Received: 26 January 2011.
DOI: 10.2298/PAN1103407S
Polemic

David Slattery

School of Management,
Cranfield University,
UK

✉ david.slattery1@ntlworld.com

Joseph G. Nellis

School of Management,
Cranfield University,
UK

✉ j.g.nellis@cranfield.ac.uk

Rethinking the Role of Regulation in the Aftermath of the Global Financial Crisis: The Case of the UK

Summary: Following the global financial crisis, many countries have embarked on fundamental reviews of their regulatory systems in an attempt to identify the causes of the near collapse in financial systems and to pave the way for a new approach to regulation. The focus of this paper concerns the intellectual assumptions on which previous regulatory approaches have largely been built, both in the UK and in a number of other countries. We examine the analysis provided by the UK's Turner Review (2009) which follows the "market failure" approach to regulation and we contrast this with the alternative "state failure" approach. Both approaches only offer partial and polarised views into the causes of the crisis. We offer a synthesis and argue that a new conceptual approach to the management of financial markets is required. The essence of this new approach is the recognition that the state and regulation are not external to the market. While this paper largely relates to the UK, it provides potentially important lessons for many other countries.

Key words: Regulation, Global financial crisis, Market failure, State failures.

JEL: E6, G1, H8.

An earlier draft of this paper was presented at the Conference of the Business & Economics Society International (www.besiweb.com) in January 2011. We would like to thank the delegates at this conference for the useful feedback and suggestions. We are grateful to Cranfield School of Management for providing research funding and support for the work reported in this paper.

Contributors to any debate about the regulation of competitive markets usually adopt one of two approaches. The first approach is based upon the theory of "market failure". Subject to certain conditions, the theory postulates that free competitive markets generate higher economic welfare than centrally planned markets. It is recognised, however, that there are circumstances when competitive markets fail to achieve the most efficient outcomes due to information asymmetry, externalities and other imperfections. In these circumstances, regulation by the state is judged to be justified in order to correct perceived market failures.

The alternative approach is based upon the theory of "state failure". Elected representatives and state officials do not always act in the public interest. They pursue their own interests and those of special interest groups. Even if they are motivated to act in the interests of maximising public economic welfare, they are unable to collect and assess the required information to make informed and sound decisions. Regulators have *bounded rationality*. Regulation, therefore, fails to achieve its objectives and often has unforeseen and damaging consequences.

The UK's *Turner Review* (2009) adopts the market failure approach. The Review does acknowledge regulatory failure but this failure is seen as one of insufficient regulation. The assumption is that regulation has failed by acts of omission rather than commission. The prescription, therefore, is for more regulation.

Other commentators, for example those published by the Institute of Economic Affairs (Philip Booth 2009; Tim Congdon 2009), adopt the state failure approach. They contend that inappropriate government policies contributed towards the genesis of the crisis in financial markets and that the ineptitude of government officials in response to the crisis then exacerbated the emerging problems rather than solving them. Government officials failed to anticipate the problems building up in the system; they have no special insight and are unlikely to be able to anticipate the next crisis. The prescription is, therefore, very different from that now proposed by the UK's Financial Services Authority.

In this paper, we examine both approaches. The arguments advanced in each case are persuasive but inevitably, each side offers only a partial and polarised view. We offer a synthesis, a new approach to the issue of the management of a complex financial system. The essence of this new approach is the recognition that politicians, government officials and market participants are part of one and the same system. Traditionally, economic theory and strategic management theory regard government policy and regulation as external to the market, as *exogenous*. Specifically, in strategic management theory, regulation is seen as an environmental variable to which managers in regulated companies need to adapt to achieve competitive advantage. But in today's complex world, this model is too simplistic. Politicians, government officials and regulators and senior managers in regulated companies are actors on the same stage. Regulation is *endogenous*. We develop this argument in this paper. We then offer an agenda for the development of theory and practice in the management of financial markets. We use this analysis to offer a preliminary risk assessment of the Financial Services Authority (FSA) proposals and outline the mitigating actions required. Although the UK regulation environment provides the focus for this paper, it is hoped that it will offer some potentially important insights for other countries.

1. The Market Failure Approach to Regulation

1.1 Fundamental Theoretical Issues

At paragraph 1.4, *The Turner Review* (2009) raises questions about the intellectual assumptions on which previous regulatory approaches have largely been built, namely the theories of efficient and rational markets. The Review suggests that these assumptions are *now* subject to extensive challenge on both theoretical and empirical grounds. The Review acknowledges that these assumptions have always been subject to *some* challenge.

This substantially understates the position. The Efficient Markets Hypothesis (EMH) has been subject to stringent criticism since its genesis in the late 1960s, particularly from the behavioural school. Behavioural theories have their roots in the seminal article by Amos Tversky and Daniel Kahneman (1974). The merits of the two opposing theories have been subject to vigorous debate for more than 30 years.

EMH has indeed been a very controversial subject as a glance at the titles of some journal articles shows:

- Reports of the death of the efficient markets hypothesis are greatly exaggerated;
- The end of behavioural finance;
- Behavioural finance: past battles and future engagements;
- A fresh look at the efficient markets hypothesis: how the intellectual history of finance encouraged a real "fraud-on-the-market".

