Democracy and Diversity in Financial Market Regulation

Nicholas Dorn
Democracy and Diversity in Financial Market Regulation

Financial markets have become acknowledged as a source of crisis, and discussion of them has shifted from economics, through legal and regulatory studies, to politics. Events from 2008 onwards raise important, cross-disciplinary questions: must financial markets drive states into political and existential crisis, must public finances take over private losses, must citizens endure austerity? This book argues that there is an alternative. If the financial system were less ‘connected’, contagion within the market would be reduced and crises would become more localised and intermittent, less global and pervasive. The question then becomes how to reduce connectedness within financial markets.

This book argues that the democratic direction of financial market policies can deliver this. Politicising financial market policies – taking discussion of these issues out of the sphere of the ‘technical’ and putting it into the same democratically contested space as, for example, health and welfare policies – would encourage differing policies to emerge in different countries. Diversity of regulatory regimes would result in some business models being attracted to some jurisdictions, others to others. The resulting heterogeneity, when viewed from a global perspective, would be a reversal of recent and current tendencies towards one single/global ‘level playing field’, within which all financial firms and sectors have become closely connected and across which contagion inevitably reigns.

No doubt the democratisation of financial market policy would be opposed by big firms – their interests being served by regulatory convergence – and considered macabre by some financial regulators and central bankers, who are coalescing into an elite community. However, everyone else, Nicholas Dorn argues here, would be better off in a financial world characterised by greater diversity.

Nicholas Dorn, a sociologist, has also published on transnational governance, the European Union, public and private regulation and economic crime.
Democracy and Diversity in Financial Market Regulation

Nicholas Dorn
Contents

Preface ix

PART I
Historical legacies 1

1 From clubs to herds: private regulation, 
public façade 3

Four reasons for starting with London 4
Political naturalness of self-regulation: town, country
and bank 7
International inclinations, domestic distain: first half
of the 20th century 10
Innovation, Europeanisation, reinternationalisation:
1950s onwards 12
A public face for private regulation: 1980s–90s 18
Approaching 2007: cosmopolitan aesthetics 24
Retrospective 1918–2008 25

2 Bail-outs as policy: constructing ‘too connected to fail’ 28

The attractions of TCTF 29
The ‘market for lemons’ in policy concepts 31
Political rhetoric: the making of the Lehman Brothers
story 32
Some prior history: normalisation of bail-outs in
the US 33
Bankruptcies no more disorderly than bail-outs 36
‘Scarcely a ripple’: failure with reassurance 39
Prospects and problems: connectedness, similarity,
contagion 41
PART II

Regulatory hubris 51

3 Two readings: regulatory insufficiency or depoliticisation 53

Symptoms: risk appetite, Ponzi finance, contagion 53
Ponzi finance not as the exception but as the rule 57
Reading 1: regulatory complicity and forbearance 58
Regulatory forbearance and use of private models 60
Reading 2: depoliticisation, convergence, contagion 64
Jurisdictional arbitrage: friend or foe? 67
Responses in the wake of 2008: conservative ends, radical means 72
Remaking knowledge: from models to judgment 74
Conclusion 75

4 Europe: from single market to multiple mechanisms 77

Approaching the private-public regulatory nexus 78
Private-public regulation 82
Case study: shielding the credit rating agencies 85
‘Technical’ delegation and parliamentary control 87
Regulation as crisis management: ‘burden sharing’ 90
Single market, EU authorities, stability: ECJ Case C–270/12 93
Regulation after markets: ‘mechanisms’ 97
EU governance via shareholdings: the ESM as IMF-style governance 100
Quo vadis EU? 104

PART III

Ways forward 109

5 Limits and distractions of transparency 111

Context 112
Debating complexity 114
Trade data as knowledge flooding 116
Market information as a public straightjacket 121
Bank resolution as focus for policy and information 122
6 Democracy as driver of global diversity

Legacies hard to overcome 132
Limits of subsidiarisation: less connected but still too similar 133
From technical knowledge to political preferences 135
Terms of debate 137
Constitutionalising regulation: locally embedded or politically ‘offshore’? 138
Ends: taking stock 143
Means: revisiting 1918: democratising financial regulation 144
Means: reviving historical debates on the purposes of finance 145
Not an easy sale 148
Finally: international standard-setting, diversity and democracy 149

Bibliography 153
Index 175
Every narrative has a pivot, key assumption or foundational myth, which threads and holds together diverse content that might otherwise, because of its complexities and scope, become too disjointed to make sense. Before the crisis, the foundational myth was that expertise could steer the ship: technocrats drove policies in relation to financial markets, so safeguarding states, economies and societies, which had become closely bound up with financial markets. Technocratic steering went hand in hand with an upward drift of agenda-making, from the national (or more specifically City) level, to international networks. Accordingly, there was an international convergence of regulatory thinking and of rule-making, levelling the ‘playing field’, to the advantage of large transnational financial market participants but exacerbating market herding, similar business strategies, connectedness, contagion and crisis. Whenever an apple cart overturns, there can be a messy situation that nevertheless is locally confined. If the apple carts are increasingly roped together then the situation can be more serious.

Following the onset of the financial market crisis, it became clear that expertise had been illusionary. What next? One possibility would be to say that international expertise must be rebuilt but on a firmer footing: this has been the understandable reaction of regulators themselves, so leaving open the project of continuing rule convergence, albeit on a more sophisticated basis than last time. This ‘more regulation’ line clearly became the prevailing point of view following 2008, with a veritable fountaining of legislation and a considerable tightening up in terms of the robustness of its application.

Yet another possibility, more radical, would be to have a look at the political structure within which basic assumptions are shaped, knowledge is constructed and the broad lines of policy are negotiated. Looking at the contexts within and the levels at which financial market regulation occurs – the restricted circles involved and the upward drift – one notices the lack of wider political debate before the crisis. Have we seen widespread and vigorous contestations, through which not only politicians but also political parties and citizens engage? Not really, at least not directly concerning financial markets, despite the lives of so many in the US, the EU and in particular the Eurozone.
having been deeply touched by down-turns in investment and by austerity measures that are the opposite of bank bail-outs. There has been public anger, yet this has taken the forms of ‘banker bashing’ and widespread cynicism over elites, rather than attempts to move banking and other financial services into the centre of political debate and democratic decision-making. How such news is presented and digested within social groups is a contingent matter; however, one cannot rule out that cynicism and/or disempowerment may deepen (van Erp 2013; Bauhr and Grimes 2013).

Where are the mainstream political parties on this and where are their intellectuals? Strangely, mainstream political parties still seem to be more ‘upward’ facing to elite policy and regulatory circles, rather than ‘downwards’ in a debate with citizens. Some celebrated public intellectuals, such as Jürgen Habermas (2013), aim to open up a deliberative space, within which (to put things crudely) Joe and Joanna Public and their political parties could engage with and work their way through issues: yet Habermas’s direction of engagement is largely upward-facing, towards European elites.

Some academics, interested in both constitutional and regulatory questions, are exploring how to break out of the trap of starting with economics and market dynamics and then trying to move to a broader social (and political?) framing. However, that seems to be a difficult direction of travel. Consider for example Julia Black’s call for a means of ‘seeing, knowing, and regulating financial markets [that is capable of] moving the cognitive framework from the economic to the social’ (Black 2013): clearly we are not quite there yet. Whatever constitutes the structural separation in our thinking about financial market regulation and mundane politics, it will not easily be shifted. What is needed is an analysis on the basis of which a strategy can be articulated.

**Democracy, diversity and stability**

The bracketing off of financial market policy and regulation, as issues outside the rough and tumble of political debate (in the common sense meaning of political) does raise some questions of principle. These have come to look like practice questions as well, in the light of widespread recognition that financial markets constitute a source of crisis and that arrangements for their governance have not been satisfactory. In large part, the purpose of this book is to explore and challenge this de-democratisation. The book attempts this from three vantage points: a sensitivity to some relevant political history, which has shaped financial market regulation (Part I, focusing on the UK and the US); exploring pre- and post-crisis regulatory responses, with attention to the European dimension (Part II); and how both democracy and the effectiveness of financial market regulation might be enhanced if brought together (Part III).

The key claim is that, if the historically-constructed separation of regulation from democratic deliberation and design-making can be breached (as it may
be to some extent as a consequence of the crisis), then one result would be less convergence in regulation, less herding in markets and less contagion globally. Democracy would introduce greater diversity into international regulatory regimes, which would address deep-seated issues of ‘too connected’ and ‘too similar’ financial markets. Stepping towards such a diversified international regime means reassessing so-called Balkanisation of financial market policies and regulations, championing this as a global public good. Pluralisation is not a curse; it is a blessing. In order to make this case, it is necessary to be very clear about the scope and nature of the issue being addressed here.

To clarify and place limits around the claim being made here, it is definitely not that all types of economic crisis could be avoided by regulatory diversity. Nor is the book putting forward a macro theory of capitalist crises in general; nor a micro theory about particular financial products. Such macro and micro theories can be found in many excellent books on the financial market crisis, each of which constructs its own history of the crisis, against which certain recommendations might make sense. For example, British readers in particular may know Andrew Gamble’s *The Spectre at the Feast* (2009), which places current difficulties within a longer history within which market crashes, defined in terms of economic movements that are quite quickly recoverable from, are distinguished from crises: more profound and also of a political nature. Gamble’s claim is that capitalism is inherently prone to such economic/political crises and that these are times when the political balance can shift. Previous well known commentators, including Harold Minsky and Joseph Schumpeter, have made broadly similar claims, if from differing political positions (for Minsky, see Chapter 3). The belief that a tendency to crisis is inherent in the market system is shared between neo-Marxists, neo-Keynesians, defenders of free enterprise and central bankers. For all apart from the last group, recognition of financial market crisis moves financial market regulation onto political terrain.

It is that move and its potential consequences that are explored here, with specific reference to the crisis that became apparent from 2007 onwards, turning into the Eurozone crisis and becoming the trigger for a huge amount of regulatory reform. What is left somewhat ambiguous is whether or not the basic rule of the regulatory game – that regulation is technical not political (in the narrow sense of being democratically driven) – has been or is being breached. The question is, what does the financial crisis open up in terms of potential changes, real and imagined constraints, strategies and consequences? Thinking of the recent past, present and future, what are the preconditions for change? Must policy-making processes necessarily behave like an interlinked set of elastic bands, temporally deformed, which at the earliest opportunity snap to their former constellation – or is some lasting reshaping possible? Note that at this point we are not concerned with the detailed content of financial market regulation, but with the ways in which regulation...
is produced. Similarly, we are not much concerned here with the architecture or organisational structure of national regulatory agencies (single regulator, ‘twin peaks’ or multiple poles of regulation). Rather, we are concerned with policy processes and, in particular, with their rationales.

**What this book does not do, because it has been done already**

Books on the financial crisis, the closely related Eurozone crisis and evolving policies and regulation are many and burgeoning. There are some excellent, popular, easy to digest whodunits, professionally-orientated works and academic accounts. As an example of a whodunit, Lewis’s *The Big Short* (2010) remains hard to beat, giving a flavour of the frustration of traders who were ahead of their time in terms of understanding a coming turning point in the market, whilst nearly everybody else (including regulators) were blissfully incorrect. Middle-brow contributions of note include Taleb’s *The Black Swan* (2007), Tett’s *Fool’s Gold* (2009), and Coggan’s *Paper Promises* (2011). Some of the whodunits and middle-brow works have a debunking tone, replacing the fable of finance as a golden goose with an image of recurrent black swans. This carries with it a pessimistic sense that, if crisis is the nature of the beast, not much can be done: *c’est la vie*.

However, across much of the specialist and academic literature, there is a more activist tendency, the crisis being attributed to a lack of holistic ‘joined-up’ thinking and action, which might be corrected in future. Avgouleas’s ambitious work, *Governance of Global Financial Markets* (2012) is in the pro-convergence camp, calling for a global regulatory system with new entities for financial stability safety, soundness and market conduct, knowledge-gathering and policy-development organisation and global resolution, overseen by a governing council representing the World Bank, the United Nations, the EU and members of the G20. According to that vision, we need better communication within technocratic circles and faster movement towards a single global regulatory regime. In some other work a pro-convergence theme is undercut by discussion of practicalities, as manifested for example in relation to bank insolvency and resolution, providing a focus for Lastra’s *Cross-border Bank Insolvency* (2013). Others maintain a more national focus, for example Acharya with others’ edited work *Regulating Wall Street* (2011) and MacNeil’s *Introduction to the Law on Financial Investment* (2012). There are also many edited collections and conference compilations, for example Alexander and Moloney’s *Law Reform and Financial Markets* (2011), crossing boundaries without being strongly themed.

One consequence of the crisis has been that lawyers, previously rather hidden under the skirts of economists, have emerged with a clearer voice. Many lawyers are less overtly committed to global convergence, being even-handed in their appraisals: for example Dragomir, in her *European
Prudential Regulation and Supervision (2010), which is a detailed study of the institutionalisation and trajectory of financial regulation at EU level. The coordination/convergence theme is also put into question by other legal and constitutional studies and by international comparative studies, for example Ferran and others’ The Regulatory Aftermath of the Global Financial Crisis (2012). Ferran’s Building an EU Securities Market (2004) is good on the heyday of single market regulation.

Sociologically-inclined work on capitalism and regulation provides broad points of reference, for example the well known work of Braithwaite such as his Regulatory Capitalism: How it Works, Ideas for Making it Work Better (2008); Picciotto’s slightly more edgy Regulating Global Corporate Capitalism (2011); and Levi-Faur’s edited Handbook on the Politics of Regulation (2011). Economic sociology in the traditions of Granovetter and Swedberg (2011) has focused more upon markets and traders per se, having less to say about regulation/policy, the latter being taken as part of the context and embeddedness of markets but not as a focus for enquiry. That is also the case for much of the ‘social studies of finance’ (Callon 1998; MacKenzie 2003a; Beunza and Stark 2012). A notable exception is Williams’s Policing the Markets (2012), which however focuses on enforcement in relation to market misconduct rather than on prudential regulation or anti-crisis policy-making. Moving from micro and meso to include also macro perspectives, an impressive list of scholars including Sassen, Davis, Anbolafia, and Bai and Gao have contributed to Cetina and Preda’s 2012 600-page collection, the Oxford Handbook of the Sociology of Finance.

One book seeking to unpack those issues in cultural, sociological and historical terms is Engelen and others’ After the Great Complacence (2011), from the Centre for Research on Socio-Cultural Change (CRESC, a joint centre of Manchester University and the Open University). Engelen and others seek to show how regulatory ‘knowledge’ has been constructed within a ‘technical’, supposedly non-political space. That space accommodates both the conventional thinking of ‘econocrats’ and some relatively innovative thinking of more independently-minded regulators, some of whom will be referred to in the following pages. Some of the CRESC team have also been involved in advocacy for local/regional governance of finance. There is some continuity between Complacence and the present book, insofar as both diagnose as problematic the weakness of democratic steering of policy on finance. However, there are many differences between that and the present book, one being that the CRESC authors describe the development of the City of London and its relationship with government in terms of successive shifts though different forms of power (Johal and others 2014; Engelen and others 2011). By contrast the present book points to what it claims to be an underlying historical continuity, extending internationally and into the EU (until the crisis). Questions of political strategy are taken up in the final chapter.
A general, methodological point of linkage between the present book, the CRESC work and also MacKenzie (2003b) and sociologists of science in general can be found in the notion of *bricolage* – the creative, ad hoc re-use of existing resources, including technical tools, ideas and cultural resources. This notion is normally applied to one’s objects of study, such as market and regulatory practices, seeing the latter in terms of actors’ creative re-use of those cultural ideas and technical tools that are to hand (in fact, how else could one proceed?). Moreover, *bricolage* could also refer to how we study market actors and regulators: academics’ thinking and acting obviously involve selective re-use of the work of others. In all respects we can agree that ‘The *bricolage* hypothesis has a corollary: history matters’ (MacKenzie and Pardo-Guerra 2013: 7). This book takes that seriously. In order to understand financial market regulation, we need history as well as contemporary studies. Moreover, if we are interested in understanding the recent past and the future prospects for financial market regulation in the European context, then there are histories, plural, to consider: UK, EU and US histories at the very least.

The following pages attempt to bring the following elements into conversation with each other: UK history, looking at evolution of private regulation under public auspices in the UK; US influences, the US being the principal birthplace of ‘too big to fail’ and bail-outs in financial markets; the EU, in respect of governance of the single market and of the ‘mechanisms’ that the EU has produced in its effort to control the Eurozone crisis; democratic processes (primarily domestic) and the relation between them and technical expertise (increasingly regionally and internationally networked); and the difficulties facing attempts to ‘de-connect’ financial markets.

**Plan and outline of the book**

As already mentioned, the book develops in three parts: historical legacies, regulatory hubris and the way forward.

Part I opens with a chapter exploring the historical pedigree of financial market regulation, through a UK focus and a chronology starting with the universal suffrage in 1918. ‘Club’ self-regulation in the City of London was barely touched by democracy. Whilst in the first half of the 20th century there were debates over the City’s role vis-à-vis the wider national economy, governance of the City remained inwardly-focused, cartelist and circumscribed in terms of class and culture, its autonomy being defended by sectoral cartels and by the Bank of England. After the Second World War, the Bank of England began a slow process of opening up the City to international competition, with attendant loosening of historical, locally-determined and culturally-embedded modes of self-regulation. During the 1970s and 1980s, partly in response to market scandals, self-regulation was absorbed into and codified within a formally public regulator. This resulted in what was to
become known as ‘light touch’ regulation, which is reconceptualised here in terms of masquerade: the institutionalisation and internationalisation of self-regulation behind a façade of public regulation. These historical developments had a consistently democracy-excluding effect, which was deepened by international networking and convergence of thinking amongst regulators. Subsequent chapters show how these British influences, together with US regulators’ long-running commitment not to allow ‘significant’ (large) financial firms to fail, provided the breeding ground for crisis and continue to do so. Throughout the book some ‘post-crisis’ counter-tendencies to convergence are discussed, including subsidiarisation, resolution planning and, fundamentally, politicisation.

The second chapter shifts to the US, exploring some consequences of banks and other financial firms being regarded as being ‘too connected to fail’ (TCTF) and of bailing out their senior bondholders. The consequences included austerity, political dissent and a deepening of moral hazard – bondholders were effectively invited to back further risk-taking at public expense. The commonly given justification for bail-outs is not simply that the insolvency of Lehman Brothers had negative consequences but that those consequences exceeded those of bailouts of other firms, such as Bear Stearns and AIG. This chapter argues that such a policy stance is, in Akerlof’s terms, a ‘lemon’: unverifiable, disputable and having undesirable consequences. Systemic consequences of bail-outs and insolvencies differ little; however, the costs fall differently on public and private actors. The progressive decline of the market throughout 2008 was a response to the continuously emerging bad news about the condition of the financial system, as one bail-out followed another. When there arose political resistance within the US Congress to their continuation, Lehman’s surprise insolvency offered the administration an opportunity to engage in hyperbolic commentary, stampeding Congress into authorising more public funding. The possibilities for overcoming TCTF beliefs are critically explored, with reference to the Volcker Rule, the Vickers Report and special resolution regimes.

Turning to Part II of the book, Chapters 3 and 4 look at the systemic financial market crisis of 2007 onwards and the Eurozone crisis that followed. These revealed evasions of regulatory controls and frauds that had been less visible in the previously buoyant, celebrated and under-scrutinised conditions. They also revealed something more fundamental: a pack of cards, not only of markets’ own making but also of regulators’. Chapter 3 first explores the presenting symptoms of market over-reach and regulatory failure. It goes on to make two readings of systemic market crises, which have quite distinct implications for assessment of recent regulatory reforms and for the ways in which policies and implementing structures should be developed in future years. One reading of regulatory failure – which has become the conventional view – attributes it to regulatory forbearance: deregulation, under-regulation, light touch, insufficient cooperation and expertise, etc.
The implication of that would be a need for more regulation, better informed and more extensive, so filling lacunae, becoming more robust and also being more evenly implemented across all jurisdictions. The chapter then makes an alternative reading of regulatory failure, in terms of insufficient politicisation of regulation (in terms derived from the longer historical perspective of Chapter 1). Both readings – insufficiency of regulation and its depoliticisation – may have merit; however, here the emphasis is placed on the latter, diluting if not displacing the notion of financial market regulation as a purely ‘technical’ discourse. In concrete terms, this implies shifting systemic regulatory oversight responsibilities away from ‘independent’ agencies, to government bodies and/or departments that are not simply held accountable to their parliaments and electorates, but are strongly driven by the latter. This would offer citizens some voice and decision-making power in relation to ‘their’ financial markets and in relation to any public subsidies they might like to make available. It would also, from a normative point of view, begin to make political amends for the history of public masking of private regulation observed in Chapter 1. The chapter also explores some issues around jurisdictional arbitrage, which is conventionally regarded as a danger sign; yet celebrated cases (eg Lehman Brothers International) can be regarded as arising more from regulatory forbearance than from diversity.

Chapter 4 charts the development of financial market regulation within the EU. Although the primary focus of this chapter is on the evolution of European financial market regulation per se, mention is also made of adjacent policy areas, notably competition policy matters – where pre-crisis action by the European Commission ironically resulted in a transfer of public subsidies and support from public banks to private banks – and external relations, where the Transatlantic Trade and Investment Partnership became controversial as a meta-framework. As for financial market regulation as such, this proceeded through three phases: (i) a serene single market phase, this being initially a statist project, which increasingly became ‘owned’ by the markets; (ii) a chaotic crisis management phase, amid the discovery of connectedness and contagion between banks and sovereign states; (iii) the institutionalisation of new ‘mechanisms’ that seek to bind together the Eurozone, whilst more rigorously excluding democratic influences. On financial market regulation per se, the single market phase saw a coalition between European federalists and the City of London, in which the latter eventually obtained the upper hand, installing self-regulation within a public façade at EU level (linking this chapter with Chapter 1).

In the crisis management phase from 2008 onwards, bank bondholders in the EU were generally protected by public bail-outs, just as in the US (see Chapter 2) but, unlike the US, EU policy-makers made an unprecedented turn towards austerity. A critical eye is cast over the Eurozone’s new governance ‘mechanisms’, collectively summarised as ‘banking union’. A single
supervisor for Eurozone banks is not surprising, although it creates new friction points between Eurozone ‘ins’ and ‘outs’. A more fundamental break is produced by the creation of a European Stability Mechanism, in the form of an international organisation beyond the EU, with Eurozone member states governing by way of their shareholdings. A previously slowly unifying European legal order has been rendered into distinct modes, with financial market regulation straddling both: single market governance, weakly democratised but with some European and national parliamentary oversight; and a new, extra-EU regime, the judicial and political controls of which are ‘in progress’. To observe that financial market regulation – or rather its failure – provoked all this is to offer a mixed compliment.

Part III discusses two contenders for the future of financial market regulation: more professional but still technocratic regulation, which would aim to be better informed, under a banner of transparency; alternatively, democratisation of decision-making about the broad shapes to be taken by financial markets, putting regulators into the position of servicing public politics. On transparency, Chapter 5 discusses the information requirement for financial market regulation. This depends on what the purposes of regulation are. Following the crisis, regulators recognise two new purposes: prudential regulation to reduce risks of failure and resolution planning to reduce the impacts and costs of failures that nevertheless occur. This chapter argues that the information requirements for these purposes are quite distinct. However, in the years immediately following 2008 a blurring occurred, as a result of which regulators became indiscriminately data-hungry. Increasingly, regulators seek and analyse trading data, that is to say categories of knowledge defined and produced by the market. However, regulators have difficulties in interpreting and utilising such knowledge, for reasons discussed in the first half of this chapter. Calls for yet more information about trading, posed in terms of the merits of transparency, can only result in information swamping of regulators. A focus on resolution of banks and other financial firms provides a more ‘doable’ information requirement. However, two regulatory concerns – over market connectedness and legal challenges by bank bondholders – seem to cut across the policy objective of reducing creditor bail-outs at public cost. To address these systemic and distributional issues, the design of resolution schemes should be publicly debated and democratically shaped.

The final chapter summarises and applies the lessons of the book as a whole. International market regulation evolved as private regulation with a public face, having developed within and been internationalised through the portal of the City of London. The default policy option of public bail-out of private risk-taking spread from the US to other jurisdictions. International networking and EU integration channelled these UK and US traditions and their consequences into European regulation. Regulatory cooperation took the form of intellectual herding and rule convergence, thus tightening
similarity, linkages and contagion potential within financial markets. The contradictory lesson learnt from the crisis by regulators was that systemic risks need to be addressed through macro-prudential regulation – generally favouring a continuation of international convergence – yet a continuing need for crisis management requires resolution capabilities and political assent, both of which remain primarily nationally rooted.

The chapter sympathetically but critically discusses the continuing tendency to bail out private risk takers. Subsidiarisation, a strategy for making financial entities resolvable, is portrayed as ameliorating ‘too connected to fail’, whilst not addressing the problem of similarity of business models. The book concludes by re-examining regulators’ role and their cooperation with each other in terms of their acceptance of democratic inputs and diverse outputs as global public goods. Regulators already support each other by learning from differences. In order to give financial market regulation some legitimacy and also to reduce the potential for financial markets to be ‘too big’, ‘too connected’, ‘too similar’ and systemically contagious, democracy and diversity need to move centre stage.

Some debts incurred: acknowledgements

This book incorporates some elements from work previously published elsewhere, these being variously reworked and updated. The exceptions are Chapters 1 and 6. Chapter 1 seemed to force itself on me, as a framing chapter, when according to the timetable agreed with the publisher I should have been finishing the manuscript. Regarding Chapters 2 to 5, acknowledgements are gratefully made to the following journals and edited books and to their editors and publishers. Because chapters within books are now sold separately as well as together, specific acknowledgements have been incorporated in the chapters to which they refer; they are also collated here.

Chapter 2 is a revised version of work originally published in 2012 in Law and Financial Markets Review 6(4) 271–83, and is published here with the permission of Hart Publishing. Chapter 3 incorporates work originally published in the British Journal of Criminology, which is published by Oxford University Press. Chapter 4 incorporates some material published in two sources, the first being ‘Render Unto Caesar: EU Financial Market Regulation Meets Political Accountability’, which was published in 2012 in the Journal of European Integration 34(3) 205–21 and is reproduced here by permission of Taylor & Francis available at http://www.tandfonline.com. The second source is ‘Connectedness, Crisis and the Challenge to European Democracy: from rapture, through fear, to banalisation of financial markets’, published in 2013 in a collection edited by Cruz, Leite and Faria under the title Infrações Económicas e Financeiras: estudos de criminologia e de direito (Economic and Financial Offences: criminology and law studies), Coimbra Editora, Portugal. Chapter 5 is a revised version of ‘Knowing markets: would less be more?’
Economy and Society 41(3) 316–34 (2011). Apart from those specifics, there is also some minor self-plagiarism that remains within the bounds of fair use.

The author extends personal thanks to the many people who variously invited him to participate in conferences, to participants in those conferences and to all those who helped through critical discussion. It would be unmanageable and invidious to try to list all such interlocutors; however, once again the CRESC team at Manchester played a facilitative part, especially Mick Moran and Karel Williams. The author’s recent Erasmus University Rotterdam colleagues Henk van de Bunt, René van Swaanningen, Judith van Erp and Clarissa Meerts deserve mention, as do his postgraduate students. There is nothing quite like teaching an interdisciplinary course on ‘global governance’, with students from all parts of Europe and further afield, to see if one is making any sense. Simone White, Mike Levi at Cardiff and Tom Vander Beken at Ghent have always been supportive. The author adds thanks to those involved in refereeing and editing – largely hidden labour, yet a vital part of the knowledge process.
Part I

Historical legacies
This page intentionally left blank
This chapter explores the historical pedigree of financial market regulation, through a UK focus and chronology beginning in the early 20th century. The writ of the sovereign stopped at the gates of the City of London, the coming of democracy making no difference there: private regulation within banking and other financial services continued. The Second World War saw the Bank of England become a public body but its functioning was unaffected. From the 1970s, self-regulation was absorbed into and codified within a formally public regulator. This resulted in ‘light touch’ regulation, which is reconceptualised as the institutionalisation and internationalisation of self-regulation behind a façade of public regulation. These historical developments had a consistently democracy-excluding effect, which was deepened by international networking and convergence of thinking amongst regulators.

Subsequent chapters show how these British influences, together with US regulators’ long-running commitment not to allow ‘significant’ (large) financial firms to fail, provided the breeding ground for crisis and continue to do so. Throughout the book some ‘post-crisis’ counter-tendencies will be discussed, pointing in the direction of ‘cooperative decentralization’ of financial markets regulation, including subsidiarisation, resolution planning and, more fundamentally, politicisation.

The history outlined here suggests that there can be no ‘return’ to some earlier, industrious society in which finance was a servant; no ‘re-regulation’ that puts the genie back into the bottle. As will be illustrated here, regulation was enshrined within public institutions in the pre-crisis years and took the functional form of collective private regulation. Of course, there have been several periods of challenge to finance – this chapter will note one such period in the early to mid-20th century; however, in the long run finance has a tendency to re-emerge as the ‘sovereign’. This condensed, critical history is offered as a part of the ongoing search for an alternative. Revisiting the history of financial market regulation sensitises us to some pertinent long-term issues, which call into question the scope of the rather reactive reforms of financial markets that have snowballed since 2008.
Not much presented here is new: the author unashamedly and gratefully rides on the coat-tails of specialists in British history, culture and class relations in relation to the City, the Bank of England and other economic and political interests. What may be new is the bringing together of a backward glance at 100 years of regulation with some questions about the future of national, regional and international architectures and functioning of financial market regulation. The strategic aim is to unsettle conventional assumptions.

For example, can the condition of financial markets that is variously called ‘too big to fail’, ‘too connected to fail’ and ‘too similar to fail’ really be rectified through more detailed rule-making and greater regulatory convergence? Even many regulators doubt that. Why then does regulatory cooperation tend to strain towards complexity and convergence as its strategy? The answer lies partly in the interests and influences of large financial market firms, whose interests are served by a level playing field. However, there is also something in the history, culture and functioning of regulatory networking that points in the same direction, as explored here.

A related conventional assumption, which is taken aim at here, is that expert and technical knowledge constitute the proper basis for reform – and that, by contrast, Joe Public is a clot, whose attention is best focused upon market wrongdoing, indignation and naming-and-shaming. If technocratic experts meeting in international circuits know best, and if Joe Public might endanger the system, then it might be thought to follow that democratic inputs are to be carefully managed, rather than being seen as the motor of policy-making. That would extend the historical logic of the last 100 years. Financial markets have come to be something of an exception to the supposed general rule of democratic direction of policy-making.

Four reasons for starting with London

Undeniably, different countries have differing histories, economies and cultures and these differences have impacted the historical development of their financial market regulatory regimes – which interact at the international level in complex ways (Vogel 1997). Prospectively, as is argued throughout this book, such differences should be regarded as assets – from the points of view of prudential regulation, stability, resolution and ability to recover from crises. Equally, recognition that jurisdictions have specific regulatory histories alerts the reader to a potential danger: (over-)generalising from a case study of any one national or local context. Obviously, any narrative has to start somewhere but what could justify starting with any particular region, country or city. Why London?

There are some good reasons for saying that, despite the particularities – indeed idiosyncrasies – of the historical development of UK financial market regulation, taking it as a starting point reveals something about Western financial market regulation as it has evolved in an increasingly internationally
networked manner. The first point, a common-sensical but minor one compared with those to follow, concerns London’s international position and ‘weight’ in market terms. The City rose to international prominence as a financial centre over a long historical time period, first displacing Amsterdam and then outstripping Paris, Berlin and even New York (Cassis 2005; Michie 2006).

This chapter does not cover the earlier history but takes up the situation as it was at the start of the 20th century, tracking bank regulation through wars, recessions, the mid-century relative decline of London and its revitalisation as a global platform. By the 2000s, London had reinvented its traditions and market offering to become the largest international financial market prior to the crash; the US market was bigger but more domestically focused. That international weight is a part of the justification for starting with London.

Secondly, and rather more fundamentally, London rose to international prominence partly because of the ‘light touch’ regulatory regime then offered by the UK which, from a stricter regulatory perspective, might be considered as ‘offshore’. It is widely accepted that, prior to the crisis, UK regulation came close to being self-regulation; moreover, the British authorities rarely brought enforcement actions. These features had long attracted criticism from US commentators on competition grounds, as well as from European commentators critical of neo-liberal ‘hands off’ approaches to markets generally. Nevertheless, prior to the crisis, the City of London retained a certain reputational charm, sufficient not only to attract ‘innovative’ international business but also to define an era. London provided a base for many of the firms and types of transaction that were to prove most problematic, thinking for example of American Insurance Group, whose Financial Products division in London insured sub-prime bets, and thinking also of Lehman Brothers International, whose demise is conventionally cited as the epicentre of the crisis. (See, however, the discussion of jurisdictional arbitrage in Chapter 3 and the rebuttal of the conventional Lehman story there and in Chapter 5.)

In any case, by 2007 the City had become a standard-bearer for those aspects of regulatory culture which became implicated in the financial crisis. By doing business through London, foreign firms and individuals were able to circumvent the somewhat tighter regulatory requirements of some other jurisdictions. The eventual consequences cannot all be laid at the feet of London, as other national regulators came to perceive that ‘their’ firms could do good business through London, so chose not to spoil the party. The success of the City coloured the international regulatory climate.

To arrive at the third – and most fundamental – justification for starting with London, we need to distinguish between analyses made in terms of deregulation and in terms of depoliticisation.

Characterisations and critiques of deregulation are widely found in the international literature and in contemporary debates on regulatory reform.
A strict reading of that, term, deregulation, would suggest that regulation of financial markets had evolved historically, yet then was reversed, rule books being torn up, resulting in a free-for-all and crisis. That, however, would be empirically incorrect. In the decades prior to the crisis there was a veritable explosion of regulatory discourses, principles, rules, sub-rules, guidance and so on, in all the leading financial centres (Moran 1994). What is really meant by critics of deregulation is that, whilst many innovative market practices were tolerated, these and older practices were hedged around by ever-expanding thickets of rules – many of which, however, amounted to little more than a public blessing of firms’ wish-lists, based on the latters’ (not always perfect) understanding of their own interests.

This begins to move our understanding in the direction of ‘public’ regulation as being a façade for self-regulation, as explored here in relation to London (and having wider applicability, as other chapters show). It also put some question marks around the advisability of calling for reregulation (‘more regulation’). That could simply mean business as usual, in terms of public regulation enshrining the creativity of private actors. A further disadvantage of blaming financial crises on deregulation is that it would leave unexplored questions of political control and of international convergence/diversity. If all that is required for the future is ‘more’ regulation, then that could be delivered in technical, expert, independent and depoliticised forms (again as it was prior to the crisis). A debate in terms of deregulation and reregulation too easily slips into advocacy for the ‘rule of experts’ (Engelen and others 2012).

By contrast, telling the history of financial market regulation as a depoliticisation story avoids (re)regulatory nostalgia and subservience to technocracy. The depoliticisation story, told here in relation to the UK, is that rather than regulation of financial markets first evolving as a robust and public form, which was subsequently weakened, public regulation of financial markets never took hold, except in the mystifying form of a masquerade: private regulation behind a public façade. The applicability of the depoliticisation story to the development of (self-)regulation in the City of London raises a political irony in relation to the claim sometimes made that the UK is the mother of democracies.

Fourthly, beyond irony, and most importantly from a global point of view, the British were (and remain) very ‘hands on’ in shaping the international regulatory architecture. This has resulted in a second level of depoliticisation of policy-making: after domestic depoliticisation, meet international depoliticisation. UK regulators have been highly active in international regulatory networks, starting with the Basel Committee on bank capital standards from the 1950s onwards (see below). By internationalising the process of agenda-setting in financial market regulation, these networks helped to keep agenda-setting above elected politicians’ heads, hence also above political parties’ heads, so turning potentially political questions into technical issues.
This does not mean that national law-makers cannot tweak proposals; it means that they are faced with a ready-made agenda, considerable detail and pressures not to rock the boat.

Understanding how institutional arrangements, thinking and practices were arrived at within the global platform that the City became and their spread into international markets and regulatory networks, is a useful resource for thinking about future policy options for regulatory design. The wider significance of the City of London is that, just as it ‘imported’ much of the international trade in financial services into its jurisdictional space, it also ‘exported’ its ethos. The extraterritorial concerns and local autonomy of ‘gentlemanly capitalism’ – discussed below as having constituted the historical basis for the governance of the City of London in the first half of the 20th century – did not pass away; rather, they diffused into governance at a higher level.

These four characteristics of UK financial market regulation – its hosting of the largest international platform, its market offer of offshore-like self-regulation within a classy wrapper, its ability to keep these issues off the political agenda (despite some historical challenges, see below) and its central involvement in the formation of international regulatory architectures and culture that in political terms echoed the characteristics of its domestic form – make the case for an initial focus on the UK’s regulatory regime. The question then is: How did the City come to occupy such a central place? The story evolves along three dimensions, each marking an historical period.

Political naturalness of self-regulation: town, country and bank

Twentieth-century self-regulation in the City can be traced back to a longer and wider history of self-regulation of economic life, through trade guilds and the professions. Rule-making and enforcement in such groups were rooted in direct social contracts between traders, clustered in discernable, geographically specific, culturally coherent communities that possessed – highly relevant for the purpose of the present discussion – moral, affective and (self-)regulatory coherence. Sociologist Alex Preda (2005: 455) has applied Weber’s notion of ‘status group’ to such communities:

Status groups are defined through common rituals, habits, ‘tradition’, prestige, and the ‘monopolistic appropriation of privileged professional chances’ [according to Weber]. Rituals regulate conduct of activities, access, time and space. Rituals also generate categorical identities and personal reputations [. . .] Monopolistic appropriation can be achieved through a mix of economic and social criteria: for example, membership fees can be combined with apprenticeships and/or with social origin in order to restrict access. By combining monopolistic appropriation with
specific rituals and traditions, status groups integrate two mutually reinforcing aspects: a charismatic, prestige-based one, and a means-rational one.

The prerogatives of such self-organising groups became recognised in legislation from the 17th century in England, from the 18th century in France and in the 19th century in the US, Preda reports (ibid: 459–60), making what Max Weber (2000, 326–27) called ‘closed clubs’, constituting a ‘monopoly of the rich’. Such self-organisation not only serves practical purposes within the trading community (resolution of disputes, etc); it also has political boundary-maintaining purposes, in two senses. The economic activities in question were reserved for those who had been accepted into the group (guild, cartel). Moreover, private regulation (as we would call it today) kept at bay any outside interference in the rules of the game (cf Gilligan 2014, who puts things in terms of the relative autonomy of the City of London).

