. The Federal Reserve, the Bank of England and some of the smartest financial brains in financial circles were caught offside. The demise of Lehmans in September 2008 came as a shock even to those closest to the market in Wall Street. Irish banks in general had broadly stayed clear of the toxic debt instruments that wreaked havoc in the US and the UK. They displayed commendable caution and canny conservatism and resisted the blandishments of easy money. Nonetheless the crisis in

confidence that these developments caused in the global banking sector impacted significantly on their access to liquidity and on the viability of their loans.

The second factor was the property boom that had reached a very significant scale in Ireland even by comparison with the UK and the US. For many years to come, we will be asking how it could have happened that the major Irish banks, which had successfully weathered the wildest swings of fortune for many decades (the Bank of Ireland was founded in 1783), succumbed so badly to that most pedestrian of dangers, the property bubble. Why did the economics profession not see this coming? If some did see it, why were the warnings not expressed more vocally and urgently? And why were their warnings not listened to and acted upon in time?

There are no easy answers to these questions. Nor is there any sure answer to the consequential question of how to prevent a disaster of this magnitude happening again?

This study by William Scally (Reports 1 and 3) and by Shane Fitzgerald (Report 2) provides a helpful and perceptive contribution to our understanding of the issues involved and the measures currently on the table to provide better regulation. Their work was supplemented by a magnificent series of lectures on the theme of financial regulation initiated and hosted by the Institute of International and European Affairs (IIEA).

The study begins with a report outlining the rationale of financial regulation. While the market clearly – especially in retrospect! – abounds in market failures, Scally's analysis demonstrates how difficult and controversial it is to find an adequate response to these failures. His report brings the reader through the labyrinth of important concepts such as moral hazard, regulatory capture and narrow banking in a sure footed and reader-friendly way. He draws on a rich vein of contemporary literature on these topics and gives a balanced and insightful assessment of its conclusions.

Shane Fitzgerald's contribution deals with proposals for reform at a European level. His task is made especially difficult by the fact that the proposals themselves and the context for reform seems to be in a perpetual state of motion. The narrative explains and describes the evolution of proposals but does not stop there. Every so often the author treats us to his own pithy and thoughtful assessment of the merits, defects and political constraints of the various proposals. The chapter is an invaluable guide for anyone wanting a short well-informed analysis of the EU's attempts to deal with the defects of the global financial system.

The third report brings us through an analysis of what went wrong in the Irish financial system. William Scally adopts a strategy of letting the main actors speak for themselves. He makes skilful use of the reports of Oireachtas committees. His use of quotation results in some fascinating insights into the thinking of some of the key players (mainly public sector officials) who had to deal with the property bubble. He avoids cheap point-scoring and facile conclusions. All the contributors he refers to are treated in a balanced manner. He keeps his own views in the background, confining himself to brief trenchant commentaries interlaced throughout the text. He is particularly persuasive in outlining the

real difficulties involved in calling a halt to a property boom once it has got into gear. His discussion links back to the analysis of market failures and regulatory capture discussed in the first section of the study. One is left with the impression that, absent the crisis in the United States financial system, the Irish property and banking boom might well have continued for several years more. Exogenous forces brought it to an abrupt halt; internal (endogenous) regulatory and other forces showed little evidence of capacity or willingness to restrain it. Anyone reading this section of the study will come away with a deeper insight into the perspective of the Department of Finance, the Central Bank and the Financial Regulator into what we now know was, without exaggeration, a really major failure in public policy.

The study provides not just a review of the past but also an insight into the direction of change necessary to prevent a recurrence of a similar disaster in the future. If the public sector merits criticism for its failure to anticipate the economic downturn, it has responded vigorously and with skill to the task of setting the economy on a more sustainable path. The financial sector is being reformed and strong action has been taken on the public finances. These measures will no doubt constitute the subject of debate and research for many years to come.

Professor Dermot McAleese
Chairman, IIEA International Financial Reform Working Group
4 June 2010

Acknowledgements

The IIEA's International Financial Reform Working Group came together in 2009 and evolved in various formats from then up to March 2010.

Three reports, which are now published, emerged from the process. These reports do not take account of any events since April 27th, 2010. It is hoped that they will provide a basis for further discussion and research among the members of the Working Group itself, the membership of the IIEA, and a wider public.

Special thanks are due to all who participated and contributed to the project whether by giving their views at meetings or in other ways. In particular, the written contributions of Denis O'Leary and Jonathan Westrup were extremely important. We consulted Martin O'Donoghue and Donal de Buitelir at certain stages of the project and their wisdom and experience were invaluable. None of the above is responsible for, or necessarily agrees with, the views expressed in this study. The views expressed are solely those of the authors alone.

Shane Fitzgerald, from the staff of the IIEA, as well as contributing the second report, was an able and diligent co-ordinator and reference point for the project.

Naturally, responsibility for reports 1 and 3 rests with William Scally and for report 2 with Shane Fitzgerald. These reports are not to be taken as representing the views of the IIEA. Dermot McAleese has contributed the Foreword.

Dermot McAleese
Project Chairman

William Scally
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4 June 2010

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Introduction

The question of how best to regulate economic activity is fundamental to contemporary economic analysis, public policy formulation and political discourse.

In this report, the merits or otherwise of regulating banking and financial services are first placed in the context of the general regulatory debate. Then specific features relating to the financial system are discussed in the context of developments since 2007.

The Market System – The Context

A distinction can be drawn between the market system and the market. “Although not all societies embrace or contain a market system all existing societies make use of markets”.¹ In the view of Charles Lindblom, while markets did exist for various items in Maoist China or the USSR, “these societies were not called market systems because a market system exists only when markets proliferate and link with each other in a particular way”.² Market systems organise and coordinate activities not through government planning but through the mutual interaction of buyers and sellers.

The state achieves some coordination of society, and the market system does so also. But Lindblom argues: “the market system is not, however, Adam Smith’s laissez-faire, not a market system tied to a minimal state. In our time it is a governed market system, heavily burdened or ornamented with what old fashioned free marketers decry as interferences”.³ In such systems, the state is the largest buyer, provides services on a gigantic scale, often gives away the product or service (for example primary education) rather than selling it, sets prices (for example in agriculture) rather than letting supply and demand do it, and collects funds to disperse through social welfare programmes and so on.

As regards finance, Lindblom notes, the state “is a gigantic borrower and frequent lender” and “a powerfully active manager of supplies of money and credit through its controls over banking and its own fiscal policy”.⁴

He then concludes in broad terms as follows: “Some of these governmental activities are necessary to make a market system flourish. Some are at least helpful, some are wasteful. Some represent nothing better than raids on the public purse. However evaluated they are part of the story of how the market system works”.⁵

This then is the broad context in which economic and public policy debates on regulation occur. Clearly in parts of the world there are elements of the household type of economy and societies where physical planning or command and control approaches predominate. However, with increasing globalisation, regulatory issues now emerge at national, continental and world levels.

In this report, economic analysis, political choices, value systems and associated ideological positions are all considered to be germane to arguments over the purpose and optimum level of regulation. For example, in the sphere of multi-lateral trade liberalisation, economic analysis may strongly suggest mutually beneficial incremental advances, but at the institutional negotiating level between countries and blocs, progress may be painfully slow or non-existent. Similarly, in the different sphere of climate change action programmes, there are continuing tensions between scientific arguments, economic assessments and political preferences. These tensions will have an intergenerational impact. As discussed later, international responses to the financial crises of 2007-2010 are on-going and substantial but still lacking in important respects.

Regulation and Market Failure

Modern society partly consists of galaxies of prohibitions. Examples include public health, safety at work, greenhouse gas emissions, food processing and preservation, transportation, copyrights and patents. Many of these prohibitory systems, depending on how they are enforced and on the extent to which they are consistent across national economies, impact strongly on overall economic activity.

Since the onset of the financial crisis, some people have argued that banking and the financial services sectors should be subjected more to regulatory approval and/or testing of new products akin even to approaches used in public health systems, for example by the US Food and Drug Administration. This proposal raises the issue of the balance of advantage between prohibition and innovation which is discussed later in the report.

Many areas of economic activity are subject to market failure or the potential abuse of dominant market positions. Market failure occurs where markets do not function with an outcome of maximising economic welfare. For example, where there is an absence of free choice, asymmetry of information between market participants, or where externalities – that is benefits or damages to economic welfare – are not or cannot be counted into the actual price of the proposed transaction. Environmental policy is one particular modern area where taxation, subsidies or market related approaches such as emissions trading schemes are directly relevant to overall welfare assessments.

Potential diminution of welfare may arise from the unlawful exercise of market power in one form or another. Trade liberalisation in products and services and specific statutory competition assessment and enforcement agencies address these issues.

The free market may not allocate resources in an optimum manner. Market failure may be widespread. In this context, uncertainty about the future and imperfect information are highly relevant.