George M. Frankfurter and Elton G. McGoun (1999) criticised EMH and suggested that EMH is based upon an ideology. They refer to Fama's original definition: a market in which prices always fully reflect available information is *called* “efficient” – see Eugene F. Fama (1970). Frankfurter and McGoun suggest that the language used in EMH is value-impregnated: in Western culture, and especially in Protestant ethics, “efficiency” is a morally good thing. They take issue with the notion that EMH, and positive economic theories generally, are value-neutral.

From a different direction, Nobel laureate economist Joseph Stiglitz has long questioned the basic premise of neoclassical economics that perfectly competitive markets generate Pareto efficient resource allocations. Stiglitz has taken the view that there is something seriously wrong with the standard competitive equilibrium model which assumes perfect, or near perfect, information. He shows how even a small amount of information imperfection can have profound effects on the nature of the equilibrium. In the information economics paradigm which Stiglitz outlines, markets are almost never Pareto efficient - see, for example, Stiglitz (1981, 2002).

The limitations of mathematical modelling in economics are also well documented. In earlier research, Wassily Leontief (1971) was concerned about the uncritical enthusiasm for mathematical modelling and the weak empirical foundation of much economic theory based upon such modelling. A more recent critique can be found in Alexander Rosenberg (1994).

In the light of this literature, the question which arises is: why have regulators based their regulatory philosophies on the theories of efficient markets? Have regulators only just discovered the limitations of these theories? Or have regulators been captured by advocates of free markets and minimal regulation? Regulators are of course subject to political control and are bound to follow the prevailing political ideology which has its roots in the Thatcher/Reagan era of the 1980’s. The current financial crisis has brought about a change in sentiment in the political market place. The change in regulatory philosophy now proposed by the FSA is more a function of this ideological change than a reappraisal of the fundamental economic theories.

Our argument is that in order to identify the reasons behind the crisis, it is important to examine the behaviour of politicians and regulators as well as the behaviour of market participants. Politicians and regulators are subject to the same bounded rationality and decision making biases as market participants. Business leaders believe their own stories, but then so do politicians and regulators. Politicians and regulators also have their own interests to protect. They can be subject to conflicts of interest.

The Turner Review (2009) signals a major change in regulatory philosophy. Such a change is a political necessity and responds to the public call for action. It represents a major shift in the power balance in the financial market place, the market place being occupied by politicians and regulators as well as business leaders. The Review can be seen as a statement of this changing power balance. As such, the Review does not, and cannot, contain a critique of the role of politicians and regulators in the crisis, other than the necessary acknowledgement of the insufficiency of past regulation.

But this change in the power balance in the political/financial market place also has risks which are not identified in the Review. An era of what is perceived as under-regulation may be succeeded by an era of over-regulation (or by inappropriate and ineffective regulation). We return to this point later in this paper.

1.2 The Real Market Failure

Although, in the light of the above, *The Turner Review* (2009) is not very persuasive with regard to the reasons it gives for the change in the FSA's regulatory philosophy, it undoubtedly identifies correctly many of causes of the crisis. It is correct in pointing out the increased interconnectedness of the global economy and the relationship between growing macroeconomic imbalances and financial innovation. Clearly, the development of new financial instruments, the invisible chains of multiple relationships between multiple institutions, the increase in leverage, inappropriate remuneration policies linked to short term performance and the increase in the size of the financial sector relative to the real economy all contributed to the near collapse of the financial system. These are real and substantial issues in the financial system which require major action by governments' regulators and commercial organisations.

2. The State Failure Approach to Regulation

2.1 The Theoretical and Empirical Foundations

The set of theories which fall under this heading have their origin in the evaluation of the regulatory regimes which were put in place in the USA following the depression of the 1930s. Questions about the efficacy of these regimes began to emerge in the 1960s. George J. Stigler (1971) argued that industries and occupations with political power had demanded regulation to restrict entry and to enhance their own economic welfare. There was a demand for regulation which politicians were happy to supply. Sam Peltzman (1976) saw Stigler as presenting a revisionist view of regulation. Regulation was previously seen as serving the public interest but there was a growing realisation that this was not always the case. Politicians, like the rest of us, are self interested maximizers. Richard A. Posner (1971) suggested that one of the properties of regulation was akin to taxation: regulation could be used to redistribute wealth. A number of authors have picked up this theme, arguing that politicians exploit this property of regulation as it provides opportunities to raise taxation and distribute benefits without the accountability of normal forms of taxation. Gary S. Becker (1983) suggested that competition among pressure groups for political influence determines the equilibrium structure of taxes, subsidies and other political favours.

Richard H. K. Vietor (1994) conducted a detailed study of four regulated industries in the USA (banking, telecoms, gas transmission and airlines) and four leading companies in those industries. He found that the regulation of these industries had major unexpected and undesirable effects upon competition and economic welfare. Regulation controlled both strategic and operational decision-making in companies. But regulators were unable to keep up with economic and technological change and the regulatory regimes became divorced from reality. A number of other studies have reached similar conclusions, for example, in the crisis affecting the Savings and Loan industry in the USA (which we refer to again later).