However, the political character of City financial circles was not simply a matter of localised cartels, entry barriers, restrictive practices and conduct expectations. The City as it emerged from the 18th and 19th centuries was equally defined by connections with the aristocracy, producing a ‘gentlemanly’ City culture. Relations between the landowning classes (‘country’) and financial traders (‘town’) had consequences for the governance of banking and other financial activities. As Hopkins described it (1988: 6–7), the evolution of finance from the 19th to the 20th century involved:

progressive, profit-seeking activities which can properly be called capitalist. But their capitalist qualities were of a particular kind, being associated with managing men and money rather than machines, and being removed from direct contact with the world of manufacturing in the Midlands and the north. They pointed the way forward to an economic order which remains easily recognisable today, but they also proved to be compatible with the existing social hierarchy, and thus enabled change to be combined with stability. The leading representatives of the City and the service sector in the south-east not only made large fortunes, but also made them in ways which were socially acceptable: they were gentlemen as well as capitalists. [They later] adapted, cautiously, to the dangerous world of democratic politics.

The key point is that, although ‘The City’s overt political influence remained limited’, as Cain and Hopkins (1987: 6) put it, this reflected the general understanding that finance questions ‘were regarded as being beyond the realm of party politics’. If something is understood to be outside the party political arena, then it does not need any influence over the latter nor defences against it. The governance arrangements in place were symbolically represented and deeply entrenched:
The Stock Exchange and Lloyd’s were beyond the purview of the state. The City policed itself, which meant, according to some critics that it did not police itself at all. This was something which permeated the whole of the City. The corporation and the guild companies had managed to avoid reform, so that they still remained largely beyond government control. The ancient right that the monarch could not enter the City without the permission of the lord mayor survived and this privilege had, in a sense, been inherited by the commercial and financial institutions of the City.

(Daunton 1989: 154)

Replace the word ‘monarch’ in Daunton’s statement with the word ‘Parliament’ and one arrives at a definition of financial market regulation that proved resilient in the face of democracy.

Along similar lines, the historical literature debates the relationships between parliamentary politics, cabinet policy-making, the Treasury, the Bank of England (henceforth the Bank) and City firms. Here we do not need the detail, only the headline governance consequence: the Bank maintained close relationships with established City banks, acting on the market as an older brother, through ‘moral suasion’, whilst insulating the sector from direction by or interference from government. Far from being a transmission belt for commands from government to the City, the Bank acted as one of several political cut-outs. The social cohesion of the London merchant banks created:

conditions in which the Bank of England could function as the regulator, guardian and guarantor of the British financial system without statutory authorization or constraint. While it suited the collective interests of the merchant banks, the Bank of England was given the loyal co-operation it required to operate with extensive but unspecified authority. With the full support of the merchant banks, the Bank of England distanced itself from its own shareholders and from particular sectional interests, to become the mouthpiece and public symbol of a united City. [. . .] Thus, while the Bank could operate in ways that conflicted with the short-term interests of particular merchant banks, the latter’s social and moral cohesion guaranteed support for the Bank but at the same time demanded some reciprocity or compensation in the longer run.

(Lisle-Williams 1984: 359–60)

In short, the Bank adopted as policy the interests of leading banks as seen by their proprietors and, within that framework of private regulation, dealt with problems as they arose and policed the perimeter, keeping unwanted influences at bay. On the basis of careful mapping of economic and marriage linkages between City bank proprietors and country interests, Lisle-Williams
suggests that linkages were tightest for the larger merchant banks such as Barings, being relatively diffuse elsewhere. There was a ‘relative density of social ties between merchant banking families and the influential, long-established core of the aristocracy [which was] highly influential in the Bank of England’ (ibid: 358, 359). The *sang-froid* was subsequently to come under a little strain at certain times during the 20th century, although it weathered all storms through to the 1950s–1980s when – rather than being defeated (as many accounts of post-war financial regulation have it, see for example Moran 1988) – it intelligently mutated into something more modern and mobile.

**International inclinations, domestic disdain: first half of the 20th century**

For the City, there were two potential domestic sources of interference or challenge: industrialists and their employees. There were also external sources of problems: wars, recessions and international competition. We discuss the internal challenges first. Both the working classes and industrial proprietors became restive at certain times. However, neither acting alone nor any combination achieved any leverage over the City; in fact the opposite was true. The politically insulated nature of financial markets became increasingly politically noticeable during the First World War and in the run-up to 1918, when the UK introduced the universal franchise. Internationally, political pressures were acute – much enhanced by the revolution in Russia, which involved the dispatch of the ruling classes there – and in the UK the question arose as to how to reconcile existing prerogatives with the granting of wider political rights. Should the guilds, trading associations and professions (cartels as we would call them today) be opened to all, and should they be governed by Parliament – or alternatively should they be exempted from interference by that potentially unruly and unfriendly forum? One need only pose the question to identify the arrangement arrived at, at the time of the granting of universal franchise:

The Bank of England, which had hitherto been fairly marginal in the regulation of the City, now emerged as a critical institution. It used its authority to reshape the government of markets. The war had destroyed the kind of open international economy of which the City had been a centrepiece. After 1918 City markets were organised into a series of cartels policed by trade associations. The cartelisation of the markets, coupled with the authority of the Bank of England, was sufficient to sustain what the City called self-regulation: accepting the disciplines of self-regulation was the price firms paid for being allowed into the privileged cartels. The stability of the self-regulatory system in the decades after 1918 allowed the City further to elaborate its regulatory ideology. This pictured the
City as a special part of the economy, claiming exemption from one of the main features of 20th century economic government in Britain – the apparently inexorable rise of the state as a regulator of economic life. (Johal et al 2012: 69)

City self-governance continued, side-stepping democratic control. This was partly because of the strength of the union between the City and the upper classes, and partly because the City had political salience for the industrial classes only insofar as the City seemed to affect immediate material conditions. Thus criticism of City banks, insofar as it was voiced, focused upon their disinterest in supporting British industry. In the 1920s the accusation was that a City of London elite, partially intermarried with the aristocracy, was not only socio-economically separate from but also culturally indifferent to the industrial classes outside the capital and the need for domestic investment.

The contrast often made at the time (and also in the 1970s, see later in this chapter) was with the German banking system, which was closely intertwined with industry. However, whilst some of the literature on Britain’s industrial decline bemoans the City’s indifference, other more City-friendly commentators point out that British industry was traditionally serviced by local and regional banks, which had only relatively limited resources. Others have highlighted the commercial operating requirements and/or structural characteristics of City banks. Ross (1996: 328), for example, says that City banks had to have an eye on the liquidity of the markets in which they operated: investment in industry was relatively long-term. Williamson (2004) maintains that it was not the responsibility or destiny of British banks to support industry: London finance represented a more advanced and successful form of capitalism than German banking, and much of British manufacturing was on the skids in any case.

The investment activities of the City over the centuries make it clear that its gentlemanly capitalists (Cain and Hopkins 1987) might have been culturally and politically disinclined to support the industrial efforts of compatriots in the Midlands and the north of England, yet they had no general bias against investing in industry or infrastructure, as long as there were prospects for thumpingly good returns. This more often meant abroad than at home. As an oft-cited article in The Economist had put it in 1911: ‘London is often more concerned with the course of events in Mexico than what happens in the Midlands, and is more upset by a strike on the Canadian Pacific than by one in the Cambrian Collieries’ (cited in Hunt 2004). If German finance capital cared to blunt its international prospects by investing in ‘its’ industry, allowing the City the edge internationally, so be it (see also Walker 1980).

The political bargain of 1918 stayed in place, largely insulating finance from the fortunes of other sectors. That division also survived a change in political climate, in favour of planning for post-war reconstruction. In the US
the 1930s had triggered a more interventionist state, in the shape of the New Deal, and during the 1939–45 war the US was the prime mover in an effort to create a new international economic order, corresponding to the longed-for international peace. This resulted in the Bretton Woods institutions and the attempt to stimulate international trade by flexible management of major currencies, meant to facilitate Keynesian efforts to support domestic investment, employment and social welfare – changes which for some commentators represent a ‘structural break’ (Helleiner 1995: 316). Around these efforts there arose ‘a new class of professional economists and state managers, whose social base was amongst labour and national industrial leaders [who] favoured more interventionist policies that would make finance the “servant” and not the “master” of political and financial life’ (ibid). That was not to be.

**Innovation, Europeanisation, reinternationalisation: 1950s onwards**

Whilst financial market self-regulation had barely been disturbed by domestic political and economic developments in the first half of the 20th century – including the granting of the universal franchise (not relevant, since finance positioned itself ‘outside’ politics) and Britain’s slide into industrial decline (not relevant either, because the City looked abroad for its opportunities) – the City did suffer from international developments. The 1914–18 war had reduced international markets, this being exacerbated by recession in the 1930s and the war of 1939–45.

All these conditions contributed to a trimming of the City’s international profile between 1914 and the 1950s. It became more domestically focused, less footloose and, potentially, more open to direction by new forces, both domestic and international. Domestically, the City banking lineage and organisational principle remained social class. Even though, in the spirit of the times, the Bank of England was nationalised in 1946, that in itself made little difference. Social class remained cohesive and unchallenged as the glue binding together the largest and most established banks and their regulator. Despite two wars, one serious recession and the ongoing modernisation of the wider society, the City maintained its self-governance. As Susanne Lütz (2004: 173) summarises from a number of sources:

Statutory regulation played a relatively minor role in the prudential control of banks. The Bank [of England] continued the long-standing tradition of a light supervisory touch whose only threat was expulsion from any of the various banking associations. When the central bank was nationalized in 1946, the new Banking Act gave it the right to issue ‘directions’ to bankers thought to be in need of corrective action. In
practice however, informal guidance or ‘moral suasion’ of the Bank sufficed. Section 123 of the Companies Act of 1967 conferred a form of privileged status upon certain banking institutions. Certificates were granted to those deemed bona fide carrying on the business of banking. The practical effect was to establish a status ladder which could be climbed by banks as their reputation grew and their expertise developed. [. . .] The Bank developed clientelistic relationships with the senior management of the Clearers which were on top of the status ladder. Mutual understanding between the top management of the city banks and board members of the Bank of England was enhanced by common class and public school background.

So, at least until the 1950s, class acted as a constitutive force, constructing regulation on an economic and cultural terrain in which the mentalities of those within the Bank of England and within the bigger banks remained closely intertwined, indeed almost indistinguishable. At the social and cultural periphery of the City, however, things were different. Lower status, less well connected City firms were more or less left to their own devices. This opened the door to scandals, to be discussed.

Internationally, even peace brought challenges. The City’s position in the post-war period was very much as the junior partner of US capital. However, eventually a way was found to recreate London’s historical position in financial services. Cain and Hopkins (1987: 17) put the general situation in the following terms:

In the Great War, Britain had needed American capital to secure victory: after 1939 her very survival depended on American aid. [. . .] The initial quid pro quo sought by the United States for her extensive aid was the abolition of imperial preference, the destruction of the sterling system, and – ultimately – decolonization. However, with the emergence of Russo-American antagonism after the [second world] war, all these elements of Britain’s world power survived as valued assets in the Cold War, so much so that sterling was launched on a new international career in the 1950s as a junior partner of the dollar. Gentlemanly capitalists who had once provided the framework for the Pax Britannica now survived to fight another day under the protection of the Pax Americana.

Faced with this role as junior partner, the City could either sulk, turn inwards and accept the role of a subordinate, or seek to regain the advantage in the new international order. The latter course emerged. Three international turns were made by the Bank of England from the 1950s onwards.

• The Bank began to open up the City, by giving assent to financial innovation and the new players best able or willing to drive it, ditching
the cartels in favour of those new forces – which were allowed to be even more self-regulating than the cartels had been.

- It cautiously aligned its agenda with a pro-market vision of the European Community, going as far as ‘technical’ involvement in planning for monetary union.
- It initiated, encouraged and shaped international networking between regulatory peers, which came to function as a channel for diffusion of views and regulatory influence both within Europe and at home. By widening its networking, from local to European and international channels and whence back down to national channels, the Bank played a key role in maintaining and elaborating financial regulation as a depoliticised space. Furthermore, when faced with serious external and internal challenge – a sterling crisis and demands from the International Monetary Fund (IMF) in 1967 – the bank used the gravity of the situation as leverage, pushing the then Labour Government into submission and distributing the costs in a manner that did not hurt the City (see further below).

Through these means, City firms and the Bank of England together rediscovered (or rather, reinvented) a global perspective, which had been strong up until 1914 but had been somewhat submerged by two wars and inter-war recession and the rise of the US. This (re-)internationalisation was driven from the 1950s onwards by the City more than by government. Only after the principal outlines had been laid and found to ‘work’ – from the point of view of providing London with a considerable international competitive advantage – did the state step in, from the 1970s onwards, to consolidate, generalise and formalise arrangements (resulting in the so-called ‘Big Bang’, a Securities and Investment Board (SIB) and eventually a Financial Services Authority (FSA), to be discussed below).

We start with the cartels and the Bank’s progressive letting go of them in favour of financial innovation. For the first half of the 20th century, the Bank had favoured the continuation of self-regulation of City cartels, seeing this as a way of ensuring stability – the closed community was seen as a moderately effective self-discipliner (Schooner and Taylor 1999). However, from the 1950s onwards, a series of market-based and (cautiously) Bank-supported developments resulted in the opening up of London, a process that was later, in the 1970s and 1980s, legislatively formalised by Labour and Conservative Governments. The initial market driver of this process was the invention of new international markets, called ‘euromarkets’, of which the first was the Eurodollar market.

This terminology is somewhat confusing from today’s perspective, since the birth of these instruments of course had nothing to do with the euro, which did not then exist, nor even anything to do with the European Community (EC), which was then only coming into being. However, the terminology
makes sense from a US perspective, given that the market developed in the UK, seen from the US as part of Europe. Euromarkets were dollar-denominated instruments which, as with much financial innovation since then, arose in response to controls, in this case US exchange controls on the dollar. US citizens and US firms had dollars for international investment but were legally constrained in their international deployment of dollars through US exchanges. However, London traders, cautiously (at first) abetted by the Bank of England, developed instruments involving transactions via London firms (see *inter alia* Burn 1999).

As the trade expanded, the UK Treasury (possibly acting also for the US Treasury) made enquiries of the Bank of England as to the characteristics and size of the trade and which London banks were principally involved. The Bank refused to give such information. This had the effect of politically ‘insulating’ the trade (ibid: 240). The Bank pointed out that trade was not covered by any UK legislation as long as non-UK residents were involved and the Bank had no obligation to report to government. As for its policy as a regulator, the Bank left the parties involved to regulate themselves – a forerunner of policies to come in future decades, as the City developed as a kind of ‘offshore’ financial centre, in which some trades that elsewhere might be forbidden or more restrictedly regulated could take place in London to the latter’s advantage.

Tellingly, seeing the Bank’s position and the upward curve of the trade, the Treasury saw no need to introduce legislation. In the early 1960s the Bank took steps actively to facilitate the Eurodollar market – in stark contrast to some other European jurisdictions in which this market became specifically legislated against (Lambie 2013: 345). The trade boomed in London.

There is a regional link to be made here, between these market-driven, Bank-facilitated developments and the UK’s tentative approaches to the European Economic Community (1961 and 1969) and its eventual membership (1973). There was support for British membership from big business (exporters) and consequently within the Conservative Party, with some opposition from the left. However, there were domestic and external obstacles: domestic reservations over the prospects of being drawn into political union and monetary union (reservations shared across the political spectrum) and suspicions in some existing EC Member States about the UK’s free trade agenda for the EC (President de Gaulle had blocked British entry in the 1960s). In the UK, the EC was commonly described as ‘the Common Market’ and it was that *market* vision that was aimed at by proponents. Even so, free traders were concerned that the EC would be insufficiently open to global trade and for a while the UK pursued the competitive strategy of championing the European Free Trade Area (EFTA) as something to which the EC might eventually capitulate.

The literature refers to a number of considerations that caused Britain finally to go into the EC. Britain’s economic decline and weakness is
commonly cited as a reason for entry, as is the strong support of the US for the EC as part of the security architecture and political counterweight to the Soviet Union (Milward 2002). Relatedly, it has been suggested that, by entering the EC, Britain’s becoming ‘a vehicle and protagonist for the globalisation of Europe’ (Gifford 2007: 465), which, if correct, confirms what de Gaulle had feared. Entry not only helped to open up the EC to international trade, but it could also be seen as a meta-reform at home: ‘membership of the EC was trumpeted as a liberal measure opening up British markets to competitive pressures that would force [UK] business to rationalise’ (ibid: 467–68).

Reciprocally, British entry into the EC could be seen as a part of the politics of opening up the British economy, including financial services, to the rigours of a global economy. If these consequences were taken into account by the Bank of England at the time, then they might have been found to be compatible with the Bank’s then-emerging strategy of encouraging innovation, internationalisation and decartelisation in the City. Some evidence does suggest that the Bank was strategically pro-EC, acting in accord with the City’s historical international orientation. For example, to the considerable annoyance of Prime Minister Margaret Thatcher, Governor of the Bank Leigh Pemberton later went so far as to sign the 1989 report of Jacques Delors on monetary union – although possibly doing so somewhat in the spirit of a technical exercise with European peers, without believing that it could come to pass (Guardian 1989).

There is a link between the Bank’s preparedness to be seen to be working with the EC and its broader international networking. They are clearly related. Understanding and shaping the emerging EC agenda on financial service regulation facilitated the bank’s domestic agenda-shaping, underlining that Parliament was the agenda-taker. According to the European and international relations literatures on single- and multi-level games, policy agendas may be constructed within regulatory niches at domestic level. However, these agendas are strengthened if they can be adroitly rocketed up to international networks, where they are negotiated with other insiders, the settlement of which then parachute down to the European policy machine. Eventually, these agendas come to national parliaments as European legislative proposals, leaving little leeway for change and already endorsed by two higher level actors. The temptation to get ahead of the curve, to get in at the drafting stage, is clear. Michael Moran (1994: 162) has noted that:

The Bank of England was the major promoter of regulatory change in the 1980s. It promoted change in the interests of defending London’s leading position, and with good reason. London’s status as a major financial capital allows the Bank to play a leading role in the international community of central bankers. How else could the central bank of a declining industrial power with a weak currency hope to play a leading
role on the world stage? [. . .] Occupying a leading place internationally has become more important with the development of transnational networks of institutions supervising financial institutions. The Basel Committee on Banking Supervision, and the International Organisation of Securities Commissions (IOSCO) provide institutional bases for these networks among the leading capitalist states. Taking a leading part in these organisations is a great source of job satisfaction for individual regulators, and a source of prestige for national regulatory institutions.

International and/or regional negotiation of the agenda is the most sensitive and generally the most decisive aspect of domestic policy formation. Where opportunities to be included at that early stage are lacking, because international networks are only loosely organised, it makes sense to tighten them and to institutionalise new fora. That is what the Bank of England did in respect of the Basel Committee on bank capital adequacy standards.

The process may be illustrated through ironic remarks made in 2013 by British Conservative Member of the European Parliament Kay Swinburne, to the effect that the European Commission tends to indulge in ‘political front-running’ (unscripted remarks made at a meeting on ‘Financial indices and benchmark settings: the road ahead for Europe’ on 27 June 2013 at the Centre for European Policy Studies, Brussels). In market and regulatory parlance, front-running refers to a form of insider trading in which, seeing that a large trade is about to be made, a market insider seeks an unfair advantage by trading ahead of it. Political front-running, by analogy, is when a political actor sees which way the policy wind is blowing and seeks not simply to join the parade but to get in the front line and take over the megaphone.

In the present context, an allegation that the European Commission is politically front-running means that the Commission looks to see what policy proposals are emerging from the wider international debate and then seeks quickly to propose binding EU legislation to that effect. The Commission is happy – the paperwork is quickly and efficiently assembled, political assent is obtained and legislation occurs – whilst those national regulators who negotiated the agenda through international networks may be even happier. It is not surprising that governors of the Bank of England should be prepared to risk the ire of mere prime ministers in order to facilitate such governance mechanisms.

To summarise, it can be said that, stimulated on several fronts simultaneously – international commercial challenges to the position of the City of London (from US, Japanese and European finance capital), the quandary of how to respond to the EC and a post-Second World War political atmosphere that eventually brought to power a left-of-centre government – the Bank of England stepped up its international networking. This facilitated the Bank’s influence both in the EC and at home. Agenda-making, which had been in the hands of national elites, shifted to a higher level.
The sterling crisis of the mid-1970s and the resulting reconfiguration of UK fiscal policy are touched on only briefly here (for detail and sources, see Lambie 2013). What is of interest for present purposes is the relationship between the City and the government of the day. On coming into power in 1974, the Labour Government faced a continuing decline of the manufacturing base. During this period there were voices on the left calling for radical steps: not only nationalisation of wide sections of industry but also of the banks and the stock exchange, with further steps to be taken in relation to the Bank of England which, although nationalised during the war ‘has yet to be socialised’ (cited in Lambie 2013: 250–52).

In 1976 the Bank of England ceased to support the pound, the Treasury provided the government with worrying forward budget projections and, after considerable debate, an IMF loan with conditions was agreed. This decision was noted with relief in the City and by US officials who, believing that not only international financial markets but also the Western alliance were at risk, had spent time briefing not only the government but also the then opposition leader Margaret Thatcher (ibid: 355). The Bank of England was politically very active in this period, as indeed it had been in an earlier crisis in the 1930s, seeking to ‘win the Labour government to retrenchment’ (Janeway 1995: 263).

Seen in historical perspective, the universal franchise of 1918 had at no time resulted in a public politicisation of bank regulation. On the contrary, banking retained its capacity to bring its private governance into government. The Bank of England has channelled the historical interests and values of the City, at times playing its hand rather bluntly and at other times rather creatively. In particular, considering the Bank’s shifts in the 1950s–60s – from safeguarding the tradition-bound incumbent banks to letting them sink or swim, from market conservatism to tolerance of and support for market innovation, and from a domestic focus to an international and European orientation – all these shifts can be seen as interlocking elements of its strategy for post-war revival of the City’s fortunes.

The regime that emerged became relatively influential within the EC and its successor the EU. The agenda and positions taken by the European Commission – conventionally regarded as the initiator of legislative proposals in the EU – are at least partially shaped by the agendas and positions developed by international networks and committees on banking, securities and other aspects of financial markets. Importantly for our understanding of the past, present and possible futures of financial market regulation, the City-Bank nexus renovated private regulation from the 1950s onwards in ways that anticipated government action in the 1980s and 1990s.

**A public face for private regulation: 1980s–90s**

Bringing the state more centrally into the regulatory story, the SIB was established in the 1980s, this being replaced by the FSA with capacity to
promulgate and enforce regulatory principles and rules in securities markets and in banking – displacing the role of the Bank of England in the latter respect (Financial Services and Markets Act 2000). This is conventionally represented as the beginning of public regulation of the UK securities markets and other financial services. The FSA’s approach was ‘principles based’ regulation, which in time was to become to be seen as ‘light touch’ regulation, importing assumptions and models from its increasingly international regulatees and outsourcing supervisory duties to them.

This section of the chapter gives reasons for differing with the proposition that, with the SIB and then the FSA, public regulation had been established. Rather, what occurred was institutionalisation and codification of private regulation behind a public façade: public regulation in name only. Bureaucratic, yes, and in that Weberian sense, state-like. But functionally, no: not so much light touch regulation as self-touch. This was a continuation of financial market self-regulation under the rubric of ‘the public good’.

The Bank of England’s post-1945 international networking, its European influence and its benign neglect in relation to market innovations from the 1950s and the government’s formal opening of the City in the 1980s and 1990s can all be seen as laying down the conditions for a modern renaissance of the City. It reconjured its centuries-old international offering and motored towards a new predominance. Nevertheless, success was hardly guaranteed and a foreseeable downside of opening up was catastrophic for established firms, which lost their market positions and, generally, their identities. Given the short-term impacts, why was there ineffective elite resistance to these changes?

A commonly-cited reason for weak resistance to these changes is a succession of scandals. Notwithstanding the commercial success of the Bank’s increasingly ‘hands off’ stance, opening up London to competition from non-establishment firms (British and also foreign, notably American, European and Japanese), not all the market entrants felt at all bound by (or even were much aware of) previous understandings. Indeed, in terms of cultural orientations and social linkages, the ‘club’ model obviously became inapplicable. The trouble came not from the fast-growing securities side (eg Euromarkets) but from incautious lending by banks, especially ‘secondary’ banks (banks other than the bigger and more established ones). There was a liquidity crisis, in response to which the Bank organised support from more established banks (Schooner and Taylor 1999). Moreover, by 1984 problems emerged in a financial firm, Johnson Matthey Bankers, which was classified by the Bank as being ‘of high reputation and standing’ and for that reason was very lightly supervised. Then in 1991 the Bank of Credit and Commerce International (BCCI) – as much an ‘outsider’ in British cultural terms as Johnson Matthey had been an ‘insider’ – was closed, amid allegations that the Bank of England had been negligent (Bingham 1992).
In the public and political scrutiny over Johnson Matthey, the Chancellor of the Exchequer, Nigel Lawson, made the rather English understatement that the Bank’s supervisors ‘did to some extent fall down on the job’. One backbench MP was less constrained, describing the Governor of the Bank of England as a ‘useless deadbeat’ (cited by Schooner and Taylor 1999: 633). Lawson later offered the rather more incisive explanation that ambitious Bank of England employees were attracted to the ‘sexy’ side of the Bank dealing with monetary policy, whilst the bank supervision side was regarded as ‘humdrum’ and a ‘backwater’ (ibid: 635 and Lawson 1992: 406). Indeed, such a status gradient continued in central banks and regulatory circles at least until the crisis beginning in 2007.

While scandals can weaken reputations – and the Bank’s reputation was credibly weakened by Johnson Matthey and by BCCI – scandals are rarely enough to bring about structural change. For that to occur, there needs also to be a vision of the future. Certainly in the UK there was a wider and more proactive impetus for change, coming from a perceived need in City and political circles (first Conservative, then Labour) to continue to make London as a venue more competitive internationally. Some other countries also began from the 1980s onwards to open up their financial markets to competition, however generally on terms that still favoured incumbents (‘national champions’). The peculiarity of London lay in a greater degree of opening up, with the position of the national champions being put at risk (and in most cases sacrificed) for the position of the trading venue. What vision drove such risky moves?

The Conservative Government’s turning against City incumbents in the 1980s had actually been signalled much earlier by the Bank of England, which initially rather cautiously from the 1950s onwards had tolerated market innovation, ‘non-establishment’ entrants, an acceleration of foreign firms and a letting-go of the old, high-status and class-based culture of control (see above). The Bank had also taken a hand in European market construction, even in the face of grave reservations in political circles in London and Paris (Gaullist suspicions over British hyper-liberalism being a trojan horse within the EC). The Bank had rekindled the international side of the City, helping it to develop international, dollar-based trades and to dominate the European single market in financial services. This put London on the path to becoming a global platform. For contemporary observers, these were exciting times. According to one popular account:

After years of being kept at bay by an anachronistic old boys’ network, foreign interlopers, armed with sacks of cash, were now free to take over some of the most hallowed of City institutions. UK retail banks, meanwhile, were free to set up integrated investment banking operations for the first time. Face-to-face trading was rendered obsolete with the
switch to dealing-rooms filled with electronic screens, which greatly increased the efficiency of the market. The new reality bore no resemblance to the cosy, clubby ways of the pre-1986 City. (Fortson 2006)

However, the final sentence in the above quotation requires finessing. Certainly the market was transformed: the UK did indeed import many foreign financial firms, variously displacing and replacing its native firms, but in doing so it effectively exported its self-regulatory tradition. On the one hand, the City was indeed ‘internationalised’, with most previous incumbents being decimated by incomers. On the other hand, such was the success of that project that, far from private regulation being extinguished, it vaulted from its ‘clubby’ niche to international prominence, as London became the venue of choice for international finance in the 1990s. Thus, the changes made by the state in the 1980s and 1990s followed the market’s own innovations and the Bank of England’s strategic turns to international and European circles.

Whilst standard accounts of this transition in UK financial market regulation describe it as momentous, epoch-changing and strongly directional – from market-based self-regulation, through nominal public oversight, to public regulation proper – we suggest that it is rather more difficult to interpret. In a commentary published in 2004, the new approach was appreciated on the grounds of being based in statute – in contrast for example with the regulation of accountancy, which continued (and indeed continues) to be self-regulated, giving rise to a perception problem: ‘private bodies, even with statutory recognition [. . .] are not necessarily well placed, or perceived to be well placed, to take into account the wider public interest’ (Dewing and Russell 2004: 114, original emphasis).

In another narrative: ‘All vestiges of the self-regulatory regime were swept away, and the traditional conduit between the City and the government was stripped of its oversight function, creating a new regulatory paradigm’ (Westrup 2006: 8). Writing in the 1980s, Michael Moran referred to governance of the City as becoming ‘politicised’, in the sense that the industry ‘lost the battle to keep the politicians and the civil servants at bay’ (Moran 1988: 26). However, he noted that the new system ‘is conventionally described as self-regulation within a statutory framework’. He went on to characterise it (1988: 24) as follows: ‘It is, in essence, a franchising operation: semi-private and private bodies (the SIB and the various Self-regulatory Organisations) will be awarded a franchise to exercise legally backed powers of regulation’.

This regulatory ‘franchising operation’ represented by the SIB and Self-regulatory Organisations (SROs) lasted half a decade before being replaced by the FSA. So, did the latter represent a shift from private or ‘franchised’ regulation to public regulation? Let us start with some practicalities, from the
point of view of market participants. The SIB and SROs presented a very complex structure, with many financial firms having to belong to several SROs (Moran 1988: 27). Whilst this system of ‘functional self-regulation’, with its many ‘overlaps’ and ‘duplications’ (Peeters 1988) might have been financially bearable for larger firms, it was administratively complex and also potentially off-putting for foreign firms, so not really in line with an objective of promoting London as an international centre. On coming to power in 1997, the Labour Government went further along the path, in accordance with its intention announced whilst in opposition, to change the Conservatives’ arrangements so as to bring about ‘independent rather than self-regulation’ (Bell 1997: 75). SROs and the SIB were replaced by the FSA, constructing a large, unitary but complex regulatory space, including ‘top level’ statements of principle, codes of practice and guidelines covering responsibilities of directors and senior management, including obligations for systems, controls and compliance. One possible reason for Labour to transform the regulatory architecture of the outgoing government may have been just that: political point-scoring. (There was a return match in 2012 when the Conservative Government dismembered Labour’s FSA.) At the time of its creation the FSA provided another opportunity to declare that, now, self-regulation really was finished. After all, the SROs were no more!

Was it a de facto disappearance or merely de jure? Looking back on those days with the benefit of hindsight, there could be grounds for saying that the disappearance of the SROs was illusory:

From the beginning the [Financial Services] Authority had an explicitly formulated philosophy of cooperative and consensual regulation: any kind of adversarial confrontation with actors in the markets was only to take place as a last resort. The origins of this regulatory philosophy lay partly in an instinctive cultural subordination to the markets, who after all provided its funding. In addition, while the Authority paid well by the standards of the public sector, in the overheated City labour market of the late 1990s, it certainly did not pay well enough to attract outstanding talent from the City. It suffered from high staff turnover and, as the detailed review of its dealings with the first high profile casualty – Northern Rock – showed, its relatively junior and inexperienced staff were easily overawed and dominated by the powerful personalities who led the most aggressively competitive institutions.

(Johal and others 2012: 71–72)

With the benefit of hindsight, it is clear that the ‘public’ nature of the FSA was indeed undermined by an economic and cultural subordination to the markets. The FSA was not funded by public funds but by a levy on the
industry; moreover, its public accountability was weak, an issue addressed by neither Conservative nor Labour governments. It was also quietly warned not to do anything that might be seen as killing the golden goose. Further, it was crucially dependent on the market for its information. The FSA was born into an age in which it had become normal for financial firms to develop and deploy proprietary information models in order to manage risk. Thus, in common with regulators generally, the FSA became reliant on the outputs of such models, whilst not being in a position to understand them (see also Chapter 5). Such reliance institutionalises the private as distinct from public nature of information for regulators as well as for firms. This was of course a global trend, in which London was a key participant.

In terms of the debate over the nature of regulation, private proprietary models can be seen in terms of resurgence, in highly technical and desocialised forms, of the private regulation characteristic of the City prior to the reforms of the 1980s and 1990s. Historical transitions in the ways in which knowledge is constructed – first from clubby chats to slide rules, then from slide rules to computerised models – certainly represented change. However, this was not change from private to public. Such knowledge remained private in two senses: (a) being constructed within the private sector, by regulatees; and (b) the regulators typically understanding neither the new models nor the metrics. As the sources of regulatory knowledge move from local and socially class-bound circuits to international banks and their quantitative analysts, it is hard to argue that the knowledge sheds its private basis.

Turning now briefly to perspectives on the 1980s and 1990s from the vantage point of the present time, clearly there is a danger of projecting current concerns back onto that earlier period. From the perspective of our experience of the crisis from 2007 onwards, we now ‘know’ that UK financial market regulation from the 1990s onwards was not only ‘light touch’ but also provided a series of regulatory lacunae through which systemic risks could build. However, such a retrospective analysis would fail to frame the forces behind the modernisation of the City from the 1950s into the 1990s. The transformation was animated by three visions: innovation, internationalisation and Europeanisation. It was driven by forces within the City and the Bank of England, extracting self-regulation from a restricted class context and codifying it as the basis for a top global trading platform. Certainly the formal ownership of regulation changed. The practices also shifted, geographically, from dispersed, private and localised locations, to international and virtual locations. Facilitating these locational shifts was continuity with and international merchandising of a deeper heritage: the pre-democratic autonomy of finance. The success of the exercise is striking as a creative combination of pre-modern heritage and post-modern marketing. The spirit of private regulation survived and prospered, populating the public institution, its culture and modus operandi.
The focus here on London is not intended to detract from the importance of other jurisdictions, which were generally tighter in terms of rule-making and sometimes also rule application. The so-called ‘London loophole’ (Grant 2008) meant that US and other international firms could often evade more restrictive regulation in their home jurisdictions by trading through subsidiaries or affiliates in London.

However, it is interesting to reflect that US or other regulators could have closed the loopholes, had they wished to, by prohibiting firms that were based in or had a trading presence in their own jurisdiction from exploiting such ‘offshore’ loopholes. Such a possibility has since been demonstrated, as the US implemented its Dodd-Frank Act (United States 2010; Skadden 2010). The historical point to hang on to is that, although from an international perspective the façade of public regulation in the UK looked more than a little transparent, it suited many in the international regulatory community to collude. But why? That this had something to do with lobbying by the industry in the US and internationally is beyond dispute. US tears shed over the UK’s ‘unfair’ advantage vis-à-vis its regulatory regime became crocodile tears once US firms were ensconced and increasingly dominant in London and benefiting from its historic regime, with ease of entry into the EU (remembering de Gaulle’s concerns).

As for regulators worldwide, the internationalisation that London did so much to pioneer through its open-door policy and its cosmopolitan activism in international networks has helped to provide congenial occupational and cultural settings. By the beginning of the first decade of the new millennium, regulators had become less locally-focused and more internationally networked and orientated. The occupational culture also became rather ‘intellectual’. The mood of the times was (and still to some extent remains) one of cool admiration for certain kinds of conceptually impressive model-building and for those colleagues who appeared to be most in command of them. It became de rigueur for regulators to refer to policy propositions as being (or not being) ‘intellectually compelling’ – insofar as policy propositions could be said to flow from rather decontextualised and abstract technical models, resting on a range of (often idealised) assumptions and (often ill-fitting) quantitative data. It is not so much that affect is absent or suppressed in such a community (as is sometimes implied by the experts themselves). Rather, emotion is directed to particular objects and expressed in a particular manner.

In appreciation of this development in regulatory culture – moving regulation from splintered and localised guilds, to a cosmopolitan community – we offer the terms aesthetics and aesthetes. Aesthetes are persons who represent themselves as having a particularly high appreciation of beauty, whether in art, nature or science and who have developed ways of representing them in an elegant manner – in this case, the workings of financial markets,
models thereof and ‘proofs’ from first principles and/or from data. From the 1990s onwards, and increasingly from the 1990s, regulators became partially detached from national contexts and pressures, increasingly taking their bearings from international peers, working with denationalised and decontextualised market models, big data and international esteem.

In one sense, the professed emotional coolness, scientism, intellectual intensity and ‘ivory tower’ aspects of regulatory culture in the 1990s and first half of the 2000s might make it seem rather like the popular stereotype of scientists: brainy boffins. However, whilst sharing with the natural sciences a search for and appreciation of beauty in theory-building and a clamour for data, financial regulation from the 1990s onwards also constituted an increasingly internationally networked elite, which enjoyed direct policy access. With particular reference to the US (although the point might have wider applicability) James Crotty (2009: 577) has deprecated these developments in the following terms:

The design and implementation of the changes needed in financial markets is a political as much as an economic challenge. Unfortunately, most elected officials responsible for overseeing US financial markets have been strongly influenced by efficient market ideology and corrupted by campaign contributions and other emoluments lavished on them by financial corporations. […] Moreover, powerful appointed officials in the Treasury Department, the SEC, the Federal Reserve System and other agencies responsible for financial market oversight are often former employees of large financial institutions who return to their firms or lobby for them after their time in office ends. Their material interests are best served by letting financial corporations do as they please in a lightly regulated environment. We have, in the main, appointed foxes to guard our financial chickens.

This tendency was to some extent deepened in the years following 2007, as crisis management initially resulted in policy-makers being sufficiently panicked at times to turn away from their political scripts and to cede the ground further to technocratic actors. It was only as the crisis came to be seen as enduring – especially in Europe – that more frankly political responses started to reassert themselves (as will be discussed in later sections of the book).

**Retrospective: 1918–2008**

It is now possible to make a provisional summing up of financial market regulation in the UK over 100 years, in terms of regulatory architectures, knowledge and political control. A history understood in architectural terms would portray a rich tapestry of administrative developments, key personages,
cultural settings, market scandals, governance shortcomings, commissions of
enquiry and rejiggings of responsibilities. In such terms, there certainly have
been changes, which may appear radical to insiders who help to bring them
about or are affected by them. But seen from a greater distance, there is
a remarkable sameness. The historically-given form of regulation – self-
regulation – was never transposed into public regulation: not when the Bank
was formally nationalised during the Second World War; and not during the
1980s–90s with the developments that led to the FSA.