In his book, *How Markets Fail*, John Cassidy refers to the work of Francis Bator who he believes was the first economist to use the phrase “market failure” in articles in the late 1950s.

Cassidy says: “Even in the world of perfect foresight, he argued, there would be at least three other sources of market failure. One is oligopoly or monopoly power. In the free market model each industry consists of large numbers of competing firms, none of which can capture more than a small share of the market; the survival of atomized competition depends on the assumption of diminishing returns to scale”. In many manufacturing industries, for example, this is not realistic.

The second market failure identified by Bator was the problem of “public goods” “or that businesses may have little incentive to produce some things that people value highly such as bridges, hospitals, parks and fire departments because they can’t charge enough to make it worthwhile”. Usually one person’s use of such goods does not prevent others from using them, and it is often very difficult to prevent other people from using them for nothing.

The third source of market failure was the phenomenon of “spillovers” or externalities. Such externalities could be positive or negative and as mentioned above are highly relevant to issues related to climate change or the environment. Recent events have shown that they are of direct applicability to the modern financial sector.

Regulation in Banking and Financial Services

In this section, the interaction between regulation and financial market activity is discussed.

The substance of past debate on financial regulatory issues at a theoretical level was summarised in a speech by Adair Turner, Chairman of the UK’s Financial Services Authority, entitled “After the Crises: Assessing the Costs and Benefits of Financial Liberalisation”.⁶

He categorised the debate in terms of contrasting economic theories, that is, neoclassical versus Keynes/Minsky assumptions. First, as regards neo-classical theory:

The predominant neoclassical school of economics has perceived increased financial activity – greater market liquidity, more active trading, and financial innovation – as a broadly positive development. This is because extensive financial activity is essential to complete markets. The first fundamental theorem of welfare economics, demonstrated mathematically by Kenneth Arrow and Gerard Debreu, illustrates that a competitive equilibrium is efficient. But this is only true if markets are complete, i.e. if there are markets which strike all possible desired contracts, including insurance contracts and investment contracts linking the present and the future, as well as markets for current goods, services and labour. Therefore, the more liquid are financial markets and the more extensive is financial innovation, the more efficient the economy will be.

More liquid commodity futures markets are beneficial because they enable users and producers of commodities to hedge their risk more efficiently.

Liquidity in the credit default swaps market enables investors and issuers of corporate debt to achieve and continuously adapt their desired risk profile.

The complex structured credit markets which grew from the mid 1990s were beneficial because they enabled investors to select precisely that combination of risk, return and liquidity which matched their specific preferences.

And the wider the set of options for linking suppliers of funds with users of funds – including via the provision of market liquidity which enables investors’ time horizons to diverge from the contractual maturity of the instruments themselves – the more efficient will be the allocation of capital.

In each case therefore ‘innovation brings us closer to the Arrow-Debreu nirvana where all possible markets exist and are complete’.

Moreover, these advantages of financial markets apply not merely within an economy, but between countries. The less restricted and the deeper the markets for capital flows between countries, the more efficient the international allocation of capital will be, with globalisation and financial liberalisation therefore naturally and beneficially linked.

Of course, these propositions do not mean that there is no role for regulation of financial services and financial markets. But the neoclassical approach does tend to dictate a particular regulatory philosophy, in which policymakers ideally seek to identify the specific market imperfections preventing the attainment of complete and efficient markets, and in which regulatory intervention should ideally be focused – not on banning products or dampening down the volatility of markets – but on disclosure and transparency requirements which will ensure that markets are as efficient as possible.

In Turner’s view, these propositions and the strongly free market implications drawn from them have been dominant in academic economics over the last several decades, “though with dissenting voices always present”. Among policymakers in the financial ministries, central banks and regulators of the developed world, they have been even more dominant.

By contrast, he elaborates on the Keynes/Minsky school of thought as follows:

*However, this benign view of limitless financial deepening – of increased trading activity and innovation – is rejected by the Keynes/Minsky school of thought. Keynes, most famously in Chapter 12 of *The General Theory*, argued that liquid financial markets did not ensure allocative efficiency through the attainment of a rational competitive equilibrium, but were instead subject, for inherent and unavoidable reasons, to self-reinforcing herd/momentum effects. Professional investment was, he*

famously said, like a ‘pick the prettiest girl photo competition’, in which the successful competitor was the one who correctly and most rapidly predicted the preferences of the other competitors. ‘It is not a case of choosing those which, to the best of one’s judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees’.

Keynes therefore believed that the professional investor or trader, be it in equity markets, currency markets, or, he would have said today, the CDS market, is ‘forced to concern himself with the anticipation of impending changes, in the news and in the atmosphere, of the kind by which experience shows that the mass psychology of the market is most influenced’. And he argued that pure speculation, unattached to fundamentals, could drive self-reinforcing bubbles, which not only served no useful allocative role, but which produced important destabilising effects.

Keynes’s argument received strong empirical support from Charles Kindleberger’s analysis of market manias, panics, and crashes through the ages. Hyman Minsky developed a theory of the dynamics of the capitalist economy and of its financial institutions, in which sustained good economic times were likely to produce a shift in the relative balance of financial activity away from hedging and rational allocative activities towards purely speculative activities, which in turn could lead to sudden collapses in values, debt deflation traps and major real economic disruption. And indeed, some of the world’s most successful financial speculators – in particular George Soros – have themselves argued that major liquid financial markets are not driven to equilibrium by fundamental factors, but are subject to endlessly reflexive disequilibrium dynamics.

Turner indicates from the evidence that at the macro level there is no clear and positive relationship between the financial intensity of the economy – measured in all sorts of different ways – and the overall rate of economic growth. He also notes that a wide variety of studies have cast doubt on whether free movement of capital “and in particular short-term capital” is at all positive for growth. “Overall, therefore, [he] believe[s] that the case that short-term capital flow liberalisation is beneficial (as Jagdish Bhagwati argued in his famous 1998 article, *The Capital Myth: The Difference between Trade and Widgets and Dollars*) is based more on ideology and argument by axiom than on any empirical evidence”.

Turner goes on to say that it does not necessarily follow that comprehensive capital controls are the required answer: “there is a reasonable argument that ... the pragmatic case against them (at least their comprehensive application) is quite strong, simply because they may be unenforceable and tend to produce other distortions”.

Therefore, perhaps what we should draw from Turner is that “free” financial markets are not optimum in any long-term economic sense, but also that there are limits to regulation and to the practicality of enforcing even well designed regulation.

In the preface to his book, *Freefall: America, Free Markets, and the Sinking of the World Economy* (2010), Joseph Stiglitz is definitive on the perceived errors of past ideas and policy, with special reference to the USA as follows:

One might have thought that with the crisis of 2008, the debate over market fundamentalism – the notion that unfettered markets by themselves can ensure economic prosperity and growth – would be over. One might have thought that no one ever again – or at least until memories of this crisis have receded into the distant past – would argue that markets are self correcting and that we can rely on the self-interested behaviour of market participants to ensure that everything works well.

Those who have done well by market fundamentalism offer a different interpretation. Some say our economy suffered an “accident” and accidents happen. No one would suggest that we stop drivers driving cars just because of an occasional collision. Those who hold this position want us to return to the world before 2008 as quickly as possible. The bankers did nothing wrong, they say. Give the banks the money they ask for, tweak the regulations a little bit, give a few stern lectures to the regulators not to let the likes of Bernie Madoff get away with fraud again, add a few more business school courses on ethics, and we will emerge in fine shape.

This book argues that the problems are more deep-seated. Over the past twenty five years this supposedly self-regulating apparatus, our financial system, has repeatedly been rescued by the government. From the system’s survival, we drew the wrong lesson – that it was working on its own. Indeed, our economic system hadn’t been working so well for most Americans before the crisis. Somebody was doing well, but it was not the average American.⁷

The view in his book is “that essentially all the critical policies, such as those related to deregulation, were the consequences of political and economic ‘forces’ – interests, ideas and ideologies that go beyond any particular individual”.⁸

Stiglitz’s assessment is that when President Regan appointed Alan Greenspan as Chairman of the Federal Reserve in 1987, he was looking for someone committed to deregulation and that therefore “the problem was not so much Greenspan as the deregulatory ideology that had taken hold”.⁹

This view is borne out by remarks in Greenspan’s 2007 autobiography, *The Age of Turbulence*, when he says, referring to the staff of the Federal Reserve:

What I had not known about was the staff’s free market orientation, which I now discovered characterised even the Division of Bank Supervision and Regulation ... So while the staff recommendations at the Federal Reserve Board were directed to implementing congressional mandates, they were always formulated with a view towards fostering competition and letting markets work. There was less emphasis on ‘thou shalt not’ and more on management accountability and disclosure that would enable markets to function more effectively. The staff also fully recognised the

*powers of counterparty surveillance as the first line of protection against overextended or inappropriate credit.*¹⁰

He went on to say that this view of regulation was influenced by the economists in the institution and on the Board as “they were generally sensitive to the need to buttress the competitive market forces that the financial safety net tends to impair. This safety net – which includes such safeguards as deposit insurance, bank access to the Fed’s discount facilities, and access to the Fed’s vast electronic payments system – reduced the importance of reputation as a constraint in excessive debt creation”.¹¹

Reflecting on the Great Depression, he concluded “that on balance, deposit insurance is a positive” while recognising nonetheless that the presence of a government financial safety net undoubtedly fosters “moral hazard”.¹²

In a Congressional Hearing some two years later Greenspan admitted to errors or flaws in his approach. Yet the passages quoted above show the intellectual orientation on the public management of financial systems that was dominant in the USA, in the UK and elsewhere in Europe – for example, in Ireland and Iceland – in recent decades.