This work contributed to a change in sentiment starting in the late 1970s which led to the deregulation of a number of industries and the re-regulation of others. The UK experience was different, with the extensive use of public ownership and the unique history of financial services in the City of London. But in the USA and UK, and elsewhere, there was a change in the balance of power in markets, with politicians and regulators generally taking a less active role.

2.2 Regulatory Failure in Financial Services

Although, across the economy as a whole, the level of regulation and government intervention in markets reduced in the 1980s, financial services have still been actively regulated. The Basel Accord and the UK regulatory regimes (prudential and conduct of business regulation) both have their origins in the 1980s. It is of course these regimes which are subject to scrutiny now, following the global financial crisis. *The Turner Review* (2009) along with the prevailing political sentiment, takes the view that the problem with these regimes is that they were deficient, in the sense that they were too light or not "scary" enough. There is, however, an alternative view based upon the ideas of state failure. A good example is provided in the recent Institute of Economic Affairs (IEA) publication referred to earlier – Booth (2009).

In the IEA compilation, a number of authors put forward evidence of government and regulatory failures which they argue have contributed to the financial crisis.

- John Greenwood (2009) suggests that UK monetary policy went off the rails in the three year period from 2005 until the beginning of 2008; the UK's Monetary Policy Committee (MPC), with the responsibility for setting interest rates, underestimated the potential impact on inflation of rapid money growth and the impact on financial stability of overvalued asset prices;
- Eamonn Butler (2009) and Anna J. Schwartz (2009) identify loose monetary policy in the USA over a longer period. They also refer to USA government policy of promoting home ownership to borrowers with below median incomes. Congress and the White House subsidised low-income housing outside the budget, at least in the short run, through Fannie Mae and Freddie Mac. This led to banks making bad loans and to a boom in house prices. The bubble burst in 2006. As identified in *The Turner Review* (2009), this was the direct antecedent of the global financial crisis;

- James Alexander (2009), Michael Beenstock (2009), and Kevin Dowd (2009) concentrate on regulatory failure, and particularly, the failure of capital regulation. But in this analysis, unlike the analysis in *The Turner Review*, regulation fails by acts of commission. Regulation encouraged banks to create opaque financial instruments and to use similar risk models. Regulation made banks more accountable to their regulators than to their shareholders. Relevant information was available to regulators but not to market participants, undermining market discipline.

This critique of regulation does not arise by virtue of hindsight. The emergence of new financial instruments designed to avoid capital regulation has been well signalled. Research sponsored by the Basel Committee (Patricia Jackson 1999) showed that innovations in the market had enabled banks to arbitrage between the economic capital that banks felt they should be holding and their regulatory defined capital (see also David Jones 2000). John F. Mahon and Edwin A. Murray (1981) proposed, following a study of the regulation of insurance companies in the USA, that as the environment in which the firm operates becomes more regulated, the less the focus of organisational planning on the customer or consumer, and the greater the emphasis on the regulator. This clearly has implications for the more intensive regulation proposed by the UK's Financial Services Authority.

In another of the IEA publications, Congdon (2009) provides the theoretical basis for the lender of last resort function of a central bank. He shows that this function arises endogenously in the market and does not need to be imposed by the state. There is no need for the central bank to be publicly owned, and there are good arguments for the privatisation of the Bank of England.

Congdon argues that the lender of last resort function and the supervision of banks are complementary activities. Central banks should only lend to solvent banks with transient liquidity problems. In order to distinguish the insolvent bank from the illiquid, the central bank needs the data and understanding from its banking supervision. The transfer of banking supervision from the Bank of England to the FSA in late 1990s was therefore a mistake. The consequence was that when the problem of the UK's Northern Rock Bank arose in 2007, no one in the Tripartite relationship (involving the Treasury, Bank of England and FSA) knew what to do. The Bank of England seemed to regard its sole function as controlling interest rates. It failed to act as lender of last resort to Northern Rock. It also frustrated the takeover of this bank by Lloyds TSB by failing to agree to back-up facilities for Lloyds TSB. Congdon argues, therefore, that the Bank of England failed in its duty to act as lender of last resort.

Again, this critique of regulation does not arise with hindsight. The wisdom of creating the monolith of the FSA was questioned at the time – see Michael Taylor (1997). The FSA's predecessor, the Securities and Investments Board (SIB), had a turbulent history since its inception in the mid-1980s. It can be argued that the structure of the UK's regulatory institutions is still not fit for purpose.

In its operations, the UK regulatory regime that has been in place since the mid-1980s has been subject to much criticism. Most recently the criticism has come from the UK's Parliamentary Ombudsman in its report on the Equitable Life affair –

see Ann Abraham (2008). This sorry saga has yet to be fully resolved as government has been reluctant to accept the recommendations of the Ombudsman which raises important questions about the accountability of regulators.

2.3 The Real State Failure

Whatever one thinks of the theory of state failure, some policies and actions of governments and regulators have contributed to the crisis. The promotion of home ownership with little regard to affordability; the uncontrolled extension of credit; the failures of monetary policy; unwise changes to regulatory institutions and the failure of regulatory operations all contributed to the crisis. Arguably, the FSA (as well as other regulatory authorities in some other countries), has failed to meet one of its statutory objectives, namely to maintain confidence in the financial system.