As noted above, throughout the first half of the 20th century, self-
regulation worked through sectoral cartels, with the Bank of England
maintaining cordial relations with owners of City banks. The subse-
quent transitions in the post-Second World War period, first from cartels to
sectoral self-regulatory organisations, followed by the absorption of those
arrangements into a unitary regulator, the FSA, could be read either in terms
of a transition from private to public governance or in terms of colonisation
of the state. At the time, it was widely seen as the former. There were few
detractors, it being believed that a ‘great moderation’ had been constructed.
Political boat-rockers were marginalised in mainstream political parties, even
(or especially) those on the centre-left (thinking of the Labour Party). Within
the academy, regulatory scholarship conceived of meta-regulation or respon-
sive regulation, according to which regulatees were to be softly coaxed into
applying the risk and compliance systems that they had negotiated with
regulators.

Following 2007, however, regulators changed tack, developing a two-level
mode of self-criticism, perceiving that: (a) market preferences had perco-
lated through the apparently ‘public’ regime, in particular the preferences of
large international firms in respect of regulatory style (light), risk models
(proprietary) and compliance (self-certified); (b) regulation had been focused
on individual firms, when it should also have been looking at interconnections
and the system as a whole (problems at a macro-prudential level). As a result,
post-crisis regulation became tougher at firm level and more systemically
orientated.

Since large firms and their transactions span national boundaries, post-crisis
regulatory knowledge implies greater international cooperation. Whilst there
is a clear analytical and practical difference between international cooperation
and international convergence (a distinction with which both lawyers and
political economists are very familiar), there has been a tendency for regulators
to slide from the first to the second. In short, post-crisis regulators’ self-
criticisms, and their signalling of the needs for reform, have accelerated the
‘upward’ drift in decision-making from states to international regulatory
networks and bodies.

On the other hand, there have been some counter-tendencies, variously
driven by practical considerations, legal challenge and political rumblings.
‘Banks are international in life, but national in death’ and the need for
resolvability has consequences for the organisation of regulation, acting as a counterweight to internationalising tendencies (the situation is complex, see Chapters 2–6). On legal challenge, the courts in Europe have generally sought to avoid challenges to policy; however, they do ensure that affected or otherwise-objecting parties have opportunities to be heard (Chapter 4). On democracy, whilst in ‘normal’ times regulators get by with quite limited political accountability and with post-hoc reporting to specialist sub-committees of parliaments, in exceptional or crisis times a brighter and wider light may be shone.

At the time of writing the tension between the two tendencies – deterriorialisng technocracy and reterritorialising democracy – was unresolved. It might remain so for some time. In those terms there seems not to have been a decisive shift: neither ‘upwards’, continuing the reconstruction of regulatory knowledge as a single, post-national and ‘post-political’ project; nor ‘downwards’, politically re-embedding regulatory knowledge in domestic, democratically-determined and diverse politics.
Bail-outs as policy
Constructing ‘too connected to fail’

As far as policy in the US is concerned, bail-outs of troubled financial firms – legitimised by the belief that financial firms are ‘too connected to fail’ (TCTF) or, in a more populist formulation, ‘too big to fail’ (TBTF) – became institutionalised long before 2008. It then became taken as the model for European action.1

The US policy rationale articulated for bail-outs in the period following the First World War, and in particular from the 1980s onwards, has been that insolvencies are more dangerous than bail-outs. However, there are reasons to regard bankruptcies as not heightening systemic risk, not burdening the public purse and not perpetuating moral hazard. Neither are bail-outs necessary to protect depositors, since their interests can be protected by moving them and their assets to another entity, prior to liquidation of what remains. In fact, it is notable that the bail-outs in the US have not only concerned retail banks but also investment banks, notably Bear Stearns in mid-2008, following which political opposition arose to the policy. Whilst the focus of this chapter is on US developments, some sideways glances are cast at wider, international cases including Barings and BCCI. The objective is to trace the situation up until and during 2008, when bail-out policy came to be a contested matter.

Focusing on the Lehman Brothers affair, this chapter shows that, whilst its insolvency may have proved inconvenient for many market participants, nevertheless it was highly convenient for US policy-makers to invoke an atmosphere of catastrophe, turning a market movement into a political crisis. In such an atmosphere, political representatives could be won over to the view that private costs have to be socialised for the common good. The US political class acted because they were told (and may have believed) that the world as we know it would end if they held onto their idea that capitalism was a system in which the consequences of risks are borne by those who took them.

1 Chapter 2 is a revised version of work originally published in 2012 in Law and Financial Markets Review 6(4) 271–83 and is published here with the permission of Hart Publishing.
Elites were similarly panicked in 2010 in Ireland, the public pension pot being raided to pay off bank bondholders and austerity measures being introduced to balance the books in the long term. Similar action was taken in what came to be known as other ‘peripheral’ Eurozone countries. The issues discussed here primarily in relation to the US – the setting within which TCTF has been raised as an idea, reaching its apogee in 2008 – are therefore of wider significance. Although it is widely acknowledged that bail-outs have negative effects in terms of costs, moral hazard and incentives for further risk taking by private actors (Goldstein and Véron 2011) there is little sign (as of 2013) of a decisive break with these practices.

The core *apologia* is that many financial firms are TCTF, meaning that their failure could bring down the financial system. The institutionalisation and indeed naturalisation of the idea of TCTF may be illustrated in the following recent statement of the European Commission (2010: 2):

> During the financial crisis, governments discovered that banks and other systemic financial institutions could not be allowed to fail. Put bluntly, there was no simple way for a bank to continue to provide essential banking functions whilst in insolvency, and in the case of a failure of a large bank, those functions could not be shut down without significant systemic damage.

However, did governments really ‘discover’ this – in the sense that one might find truth on the sidewalk, like a dollar or euro? Or did they adopt the idea, in the manner that one might buy an investment? And if the latter, then who were the sellers and what was the marketing? How did the sellers overcome resistance to TCTF and to its implications, including financial transfers from the public to the private sector?

**The attractions of TCTF**

Certainly, a general breakdown in the financial system would have far-reaching consequences, not only for bank depositors but also for wider communities. However, public bail-outs are by no means the only ways of averting such consequences: measures are available and can be administered in such a way as to protect bank depositors, trading counterparties and stability, whilst placing the costs of past risk-taking where they belong – upon bank investors, bondholders as well as shareholders. Assets, including bank premises, staff and systems deposits can be transferred over a weekend to new owners, public or private, and customers can continue as before.

That much is incontestable. The controversy is about the terms on which it should be done (Flannery 2009). For example, Acharya (2009) states that regulators should penalise failed banks’ investors – so encouraging banks to take on risks that are *not* highly correlated with those of other banks. The
banks that remain healthy could then buy any remaining assets of those that fail. That would be a much healthier situation than bail-out, from the point of view of moral hazard, market stability and public finances. Acharya’s analysis has the merit of showing that banks’ tendency to increase inter-bank connectedness – by adopting similar trading strategies, holding highly correlated portfolios and holding each other’s debt – is by no means irrational. On the contrary, it is an eminently rational manner of getting support from the public purse.

What then explains that the fact that bail-outs became the historical norm, commanding support amongst policy-makers, at least until very recently? Elite influence might be invoked: powerful constituencies resist bank failures (Ertürt and others 2011; Gros 2013b). So do banks themselves and also holders of their bonds, who would be hurt by failure. However, explaining this protection of banks solely in terms of their political influence seems somewhat circular, because it leaves unanswered the question of why policy-makers accede. That banks and bondholders have political influence cannot be denied. However, other sectors of the economy also have political connections, which are not always enough to buy them protection from insolvency. Moreover, although bondholders may have political connections and influence, there are other categories of financial market participants who also have political connections and influence, for example some hedge funds, who do not share bondholders’ interests because they may be betting against them.

The TCTF argument is that there is something special about finance, which makes it different, meaning that it can be exempted in practice from the normal rules of the capitalist marketplace. This is a view that, quite understandably, finds favour within the larger banks; moreover, it seems to be (uneasily) accepted by many policy-makers. As one observer puts it, ‘European policy makers are petrified to act’ (Milne 2011a), in the sense of allowing or managing the insolvency of even quite minor banks. Bank-to-bank contagion and systemic collapse are seen as risks too great to entertain. One concern is over similarities in business models (on which, more below). Also bonds issued by banks and financial entities are quite often held by others; for example, in 2011 there were indications from the Eurozone that much Irish bank debt was held by German and French banks. This might be one reason why the European Central Bank (ECB) has been adamant that the Irish banks should not be allowed to become insolvent. However, given the lack of transparency in such decision-making (let alone accountability (Kaltenthaler 2010)), it is difficult to draw firm conclusions about the reasons for the ECB’s stance.

The ECB is not the only source of resistance to insolvency. An Irish academic has noted that, whilst the ECB may have played the most obvious role in protecting bondholders, the US authorities also intervened (Morgan 2011). In a conference call with G7 finance ministers in late 2010, although bondholder ‘haircuts’ were supported by the IMF (and
by the UK Prime Minister), they were opposed by US Treasury Secretary Timothy Geithner (ibid). The latter stance has a long pedigree, being clearly visible in the United States from 1984 onwards, when the authorities bailed out the Continental Bank of Illinois and announced that no significant US bank would be allowed to fail (see below). Nevertheless, there have been some exceptions in the wider international sphere (Barings, BCCI and others discussed below); even in the US, bail-outs have become controversial. However, the underlying rationale of TCTF retains a hold on the thinking of policy-makers.

The ‘market for lemons’ in policy concepts

An explanation of TCTF as an elite belief system is needed. This chapter suggests that this may be posed in terms of the historical shaping of ideas about financial markets and regulation. It takes up this task in terms of a direct assault on the core proposition — endlessly presented by mass media and industry commentary as ‘fact’ — that the insolvency of Lehman Brothers was the high-point of risk to the financial system in 2008, that any future insolvencies would also be highly threatening and that the policy of TCTF is in the public interest.

That familiar story can be deconstructed as being a sales pitch: in the vernacular, it is a ‘lemon’. In his now classic paper, The Market for Lemons, Akerlof (1970) suggested that, in the market for used cars, there are cars capable of giving many years’ reliable service (‘cherries’) and also ones likely to fall apart (‘lemons’). Much of the information needed to distinguish a cherry from a lemon is known to sellers but not to buyers (information asymmetry), so prospective buyers do not know whether they are being offered a cherry or a lemon. They can only guess or hope that it is of average quality, so will offer no more than the corresponding price. This means that, whilst owners of lemons can offload them at the average price, owners of cherries cannot achieve a superior price: in markets marked by information asymmetry, everything is a potential lemon.

Since such problems can have a chilling effect on markets, Akerlof suggests that governmental regulation is justified in order to increase transparency, fairness and trade. The argument has been widely applied to financial markets, seeing the roots of the crisis in private ordering, regulatory outsourcing and deregulation (Quinn 2009). Not only were Bear Stearns, Lehman Brothers, AIG and many other ‘troubled’ firms trading in lemons (securities whose values were unknowable), but these firms themselves became recognised as being lemons. Throughout 2008, financial market participants began to act on their knowledge that the whole financial system was of such a nature: that much is history, whose repercussions remain with us.

Public policy and (re-)regulation also suffer from information asymmetry. We simply do not know for sure what the consequences of any given policy
would be: we only have our beliefs or our hopes. Two closely linked propositions – (a) that insolvencies of financial firms are too dangerous in terms of systemic stability and hence need to be bailed out; and (b) that bail-outs have no or at least lesser impacts upon systemic stability – have attained the status of belief. According to that belief, amid all the events of 2008, amid all the bail-outs, it was one ‘non-bailout’, the insolvency of Lehman Brothers, which created the greatest danger. Owing to an inability to wind back history and to rerun it under different conditions – for example, allowing Lehman Brothers to enter insolvency – there is a lack of empirical evidence on whether, in general and in principle, bail-outs or insolvencies are more destabilising. Nevertheless, some market data is cited here, focusing upon the period following Lehman’s insolvency and AIG’s bail-out.

In any case, we can readily concede that a large insolvency occurring as an exception within a general policy of bail-outs might cause discomfort. Indeed the converse, a big bail-out within a policy norm of allowing insolvencies, might also disrupt. Is it the singular event that causes consternation, or is it its relationship to the policy framework and to market expectations? A surprise insolvency within an historical stream of bail-outs calls for both aspects – the surprise and the norm – to be problematised.

**Political rhetoric: the making of the Lehman Brothers story**

During September 2008, statements made by US policy-makers – to the effect that a crisis situation had emerged – turned an ongoing market correction into a sharp political crisis. Far from spreading calm, which had been the strategy hitherto, in September policy-makers talked up the crisis. Focusing upon Lehman Brothers, policy-makers proposed and eventually obtained unprecedented measures, notably the Troubled Assets Relief Program (TARP):

Immediately upon the Lehman [Brothers] bankruptcy, the Fed and Treasury went to Congress for additional authority, in particular the ‘Troubled Assets Relief Program’ (TARP), in effect a request for $700 billion blank check. The Congressional response, in the midst of the election season, was a spectacle. [. . .]. The President, the Secretary of the Treasury, and the Chairman of the Federal Reserve Board made extraordinary statements of the economic peril faced by the US – indeed, the world. In order to rescue the financial sector – to avoid the catastrophe whose prospects already scared Wall Street – the political and economic leadership had to scare the entire country. [. . .] In short, the consequence of seeking additional authority mid-crisis to deal with a six-alarm fire was to give us an eight-alarm fire.

(Gordon and Muller 2010)
Thus, there is an argument that the market was not unduly spooked by Lehman’s failure. Rather, the markets were reacting to a string of bad news – one firm in trouble after another – that process of reaction then being amplified in September 2008 by the authorities’ pronouncements of crisis and catastrophe, through which they justified bail-outs in all the other cases. A broadly similar view has been taken by Willem Buiter, for whom the destruction of Lehman Brothers and most of its unsecured creditors would have been ‘the best option available to the authorities, given the absence of a Special Resolution Regime’ (Buiter 2009: no page number). This is because ‘Markets and market participants are educated only by painful example’ (ibid). The deepening of market problems occurred not at the time of Lehman’s failure, nor as a reaction to that event per se, but rather over a longer period – both before and after Lehman Brothers – as the market and the political class realised that most other firms, notably AIG, were in a similar condition:

The cardiac arrest followed the realisation, well after Lehman went kaput, that (1) most of the internationally recognisable US banks were insolvent or would be but for past, present and anticipated future government financial support; that (2) many other non-bank financial institutions (AIG) and shadow-financial institutions (GE) were either insolvent or at death’s doorstep; and that (3) the government was not on top of the issues and the Congress was deeply divided and irresponsible.

(ibid: no page number)

From Buiter’s perspective, policy-makers were incompetent and irresponsible. A more nuanced interpretation, favoured by the present author, would be that politicians were indeed taken aback; however, high officials and their interlocutors in connected firms were *highly competent* in seizing the opportunity to invoke and entrench the concept of TCTF and the practice of bail-out.

**Some prior history: normalisation of bail-outs in the US**

The Federal Deposit Insurance Act 1950 (FDIA) gave authority to the Federal Deposit Insurance Corporation (FDIC) to supply financial support to a bank in danger of closing, if the operation of the bank is ‘essential to the community’. ‘Community’ may have originally meant a geographical community but later was interpreted to mean financial community. Amendments to the Act required the FDIC to take the line of action that is least costly, *except* when a more costly action is merited because it would reduce ‘serious adverse effects on economic conditions or financial stability’. The powers of the Federal Reserve include a power to lend to banks and other financial institutions.
In relation to Freddie Mac and Fannie Mae, the two government-sponsored housing lenders, the Housing and Economic Recovery Act 2008 provides for government to support them by buying their assets (debts) if that is necessary to bring stability to financial markets; or alternatively, if they become ‘critically undercapitalized’, to put them into receivership or insolvency. Finally, in 2008 after much political commotion, the Emergency Economic Stabilization Act set up the TARP.

These powers have been exercised as follows. In 1984, the FDIA was invoked in relation to the Continental Illinois Bank and Trust Company. First, the authorities protected all bank depositors and all creditors (including bondholders), granting a $US2 billion loan, whilst a search was made for a possible buyer for the bank. No buyer emerged. The authorities then bailed out the bank by purchasing most of its bad loans, taking some of its stock and replacing its management. Speaking before the Senate Banking Committee, the Comptroller of the Currency stated that the government would not allow any of the largest US banks to fail.

Continental Illinois was the first demonstration and confirmation of a TCTF policy. What impact this may have had on the thinking and risk-taking of bankers is hard to gauge: no sociological or political study is known to the present author and the economics literature is somewhat equivocal (Wall and Peterson 1990). However, it seems reasonable to suggest that declaration of a bail-out policy would do little to discourage risk-taking over the following two decades. In May 2008, the mid-size investment bank Bear Stearns found itself in trouble, owing to its purchases of sub-prime securities, and was effectively bailed out, with the Federal Reserve making a loan of $US30 million to JP Morgan, who on these terms bought Bear Stearns and its liabilities (Silva 2010). Ben Bernanke, Chairman of the Federal Reserve, said that ‘sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions’ (Bernanke 2008b). Although the public money was used to encourage a sale of Bear Stearns, rather than being pumped directly into the firm, the sale would not have occurred had not the public funds been made available.

Thus the doctrine of bail-out was for the first time extended from retail banks to pure investment banks. The background to Bear Stearns’s difficulties is that, in common with Lehman Brothers, Goldman Sachs and other investment banks, it had created a market in mortgage-backed securities. Because of high leverage, these proved lucrative in a rising market. To expand its trading, Bear Stearns and others set up hedge funds, which bought the securities, then going to other financial firms for loans, using the securities as collateral. The hedge funds then used these loans to purchase further securities from Bear Stearns, and so on – in a circle of purchasing/borrowing/purchasing. Bear Stearns also kept part of its sub-prime debt on its own books, purchasing insurance (credit default swaps (CDSs)) against any fall in its value. Other banks did much the same. Very substantial amounts of such insurance were issued by American
Insurance Group (AIG), quite cheaply, owing to the widely-held assumption that prices would not fall.

When the market did in fact turn, from 2006–07 onwards, all these firms experienced difficulties, as did Freddie Mac and Fannie Mae. In early September 2008, the authorities invoked the FDIA to put Freddie Mac and Fannie Mae into conservatorship – effectively, government ownership. Conservatorship is a legal form that protects bondholders, since it does not involve insolvency. Freddie Mac and Fannie Mae’s bonds continued to trade in the markets, with only slight discounts to face value, bolstered by the government action. Under the standard contractual terms of the International Derivatives and Futures Association, conservatorship counted as a ‘credit event’ equivalent to insolvency, so that insurance contracts (CDS) on Freddie Mac and Fannie Mae were triggered. Nevertheless, since the bonds were trading close to their face values (thanks to the authorities), the amounts payable by the insurance/CDS were much lower than they would have been if the bonds had been wiped out by insolvency proper. Hence, government action on Freddie Mac and Fannie Mae ‘killed two birds with one stone’: it underpinned US mortgage markets, whilst giving succour to insurers, notably AIG.

Lehman Brothers’ difficulties also came to a head in September 2008. The above-mentioned actions by the authorities had led the markets to expect some type of rescue of Lehman Brothers – either a Continental-style bail-out or a Bear Stearns-style takeover supported by public funds. Barclays of the UK was a possible bidder for all of Lehman Brothers; however, that sale did not go ahead, there being insufficient time to satisfy UK company rules requiring such a purchase to be put to shareholders. Barclays would have been taking on considerable risk, absent any US government guarantee such as that just offered to JP Morgan in relation to Bear Stearns. Following the no-sale, with all counterparties backing away from Lehman Brothers, the latter entered into insolvency on 15 September 2008.

Henry Paulson, Secretary of the Treasury, subsequently claimed that letting the firm fail was merited on grounds of discouragement of moral hazard – an argument somewhat at odds with the earlier decision to subsidise the sale of Bear Stearns (to avoid ‘a chaotic unwinding of positions’, see above). Another consideration might have been that the prospective buyer, Barclays, was not a US bank, so the US authorities could be in a politically awkward position if offering financial support. (As it turned out, the US authorities did Barclays a favour because, following Lehman’s insolvency, wiping out much of its debt, the bank was able to buy the parts of Lehman that it wanted at knock-down prices.)

Within a week of Lehman Brothers’ failure, US policy-makers declared that a crisis existed, meriting the bail-out of AIG, in order to avert its ‘disorderly failure’ and subsequent contagion effects. AIG had issued most of the insurance/CDS contracts sold against sub-prime-related and other securities.
As the sub-prime market turned, AIG had to post increasing amounts of collateral on these contracts, for which it did not have the cash. From 16 September 2008, the US authorities provided AIG with credits and loans in excess of US$100 million, taking the firm’s assets as security for the loan, also taking 80 per cent of the stock (thus heavily diluting shareholders) but not touching senior bondholders.

In October 2008 the US authorities obliged nine financial firms to participate in the TARP (Board of Governors 2008). As one commentator has observed: ‘There is no mention [in the announcement that TARP funds were to be taken up] of these institutions applying to TARP’ (Silva 2010: 128). Bank of America, JP Morgan, Citigroup, Wells Fargo, Goldman Sachs, Morgan Stanley and Bank of New York Mellon between them accepted US$125 million of TARP funds. Such action was insufficient to prevent Citigroup shares from falling over 70 per cent in a few weeks and on 23 November the authorities used over US$300 million to support Citigroup’s sub-prime-related losses. Again, shareholders were diluted but bondholders untouched. The authorities took this action in order ‘to strengthen the financial system and protect U.S. taxpayers and the U.S. economy’ (Board of Governors 2008).

Bankruptcies no more disorderly than bail-outs

Here we make the case that, even in times of severe market stress, the market impact of insolvency of a large financial entity may be no worse than the impacts of bail-outs. We insist that there are no ‘pure’ or direct systemic impacts of insolvencies or of bail-outs; rather, systemic impacts depend on how these events are understood by market participants, which in turn has something to do with how events are represented by policy-makers. Clearly, by 2008, bail-outs had become the default option in response to serious difficulties of any large or ‘systemic’ financial firm. This tendency was reinforced following the one big exception, Lehman Brothers, on the grounds that such failures may exacerbate ‘meltdown’ (Bernanke 2012).

However, there are several reasons to question the ‘after Lehman, never again’ justification for bail-out rather than insolvency. First, as the above history reminds us, bail-outs were already well entrenched in policy terms before Lehman’s failure. This suggests that we may be dealing with a deep-seated policy preference, which may have been reinforced by Lehman but cannot have been created by it.

Secondly, market data indicate that, whilst news of Lehman’s failure and insolvency was not well received by traders, it was no worse received than the several other failures and bail-outs around that time: just one event in a string of bad news. John Taylor, a US economist and previous member of the President’s Council of Economic Advisors, has made a time event analysis of market turbulence in 2008 (Taylor 2009). This suggests that the markets were
digesting the failure of Lehman Brothers and other firms. Similarly, utilising a series of market indicators, Ayotte and Skeel offer evidence (2010: 26) that Lehman’s insolvency was followed by no more volatility than that following AIG’s bail-out, which followed shortly thereafter:

Looking across the four indices, the daily market reactions surrounding the news of the Lehman bankruptcy filing and the AIG rescue loan indicate that the reaction to the AIG news was of equal, if not greater, magnitude. The fall in the stock market, as measured by the S&P 500 index, was nearly identical. The rise in the VIX, an index used to measure volatility (and informally known as the ‘fear index’) saw a slightly higher percentage increase following the Lehman bankruptcy. The TED spread, credit market risk, saw a larger percentage point increase following the AIG bailout. Similarly, yields on short-term U.S. Treasury bills (a measure of investor flight to safe assets) saw a larger fall following the AIG news.

On that basis, Ayotte and Skeel suggest that market reaction to the AIG bail-out was equal to, if not greater than, the reaction to Lehman’s insolvency. As they say, this evidence is by no means conclusive. Nevertheless, David Tarr (2010: 1) has argued that most of the bad news, including Lehman’s failure, was accommodated without breakdown of market mechanisms:

[W]hen Washington Mutual failed [in October 2008] it was placed into FDIC [US federal] receivership and reopened literally the next day as J.P Morgan Chase, with account holders having full access to their deposits and bank services. When Lehman Brothers went bankrupt [. . .] the Depository Trust and Clearing Corporation (DTCC) [. . .] unwound all of Lehman’s credit default swap holdings within four weeks with all parties receiving payment on the terms of their original contracts, i.e. there was no systemic impact from losses on the Lehman credit default swaps.

More broadly, the Senior Supervisors’ Group concluded that the September 2008 Lehman Brothers, Fannie Mae, Freddie Mac and Landsbanki Islands credit events ‘were managed in an orderly fashion, with no major operational disruptions or liquidity problems’ (Senior Supervisors’ Group 2009: 2). Note the inclusion in that list of Lehman Brothers (the US parent of Lehman International, although investors in the latter had to wait a considerable time). The group, made up of financial regulators of the US, France, the UK, Canada, Germany, Japan and Switzerland, reached their conclusions after discussion with financial market participants. The group found that: ‘According to all surveyed participants, the credit events in the latter half of 2008 in general were managed in an orderly fashion, with no major operational disruptions’ (ibid: 3).
In other words, if Lehman’s insolvency stands out from the bail-outs, it does so for reasons other than systemic impact. This does not of course mean that insolvencies hurt no one. For example, it seems that many hedge funds were caught out by the Lehman insolvency:

Lehman’s Chapter 11 filing was a disaster for the hedge fund industry. [. . .] While clients pulled roughly 50 percent of Lehman’s prime broker assets out of the troubled firm in the week preceding its Chapter 11 filing, a number of funds did not do so in time. After Lehman declared bankruptcy, those funds found substantial portions of their assets effectively frozen.

(Hood 2010: 66)

However that need not concern us from the point of view of systemic stability. To put it in the celebrated and hackneyed words of Schumpeter (1939, 1950), ‘creative destruction’ took place. Firms adopt entrepreneurial strategies of their choosing: some succeed, some fail, the successful ones pick over the remains of the failed, the market systems rolls on. Possibly the managers of those hedge funds imagined, in the light of the history of US bail-outs, that Lehman would not be allowed to become insolvent: ironically or not, hedge funds were relying on government action, which they thought predictable. That turned out to be a poor judgment in that instance. However, from the wider perspective of how the broader markets dealt with the insolvency, there was little to complain about.

In conclusion of the first half of the chapter, the consequences of bail-outs or insolvencies have to be assessed within a particular historical context. For example, one in which either insolvencies are normally tolerated (then a bail-out in such a context would be an aberration or else denote a new turn in policy, see discussion of Continental Illinois above); or one in which bail-outs are the norm (in which context an insolvency would be an aberration, as was the case for Lehman); or one in which there was contingent decision-making and political bargaining over each insolvency/bail-out decision (as might be the case under a bank resolution regime, to be discussed below). Up to and including 2008, bail-outs had become the norm, Lehman being the exception, so we do not know what would have happened in the converse situation, that is, had most financial firms been allowed to fail in 2008.

Of possibly greater interest, we do not know how many of those firms might have taken early action to avoid trouble had they not had the comforting backdrop of the by then well established historical norm of bail-outs. All we have is the reasonable assumption that moral hazard and implicit or explicit state guarantees for financial entities can be expected to worsen speculation, bubbles and crashes. Thus, there are reasons to believe that a situation such as that facing US policy-makers in 2008 arose at least in part because bail-outs
had become the historical, expected, indeed assured, policy norm over the preceding decades. The question then arises as to how (if at all) to exit this way of thinking and of action. One possibility is to look, comparatively, at insolvencies on the wider international stage.

‘Scarcely a ripple’: failure with reassurance

The case of Lehman Brothers is peculiar for three reasons: it took place in a national and historical context in which bail-outs had become the norm; its failure seems to have resulted from muddle and contingencies rather than from any in-principle reversal of the policy taken with Bear Stearns; and once failure occurred, policy-makers and regulators from the President downwards represented its failure as a disaster, threatening the entire financial system.

By contrast, history also presents several cases when regulators took pains to handle failures in a manner as reassuring as possible – Barings, BCCI, Drexel Burnham Lambert and Long Term Capital Investment. In some of these cases there were concerns about wider systemic effects; however, TCTF seems not to have been an issue, or at least an issue that did not impede insolvency.

BCCI was a large international bank (in the top 10 by market capitalisation), operating in over 50 countries, and was characterised by a structure that made it easy for all national regulators to say that it was someone else’s responsibility. Nevertheless, US anti-money laundering policy led to regulatory probes and to the eventual liquidation of the bank in 1991. Far from propping up the bank, the authorities took the decision to eliminate it, whilst seeking to protect certain national interests. Price Waterhouse, commissioned by the Bank of England to make a report on BCCI itself, delivered the so-called Sandstorm report. Published versions of this omitted certain matters on grounds of sensitivity and relations with certain other countries; however, legal actions have obliged the authorities to disclose some information (see Sikka v Information Commissioner 2011).

After BCCI’s closure, the British Government commissioned a judge to report on how matters had been handled by the regulator, at that time the Bank of England. Bingham’s report (1992; see also McGuire 1993) acknowledged that there had been unsatisfactory aspects of the Bank of England’s supervision of BCCI. Certain appendices of Bingham’s report remain unpublished. For present purposes, however, the main interest in the BCCI liquidation is that, as Herring recalls, it had ‘remarkably little impact on financial markets’ (Herring 2005: 328). In explanation, he points to some specific circumstances of the case:

Not only was this due to the care with which the authorities implemented the intervention, but also to the fact that most sophisticated market
participants had cut lines to BCCI long before. Moreover, BCCI was not a major participant in payment and settlement systems nor was it active in the OTC [over the counter] derivatives markets.

We might add that that, in addition to not being closely connected to the ‘plumbing’ of the international financial system (despite its size), BCCI had a business model that was seen as not being similar to that of other medium or large banks (unlike the case of Bear Stearns, above). Thus, BCCI was neither TCTF nor ‘too similar to fail’ (TSTF). There is a related consideration: BCCI was by no means part of the mainstream international banking world as then represented predominantly by London and New York. It was seen in ‘outsider’ terms. Such status – low social connectedness as well as low financial connectedness – both facilitated action against the bank and limited the systemic impacts. These special circumstances underline that BCCI was an outlier (Brunnermeier and others 2006) and its demise in no way could be mobilised as evidence for or against TCTF propositions.

Barings, by contrast with BCCI, was very much an ‘establishment firm’. The activities of ‘rogue trader’ Nick Leeson drew attention to Barings’ poor procedures and management oversight. However, Barings’ 1995 insolvency ‘barely caused a ripple’, according to the Contact Group (2002: 27) on the Legal and Institutional Underpinnings of the International Financial System:

The Barings insolvency was smooth for at least two reasons. First, most of the Barings derivatives liabilities were subject to adequate risk management, both that of Barings’ counterparties and that of the Singapore exchange, which served as a central counterparty for many of Barings’ exchange-traded liabilities. Second, Barings’ bank was quickly sold as a unit, although the holding company was subjected to a prolonged liquidation.

The 1998 failure of the Drexel Burnham Lambert Group sits between BCCI and Barings, in the sense that Drexel was an establishment firm that became embroiled in fraudulent trading, pleading guilty to charges of racketeering and securities fraud. Drexel’s employee Michael Milken had led the development of the low-grade (junk) bond market (that is, bonds issued by other entities, not by Drexel itself). This market experienced problems from 1989 onwards and these combined with criminal charges led to the firm’s insolvency. Despite concerns over systemic risk, the authorities in the US and London limited their intervention to ensuring that the insolvency was as orderly as possible, reassuring counterparties that outstanding transactions would be completed. In the event there was minor disorder: some market participants lost money, others may have gained (Benveniste and others 1993).

Long term capital management (LTCM) was another innovator in securities trading, using high levels of leverage and arbitrage models (MacKenzie
2003a) that assumed moderate stability in sovereign bond markets – an assumption that was, however, violated by events from 2007 onwards in Asian and Russian bond markets. Had LTCM become insolvent then its trading counterparts would have had the right to terminate, net and set-off derivatives contracts with LTCM, which might have transmitted problems throughout the financial system. Pushed by the Federal Reserve, a consortium of creditors agreed to support the firm: there was no public bail-out as such.

Explanations as to why these firms were not bailed out with public money may be sought both in the wider context and in the peculiarities of the firms. With regard to the context: Barings, BCCI, Drexel and LTCM faced difficulties at a time when markets were not under great stress and so it was felt that insolvencies could be absorbed – in contrast with policymakers’ perceptions during 2008. With regard to the peculiarities: in each of these cases, it could be argued that there were specific circumstances not pertaining to other firms. To take Barings, for example, the activities of Leeson were seen as a one-off, not raising any issues over business models, similarity or connectedness. Today, after a string of such incidents, including Jérôme Kerviel at Société Générale and Kweku Adoboli at UBS, regulators may be becoming more concerned about the continuing management inadequacies that allow them to occur. BCCI was an outsider under investigation for widespread money laundering. Drexel also faced certain reputational challenges.

It is tempting to speculate what might have happened had the above difficulties arisen in 2008, yet it would be unproductive to do so because of historical differences in contexts and business models. Might Barings have been rescued, despite its low connectedness, given policymakers’ fears about contagion? Possibly the question makes no sense, since by 2008 Barings might well have developed a quite different model and connectedness, compared with the 1990s.

Might all or some of BCCI, Drexel and LTCM also have been rescued, despite their poor reputations? Drexel at least can be seen as having the sort of business model that became the norm for Bear Sterns and others. Would all or some have been rescued as part of the wider effort or would a deliberate line have been drawn? All we can be sure of is that, during 2008, the orthodoxy was that even mid-sized firms were TCTF. Having looked at these aspects of the past, the remainder of this chapter explores some potential future alternatives to this orthodoxy.

**Prospects and problems: connectedness, similarity, contagion**

TCTF, TSTF, TBTF and ‘systemically important financial institution’ (SIFI) constitute a cluster of closely related but differentiable ideas that
have taken hold in policy discourse following the emergence of the financial crisis. These concepts sensitise us to the fact that it is not just the size of a financial firm that may predispose policy-makers to bailing it out. Connectedness or even similarity of business models can also trigger support. In illustration, Gordon and Muller (2010: 11) say Bear Stearns was a case of TSTF. Bear Stearns was not TBTF, and its connectedness with other firms, whilst considerable, would not by itself be enough to threaten the financial system as whole. However, Bear Stearns’ business model and investments were rather similar to those of Lehman, Merrill Lynch and Citigroup. As a result of that similarity: ‘the handwriting was on the wall for those firms. Even without interconnections to those firms, Bear’s failure could disseminate throughout the financial sector’ (ibid). As Helwege (2010) critically comments in relation to the events of 2008, the problem was more a case of ‘information contagion’ than ‘counterparty contagion’. Bear Stearns was one of many such instances.

On those grounds, given the similarities between business models of medium-sized and large financial firms, it is hard to see any being allowed to fail. The bulging concept of TCTF/TSTF/TBTF/SIFI legitimises bail-outs, disciplining citizens and taxpayers to shoulder the costs, as if there is no alternative. If the market believes that a financial firm falls into such a category, then normal market disciplines do not apply. Each such firm can take high levels of risk, both they and their counterparties believing that, if risk is miscalculated, then government will not let them fail. In other words, states underwrite risk-taking.

Bank of England estimates suggest that, as of 2010, this implicit subsidy was worth at least £100 billion to UK banks. The Bank’s financial stability report (Bank of England 2010b: 51) for December 2011 articulated policymakers’ unhappiness over this state of affairs:

The distress or failure of a systemically important financial institution (SIFI) is likely to entail large-scale economic costs. These costs engender expectations of government support and so allow SIFIs to benefit from an implicit funding subsidy from taxpayers. This subsidy encourages SIFIs to rely more heavily on debt finance and to take on additional risk to maximise the value of the subsidy. Breaking this self-reinforcing cycle is a key priority for policymakers internationally.

If market actors could be obliged to shoulder a greater part of the responsibility for bank risk-taking, the argument goes, then they would bring market pressure to bear on management. If they failed to do so, resulting in bank failure, it would be they who would pick up the tab. This would signal an end to (or at least a reduction in) the moral hazard occasioned by implicit subsidy by the public sector and could, in principle, have the desirable consequence that the international and interwoven communities of banks and
their bondholders would discipline themselves. Allowing banks to fail and allowing bondholders to share the pain of such failure would discipline bank management to reign in risk (Tucker 2011).

For many investors, the answer is simple: the Irish banks should be allowed to fail with senior bondholders taking a hit. If the market is well prepared, financial calumny should be avoided and regulators would have set an important precedent. If you want to allow a Barclays or a Deutsche Bank to fail in the future, then you want to start on a small bank with limited links to other big institutions, rather than experiment on a systemically important institution. One of the Irish banks, therefore, would seem an ideal candidate with which to start.

(Milne 2011a)

However, there continues to be strong resistance even to small, well managed failures, very few having occurred. In 2011, the Danish Government did allow a small bank, Amagerbanken to fail (Bernstein 2011: 181). In Denmark, as elsewhere, implicit state guarantees to the banks had allowed the latter to take risks, thinking that they would be rescued if things did not work out, meaning also that investors would lend the banks funds at an artificial (below market) price. With that state guarantee removed in Denmark, banks’ costs of funding rose. Some Danish politicians then had second thoughts, saying that: ‘Making things tougher for surviving banks was not the idea’ (Editorial 2011: 8). The Financial Times editorialised as follows: ‘But if this was not the idea, it should have been. Banks’ funding previously enjoyed a public subsidy which, as Ireland has shown, risks bankrupting the government. Having banks pay the true cost of their funding is a benefit to society, not a harm’ (ibid).

Trying to get round the difficulty of contagion, Adair Turner has remarked that bonds could safely absorb losses of a troubled banks only if ‘those bonds are held outside the banking system [and] are held by investors who have so arranged their assets and liabilities that they could face the imposed losses without that in turn inducing systemic effects’ (Turner 2011: 9). In his view this would also apply to contingent convertible bonds (CoCos) – convertible instruments that are structured to behave like bonds in good times and to convert into equities when and if things become difficult. Since those conditions are, in Turner’s view, unlikely to be met, ‘the truly radical and ideal solution’ would be that bonds (or bond-like instruments) become a much smaller proportion of banks’ capital (ibid). In other words, reduce contagion by reducing the importance of bonds in banks’ capital structures. This would of course be at odds with current international policies, following the Basel III accords, that banks should issue more bonds. In this respect Turner’s proposal is indeed ‘radical’, indeed heretical.
Moreover, Turner explicitly articulates an important implication of official thinking about moral hazard and public subsidy. Central bankers freely acknowledge that, *in theory*, bondholders should share the pain of failures of speculative investment, since it is only if they feel themselves to be at risk that they would discipline bank management to reign in risk (ibid). As noted above (Bank of England 2010b: 51) the implicit subsidy is worth something like £100 billion to UK banks; and more of course at EU and international levels. And yet, nothing is done to discourage or prevent the most damaging aspect of connectivity via bond holdings – between banks. By allowing Bank A in Country 1 to be a large holder of the bonds of Bank B in Country 2, which in turn holds bonds in A and C (and so on), public policy underwrites risk-taking.