Greenspan was clearly right to raise the “moral hazard” issue which is still at the core of policy debate and is discussed later in this report. Arguably, his views on the importance of management accountability, counterparty surveillance, disclosure and the importance bankers attach to reputation have been proven wrong by events.

In a footnote, he retracted from his view on the payments system which he had thought should be wholly private but as operated by the Federal Reserve, offered what he approves namely “riskless final settlements”. Also in a footnote, it is stated that the “Fed’s discount window serves a lender of last resort; a function the private sector cannot provide without impairing a banks shareholder value”.¹³

Having “learned a great deal about what kind of regulation produces the least interference”, Greenspan offered three rules of thumb as follows:

- Regulation approved in a crisis must be subsequently fine-tuned.
- Sometimes several regulators are better than one because solitary regulators can become risk averse, and in trying to guard against all imaginable negative outcomes, create a crushing compliance burden. In the USA, the various regulatory agencies had tended to keep one another in check.
- Regulations outlive their usefulness and should be reviewed periodically.¹⁴

It would appear that these rules of thumb are useful and directly relevant to the ongoing debate on regulation, whether they produce the ‘least interference’ or not.

In “Narrow Banking: The Reform of Banking Regulation”,¹⁵ John Kay raises important issues about the type of banking system that should emerge in the future, about the nature of regulation and about institutional dimensions, in the first instance in the UK context of the role of the Bank of England, the Financial Services Authority and the Treasury.

For example, under the heading *How we got here* he states:

It is far more important to decide what regulators should do than to decide the name of the organisation in which they do it. If we are clear about the nature and scope of regulation, which at present we are not, then the design of regulatory institutions will follow.

Regulatory activity in banking has since 1988 been focussed around the Basel agreements. Basel is the home of the Bank for International Settlements, the prime mover in coordinating international discussions. The key criterion is capital adequacy. Capital requirements may be relaxed if the bank has sufficiently robust internal risk management systems. The procedures which meet these criteria of robustness are generally based on the ‘value at risk’ methodology pioneered by JP Morgan.

These rules proved worse than useless. Banks entered the crisis with capital generally in excess of the regulatory requirements. These provisions proved not just inadequate, but massively inadequate, for the problems they faced. Risk management systems based on value at risk comprehensively failed to describe either the nature or the intensity of the financial crisis that began in 2007.

During the crisis, several banks continued to report compliant capital ratios although the pricing of their equity and subordinated debt indicated that the market believed they were insolvent. Certainly their continued existence depended entirely on government support. With their reported capital ratios eroded, and the threat that the required regulatory ratios would be increased, all banks reacted by reducing lending into the recession. Risk management systems based on value at risk comprehensively failed to describe either the nature or the intensity of the financial crisis that began in 2007.

Capital adequacy rules not only failed in their primary objectives but also had other material adverse effects. The explosion of asset securitisation and the use of off-balance sheet vehicles (SIVs and conduits) were both developed to evade the Basel rules. Such regulatory arbitrage increased complexity and diminished transparency in the financial system. The effect was to conceal what was happening not just from regulators, but from the senior management of banks.

Banks which had more capital than was needed to comply with regulation came under pressure to reduce their so-called ‘surplus’ capital. The trend to capital inadequacy was aggravated by the mistaken belief that the efficiency of a bank was measured by its return on shareholders’ equity. Reducing equity was easier than

*increasing returns. Regulatory sponsorship of specific risk management techniques allowed senior managers in banks to delude themselves that the controls implied by these techniques were adequate.*¹⁶

Moral Hazard – Is There an Answer?

Most banks, including investment banks with the exception of Lehman, which were in serious risk of going out of business were directly supported by governments or by central banks in the USA and Europe in the 2007-2009 period. Some of the support was indirect (for example, the rescue of AIG in the USA in September 2008, eased potentially serious funding problems for Goldman Sachs and others).

Deposit insurance has already been mentioned in the context of Greenspan's view on the balance of advantage and disadvantage of regulation. The tendency in some countries as the recent crisis developed has been to ramp it up, for example, starting with Northern Rock in the UK in September 2007, and in Ireland in 2008, first for retail deposits before the insurance or guarantee principle was extended to other bank liabilities.

Another issue which arises is whether major banks and other large financial institutions in what has come to be called the “shadow banking” sector are ‘too big to fail’ (which means too big to be allowed by governments to fail). In the event of failure, the depth and scope of certain institutions’ activities may have devastating effects on the financial system and even the borrowing capacities of sovereign governments, with consequent detrimental effects in the real economy on output, trade, employment and investment. The “externalities” here can be large and negative.

Even if banks are not particularly large in relation to the broader economy (for example, Anglo Irish Bank in Ireland) they may be so inter-connected with other institutions that they must be rescued by public authorities for reasons similar to those which argue against permitting the failure of larger banks.

The issue was strongly put in an address by Mervyn King, Governor of the Bank of England to Scottish Business Organisations in October 2009 as follows:

Tonight I want to focus on the second of those challenges – reform of the structure and regulation of the banking system. Why were banks willing to take risks that proved so damaging both to themselves and the rest of the economy? One of the key reasons – mentioned by market participants in conversations before the crisis hit – is that the incentives to manage risk and to increase leverage were distorted by the implicit support or guarantee provided by government to creditors of banks that were seen as “too important to fail”. Such banks could raise funding more cheaply and expand faster than other institutions. They had less incentive than others to guard against tail risk. Banks and their creditors knew that if they were sufficiently important to the economy or the rest of the financial system, and things went wrong, the government would always stand behind them. And they were right.

The sheer scale of support to the banking sector is breathtaking. In the UK, in the form of direct or guaranteed loans and equity investment, it is not far short of a trillion (that is, one thousand billion) pounds, close to two-thirds of the annual output of the entire economy. To paraphrase a great wartime leader, never in the field of financial endeavour has so much money been owed by so few to so many. And, one might add, so far with little real reform.

It is hard to see how the existence of institutions that are “too important to fail” is consistent with their being in the private sector. Encouraging banks to take risks that result in large dividend and remuneration payouts when things go well, and losses for taxpayers when they don’t, distorts the allocation of resources and management of risk.

That is what economists mean by “moral hazard”. The massive support extended to the banking sector around the world, while necessary to avert economic disaster, has created possibly the biggest moral hazard in history. The “too important to fail” problem is too important to ignore.¹⁷

In King’s view, there are only two ways “in which the problem can in logic be solved”. One is to accept that some institutions are too important to fail, and then try to ensure that the probability of those institutions failing, and “hence of the need for taxpayer support, is extremely low”. The other is to find a way whereby institutions can fail without imposing unacceptable costs on the rest of society. He then goes on to consider possible components of a solution though he sees drawbacks in them all. Such approaches might include capital requirements related to risk (the Basel approach) or some type of separation between various banking activities. For example, “utility” type services could be separated from the riskier financial activities of banks such as proprietary trading.

These ideas are examined later in this report and elsewhere in this series. A further related observation by King is highly relevant:

What does seem impractical, however, are the current arrangements. Anyone who proposed giving government guarantees to retail depositors and other creditors, and then suggested that such funding could be used to finance highly risky and speculative activities, would be thought rather unwordly. But that is where we are now.¹⁸

Perhaps, certainly in relation to Ireland as the crisis evolved it might be more accurate to have stated “that is where we were then”. In other words, the various guarantees and their costs are the consequences of what happened or what an amalgam of economic and commercial actors, regulatory and monetary authorities, and governments allowed to emerge. “Where we are now” in Ireland is seeking to enhance the effectiveness of regulation, in the context of EU developments, and re-capitalising the banking system to promote stability into the medium term.

In any event, King also queries the relevance and usefulness of regulation to deal with speculative activities: “the sheer creative imagination of the financial sector to new ways of taking risk will in the end, I believe, force us to confront the ‘too important to fail’ question. The belief that appropriate regulation can ensure that speculative activities do not result in failures is a delusion”.¹⁹

This leads to the discussion on the merits of planning for the orderly wind down of failed institutions, the idea of so-called ‘living wills’.