If regulation has failed in the past to achieve its objectives and/or has unforeseen and undesirable consequences there is no reason to suppose that such failure and consequences will not arise in the future. Who is to regulate the regulators? In principle, regulators are accountable to politicians but the role of politicians can be questioned as indicated above. Who regulates our politicians? Are our democratic institutions sufficiently robust to hold politicians to account?

3. Market Failure and State Failure – A Synthesis

The above narrative shows that arguments can be put forward for both "market failure" and "state failure" in the analysis of the causes of the global financial crisis. To an external observer, not involved in transactions in the market place or in its regulation, this may not seem surprising. To err is human, and mistakes will be made by all participants in any complex system. The advocates of market failure on the one hand and state failure on the other hand look like competitors for power in the financial system. Over the decades power relationships have changed, as sentiment and vested interests have changed. Regulation has been followed by deregulation (or re-regulation) and we are now destined for a period of increased regulation. We might expect, as the impact of the new regulatory regime reveals itself over the next decade or so, that there will be a change in sentiment in favour of deregulation at some stage in the future.

3.1 The Interdependence of the Market and the State

The point we wish to make in this context is that the perception of the state as being somehow outside the economic system is false. The state is not exogenous to the market. In particular, the state provides the framework of law which creates the foundations of the economic system. The economic system which evolved in the Western world is underpinned by a substantial legal framework (and underlying culture) which provides, among other things:

- The creation and protection of property rights;
- The recognition and enforcement of contractual agreements;
- The creation of money as means of exchange for goods and services;

- The creation of a duty of care in defined circumstances, with provision for compensation for loss in the event of negligence;
- Competition and fair trading rules to protect market participants from fraud and other abuses;
- Governance and accountancy rules;
- The right to create a corporate entity with limited liability;
- Procedures for the resolution of disputes and the prosecution of offenders;
- The creation of state agencies to design, change and enforce the rules.

The economic system in which we work cannot exist without this framework of law and culture. The idea of a “free market”, a market free of state intervention, fails to recognise this reality. Also, the idea that “market failure” justifies state intervention misses the point. The concept of a perfect market arose in economic theory as an attempt to simplify economic phenomena to make them tractable to analysis. The application of economic theory and mathematical models to actual economic systems without an understanding of the simplifying assumptions made in those theories is fallacious. Real markets are imperfect and cannot be assumed to be efficient. The idea that the state can somehow “perfect” occasional “imperfections” in otherwise perfect markets fails, therefore, to recognise the realities of markets (and, of course, of the limitations of the political process).

The interdependence of the market and the state can also be seen in the management of the public finances. Governments finance their expenditure by raising taxes and by issuing debt. Taxes are paid by, and money is lent to government by, corporations and individuals. Corporations and individuals cannot then use this money in the markets but governments spend it instead. Government uses money to buy goods and services in the market and redistributes some money in the form of benefits and grants to other individuals or bodies. Public finance and private finance are, therefore, intimately linked.

3.2 The Need for a New Conceptual Framework

The conceptual framework in which the debate about regulation takes place is therefore flawed. We need a new conceptual framework which recognises the reality of the political and economic system in which elected representatives, state officials and corporations are all participants. This will facilitate a more informed, and hopefully a less polemical, discourse about the actions that those participants need to take in the light of changing circumstances.

Adopting a new conceptual framework does not mean that we immediately abandon all we have learnt about how economic systems work. We still, for example, recognise information asymmetry but not as a “market failure” which justifies “state intervention”; instead it is a market phenomenon. As a market phenomenon, information asymmetry may or may not be a problem in any particular context. If it is a problem, there may or may not be a cost effective solution. In some contexts information asymmetry may provide an incentive for entrepreneurial activity creating new sources of wealth. In this new conceptual framework, information asymmetry is not automatically regarded as a market failure which requires regulatory action.

A new conceptual framework will help to refocus the discourse about how the powers within the system (politicians, regulators and major corporations) manage the system to minimise the risks of crises and maximise economic welfare. It will help to shift the debate from ideological propositions to an examination of the system itself and the relationship between the various actors in the system. *The Turner Review* (2009), along with many commentators on the crisis, recognises the importance of the relationships between the UK's Tripartite institutions (the Treasury, the Bank of England and the FSA). The importance of the relationships between each of these official institutions and financial institutions generally is recognised implicitly in the analysis but such recognition needs to become much more explicit and transparent.

The behaviour of one actor in the system will affect the behaviour of other actors and in turn will determine economic outcomes. Reflecting on past events we can see, for example, how the public policy in the USA of promoting lending to individuals on lower than average incomes for house purchase affected the lending behaviour of the banks. In turn, this increased the risks of credit defaults and the risk of house price bubbles. We can see how capital regulation created incentives for financial institutions to innovate to produce new financial instruments to avoid that regulation which in turn created serious systemic risks in the system.

Looking forward, if regulators now impose more prescriptive rules upon banks, and seek to impose their judgements upon the boards of the banks, then this is likely to make those boards more accountable to the regulators than to shareholders, undermining market discipline. What will be the medium to longer term impact of this initiative? How will banks respond? Will they seek to innovate to avoid regulatory prescriptions or will they use political influence to frustrate the activities of the regulators? Will the initiative stifle beneficial innovation, reducing economic welfare? How will this initiative affect the growing corporate social responsibility and sustainable business agenda? Will it remove the incentives and opportunities for banks to create sustainable business models and to rebuild trust in their brands?