In the extreme circumstances of the Eurozone crisis, the most vulnerable of such assets were dumped wherever possible (sometimes being exchanged for cash with the ECB). However, as immediate signs of crisis may moderate, so banks might again begin to eye each other’s bonds favourably – seeing these as means whereby ‘normal’ inter-bank linkage, and hence public subsidy, can be maintained. That is to say, banks will always ‘game’ public policy if allowed to do so.

We now turn to some recent policy initiatives, to see to what extent they might be capable of tackling connectedness or whether they might be blunted by the latter.

**Firewalls within (but not between) banking groups: Volcker and Vickers**

The debate on the merits or otherwise of separation of wholesale and retail parts of banking offers another way into understanding connectedness, contagion and crisis management. The debate has been lively in the US, where it is referred to as the Glass-Steagall debate and has led to the Volcker Rule (Wallison 2011; see also Sullivan & Cromwell LLP 2011) and in the UK, where it has been led by the Vickers Commission (Independent Commission on Banking 2011a; 2011b). In 2011, the European Commission welcomed these ideas and later legislation was eventually agreed (see Chapter 4).

The Vickers Commission posed the issues in terms of legal and economic structures within banking groups: what degree of functional separation may be required in order to safeguard the retail side, if the wholesale side gets into trouble (or vice versa)? Vickers suggests that ring-fencing assets within different operating parts of a banking group would create ‘resolvability’ – meaning the ability of the group, working with regulators, to resolve its problems in a manner that would maximise survival chances for the less troubled part(s) of the group. So, for example, the retail arm of a bank might be given temporary support and then sold on within the market, whilst the
wholesale side might be allowed to fail (Randell 2012). The UK Government accepted the principle of ring-fencing and other recommendations made by the Independent Commission, with the Financial Services (Banking Reform) Act 2013 taking effect during 2014 (UK Government 2013).

Unfortunately, ring-fencing does not really remedy the central structural problem. If the problem of contagion, as Turner’s analysis suggests, arises at least in part from banks’ and other financial actors’ tendency to hold each other’s assets, then internal firewalls are inadequate. One can foresee a situation in which a banking group has been split internally into functional units, each with their own identifiable capital base in terms of bonds and other assets – yet these units continue the practice of holding the bonds of other banks.

To put it simply: regardless of whether banks might be split in terms of their legal structures (Glass-Steagall), or split in terms of functional units under the same group ownership (Vickers), such action in itself would not bar them from holding others’ assets. If banks – or units within banking groups – continue to hold each other’s assets, then such cross-holdings would remain a source of the contagion risk worrying Turner, Haldane and others, and motivating the setting up of the Vickers enquiry. The present author put that issue to journalist Martin Wolf who, as a member of the Vickers Commission, was presenting its interim findings at a seminar in Brussels in 2011. Mr Wolf agreed that there would be a problem ‘if the entities that hold the debt have to be rescued themselves [. . .] so you need look at who holds the debt’ (author’s contemporaneous notes made at a seminar at the Centre for European Policy Studies on 8 July 2011).

Nevertheless, looking to the text of the Vickers Commission’s final report (Independent Commission on Banking 2011b), one finds that this issue is not dealt with. The report refers to inter-bank linkage and contagion risk in terms of market sentiment and ‘crises of confidence’, which hardly takes account of vulnerabilities arising from holdings by one bank or unit therein of the bonds of another bank or unit. Remarks made by the Bank of England’s Andrew Haldane (2011a, 2011b) in respect of accounting standards and the tax-deductibility of debt move in the right direction.

Special resolution regimes: reimagining Lehman

In principle, bail-outs suit neither free market advocates nor citizens, who must pay for them. Thus, special resolution regimes (SRRs), whose justification is that they address moral hazard, cost less money than public bail-outs and are less destabilising than ‘disorderly’ insolvency. As Čihák and Nier put this view (2009: 6) with reference to the beginning of the financial crisis in the US:

Authorities were often confined to two alternatives: corporate bankruptcy —as chosen for instance by the U.S. authorities on September 15, 2008
in the case of Lehman Brothers, a global financial-services firm—and an injection of public funds—as chosen by the U.S. authorities in the case of the American International Group (AIG), a mere two days later. Events have shown that both these alternatives can be very costly. A disorderly bankruptcy can magnify the systemic impacts of the failure of a financial institution. When the authorities aim to avoid these impacts, and inject capital to support the institution, events have shown that the fiscal outlays incurred in the course of an open-ended injection of capital can also be large.

Accordingly, public policy attempts to avoid the choice between (allegedly) orderly bail-outs and (allegedly) disorderly insolvencies, through SRRs (European Systemic Risk Board 2011; Clifford Chance 2011). SRRs have been legislated for in the US, UK and many other countries and are proposed for the EU generally (Krainer 2012; Schoenmaker 2012). SRRs offer to policy-makers and regulators a set of options – a ‘toolkit’, as a senior official at the Bank of England has put it (Brierley 2009). For example, the UK’s Banking Act set out a choice between: (a) three ‘stabilisation options’ (a private sector purchaser, transfer of business to a ‘bridge bank’ or temporary public ownership); (b) a bank insolvency procedure; or (c) bank administration procedure. In practice, the authorities have deployed each of the three stabilisation options. A private sector purchaser, Lloyds TSB, was found for Halifax Bank of Scotland (HBOS). Dunfermline Building Society was partly transferred to a bridge bank, the remainder being bought by Nationwide. Bradford and Bingley was partly placed in temporary public ownership and partly sold to Santander (Singh 2011: 15–21).

It is clear that no predictions can be made about future decisions in as yet unseen circumstances. However, it is possible to explore the possibility that continuities in regulatory personnel and thinking might contribute to shaping future action in ways not unlike the past. There are reasons for both optimism and pessimism.

Some recent scenario work suggests that an optimistic stance might be merited – on the grounds that resolution provides mechanisms for more orderly management by regulators in the case of difficulties being experienced by a ‘big’ or otherwise systemically important firm. For example, for the US, following a decision to refer a firm to the FDIC, the latter assumes powers to require information, to advise management and possibly to replace it, to invite in potential buyers to whom viable assets may be sold (possibly with publicly-funded sweeteners), whilst allowing insolvency for the ‘rump’ entity.

How could this work in practice? A staff paper on ‘The Orderly Liquidation of Lehman Brothers Holdings Inc under the Dodd-Frank Act’ (Federal Deposit Insurance Corporation 2011) presents arguments and calculations to the effect that such procedures could be applied to large financial firms in ways
that maximise financial value. The FDIC’s scenario on how Lehman Brothers could have been handled, had the Dodd-Frank Act already been in force, suggests a receivership, in which all equity (share value) and all subordinated (junior) debt would have been eliminated, whilst other creditors would have been reimbursed at 97 cents on the dollar (Federal Deposit Insurance Corporation 2011: 18).

Two observations seem in order. First, the FDIC scenario certainly seems quite rosy from the point of view of senior bondholders. Secondly, this might be achieved only at the expense of other market participants. The scenario appears to be based on the assumption that, after due diligence and with the consent of its shareholders, Barclays would have proceeded with its bid at the level originally discussed in 2008. The reader will recall that Barclays’ 2008 bid did not proceed, owing to an inability to call a shareholders’ meeting in the time available and the UK regulator, the FSA, being unwilling to waive the requirement for such consent. It is now widely acknowledged that Barclays had a lucky escape, later being able to pick up the parts of Lehman that it wanted at fire-sale prices. To the present writer, it appears that the scenario as envisaged by the FDIC – reimbursement of creditors at near par – would have been possible only at the expense of Barclays and its shareholders and other stakeholders. In other words, resolution on the terms envisaged by the FDIC would have resulted in a transfer, not a net gain. Senior bondholders might indeed have been saved; however, that could only be at a cost to Barclays and/or the authorities. Moreover, in a scenario in which bondholders receive the slightest imaginable haircut, prospects that bondholders might instil greater market discipline would seem remote.

A procedural concern is that the ‘toolkit’ given by SRRs is a recipe for intervention à la carte, open to horse-trading between market participants, regulatory agencies and policy-makers involved. For example, it remains open to the US authorities to decide not to refer a troubled firm to the FDIC and instead to offer public funds. During the negotiations over the Dodd-Frank Act, the FDIC had fought for the power for it to decide when its resolution procedures should be triggered (Bair 2009). However, a rather more cumbersome decision-making process was eventually adopted, involving either the Secretary of the Treasury or the Federal Reserve acting with the FDIC: the FDIC cannot act alone (Federal Deposit Insurance Corporation 2011: 6). This is to be understood in the context of political preferences to leave open the possibilities for bail-out by the public authorities (possibly accompanied by market participation). The menu of possibilities is broadly similar to UK arrangements (HM Treasury 2011) and anticipated Eurozone arrangements (where the proposed procedures are byzantine; see Gros 2013a; 2013b).

Thus, there remains the possibility that in the future, just as in the past, bail-outs may continue. This accords with bondholder and banking preferences. Consider the following intervention:
Bob Diamond – the former head of Barclays who tried to buy Lehman Brothers before its collapse five years ago – has joined a chorus of criticism over the lack of progress in ending banks’ ‘too big to fail’ status. Citing ‘insufficient’ progress in ways to safely wind down failing financial giants, Mr Diamond has called for fresh international co-ordination to end the fragmenting approach to bank regulation. […] He says that various regulatory advances have helped cut risk in the system but warns: ‘A global framework is required if we are to avoid the kind of capital regulatory arbitrage that weakened the financial system’.

(Financial Times 2013b: 1)

What made Mr Diamond’s public intervention rather striking is that it combined a general call for global convergence (of rules and hence firms) with a specific call for action to end TBTF. This chapter has summarised the origins, recent applications and perverse effects of TBTF, linking it to TCTF. It has been argued, broadly following Haldane (2010), that large firms benefit from TBTF and on those grounds might have an interest in maintaining it. Yet here is Diamond, apparently calling for measures against TBTF – as long as they are in an internationally convergent form. Such support for European legislation against TBTF, and for internationally convergent forms of such legislation, is by no means an aberration. Large financial firms broadly supported the Commission’s efforts to harmonise bank resolution measures and to advance international standards, as was clear from briefings given around the European Commission and Parliament when EU legislation was being drafted and negotiated with industry stakeholders (early 2010s).

How can this be understood? There are two possibilities. One possibility is that large firms are ready to lose the public subsidy that they enjoy in good times (Haldane 2010 on ‘The $100 billion question’) and also to lose the implicit assurance than central banks will stand behind them in bad times. As long as their competitors are in the same boat, through regulatory convergence, maybe large firms do not mind a less subsidised future and a higher risk of being ‘let go’. An alternative possibility is that large firms are confident that such policies would, as far as large firms go, remain the path not taken. Nothing is settled until concrete cases arise but there is a possibility that that practice would be accommodative. This is not simply because of elite linkage but also because there remains considerable uncertainty as to the systemic outcomes, if ‘significant’ firms are not propped up (see above). Such uncertainty extends even to stress-testing of banks – which on the one hand has come to be considered essential in trying to prevent failure, yet on the other hand could trigger a loss of confidence and hence failure.

For example, in late 2013 there was considerable sensitivity over the criteria for the bank stress-tests to be conducted by the EU in 2014. The ECB sought to reduce the possibility that overly rigorous criteria could
‘further hamper banks’ funding’ (July 2013 letter from Mario Draghi, cited in Thompson and Steen 2013: 24). Such concerns about the present and future are entirely consistent with the historical evidence, reviewed in this chapter, that large firms are likely to be ‘resolved’ by being stuffed with central bank or treasury money – it being the smaller banks that may be allowed to fail or be restructured by regulators in such a manner that interesting parts can be available for takeover by larger entities such as Barclays.

**Conclusion**

This chapter has drawn together evidence and argument to support some relatively modest conclusions: that TCTF is not a ‘fact’ but a political construction; that historically it developed within a particular national context, that of the US, notwithstanding which it influences policy minds globally; that bail-outs are no better than bankruptcies when measured against yardsticks such as systemic stability, costs to the public finances and stability of (hitherto) sovereign states; that moral hazard had been deepened for the coming years; and that, whilst resolution schemes are to be welcomed, the same considerations as made in the past may mean that in practice little may change other than bail-outs being made more smooth in an administrative sense.

The underlying problems are as much owing to regulators’ beliefs as market pressures. TCTF beliefs, bail-out expectations and systemic instability are mutually constitutive. In response to such beliefs, this chapter suggests that breakdowns in the system do not result from failing firms, but from stopping them failing. That much has long been recognised by true believers in the market system (Leathers and Raines 2004); however, one does not have to be a supporter of *laissez faire* to agree on that point. One’s concern can focus on the invidious consequences of bailing out risk-taking investors and placing the resulting burden upon the public purse.

There remain attempts at radical thinking amongst elites, a highly questioning attitude in the mass media and the prospect that public disquiet cannot be assuaged. In the US from 2008 onwards and in the Eurozone from 2011 to 2013, there has been widespread unease. However, the very language of debate – ‘burden sharing’ or ‘private sector participation’ (discussed in Chapter 4) – shows the extent to which the public policy agenda continues to privilege certain private actors. Obligations on banks to raise additional capital miss the point about connectedness through cross-holdings of bonds. Fire-walls within an office are not much good if the roof or basement is left open plan. Tackling connectedness will fail unless it looks at who (effectively) owns whom, via bonds.

The reader is invited to imagine a parallel universe in which it had become normal for investors to carry all their losses and in which there arose a debate about the public helping them out to a modest extent. It is hard even to imagine such a world, showing how far policy has travelled in the opposite
direction. We do not have all the evidence to hand (as yet) to be able to assess the final scorecard from TCTF policies. Nevertheless, borrowing from and extending Akerlof’s 1970 paper cited above, financial market policies are public goods having something in common with private goods: we can never be sure whether we are being sold a lemon. Policy discourses that gloss over history, pointing selectively and excitedly at Lehman’s 2008 failure, are particularly suspect.
Part II

Regulatory hubris
Chapter 3

Two readings

Regulatory insufficiency or depoliticisation

In this chapter it is argued that an absence of democratic oversight of financial market regulators permitted their thinking to develop purely within closed, international, technocratic and ‘independent’ (of oversight) networks, with dire consequences in terms of systemic market risk. Within this world, a particular cultural and intellectual climate developed, within which regulators throughout the world: (a) found it ‘natural’ to utilise common models and data sets (largely developed by private interests, see below), side-lining questions of systemic risk; and (b) failed to discern the continuities between, on the one hand, the ‘innovative’ financial products and markets within their purview and, on the other hand, Ponzi schemes. When all regulators utilise the same conceptual frameworks, ‘models’ and data, this common agenda-setting results in common ‘blind spots’ and hence, potentially, vulnerability to systemic crisis.¹

What, if anything, might be done to reduce the harms imposed by crises in the future? The answer to that substantive question hinges on a question about process: what potential is there for meaningful public debate – or are citizens always to be reduced to being spectators, consumers and funders of last resort, in relation to policies crafted by market forces and regulators? In the run-up to the crisis, ‘speaking rights’ were available only to certain specialists, who imported technical assumptions and knowledge from the market into the regulatory agencies. In the light of the evident failure of that approach, it is time to reverse the direction of knowledge and power, or at least to make it two-way. The chapter argues in favour of regulatory diversity, driven by democratic accountability, some signs of which can now be seen (see below and Chapter 6).

Symptoms: risk appetite, Ponzi finance, contagion

Within the social sciences, notions of risk, precaution and pre-emption have been much debated in the period following the Second World War. However,

¹ Chapter 3 incorporates work originally published in the British Journal of Criminology, which is published by Oxford University Press.
within financial markets and in the discourses of their regulators, risk has possessed a positive rather than a negative sign: risk-taking and the ‘risk appetite’ driving it were perceived as being part and parcel of market innovation. There arose in the 1990s the idea of a ‘new financial paradigm’ and, in the 2000s, of a ‘great moderation’ in the volatility of markets, this supposedly being underpinned by market innovations and/or regulatory fine-tuning. As Ben Bernanke put it, before he became chairman of the US Federal Reserve: ‘One of the most striking features of the economic landscape over the past twenty years or so has been a substantial decline in macroeconomic volatility’ (Bernanke 2004). This reflected a consensus amongst regulators that things were well under control. Given a perception of economic conditions as benign – pace theorists of risk society (Beck 2006) – market participants had an appetite to increase risk-taking in order to increase profits.

Such an assessment now seems inseparable from a sense of complacency. As Coffee and Sale (2008: 29) critically observe: ‘the unique fact about financial institutions in general, and investment banks in particular, is their fragility’. Characteristically, financial institutions borrow, sometimes on a day-to-day basis, in order to have enough finance to cover the longer-term obligations. Every now and again there is a shortage or withdrawal of that short-term finance and then there is a problem (‘crisis’). As Coffee and Sale note, this speculative use of capital is the way the game has been played for some time: the recent very strong instability reflects the extent to which this model has been extended from the 1990s onwards. In such a fragile situation, a precautionary regulatory stance would seem to have been merited; however, it was not taken. Even after the events in New York on 11 September 2001, which might have been expected to infuse into market cultures a general sense of need for precaution, that sensibility did not seem to transfer into thinking on financial markets (Hellwig 2008: 51). In other policy fields, notably environmental policy, a precautionary principle – for example, aiming to avoid passing ‘tipping points’ in relation to global warming – was a matter of lively debate. Not so in financial market regulation, for reasons we explore.

In December 2008, a major and very long-running fraud came to light at an investment service, Bernard Madoff Investment Securities. In brief, Mr Madoff admitted that, over 10 years or more, his investment activity had been ‘all just one big lie’ and ‘basically, a giant Ponzi scheme’: incoming money from new investors was used to pay apparent profits to existing investors. Such schemes are vulnerable to any decrease in new investors or withdrawals from existing ones. They can be viewed as isolated events or as being symptomatic of more general features of markets. There are many features of the Madoff case that should have scared off most of his ‘sophisticated’ investors, including not only very rich individuals but also other major investment firms and banks. Some investment managers, who spoke with Mr Madoff at the instigation of clients who were interested in investing with him, were unable to understand
the nature of his business and did not recommend the scheme to their clients (Financial Times 2008a). Madoff’s declared profits were not only high but also remarkably stable from one year to the next, showing none of the ups and downs that characterise most genuine investments. Finally, his operation involved a small staff, several family members and little external oversight – all ‘red flags’ for fraud that should have alerted the regulator (Financial Times 2008b). As Dalmady (2009: 11) has parodied the situation:

One does not have to be a detective, or even a financial expert, to spot financial institutions that may prove insolvent, or worse, with the passage of time. As the saying goes, if it looks like a duck, if it waddles like a duck and if it quacks like a duck, it must be a duck.

At various times, Madoff’s quacking and waddling did draw some critical attention and puzzlement, yet action remained very limited. In 1998, JPMorgan Chase decided not to invest in Madoff because (putting it diplomatically) it could not understand his business model; however, the bank did not contact the authorities with those suspicions until after the collapse of the firm in 2008 (US Attorney’s Office and FBI 2014). In 2014, JPMorgan Chase entered into a deferred prosecution agreement and paid $US1.7 billion to the US authorities and other sums to private litigants in relation to its earlier non-action. However, the bank might be regarded as being no more at fault than the regulators. The Securities and Exchange Commission (SEC) conducted two inquiries into Madoff, in 2005 and 2007, finding that some rules had been broken in broker-client relations but not forwarding the issues for enforcement action.

What is curious, and what remains to be explained, is that those suspicions and investigations seemed not to have concerned the wider matters mentioned above. Part of the answer may lie in the good reputation of Mr Madoff and his firm, his support for charities, his social and political connections (CNBC 2008) and the fact that the firm took care to involve itself in SEC consultations over rules and regulations (Securities and Exchange Commission 2005), as would a reputable firm concerned with regulatory details that might affect its business. Another part of the answer may lie in the ways in which regulators tended then to allocate their supervisory and investigation resources – focusing on surveillance of new and smaller firms, on the basis that risk controls there might be below an acceptable standard – whilst allowing longer-established and larger firms to run their own risk assessments. In the wake of the financial crisis, which most definitely involved large firms, regulators have reversed their previous assumption that big firms do not need much direct oversight (Financial Times 2008c).

The sensational and front-page nature of Ponzi-type frauds should not divert us from the smaller but much more commonplace forms of fraud,
awareness of which permeates the financial crisis. Considering the credit markets, and starting with retail-level loans (for example mortgages), it is now clear that, prior to 2007, too many sales were being made to people who previously would never have dreamt of taking such a contract, with little attempt being made to check whether they had the means of repayment. The risks were exacerbated for the US by the public knowledge that, in the event of a downturn, mortgage holders could simply return the house keys, then being free of all obligation (although with damaged credit ratings, for those who had credit ratings). Hence, for many, purchase was a one-way bet, with an easy exit when/if the market soured. This is what happened generally, and to a bundle of 2,393 sub-prime mortgages referred to as XYZ by the rating agency Moody’s, which it had rated as AAA:

Moody’s monitors began to make inquiries with the lender and were shocked by what they heard. Some properties lacked sod or landscaping, and keys remained in the mailbox; the buyers had never moved in. The implication was that people had bought homes on spec: as the housing market turned, the buyers walked. [. . .] Amy Tobey, leader of the team that monitored XYZ, told me, ‘It seems there was a shift in mentality; people are treating homes as investment assets’.

(Lowenstein 2008; see also Gerding 2009)

Mortgage fraud was rife in the US in particular in the mid-2000s – being driven by investor demand for securitised products, by the fees to be made by those who sold the mortgages to the retail purchasers and by the slowness of the authorities to stem millions of abuses:

The shortfall in mortgage servicing from this sub-prime lending should have been anticipated by the originators and by the arranger who acquired the stream of payments and structured them [. . .] Here again agency [conflict of interest] problems arose. They related not only to internal remuneration incentives in the various firms involved, but also to the shared interest of arrangers and the rating agencies in doing business even if it meant exaggeration of ratings.

(Honohan 2008: 20)

If so many observers knew that there was fraud in the system – or could have known had they enquired – then why was insufficient action taken by the regulators to restrain these fraudulent practices? There is a technical answer to this, concerning the ratings agencies, which will be discussed below. However, there is also a cultural answer: these frauds were structurally quite similar to wider phenomena in the financial markets that had become normalised.
Ponzi finance not as the exception but as the rule

Many sectors of the economy, including energy, communications and environmental services, have seen high-profile business embarrassments, difficulties and collapses from the 1990s onwards, including Enron, Xerox, Waste Management, Cisco Systems, AOL Time Warner, Tyco, WorldCom and Ahold (Markham 2003, Levi 2008; Coffee 2002a). Most of these have involved attempts, through improper accounting, to give the impression that companies’ profits were higher and more stable than in fact they were, through techniques of income-smoothing such as ‘channel stuffing’ and ‘cookie jar reserves’ (Markham 2003). The number of accounting restatements, reflecting such practices, ballooned from the late 1990s onwards.

Some commentators have argued that such practices were provoked in part by deregulation in the Reagan years (Coffee 2002a) and by performance-related pay and bonuses for senior management, which created a corporate culture sympathetic to the idea of steady and rising income and profits streams. Conversely, others argue that incentives to misrepresent could be reduced by relaxing disclosure requirements upon companies: investors would then choose from a disclosure ‘menu’ according to their appetite for risk (Markham 2003: 795 ff). Leaving aside such differences, commentators generally agree that rather shady practices became almost normalised amongst companies from the 1990s onwards; some say that something similar may have happened to the accountancy firms that were supposed to be the main defence against such developments (Sikka 2008). But why did such normalisation occur?

A common observation is that capitalist market economies go through successive waves of crisis, as speculative over-borrowing is followed by panic selling. Followers of Hyman Minsky refer to so-called ‘Minsky moments’ – crisis points during which investors are forced to sell good assets in order to pay back their losses on bad assets (Minsky 2003). These are seen as intrinsic characteristics of market economies:

[During] periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system. In particular, over a protracted period of good times, capitalist economies tend to move to a financial structure in which there is a large weight to units engaged in speculative and Ponzi finance.

What Minsky meant by this is that conservatively-operated financial units – meaning those able to meet their contractual payments obligations out of their cash flows – are gradually edged out of the market by more ‘speculative’ traders, and by the even more adventurous ‘Ponzi’ traders, as he termed them. These may not start out with fraudulent intent; however, with little or no cash generation within the business (because expenses outweigh any profits), they
are reliant on attracting investment in order to pay costs. Minsky suggests that periods of stability lull market players (and regulators) into thinking that the stability is an inherent and defining aspect of the financial system. In such a situation, more risky financial tactics are adopted, as investors believe that risk has been mitigated, if not banished. As this way of thinking spreads, from the professional investment world to the whole population, so Ponzi styles of investment become generalised, becoming the norm at certain (turning) points in the cycle (Wray 2008: 15).

To take an example, much of the activity in securities markets concerned the passing on of debt risks by buying insurance against the possibility of default (CDSs), as pioneered by AIG (Morgenson 2008). AIG seemed fine until the market turned, whereupon the US Government felt obliged to prop it up (Sjostrom 2009). There is no suggestion that AIG or its former managers intended to commit fraud; rather, it is that the taking on of obligations beyond the capacity to repay is a Ponzi-like characteristic. Some commentators have tried to generalise this perspective to international relations and security matters (Galbraith 2008).

Focusing on 2008, recognition of such ‘moments’ and fear of a financial meltdown became one of the drivers of that process – just as, previously, the belief that markets could only go up was one of the drivers pushing it up. As one newspaper put it: ‘Markets are ruled by fear and greed, they say, but those two ingredients are not the whole recipe: ideas play a part, too. And, as all bankers worth their Blackberry know, the current big idea is the “Minsky moment”’ (Guardian 2007). That scary idea reappeared within Europe from 2009 onwards. The question remains, why did regulators not see the problems coming? It is one thing to observe that regulators were swept along with the tide but quite another reason to pin down why this was the case. Here two readings of this are offered.

**Reading 1: regulatory complicity and forbearance**

Most official commentaries on ‘what went wrong’ broadly follow the US ‘President’s Working Group on Financial Markets’ (Bernanke 2008a). This focuses on the so-called ‘originate-to-distribute’ model of financial trading in relation to mortgages and instruments referencing them; however, in principle it equally describes the creation of and trading in other types of debt: car purchase plans, credit card debt, company bonds, etc. Federal Reserve Chairman Ben Bernanke (2008a: 2) summarised the three stages of origina-
tion, securitisation and distribution as follows:

In the first stage of the process the originator – a lender or a broker serving as a lender’s agent – extends the mortgage loan to a potential homebuyer. The originator is responsible for the underwriting – that is,
for ensuring that the borrower is creditworthy and that the terms of the mortgage appropriately reflect the risks of the transaction.

Then follows securitisation (ibid), in which:

... the originator sell(s) the mortgage to another financial institution, let’s call it the packager, which combines the mortgage with many other loans to create a marketable security. [...] However, much more complex securities can also be created, backed for example by a mix of different types of loans or other assets combined with various guarantees or hedges.

Finally, the products are sold into the market (ibid):

In the third stage of the originate-to-distribute process, these tranches [of debt] are rated separately by one or more credit rating agencies, then sold to investors with differing preferences for risk or retained by the lender. In principle, the originate-to-distribute model spreads risk...

In the event, many of the financial institutions that might have expected to pass on most of their risk were holding much of it when market conditions sharply deteriorated from 2007 onwards in the US and the UK (and again in the Eurozone from 2008 onwards). This may have been the result of a reluctance to pass on the perceived profits associated with those risks. Nevertheless, large amounts of levered debt were indeed passed to a range of investors throughout the world – to pension funds, local government, private investors – attracted by the prospect of reconciling strong income flow and apparent safety offered by these instruments.

Why were investors so comfortable with these ‘packages’, the contents of which few of them understood? The apparent safety of the securitisation (the very language carries with it some reassurance) was a prime motivation for many investors but there were also positive inducements from informational gatekeepers and, ironically, from regulators. Much commentary has been directed towards the ratings agencies, and to their unfortunate joining together of: (a) technical errors; and (b) misleading symbols (AAA mortgage-backed bonds might be seen by some in the market as meaning something similar to AAA sovereign debt, for example US Treasury bonds). On technical errors, rating agencies ‘underestimated the default correlation in mortgages by assuming that mortgage defaults are fairly independent events. Of course, at the height of the business cycle that may be true, but even a cursory glance at history reveals that mortgage defaults become highly correlated in downturns’ (Danielsson 2008; see also Danielsson 2002).

On the symbolism of AAA, there is a now obvious question to be asked: ‘is a rating metric suitable for sovereign bonds, investment, and
sub-investment-grade corporate bonds, or project finance also suitable for structured financial products? (Mizen 2008: 563). However, perhaps ‘the market was not fooled’ (Danielsson 2008: 14) by the symbolism. Market professionals are not babies: they perfectly understood that an AAA rating on a relatively new and highly structured product referred to a comparison within that category of product, rather than to dissimilar, longer-established product lines offering a lower rate of return (ibid):

After all, why would a AAA-rated SIV [structured investment vehicle] earn 200 basis points above a AAA-rated corporate bond? One cannot escape the feeling that many players understood what was going on but happily went along. The pension fund manager buying such SIVs may have been incompetent, but he or she was more likely simply bypassing restrictions on buying high-risk assets.

The implication is that the ratings agencies used the same symbols for esoteric products as for more mundane products because this allowed the esoteric products to be sold to a wider base of (risk-averse) investors. That in turn would generate more business for the ratings agencies. Fund managers, who throughout the 1990s were under pressure to improve performance, accepted this conceit. Their high demand in turn stimulated the invention and supply of new securities. As Coffee and Sale (2008: 19) put it:

Correct as the President’s Working Group was in noting the connection between the decline of discipline in the mortgage loan origination market and a similar laxity among underwriters in the capital markets, it largely ignored the direction of the causality. In retrospect, irresponsible lending in the mortgage market appears to have been a direct response to the capital markets’ increasingly insatiable demand for financial assets to securitize.

To summarise, blaming the ratings agencies is merited insofar as it points to a conflict of interest. However, such blame could also function as a diversion, similar to the blame attached to a servant for carrying out his master’s bidding. If the sub-prime phenomenon was driven from above (by the capital markets) and from below (by investors), then it is hardly surprising that there was pressure upon the gatekeeper in the connecting chain.

**Regulatory forbearance and use of private models**

Financial market regulators observed, and allowed, the emergence of new and innovative, markets that, being new, were outside the scope of existing regulation. Why did the regulators not enlarge the scope of regulation in order to bring these activities within their control? Possibly it was partly because they
were preoccupied with competition between national financial centres and interests – market participants were said to indulge in ‘regulatory arbitrage’, meaning they would relocate trading operations to less burdensome regulatory centres (for a review, see Prentice 2005; and for a critique, see later in this chapter).

Much of the debate on financial market regulation prior to 2007–08 focused on the distinctions between ‘rule based’ regulation (of which New York was taken as the paradigm) and ‘principles based’ regulation (London), and on the question of whether the former is more constraining than the latter. However, that debate primarily concerned the listing of firms on stock exchanges (Coffee 2002b), which is not the arena in which the ‘credit crunch’ problems emerged. In relation to two structural features of credit markets that were clearly implicated in the crisis – off-balance sheet vehicles, especially of banks, and the formation of rules concerning wholesale financial products including derivatives – there is a uniformly ‘light touch’ regulatory stance. Off-balance-sheet vehicles had emerged as a known and tolerated way for banks to get round Basel capital adequacy rules: by transferring debt and risk to an off-balance sheet subsidiary, the banks were able to continue to take on risk (Mizen 2008).

Additionally, on-balance-sheet measures of bank debt shot up in the period to 2008. In the US, regulatory reforms encouraged this for the biggest financial institutions. As Mizen points out (2008), as at the beginning of 2008, the US hosted five major investment banks that were not owned by a larger commercial bank, namely: Merrill Lynch, Goldman Sachs, Morgan Stanley, Lehman Brothers and Bear Stearns. By the end of the same year, all had either failed or abandoned their status as independent investment banks. The same five had been allowed by the authorities to adopt ‘alternative’ and more ‘relaxed’ rules about the safety-net capital that they were obliged to hold. As Mizen put it: ‘The result was predictable: all five of these major investment banks increased their debt-to-equity leverage ratios significantly’ (Mizen 2008: 560–61; see also de Fontnouvelle and others 2005; Dierick 2004). In the spirit of competition, European banks also took on more risk, thus: ‘UK bank assets jumped from a manageable twice gross domestic product in 2001 to almost 4.5 times by 2008. These, then, are [like] under-capitalised hedge funds with liabilities large enough to destroy the solvency of the British state’ (Wolf 2008: 9).

When one considers regulators’ tolerance of banks building up such large debts on their balance sheets, alongside ballooning off-balance sheet debts, it appears that the deregulatory trend in this period was strong. Commenting, the then chairman of the US Federal Reserve said: ‘We [regulators] will review our own use of credit ratings as a risk metric’ (Bernanke 2008a: 4). Not only had the regulators allowed the ratings agencies to develop and maintain client-friendly methods that sent such positively-biased signals to the market but they had also built into regulatory standards a requirement that certain categories
of market participants must take account of ratings – and licensed a very small number of rating agencies (for a critique of this written a decade before the crisis, see Partnoy 1999). The result was that many institutional investors, including pension funds and the like, instead of making in-depth enquiries of their own, were all obliged to follow the same standard advice – thus ensuring a ‘Gadarene swine’ effect, deepening collective risk and the depth of the eventual crisis:

Too much homogeneity among risk management strategies among financial institutions can increase systemic risk. If firms have the same strategies and similar portfolios, market shocks can cause the firms to sell the same types of assets at the same time to cover their positions. A widespread sell-off would cause values of these assets to plummet and trigger a sell-off of yet another class of assets.

(Gerding 2009: 64–65)

Moreover, the regulators constructed their own worldview partly on the basis of such data. It must be expected, in any regulatory system, that day-to-day working relations between firms and the regulator, friendships, alliances and criss-crossing career paths produce a net of shared orientations and forms of knowledge (Pratt 2009; Bó 2006). Regulators’ reliance on the same worldview, risk methodologies and market data as that used by market actors further deepens systemic risk because, even allowing for high levels of professionalism and commitment to independence, still the regulators were compromised in terms of their knowledge base. (For more on the knowledge base, going forward, see Chapter 5.)

Problems with the ratings agencies have since led to their tighter regulation, in the EU as well as the US. Ironically, however, that might imply even greater centralisation of production of market information. By contrast, some commentators have advocated the opposite approach – arguing for deregulation and more competition in the provision of risk information – on the basis that multiple sources and methods of calculating risk could improve quality (White 2009). Be that as it may, so central to the crisis has been the contribution of a narrow information base, blindfolding regulators, that any radical change would be an improvement, whether that be the ‘freeing’ of information on risk, or its tighter control by the state, or a heterogeneous mix of information sources.

Regulators also relied on private sector risk models when defining banks’ needs for capital reserves. Martin Hellwig recounts that, when in 1993 the Basel Committee on Banking Supervision consulted on a standard approach to bank capital requirements, ‘the banking industry responded with intensive criticism, arguing that such regulation would represent a step back from the “sophisticated” risk management procedures that they themselves had started to implement on the basis of quantitative models’ (Hellwig 2008:...
The banks won and their ‘model based’ approach was codified in 1996. Hellwig suggests (ibid: 54–55) that: ‘in this discussion, the notion that there is a difference between private interests and the public interest in risk management and risk control of a bank seems to have been lost’.

How did regulators arrive at the point of putting individual private interests before both the collective private interest (beyond the short term) and the public interest? Hellwig suggest that public policy-makers were influenced by consideration of the competitive advantage that might accrue to their countries’ banks: ‘In particular, for countries with banking institutions at the forefront of change, most prominently the United States, the introduction of the option to rely on a model-based approach seemed like a chance to have ‘their’ institutions benefit from their advantages in global competition in newly developing markets’ (ibid). Further, in relation to derivatives such as futures and options (ibid):

A similar logic may have been at work in the late nineties when Federal Reserve Board Chairman Greenspan, Treasury Secretary Rubin, and Securities and Exchange Commission Chairman Levitt, all three of them with strong ties to the investment banking community, used their influence to stop attempts to bring derivatives trading into the domain of statutory regulation.

In summary, the pattern of what was not regulated, what was and, if so, how it was resulted from negotiations in closed fora, as described many years before the crisis in the following terms: ‘The absence of any external reference-point makes it difficult, if not impossible, for regulators to establish what “public interest” they should be defending’ (Picciotto and Haines 1999: 368). How could such a situation have come about? Some regulators defended themselves by saying that their hands had been bound by policy-makers. In an exchange in the UK House of Commons in February 2008, this was referred to as the ‘Nuremberg defence’: regulators were obliged to adopt light touch regulation because their political masters told them so (Waugh 2009).

However, policy-makers’ alleged subversion of regulatory agencies is just one of several possible perspectives. The converse perception, to be found in the law and policy literature, is that regulatory agencies can be all too eager to alter, widen, narrow or effectively subvert their purposes (Cohn 2001). An example is given by the Bank of England which, having become focused on interest rate policy, neglected the wider question of stability: the then governor of the Bank, ‘Mr King made its financial stability unit a backwater whose views did not adequately permeate monetary policy’ (Giles 2009).

One well known explanation of regulatory neglect and inaction is ‘regulatory capture’ (referring to the ‘vast literature’ reviewed inter alia by Michael Moran 2002). From a perspective favourable to public regulation, varieties of the capture thesis propose that initially-independent regulatory
agencies may fall under the influence of those they are supposed to regulate (see for example Martimort 1999; and, for an early US perspective, Bernstein 1955). Capture may refer to corruption of individuals by private interests; to an institutionalised condition of ‘cognitive capture’, in which regulators’ assumptions and thinking are formed through their repeated interactions with and eventual identification with regulatees; to ‘regulatory rapture’, as assent that gives way to cheer-leading (Anderson 1982; Dorn 2010; Hellwig 2008); and/or to a wider situation of shared ideas or ‘cognitive affinities’ between the industry, politicians, regulators and citizens (Larson 2013: 8) – this having something in common with the ‘Nuremburg defence’ mentioned above. Of course, any ‘cognitive capture’ proposition must implicitly rely upon an assumption of a preceding, pre-capture situation – which might not actually have been the case, had private actors always been in charge (see Chapter 1).

Overall, the ‘insufficient regulation’ reading of financial market instability does have some merit. However, this reading of the crisis turns out to be strangely circular: regulation was light and sometimes missing because just about everyone who was involved wanted it that way. That, however, takes us back to the question of who was involved, who was not and why not.