In the end King sees the choice as one of separating activities or pushing for ever increasingly detailed regulatory oversight, with the cost that that entails for the innovative capacity and efficiency of the financial system.

In the speech referred to earlier, Turner also addressed the ‘too big to fail’ issue. He reiterated the view that public authorities in many developed countries ensured the stability of the financial system by underpinning the liquidity and solvency of major banks. Measures included a combination of capital injections, exceptional central bank liquidity provision, and government guarantees of medium term bank funding. These measures have been crucial in restoring confidence, but in Turner’s view “they have also reinforced the problem of moral hazard”.²⁰

In the case of large systemically important banks “authorities have in all cases chosen to rescue the entire bank group and to impose losses only on equity holders (through dilution) and on no other category of funds providers, not even on those who have subscribed to subordinated debt capital”. He refers to the “too big to fail” problem as a key priority of the Financial Stability Board with the options under consideration including:

- Capital surcharges for large systemically important banks to reduce the probability of failure.
- The development of contingent capital instruments that would automatically convert to loss-absorbing equity well before failure.
- The development of recovery and resolution plans for individual banks which would enable a bank to be internally re-organised without rescuing the entire bank group as a single unit.²¹

Overall, Turner concludes that while action to deal with systemically ‘too big to fail’ banks is necessary, it should not be assumed that it is sufficient. There are also issues associated with medium sized banks, the non-bank institutions and the volatility of securitised credit systems.

Also suggested by Turner, are the design of new tools to control the volatility of the credit cycle, especially in residential and commercial real estate (in his view interest rate adjustments via monetary policy are unlikely to be effective “given the huge divergence of the interest rate elasticity of demand for credit between different sectors”). He suggests discretionary variation of capital requirements throughout the cycle, either across the

board or in relation to specific sectors, such as commercial real estate, and possibly new regulations to impact on borrowers such as limitations on allowable loan-to-value ratios.

Finally, Turner argues for a more open approach to the benefits and potential downside of increased market liquidity, and for a more balanced regulatory approach. The importance of liquidity in current or close to current markets such as Forex and commodities spot and forward, and for capital allocation mechanisms which link savers to investors such as equity and bonds, is fully acknowledged. However, he argues that the benefits of market liquidity are subject to declining marginal utility. Keynes is also invoked as follows: “Of the maxims of orthodox finance, none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is positive virtue on the part of institutional investors to concentrate their resources upon the holding of “liquid” securities.”²²

However, the limitations on useful action are also noted:

*There is, for instance, no economic value that I can discern from the operation of speculation in currency ‘carry trades’, which are among purest examples of what Professor John Kay labels ‘tailgating strategies’ – riding an unsustainable trend in the hope that you will be clever enough to get out just ahead of the crash. But there may be no instruments that can eliminate carry-trade activities without undermining useful Forex market liquidity of value to non-financial corporations.*²³

In the end, on the liquidity issue, the implications suggested for public policy include:

- Setting trading book capital requirements (for commercial and investment banks should shift from a bias in favour of liquidity to a bias to conservatism (towards relatively more capital).
- The potential danger of destabilising speculative activity, even if performed by non-banks: “if necessary, highly leveraged hedge fund speculation should be constrained by leverage limits”.
- The potential role for financial transaction taxes should not be excluded. It is noted that the transaction tax debate is littered with articles by academics convinced of the theoretical case, “but who have subsequently failed to promote the idea”.

The Narrow Banking Approach – Is it Useful?

In “Narrow Banking: The Reform of Banking Regulation” John Kay raises key issues relevant to the moral hazard problem and externalities generally. In his view, “the most urgent purpose is to protect the non-financial economy from financial instability”. His proposals develop “the concept of narrow banking – often described as separating the utility from the casino. The model of narrow banking is one on which all retail deposits are secured on safe assets”.²⁴

This approach is formulated in the framework of a particular reading of the crisis which stresses the primary responsibility of bank managements, and undesirable facets of the relationship between banks, regulatory authorities and their professional advisers. The following passages illustrate this view:

The Basel agreements, and the growth of financial services regulation more generally, have caused the emergence of a regulation industry. That industry comprises regulatory agencies, the compliance departments which are now a major part of all financial institutions, and an army of consultants and lawyers who mediate between the two. All these groups gain power and prestige from the complexity of their activities. They have an interest in the continued expansion of established systems or regulation, and have been given an opportunity to achieve that by the current crisis.

The assessment of capital requirements, and the management of risk, are properly matters of individual business judgment, to be made by managers in consultation with their lenders and their shareholders. They should be among the most important matters of business judgment in financial institutions. The devastatingly negative consequence of regulation prescription in these areas is that such prescription has undermined business disciplines and the risk management responsibilities of senior executives. Rather than imposing controls on their own traders, the senior management of financial institutions have conspired with those traders to evade controls which have been imposed by outside agencies. The outcome is a culture which regards control systems as bureaucratic burden rather than administrative tool.

In the last two years, managers of very large businesses have, with every appearance of sincerity, blamed regulators for the failures of their own risk control systems. The lesson for regulation generally is that regulation which is not well directed and not effectively enforceable is not harmless simply because it is useless.

Such structures impede the development of market solutions and internal processes designed to address the problems which regulation itself fails to handle.

The lesson of the failure of the Basel accords is not that the regime should be elaborated beyond the 400 pages of the text in the current accords. It is that the whole system that should be swept away, and the responsibility for capital adequacy and risk management put back where it belongs – in the hands of the executives of banks, who should then carry heavy and exclusive responsibility for failures of control. There must be a better way. There is. It involves a combination of tighter, but more narrowly focussed regulation and a larger role for competition and market forces.²⁵

Regulation and Risk

The robustness of the core financial system is central. No systems, however well designed, can eliminate mistakes and failures. Robust engineering systems have independent backup systems, are loosely coupled so that small disruptions are easily absorbed and are designed with modularity so that failed components can be replaced without major disruption. Kay argues that although financial institutions apply these principles to their technology, “similar measures are not in place – or widely thought relevant – to the substantive operations of these institutions, or for the financial system taken as a whole”.²⁶

In Kay’s analysis, the specific problems which arise in financial services fall into three broad categories: macro-prudential supervision, retail bank runs, and counter party risk in wholesale markets.

Counter party risk has been the main issue in recent discussions of systematic risk in wholesale financial markets. Kay speculates that:

The average reader may be asking ‘what does any of this have to do with me?’ and it is a good question. The answer is that many people believe that the problem of counter-party risk is of such magnitude that regulatory authorities should intervene to ensure that such risks do not materialise. Put bluntly, they think that taxpayers should bail out any institution whose counter-party risks are sufficiently extensive – ‘too big to fail’, as this view holds Lehman was, and as the US Treasury concluded AIG was. Put more bluntly still, they think that taxpayers should act as unpaid insurer of most transactions in wholesale financial markets.

When spelled out, this proposition is so preposterous that the fact that it can be seriously entertained provides a revealing insight into the political power of the financial services industry and the degree of panic which seized policymakers in 2008.²⁷

Empathy is expressed for older methods of self-regulation like the London Stock Exchange, which guaranteed payments in the event of default as a collective liability of the Exchange.

The growth of financial services regulation in the last two decades has led to the nationalisation of a range of functions which were previously the responsibility of self regulatory agencies – such as exchanges – and even of the control systems of financial institutions themselves. These functions are not, in the main, more effectively performed by public agencies. The issue in every case is whether the greater power of enforcement that comes from statutory authority offsets the informational disadvantage experienced by an external regulator, and mostly it does not.

But the formation of the FSA and the establishment of a statutory financial services compensation scheme led to the assumption by public agencies of responsibility for what had previously been handled by self-regulation.

Since the 1970s much of the growth of financial markets has been in derivative securities, and many of these are traded ‘over the counter’, which means that they are not necessarily standardised or dealt through exchanges. Market mechanisms have been developed for minimizing the resulting counter party risk.

The development of such market mechanisms is not only the route ahead, but the only possible route ahead. Government subsidy for all or most financial sector counter-party risk is not acceptable. Not just because this is not an appropriate government expenditure, but because the existence of such support undermines the imposition of risk disciplines within financial institutions and the evolution of market mechanisms to deal with counter party risk. The notion that supervision will in future prevent failures such as those of Long Term Capital Management or Lehman and therefore this problem of moral hazard will not emerge is an engaging fantasy.²⁸

Separation Not Supervision

Very definitive views are expressed on the distinction between the terms regulation and supervision, which Kay believes are used almost interchangeably in financial services.

In his view: “supervision is by its nature wide ranging; regulation is focussed”. Supervision is general rather than specific, seeks to impose a particular conception of good business practice across the industry, is subject to creep and also to regulatory capture, and involves a form of shadow management. But “it is almost inevitable and wholly inevitable in the financial services industry – that shadow management will be at a disadvantage to the real management in terms of the competence of its staff and the quality of the information available to it”.