If regulators do not have the answers to these questions, they will not be able to assess the risks of their own activities and to put in place actions to mitigate undesirable outcomes which extensive research on past regulatory activity has shown is almost certain to occur. *The Turner Review* (2009) is notable for the absence of any risk assessment of its proposals. No doubt we will have, in due course, a regulatory impact assessment but the FSA is setting in place a substantial agenda without even a preliminary assessment of the risks of adverse consequences. Also, when we do come to the regulatory impact assessment, do we have sufficient understanding of the dynamics of the system to make a reasonable assessment of the risks?

In summary, we are arguing here that we need a greater understanding of the boundaries of and the dynamics of the political and economic system. We need a better understanding of the inter-relationships in the system and of the effect that the actions of one actor in the system has on the other actors and the system as a whole.

3.3 The Need for Transparency and Public Accountability

There is already a demand for more transparency in the relationship between the regulator and regulated institutions, as evidenced recently by the request for information about the stress tests carried out by the FSA with the UK's banks. On the other hand, it is important that the Tripartite institutions should be able to conduct some business with financial institutions in private, to protect commercial confidentiality. There is also a very good argument in favour of allowing the Bank of England to make facilities available to banks covertly to avoid market panic. So there is a balance to be struck.

But with this caveat, there is a need for increased accountability of politicians and regulators, and indeed the financial institutions which are crucial to our economic welfare. Clearly, the financial crisis has raised public awareness and concern. More recently, the publication of details of British politicians' own financial affairs has raised wider concerns about our democratic governance. Moving forward now, what will be the mechanisms by which the powerful actors in the political/economic system will account to the wider public for their behaviour?

Some governance issues are addressed by *The Walker Review* (2009) of the UK banking industry. However, in the Terms of Reference of this Review there is a lack of explicit recognition of the interconnectedness of the system in which boards of banks and institutional shareholders operate alongside governments and regulators. It is clearly relevant to ask questions about the balance of skills, experience and independence required on boards of banking institutions, but what about the institutions in the Tripartite arrangement? The Tripartite parties are taking much greater powers within the economic system but do they have the required skills and experience? Are there sufficient checks and balances within the system? How will the Tripartite parties be accountable for their actions?

4. Towards a New Conceptual Framework

The first step in creating a new conceptual framework is the recognition of the need for one, which follows from the recognition of the limitations of the current framework. We hope that this paper will start this debate, moving us on from the rather sterile arguments about market failure and state failure.

The next step is to identify the key elements that the new framework needs to contain. We have argued that we should regard politicians, regulators and financial institutions as part of the same political/economic system. We have started to redefine the boundaries of the system we seek to examine. *The Turner Review* (2009) argues, cogently, that we need to see regulatory policy in the context of the macroeconomic and global environments. The Review therefore redefines the boundary of what was previously regarded as relevant. We wish to go further and recognise that the behaviour of politicians, regulators and financial institutions is intimately linked. The relationships between these actors in the political/economic system are therefore relevant.

Also relevant are the relationships between the various structures in the system. For example, the issue of leverage cannot be understood without examining the effect of the law on limited liability and the impact of fiscal rules which distinguish between the costs of equity and debt. The rules on limited liability create the opportunity for leverage and fiscal rules increase the rewards to shareholders from debt financing. The elements of the legal framework in which commerce is conducted, as outlined above, are intimately linked.

The task, therefore, to develop a new conceptual framework involves redefining the boundaries of the system and examining the relationships within the system as newly defined. As indicated earlier, we do not abandon all the information and knowledge we have about how economic systems work, particularly the learning from the most recent events. What we need to do is to re-examine and reflect on the past in the light of the newly defined system. This is an iterative process. As we re-examine the past with a new approach we will develop the new conceptual framework.

We also need to examine in more detail the relationships between the actors in the system in order to understand how the behaviour of one actor affects the behaviour of others, and hence increase our understanding of how the system evolves. We do not have a shared understanding of the relationships between regulators and financial institutions, between financial institutions and politicians and between politicians and regulators. This is a closed world. It needs to become much more open.

If we are to make progress with this agenda, then governments, regulators and financial institutions all need to be prepared to be more open and accountable. This will be especially difficult for governments. It will also be difficult for financial institutions seeking to recover from the crisis and to rebuild their reputations with the public at large. But public accountability must be a top priority as we move forward. The new conceptual framework must define what accountability consists of and what the mechanisms are for providing accountability.

In this paper we are not attempting to produce a finished blueprint of a new conceptual framework. Our primary aim is to open up the debate on the need for a new way of thinking. But we can start to use the ideas we have presented to produce a preliminary risk assessment of the proposals contained in *The Turner Review* (2009) and in the FSA Discussion Paper (2009).