**Reading 2: depoliticisation, convergence, contagion**

The first reading of the crisis, in terms of insufficient regulation (implication: let us simply have more) was an understandable reaction to the crisis but that was an insufficient one. A second reading can be made: the evolving crisis in the international markets resulted from market similarity and connectedness, these being exacerbated by regulators, through increasing convergent global rule books. If monoculture magnifies the danger of systemic collapse, then difference can provide a margin of safety:

In situations of financial contagion, regulatory differences can be a ‘safety valve’ against spreading financial crisis. In the financial crisis of 2008 for example, nations such as Canada and Japan, which had not fully adopted the North Atlantic approach to financial regulation, fared better than others which had joined the international consensus precisely because their markets were not so accessible to the kinds of techniques financiers had developed to get around international rules. (Riles 2013b: 12)

Although the above observation is readily and widely acknowledged, it proves tremendously hard to act upon: regulators commit themselves to cooperation with peers and slide from that to convergence. Given concerns around market herding, TSTF, contagion and the potential for crisis under conditions of market ‘monoculture’, one might expect ready and wide
acknowledgement of the merits of market disconnection through regulatory
diversity. Quite the contrary, however; important market forces and regulators’
established forms of knowledge can combine to translate the (indisputable)
merits of ‘cooperation’ into ‘convergence’. The consequence is that, even
though regulators generally have to act at the level of their various jurisdictions,
they seek to carry out rather similar actions there (witness subsidiarisation, to
be discussed in the final chapter). Thus, both market forces and regulatory
habits limit the possibilities for tackling ‘too connected’, ‘too similar’ and
contagion.

However, under different political conditions, regulatory cooperation and
knowledge need not inevitably adopt sameness as the motif. Bringing
democracy into financial market regulation – tentative signs of which were
seen in the US and the EU at the time this book was in preparation – is
merited in two senses. It is merited in normative terms, since its exclusion from
normal political debate is as unacceptable exception, as is the well known
‘national security exception’, which places so much of foreign and national
policy beyond the democratic process. It is also merited on grounds of policy
and regulatory effectiveness: democratisation of financial market regulation
offers a way out of the over-connectedness that exists, both within the market
and between it and its regulators.

Less technocracy, more democracy, more regulatory diversity, less
connected markets, and so shallower and less systemic crises: that is the
forward agenda offered here, as well as the revisionist analysis of recent events.
The regulatory condition for systemic crisis – the global sharing of assump-
tions and models, the reliance on a small number of ratings agencies, other
shared vulnerabilities – was regulatory convergence. Such convergence was
possible because financial regulation ‘floated off’ from its potential moorings
in democratic politics. Had the broad outlines of financial market regulation
at national and/or regional levels been democratically directed, through
elected representatives, possibly by referendums on controversial issues, then
inevitably regulators would have been somewhat constrained from conver-
gence with their professional constituencies at the international level. Ergo,
there would have been greater diversity in national regulatory systems,
weakening the conditions for the particular type of crisis that erupted from
2008 onwards. In a less tightly ‘connected’ financial system, contagion within
the market would be reduced, so crises would become more localised and
intermittent, less global and pervasive.

The question then becomes one of how to reduce connectedness
within financial markets. Politicising financial market policies – taking dis-
cussion of these issues out of the sphere of ‘technical’ and putting it into the
democratically contested space, alongside social, health, welfare and general
industrial policies – would encourage differing policies to emerge in differ-
ent countries. Diversity of regulatory regimes would result in some business
models being attracted to some jurisdictions, others to others: ‘forum
shopping’ (for lawyers) or ‘jurisdictional arbitrage’ (for market theorists) should be recognised as a global public good (see next section). The resulting heterogeneity, when viewed from a global perspective, would be a reversal of recent and current tendencies towards one single/global ‘level playing field’, within which all financial firms and sectors have become closely connected and across which contagion inevitably reigns.

The unpredictability of the democratic process, if made the driver of financial market regulation, would underpin a more differentiated and hence safer system. The argument here is broadly compatible with, yet extends, a strand in the political economy literature, according to which the origins of crisis are to be found not primarily in deregulation but rather in the ‘technocratic obscurity and political insularity’ of regulatory depoliticisation (Major 2012: 555). As described in Chapter 1, a historical side-stepping of democracy by financial markets allowed what was functionally private regulation to persist, although it acquired a public face. The resulting pseudo-public regulation detached itself from states and coalesced into an internationally networked knowledge community, which remained closer in culture, affiliations and thinking to regulatees than to citizens. Historically, politicians heeded this community.

None of this is meant to imply that regulators are robots, formed by historical conditions and thus incapable of self-reflection or novel actions. Certainly the vigour of regulatory debates and novelty of actions since the emergence of the crisis show that any such notion would be wide of the mark. However, there remain some fundamental issues: the problem of ‘fighting the last war’; the tendency within any ‘community under stress’ (Tsingou 2010) to search for safety in conformity – a tendency that may even have deepened as a result of the discomforts generated by failure; and the implausibility that any technocratic community, including one whose failures have been rewarded with an expansion of power, would seek to clip that power by calling for stronger democratic oversight.

On fighting the last war, one characterisation of the international regulatory community could be that, since 2008, they have shifted in their working assumptions from Tea Party to Social Democracy. In one sense this is not only understandable but also justifiable, insofar as too much private regulation (and too much dressing up of private regulation in public clothing) was clearly implicated in the crisis from 2008 onwards. However, it does not necessarily follow that ‘more regulation’, imposed globally in a uniform manner by a technocratic elite, would prevent future problems from building into systemic crisis. Social democratic regulation writ large could be as connection-friendly and similarity-building as neoliberalism writ large. Only a diversity of regulatory regimes, encouraging a variety of business models and disincentivising connectedness, would lean against the contagious tendencies of financial markets.
Jurisdictional arbitrage: friend or foe?

Jurisdictional arbitrage (alternatively, regulatory arbitrage) refers to financial firms moving from one market to another – or conducting particular forms of business in or through some jurisdictions rather than others – because of perceived advantages vis-à-vis regulation in or between jurisdictions.

By definition, jurisdictional arbitrage requires as its condition of existence that jurisdictions differ in their rules. Under conditions of wide regulatory diversity, there is much scope for arbitrage; under conditions of moderate convergence, still some scope; whilst if all conditions that are relevant for all market participants are harmonised (a hyper-globalist dream) then there would be no scope at all for jurisdictional arbitrage.

The question is, should such arbitrage be viewed as an alarming sign (as it is conventionally) or as reassuring (as a prerequisite for systemic stability)? There are a number of issues here and they are not at all settled. Riles (2013b: 6, 10) has suggested that:

For the regulators and academics thinking about regulatory arbitrage problems, the notion that harmonization is the answer is largely taken for granted. [. . .] Yet the extent to which we accept that regulatory arbitrage is a problem depends on the extent to which we agree that legal differences are inherently a problem.

Of the several objections to regulatory arbitrage, here we critically discuss four: (1) pros and cons in terms of jurisdictional competition and regulatory learning; (2) the commonly-cited possibility of a ‘race to the bottom’ in regulatory standards if jurisdictions compete for business by lowering standards; (3) a thematically related but intellectually separate argument that jurisdictional diversity and arbitrage hold responsibility for crisis; (4) preferences generated by regulatory networking.

First, some observers suggest that a certain amount of regulatory diversity may have advantages on the basis that it allows regulators, somewhat like scientists, to learn from comparing and studying differences (Dragomir 2010; Helleiner and Pagliari 2011). On those grounds, a loosening of global standards might be not only accepted but welcomed, since regulatory competition and difference can offer learning points. Thus, jurisdictional arbitrage might be not only tolerated but actively preferred to global standards. Dragomir (2010: 101) offers a summary on this point:

The main counterargument against global prudential standards [. . .] refers to the negative effects of inhibiting regulatory competition. The argument goes that harmonisation hampers competition between regulators and, thereby, lowers incentives for regulatory innovation and flexibility. The imposition of global standards creates a level playing-field
among jurisdictions, which reduces regulators’ fear flow towards lower-burden jurisdictions.

Thus, one set of concerns is articulated around competition: if competition and innovation are global goods, then regulatory diversity encourages those global goods – at the expense of causing loss of business for some (“higher-burden”) jurisdictions. That way of framing the issues sets them up in terms of market dynamism and winners and losers. In locating specific interests within this framing of the issues, it is necessary to differentiate between those firms having global ambitions and reach, and those that do not. The former are generally in favour of regulatory convergence and hence inclined to make strategic use of the concept of arbitrage, pointing to its disadvantages for them (even if the same firms may actually routinely arbitrage differences when allowed to do so). Such firms can be expected to continue to support the globalisation of the regulatory field, using whatever arguments are at hand. On the other hand, diversity could find support from smaller, local and national firms, which inhabit still-remaining local markets, and to some extent are protected by peculiarities of domestic regulation.

Secondly, a related but distinct set of concerns is that diversity leads to a ‘race to the bottom’ in terms of standards. On this view, regulatory forbearance, light touch regulation, tolerance of Ponzi finance – as observed in the run up to the crisis – are symptoms of such a race to the bottom. But on what grounds (and with what evidence) could it be said that diversity operates only in one direction: ‘downwards’? Or that it has only one dimension? Whist it is clear that there is ongoing competition between jurisdictions, the dynamics of that are not one-dimensional and cannot be reduced to high versus low (see Singer 2007; Helleiner and Pagliari 2011).

There are many reasons that firms might have for seeking access to diverse financial centres and channels, only some of which concern regulatory standards; and when they do concern regulatory standards, by no means are they always downward-pressing. Choice of trading venue may involve many considerations, including: firms’ familiarity with the jurisdictions concerned; availability of tried and trusted transaction channels, service-providers or counter-parties; overall transaction costs, a part of which but by no means all of which will be influenced by compliance requirements and tax rates (if any) on the activities or transactions concerned; the legality of certain transactions (see Chapter 1 for the innovation and development of Euromarkets in London); and, finally, the reputational profiles of the jurisdictions – requirements for which and assessment of which may vary, depending on transactions and on the parties concerned. Indeed, a balancing of advantages and disadvantages of ways, location and conduits of business is typical. Were it otherwise, there would be no Chicago, New York, City of London, Paris or Hong Kong; all business would have migrated to Bermuda or Russia.
The general point to be made about a ‘race to the bottom’ argument is that, whilst it admittedly may have sloganising power, it can be turned upon its head and furthermore it is vulnerable to decomposition. Far from a race to the bottom being inevitable, a race to the middle or the top is conceivable, whilst a race to differentiate along several dimensions is the more likely outcome. As Dragomir (2010: 101) summarises matters: ‘no jurisdiction will attract or retain business on the basis of low quality standards, thus the risk of a race to the bottom is considered rather slight’. However, considering a possible relationship between regulatory diversity and systemic stability, the same author suggests that ‘the risk of promoting inefficient or ineffective regulation is relatively high, as demonstrated by the 2007–9 crises’ (ibid). No doubt this is one area in which further work is needed. However, an interim conclusion can be that the ‘race to the bottom’ hypothesis is simplistic, one-dimensional and contentious.

Thirdly, and in order critically to explore the proposition that diversity and arbitrage exacerbates contagion and instability, we return briefly to two moments in history in which the City of London played a key role: in the post-Second World War development of the Euromarkets and London-based activities of US firms prior to 2008.

A textbook example of the historical development of jurisdictional arbitrage was mentioned in Chapter 1 – the development of the Euromarkets in the City of London. To recap, these markets grew because they allowed US nationals to carry out trades that they would have been unable to do in the US jurisdiction. The London market’s innovatory capabilities and the regulators’ tolerance (indeed protection) helped to restore the City’s fortunes after a long historical stagnation. The interest for present purposes is the stance taken by US and UK regulators. As Jordan and Majnoni (2002: 267) have reflected: ‘The Euromarket has sometimes been characterized, erroneously, as an “unregulated” market’. In truth the situation was more subtle than that, because the market could not have existed without regulation (ibid):

Taking advantage of the difference in the fiscal and legal characterization of the transactions (as between the US and Europe) market practitioners have skillfully flown below the radar screen of formal national regulation. US regulators looked at the nature of the transaction; if it was centered in Europe, they let it go. European regulators looked at the nationality of the issuer; non-European issuers did not trigger a regulatory response. The Euromarket flourished in the interstices.

As discussed in Chapter 1, the Euromarkets actually triggered all manner of responses. The Bank of England, as the Big Brother of the private regulatory system then in place, took an increasingly close and ultimately benevolent interest, finally finding the new trades to have promise, leading it
to stonewall on enquiries made through the Treasury. The US response was even more interesting: far from closing the London loophole – which it could have done through rule changes in the US that could have constrained US nationals – the US let it continue. One reason may have been that, as London developed as a global platform and US firms became more active in Europe, so the US perspective on London became more positive. Indeed, there was a general pattern in US regulation of tolerance of international activities that were not permitted at home.

On these grounds, regulatory acquiescence was a matter of policy. As regards the near failure and subsequent rescue of AIG, the *New York Times* Editorial (2012) observed that ‘one of the reasons the A.I.G. Financial Products unit escaped the notice of regulators was that it was based in London, where it operated under a French banking license’. This is an interesting observation, although perhaps the notion that the London unit ‘escaped the notice of regulators’ is not quite right, being too kind to the US authorities. The facts are that the US parent company, registered in Delaware, was regulated by the US Office of Thrift Supervision, itself under the oversight of the US Federal Exchange. AIG Financial Products, a division of the company, opened a subsidiary in Paris, Banque AIG, which was regulated by the Commission Bancaire. In accord with EU single market rules, Banque AIG opened a London branch. The latter traded in derivatives, in particular CDSs, insuring property mortgage related products against default risk. The Commission Bancaire recognised the Office of Thrift Supervision as an ‘equivalent regulator’ and the latter continued as the lead regulator.

To summarise, the AIG London office was not regulated by London, nor by Paris, but (in principle if not in practice) by the US authorities. It follows that responsibility for the lax supervision of AIG may properly be attributed to the US authorities which, in the pre-crisis period, were all too happy to allow the international activities of AIG to run effectively in a regulatory void, remitting profits back to the US parent. The US authorities’ stance vis-à-vis AIG’s international activities was light touch regulation taken to extremes: regulatory connivance.

The US authorities’ failure to regulate AIG had nothing to do with regulatory diversity or convergence. Quite irrespective of whether the global picture is one of regulatory convergence or diversity, it would be perfectly possible not only for regulators to agree a lead regulator or other arrangements, but also actually to implement such arrangements in practice. It was not regulatory diversity that allowed AIG to build up extraordinarily high levels of risk (insuring primarily against sub-prime risks); it was the US authorities’ failure to do their job. For AIG to be cited as evidence of the risks posed by regulatory diversity – as distinct from regulatory forbearance in the presence of Ponzi finance – it would have been necessary for AIG’s London office to have been supervised according to the rules of a particular jurisdiction, which *in effect* it was not.
As with AIG, so in broad terms with Lehman Brothers (also discussed in Chapter 2). Lehman took large risks (increasingly large from 2007 onwards) on sub-prime, whilst routing its trades and arranging its accounting between two jurisdictions, the UK and the US, such that the risks appeared to be acceptable. The splitting and manipulation could have been stopped by either jurisdiction, had they had a mind to do so. One possible solution – which would not have suited the likes of AIG and Lehman – would have been for any of the jurisdictions involved to require financial entities to apply nationally applicable rules across the board or, alternatively, not to have activities involving parties in the said jurisdiction above a defined monetary value. Market participants wishing otherwise could go elsewhere.

Finally, turning to preferences within the international regulatory community, acceptance of rule convergence – which sets up arbitrage as a problem – developed as part of that community’s shared ‘common sense’. Several explanations of the social and behavioural mechanics of this have been advanced. Macey (2003: 1353) has suggested a rather psychologised mechanism driving convergence, as ‘a basic survival response on the part of bureaucrats whose regulatory power is threatened by increased competition [from each other] and [also by] private-sector globalization’. On a less prejudicial note, Singer (2007) has suggested that regulators strive to achieve a balance for their home jurisdictions between competiveness (which he equates with low regulation) and stability (which he equates with high regulation). Rather than simply going ‘low’ and thus risking stability of the home market, they strive – through networking with the regulators of other jurisdictions – to arrive at a common position, according to Singer. For Europeans, such theorising would have to be widened to take in the context of development of the single market of the EU.

A more general proposition, to which the present writer subscribes, is that regulatory thinking on convergence and arbitrage is induced through regulators’ networking with each other regionally and internationally, as well as with representatives of large financial firms. In times of calm, connections with politicians, let alone citizens, are loose. This creates a particular cultural world and epistemic community. This environment does not necessarily make regulators captive of particular interest of specific firms, nor even necessarily induces cognitive capture through interaction with the largest firms (Young 2012). The strongest interactions, negotiations and processes of construction of knowledge remain those between regulators themselves. The increasingly networked environment predisposes regulators not to diverge from each other.

This makes jurisdictional difference and the possibilities for regulatory arbitrage obvious talking points and potential problems for regulators: regulators seek to bring greater coherence to their world. Ironically, the closer the various jurisdictional regimes come to each other, the more possible it becomes to focus on and work on the remaining differences. There is a sense,
therefore, in which regulatory convergence and problematisation of arbitrage can constitute a positive feedback cycle.

Responses in the wake of 2008: conservative ends, radical means

From 2009 onwards the first, ‘sub-prime’ wave of the crisis initially appeared to have been contained. However, the picture quite quickly became rather complicated, indeed messy, with recoveries in some markets, particularly housing in the US, alongside varied but acute problems in many European countries (Ireland, Greece, Spain, Portugal, Italy, Slovenia and the Eurozone as a whole, see Chapter 4). In some countries, such as Greece, the problems originated in public finances as well as in banking, whilst in many other countries, notably Ireland and Spain, the problems arose in the real estate sector and in financial markets, then being transferred to the state through socialisation of losses. The messiness of the situation was made all the greater by a series of exposés of wrongdoing within financial markets, dwarfing the Madoff scandal and illustrating that insider trading (Jeng 2013), mis-selling (Dorn and Levi 2011) and market manipulation (McConnell 2013) had become core elements of financial markets.

For financial market regulators, these contagions (in both the strictly financial sense and in a moral sense) posed intellectual and practical challenges. The general responses to these challenges are briefly discussed here under the headings of: (i) ends and means; (ii) the knowledge base for action; and (iii) levels of action. Altogether, we shall conclude that a certain amount of innovation, creativity and support for flexibility and variability characterised regulatory responses in the late 2000s and early 2010s. However, some pre-crisis fundamentals were not overturned. Regulation following the crisis can be characterised in terms of plasticity, rather than either rigidity or paradigm break.

First, there was the question of ends, then of means. What to do with what was suddenly revealed to be a severely malfunctioning system? The global regulatory community was conservative on ends but more radical on means (Bernanke 2008a; Turner 2011). In the short term, crisis management was understood not as how radically to change the system but how to save it. In the medium term, the pre-crisis model of financial services had somehow to be salvaged; it should be reformed rather than transformed or displaced.

One means of doing this, radical innovation, was forced upon regulators: new tools, rationales, justifications and rules had to be made up. Vigorous and unprecedented actions were taken and, where these were legally or politically questionable, they were rationalised in terms of there being no alternative – or if there was an alternative then it was unpalatable. For example, the US Treasury first put pressure on (supposedly) relatively healthy banks to take over failing ones; secondly, it put strong pressure on Congress to release public
funding (see Chapter 2). The UK offered an international example in state intervention and nationalisation of the banks – incidentally illustrating willingness of national elites to bail out regional interests, in Scotland, action later echoed by Spain in relation to banks in its politically boisterous regions. The Irish Government, under pressure from the US and the ECB, dipped into the public pension pot in order to bail out its banks and their senior creditors. In short, large banks were propped up by public funds and senior bondholders got their money back.

These actions might not have been approved had they been put to full public debate and either referendums or votes in parliaments; however, they were decided and acted on without any such checks and balances. The justification was that a crisis existed and that decisive action was needed. It is striking, however, that the decisiveness went in a particular direction. Only in a very few cases were banks closed and bondholders hit, for example only where a failing bank was small (Denmark: Amagerbanken) or the investors and/or depositors politically unpopular (Cyprus: Laiki Bank). Generally, resolute action consisted of public funds being committed to bail out private actors, without the relevant publics being asked beforehand. The more the situation deteriorated, the more strongly the need for this was asserted, particularly within the Eurozone. There was a mood of determination to do ‘whatever it takes’.

This kind of argument involves a commitment to ‘consequentialism’: that the costs of not acting in this way would be too awful to contemplate. In legal theory, it finds expression in the notion of establishing legal validity by reference to sources outside specific constitutional or treaty provisions. […] However formulated, the argument remains the same: the Euro Area requires the ultimate capacity to act when the danger to it is ‘close and serious’ and its very existence is threatened.

(Dyson 2012: 803)

The same author points to the heroic aspect of crisis management, reminding us of its linkage to discourses on war, in particular the ‘just war’ theory: ‘necessity knows no rules’, as Walzer puts it (1992: 254). Yet one might ask, whose necessity? The ‘necessity’ that European politicians must heed central bankers was similar to the same sort of necessity that members of Congress must heed US regulators: that they were too spooked to do otherwise. However, alongside this similarly between the US and the EU, there is a difference: the US did not couple bank bail-outs with public austerity: only the Europeans did that. Arguably, the Eurozone could have survived in an alternative scenario, with a harder line taken on bondholders and on bank restructuring and lighter raids on the public purse. Having a Eurozone across large parts of which banks survive only in ‘zombie’ form – technically alive but unable to do much by way of playing a part in the real
economy, and collectively requiring more capital following tests in 2014 – seems a small payback for public austerity. Hearing, as one did in 2013–14, that by injecting public money into the banking sector, the European authorities created takeover opportunities for US capital, does not do much to burnish the sense of ‘necessity’.

Remaking knowledge: from models to judgment

What could be salvaged from the patently delegitimised stock of pre-crisis regulatory knowledge? There has been a scramble to invent new ways of picturing the market and the core task of regulation, which came to be understood as ensuring stability instead of taking it for granted. ‘Prudential’ regulation was invented, meaning regulation of the system as a whole, for stability and, when that is not present, for crisis management and resolution. When the crisis hit, there had been little clarity about how to achieve these goals: regulators had entered uncharted country and they lacked navigation tools. Previous ways of thinking did not even foresee the possibility of the shocking and fast-evolving situation, let alone prescribe responses. Regulators found themselves to be ‘flying blind’ (Financial Times 2013a).

There has been a generalised loss of faith in models – or maybe it would be more accurate to speak of a reduction of reliance on models. This especially involves scepticism in relation to the models developed by regulatees. Such scepticism is merited by the acknowledgement that models developed by firms are characterised by a mix of technical expertise, selective attention to issues of greatest interest to the firms concerned, and construction of evasions, defences and gaming in relation to regulatory and compliance requirements (bank capital adequacy and leverage, for example). More fundamentally, regulators came to recognise that firm-specific models, even if somehow amalgamated, would provide a poor basis for understanding market interlinkages, connections and potential contagion chaînels and processes, such as would be necessary for a systemic understanding.

Thus began regulators’ attempts to distance themselves from economic modelling and to develop the ‘judgment approach’. The attempt to reform regulation by giving up some of its ‘scientific’ pretensions can be regarded as a politically ambiguous but potentially awkward move. It is of great interest if construed as offering a potential entrée for democratic direction of financial market regulation. On the other hand, the shift in knowledge, from models to judgment, might be understood as remaining within the technocratic community. The neoliberal assumptions that came to the fore in the 1980s and 1990s have been shaken, provoking a return to a more interventionist (and possibly Keynesian) knowledge base (but see Blyth 2013), although not necessarily signalling a public opening-up of the issues.

This story can be summarised as a turn away from deregulation and yet, at the same time, as an attempt to reinstate the professionalisation of regulation,
re-establishing its technocratic credentials. By no means have regulators given up on technical thinking, modelling or data; indeed, following the crowd, they have become even keener on ‘big data’ in particular. This is partly because their loss of faith in particular knowledge sets, models and metrics has prompted them to cast about in quite a general manner for a wider set of information sources. If one no longer is even pretending that one really understands the next moves and interactions within the systems that one is regulating, then an understandable response can be to collect all the data that one can and in as granular detail as possible, hoping to sift and interpret it in some manner yet to be determined (Bholat 2013; Riles 2013a; 2013b; Chapter 5).

These are ambiguous changes. Financial market regulation’s reclothing of itself as prudential regulation, its distancing of itself from palpably failed techniques and models and its development of the judgment approach combine to create conditions in which public scrutiny, debate and input no longer appear absurd. On the other hand, the casting around for data and the drive to rebuild expertise may function (once again) to insulate regulatory networking from socially and cognitively more diverse influences.

Conclusion

With the advance of globalisation, there have been strong pressures towards, if not regulatory harmonisation, at least convergence through regulatory networking. The latter became ‘no longer primarily of an international [inter-state] character, but also supranational and infranational, frequently by-passing central government’ (Picciotto 2006: 2). Powerful actors – international financial market players and regulators – have been ‘by-passing central government’ with little in the way of countervailing pressure or constraint.

In contrast, this chapter calls for democratisation of financial market regulation, and finds encouraging some ‘green shoots’ of such democratisation (Her Majesty’s Treasury 2009; Investors’ Working Group 2009: 26). Financial market stability, like environmental security and personal safety, is a public good that cannot be left to bargains struck between market participants and regulatory agencies. Since everyone is a stakeholder, the debate must be open to all as far as basic principles are concerned: such is the argument in principle. Democratic oversight carries the functional advantage that it can be expected to result in greater regulatory diversity – reflecting the twists and turns, indeed the idiosyncrasies of public debate and the unpredictability of populist agenda-setting. Such diversity would reduce the ‘herding’ that has been a feature of the crisis.

In practical terms, regulatory diversity would be exhibited primarily between national states, since it is (still) nation states that provide the primary channel for participation by citizens in public policy-making. In the longer
run, diversity between regional blocks might be underpinned by enhancement of democratic direction of the broad objectives of the regulatory policies of such regional blocks. However, as Chapter 4 illustrates, taking the example of the EU, there are strong pressures to curtail such tendencies; indeed, existing democratic deficits have been joined by new democracy pre-empting mechanisms.
Europe
From single market to multiple mechanisms

Following the establishment of the EC (subsequently the EU) in the post-Second World War period, the development of financial market regulation became an important part of single market regulation. This involved a coalition between European federalists and the City of London – in which the latter initially got the upper hand, installing self-regulation within a public facade at EU level (linking this chapter with Chapter 1). In the crisis management phase that arose from 2008 onwards, bank bond-holders in the EU were generally protected by public bail-outs, just as in the US (see Chapter 2) but, unlike the US, EU policy-makers made an unprecedented turn to austerity. The third phase involves new governance ‘mechanisms’ collectively summarised as ‘banking union’ within the Eurozone.¹

From the language and political declarations of European leaders in the period 2008–14, one might be forgiven for thinking that what the European Union did in response to the crisis is to save its historical project of integration. That is what ‘saving the Euro’ and ‘banking union’ bring to mind. On inspection, however, something more complicated has occurred. Single market regulation has been joined by extra-EU mechanisms, creating a complex and fragmented political, legal and regulatory space. This is conventionally summarised as ‘banking union’ but actually introduces as much splitting as union. In some respects, the EU framework has been able to accommodate responses to the crisis, through expanded competencies for the

¹ Chapter 4 incorporates some material previously published in two sources, the first being ‘Render Unto Caesar: EU Financial Market Regulation Meets Political Accountability’, which was published in 2012 in the *Journal of European Integration* 34(3) 205–21 and is reproduced here by permission of Taylor & Francis http://www.tandfonline.com. The second source is ‘Connectedness, Crisis and the Challenge to European Democracy: from rapture, through fear, to banalisation of financial markets’, published in 2013 in a collection edited by Cruz, Leite and Faria under the title *Infrações Económicas e Financeiras: estudos de criminologia e de direito* (Economic and Financial Offences: criminology and law studies), Coimbra Editora, Portugal.
ECB (albeit only in relation to banks, not other financial firms; and only in relation to the Eurozone, not the ‘outs’). In other respects, Eurozone Member States’ development of crisis-fighting competencies has taken place outside the EU framework. Notably, the creation of the European Stability Mechanism (ESM) has something of the political appearance of being a reversal of the historical project of European integration. However, matters are more complicated and surprising than that: the new EU mechanisms involve political cross-dressing, in which central banks take on more of the clothing of governments, while states take on more of the clothing of the market.

**Approaching the private-public regulatory nexus**

Mixing of private and public strands is not without historical precedence. In the following pages, the pre-crisis phase of European financial regulation will be described in terms of a strategy of opening up EU financial markets, so creating conditions in which the size and market power of EU-based financial firms could be increased, so enhancing international competitiveness, particularly vis-à-vis the US. As a consequence of the success of that strategy prior to 2008, large financial firms became increasingly interested in the EU regulatory regime. That, in turn, provided further support for market integration – a level playing field and minimal constraints on cross-border operations being in the interest of large firms. In addition, firms originating from the US and London favoured a style of regulation verging on self-regulation, albeit under public auspices (see Chapter 1 on publicly-masked forms of private regulation). The resulting atmosphere helps to explain some of the preconditions for crisis, as described here: for example European regulators shielded the credit rating agencies from oversight.

That later came to be seen as a mistake, although it made sense as part of a historical project of relying on regulation by market actors (see Chapters 1–3). Such episodes warn us against any version of the ‘blame game’. Standard commentaries contrast ‘market failure’ and ‘regulatory failure’ narratives on the crisis. Market failure analyses support a thesis that neo-liberal tendencies towards self-regulation have been discredited, hence ‘more regulation’ is needed, including EU regulatory integration. Regulatory failure analyses are deployed to the opposite effect, pointing either to sins of commission (eg policy support for wider housing ownership is said to have legitimised sub-prime and caused a misdirection of capital), or sins of omission (the regulators allowed the market to innovate its way to products and structures outside regulatory boundaries and, for those practices that were regulated, regulatory competition led to slackness, more like self-regulation in practice).

From the point of view of their political implications, market failure and government/regulatory failure narratives appear to differ, each carrying
distinct implications. However, any failure of the public and private partners in financial market regulation would seem to be a conjoint one. When one moves from what happened to the question of how it happened, then one finds dense interactions between market and policy/regulatory players (Picciotto 2006; Picciotto and Haines 1999). Interactions occur in overlapping fora, criss-crossing public/private and national boundaries, as players propose concepts for attention, constituting the regulatory agenda through claims-making and alliance-seeking. That being the case, there cannot be any pure market community and failure, nor any pure government/regulatory community and failure. Failure would be shared.

That said, the posing of questions in terms of failure would rule out other, potentially highly pertinent questions. For example, who gains? From certain perspectives, the crisis can be judged as productive.

First, the regulatory community has hardly been disbanded as a result of the crisis. On the contrary, it increases in size, responsibilities and influence, becoming for example embedded more centrally in the EU architecture (see below). Regulatory networking in and of itself tends to lead over time to attempts to converge or merge regulatory rule books, generally favouring the strategic positioning of bigger financial firms. Also, the crisis has resulted in a push for further convergence, partly because no other intellectual option is on the table.

Secondly, the ‘too important to fail’ (TITF) financial firms have had their wings clipped only slightly and, more importantly in strategic terms, they have been able to leverage the crisis to further their objective of a global ‘level playing field’ (Deutsche Bank Research 2007). The balance of market lobbying is pro-convergence, partly because larger, cross-border firms are better placed in resource terms than small ones for the intellectual and lobbying efforts required. There emerges a natural alliance between pro-convergence regulators and these larger firms, providing a coherent and hegemonic agenda, whereas smaller firms and regulators that might favour a different set of objectives find it difficult to formulate a coherent agenda. Thus, not only does ‘size matter’ but size also speaks clearly and melodiously, burnishing the raison d’être of international regulatory networking.

The question about market and regulation then widens, from one about failure and responsibility, to include consideration of gains. Exploring this entails an examination of the forms taken by market/regulatory negotiation, looking for, alongside the moments of panic and despondency, moments of decisive leadership and institutionalisation of influence.

How may these questions be approached? Amongst other authors, Knill (2001) discusses private governance in broad terms, as not being governance without government, but rather as a combination in which, depending on circumstances and strategies, public and private coexist, in patterns of loose coupling, close cooperation in terms defined by either or both sides, and occasional antagonism. More recently, Mattli and Woods (2009) and their
contributors examine regulatory capture, or ‘hijacking’ as they term it. Such themes are less prominent in the earlier literature, which was more concerned with networking and cooperation issues, with questions of efficiency in service delivery (as distinct from systemic stability) and with the relationship of ‘new governance’ to democracy (Rhodes 1997; van Kersbergen and van Waarden 2004; Best 2007). On financial market regulation specifically, there is much literature on the EU Financial Markets Action Plan and the Lamfalussy policy/regulatory architecture that spawned the financial regulation committees (Lamfalussy 2001; Avgouleas 2005: 180–87). These reforms have been extensively discussed within regulatory and integration studies (Posner 2010; Ferran 2004; Quaglia 2008; High-Level Group on Financial Supervision in the EU 2009).

Some of that literature engages with notions of regulation as a cooperative or ‘decentred’ venture (see Ayres and Braithwaite 1992; Baldwin and Black 2008; Black 2001; Black and Baldwin 2010). Such decentring and cooperation raises a theme very relevant for regulation of markets in general, and financial markets in particular: private-public ‘information asymmetry’: policy-makers and regulators do not have all the answers partly because they do not have all the information. By definition, financial market participants have more information in their areas of operation. Because the regulators are blind without information, it might appear to make sense to understand financial market regulation as a field within which information-sharing is necessary. The question then becomes, how, on what terms and with what consequences.

The existence of informational asymmetries as between regulated firms and specialist securities regulators and, in turn, as between specialist regulators and government legislators is an obvious example of such fragmentation. Decentralised analysis of regulation has implications for its institutional design because it suggests that designers should pay careful attention to how they can best capitalise on fragmented resources and draw them all into the regulatory process. One good design strategy would be explicitly to recognise that regulation is the product of interaction between numerous actors and to build networks accordingly. (Ferran 2004: 90–91)

Ferran’s account, written well before the crisis, has the great merit of recognising that financial markets firms are powerful forces and may be drivers of regulation – a possibility insufficiently acknowledged in some other pre-crisis work, which articulates private sector actors rather weakly. To take some examples: Dyson and Marcussen (2010) talk of ‘transverse integration’, comparing degrees of convergence in different policy sectors, such as the single market and monetary union. One looks, however, without much success for a strong concept of market forces: those authors implicitly privilege
relations between Member States as the motor of (and brake upon) integration. Spendzharova (2010) thinks in multi-level terms, in the sense of international influences on national regulators in accession countries, but again without much consideration of influences from the market. Posner’s well known scholarship (Posner 2010) accounts for shifts in regulatory leadership – with the EU integration process underpinning its increasing leverage vis-à-vis US policy-makers regulators – in balance of power terms, US versus EU. He says: ‘EU financial governance transformation [that is, prior to the financial crisis] has already brought an end to US regulatory dominance at the international level’ (Posner 2010: 58). That story line has the limitation that it constitutes the dynamics of change primarily in terms of segmentations within the international public sphere (US, EU, Member States). The private sector is represented, if at all, in the same terms (as US firms, pan-EU firms and national firms). Such a representation of market players and interests, as jurisdictionally differentiated, has the consequence that some continuities of interest within the financial markets may be underplayed and some discontinuities overlooked.

In short, ironically, some studies of European financial market regulation take insufficient account of the market. This is problematical for several reasons. Large and cross-border firms, regardless of their national origins, tend to share the interest of the European Commission in regulatory convergence, whilst smaller players, with local or national footprints, may be vulnerable in a single market. In terms of representation of interests, firms differ in their access to European policy-makers and regulators and influence upon them. Large firms have greater financial resources – and also a higher level of market information – than either small firms or regulators. Moreover, certain think tanks have links to large financial firms, capable research staff, task forces and seminars, within and around which policy-makers, regulators and well resourced elements of the private sector interact. Thus, large financial firms are in a position to assist regulators and policy-makers in so many ways, not only with data but also with analysis, interpretation and thinking through the consequences of possible scenarios, to the point of developing a shared culture (Arup 2010).

The information asymmetries between large firms and regulators are difficult to address. Talking of one of the foci of the present chapter – the Committee of European Securities Regulators (CESR, now replaced by the European Securities and Markets Authority, ESMA) – Ferran (2004: 90–91) commented as follows. ‘By sharing the regulatory burden with marker participants in this way it [CESR] can reduce the pressure on its own tiny resources. At the same time, however, there is an ever-present risk that CESR will cross the line between drawing upon expert input constructively and being in thrall to it’. This was a pertinent and prescient observation, explored further below.
Private-public regulation

By the early 2000s, a private-public vision had emerged, constructing regulation in terms of ‘technical’ management of issues through multi-level networks (international, regional, and national), which took market actors as partners in regulation rather more than as subjects of regulation. A case study is presented of the role of the CESR later replaced by (ESMA) in relation to credit rating agencies. Focus on these agencies is justifiable given their role in the financial crisis. CESR acted on the international stage in a manner that had the unfortunate effect of shielding these private actors from meaningful reform. With the benefit of hindsight and an understanding of how credit rating agencies were implicated in the early (sub-prime) stages of the crisis, the action of EU regulators in shielding the former does not look good; indeed, it might be hard to comprehend (although notions of networks, epidemic community, cognitive capture and market rapture may have some purchase, see Chapters 1–3). However, what otherwise might look bizarre becomes interpretable when seen in the context of the times. Public regulation developed as a mask or façade for private regulation internationally and within EU networks, just as it did in the City of London (as discussed in Chapter 1).

The rapture of technocratic networks had consequences not only in terms of crisis-generation but also in terms of keeping democracy at arm’s length. Nevertheless, historically (and more recently, see later in this chapter) the European Parliament has played an important role, pushing back against any notion that financial market regulation is a purely ‘technical’ matter, properly left to conversations between regulators and market entities. The Parliament succeeded in radically amending proposals put forward in 2009 by the European Commission to the effect that the latter should be empowered to adopt technical implementing proposals by the (then new) European Supervisory Authorities without the possibility of Parliamentary or Council veto. The Commission’s proposal was amended by the Parliament in line with Article 290 TFEU (Treaty on Functioning of the European Union) on delegated acts. Thus, the Parliament and the Council retained a degree of control of that particular agenda. However, as the crisis in Europe deepened from 2010 onwards, the European Parliament was faced with further challenges, as new responsibilities were given to the ECB and new mechanisms were agreed by Member States, largely treaty-based but outside the structures of the EU. (These post-2008 issues are taken up in the second half of this chapter.)