This approach can be contrasted with the following remarks by Governor Honohan: “Since the nationalisation of Anglo Irish Bank, the Regulator here has adopted what has been termed an ‘intrusive’ approach to supervision of the main firms. This involves on site presence on a daily basis by several regulatory staff in each of the institutions covered by the Government guarantee. They have been sitting in as observers on key decision making committees in each of these banks as well as conducting a number of specific investigations and reviews”.²⁹ The current Irish situation, of course, has arisen from a fairly unique set of circumstances and the Governor appears to have been referring to what was believed to be a necessary short term response.

In the UK context, in Kay’s view, macro prudential supervision should be a responsibility of the Bank of England, and “it would be better if micro prudential supervision were not undertaken at all”. In summary, regulation should seek to work with market forces; “competition where possible, regulation where necessary and supervision not at all, should be the underlying principle”.

In the context of an overall approach to what is required, separation of activities is recommended by Kay: “the most urgent, and in many respects simplest, mechanism of regulatory reform is to require firewalls and firebreaks between different activities”. The structure for the future should be that in the event of an overall failure of the organisation “the utility can be readily separated from the casino”. That means the establishment of distinct narrow banks.

Large conglomerate banks are not necessary. The narrow banks might operate as stand-alone entities or be separately capitalised subsidiaries of financial holding companies. As regards implementation, narrow banking would focus on the traditional functions that the financial system offers to the non-financial economy, i.e. payments systems and deposit taking.

Only such institutions could describe themselves as banks – they might (but need not) engage in consumer lending, lend on mortgage, and lend to businesses, but would not enjoy a monopoly of these functions. Narrow banks would be regulated, preferably by licence, and not supervised; they would have to comply with rules (for example restrictions on activities, creditor priority in liquidations, reserve requirements) but neither their business strategies nor whether they are well run would be scrutinised.

Even if there were definition difficulties, narrow banks would be prohibited from proprietary trading. Public subsidy should be avoided, and retail deposits qualifying for deposit protection should be supported 100% by genuinely safe liquid assets. The inclusion of other assets would require a regulatory assessment of asset quality. Funds required for retail lending activities should come from their own capital or through securitisation and from wholesale markets and conventional borrowing. In the long run, the quality of lending books should enable narrow banks to obtain funds “in the fine terms formally available to soundly managed and well capitalised financial institutions”. Specialist lending businesses might focus on small and medium sized enterprises which have been serviced up to now by retail banks. In this context, (and presumably by reference to the UK), Kay offers the suggestion that “government could usefully promote the development of such businesses, perhaps based, for example, on relevant divisions of the Royal Bank of Scotland or the struggling Irish banks”.

Commentary

The narrow banking approach is open to extreme and limited interpretations. Some proposals in the USA such as the Volcker proposals³⁰ on separation of banking activities have similar resonances. One can debate whether the narrow banking approach is good sense, merely seeking to put the clock back, or both. Could it be too restrictive on the functioning of the real economy? What would go in the “casino” outside and could we be sure it would not matter? Despite these unresolved issues, the approach is a useful reference point in considering regulatory systems for the future.

Regulation vs. Innovation: A False or Real Conflict?

This topic is explored by reference to the emergence of a selection of new financial products in recent decades.

Securitisation

The rise of securitisation from the 1970s was of major importance. In the USA at that time the Government National Mortgage Association (Ginnie Mae), a government sponsored agency, issued a new type of bond known as a residential mortgage backed security (RMBS). Bonds are loans repaid with a reliable set of cash flows. Up until the 1970s the biggest issuers of bonds were governments and corporations.

The early idea for bonds based on residential mortgages was to take the original loans, pool the monthly payments, and use such cash as backing for the bond. Originally, such bonds were government guaranteed, but by the mid-seventies securitisations of home loans that were not government guaranteed were issued.

In 1983, Freddie Mae marketed the first collateralised mortgage obligation (CMO) whereby the cash flows from a pool of mortgages and mortgage backed securities were divided into a number of layers or tranches. As Cassidy says in *How Markets Fail*, “the purchasers of the senior tranches got first claim on the underlying cash flows; the buyers of the Mezzanine flows got second dibs, the holders of the junior tranches were entitled to whatever was left”.³¹

Such a secondary market in mortgages and credits meant that banks were able to sell many of the loans they made. The “originate-to-hold” model of banking was gradually replaced by the “originate-to-distribute” model. It is the buyer of the mortgage securities rather than the bank who issued the loan who suffers if a mortgage holder falls behind in his monthly payments.

Cassidy summarises the effects of this as follows:

*Securitisation enabled banks to move many of their loans off their balance sheets. This meant they didn't have to keep as much capital in reserve to satisfy their regulators which boosted their profits. To help this process along, many banks following the lead of Citigroup set up special purpose vehicles (SPVs) – also known as structured investment vehicles (SIVs) and conduits – which became heavy purchasers of RMBS, CMOs and other securitised products. (The buyers also included mutual funds, hedge funds and wealthy endowments). Thus conceived, the so-called shadow banking system would grow to elephantine proportions while remaining largely beyond the purview of regulators, bank stockholders, and journalists.*³²

It appeared that half of the loans that US banks initiated in 2001 had subsequently been transferred to non-bank entities, mostly through securitisation. As Paul Davidson said:

“The downside aspect of this shift in the source of bank profits from interest earnings to originating and servicing fees is that bank loan officers do not worry as much about the credit-worthiness of borrowers as long as there is a strong market for their loans ... There is therefore an incentive for bank loan officers to become ‘loan pushers’ and ‘loan traders’ rather than investigators of the soundness of the borrowers’ use of loan money”.³³

Credit Default Swaps

The pace of financial product innovation from the 1990s onwards especially in the USA is highlighted in *Fool’s Gold* by Gillian Tett (2009). The author focuses particularly on how credit default swaps (CDS) developed into an enormous market. One passage reflects on the thinking inside the JP Morgan organisation as to what could happen if the default risk associated with a loan could be offloaded:

*Such a development would overturn one of the fundamental rules of banking, that default risk is an inevitable liability of the business. If a technique could be developed to package default risk to that it could be traded, that would be an enormous boost for banking in general. For the first time in history, banks would be able to make loans without carrying all, or perhaps even any of the risk involved themselves. That would, in turn, free up banks to make more loans, as they wouldn’t need to take losses on those loans defaulted. The derivatives buyers who had gambled on that risk would take the hit.*³⁴

Some Size Indications

Turner in the address referred to earlier noted the growth in trading in financial instruments in recent decades:

There were huge increases in the value of foreign exchange trading activity relative to global GDP from the early 1970s on, and similarly with inter financial institution balance sheet claims.

From the 1980s and the 1990s on, these trends were accompanied by:

- *the emergence of a huge market in interest rate derivatives, with the notional value of over the counter (OTC) interest rate contracts arising from close to zero in 1987 to over \$400 trillion in 2007.*
- *Huge growth from the mid 1990s in a series of inter-related credit markets. New technologies of pooling and tranching enabled growth of an over \$2 trillion market in private label asset-backed securities, supporting a new originate and distribute model of credit extension. Global credit derivative contracts (CDS) outstanding grew from zero in the mid 1990s to over \$60 trillion in 2007, with the scale of the hedging activity massively outpacing the growth of the underlying credit instruments which CDS enabled investors or issuers to hedge. And Collateralised Debt Obligations (CDOs) grew from zero in the early 1990s to over*

\$250 billion by 2005, with the notable development of synthetic CDOs – credit exposures manufactured through the use of CDS market, rather than out of the underlying liabilities of non-financial counterparties.

- *And the immense growth of commodities futures trading; for example, with the volume of oil future trading growing from far less than the volume of physical oil produced and consumed in the world in the early 1980s to over ten times the volume in 2008.*

Regulatory and legislative action was at least not unaccommodating. The IMF's Global Financial Stability Review of April 2006 observed that credit derivatives enhanced the transparency of the market's collective view of credit risks, which led to improved market discipline and greater dispersion of credit risks by banks which would help to make the banking and the overall financial system more resilient. Some concerns were expressed, but as Turner says, "the predominant view in policy making circles was not only sanguine about increased financial activity and financial innovation, but positive".

What Should be the Regulatory Reaction?

In the Report of the Warwick Commission on International Financial Reform,³⁵ Mark Blyth discusses regulatory solutions to multi-level problems. He observes that much of what one wishes to regulate "may have no regulatory solution; instead what we face are political problems looking for regulatory solutions". This may be at the level of the global economy, at the level of national financial systems or at the level of markets themselves where financial products implicated in the crisis must be dealt with.