5. The Risks within the FSA's Proposals

As indicated earlier, research into various industries, particularly in the USA, has suggested that prescriptive regulation has unforeseen and adverse consequences. A number of authors (see for example George J. Benston 1985; William H. Starbuck and P. Narayan Pant 1996) cite regulation as one of the main causes of the collapse of the US Savings and Loan (S&L) industry in the 1980s. The initial cause of the problem was the specialisation of S&Ls in fixed interest rate long term mortgages funded by short term savings deposits with regulated interest rates and subject to federal deposit insurance. This business model was imposed by regulation going back to the 1930s and was supported by tax subsidies and by custom. When short term interest rates rose from around 7% in 1978 to 16% in 1981, S&Ls faced a run on their deposits. Congress began to deregulate deposit rates in 1980 which helped S&Ls stem the outflow of funds but also led to interest margins becoming negative as the rate on mortgages could not be increased. Subsequent regulatory action failed to stem the crisis which was building and may have contributed to the collapse of more S&L institutions.

5.1 Identifying the Risks

Studies such as those into the S&L industry show that serious issues arise when regulators usurp the decision making power of boards of companies. This has implications for the FSA's decision to move to 'intensive supervision', and particularly for the proposition that "... supervisors will make judgements of the judgements of firms' senior management and require action if, in their view, the latter pose risks to the FSA's objectives." – see FSA (2009, para 1.66) This statement is at odds with the statement in the previous paragraph that "... a firm's senior management must always carry responsibility for their actions" but more generally, the FSA's approach raises a number of significant governance issues.

The FSA is effectively saying that it is prepared, in pursuit of its own objectives, to veto commercial decisions made by the senior management of financial institutions. This raises questions about the accountability of the directors of financial institutions, about the role of non-executive directors and shareholders, and about the accountability of the FSA supervisors.

Where an FSA supervisor vetoes a decision made by directors and imposes his/her own decision then those directors cannot be held accountable for the decision of the supervisor. Where the issue in question goes to the heart of the firm's business strategy, and to its competitive position in the market, then it will be difficult for shareholders to hold directors to account for the strategic direction of the company and for its financial performance. How will directors and shareholders respond in these circumstances? Directors who have their decisions over-ruled by supervisors will lose authority so they may seek prior agreement from the supervisor on key strategic issues. Likewise, institutional shareholders may seek to engage with FSA supervisors on the investment strategies of financial institutions. Similarly, non-executive directors may build relationships with the supervisor. The focus of strategic decision making will therefore shift to the FSA.

Is the regulator equipped to fulfil the role of setting the strategic commercial direction of financial institutions? Does the regulator have the necessary depth and quality in its supervisory resources? Supervisors will need to be capable of spotting systemic risks but they will also need to have commercial skills if they are to be engaged in the strategic business decision-making of financial institutions. If a supervisor imposes a commercial decision on a financial institution which turns out to be disastrous for this institution, will the regulator be accountable to the shareholders for the financial loss they suffer and will the regulator/government pay compensation if it is found that there is maladministration?

If the regulator is to be involved in the strategic decision making of financial institutions, how will the marketplace evolve in the coming years? How will the regulator's involvement affect competition, the evolution of sustainable business models and the economic performance of the market? The experience in the USA showed that where regulators set deposit and lending rates, the banking market stabilised for a time but this proved to be unsustainable. Regulators were unable to make key strategic decisions in a period of changing economic, social and technological circumstances. The UK's FSA may not be seeking to set deposit and lending rates, but the implications of intensive supervision are that it will be involved in decisions on business models so the same risks will arise as those which manifested themselves in the regulated market place in the USA prior to the deregulation of the 1980s. The risks are that markets will become dysfunctional and fail to meet the expectations of consumers and investors. Financial institutions may become economically unsustainable.

The FSA's regulatory approach, therefore, contains substantial risks which need to be managed. Intensive supervision will affect the behaviour of executives in the financial services industry. It is of course intended to affect behaviour, but it may not do so as expected. Moving forward, regulators will see changes in behaviour of executives and will then respond. Executives will respond to the regulator's response, and so on. Political circumstances will change also, and decisions made by governments will affect economic outcomes. The risk is that after a time financial markets become economically unsustainable.

5.2 Mitigating the Risks

Managing these risks involves, first of all, recognising their nature. This brings us back to the need for a new conceptual framework. We need to recognise, firstly, that the behaviour of politicians, regulators and financial institutions are intimately linked. The mitigating action for the risks identified then follows. We need to observe the behaviour of all these participants in the political/economic system as we move forward along with the performance of the market. As indicated above, we can learn from a re-examination of the past and from a new study of the relationships that have existed between the participants in the recent past. But circumstances have changed since the recent global financial crisis. Governments and regulators are now taking a much more leading role. The balance of power has shifted so it is crucial to examine the relationships as they evolve.

A second mitigating action is to examine the relationships between the structures within the system, the inter-relationship between the elements of the underlying legal and cultural framework. So, taking again the issue of leverage, it may be that there are better ways of responding to the problem than new regulatory prescriptions. We could examine how the rules on limited liability, the fiscal rules and the functioning of the equity markets relate to each other and create the incentives for increasing debt finance as opposed to equity. It may be that changing some of these underlying rules will be more effective in reducing systemic risk by improving market discipline.

This is not going to be an easy task, but if we do not undertake it, we will be faced with another crisis which will have its origins in the response to the present crisis.

6. Looking Forward

We end this paper by looking at how events might unfold. What are the possible scenarios?