The dynamics between public and private actors in regulatory networks and the consequent marginalisation of ‘outsiders’, including political representatives, have both knowledge and institutional aspects. Network participants adopt specialised forms of knowledge and deploy these in support of their claim to legitimacy. Their claim is that the issues are complex, specialised and
‘technical’, thus being distinct from ‘policy’ or ‘political’ questions. As a result, not only citizens but also their political representatives lose both interest and leverage: the upshot is private-public regulation, in the sense that private interests lead. The combination of complexification of the networks, concepts and language makes it more than difficult for outsiders, such as politicians, to identify or assess what the issues might be. If they feel uneasy about the form of the regulatory debate, they may need to find specialised and accredited members of the regulatory community to champion their doubts, this having the longer term effect of legitimising the claim that the issues are technical, not political. The formation of knowledge as technical detaches it from the public sphere.

The claim about complexity and its political implications has in the past been too readily conceded by some otherwise critical observers. For example, Ferran (2004: 123–24) says: ‘Across the board new collaborative methods of governance, embracing dialogue and co-ordinated efforts at mutual problem-solving between the central institutions, national bodies, technical experts and other parties, are emerging in order to deal with the increasing complexity of the issues on the EU’s policy agenda’. This somewhat misses an aspect of complexity in financial innovation, which far from being a ‘natural’ state of affairs is produced and deployed by firms – not simply as part of their battle for market share but also for purposes of gaming regulation (McBarnet 2010). Then the seething ensemble of complex and opaque products and their interconnection is pointed to as being the reason why their producers are best placed to propose regulation.

What this scenario constructs is the unsettling prospect of a positive feedback cycle, in which the sphere of the ‘technical’ expands, as more complexity in financial products creates more ‘technical’ decision-making and a shrinking of the sphere of ‘policy’. At certain historical points, the process of technocratic governance, complexification, closure and de-democratisation, if left unchecked, attains institutional form – as it did in the EU with the adoption of the Lamfalussy framework (justified on just such grounds); as it almost did in 2009–10 with the EU’s reforms to that financial architecture, creating new authorities. It did in fact do so in 2012–14, creating a number of ‘mechanisms’ beyond parliamentary control. At such turning points, the policy community may accept in principle the claim that certain issues are ‘technical’ rather than ‘policy’ (even if in practice the boundary line may be hard to discern or may be contested) and so the policy community may accept that such issues should be dealt with in specialised fora.

Such was the general idea of the beginning of technocratic financial market regulation at EU level, the ‘Lamfalussy Process’ held that: ‘politicians in the Council and the European Parliament (EP) only adopt broad policy guidelines, while detailed regulations and rules are decided over by expert committees’ (Grossman and Leblond 2008: 5). Summarising considerably, the Lamfalussy arrangements may be described as follows. Legislative
proposals were adopted under the ‘co-decision’ procedure by the Council and the European Parliament (‘level 1’). The Commission’s implementing acts (‘level 2’) took into account technical advice from ‘level 3’ committees, consisting of national regulators. As the House of Commons Treasury Committee observed (2006: 12): ‘In finalising their advice, the Level 3 committees consult extensively with providers and users of financial services’. As revised in 2006, the Comitology Decision provided for new regulatory procedure with scrutiny (RPS) (OJ 2006: Article 5a). RPS applied to measures of general scope that amend ‘non-essential elements’ of basic legal acts adopted under the co-decision procedure. Under RPS the Council, or Parliament acting by a majority, could veto a Commission decision.

Grossman and Leblond (2008: 5) comment that the allocation of responsibilities under Lamfalussy was ‘a response to the perceived shortcomings of submitting highly technical legislation to the EU’s co-decision procedure’. Indeed, that is a familiar commentary on and justification for the introduction of the Lamfalussy framework (Lamfalussy 2001: 14). Full-time politicians cannot be expected also to be high level economists or financial engineers; hence, if politicians accept that the issues are best posed in terms favoured by high level economists or financial engineers, then they circumscribe their own ability to understand what legislative measures may mean or imply in practice. In that case, the veto power – which in any case is posed as a negative power – is unlikely to be used. This situation may be contrasted with those in which the Parliament takes a more proactive role.

In evidence to the House of Commons, the British Banking Association argued that: ‘Generally if a decision is regarded as uncontentious or not having a significant effect on the industries or consumers of one or more Member States it is accepted as being technical. Otherwise a decision is at risk of being described as political by one or more interest groups or by politicians’ (House of Commons Treasury Committee 2006: 12). However, that rather begs the question. If the issues are articulated in such a manner and in such language that does not empower understanding amongst policy-makers (let alone among the public), then it is difficult to say that silence means assent. As one Member of the European Parliament (MEP) has acknowledged, not everybody fully understands what is meant by such terms as a ‘naked short’ or a ‘dressed option’ (Kay Swinburne MEP: unscripted remarks made at a meeting on ‘Financial indices and benchmark settings: the road ahead for Europe’ on 27 June 2013 at the Centre for European Policy Studies, Brussels). Hence, in terms of making decisions or allocating powers to others to do so, policy-makers including MEPs must take much on trust. It must be acknowledged that the pace of innovation and rate of production of new products (Engelen and others 2010) disadvantages public understanding. The dressing up of issues in impenetrable language is not emancipatory, even if it adds to the sense of community and camaraderie in market and regulatory in-groups.
The outcome is that, whilst the public and its representatives are put in the position of observers, ‘technical’ committees and their consultees deal with intrinsically political issues, by means that include defining them as non-political. Furthermore, regulatory networks have on notable occasions very clearly stayed into policy-making territory, not always with the best consequences. We now consider briefly an example in relation to the important regulatory topic of credit rating agencies.

Case study: shielding the credit rating agencies

Many years before the emergence of the crisis, the credit rating agencies had become a focus for much practical concern (and academic critique), particularly on the grounds of conflict of interest: the agencies were only paid if the ratings that they offered for securities were acceptable to the issuers of those securities (see Partnoy 1999). However, in the mid-2000s, CESR mounted a concerted action in defence of the status quo concerning the agencies (Mügge 2006: 1015–16). As Posner (2010: 53) relates, on this and on other issues, CESR ‘demonstrated an ability to act independently [of policy-makers] and as a unified actor’.

In the aftermath of the Enron and Parmalat scandals, for instance, CESR’s members, acting in unison, used their memberships in IOSCO to outmaneuver national politicians considering new oversight for rating agencies [. . .]. Before making a report to the Commission in April 2005, CESR’s members voted in favor of an IOSCO initiative that left the status quo largely in place and simultaneously ended serious debate in Europe – at least until the 2007 financial crisis began to gather steam.

Had CESR not acted so decisively in the mid-2000s in favour of the credit agencies’ business model, then it is conceivable that the agencies (or regulators’ reliance on them) could have been reformed at an international level. Such reform could have moderated some aspects of the financial crisis, given that the crisis was in part driven by over-optimistic ratings being accepted by regulators as well as by investors. It is not really adequate to observe, as Posner does, that CESR acted independently of policy-makers; rather, CESR fronted the policy-making process, thereby preventing reform.

In the event, CESR was obliged to revisit the issue in 2010, owing to the widespread perception at the time that the credit rating agencies had been implicated in several aspects of the financial crisis: being too cooperative in assisting securities issuers to gain high ratings for mixed and opaque products; too slow to change their view in the important period within which market conditions were deteriorating; and, in the eyes of some, too fast to question
the sovereign ratings of some EU Member States. There was deep concern that regulators’ recognition of rating agencies could have perverse consequences. In the words of the Bank of England (2010a: 61):

Recognition for regulatory purposes can alter the market perception of a rating; it may cease to be seen as an opinion but instead as a point of fact. Moreover, banks’ dependence on the same small set of CRAs [credit rating agencies] may reduce diversity in the financial system, leading to concentrated exposures. The ‘cliff-edge’ effects of ratings downgrades can also amplify procyclicality.

Because of such concerns, a Regulation of the European Parliament and Council on Credit Rating Agencies came into force in late 2009 (OJ L 2009). The agencies are obliged to be registered in the EU and must explain their methodology in general terms. However, their conflict-riven business model remained unaffected (Utzig 2010). Concerning the implementation of this agenda, CESR issued for consultation two guidance documents, one on registration of the credit rating agencies and one on regulatory enforcement of their standards (Committee of European Securities Regulators 2010). Moody’s replied defensively (Moody’s Investors Service 2010), claiming that rating agencies are ‘independent’, pointing out that the Regulation in question prohibits regulators from interfering ‘with the content of credit ratings or methodology’ and seeking to excise and/or rewrite several aspects of the text of CESR’s draft guidance (Moody’s Investors Service 2010: 2). In general, Moody’s portrayed CESR as not properly understanding how the agencies work (saying for example that different persons within Moody’s applying its methodology might arrive at different results; see also Duff and Einig 2009). Moody’s sought to restrict the committee’s guidance to a mix of the plain words of the Regulation and specific readings of it favoured by the regulated body. It claimed that the draft guidance amounted to ‘gold plating’ of the Regulation.

All this should be seen in the context that, as a consequence of policymakers’ and regulators’ transatlantic dialogue (Alexander and others 2007), the EU had deferred to the US on the bigger and more troubling question of whether fundamental changes might need to be made in the way that rating agencies are commissioned and paid (Bai 2010). In the event, the US Dodd-Frank ‘Wall Street reform bill’ was agreed in the summer of 2010 only after a provision on the credit rating agencies had been deleted and replaced by ‘studies’ (United States 2010; Skadden 2010). After that, the European Commission opened a further consultation on this topic and legislation followed, in the sense that the rating agencies became subject to EU regulation (although the agencies were not obliged to change their business model).
This case study underlines the analytical and methodological point that EU securities regulation has to be grasped in terms of relations between regulators (national/EU-level/US) as well as in terms of closeness to important market forces. A necessary condition of this closeness is policy-makers’ tolerance for the construction of a sphere of ‘technical’ issues, within which what otherwise would have been public policy is privately formulated. Furthermore, as the record shows, at times a regulatory committee may completely forget its claim to wear a ‘technical’ hat and may act quite openly on (what should be recognised as) contentious policy issues. However, it may be argued that policy issues should be reserved for political representatives. It is from such a perspective that agreement reached between the Parliament and Council in 2010 concerning delegation of powers to the EU Commission in relation to the new European financial market authorities represented an advance.

‘Technical’ delegation and parliamentary control

We have previously cited Ferran on the possibility that a financial market regulator might stray into policy-making. We now ask who – or rather which institution – might be in a position to play referee, so to speak, if ever there might be a drift, a slide, a stumble or a jump in that direction? In 2009–10 there arose circumstances that help us to answer this question. The European Commission made a series of legislative proposals on financial regulation, based on the de Larosière report (High-Level Group 2009) and on suggestions made by regulatory committees and by the market.

Political discussion of those proposals fell within the wider context of the coming into force in December 2009 of the TFEU. Briefly, the treaty distinguishes between delegated acts of the Commission on behalf of the Parliament and the Council (Article 290 TFEU), and implementing acts of the Member States or in some cases of the Commission, which would be controlled in this respect by Member States (Article 291). In Declaration 39 annexed to TFEU, the Commission signalled its intention ‘to continue to consult experts appointed by the Member States in the preparation of draft delegated acts in the financial services area, in accordance with its established practice’ (OJ C 2010: 350).

Concerning delegation (Bergström and others 2006), Article 290 TFEU does not spell out the mechanisms or legal basis under which the Parliament and Council would scrutinise a delegated act. During 2009, the Commission proposed two powers for the legislator: a ‘right to opposition’ that would be ‘suspensive’ of the proposal in question; and a right to post-hoc ‘revocation’ of the regulation once in force (European Commission 2009a). The response of Parliament was to broaden its legislative options, arguing that ‘Article 290 TFEU gives the Legislator the freedom to choose which control mechanism(s)
to put in place’ and that the options of objection and revocation are ‘purely illustrative’. Thus, ‘one could envisage subjecting a delegation of power to other means of control, such as an express approval by Parliament and the Council of each delegated act [. . .] (Committee on Legal Affairs (Szájer report’) 2010a: 4–5).

Naturally, these general inter-institutional considerations of the Parliament shaped its response to the Commission’s specific proposals on the powers it might wish to confer in matters of financial market regulation. The proposals included that three existing committees on financial regulation should develop into authorities (European Commission 2009b; 2009c), for example that the CESR should become the ESMA. Several aspects of the proposal proved contentious. By way of background to the CESR/ESMA transition, in 2004 CESR had published its noted ‘Himalayas Report’, describing its strategy of expanding the scope of its activities in an adaptive and piecemeal manner, rather than relying upon the classic EU model of proposing new powers or institutions. The guiding idea was ‘understanding the needs of the markets and their degree of integration’, which led CESR to conduct interviews with ‘key market participants’ and ‘major players within the EU institutions’ (European Committee of Securities Regulators 2004: 2). From this work it was concluded that ‘CESR should have an “adaptive” and forward looking strategy depending on evolutions of the market, rather than trying to suggest the creation of new institutions without precise idea of what their role would be’ (European Committee of Securities Regulators 2004).

Thus, in a partial break with competency-seeking, CESR’s Himalayas Report proposed a less institutionalist, more entrepreneurial strategy for regulation. Nevertheless, the report can be said to set out a dual track strategy (entrepreneurial and institutional), since it also identified ways in which it itself might in the future be empowered to take ‘EU decisions’ (European Committee of Securities Regulators 2004: 16). The Commission’s 2009 proposal on CESR’s evolution into ESMA proposed that it would be ‘efficient and appropriate to entrust the Authority [ESMA]’ with the elaboration of ‘draft technical standards, which do not involve policy choices’ (European Commission 2009b: recital 14). The Commission would then legislate on the basis of those draft technical standards. However, in a critique, Tridimas (2010: 15) has claimed that the effect of the 2009 proposal of the Commission, had it been accepted by the Parliament and Council, would have been a reversal of the existing relationship between the regulatory committee/authority and the Commission, in which the former proffers advice and the latter decides:

The proposed regulation, however, operates a system of reverse accountability which brings the powers of ESMA very close to a regulatory competence: where the Commission decides not to endorse the standards submitted by ESMA or decides to amend them, it must provide reasons
for its decision. The term ‘technical standards’ is in itself open to interpretation.

In proposing that the Commission would enact the ‘technical’ recommendations of the new authority, the Commission’s 2009 proposals did not specify any control over those acts by the Parliament and the Council.

In the context of the wider struggles over such issues, it is not surprising that three committees of the Parliament – Legal Affairs, Constitutional Affairs, and Economic and Monetary Affairs (lead committee) – found that proposal unpalatable, because ‘in some instances where technical standards are proposed, the Commission would be able to amend these proposed technical standards with no oversight from the European Parliament, Council or ESA in question (Committee on Legal Affairs 2010b: 217). By invoking Article 290 TFEU, the Committee on Legal Affairs was able to operationalise the long-standing concern of the Parliament about desirability of ‘express approval by Parliament and the Council of each delegated act’ (Committee on Legal Affairs 2010a).

Accordingly, the Parliament extensively amended the Commission’s proposal. Article 290 was adopted as the legal basis (Committee on Economic and Monetary Affairs 2010, amendment 3: 219). The core point was spelt out in new article 7b(2): ‘If the European Parliament or the Council objects to a delegated act, it shall not enter into force’ (Committee on Economic and Monetary Affairs 2010, amendment 49: 33). The Council adopted the final legal texts in late 2010 (European Union 2010). The result of this manoeuvring was that draft legislative acts of the Commission, which have been proposed to the Commission by the European regulatory authorities (ex-committees), are reviewed and either tacitly accepted or actively rejected by the Council and the Parliament. This might not simplify the legislative process, nor make it more ‘efficient’ in the Commission’s sense of entrusting decision-making to ‘a body with highly specialised expertise’. However, it confirms that it is for political representatives to police the boundary between what is ‘technical’ (to be passed without challenge) and what is policy (to be tested politically). For a wider review on delegation, see Xhaferri 2013. Having said all this, it must be acknowledged that Parliament itself is a site of intensive lobbying (replicating the pressures upon regulatory committees/authorities/networks; see for example the discussion of credit rating agencies above). Also, the Parliament is disadvantaged by information asymmetry (even more so than regulators).

In summary, in the late 2000s the Parliament may have succeeded in maintaining a democratic review of proposed changes in financial market regulation. As the crisis continued and regulators and market participants pleaded urgency, this democratic line was to be repeatedly challenged and eventually decisively breached.
Regulation as crisis management: ‘burden sharing’

From 2009 onwards, European policy-makers, bankers and other financial market participants became locked in urgent yet protracted debates over public and private indebtedness. Over previous years, the banks had somewhat rashly foisted loans upon the Greek Government, upon Irish and Spanish property speculators and upon many other private and sovereign borrowers. When the bubble popped, the debate revolved around the question of who should pay (Goldstein and Véron 2011). This was not a simple question, since interconnectedness between countries and ‘their’ banks became perceived in terms of one potentially pulling down the other, as well as in terms of pan-EU contagion between banks and between countries. Over time it became recognised that shifting private losses onto public budgets causes additional stress to sovereign states. Nevertheless, the mood amongst EU elites accepted the socialisation of bank-related private debt, this being represented in terms of saving not only the banks’ senior bondholders but also the Euro.

Some quick country case studies illustrate some of the difficulties. The Irish Government, faced with insolvency of banks owing to lending against a property boom, recapitalised the banks with public funds, reimbursing senior bondholders (private investors who had been attracted by the bubble conditions, including banks from elsewhere in the EU). This had the effect of transferring speculative losses away from private investors and onto public actors (taxpayers present and future, the state pension scheme, etc).

The Spanish Government copied the bad example set by the Irish. The government amalgamated the failing cajas into one entity, Bankia – possibly under the false impression that one big insolvent bank was better than several smaller ones. In a move that became notorious, Bankia then solicited funds from its customers (ordinary depositors with the bank), who did not realise that they were lending to a failing entity. These new funds were insufficient to offset the debts of the cajas. The government turned to Eurozone partners, seeking additional funds for Bankia. The Eurozone initially took the position that, in any lending to banks in Spain, eventual repayment must be guaranteed by the Spanish Government. So, once again, public finances were made responsible for private losses.

In both those cases it was clear that not only national decision-makers were implicated. Generally, the ECB has been adamant that senior bank bondholders should be repaid in full, which implied that banks could not be allowed to go into insolvency (under which, all bondholders are at risk of recouping at best a proportion of their risk investment). There were also cross-Atlantic influences, sometimes overt to the point of diplomatic insensitivity. Unusually, a Eurozone ministers’ meeting was attended by Timothy Geithner, Treasury Secretary, who urged that the EU should follow the example of US bail-outs in 2008 – paying bondholders in full, using public
money. As noted by the *New York Times*, at least one finance minister present found it odd to be discussing detailed arrangements for a Eurozone bail-out fund ‘with a nonmember of the euro area’ (*New York Times* 2011). However, this public presence usefully illustrates some of the dynamics that are usually less visible.

The Greek situation was more complicated – in its origins, iterations and outcomes. There was high public (state) indebtedness, as well as private (bank) indebtedness. The EU at first advanced proposals that investors in Greek sovereign bonds should bear some proportion of their losses, in order to make publicly-funded bail-outs cheaper and more politically palatable. This proposal is known as ‘burden-sharing’, or ‘private sector participation’. This was seen as an ‘exception’ (in relation to Greek sovereign bonds only). Bondholders pragmatically perceived that it might be better business to get back some money, rather than to push too hard and possibly cause a default and possibly recover no money.

The Institute of International Finance IFF (2011) formulated an offer, with some creditors signalling willingness to take a partial loss on some forms of debt and to reschedule (prolong) others. Their condition was that public budgets should underwrite any remaining risks (see Institute of International Finance 2011; Jenkins and Milne 2011). Presenting its offer, the IIF suggested that average losses to its members would have been around 21 per cent (roughly half the loss then being indicated by market prices for those instruments). The Council accepted the IIF offer; however, both the offer and its acceptance by the EU were then undermined by the rating agencies, which signalled that such arrangements would amount to a ‘selective default’ by Greece on its obligations to repay in full and on time (*Bloomberg News* 2011). Since policy-makers were trying to avoid defaults (which might then spread in a wave), the warning of Standard & Poor’s undermined the rationale for EU acceptance of the IIF offer.

More fundamentally, European elites eventually realised that Greece simply did not have the economic capacity to repay even four-fifths of its loans, plus interest calculated at a punitive (above market) rate. This was especially so since the cuts in Greek spending being demanded by the EU as part of the package would slow down economic activity, thereby reducing tax incomes to the state. Such considerations led to a public debate on whether bondholders should take losses more in line with then current market prices – which would have meant them losing about one-half of their investments, rather than one-fifth as previously proposed by the IIF. Indeed, in October 2011, a steering committee representing bondholders negotiated a discount of 50 per cent, roughly corresponding to the then market value of Greek sovereign bonds (*Bloomberg News* 2011; see also Münchau 2011: 13; Spiegel and others 2011). In this manner, holders of sovereign bonds would lose substantial sums, yet senior bondholders of the Greek banks would be ‘made whole’; the former were effectively sacrificed for the latter.
A problem with such political trade-offs is that it can make sovereigns’ future fund raising more difficult and more expensive. During 2011 market prices dropped for the sovereign bonds of many Eurozone members, including France as well as Italy and Spain. In one week of November even Germany failed to sell into the market all the debt that it had offered. Chancellor Merkel reportedly concluded that those who had advised her to support burden-sharing had misled her, since even the IIF’s modest proposals in the summer for reduction in Greek debt (let alone the autumn proposals for 50 per cent) might undermine faith in sovereign bonds of other Eurozone countries, such as Italy, even threatening Germany’s creditworthiness (Milne 2011b). From that perspective, private sector burden-sharing – in the sense of private holders of sovereign bonds being required to take any portion of their losses – might boomerang. Burdens of past public debt had therefore to be borne by the populations involved: such was the view that became entrenched.

That left unanswered the question of private bank losses, which were serious in most EU countries. For a while in 2011 it looked as if the Eurozone might collapse – not so much in the sense that that Member States might reject the terms on offer and might reinstate their previous currencies and thus their ability to print money, but rather in the sense that the banks, burdened with losses, would simply stop functioning. Against this possibility, the ECB stepped up its support for banks, culminating in Longer Term Refinancing Operations (LTROs, from December 2011 onwards). LTROs offered banks loans at very low rates, over an extended period. They were gratefully accepted by the market. Addressing the President of the ECB, one MEP put matters as follows:

You provided about EUR 1 trillion in liquidity to banks, at low rates and with questionable collateral. It did not really help lending to firms and households, as you admitted yourself. Instead, banks used the money to buy government bonds from troubled states.

(Derk Jan Eppink MEP, cited in Committee on Economic and Monetary Affairs 2012: 9)

The ECB’s actions were partly designed to encourage banks to continue to hold sovereign bonds, thereby indirectly supporting the positions of troubled states such as Greece (and later Spain, Italy and Portugal). Doubts soon arose that the most troubled banks would actually purchase sovereign bonds, because of their riskiness. Moreover, to the extent that such purchases might occur, they would more closely link the fates of private banks and public funds, so increasing intra-state connectedness. From some perspectives, ‘artificially prolonging the life of many non-viable banks’ seems unhelpful (Eijffinger 2012: 5). However, from the perspectives of the ECB itself, the LTROs at least bought some time, within which other initiatives might work and, as
stated by Mario Draghi (cited in Committee on Economic and Monetary Affairs 2012: 9): ‘Buying time is not a minor achievement’.

In summary, the ECB created large quantities of money for the banks – and hence for investors in them – whilst not intervening in the banks’ business models. In the view of the ECB: ‘the Central Bank cannot interfere with the banks’ use of the liquidity since that is their business decision’ (Draghi, cited in Committee on Economic and Monetary Affairs 2012: 6). Clearly, there is a contrast between the respect shown by the ECB for banks’ business models, and the views it has taken on support for sovereigns. If the ECB has been operating in a purely technical manner, simply reflecting its duties and powers, then we can conclude that the European Union has indeed created an interesting policy design.

Single market, EU authorities, stability: ECJ Case C–270/12

A commentator on EU financial market regulation has written that: ‘In the wake of the crisis [. . .] the different local safety valves which might protect the EU market against systemic regulatory and supervisory error in a uniquely challenging reform context are closing’ (Moloney 2010: 1323). Moloney’s statement draws our attention to the way in which regulation has been strongly shaped by the commitment to harmonisation. Analytically, Moloney is sensitive to the benefits of flexibility and a degree of diversity in financial market regulation (including space for learning from observations of how different regimes perform, etc) and she underlines some of the dangers potentially arising from homogenised systems (‘centralization risks’: ibid 1372). She says:

It is axiomatic that overwhelming crisis in the financial markets resets the regulatory agenda. [Despite that:] The law and finance literature underscores that the relationship between regulation and good market outcomes is poorly understood [and] financial market convulsions have not always led to effective law-making. The burgeoning commentary on the crisis has identified multiple causes of the crisis which are unlikely to be susceptible to neat regulatory solutions. It has highlighted the reactive nature of crisis-driven rules which tend to ‘fight the last war’. It has exposed the difficulties rules face in capturing the complexity risk to which markets are increasingly prone, in addressing frequent and systemic deviations from rational behaviour, and in managing the risks posed by the tendency of interconnected market actors, often relying on similar model-based strategies, to respond in a homogenous manner to market events.

(ibid: 1320–22)

Since that was written, it has become clear that reliance on ‘models’ (especially those produced by the market) has lessened and has been partially
replaced by still-developing forms of precautionary regulatory ‘judgment’. From that perspective, regulatory thought might have become less lemming-like. On the other hand, the development of the EU’s financial regulatory architecture, from committees to authorities (see previous sections) – a development taking place within the legal and political space of the single market – involves a deepening of convergence tendencies in financial market regulation. Not only are market actors interconnected (see Moloney 2010) but so are regulators and, indeed, they are becoming more so as a result of incessant crisis.

Do single market harmonisation and centralisation of regulatory powers sit well with crisis management and systemic stability? A 2014 judgment of the European Court of Justice (ECJ) gives us an authoritative legal answer to the question. Yes they do, said the Court, in a judgment of constitutional importance for rule-making, the balance of powers between European and national regulatory authorities and the climate of regulatory thought. ECJ Case C–270/12 was brought by the UK and defended by the Council and the Parliament. The case concerned a power given to ESMA to suspend certain aspects of financial market trading (short selling and CDSs) in the presence of what ESMA saw as a ‘threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union’, if the national regulator(s) had not taken action. Note that there was no disagreement in this case over the proposition that suspension of trading might sometimes be necessary; rather, the question was who would decide: a national regulator or an EU authority. Competence in this matter had been given to ESMA under the widely-used single market provisions of Article 114 TFEU.

First indications were that the UK might succeed in getting the specific powers given to ESMA set aside. The Opinion given by Advocate General Jääskinen was that the single market constitutes an incorrect basis for this particular ESMA power to intervene, since the purpose of such intervention would not be to safeguard the single market as such; rather, it would relate to another objective, namely financial stability. As he put it:

The outcome [of the ESMA power] is not harmonisation, or the adoption of uniform practice at the level of the Member States, but the replacement of national decision-making under [by] EU level decision-making.

(Opinion of Advocate General Jääskinen 2013: para 53)

The Advocate General went on to suggest that Article 352(2) TFEU would form a more suitable basis. Known as the ‘flexibility clause’ in the Lisbon Treaty, Article 352 allows the EU to take measures to attain EU goals for which no specific legal basis is provided in the treaties, subject to unanimity
in the Council (as distinct from a qualified majority in the case of single market measures), the assent of the European Parliament and, interestingly, prior notification of national parliaments. Under this provision, the European Commission would put national parliaments on notice of the proposals, allowing time for deliberation and, as they might feel appropriate, expression of an opinion or passage of a vote that – whilst it might not be binding on the relevant national officials or ministers, nor of course on MEPs – might nevertheless carry some weight, potentially affecting proposed legislation. That is quite a different process from the single market policy-making process under Article 114 TFEU, which is a process between the Commission, the Parliaments and Council which, whilst not ruling out prior scrutiny by national parliaments, does not do much to encourage it either.

The Advocate General’s Opinion was widely commented upon, in the expectation that the Court’s judgment might follow his line. Some issues of constitutional significance had been raised, the first of which concerned the question of how far the single market can be stretched as a governance framework. The point here raised by Advocate General Jääskinen was that, even if integration has been the traditional motif for policy proposals vis-à-vis EU markets, and even if it remains central when considering how to dismantle cross-border barriers in financial markets, there is still a difference in principle between that and considerations of financial stability. That too is the message of this book and the suggestion of Moloney (above).

Secondly, the Advocate General’s Opinion might be seen as a nod towards widespread concerns about the position of national parliaments in the rapidly evolving EU political order – concerns that animate further concerns across the political spectrum and have drawn in constitutional courts (Küver 2010: 580–87; German Law Journal 2013: whole issue). In his Opinion, Advocate General Jääskinen pointed out not only that Article 352 has wider scope than the single market – thus potentially encompassing financial stability – but also that its deployment ‘would allow the European Commission to bring proposals based on that article to the attention of national parliaments [which] would thus have opened up an important channel for enhanced democratic input’ (Opinion of Advocate General Jääskinen 2013: para 58). The word ‘allow’ in that quotation is rather poignant.

Thirdly, the case was seen by some commentators potentially to problematise the development from 2013 of the Single Supervisory Mechanism (SSM), which is an inherent part of Eurozone banking regulation (to be discussed in the following section). Had the ECJ followed Advocate General Jääskinen’s Opinion, then EU-level prudential regulation might be considered less as part of the single market logic and could follow more divergent courses.

In short, some of the issues raised by Case C–270/12 included single market versus other legal basis for stability issues; democratisation including national parliamentary procedures and implications for the overall design of financial market regulation. Commentary on Advocate General Jääskinen’s
Opinion included the following from a think tank, which touches on each of these points:

[This could prove to be an important ruling for a number of reasons: First, it would halt the transfer of further powers (without national permission) to an EU agency and allow the UK to keep control over an important part of financial services regulation; Secondly, it would show that the UK Government can have success using the right legal channels effectively. This could bode well for other cases [...] It also highlights that the single market article, which, as we noted before, has been stretched significantly, cannot be a ubiquitous catch-all legal base for things that the Commission believes fit with its view of the single market. This could become important in future negotiations, particularly over banking union.]

(Open Europe Blog Team 2013)

To the evident disappointment of such commentators, the judgment of the ECJ (2014) in no way followed the Advocate General’s Opinion. Its four-part judgment may be summarised for present purposes as follows: the powers given to ESMA – to act in exceptional circumstances and if the national authority had not acted or has done so insufficiently – are ‘technical’ tasks, without a ‘large measure of discretion’, as had been argued by the UK. The Court found that the powers are clearly circumscribed and are ‘executive’, rather than ‘quasi-legislative’. The EU legislator may delegate such powers not only to the European Commission but also to bodies and authorities – nothing in the treaties rules that out and some readings imply it positively (European Court of Justice 2014: Articles 79–87). Finally, on the question of whether Article 114 TFEU on approximation of the single market provides a proper basis for such power, the ECJ replied affirmatively. Effectively, its judgment (at Article 115) merges notions of single market harmonisation and stability.

Case C–270/12 is important in legal terms and interesting in political and tactical terms. It shows that, whilst it is possible to articulate a coherent discourse within which market stability is conceptually distinguished from regulatory convergence and centralisation (as in Advocate General Jääskinen’s Opinion), it is very difficult to advance such a discourse.

In political terms the UK, historically the standard-bearer for neoliberalism and a champion of development of financial services regulation within the context of the single market (see Chapter 1), has developed concerns about governance within that framework. This may be partly because, as an editorial in the financial press put it: ‘The City has been given to fretting that regulatory change accommodating banking union may ultimately prove to be a ploy by Europe’s Lilliputians to tie down London’s Gulliver’ (Editorial 2014:
8). This is possibly so, even if the UK’s exclusion from the decision-making circle provided by banking union results from its own choice not to join the euro.

There is, however, a deeper and less reactive historical aspect. Ever since the City first became interested in the single market (many years before UK entry into the EC, see Chapter 1) the UK’s position vis-à-vis the single market has had a paradoxical element: it has sought to advance the single market rather more as a flexible framework than as a truly uniform, harmonised regulatory space. This is consistent with City thinking, which generates competitiveness in terms of differentiation of its market offerings – sometimes in the past towards regulatory slackness but at other times regulation that is tougher than elsewhere. Pre-crisis ‘gold plating’ of EU financial market regulation was often complained about. As a consequence of the crisis there has been yet more emphasis on regulation, underpinned by a more precautionary attitude than hitherto (see Chapter 3). The UK’s current desire to retain flexibility of action is more biased towards early intervention than away from it.

However, bringing Case C–270/12 was a tactical error. It made it seem that the UK was seeking to avoid precautionary action that might in future be recommended by ESMA and might be needed. Creating that impression was unfortunate and misleading, it being quite possible that, in future situations of market stress, the UK would be ahead of the balance of opinion on ESMA (just as it has been ahead of some other EU Member States in terms of prudential regulation and resolution). If feeling EU-litigious, it would have made better tactical sense for the UK to concoct a case of regulatory insufficiency on the part of ESMA, another authority, the Commission or Member States; or to have brought no case at all. As things stand, the UK Government took to the public stage to misrepresent politically its objectives in respect of financial market regulation. That might be because euro-scepticism contaminated legal, regulatory and democratic considerations.

Specific UK concerns aside, and grasping the substantial point addressed in its judgment, the Court has spoken and, from a constitutional point of view, has affirmed that regulation of financial markets for purposes of stability can be properly located within single market harmonisation. This, however, does not mean that regulation cannot also be located in other legal orders. In fact it seems that the EU has invented a series of locations for and modes of financial market regulation: what they have in common is that they all have centralising tendencies.

**Regulation after markets: ‘mechanisms’**

Within the EU context, something legally, institutionally and politically novel has occurred (Howarth and Quaglia 2013). Policy-making, institution-building
and regulation have overflowed beyond the single market policy (which had democratic deficits, which the European Parliament was able to address to some extent: see above). A new ‘post-single market’ policy space has been constructed, within which efforts have been made to tighten technocratic decision-making and to pre-empt democratic influences.

As for background, the Eurozone was constructed without adequate means of preventing a crisis and also without a crisis management capacity. As the crisis unsettled first markets and then sovereign states, elites felt political compulsion to act to prevent the unravelling of the Eurozone. This entailed going beyond powers explicitly provided for in the EU treaties (Dyson 2013; van Cleynenbreugel 2013; see also Chapter 6). As for financial market regulation, certain actions came to be seen as being essential in respect of stability: bail-out, ‘bail-in’, restructuring and resolution. However, it has proved difficult to accommodate these tasks within the existing EU legal order. The choice, therefore, was either to drop those tasks, to press on with them within the existing legal order in the face of highly probable legal challenge and subsequent mess and unravelling or to set up a new legal order or orders. Eurozone states chose the latter path.

The European Banking Union consists of three new mechanisms, which come into play at different points along the path of financial ill-health. There is a political economy of triage, the boundaries of which remain somewhat fluid, so the brief description given here can only be taken as an approximation. All ‘significant’ banks in the Eurozone are subject to the SSM. Those that are sick but possibly can be helped/disciplined back to health may receive conditional funding from the ESM. Those that are close to death, raising issues around assets and debts, are subject to the Single Resolution Mechanism (SRM), which is also applicable to non-Eurozone banks. The question of the relations between these mechanisms, in the sense of whether there is a hierarchy of governance between them, is arguable: one notion is that a cascade of decision-making is implied (Dorn 2014a).

The SSM is within the EU’s Lisbon Treaty framework; however, it splits the Eurozone’s ins and outs. The ESM and the European Resolution Mechanic (ERM) are international organisations outside the EU, although they can make use of some of its facilities (European Commission and ECJ). The SSM became effective in relation to banks in the Eurozone from February 2014. It cements the leadership of the ECB, involving also the European Banking Authority, consisting of national regulators.

One political obstacle to the SSM was the concern of some of the Eurozone ‘outs’, notably the UK, that the Eurozone ‘ins’ might in future, through the SSM and by majority with the EU, effectively monopolise decisions that hitherto had been a matter for all EU Member States. However, by no means did the ‘outs’ oppose the idea that the Eurozone does need its own stability regulator:
The main priority of the British government – which had no intention of joining the SSM – was to avoid a potential eurozone bloc within the single financial market. The British, supported by seven other non-eurozone Member State governments, threatened to block banking union if there were insufficient safeguards put in place for the ‘euro-outsiders’. Crucially, the British feared the adoption of subsequent financial legislation that would be detrimental to the British financial sector. However, the broader issue of concern was the satisfactory coexistence of a more integrated eurozone core and the non-core Member States. Banking union became a kind of test case for Britain’s role in a two-speed Europe.

(Howarth and Quaglia 2013: 115)

Notwithstanding such hiccups, the SSM was agreed by the EU under Article 127(6) TFEU, which provides for the Council to ‘confer specific tasks upon the ECB concerning policies relating to the prudential supervision of credit institutions and other financial institutions’. A committee of the UK House of Lords noted the significance of the powers accorded to the ECB/SSM:

The ECB will become an exceptionally powerful institution if it takes on the proposed supervisory powers. Four principles of accountability need to be borne in mind: That the ECB should be fully answerable to the Council and European Parliament for the supervisory decisions that it undertakes; That an effective, calibrated and streamlined mechanism of accountability to national parliaments should be established, in particular in relation to individual supervision decisions that have a significant impact on an individual Member State’s banking sector. It must be for national Parliaments to set out how any new accountability structures and frameworks should operate in practice; That an effective appeals system should be established within the ECB, with a timely and appropriate system of external legal challenge; That the accountability mechanism should be able to operate speedily and effectively at moments of acute crisis. Judged by these principles, the accountability provisions in the original proposals are patently weak.

(House of Lords EU Committee 2012: para 56)

As for legal control, the ECJ has in the past considered and ruled upon the limits of ECB independence, showing in general that its institutional status within the EU makes it subject to that legal order:

The [European] Court [of Justice] is clearly in favor of a limited notion of independence, confined by the functions, tasks, and powers specifically
conferred upon the ECB. The Court upheld a concept of ‘independence within the Community structure’ (not independence from the Community) that is reminiscent of the notion of ‘independence within government’. The ‘recognition that the ECB has such independence does not have the consequence of separating it entirely from the European Community and exempting it from every rule of Community law’.