For example, one particular set of derivatives contracts, particularly Credit Default Swaps (CDS), were seen to be critical elements in the elaborate daisy chain of risk that brought down AIG and that facilitated massive public interventions to shore up the global financial system. Consequently, politicians across the world seek to regulate their use far more than before. But are we likely to try and regulate these instruments because they can be regulated, rather than the fact that they should be regulated?

The following considerations are worth bringing to bear on this question. First of all, while it is true that such instruments can be used for speculation as well as hedging it is in practice often difficult to distinguish between the two positions. Do we really want to limit hedging in order to reduce risk? Second, while the banks that sell these instruments are self interested actors who reap huge profits from their sales, their claim that too much regulation will stifle innovation and growth needs to be taken seriously. The problem of coming down on one side or the other of such a claim is that it is very hard to test the proposition empirically. Establishing econometrically that over the counter products add to the growth is as difficult as showing that they take away from growth. Their production certainly generates fees, but given the skewness of the income distribution in the US and in the returns to finance in general, it is not clear that they add much to the growth of the economy more broadly construed. In short, banning such instruments or posting them on exchanges or

*establishing a central clearing counterparty (CCP) or increasing trade reporting may be the regulatory solution we reach for because that is the one we can achieve rather than what really needs to be addressed. This is possible. And this is precisely what political solutions should focus on.*³⁶

There is support for outright bans for some products. For example, in a *Financial Times* article, Wolfgang Munchau proposes a ban on the trade in credit default swaps without ownership of the underlying securities: “A naked CDS purchase means that you take out insurance on bonds without actually owning them. It is a purely speculative gamble. There is not one social or economic benefit. Even hardened speculators agree on this point. Especially because naked CDSs constitute a large part of all CDS transactions, the case for banning them is about as strong as that for banning bank robberies”.³⁷

Commentary

There is no simple answer to dealing with the interface between regulation and innovation which may ultimately prove damaging to the financial system and the economy, or which may be beneficial. In this context, the views of the Warwick Commission are now discussed.

How Might Effective Regulation be Organised? – The Findings of the Warwick Commission Report

There is no simple answer to dealing with the interface between regulation and innovation but the Warwick Commission Report is persuasive on many of the key issues. Its findings are now discussed.

The Commission brought together economists, political scientists and lawyers in order “to explore how [to] best enhance international financial stability through regulation that is sensitive to what countries want from their financial systems”.The Report adopts a number of perspectives.

Firstly, in trying to prevent or dampen future crises, we should focus not just on the specific character of the present crisis, but on those factors that are common across crises because there is certain to be a different financial innovation or product at the centre of the next crisis. If the current crisis is the 85th international banking crisis, the last eighty four occurred without credit default swaps and special investment vehicles and the last eighty or so had little to do with credit ratings.

Secondly, it is not wise to think in terms of increasing or decreasing the quantity of regulation because there regulation can be good and bad. If parts of the current approach to regulation has incentivised systemically dangerous behaviour, doubling up on existing regulation may make matters worse.

Thirdly, large international banks have supported a level playing field in regulation between countries (home country regulation) and within countries (unitary regulators) and an end to Glass–Stegall type segmentation of financial sectors. But in certain areas of finance “an unlevel playing field has merit”. Policy responses to economic cycles in different countries may be different and within countries the playing fields should be tilted “to reflect the unlevel capacity for financial institutions and to help risks to flow where they are best matched by risk capacity”. There will be different national economic priorities, financial structures and institutional capacities.

In the end, the Commission recommends five key policy reforms. But before outlining these, it is useful to select certain important observations from the Commission’s work.

Aspects of Risk and Market Failure

Asymmetrical information and social externalities are the two principal drivers of market failures in finance that require regulation. Principle agent problems abound also but they are not so unique to finance.

Micro prudential rules can undermine systemic resilience and should not create homogenous behaviour. Macro prudential regulation is where the glaring deficit in regulation lies; it should deal with the systemic implications of the collective behaviour of financial firms. In this context, counter cyclical capital provisioning is proposed.

Risk is not one thing alone; there are different types of risk and credit risk, liquidity risk and market risk for example should all be hedged differently. The report comments: “A financial system will be safe if each of these risks is held by market participants with a capacity for that specific type of risk. A financial system would be unsafe, even if each institution held more capital, if risks were not held where there was appropriate capacity. Arguably the neglect of issues of funding and the over-emphasis on market prices did just that”.

The crisis and dysfunction in over the counter wholesale markets has raised the issue of greater regulation, but complexity itself may not be bad though it may be used to help people do bad things. It is well intentioned but misguided to consider defining “safe” and “risky” products to sanction the former and ban the latter. “Our primary focus should not be instruments. Instruments are fluid, easily created and abandoned”. The fundamental problem with the deceptive notion of good and bad, safe and risky instruments is that risk is less a function of the instrument and more a function of behaviour.

It is noted that the gross positions of derivative traders are many times their net positions. Central clearing of trades between major counter-parties allows traders to forget about counter party risk (because the clearing house takes over the position).

The Historical Record and its Consequences

The “efficient market hypothesis” whereby functional prices embody the true value of their real counterparts, and price movements reflect fundamental values, is now discredited. So too is the related proposition that if crises do occur, they must be the result of policy error, that is government interference and excessive regulation. The Warwick report states that:

The problem with the proposition that regulation causes crisis is that the historical record does not support it. From the 1940s through to the 1970s, the economic order of the day supported merchandise trade that was seen to be welfare enhancing, while discouraging financial flows through capital controls and regulations, since these were seen to be welfare diverting and the cause of speculative excess.

In this period OECD countries experienced very few financial crises and grew strongly in comparison to what came before. Only with the deregulation of finance in the OECD countries, and later the rest of the world since the 1970s, has the incidence and severity of financial crises increased. And as the current crisis amply demonstrates, it has increased markedly.

To admit this is not to wish for a return to the supposed ‘glory-days’ of a limited and de-globalised financial sector. While the risks to the system have increased, and with them their attendant costs, so have the benefits.

The point of regulation is to skew the balance in favour of the latter over the former. The original form of securitisation, in which long-term loans from good borrowers that were on the bank’s balance sheet for some time were moved off it in order to make room for new lending, did promote the development of deeper capital markets with more access to credit for consumption smoothing (we have suggestions on how to improve risk allocation below). Derivatives have both complicated, and eased, risk management. Savers get higher returns and borrowers get lower rates and easier access – so long as the market does not dry up.

Moreover, in the advanced OECD economies, as employment has moved out of manufacturing and into services, finance has become an increasingly important source of jobs, income, and taxation. Given this, we need to establish two principles.

The first is that financial crises are a recurring phenomenon of capitalist economies. Trying to avoid them altogether would require a new form of organisation of an economy, which would no longer be capitalist. Sixteenth century Germans, seventeenth century Dutch, and twentieth century Texans all managed to have financial meltdowns without credit default swaps or 50:1 leverage ratios. As such, we should not treat this financial crisis as a unique event with equally unique causes that, if we attend to them, will mean that crises cease to be a problem. This view is false.

We suggest that what has to be regulated is behaviour rather than particular instruments. This is the case because booms are often a result of things appearing to be safer than they turn out to be. Securitisation was viewed as a way of making banks safer. Diversified portfolios of subprime mortgages were viewed as having low delinquency rates. Banks were so convinced of the safety of these products that they found elaborate ways to be exposed to them. Indeed, while micro-prudential regulation is certainly necessary to weed out the truly reckless institutions, instruments and behaviour, it needs to be supplemented with macro-prudential regulation as a countervailing force against the decline of measured risks in a boom and the strongly-held belief by market participants that ‘this time, it is truly different’. It never is, and it is the job of the regulators to remember that singular fact.

The second principle is that, not only are they not going away, financial crises have severe real costs. Reinhart and Rogoff have recently demonstrated, across all modern (post-1977) financial crises (18 cases), asset price collapses of the order of 35 percent for housing and 55 percent for equities and unemployment increases of 9 percent above base are the norm during the bust phase of the cycle, which can last up to six years depending on the asset class. Given this, it is little surprise then that government debts surge by an average of over 80 percent of GDP as tax receipts collapse and deficits expand as the private sector deleverages and the public sector leverages-up through bailouts to compensate.

Given all this, we must conclude that regulation to avoid the worst of both the upswing and the downswing is as inevitable as financial crises themselves. As stated above, we do not necessarily need more regulation; we need smarter regulation that enables regulators to act against financial institutions that try to capture them.³⁸

Politics and Regulatory Capture

Looking at the current crisis solely through a financial, economic or regulatory lens misses the important political dimension. Rather the more systemic a bank is the more regulated it should be, and the better it proves at risk assessment, “the less regulated it could be”. Regulation should be simple and aim to put risks in the hands of those with the best capacity for those risks. The Warwick Commission believes the opposite was the case – regulation favoured larger and more interconnected and systemic firms in a number of ways, and was “process-oriented not results oriented”. “Relationship banking was considered antique”.