We have been here before. Joseph G. Nellis and Stephen Regan (1997) argued that a global economy without adequate relationships between the state and multinational business would not serve the interests of businesses any more than it would serve the interests of the wider communities to which businesses belong. The authors identified the risks within the system as it then was in the 1990s, including the instabilities arising from unregulated capital flows; concerns about the role of stateless multi-national companies dedicated to the sole objective of maximising shareholder value; and the risks of new instruments such as derivatives. Nellis and Regan identified the potential for a future liquidity crisis in the global economy and the lack of capability to respond to a sudden crash in financial markets.

So how do we assess the current situation as we finalise this paper in January 2011? The omens are not good. For example, it is common ground that one of the causes of the financial crisis was the bonus culture within financial institutions which encouraged short term thinking and high risk activity. But as we write, the UK government seems to have given up in its attempt to address the issue; see for example The Financial Times (2011) and BBC (2011). Banks and other large financial institutions have succeeded in persuading the government not to take any further action on this front. As we suggested above, prescriptive rules would not work (except perhaps in the very short term). The government was wise, therefore, not to go down this route. But the issue still needs to be addressed and there can be no better time for the government to bring pressure to bear on financial institutions. The political context is a time of severe public expenditure constraints affecting the public at large, and especially the more vulnerable in society, yet the banks can provide rewards to its executives and employees that most people can only dream of. If in these circumstances the banks are not responsive, then it bodes ill for the future.

But the issue raises a more general question: how can financial institutions make the profits implied by these bonuses at a time when the global economy is emerging from recession? One of the other well recognised causes of the financial crisis was the growth of the financial sector relative to the real economy. The "financialization" of the economy was a major issue. Financialization is a process whereby financial markets, financial institutions and financial elites gain greater influence over economic policy and economic outcomes. It involves a transfer of income from the real sector to the financial sector, an increase in income inequality and a contribution to wage stagnation (Thomas I. Palley 2007). If governments, regulators and financial institutions do not recognise and deal with this issue, then it will remain a risk to the real economy.

Clearly, the relationship between the state and the financial sector has not matured to a point where the bonus culture and the related issue of financialization can be dealt with. This in turn raises questions about the progress of the new regime of "intensive supervision" which was introduced by the FSA and which we described above. Where does the balance of power lie now in the relationship between the FSA and the banks? We simply do not know: this is a closed world. Likewise we know little about how the relationship between the regulatory authorities in different countries is developing, and whether the global risks, which we have referred to, are being addressed effectively. This uncertainty can only lead us to be pessimistic about the future. The global economy will no doubt emerge from recession but we are not convinced that the underlying problems which gave rise to the financial crash of 2007/8 have been, or are being, solved. There remains, therefore, a risk of a future financial crisis.

We are not alone in trying to be prophetic. Kosta Josifidis, Alpar Lošonc, and Novica Supić (2010) set out two possible scenarios for the global economy. The first scenario, which they term *inertial*, is based upon the assumption that the crisis and the recession are cyclic in character. Within 2-4 years, possibly less, the economy will have recovered and governments will divest themselves of the responsibilities they assumed at the start of the crisis. We then carry on as before until the next slump. The second scenario, which Josifidis, Lošonc, and Supić call *pessimistic/realistic* starts from the proposition that the crisis of 2007/8 was not cyclic but was systemic and structural in character. This scenario is pessimistic in the sense that it regards the crisis as very serious and it is realistic as it prepares for more significant consequences: an evolutionary point has been reached which requires fundamental and comprehensive change. This involves abandoning the dominant paradigm of neo-liberalism and market fundamentalism and incorporating corporate social responsibility.

So which scenario are we following? The rhetoric from governments around the time of the crisis, which is reflected in the *Turner Review,* suggests that we need to follow the second route. But as economies recover and as banks regain confidence (and feel immune to public pressure), we are seeing the first signs of a reversion to the first scenario. We cannot help feel that we are indeed heading for the next crisis. The only question is: when it will strike?

7. Conclusion

In this paper we have examined the traditional "market failure" and "state failure" approaches to the regulation of financial markets. Both approaches have some validity and identify causes of the financial crisis. But advocates of each position offer only partial and polarised views. We have offered a synthesis, arguing that we need a new conceptual framework which recognises the relationship between the various actors in an increasingly complex political and economic system. We seek to redefine the boundaries of the system which needs to be examined, recognising that politicians, regulators and financial institutions are all actors within the same system. The market cannot be seen as separate from the state.

This new conceptual framework leads to a better understanding of the interlinked causes of the crisis and the risks arising from the regulatory changes now put in place. Mitigation of those risks requires a study of the behaviour of the various actors in the system, alongside traditional economic analysis. This requires politicians, regulators and financial institutions to be more open to public scrutiny. Worryingly, the early indications are that the fundamental issues which gave rise to the global financial crisis are not being adequately addressed.

References

Abraham, Ann. 2008. *Equitable Life: A Decade of Regulatory Failure.* London: The Stationery Office.

Alexander, James. 2009. "Regulatory Arbitrage and Over-regulation." In *Verdict on the Crash: Causes and Policy Implications*, ed. Philip Booth, 81-94. London: Institute of Economic Affairs.