(Lastra 2012: 1278)

Since the SSM was set up under the EU treaties, its operation is subject to check and challenge before the Court, evoking general principles of EU law. For a sense of what this can mean, consider the ESMA case mentioned in the preceding section (not as a template but as an inspiration). In debates in 2012 and 2013 leading to the creation of the SSM, the ECB insisted on its independence in matters related to the SSM – thus seeking to extend independence in monetary affairs to independence in stability issues, as if there could be no difference in principle between, say, setting interest rates for the Eurozone and deciding on the viability of a particular bank. However, it might turn out that grounds for challenge may differ depending on tasks, powers and bases. As will be noted later, the ESM has been made subject to the Court; however, its status as an IMF-style international organisation that is merely recognised by the EU – as distinct from being an EU institution – may give room for arguments about legal principles. Less such wiggle room for the ECB as the SSM, one might think.

**EU governance via shareholdings: the ESM as IMF-style governance**

Alongside the establishment of an SSM for the Eurozone, there has also been a deeper, more profound change in the European policy-making, which amounts to a new constitution, with minimal preceding debate. A change in architecture has occurred, stemming not so much from changes within the EU treaty structure as such, but from a new, international structure being grafted alongside or on top of the preceding constitution. The focus here is on the important case of the ESM (which non-Eurozone states may opt into; see European Parliament/various authors 2013). It is fair to say that the ESM has generated legal challenges and political controversy (Tomkin 2013).

The core rationale of the ESM is that: ‘Given the strong interrelation within the euro area, severe risks to the financial stability of Member States whose currency is the euro may put at risk the financial stability of the euro area as a whole’ (Kingdom of Belgium and others 2012: preamble 6 at 5). Addressing the objective of managing such risks, the ESM is a mechanism for bailing out and imposing conditionality on countries.
The ESM also offers a ‘top down’ mechanism for bank resolution at EU level, complementing rather elaborate plans for ‘bottom up’ resolution, starting with national capacities and funds and slowly mutualising (European Commission 2013b; and see end of this chapter). This proved to be politically delicate, particularly in northern Europe. Just as there seemed to be limits to solidarity in relation to bail-outs of troubled Eurozone states, so there would be reluctance in some Eurozone Member States to participate in bailing out banks in other Member States. This is particularly sensitive for Member States that have a large and relatively healthy economy, such as Germany as of 2013, which might contribute more than other states. Under the EU’s normal (Lisbon Treaty) decision-making procedures, one Member State, even a large one, might find itself in a voting minority. That aside, the Community method is supposed to allow citizens to have some indirect influence within each of the EU institutions – which then have procedures between themselves – so creating a public discourse, supposed to increase the chance of well thought-out policy outputs and to legitimise them. The flip side of this is that, public discourse having been stirred up on a very sensitive topic and in an increasingly nationalistic atmosphere, decision-making on bank resolution could be very difficult. Placing the process beyond such influences has been one of the motivations for constructing mechanisms fully or partially outside the EU legal order.

A persistent problem at the heart of European resolution planning has been by what means and to what extent to provide funding to support the resolution process. There is an in principle commitment to avoid the use of public funds, especially in a context when many sovereigns have been weakened by past bail-outs. However, there is also an expectation that not all entities in difficulty would be resolved by diluting or extinguishing shareholders, bailing in creditors, liquidation or takeover: for some restructurings, loans might be needed. Ideally, such loans are seen as coming from the industry itself, contributing over time; however, that is a very long road.

During 2013, several possibilities on resolution funding were under discussion. First, as the leader of the Liberal and Democrat group in the European Parliament put it: ‘If banks could rely on a special longer-term refinancing operation from the ECB, conditional upon contributing to the resolution fund, it would plug the gap without placing the burden on taxpayers’ (Verhofstadt 2013). Since the ECB had already crossed the Rubicon in terms of promising unlimited support to banks to prevent a break-up of the Eurozone, it might be thought to be institutionally and political possible for it also to create money for resolution purposes – always assuming that resolutions would be sufficiently successful for the money to be repaid.

A second source of lending for resolution purposes is the ESM. In 2013 the European Parliament introduced into the text of the regulation on bank resolution (European Parliament 2013) a reference to this mechanism. Addressing the question of what source of funding might be
available during the first 10 years of the resolution regime – during which national funds would be slowly building up but could be insufficient for resolution needs (except in relation to resolution of very minor entities) – the Parliament added the following to the legislative proposal:

‘Alternative funding’ means –

1. The [resolution] Board shall endeavour to contract for the Fund borrowings or other forms of support from financial institutions or other third parties, in the event that the amounts raised [from contributions from the industry] are not immediately accessible or sufficient to cover the expenses incurred by the use of the Fund. In particular, the Board shall endeavour to contract for the Fund a loan facility, preferably utilising a European public instrument, to ensure the immediate availability of adequate financial means . . .

(Committee on Economic and Monetary Affairs 2013: 70, Article 69, emphasis added)

For ‘European public instrument’, read ESM (European Parliament 2013). What then is the ESM? It is not governed by the ‘Community method’ of policy-making, in which roles are accorded to the European Parliament and the Council, the latter taking a decision by qualified majority roughly corresponding to weight of population. By contrast, the ESM is an international organisation, with capital and shareholders, the latter being the Member States participating in the ESM and contributing to its capital. The ESM board’s decisions result from voting that is weighed according to each Member State’s contribution to the capital fund. Thus, whilst participation is open to all European Member States (all those in the Eurozone plus aspiring members and also those ‘outs’ who wish to participate), decisions are by financial muscle – quite in contrast to the Community method of decision-making, where small countries enjoy influence proportionally greater than merited by their population size.

In short, the ESM’s organisational model is extra-Community, with decision-making taken by way of what Dawson and de Witte characterise as ‘raw political power and temporary policy preferences [. . .] with a natural bias tending to emerge towards more mobile, richer and integrated interests (which is a shorthand for capital and markets)’ (Dawson and de Witte 2010: 826, 827). Much attention has been given to the conditionality required for assistance to be granted by the ESM; indeed, both its explicitly IMF-like principles (Kingdom of Belgium and others 2013) and the political atmosphere in much of Europe seem to point to more of what is commonly referred to as austerity. However, the notions of legitimacy and fairness governing the ESM are equally striking, with a shift from representation of citizens (see Lord and Pollak 2013) to representation of wealth. That shift
in loco, mode and legitimisation of European decision-making – from the Community method to international shareholders – may have a wide and long term impact.

In terms of bank regulation, linkage is necessary between the ESM and ECB-led SSM. This is because the SSM is supposed to monitor banks and to identify cases in which particular banks require bail-outs (with conditionality): the ECB/SSM is the ESM’s information system. Co-working is required between two mechanisms, one of which is by definition outside the EU’s decision-making space (the ESM), whilst the other is considered to be independent within the EU. All that is in parallel with the central banks (or other financial market regulators) of the Eurozone ‘outs’. Moreover, the ‘ins’ and the ‘outs’ work together through the European Banking Authority, populated by regulators of all EU Member States (that is, not merely Eurozone members).

To call this complicated, both in the constitutional and operational senses, would be an understatement. To complicate matters even further, a hybrid legal order has been invoked for the third leg of Eurozone banking union, the SRM (for the original legislative proposal, see European Commission 2013b). The operation of the SRM was a matter of dispute as this book was going to press so our treatment of it has been curtailed. Difficulties arose over the fact that, although the SRM per se is notionally a mechanism within the EU legal order, the associated Single Resolution Fund – which is to be at the disposal of the SRM – has been constituted through an intergovernmental agreement, that is to say outside the EU (Economic and Financial Affairs Council 2013). In response, the competent committee of the European Parliament referred to the Council’s recourse to intergovernmental agreement as a circumvention of the legal order of the EU and called for the Fund to be brought back within that legal order (Committee on Economic and Monetary Affairs 2014a: 1–2). Although the Parliament could do nothing to stop Member States’ recourse to an intergovernmental agreement, it had some leverage because of the reliance of the Council upon the Parliament to pass that part of the SRM legislation that is within the legal order of the EU. The stance of the Committee on Economic and Monetary Affairs was vigorously backed by senior parliamentarians, warning in January 2014 that: ‘The current state of play in the negotiations is not promising, given the wide differences between the Council and Parliament, meaning that no deal before the European elections in May is a distinct possibility’ (European Parliament 2014: 1). In the event, a compromise was achieved, so as to present a harmonious and hopefully politically pleasing front in time for the elections to the Parliament in May 2014. An aspect of the compromise is that, whilst governance of the single fund remains intergovernmental, the ECB and the European Commission are given more influence in the resolution process, thus (in the view of the Committee on Economic and Monetary Affairs) more clearly implicating bank resolution within the EU
legal order (Committee on Economic and Monetary Affairs 2014b: 1, first two indents). The Fund will also be given a power to borrow, thereby increasing its firepower (ibid: 1, third indent).

On balance, we may say that there has been some technical convergence between the modus operandi of the SRM and that of the ESM. This has been achieved through practical horse-trading and compromises between factions among the EU elite, who are variously intergovernmental-minded and communitarian-minded (or, to put it another way, inhabit different institutions). Whether this ongoing struggle amongst elites conveys much meaning to EU citizens or energises them at the ballot box is another matter.

Quo vadis EU?

The pre-crisis constitution of the EU consisted of, on the one hand, centrally-driven market integration and, on the other hand, areas of policy that remain primarily or at least partly the responsibilities of the Member States. The latter include social or ‘moral’ issues such as abortion, for example, but also and more substantially, policies on tax and redistribution. The notion of subsidiarity, as applied to non-market spheres, provides for an ‘explicit ring-fencing of issues [which protects] the capacity of citizens to decide on contentious issues within a political unit – the nation state – that allows for the articulation, mediation and reconciliation of diverse interests, and thereby legitimises its outcome’ (Dawson and de Witte 2013: 821).

Alongside those ‘national’ tasks, market integration proceeds as the main common task. The collective core of the EC was the Common Market, as appreciated by Britain on entry (see Chapter 1). Clearly, over the past few decades, the neo-liberals won in Europe, as de Gaulle had feared, with EU market integration and hence market uniformity to the fore, whilst diversity became restricted to ‘non-market’ zones of policy. The British decision to join the EC was both a symptom of and fuel for this dichotomisation of policy-making, between market integration on the one hand, and sovereignty over non-market spheres on the other hand.

However, after the financial market crisis and the Eurozone crisis, EU governance cannot so easily be contained with a domestic and non-market sphere on the one hand, and the EC and market sphere on the other hand. By coincidence the Lisbon Treaty, a new and ‘simplified’ political architecture, was negotiated and signed just before the emergence of the financial crisis and it came into force at the end of 2009 – so, just in time to be tested by the evolution of the crisis in the Eurozone. Lisbon abolished the previously distinct EU pillars (single market, justice and home affairs, and foreign affairs) and also enhanced the influence of the European Parliament. Virtually as soon as Lisbon came into force, its adequacy came into question. On the one hand, it was found possible under Lisbon to give the ECB new competencies on financial stability, as distinct from
inflation. On the other hand, financial stability is clearly not a matter confined to the Eurozone, so the new ECB competency somewhat complicates relations between states adopting the euro and those not (known as the ‘outs’).

Also, whatever historical settlement may have been arrived at in respect of the management of inflation – this having been depoliticised and made ‘technical’ in the sense of being made a task for central banks rather than parliaments – financial stability is a more contentious matter. Stability is something about which technocrats admit that they have not yet arrived at credible knowledge, certainly not anything approaching exclusivity of wisdom (see Chapters 1–3). On stability there is a rather complex development of relations between parliaments (national and European) and central banks and other financial regulators (within the Eurozone and outside). In the middle of this sit the European Supervisory Authorities (see below), the ensemble making up the SSM.

The history of responses to the crisis in Europe illustrates the many ways in which aspects of financial market regulatory and resolution policies can invoke the constitution of the EU and in some respects go beyond it. Financial market regulation will proceed along multiple tracks, depending on the rather contingent ‘fit’ between constitutional possibilities and particular policy proposals. Some available tracks are set out below.

First, in the short term, whilst other regulatory mechanisms are still becoming fully operative or alternatively are found insufficient to deal with contingencies, there is the possibility of interstate bargaining, dealing with cross-border issues in an ad hoc manner (as was the case in the Benelux following the failure of banks such as Fortis). From a realpolitik perspective, interstate bargaining is what happens anyway, even when from a formal point of view policy-making is made through highly structured channels.

Secondly, for the medium term, financial market regulation has been split three ways between: national regulators, the European Supervisory Authorities (who have to have an eye on their Member States as well as on the European Commission, Council and Parliament) and the SSM and the ESM, in the case of Eurozone members and others who opt in. There is a fourth possible constellation – new forms of reinforced cooperation between sub-sets of EU Member States. Thus, to take the most obvious (but not necessarily likely) example, some of the Eurozone ‘outs’ might agree forms of cooperation that, whilst falling short of merging the prudential capabilities of central banks, of resolution authorities or other regulators, might provide a circuit of cooperation and assistance. However, there could be less nostalgic and more surprising alliances, based less on free trade dreams and more on specific inclinations to encourage certain business models and to discourage others, as envisaged throughout this book.

Thirdly, European policy-making is increasingly rubbing up against the protocols of international bodies and, indeed, seems to be remaking itself in
the image of the latter. For example, the Greek bail-out involved the IMF and now Europeans have developed a sort of home-grown IMF, the ESM. The ESM was designed with half an eye to bailing out (and imposing conditionality on) banks as well as on states. The ESM and the ERM and its fund will have some knock-on effects on other aspects of European financial market regulation. It will be interesting to see how prudential regulation will be influenced by these mechanisms, especially by the international, shareholder-driven ESM. It will also be interesting to see what will be left of the single market policy process and what will be the fate of the European Parliament vis-à-vis financial market regulation.

Some mix of these three tracks discussed above seems inevitable for the foreseeable future. This makes for a legally ‘lumpy’ and politically contested basis for European financial market regulation going forward, more so than it has been in the past. The struggles mentioned in this chapter between the European Parliament and other political actors over technocratic decision-making – governance through authorities/committees (the CESR/credit rating agencies affair) and under the new European mechanisms (supervision, stability, resolution) – illustrate the general point that elites persistently seek to place financial market regulation beyond democratic scrutiny. In this attempt they are encouraged by market actors.

As shown by the book as a whole, these tendencies echo down the centuries: through pre-modern cartels, private regulatory clubs, publicly-clothed but market-constituted regulation at national level, international and European networking, and mechanisms constituted by intergovernmental treaties. These are all arrangements privileging decision-making as ‘technical’ and off the public agenda. The European Parliament is by no means perfect, and its actions may be self-serving; however, its attempts to curb technocratisation are noteworthy. National parliaments have yet to find a parallel voice, either collectively or separately.

Treaties, competencies and powers (or lack of them) aside, the question of finding voice(s) hangs on the availability of vision(s) of the EU. Beneš and Braun (2014: 24–25) articulate a sense of difficulty here, as old rationales – indeed dreams – are swept aside by recent policy developments:

As the Cold War and the division of Europe recedes into history, the original rationale for keeping Europe ‘consolidated’ slips from the minds of both the decision-makers and the general public. The original ethos that enabled the unprecedented EU enlargement – at a time when the original EU12 was about to further deepen its integration (EMU) – faded away. Not all new EU Member States any longer strive for a ‘fully-fledged membership’. At least in the Czech Republic and Hungary, the political elite wrote off the idea of equal rights and obligations for all EU Member States. While for instance the Czech government initially protested
against the fragmentation of the institution (the establishment of exclusive eurozone summits), Czech politicians in fact accept or even support the model of differentiated integration. The conclusion of the intergovernmental treaties outside of the framework of the EU primary law (the Fiscal Compact and the ESM Treaty) represents a serious blow to the original idea that the deepening and the enlarging do not exclude each other and that the enlarged EU can keep its legal and institutional integrity.

One can comment that the original ethos and rationale was indeed that institutional deepening and political homogeneity could be reconciled. This was the case when the EU was growing but still remained quite compact, based on cultural similarity and a shared historical vision – a mix of Benelux-style border-crossing and Franco-German renunciation of war. That idea rubbed up against another: that the EU was an almost infinitely expandable, regional and possibly meta-regional project. So it could take in not only other Western continental states and the UK but also central and eastern Europe, the vision sometimes also looking to Turkey, the Ukraine and North African states. In that event, the EU could not stay ‘consolidated’ in the strong sense that Beneš and Braun mean. The dream had passed from policy elites and Europhile citizens (disclosure: the author voted for UK entry into the then EC) to aspiring entrants. Within the EU, so-called enlargement fatigue and political reaction set in.

Moreover, the pre-crisis political, communitarian dialogue between deepening and widening has meanwhile been transformed by the EU’s economic, structural and intergovernmental responses to the financial crisis. From the former, admittedly nostalgic point of view, intergovernmental treaties such as that setting up the ESM represent a blow to the original idea of the EU, as suggested by Beneš and Braun (2014). Tellingly, Richard Corbett, writing as a member of the cabinet of Herman van Rompuy, President of the European Council, points out that the distinction between the old dream of the EU (consolidated, federalist) and new reality (multifaceted, with intergovernmental mechanisms) is as much financial as political: ‘The ESM is indeed intergovernmental at eurozone Member State level. After all, it is financed by national money or guarantees (the EU budget is far too small) . . .’ (Corbett 2014: 10, noting the text that he puts within brackets). Not only is the EU budget too small, necessitating large national funding, but also the ESM is leveraged to attract market funding.

So, with the ESM and the associated mechanism of banking union, we are seeing not only the death of an old dream of the EU but also the birth of a new dream: a new Europe that is the financial big brother of the EU. Europe is focused more on the reconstruction of banking than on earlier visions such
as peace through market integration and democracy through political example. After the crisis, institution building is quite another thing than it was pre-crisis. Moreover, the whole idea of Europe is now different. The EU’s response to the banking crisis ruptured its body. Transposing and developing these events into something that can be represented as not only crisis management, conditionality and discipline, but also as calmly debated, democratically containable and widely ‘owned’ poses quite a challenge.
Part III

Ways forward
Chapter 5

Limits and distractions of transparency

What should be the information requirement for financial market regulation? Here, we are concerned with the public knowledge requirement about financial markets for purposes of regulation. This issue is distinct from understanding how private sector knowledge of market products and processes is generated within workplaces and trading venues (for which, see inter alia Çalışkan and Callon 2009; Engelen and others 2010; MacKenzie 2011). A focus upon public knowledge need not – and indeed should not, it will be argued – take as its point of departure privately-produced market knowledge. Knowledge conjured up for private purposes, where assumptions, modelling, data-mining, construction, validation, analyses and interpretation serve those purposes, should not be taken as information for public purposes.¹

The information requirement for regulation depends on the purposes of regulation. Following the crisis, regulators recognise two new purposes – prudential regulation to reduce risks of failure, and resolution planning to reduce the impacts and costs of failures that nevertheless occur. This chapter argues that the information requirements of these purposes are quite distinct. The chapter introduces these issues by acknowledging important debates in regulatory circles over complexity and the benefits of simplicity of analysis. It is argued that these debates (see inter alia Haldane’s 2012 speech entitled ‘The dog and the frisbee’) do not go far enough. No doubt regulatory analysis of markets should be radically simplified (echoing requirements on financial market participants that they simplify their offerings so that both purchasers and board-level management can understand them). Even so, the increasing complexity of rule books, the inevitability of them being ‘gamed’ by market participants, and the sheer volatility of global markets suggests that, if the regulatory dog chases market frisbee, then it will always be behind the curve (using the language of Haldane 2012). Happily, however, there is one positive aspect of policy – enhancing powers for ‘resolution’ of financial firms

¹ Chapter 5 is a revised version of my paper ‘Knowing markets: would less be more?’ (2011) 41(3) Economy and Society 316–34.
in ways that impact upon investors whilst minimising wider destabilisation – upon which the regulatory information requirement can and should be refocused. To protect the public interest, and to inform public regulation, legal transparency is required; trading transparency is not.

Besides having a very practical public policy objective, this chapter can be read as one more voice in the critical commentaries on neoliberalism and its legitimisation of ‘market based governance’ and private regulation before the crisis. The views of Friedrich Hayek (1944) are now as widely disavowed as they were previously endorsed. Nevertheless, whilst Hayek and his followers failed to anticipate the eventual systemic consequences of adopting market logic for economy and for democracy, we can appropriate his observations on the futility of public authorities trying to keep abreast of market trading in time and data terms. As Riles (2013a: 557) critically summarises Hayek on this point:

By definition, [Hayek] argued, state actors could not adequately know the market because by the time they gathered information about market conditions, it was already obsolete. Because their market knowledge was always retrospective, it was inherently contradictory to the prospective orientation of planning, and hence they could not intervene in the market effectively.

Hayek’s limitation (and that of neoliberalism more generally) – which contemporary regulators are in danger of replicating – was a failure to differentiate between two regulatory logics. The first concerns real-time market data, where indeed it is the case that the state will always be seriously handicapped, for reasons that are discussed in some detail in the following pages. Whilst prudential regulation can have an important role, that role has more to do with structuring markets to reduce connectedness (see Chapter 6) than with introducing surveillance systems so as to enable regulators to act as if they were senior managers of firms. Chasing market data cannot make a difference, other than a negative one, by misallocating regulatory resources and attention. The second, more useful regulatory logic, has to do with dealing with failures, in ways that restrict public costs, knock-on effects, wider contagion, a cycle of further failures, etc. For this purpose, there is an information requirement that can be met, so it is here that information resources need to be sharply focused.

Context

Unsurprisingly, regulatory actors and appointed commissions have been amongst those exploring the perceived inadequacy of knowledge in relation to what are now recognised as systemic issues – the storm clouds brewing up
but largely ignored until 2006, the authorities’ eventual recognition of the financial market crisis in 2007, the events from 2008 onwards, and policy-makers’ and regulators’ subsequent ‘activism’ in response (Financial Services Authority 2010; High-Level Group 2009; Turner 2009). Policy thinking and action have been bounded by a general strategy of ‘stabilising’ the financial markets, rather than attempting to transform them, in accordance with which governments and regulators have sought to enhance their intellectual capacities by stepping up recruitment of senior staff from the private sector (CRESC 2009). The spectre of sovereign insolvencies in Europe deepened the atmosphere of crisis management, as public authorities struggle to ‘balance the books’ – as demanded by right of centre politicians as much as by the capital markets. Greece, Ireland, Spain, Portugal and other ‘peripheral’ Eurozone countries have been particularly stressed, following the popping of bubbles in sectors such as real estate, the costs of bailing out failing banks, the fall of activity in their economies and the downward revision of projections of state revenue streams.

How all this works through in terms of reprofiling, rescheduling and/or eventual defaults remains to be seen but more public money is certainly being spent. Whilst the first wave of bail-outs involved national treasuries, increasingly the response now is as much on a collective, European and international (IMF) basis. There are few signs of a break with the policy of bailing out private financial interests at public expense. Some commentators have called for the creation of a special chamber of the ECJ, capable of reducing public debt by imposing ‘haircuts’ on bondholders (Gianviti and others 2010). However, the form actually taken by European radicalism has been the creation of new mechanisms of political economy that are positioned outside the legal order of the EU (or that straddle it; see Chapter 4). Political responses have outpaced the considerable literature on public regulation, market self-regulation and hybrid forms at national, European and global levels (Moran 2002; Black 2010; Froud and others 2010; Moloney 2010; Helleiner and Pagliari 2011).

Exploring the workings, capacity and potential for public policy in the face of the multiple challenges thrown up by the markets, this chapter takes the line that public knowledge for financial market regulation may be analysed in terms of too much market transparency. At first glance, transparency might appear a harmless nostrum or even a helpful mechanism (‘information for policy-making’). However, we can decode this apparently empowering concept in terms of its disempowering practical effects – the creation of a wall of incommensurate, uninterpretable and overwhelming information – which does not equip regulators to assess systemic risks at all. The problem is not simply that regulators fail to understand the processes of construction of knowledge by firms’ and rating agencies’ proprietary risk models. That is certainly part of the problem, as we show below, and this is now recognised
by regulators (see for example the EU regulation on credit rating agencies: Legislative Observatory 2010). More fundamentally, financial markets, large firms, ‘institutions’ such as the ratings agencies and learned commentators create such a complex intellectual/data maze that regulators get lost in it, so cannot attain an overview or basis for decisive and timely action. Helpfully, public policy today distances itself from the objective of ‘zero failure’ – preventing failures of firms, small or large (HM Treasury 2010). Instead, policy now commits firms to arranging their legal and administrative structures in ways such that, if they fail, regulators can resolve them, whilst minimising systemic destabilising effects. Many jurisdictions already have in place SRRs for this purpose (for EU aspects, see Chapter 4).

The epistemic implications of this policy shift – from ‘zero failure’ to ‘resolution’ – are fundamental. The forms of knowledge required for resolution, and hence for systemic stability, are basically legal and administrative, and relatively simple: firm- or group-level information about legal basis, systems, subsidiaries, asset ring-fencing and ‘living wills’ (Independent Commission on Banking 2011b (Vickers); High-level Expert Group 2012 (Liikanen)). A tight focus on this category of information would put the regulator in a position of clarity and preparedness, instead of being distracted and bewitched by a torrent of trading data. Trading information is economic in its form, vast in scope, tremendously complex and very fast-moving. The joy is that it is not required once we move from a zero failure mentality to a resolution mentality. In short, public policy could be empowered by breaking with the notion that private actors should present to regulators ‘live’ data about their trading. A break with market-based forms of knowledge would create the conditions within which regulators could focus on managing systemic risk.

Debating complexity

The heterodox proposition advanced in this chapter may be compared with two tendencies articulated within financial regulation: for more data on the one hand; and for less data on the other hand. The problem, as argued here, is that a debate on ‘data’ and ‘more’ or ‘less’ of it can too easily sidestep the fundamental question about the information purpose.

At the global and EU levels, it appears that one apparent lesson that is being taken from the crisis is that regulators need more data on markets and their movements. Somewhat by contrast, some others within financial regulation, notably Haldane (2012) have recently argued that ‘less could be more’: simpler models give more useful guidance than more complex models, he argues. What unites Haldane, however, with his more complexity-inclined colleagues is a fundamental – and seemingly unquestioned – assumption about the broad form or category of information under consideration: market data. The utility of that assumption is disputable. As Haldane puts it: ‘less
[information] could be more [useful]. But we ask – more useful for what purpose? The introduction of Haldane’s paper (2012: 1) positions the purpose in terms of prediction and ‘catching’, as follows:

Catching a frisbee is difficult. Doing so successfully requires the catcher to weigh a complex array of physical and atmospheric factors, among them wind speed and frisbee rotation. Were a physicist to write down frisbee-catching as an optimal control problem, they would need to understand and apply Newton’s Law of Gravity. Yet despite this complexity, catching a frisbee is remarkably common. Casual empiricism reveals that it is not an activity only undertaken by those with a Doctorate in physics. It is a task that an average dog can master. Indeed some, such as border collies, are better at frisbee-catching than humans. So what is the secret of the dog’s success? The answer, as in many other areas of complex decision-making, is simple. Or rather, it is to keep it simple. For studies have shown that the frisbee-catching dog follows the simplest of rules of thumb: run at a speed so that the angle of gaze to the frisbee remains roughly constant. Humans follow an identical rule of thumb.

Too rapidly and without query, this naturalises the concepts of prediction as the bedrock for prudential regulation, and intervention to ‘catch’ the frisbee before it hits the ground as the objective. Since the frisbee stands here for a market participant (or many, linked participants), Haldane’s story is posited on the assumption that market failures are to be avoided by urgent corrective action. It is worth emphasising here that such an assumption has become rather controversial within regulatory circles (or at least Anglo-US regulatory circles), with deep ambivalence over whether or not a ‘no failure’ regime is intended (see remarks on moral hazard below). Possibly prudential regulation could be analysed in terms of an unresolved tension between ‘no failure’ and ‘resolution’ tendencies. These observations aside, it is possible to read into Haldane’s paper an assumption about urgent corrective action, resulting in no (or fewer) failures – an agenda that has survived the crisis.

It remains remarkable that a fuller discussion of regulatory purposes does not precede Haldane’s dive into the question of data needs. A similar generality characterised the agenda for a 2013 conference organised by the Bank of England on the Future of Regulatory Data and Analytics (for outcomes, see Bholat 2013; Journal of Banking Regulation 2013: whole issue). The agenda is sharpened somewhat by a 2014 call for a Conference on Data Standards, Information and Financial Stability, which differentiates three purposes to guide the information requirement: monitoring and mitigation of systemic financial risk, assessing the solvency of financial firms and, where necessary, resolving them in an orderly fashion (School of Business and Economics 2014)). These distinct purposes are each said to require ‘comprehensive and granular exposure data’, raising the question of ‘how can
data from multiple sources and in multiple formats provide a cross-company, cross-market, and cross-border view of the exposures of major financial institutions and their contribution to systemic risk?’ (ibid; for answers, see forthcoming special issue of the *Journal of Financial Stability*). That is a huge agenda. It seems that a policy commitment has been made to data in advance of clarity over how it can deployed. Haldane’s remarks (above) at least had the considerable merit of questioning any such headlong dash into complexity. Yet the question – data for what? – remains somewhat occluded. Failure to answer that question can only lead to regulatory networks seeking to collect a rather wide range of information, with uncomfortable consequences.

**Trade data as knowledge flooding**

Six aspects of the construction of knowledge for financial market regulation are discussed here: (i) the Basel risk categories; (ii) the industry’s proprietary models; (iii) the flexibility with which financial markets ‘enact’ potentially inconvenient rules; (iv) a calculability that aims to be forward-looking as well as drawing upon historical data; (v) the information-bending effects of moral hazard; and (vi) the meaning of this swirl of data being negotiated through regulatory networks and structures nationally, within the EU and internationally.

First, the Basel banking accords conjure up four main dimensions of risk, against which the banks are obliged to make financial provision. The first three are credit risk (closely related to counterparty default risk, where the rating agencies supply key metrics); operational risks (for example, people-related risks, processes or the operating environments of specific financial firms); and market risk (meaning that markets in particular instruments such as bonds or equities might move against a bank, quite independently of individual instruments or parties to which it is exposed).

Then there are the so-called ‘residual risks’, which include matters such as reputational risk, legal risks, liquidity and – lurking in the thicket of residual risks – systemic risk. The latter has since emerged as the mother of all other risks, although its exact nature is contested. The broad point being made here concerns the sheer complexity of those forms of knowledge (and that is before one gets down to subcategories and questions of modelling and data). It is not surprising that much room remains for debate, indeed for scepticism, concerning regulators’ attempts to apply risk modelling in negotiation on the one hand with banks and on the other hand with politicians, as for example in the first round of stress-testing of European banks by the EU authorities (Committee of European Banking Supervisors 2010; *Financial Times* 2011). Those concerns were justified in the light of the collapse of Irish banks soon after they passed the 2010 stress tests.

Secondly, the complexity and uninterpretability of risk/regulatory knowledge was deepened when, during the Basel II negotiations on bank capital
safeguards in the 1990s, the regulators capitulated to the market in terms of the latter’s proprietary risk models. In the Basel I accords, the regulators and the industry had agreed to use a standard model. In Basel II, this was abandoned in favour of banks’ own, diverse, allegedly ‘more sophisticated’ models (Hellwig 2008: 54; Chapter 3). For present purposes we may add that, from this point onwards, regulators were relegated to a position of naive consumers of risk information that they simply could not understand, for reasons of their social distance from its points and methods of production. Moreover, since by such means (by design rather than by accident) risk information was made incommensurate across firms, regulators could not even crudely aggregate it.

That may be one reason for regulators becoming more reliant upon other knowledge-producers, in particular the much maligned but still-standing credit rating agencies. Before the global rise of these agencies, credit assessments had typically been a matter of judgment by actors who had direct (and often local) knowledge of the parties and issues involved, for example lending by local banks. With the development of distant assessors who seemingly rate ‘objectively’ – on the basis of their models rather than of social linkage – the knowledge produced became less grounded (Sinclair 2005; see also Partnoy 1999). Models and portfolios were tinkered with until they gave the ratings required: not difficult, since the multiple arrays of assumptions, linkage and data points offer multiple points for fine-tuning. Even modest shifts in a few of these could make a considerable difference to the output. Market participants were aware of the malleability of such knowledge. This produced the potential for uncertainty and distrust once markets began to turn.

More generally, as any field of knowledge becomes more technically elaborate, socially disembodied and complex, so the potential increases for knowledge producers and customers to disregard directly contradictory assumptions in their thinking – or even not to notice them, owing in part to divisions of labour within firms and indeed within regulators. Some of the issues might be amusing were they not so serious in their consequences. For example, in discussing the straitening effects that the failures of Lehman Brothers and AIG had upon markets, Joseph E Stiglitz (2010: 16) comments as follows:

The problems with AIG brought home the importance of counterparty risk, and the intellectual incoherence of the banks – who had failed to net out positions. When asked why, they said it was because they could not imagine the failure of the counterparty, even though they were trading CDS’s [sic] on the failure of these very same counterparties.

Why then did regulators not gently bring these matters to the attention of the firms concerned? Possibly because the outsourcing of strategic thinking
to the market meant that such an action would seem impertinent, but also because the regulators themselves were swamped in the detail.

Thirdly, further clouding of knowledge was caused as banks ‘chose to comply with the rules of global finance [in ways that] effectively redefined them’ (Deeg and O’Sullivan 2009: 740–41). Approaches to rule enactment included moving riskier assets off balance sheets or constructing synthetic lines of credit or insurance. When regulators failed to react to such innovations, firms tweaked the rules further. One result was that knowledge both for firms and regulators became even less transparent as trading widened beyond the available regulatory categories and data. McBarnet (2010) has written about gaming the system, to which some commentators have added that one consequence of regulatory consultations is that gaming may be simulated in advance, enabling lobbying for the most gameable rules (just as Enron’s writing of California’s energy market rules enabled it to game them spectacularly, prior to its collapse; see Federal Energy Regulatory Commission 2003). Such governance arrangements move knowledge off the regulators’ screens.

Fourthly, since the emergence of the crisis, the span of knowledge has increased yet again, with a new orthodoxy emerging to the effect that the backward-looking measures that dominated thinking before the crisis must be supplemented by forward-looking considerations. As the UK FSA put it in a document (2010: 9) directed to its regulatees:

The term ‘risk appetite’ is often taken as a forward-looking view of risk acceptance, while ‘risk tolerance’ is often considered to be the amount of risk a firm has accepted in the past. In this document the terms are used to capture both aspects – to reinforce a general message that firms might include a forward-looking analysis as part of their risk management and capital assessments. A purely historic approach might be perceived as neither sufficient nor ‘interchangeable’ with a forward-looking view.

This is typical of the new orthodoxy: an appreciation that the past cannot be taken as a guide to the future. Some implications will be explored below in terms of a switch from rear-view-driving, a regulatory style in which attention is focused on past aggregate trends, to ‘judgment’ (see Chapters 2 and 3), a style in which knowledge construction is on the one hand more open and speculative and on the other hand informed by recent and contemporary trading transactions.

Fifthly, complicating regulatory and market knowledge further are some issues around moral hazard, TBTF, TCTF and ‘global systemically important financial institutions’ (G-Sifs) (see Financial Stability Board 2010; Jenkins and Masters 2010 and preceding chapters). The literature suggests that high connectivity has both an upside and a downside in terms of crisis-containment:
In a highly connected system, the counterparty losses of a failing institution can be more widely dispersed to, and absorbed by, other entities. So increased connectivity and risk sharing may lower the probability of contagious default. But, conditional on the failure of one institution triggering contagious defaults, a high number of financial linkages also increases the potential for contagion to spread more widely. In particular, high connectivity increases the chances that institutions which survive the effects of the initial default will be exposed to more than one defaulting counterparty after the first round of contagion, thus making them vulnerable to a second-round default. The effects of any crises that do occur can, therefore, be extremely widespread.

(Gai and Kapadia 2010: 4)

The implication is that, when a financial firm’s failure could be tolerated by the wider market and by policy-makers, then its risk appetite will be a concern for its managers, its investors, counterparties and other immediate stakeholders. When, however, a firm is considered to be TBTF/TCTF/G-Sifi, then it enjoys a guarantee of public support – a status attaching to most large firms in the aftermath of the Lehman collapse (Lanchester 2009) – this being recognised by the rating agencies in terms of higher ratings than would have been awarded in the absence of such support. If rating agencies and the wider market factor such political knowledge into their modelling of market knowledge, then of course so do the firms concerned.

There are unsettling implications for sovereign borrowers. If, as result of bailing out its banks, a state finds its own ratings queried or lowered, then the banks headquartered in that country also find the value of their state guarantee eroded – unless the state concerned (and thus indirectly its banks) is propped up by international guarantees, as illustrated by IMF and EU mechanisms deployed in the period 2010–13. There is the potential for those processes to spread from just a few states to many, in a series of third-round defaults (extending the logic of Gai and Kapadia 2010 to the public sphere). The moral hazard of public support to technically insolvent private actors is something of a boomerang, insofar as it results in other private actors demanding evidence of public creditworthiness that cannot then be supplied.

The construction of regulatory concepts such as TBTF/TCTF/G-Sifis has the potential for unforeseen consequences. On the one hand, it is helpful that public policy now recognises the limitations of the pre-crisis knowledge strategy, which allowed financial markets to define the information requirement (Basel accords, proprietary risk models, ratings, etc). On the other hand, the new emphasis on connectedness – referring here not only to connectedness within markets and the consequences for systemic stability, but also to the merits perceived by policy-makers and regulators in deepening their networking and harmonising their thinking – carries new risks. The question of whether greater connectedness between regulators and harmonisation of
their ideas and practices might be dangerous has been raised from politically diverse perspectives (see for example Mainelli and Giffords 2009) but it does not permeate the political centre ground. However, that question should persist, given that the new regulatory mode of thinking includes, within the same intellectual frame, regulators themselves and their rules alongside and interacting with markets.

Finally, in the wake of the crisis, many countries reviewed the workings and structures of financial market regulation and some countries changed these arrangements. In most cases, the emphasis has been as much on changing the architecture of regulation as on its style or culture. In the UK, for example, systemic risk regulation migrated to the Bank of England. For present purposes, what is interesting is the rationale that the UK Government offered for this re-jigging:

Perhaps the most obvious failing of the UK system, however, is the fact that no single institution has the responsibility, authority or powers to monitor the system as a whole, identify potentially destabilising trends, and respond to them with concerted action. This is a problem which Lord Turner, the chairman of the FSA, and Paul Tucker, Deputy Governor of the Bank for financial stability, have referred to as ‘underlap’: a phenomenon whereby macro-prudential risk analysis and mitigation fell between the gaps in the UK regulatory system. (HM Treasury 2010: 4 at para 1.6)

Yet there has been widespread commentary to the effect that, as one international law firm has said: ‘it was the style and rigour of regulation that fell short ahead of the global financial crisis rather than the architecture of the financial system’ (Gibson Dunn & Crutcher LLP 2010). If so, then reforming regulatory architectures might do little for the effectiveness of regulation. The managerial capacities absorbed in reconfiguring the agencies, managing the newly-created turf wars, creating new communications channels and designing new channels of oversight are then not available for purposes of deepening knowledge of markets and risks.