The “level playing field” is not a convincing argument in the financial area.

Captured national regulators became champions of their national banks abroad. London’s light touch regulation was as much a statement of competitive intent as it was a statement of philosophy. The same could be said for the approach to regulation in New York, Reykjavik and Vienna.

It would appear that at the centre of the crisis stood those things that were the result of regulatory capture, relatively lightly regulated, systemically important, international and universal banks, the level playing field which allowed a gross misallocation of risk taking and risk capacity, the abandonment of good risk assessment in favour of computer models; and complex regulation that was complied with to the letter, but not the spirit. Regulatory capture substantially contributed to the regulatory failure. It stands to reason that to avoid financial crises we must deal with regulatory capture.³⁹

Financial industry donors gave generously across all parties, and with revolving doors (particularly in the USA) donors one day become policy officials the next. This was not illegal or irregular but engendered intellectual capture and “group think”.

As to the role of supervisors and politicians: “in most jurisdictions supervisors have the power to tighten regulatory requirements to dampen a boom. But they do not” (India and Spain being recent exceptions).⁴⁰ Politicians will always try to sustain a boom until the next election. Regulators and supervisors may succumb to such political pressure.

Following from this, a number of suggestions are made in the context of responding to political pressures:

- Regulatory policy should be more rules based, and discretion needs to be more constrained, especially in response to the credit cycle with the regulation of capital, leverage and liquidity needs tightened in the boom and loosened in the crash.
- The locus of regulation needs to be more host country than home country; host country regulation locates the source of authority within the national system, where home country regulation allows financial institutions to be regulated from afar, with the risk of allowing disruptive outcomes within the host country.
- A deliberate policy of so-called ‘right-sizing’ should be fostered

What is meant by right-sizing is important and is then developed as follows:

Right-sizing could be achieved by suggestions included in this report. First, mandating counter-cyclical capital provisioning norms will prevent banks from building assets too fast and too big. Second, a leverage ratio for all financial institutions should provide some further restraint to excessive growth. Third, going back to segregating different categories of finance, but along the lines of risk capacity, and re-establishing ‘unlevel playing fields’ will surely reduce interconnectedness and restrain the emergence of ‘financial super markets.’ Fourth, raising capital requirements for systemically important institutions should create the necessary disincentive for institutions to grow to that point where they pose substantial risks to the financial system.

A fifth idea is to use financial transaction taxes (like stamp duty or Tobin taxes) to limit short-term and churning activity. Banks profit more from high-turnover than low turnover and consequently they are likely to over-invest (relative to a social optimum) in activities and instruments with high turnover and underinvest in activities and instruments with low turnover. If you establish a buy and hold fund you may never meet a banker; if you have the same size fund, but decide to adopt a strategy of turning over the portfolio every week you will find it hard to get to your desk through the throng of bankers offering a ‘partnership’.

This is a social externality and the classic economist response is to tax the activity. A common reaction to such ideas is that they may be a good, but they are not feasible. However, financial transaction taxes are common – in the U.S., the Securities and Exchange Commission is financed by one – and have been made more feasible through the moves towards centralized clearing and settlement allowing the tax to be collected at a central point through which the majority of trades are flowing, and creating substantial costs to those trying to get round the tax by avoiding central clearing and settlement.

Key features of all of these ideas are a degree of automaticity and the introduction of rules which slow down the growth of balance sheets and prevent them from becoming so large that they pose a systemic risk overhang on the real economy. Issues of systemic risk and optimal size are complex and appear to deserve intelligent discretion, but we fear discretion is too prone to regulatory capture and greater adherence to a set of structural rules will help the financial sector play its due role in achieving sustainable and equitable growth.⁴¹

Home or Host Country Regulation?

The highly significant issue of the focus of regulation in terms of the balance between ‘host’ or ‘home’ country regulation, and the role of international bodies is discussed. The Warwick Commission effectively warns about over ambition; perhaps finance should be a “little less global”.

The crisis occurred as a result of domestic regulatory failures. However, there is a legitimate concern that our attempt to rectify these issues must be global first because finance is global and second to lessen regulatory arbitrage. We conclude that while enhanced international cooperation is good, especially whilst markets remain global, the lasting solution is to make finance a little less global. We question whether a global rule setting body would be the best way to end regulatory arbitrage. It is important to remember that a forum of global regulation was the path we were inching along; home country regulation of financial institutions in accordance with a global set of principles, coded into rules – the Basel system. Yet this system appeared to provide avenues for regulatory arbitrage that would not have been averted simply by widening the coverage of institutions and instruments.

It is also hard to conceive of a single set of regulations that would be appropriate for very different countries. China, Russia, Bermuda, Mexico, Peru, all have different credit structures, financial needs and institutional capacity. Political priorities differ too. In India, for example, financial regulators are focused on financial inclusion; in other countries that would seem to lead to lax regulation for those who need it most. However, even if we were to have a single set of regulations, national enforcement will differ as national priorities and/or enforcement capacity differs. This would be one source of regulatory arbitrage.

Another would be that home country regulators are champions of national interests. The U.S., the U.K., Iceland, Ireland and Luxembourg signed up to Basel's core principles and rules, but the expansion of U.S. investment banks into Asia after the Asian Financial Crisis, 'light touch' regulation in Britain, the international expansion of Icelandic Banks, and the pursuit of international mutual funds in Dublin and Luxembourg were part of explicit or implicit national development strategies.⁴²

The conclusion reached is that host country regulation is best suited to address regulatory arbitrage in a way that best protects all countries, no matter their size or wealth. For example, in such a system an Icelandic bank could not operate in the UK as a branch, mostly regulated from Iceland. Rather it would be regulated in the UK as a stand alone bank with sufficient capital for its activities in the UK, and “able to withstand failure of its parent”. It is admitted that this approach would dampen cross border capital flows, but should be seen in the context of the overall proposals made in the Report.

On the rules versus discretion argument the Warwick report draws a clear distinction between national and international levels of regulation; “We believe that a greater emphasis on rules is appropriate for host regulation at national level”. By contrast:

We view the emphasis on principles at the international level as a necessary response to the diversity of national legal regimes, economic and political imperatives, the rapid evolution of financial instruments and markets, and the urgency of sensibly harmonised reform. We also believe that principles-based international regulation is more effective where it takes the form of soft law: a set of informal norms and fora that do not rely on judicial enforcement, but rather on the buy-in of its constituents.⁴³

The process of negotiating international norms works best where the objective is guiding principles rather than specific rules. The Basel II accords are not considered as being of much use. National regulators come to international fora with the interest of national constituents in mind and proceed to trade concessions, producing an unsatisfactory patchwork of rules.

International Coordination

However, the Report states: “nevertheless global co-ordination of host country rules is absolutely essential”. Instruments and activities spill over national boundaries.

Coordination is most likely to succeed “if undertaken through informal channels and fora, rather than formal treaty-based international institutions”. The overnight expansion of the Financial Stability Board and the displacement of the G7 with G20 is compared favourably with difficulties in reforming structures at the IMF and the UN Security Council.

International co-operation is necessary because not all governments have the capacity to implement effective host country regulation. Also because national authorities might use host country prudential rules as a protectionist device to restrict foreign financial institutions in domestic markets. Finally, international co-operation can address externalities that lightly regulated financial systems can generate for national regulators (for example, off shore evasion of national rules by banks and competitive pressure to de-regulate in order to match lax foreign standards).

The EU Dimension

The Warwick Report argues that the financial crisis caught the European Union at an uncomfortable half-way point (for many countries a single currency and an increasingly concentrated financial industry yet with regulation, supervision and lender of last resort facilities fragmented along national lines). Spain, however, showed that you can have national regulations and a more autonomous capital requirements policy that are different to your European peers without undermining the Single Market.

Controversially, in the context of the institutional analytical framework discussed above, the report continues:

In the context of our recommendations, we consider it likely that the EU rather than Member States will become the “host” regulator and there will be EU wide colleges of supervisors and systemic regulators. This leaves open a number of questions, including the interpretation of the rules in the actual decision making location, and the independence of the specialised bodies dealing with systemic issues in terms of pushing through warnings and decisions and not merely acting as information collectors. Additionally, fiscal responsibility and lender of last resort questions would not be consistently addressed in the emerging framework.⁴⁴

In ‘Narrow Banking’, Kay takes a more direct view:

The incident [i.e. Icelandic banks in the UK etc.] should be treated as a wake up call. There are no adequate measures to deal with a major international banking failure. What would have happened if the struggling Royal Bank of Scotland, whose principal retail operation is the English NatWest bank, had been headquartered in an independent Scotland? It is only necessary to frame the question to want to go to great lengths not to have to answer it.