BBC. 2011. "Cameron and Miliband Clash over Bank Bonuses." http://www.bbc.co.uk/news/uk-politics-12168426 (accessed January 12, 2011).

Becker, Gary S. 1983. "A Theory of Competition among Pressure Groups for Political Influence." *The Quarterly Journal of Economics*, 98**:** 371-400.

Benston, George J. 1985. *An Analysis of the Causes of the Savings and Loan Association Failures*. New York: New York University Press.

Beenstock, Michael. 2009. "Market Foundations for the New Financial Architecture." In *Verdict on the Crash: Causes and Policy Implications*, ed. Philip Booth, 59-72. London: Institute of Economic Affairs.

Booth, Philip. 2009. *Verdict on the Crash: Causes and Policy Implications*. London: Institute of Economic Affairs.

Butler, Eamonn. 2009. "The Financial Crisis: Blame Governments, not Bankers." In *Verdict on the Crash: Causes and Policy Implications*, ed. Philip Booth, 51-58. London: Institute of Economic Affairs.

Congdon, Tim. 2009. *Central Banking in a Free Society.* London: Institute of Economic Affairs.

Dowd, Kevin. 2009. "The Failure of Capital Adequacy Regulation." In *Verdict on the Crash: Causes and Policy Implications*, ed. Philip Booth, 73-80. London: Institute of Economic Affairs.

Financial Services Authority. 2009. *A Regulatory Response to the Global Banking Crisis*. Financial Services Authority Discussion Paper 09/2.

Fama, Eugene F. 1970. "Efficient Capital Markets: A Review of Theory and Empirical Work." *Journal of Finance,* 25: 383-417.

Frankfurter, George M., and Elton G. McGoun. 1999. "Ideology and the Theory of Financial Economics." *Journal of Economic Behaviour & Organization,* 39: 159-177.

Greenwood, John. 2009. "The Success and Failures of UK Monetary Policy, 2000-08." In *Verdict on the Crash: Causes and Policy Implications*, ed. Philip Booth, 37-44. London: Institute of Economic Affairs.

Jackson, Patricia. 1999. "Capital Requirements and Bank Behaviour: The Impact of the Basle Accord." Basle Committee on Banking Supervision Working Paper 1.

Jones, David. 2000. "Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues." *Journal of Banking and Finance*, 24: 35-58.

Josifidis, Kosta, Alpar Lošonc, and Novica Supić. 2010. "Neoliberalism: Befall or Respite?" *Panoeconomicus,* 57(1): 101-117.

Leontief, Wassily. 1971. "Theoretical Assumptions and Non-observed Facts." *American Economic Review,* 61: 1-7.

Mahon, John F., and Edwin A. Murray. 1981. "Strategic Planning for Regulated Companies." *Strategic Management Journal*, 2: 251-262.

Nellis, Joseph G., and Stephen Regan. 1997. "Rule-based Regulation." *New Economy,* 1997: 253-257.

Palley, Thomas I. 2007. "Financialization: What It is and Why It Matters?" The Levy Economic Institute Working Paper 525.

Peltzman, Sam. 1976. "Toward a More General Theory of Regulation." *The Journal of Law and Economics,* 19: 211-240.

Posner, Richard A. 1971. "Taxation by Regulation." *Bell Journal of Economic and Management Science*, 2: 22-50.

Rosenberg, Alexander. 1994. *Economics – Mathematical Politics or the Science of Diminishing Returns?* Chicago: University of Chicago Press.

Schwartz, Anna J. 2009. "Origins of the Financial Market Crisis of 2008." In *Verdict on the Crash: Causes and Policy Implications*, ed. Philip Booth, 45-50. London: Institute of Economic Affairs.

Starbuck, William H., and P. Narayan Pant. 1996. "Trying to Help S&Ls: How Organizations with Good Intentions Jointly Enacted Disaster." In *Organizational Decision Making*, ed. Zur Shapira, 35-60. Cambridge: Cambridge University Press.

Stigler, George J. 1971. "The Theory of Economic Regulation." *Bell Journal of Economic and Management Science,* 2: 3-21.

Stiglitz, Joseph. 1981. "The Allocation Role of the Stock Market: Pareto Optimality and Competition." *The Journal of Finance,* 36: 235-251.

Stiglitz, Joseph. 2002. "Information and the Change in Paradigm in Economics." *American Economic Review,* 92: 460-501.

Taylor, Michael. 1997. *The Regulatory Leviathan: Will Super-SIB Work?* London: CTA Financial Publishing.

The Financial Times. 2011. "Bank Bonuses." http://www.ft.com/indepth/bank-bonuses (accessed January 21, 2011).

The Turner Review. 2009. *A Regulatory Response to the Global Banking Crisis*. London: Financial Services Authority.

The Walker Review. 2009. *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities.* London: HM Treasury.

Tversky, Amos, and Daniel Kahneman. 1974. "Judgement under Uncertainty: Heuristics and Biases." *Science*, 1974: 1124-1131.

Vietor, Richard H. K. 1994. *Contrived Competition: Regulation and Deregulation in America.* Cambridge, MA: Harvard University Press.

THIS PAGE INTENTIONALLY LEFT BLANK