Home country regulation makes every member of the EU dependent on the skills of the weakest regulator. Host country regulation is inadequate because the host does

not have enough control over a large financial institution based elsewhere. Adair Turner, Chairman of the Financial Services Authority, has shrewdly observed that in banking there needs to be either more Europe or less. The Single Market would be best served if there were a common European regulatory regime with a single regulator in whom all Member States had confidence and a single Europe-wide scheme for deposit protection. But there is no realistic prospect of satisfactory agreement on this in the foreseeable future.⁴⁵

The approach suggested by Kay is to restrict cross border banking with an interim objective of allowing Member States to pursue different policies with the least possible damage to competition and the Single Market.

Recommended Reforms

The Warwick Commission recommended the following five key policy reforms:

Regulation needs to be formally more countercyclical, to offset the endogeneity of risk that arises from the credit cycle. Capital requirements, leverage ratios, maximum loan to value ratios must be tightened in the boom and loosened in the crash within a rule based framework.

Risk-taking must be matched to risk capacity for the financial system to be resilient. One way to achieve this is through capital requirements for maturity mismatches (administered in a manner to avoid procyclicality).

Regulators must have the flexibility to apply tighter regulatory requirements on systemic institutions, instruments and markets. Regular system-wide stress tests should help to identify what is systemic.

Greater emphasis must be placed on host country regulation within a more legitimate system of international cooperation. Host country regulators must be able to require foreign and domestic banks alike to keep local capital against local risks. Accountable global institutions should coordinate host country regulations, share information and lessons in order to improve regulatory effectiveness and limit regulatory arbitrage, and regulate market infrastructure for global markets such as single clearing and settlement houses. They should be engaged in capacity building for countries with less developed financial systems.

Incentives for the financial sector and for financial firms to grow in size and influence, and to concentrate on short term activity, must be offset, perhaps through additional capital requirements for large institutions.

Commentary

The recommendations of the Warwick Commission are general in nature; this may be the outcome of 'committee' type thinking. The devil will also be in the detail. The recommendations nonetheless serve as an excellent starting point for discussion in later reports from the IIEA and elsewhere.

These issues are of importance to the future of the regulatory system in the EU and in Ireland. A small open economy such as Ireland, highly dependent on service exports, needs to have special development strategies in place for financial services. This is not an argument for having weak or light regulation; a good reputation and the quality of host country regulatory capacity were always important and will be vital in the future. However while the case for international co-operation is exceptionally strong; that is not to say that a "one size fits all" approach in terms of similar rules for every eventuality in each national financial system is appropriate.

Conclusions

In this report, the general theme of "Why Regulate Banking or Financial Services" is discussed in the context of the views of a variety of academics, experts and participants in the debates of recent years, and by reference to some reactions and proposals arising from the events of 2007-2010.

It is evident that the banking crisis which became increasingly visible throughout 2008, particularly in the USA and in many European countries, has been extremely severe by reference to both the current and potential costs of rescues or bail-outs of financial institutions and in the permanent damage done to the real economy in different countries.

Over the course of the past three decades or so, and particularly in the western developed world, financial markets and capital movements across national borders have been liberalised.

Usually, as for example in the USA and the UK and in Ireland, liberalisation was either associated with or followed by new legislation on regulatory structures. Often the practical effect of these structures, in the context of a policy preference framed by a belief in the efficiency and indeed ultimate self-correcting capacity of free financial markets, was to limit the scope and intensity of regulation. Behaviours associated with waves of complex new financial products were often not fully amenable to control by either the financial institutions themselves or regulatory authorities.

The events and shocks in the financial system in 2007-2009, whatever may have been their many and varied causes, have resulted in intensive examination of financial regulatory performance at international and European Union levels, and in countries such as Ireland where particularly severe problems of both bank liquidity and solvency arose.

It was generally recognized that as regulatory systems had failed, there was an urgent need to arrive at an understanding of what went wrong in the past and how the causes of future potential crises, which might be different from 2007-2009 could be prevented, mitigated or addressed. There has been and continues to be a spate of official enquiries and reports at national and international level, and a burgeoning literature. Expert opinion is not certain about the regulatory steps needed, or what measures will ultimately prove optimal or effective. But there is a general willingness to seek to implement solutions, and even radical reforms of various types.

A number of broad themes including market failure, the neo-classical and other theories on financial markets, questions of moral hazard, the issue of financial institutions that are “too big to fail”, and “narrow” or “utility” banking, and whether there is a real conflict between “regulation” and innovation, were discussed.

This report does not aim to provide definitive answers on most of these topics, but it does seem clear now that while financial liberalization may bring significant benefits, when accompanied by what might be called light or tolerant regulation, especially if there is either an ideological or practical reluctance to enforce it, can bring about major financial instability and substantial damage to the real economy.

Multi-lateral efforts, either in relation to the East Asian crisis of the late 1990s, or through the Basel Agreements in relation to 2007-2009 events were not effective in preventing the crises.

One question that needs to be addressed is: are some banks or some other financial institutions too big or too interconnected to be allowed to fail? If they are, and both international and Irish experience in 2008-2009 indicates that public authorities in the end (with some exceptions) considered this to be the case, then what is to be done in the future?

One can accept that some institutions (as Mervyn King has suggested) are too important to fail and then either seek to ensure that the probability of these institutions failing is extremely low, and hence also the need for public support, or find ways where institutions can fail without imposing unacceptable costs on the rest of society. This last approach can be achieved through increased capital requirements or by separating out “normal” banking activities such as utility type services (payments systems, deposit taking) from the riskier forms of banking activities such as proprietary trading.

A key issue is whether financial regulatory systems should be designed with primarily conservative objectives of financial stability, especially for systemically significant institutions, at the potential expense of restricting financial product innovation which may turn out to be seriously destabilizing on both the financial system and the performance of the economy.

So far, across different countries and regions analysis of what has gone wrong has been clear and convincing. Remedies for the future, with a serious chance of proper implementation, are harder to define and agree.

A number of perspectives developed in the report of the Warwick Commission on International Financial Reform were discussed in this report. These are clearly worth considering for future policy.

Observations from the Warwick Commission include:

- It is important to focus on factors that are common across financial crises; “there will be a different financial innovation or product at the centre of the next crisis”
- It is not wise to think in terms of increasing or decreasing the quantity of regulation; “there is good and bad regulation”. Doubling up on existing regulation may make matters worse.
- “An unlevel playing field has merit”: Playing fields within countries should be tilted “to reflect the unlevel capacity for financial institutions and help risks flow where they are best matched by risk capacity”
- It is unwise to consider defining “safe” and “risky” products with a view to sanctioning the former and banning the latter. We should not focus primarily on instruments which “are fluid, easily created and abandoned”, but on behaviour.
- The more systemic a bank is the more regulated it should be. Regulatory capture is an important feature of what goes on. For example, “captured national regulators become champions of their national banks abroad”, and generally supervisors have the “power to tighten regulatory requirements to dampen a boom”, but do not (India and Spain being recent exceptions).
- The locus of regulation needs to be more host country than home country with strong domestic rules. Effective international co-operation is also essential, but negotiating international norms works best where the objective is guiding principles rather than specific rules (for example the expansion of the Financial Stability Board and the expansion of the G7 to G20 is likely to be better than formal treaty-based international institutions).
- It likely that the EU rather than Member States will become the “host” regulator with EU wide colleges of supervisors and systemic regulators. However, it recognizes that there are a number of open questions in this context.

Others, for example, John Kay, have pointed out that home country regulation makes every member of the EU dependent on the skills of the weakest regulator, while host country regulation is inadequate because it does not have enough control over large financial institutions based elsewhere.

The recommendations of the Warwick Commission are general in nature. The development of the recommendations into quantified targets and their detailed implementation would be a serious task with much room for different viewpoints on detail. There are both analytical difficulties on how, for example, to recognize credit and economic cycles as distinct from long term trends and how to distinguish between the systemic significance of large banks as distinct from the inter-connectedness between a series of medium sized banks. However, the Warwick Commission recommendations form a useful reference point for the discussion on approaches to reforms at international, European and Irish levels, which follow in the companion documents to this report.

Endnotes

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¹¹ Ibid., pp. 373.

¹² Ibid., pp. 374.

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¹⁹ Ibid.

²⁰ Turner, op. cit.

²¹ Ibid.

²² Ibid.

²³ Ibid.

²⁴ Kay, op. cit., pp. 4.

²⁵ Kay, op. cit., pp. 10-11.

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²⁷ Kay, op. cit., pp. 26-27.

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³⁹ *Ibid.*, pp. 27.

⁴⁰ *Ibid.*, pp. 28.

⁴¹ *Ibid.*, pp. 36.

⁴² *Ibid.*, pp. 41.

⁴³ *Ibid.*, pp. 45.

⁴⁴ *Ibid.*, pp. 51.

⁴⁵ Kay, op. cit., pp. 67-68.