Developments in the EU illustrate the increasing demands upon regulators for surveillance of each other as much as of the market. Regulatory networks and structures at national, regional and international levels provide interlocking fora within, across and ‘on the margins’ of which, the boundaries and nature of knowledge are continuously renegotiated. Agenda are set and circumscribed through formal consultation processes, through lobbying and through informal and social mixing between regulatory staff and market participants. Picciotto (2002; 2006) amongst others has drawn attention to the exclusionary effects of these networks, which in their everyday working and occupational culture face more towards the market than towards democratic fora. Since the matters involved are defined as ‘technical’ – democratic
institutions not being acknowledged as customers for this knowledge – there is no requirement for it to be more widely interpretable (Picciotto 2002).

Moreover, small and medium-sized firms do not have the resources (in terms of cash, expertise, analytical capacity or lobbying power). The largest firms more easily than small and medium-sized firms mingle with the higher reaches of regulation, especially at regional and global levels, and more easily partner with regulators in the continuous renegotiation and reconstruction of the knowledge environment. Regulatory conversations drift from the national to the international level, as networking between national regulators gives way to closer institutional integration: within the EU, from committees to authorities and from these to the ECB and to the new EU ‘mechanisms’ (see Chapters 1 and 4). Somewhat bizarrely, the new UK regulatory architecture does not correspond to that adopted by the EU, producing yet more ‘underlap’ (to borrow the phrase cited in HM Treasury 2010). Bureaucratic discontinuities within culturally harmonised regulatory environment drive the knowledge-field further in the direction of incoherence. In this context, more data may spell more confusion.

**Market information as a public straitjacket**

The six drivers of knowledge complexification and uninterpretability outlined here – multifaceted concepts of risk, industry’s proprietary models, a drive for forward-looking calculability, the flexibility of rule enactment, the boomerang of moral hazard, the influence of large (complexity-competent) firms on regulatory networks – combine to institutionalise information incoherence at the heart of national, regional and global surveillance systems. ‘Transparency’ floats above market/regulatory networking as a marketing motif, one however that is belied by the reality that regulators remain reliant on market data, which is plentiful but not designed to meet regulators’ knowledge needs concerning systemic (in)stability.

Following the onset of the crisis and its spread from markets to sovereigns, the substantive form of knowledge has been moving from ‘rear-view driving’ to ‘judgment’. Rear-view-driving, backward-looking forms of knowledge were based on the (now discredited) notion that the future would be a smooth development of the past, without breaks or (now seemingly ever-present) ‘black swans’ (Taleb 2007). Hence securities valuations, ratings and regulatory views were reliant on statistical assumptions and on data referencing only a few recent years.

By contrast, the newly emerging regulatory knowledge relies more on contemporary data than on past data, and more on qualitative visioning of multiple possibilities rather than mechanical assumptions. Instead of ‘drilling down’, looking for specific and local accident spots, the new thinking seeks to move upwards and laterally, constructing a notion of systemic risk by modelling the inter-connectedness between seemingly different
types of markets and products (Haldane 2009; for a critique, see Froud and others 2010). All of which at first appears quite sensible, insofar as it seems to address some of the issues crystallised by the crisis. However, recalling the proviso that the future may not much resemble the past (and certainly will not insofar as the market will develop new forms in response to new regulation), we will only be able to comment on the robustness of the new approach once it has been institutionalised and tested by successive iterations of the crisis.

There is also the question of whether emergent approaches to regulatory knowledge about systemic uncertainties adequately address the political dimension of TBTF/TCTF/G-Sifi. It is by no means clear that financial regulators’ modestly reformed and still-emerging models, which still centre on economic relations in the narrow sense, even begin to articulate the political dimension of crisis-construction. Returning once again to the propositions of Haldane (2012), we can observe that, whilst the introduction to that work is posed in a common-sense, populist and even folksy fashion, the chapter goes on to invite a debate on the question of how complex or simple economic modelling should be – not whether that idiom is best suited to public policy-making. Relatedly, in academia over the past few decades, economic analyses of public policy (and in law schools and the law and economics movement) have made considerable strides, converting previously normative questions into economic, quantitative and apparently value-free propositions. However, in the light of the escalating financial bill and social distress imposed on European citizens as a result of the continuing crisis, exclusive reliance on reductionist modes of analysis seems questionable, regardless of simple/complex debates within the discipline.

Transformative efforts by academics seem merited. The underlying problem is an implicit assumption that the 2008 market panic and what followed in the Eurozone should be (indeed can be) analysed in purely economic terms. Suppose, however, that Lehman’s failure was interpreted not only as an economic event but also as a political sign: bail-outs may not always be forthcoming. If moral hazard had been embedded in market psychology before Lehman (by the bail-outs of Bear Stearns and others) – and if it has been reinforced by the authorities’ subsequent determination not to allow a recurrence – then TBTF/TCTF/G-Sifi must be understood at least partly in political terms.

Bank resolution as focus for policy and information

From the position of sensitivity to political concerns and the public interest, the principal point of departure should not be market participants and risks to them, but citizens and the public purse and risks to them. The latter
risks crystallise at the point of failure of financial market entities, when the state makes critical decisions to allow failure, or to bail out at public cost, or alternatively to contain at least most of the costs within the responsible financial communities. Nice as it would be to focus on preventing financial failures (‘no failure’ regulatory regime), the nature of markets makes that objective an unobtainable one. Therefore, creating an information requirement to serve that objective is an additional waste of public resources, as well as being a distraction for regulators and a bedazzlement and mystification of the public debate.

On the other hand, creating an information requirement in relation to minimisation of public costs at (or close to) the point of failure is a relatively modest, functional and highly worthwhile endeavour. Thus, a sharper distinction should be drawn between two aspects of what has come to be called ‘prudential regulation’: trying to prevent the failure of large financial firms on the one hand, and on the other hand ensuring that any failures that occur do not destabilise the system. The blurring of these two endeavours leads to policy and regulatory confusion and a muddled and frankly unattainable information requirement. Crises cannot be prevented; they can only be managed in ways that allocate costs.

For that reason, the authorities should get out of the business of prudential regulation in the preventative sense – that is to say, regulation that attempts to corral firms and markets into stability. It should be recognised that, when it comes to financial markets, systemic instability is the nature of the beast. There is nothing to be gained from chasing after the beast in information terms (what does the beast see now; where will it go next, etc). So, one should say no to prudential regulation in that futile, market-following, sense.

On the other hand, bank SRRs, as established in the US, UK and other countries (for EU aspects, see Chapter 4), do hold some promise in terms of reducing the tendency for one troubled financial firm to pull down others (HM Treasury 2010; Committee on Economic and Monetary Affairs 2013). The core idea in resolution is that financial entities be required to arrange their affairs in such a manner that makes it easier to wind them down in ways that minimise knock-on effects, and that the authorities have wide powers to intervene to ensure this happens. Resolution aims to be less costly (and less iniquitous) than public bail-outs and less destabilising than bankruptcy (Čihák and Nier 2009: 5).

What, then, does a SRR consist of in practice? Here things become politically and legally interesting, as we find that SRRs do not have a fixed nature. Rather, they offer a set of options (Brierley 2009: 7; for detail see page 46). These choices are distributional in their consequences and are political as well as technical. There are implications for the public information requirement.
Public information requirement for resolution

Crucially, the information requirements of the two aspects of policy highlighted in this chapter – resolution of failed entities and prevention of failure – are distinct.

Moreover, the first is entirely feasible, although the latter is not. For resolution, the categories of information required are eminently ‘doable’: information on legal basis, group structure, nature of ring-fencing, categories of debt, content of so-called ‘living wills’, etc. All this can be easily compiled and updated on (say) an annual basis, or even on a quarterly basis. Such information is what is required by the authorities in order to facilitate their tasks of seizing a troubled firm, breaking it into components, reopening its most viable parts literally over a weekend, whilst taking a bit longer to place its other assets in a ‘bridge bank’ (to be wound down over time) and/or selling to market buyers (see UK history mentioned above). Once fulfilled, this quite modest information requirement empowers the relevant actors: in the UK the Treasury, the Financial Policy Committee (FPC) of the Bank of England and the Prudential Regulation Authority (PRU).

Contrast that with the notion – central to calls for increased market transparency in order to prevent failures of firms – that regulators should chase after all trading movements, in all asset categories. That is technically ‘doable’: for example, exchanges are now mandated to obtain and report on all trades – and it does provide a huge fishing ground for regulatory enquiries. But what to do with the resulting mass of data? If regulators are interested in the safety of the financial system as a whole or (more modestly) in the evolving situation in a significant section of it, then the elapsed time required for analysing and discussing the multiple meanings and implications of the huge mass of data would render the exercise way behind the curve of events. In cases when there could be international dimensions – which would seem to be often – then submitting the (eminently contestable) headlines to debate within international colleges of regulators would only add further perplexity and delay. The demand for transparency of trading is, clearly, without merit from the point of view of prudential regulation.

Furthermore, surveillance of trading data is a distraction from what can be done. Prudential regulators should focus their information requirement upon resolution. That said, conduct-of-business regulators will and should continue to collect certain categories of information in order to protect retail customers (and to a lesser extent professional and wholesale traders). This involves monitoring what new sorts of financial products are coming into the market and what sort of buyers and sellers are involved. Financial regulators already have such powers and nothing new in principle is required here. This does not require detailed ‘live’ data from trading desks.
To summarise, prudential regulators need to hold good quality information on firms’ legal and administrative structures and on the various separation and break-up possibilities. The rationale behind that information requirement is not to protect firms and investors in them from folly, but rather to prepare for their failure and to contain the systemic ripples. This vision is already within policy: it should be sharpened. To protect the public interest in systemic stability and proper use of public funds, legal transparency is required. Trading transparency is not.

Resolution, distribution and democracy

On distributional issues, the UK resolution regime has been lauded by some for the way it protects certain classes of property (which must mean that other claims suffer accordingly). As Brierley puts it, in the event that the UK authorities might use their SRR powers in a way that interferes with a bank shareholder’s, counterparty’s or creditor’s rights by depriving them of their contractual or property rights, then ‘the shareholder, counterparty or creditor has a valid claim to proportionate compensation under the Human Rights Act 1998 (enshrining the ECHR in UK law)’ (Brierley 2009: 11–12). Under the UK SRR, such a claim is against the state, whereas in the US aggrieved parties have a claim against the insolvent bank, which could obviously ‘limit the compensation which may be available’ (ibid). That would imply that, whatever fine words are spoken in Europe about taking steps to limit public subsidy, when push comes to shove the resolution authorities could take a cautious line in relation to bondholders. That prospect passes up the potential for holding responsible senior bondholders as well as other investors, instead of these risk-takers being bailed out at public expense. In such a process, creditors’ haircuts may amount to a light trim or a crew cut, depending on the balance and distribution of assets and liabilities – also depending on the exact manner in which parties’ rights are specified in legislation, on the ‘judgment’ of the authorities and on possible knock-on consequences for other parts of the financial system.

From 2010 onwards debate within EU policy-making circles highlighted this issue, albeit with considerable ambivalence. The bailing in of senior bondholders was sometimes held to be justified on the basis that, in a market system, it should be market participants rather than state treasuries that price in and carry the risks undertaken by market participants. On the other hand, in a system characterised by high connectedness, denying public bail-outs and allowing bondholders to suffer appreciable losses could cause withdrawal of market support, not only letting go the banks directly concerned but also possibly others that seem broadly similar and/or are counterparties, pushing them also towards distress (see Chapters 2–4).
It is here that the link needs to be made with democratic direction of policies (plural). Whilst it is essential for regulators, including those responsible for resolution planning and implementation, to cooperate across the EU and internationally, it should remain for each particular demos to debate and define how – in broad principle – it wants to allocate the risks posed by the banks having headquarters or subsidiaries in its jurisdiction. If in a particular jurisdiction, after clear-eyed public debate, a decision is made through the democratic process that principles of creditor bail-in should not be applied rigorously – and that the public purse should in principle still remain open – then it would be hard to quarrel with that decision. Equally acceptable should be when a demos opts for a harder line on bondholders; which might then lead that jurisdiction to offset inter-bank bond-contagion risks, for example by reshaping its banking system so as to have lower connectedness and long term investment.

The standard resolution process (see above) envisages expert judgment-making about such decisions and in the heat of the moment; yet overt political guidelines could justifiably feed into the designing of specific resolution schemes. That would imply, in practical terms, that legislative consultation processes – both at EU and at national levels – should be posed not only as a massively technical exercise, and one which is orientated at specialists and immediate and well organised stakeholders. Such exercises should also have a more accessible level, posing distributional questions, ‘winner and loser’ options and the potential implications in relation to the shaping of the industry in particular jurisdictions (broadly, ‘What sort of banks do we want here?’). This is an issue in which subsidiarity needs to be articulated not so much in terms of detailed technique but rather in terms of moving towards rectification of the historically-produced and crisis-entrenched democratic deficit vis-à-vis financial market regulation.

Resolution, the technical debate and democracy: a political menu?

Within the EU, bail-outs to banking are intimately connected to bail-outs to sovereigns, since these private and public actors are invested in each other. Thus, bailing out a country has sometimes become necessary largely because it has chosen to bail out ‘its’ banks or has been pushed by powerful external actors to do so (in the case of Ireland, for example; see Chapters 2 and 4). Alternatively, giving support to banks can be a way of lending support to countries, if thereby banks are enabled to go on holding sovereign bonds (the case in many Eurozone countries and one of the considerations behind the ESM, introduced in Chapter 4). Either way, banks and sovereigns are linked, this being part of the intractable problem of connectedness and contagion and bail-out discussed throughout this book.
From 2013 onwards there has been much discussion of how better to handle this linkage (International Monetary Fund 2013; Buchheit and others 2013; Salmon 2014; Wigglesworth 2014). The purpose of referring to that discussion here is not to seek to evaluate the pros and cons of the proposals in technical terms but rather to profile what the participants generally agree to be a variety of approaches and to resituate them on explicitly normative ground, in such a manner as (potentially) to make them assessable to party politics and wider debate. Amongst the policy choice could be the following.

First, arrangements for handing sovereign/banking crises could be left as they have been historically. This implies that, if bail-out by an external actor occurs, this generally takes the form of quite late intervention – by which time market tensions are high and the original holders of the sovereign and/or bank bonds have generally sold them at a loss. Hedge funds, so-called vulture funds, may be the purchasers, balancing the chances of further declines against the possibility that they may be paid the full bond value, if a public bail-out is organised by the IMF or a regional fund (in future in the Eurozone, the ESM). In such cases, the public actor gives profit to the speculator – which is satisfactory for the latter but not for anyone else (International Monetary Fund 2013; Buchheit and others 2013; Salmon 2014; Wigglesworth 2014). We can summarise this as the Speculator-Friendly Bailout Option (see Chapter 2 for some history). Part of the political fall-out is that citizens in one Eurozone country may find themselves paying not only to bail out another Eurozone country but also to pay vulture funds; understandably, this very much undermines solidarity.

Secondly, in order to mitigate the above problems, legislation may be introduced to the effect that a majority (‘supermajority’) of bondholders, when voting on whether to accept an offer of partial reimbursement, can legally tie the hands of all bondholders. The result of this is either that all bondholders participate in some loss of value, or they all sit tight and see what happens next. Greece introduced such new legislation, having effects retroactively, which imposes some losses and decreases its indebtedness to slightly more manageable levels (Chapter 4). Since then it has become quite routine to make such arrangements prospectively, by inserting so-called ‘collective action clauses’ into new bonds offered for sale. The advantaged is that the majority of bondholders and the bond issuers are not held hostage to small groups of speculators (‘hold-outs’) who are seeking to extract the maximum advantage for themselves. An adjunct to this approach could be the introduction of legislation giving all relevant actors immunity against claims by vultures (see Buchheit and others 2013: mention of Belgian legislation of 1999 and 2004). This then is the Supermajority Collective Action Option. The general advantage is that less public funding goes to pay private speculators; however, the bail-out and restructuring process may still be somewhat chaotic.
Thirdly, to address those problems, it has been proposed that a body such as the IMF or the ESM could introduce rules having the effect of temporally shifting the setting of conditionality from the bail-out phase per se, to a prior phase in which participating countries would agree rules (for example, for Eurozone member states and any other EU Member States participating in the ESM, the rules might be incorporated into the relevant treaty) (Kingdom of Belgium and others 2012) or in criteria adopted by its fund. Those rules would include imposition of losses on private holders of bonds, if and when assistance is requested by the country and is agreed by the IMF/ESM. However, there has been criticism of this approach on the basis that it could accelerate crises. As soon the market sees moderate weakness in a country (or in ‘its’ banks) there could be a general stampede for the exit (funds would have no reason to buy), thus turning a potential crisis and need for support into certainties.

At the time of writing the jury was still out on this question (Salmon 2014; Wigglesworth 2014). Nevertheless, an advantage of the approach would be to make imposition of losses on all bondholders more certain and the process more routinised and robust, by inscribing it not only in bond contracts and national legislation but also in rules backed by international treaty and associated mechanism(s). There might therefore be a trade-off here between earlier and more frequent bail-outs on the one hand, versus robust process and a better balance of private-public burden-sharing on the other hand. It has been suggested (ibid; Buchheit and others 2013) that the approach may have more promise within the Eurozone than elsewhere, given the common sense of crisis and willingness to respond collectively through recently created mechanisms, notably the ESM. This could be referred to as the Earlier Burden Sharing Model.

From the perspective of this book, the opening up of wider debate and the recognition of a diversity of options for restructurings/bail-outs is to be welcomed, in terms of democratic choice and the possibility that, in the short to medium term, each of the above models (and possibly others) could be invoked by different countries. That would create a global patchwork, which could be more systemically robust than global uniformity (since any single model is likely to prove dangerous if universalised as global financial monoculture).

One can only begin here to explore how the different models might correspond to political preferences. For example, the Speculator-Friendly Bailout Option is equally opposed by right and left (for example, Tea Party types in the US and leftists in Europe). The Supermajority Collective Action Option has already been widely adopted. Its attraction is clear for those who seek justice between classes of investors (to polarise the issue: sleepy domestic pension funds versus foreign vultures). Going forward, it represents a compromise for those who would be concerned that the next-mentioned approach might bring forward crises. Thus, it could be regarded as a politically
centrist choice. The Earlier Burden Sharing Model is for those who perceive that talk of ‘sovereign’ states and bond markets is a bit nostalgic and that states may have to get used to having a credit rating and financial security inferior to some companies. From such a perspective, more and earlier restructurings of states and of their banks is a fact of life; the question is how to do that with less drama (as well as with greater fairness) is key. This could be a pragmatic neoliberal choice.

Perhaps it will not be easy to put these questions to wide and inclusive public debate. However, the difficulty might be the result of a mix of unfamiliarity and some policy-makers’ wish to have them settled at a technical level, saving us all from political responsibility for whatever happens next.

Conclusion

Former UK Prime Minster Anthony Eden, when asked what made his job difficult, famously replied ‘events, dear boy, events’. Indeed, this would be a fair shorthand for the difficulties facing resolution planning which, far from settling down to a quiet ‘post-crisis’ phase, is being reconstituted as a form of permanent governance. Just as happened in international security in the early 2000s, and in environmental governance before that, precautionary modes of thought abound, sometimes with unexpected consequences. Measures that were formally unthinkable, or that were thought of as being exceptional, have become the norm. All such ‘new normals’ raise not only questions about effectiveness of action but also about distributional justice and in relation to the democratic process.

Resolution cannot be seen as a politically neutral site, to which technocratic harmonisation can migrate after its failures in prudential regulation. On the contrary, resolution, as the new policy frontier and financial market game plan, has become central to debates and actions redefining financial markets. Previously a back-seat driver of policies (Chapter 2), resolution has become the front-seat driver, as what is decided in relation to this flows through into prudential regulation and public policies generally. This means that resolution rightly becomes a site of legal and political contestation. Through resolution regimes, the authorities attain intervention rights and capabilities to wind down firms in ways that allocate costs and that may minimise wider disruption (the latter remained unproven at the time of writing). It is upon this new, contentious, highly experimental and leading edge of policy that the both public information requirement and the political spotlight should focus.
Chapter 6

Democracy as driver of global diversity

Preceding chapters have traced the historical evolution of private regulation with a public face, policies of public bail-out of private risk taking, and EU channels through which UK and US traditions entered European financial market regulation. With crisis manifesting itself in the 2000s, first in the US-UK nexus and then across the Eurozone, private bargaining of rule-making gave way to heroic, publicly visible and thus disputable crisis management, causing regulatory knowledge and authority to be problematised. As a result of contradictory pressures in the aftermath of 2007–08, financial regulation became marked by a new plasticity. Regulatory mobilisation for purposes of crisis management took the somewhat contradictory form of an assertion of necessity for further global convergence of regulatory rules and procedures – alongside a reality of practical action that was of necessity largely nationally based.

This contradiction reached its apotheosis in 2013 in the EU, with political agreement on a European resolution mechanism, board, fund and decision-making procedures that are ‘so complex that in practice it will work quite differently from what one would imagine by looking at the formal rules. In an emergency the people with the necessary information will decide and all the others who are formally involved will probably just have to agree’ (Gros 2013a: 1; and see Chapter 4). However, what basis is there for agreement? Regulators have explicitly moved from failed industry ‘models’ to their own ‘judgment’, so implicitly admitted the contestability of the issues. These contradictions and admissions, alongside public disquiet over the broader political handing of the crisis, which in Europe at least focused on austerity measures, invite public scrutiny and debate.

One of the immediate responses to the emergence of the crisis was an extension of public support to private risk-takers, on a very wide scale (see Chapters 2–4). The bank bail-outs (or rather the bail-outs of holders of bank bonds) turned out to be extensive and expensive, placing considerable burdens on stressed sovereigns, provoking unpalatable contrasts with public austerity (at least in Europe) and feeding into a rising tide of political reaction and rejection of political elites. In this atmosphere, and in a spirit of ‘never again’,
policy-makers and regulators adopted the in-principle position that risk should be shifted back onto the markets. Firms taking on excessive risk or simply hit by bad luck should in principle be allowed to fail, with losses being borne by investors, not only holders of equity but also bonds. The prior pattern of public bail-out came to be seen as encouraging moral hazard and, in internationally connected markets in which systemic events occur, promised unbearable public expense.

However, concerns about connectedness and contagion between investors, cross-border firms and sovereigns meant that the in-principle commitment to allow firms to fail has been accompanied by an in-practice fudge. As financial journalist Martin Wolf (2014: 9) observes:

Yes, regulation and oversight have improved. But, in essence, today’s financial system is the same as before. Worse, it is yet more dominated by a small number of thinly capitalised, complex, global behemoths. The notion that such institutions could be ‘resolved’ in a panic without triggering panic remains untested and, partly for this reason, government promises not to bail them out are not credible.

Why should this be so? The thesis of this book is that the limitations of financial market regulation have something to do with an inability to construct radically new knowledge about and framings of financial markets. Moreover, whilst the new wisdoms of prudential regulation and judgment seem conceptual advances, from the perspective of the crisis, the new knowledge may also be paralysing – it so sensitises regulators and policy-makers to uncertainties that they will do anything to avoid potential systemic tipping points.

Within such a conceptual field, however strong ‘no bail-out’ policy may be in principle, it is applicable in practice only when regulators can be confident that all of the following conditions obtain. The infrastructure, entity or product line in question is not ‘too big’ to be allowed to fail (danger of taking too much of the ‘piping’ and capacity of the system with it). It is not ‘too connected’ in terms of its counterparties and investors (danger of knock-on contagion by asset sales). It is not ‘too similar’ in its business model (danger of ‘writing being on the wall’, as it was in the US in 2008 for Lehman Brothers after Bear Stearns). And it is not ‘too important’ in a symbolic sense (danger of a general loss of confidence).

Rarely could all those conditions be met (at least not in advance). Thus, heavily indebted banks in (let us say) Greece or Spain could not be allowed to fail, because they might bring down other banks, not only in those countries but in other countries too. Thus, whilst there was wide political support for an end to public subsidy – an agenda that market liberals, centrists and social democrats could agree upon – many were receptive to the ‘yes but not yet’ advice emanating from central banks. This entailed the continuation of public socialisation of private losses.
Legacies hard to overcome

The core problem is that the new regulatory sensitivity to systemic risk means that virtually all aspects of financial markets (and the various social and technical environments in which they swim) can be seen as channels through which contagion may be transmitted. Arguing for a more discriminating approach to what may pose a systemic risk and what may not, one of the architects of the Dodd-Frank Act in the US has suggested that casting the net too wide ‘would make everyone in America a systemic risk; I was really disappointed in that one’ (ex-Congressman Barney Frank, cited in Morris 2013). This reductio ad absurdum does serve a useful purpose. Whatever the pros and cons of viewing particular firms and aspects of the infrastructure as being systemic, regarding virtually all aspects of financial markets as systemic does spread regulatory resources rather thinly and it could also widen the potential for future bail-outs.

This then is the contradictory background to regulatory hyper-activism, which is simultaneously a form of sitting on one’s hands. Resolution powers and planning are political necessities, yet actually deploying them seriously (against firms that are big, similar, connected, etc) would involve an act of faith. Pre-modelling the consequences is attractive only for those who retain a touching faith in models, which fewer regulators have after the crisis than had before it. Putting a sensitivity to connectedness alongside the practicalities of cross-border coordination issues, and the political pressures in some countries and regions – ‘there are often close ties between the holders of the bank’s equity and debt and the national political class’ (Gros 2013b: 1) – it is clear that robust resolution action remains epistemically headachy and politically tricky.

Hence the slippery slope on which prudential regulation finds itself, as exemplified in the terminology of macro-prudential regulation. This starts as an attempt to support stability through a macro-understanding of the whole market system, in all its complexity, its connectedness and contexts. This project has a tendency to widen, to require an understanding not only of all ‘systemically significant’ aspects of the market, including exchanges, conduits and large firms but also of how these interact, or might interact in as yet unknown circumstances. That in turn implies surveillance not only of structures and transactions of many market participants but also information on counterparty exposures and cross-ownerships (potential future transactions), modelling of all parties’ risk-asperities and sensitivities to bad news (contagion modelling) and even modelling of the likely actions of regulators themselves (since these will feed into events).

This implies a considerable widening of the information net. In order to maximise the scope and contemporaneity of market information available to regulators, the latter seek to channel trading through specified conduits, for example exchanges, which then supply information on the trades to data...
warehouses (European Union 2012; European Commission 2013a; ESMA 2013; William Fry 2013; broadly similar provisions resulting from the US Dodd-Frank Act). This approach to surveillance is indeed a change from the neoliberal rapture and trust in markets that characterised pre-crisis regulation (see Chapters 1 and 2). It is a mammoth information project, which might be seen to fit with one of the wider phenomena of the times – ‘big data’, as exemplified by national security information trawling and by private entities such as Google, Amazon and Facebook. These initiatives may provide regulators with a welcome sense of empowerment, however it remains to be seen if they will be able to make sufficient sense of aggregate trends to identify and agree on precautionary action (cf Chapter 5).

There are also two problems here regarding democratic control. The first problem is that global initiatives by the G20 and the EU, whilst they may not result in completely harmonised requirements – because of stakeholder bargaining at regional and national levels – do result in broadly similar rules. In the perspective of this book and of some other observers (Riles 2013b; Warwick Commission 2009), such convergence exacerbates the potential for contagion and hence for global instability, for example by encouraging similar business models. That is an issue concerning outcomes.

A second and related issue concerns political process, as citizens are further distanced from policy-making. Pre-crisis regulation excluded citizens through an implicit assumption that financial markets, and possibly other parts of the economy, stood outside the arena of political debate (Chapter 1), making their regulation a ‘technical’ matter (Chapters 2–4). That assumption was part and parcel of a historically slow and politically imperceptible drift of agenda making ‘upwards’, from local to international fora. In such circumstances, the political room for manoeuvre becomes as restricted as the legal margin of appreciation, the broad direction having being set. The consultation exercises then taking place at regional and/or national level are highly constrained.

Following the onset of crisis, the new macro-prudential regulation has become an explicitly top-down project. Again, citizens are outside the process, this time for reasons of urgency as well as technicality and supposed efficiency. Thus political control – in the sense of wide debate, opportunities for contestation of the principles at stake and the possibility of citizens taking positions through democratic processes – is as much sidelined after the crisis as it was before.

Limits of subsidiarisation: less connected but still too similar

As well as having identified their primary objective (saving the system) and having begun to constitute a form of knowledge for that task (macro-prudential), regulators had to address the question of levels of responses – international, regional and national.
In the immediate crisis management period, practicalities forced a pattern of response that was quite at odds with standing beliefs and preferences within international regulatory networks, which held ‘that the allocation of regulatory responsibilities to the different layers of governance should be based on the (geographic) scope of the underlying financial activities and the importance of the regulatory objectives by reference to the common core values’ (Weber 2010: 704).

That conventional view appeared to make sense up until the crisis: follow the market. The regulatory agenda was bargained in and around fora, networks and lobbies at national, regional and international levels. As Chapter 1 mentions, the ideational circuit sometimes may run from a national platform, such as London or New York, up to international fora in which the same or closely related regulatory staff are involved, then as appropriate down to regional level, for example the European Commission, and so to national ministers and parliaments. With the broad agenda having been agreed at international level, subsequent lobbying and debate at regional and national level was confined to fine-tuning, detail, phasing-in periods, exceptions for special interests, etc.

However, when the crisis struck, the conventional view – that issues of subsidiarity should be settled by looking at the structures of markets (or, as one might rephrase it, by attending to market power and lobbying capacities) – became contradicted by the practicalities of preparing banks for possible resolution. It is at national level that the legal powers, capacities and (importantly) cash were located.

This brought to the fore strategies such as subsidiarisation: the identification of banks and their assets and liabilities in chunks corresponding to jurisdictional boundaries, regulatory competencies and state treasuries. Where entities and assets do not correspond with jurisdictions, the former should be restructured so that they fit better. Subsidiarisation allows banks, which are ‘international in life but national in death’, to be more easily managed in the event that they get into trouble. Such planning allows for possibly endangered or even failed entities to be split into parts, such that some parts may be allowed to fail, some parts being sold in the market and other parts bailed out; or the whole might be allowed to fail, the costs falling on private stakeholders (Chapters 2–5).

At first glance, subsidiarisation appears to be a reassuring sign, not only in terms of economic justice but also in terms of the political design of regulation. Subsidiarisation appears to tilt an important part of the regulator agenda away from global centralisation. Moreover, the awakening of the authorities to the political sensitivity of continuing to deploy public funds – not only in relation to one or two failing entities but in relation to the whole sector – strengthens local accountability. The upsurge in interest in policy and political circles has an impact on regulatory agencies’ occupational cultures: regulators can no longer get away with taking each other and the market as
their primary reference groups. They also have, at the very least, to show political accountability (Parliamentary Commission 2013).

However, judged from an international stability perspective, subsidiarisation has several significant limitations. It is fully compatible with and can co-exist with rule convergence. It does nothing to address similarity of business models. Equally, current approaches to subsidiarisation allow cross-holdings of assets between apparently ‘fenced’ entities, so they do not tackle the possibility of inter-bank contagion through debt (see Chapters 2–4). Moral hazard and public subsidy may be reduced but are not eliminated.

In summary, subsidiarisation in no way precludes waves of parallel failures. In order to locate the structural conditions within which contagion, bail-outs and economic injustice are amplified, we have to look elsewhere.

From technical knowledge to political preferences

As financial market regulators intellectually reconstructed themselves in response to the crisis, ecological perspectives have come to the fore (Haldane and May 2011). Indeed, thinking about the conditions for financial contagion, by drawing ecological analogies – for example between mono-culture in modern agriculture and ‘too similar’ financial market business models – does help to identify the presenting problem. More specifically, biological and disease-transmission motifs may, at first sight, seem at least to grasp some aspects of mechanisms of financial contagion. Such ways of thinking have the merit of being easily understood in outline. It also goes some way towards addressing a key weakness in pre-crisis theorising about markets and regulation, which had focused on soundness of individual firms, whilst looking insufficiently at market interconnections, hence failing to see the wood for the trees.

However, the recourse to ecological models and disease connotations have been sharply criticised in the specialist literature for their allegedly ‘deterritorialising’ effects on our conceptions of potential responses. It is said that ‘contagion reframes financial instability as a form of pathogenicity, thereby re-inscribing socio-cultural and economic relationships as biology’ (Peckham 2013: 242, drawing on King 2002). Thus, ‘epidemiological models in financial theory obscure more than they illuminate, while setting up fears and expectations that are increasingly constraining the parameters of public debate’ (ibid: 243). Be that as it may – it appears to the present author that agricultural/mono-cropping analogies may not have the alleged pathologising effects of epidemiological models – ecological analogies would seem to be easier to communicate than more traditional ‘economic’ models, partly because of a sense of familiarity (we all catch colds) and the affective dimension (fear-appeal). Thus, the new languages being deployed may, pace Peckham, at least have the merit of enfranchising much wider social groups in debates on financial markets and regulation.
Moreover regulators, in opening themselves up to wider perspectives on their tasks, have (to varying extents) broken with their previously monodisciplinary discourse, which was so exclusionary of other social groups. What has been produced since 2008, whilst still containing economic reference points and tending to invoke ‘metrics’ (thus qualifying as evidence-based), is a much wider discourse than pre-crisis. Optimistically it may be regarded as proto-multidisciplinary, in contrast to pre-crisis mono-disciplinarity. Whist there may be attempts to found a new and exclusive ‘grand narrative’ on the financial market regulation, so far none has become hegemonic. In short, concerning financial market regulation, it would be more accurate to refer to knowledges plural, than to knowledge singular.

It is necessary to unpick the potential implications of this with some care. An observation about lack of a strong and seemingly scientific paradigm could very easily slip towards a seemingly common sense normative proposition: that only if a unitary, coherent, authoritative expert knowledge field could be constituted, then a basis for better policy-making would be obtained. That indeed has been the one response, as typified for example in the answer of eminent economists when questioned by Her Majesty Queen Elizabeth: why did no one warn us of the incubation of the financial crisis? The eminent persons, having failed to spot the brewing of the crisis, opined that what is needed for the future is more of their expertise, only better networked in disciplinary and international terms (British Academy 2009: 3). However, that proposition does not follow: it reifies expert knowledge and elevates it to a status that can never be justified. It rests on an implicit and illegitimate prior assumption: that a single, unified, integrated and pan-expert form of knowledge about financial markets and their regulation is not only possible but also desirable and that it could be applied globally without unanticipated consequences. If this book conceptualises a perfect enemy, it is that proposition: that the experts should multiply and network more strongly and then there would be a beautiful synergetic moment when they would collectively come up with ‘the answer’ (see also CRESC 2009).

Fortunately, such a cosmopolitan-technocratic project faces difficulties. ‘Fortunately’ because of the continuing danger that it entails. Financial market phenomena and cultures became and remain ‘too similar’ and ‘too connected’ regionally and globally, so creating the condition for contagion both with the private sphere and between private and public. And yet, as a supposed antidote to this continuing condition, we are offered the prospect of construction of regulatory knowledge, structures and rule books with bizarrely parallel features: knowledge that aspires to be better connected, more integrated and with greater global reach, so supporting a global solution. However, that would be to confound the problem. A more tightly integrated global regulatory system can only lead to more closely connected markets, transmission mechanisms, herding, global players that are TCTF. There is an alternative.
Terms of debate

In is important to distinguish between two critiques of regulation before the crisis. The first critique, which quickly emerged as the new conventional view, being shared by and indeed advocated by regulators (see inter alia Bernanke 2008a; Turner 2011; and Chapter 3) portrays financial market regulation as having been a public institution but having become light touch, owing to cognitive capture and neoliberal assumptions. A second critique characterises regulation as never having been public but rather being private regulation behind a public facade or mask (Chapter 1).

The difference here is by no means trivial or merely semantic. If one says that financial market regulation is public governance that unfortunately has decayed and malfunctioned, then it is a short step to saying that its essential character – its positioning in national and international political orders – is fine. All that is needed is that it be tightened up and strengthened, made more activist, more strongly institutionalised and protected from pernicious influence. Such influence has conventionally been attributed to the cognitive capture that results from regulators and regulatees forming overlapping epistemic communities or, more crudely, to revolving doors (Miller and Dinan 2009). However, thinking and speaking in terms of revolving doors and cognitive capture would need to be informed by a view of whether these are recent phenomena or historically embedded ones. If the latter, then simply strengthening the technical capacities of regulators, by bringing in more expertise, might make those doors revolve all the more. Moreover, speaking of capture only makes sense if there was ever a previous condition of non-capture – which there may have been in the US (a question beyond the scope of this book) but was not in London, the EU’s main platform for international financial markets and portal through which regulatory knowledge and crisis propagated (Chapters 1–4).

In short, a narrative of public-regulation-gone-astray gives us only half the story. The other half of the story, and a less encumbered way forward, can be arrived at by transposing the observation about the lightweight nature of financial market regulation into the frame of reference of it being essentially private, having been historically generated as private and then adorned with public dress. Saying that would imply going beyond saying, as Pagliari (2013: 388) does, that both before and after the crisis ‘the objective [of European and other regulators] of achieving greater regulatory autonomy combined with, and often provided a mask for, vested economic interests’. We can fine-tune Pagliari’s statement by observing that political autonomy was the founding condition of UK financial market regulation, which was then geopolitically generalised by an upward shift of locus internationally and within the EU (where it eventually met certain political points of resistance; see Chapter 4). A historically as well as politically informed perspective opens up radical policy options, including either that the public mask could be taken...
away – so allowing private regulation to operate openly, governed by international commercial law (see Johnson 2013) – or that for the first time financial market regulation could be reconstructed as a public function.

The argument here is that both of the above critiques are applicable to financial market regulation, it being desirable to put emphasis on the second, going forward. Yes, financial market regulation has been based on neoliberal principles and has been something of a front for ‘vested economic interests’ (Pagliari 2013). On that basis, a flurry of regulatory activism is an understandable response, tightening pre-crisis rules and inventing new ones wherever gaps can be seen – even if the inventiveness of finance means that new market spaces will soon be constructed. However, by itself ‘more regulation’ is not a sufficient response and it poses two dangers. It is not sufficient for a number of reasons. Throughout the post-Second World War period, regulation has increased in quantity rather than decreased across all sectors (this being a truism with regulation studies) yet such increase alone very clearly led to the financial crisis. From the pro-democracy perspective of the present book but also from some other perspectives, ‘more’ may not mean better; for example Siems and Schnyder (2014: 15) argue that, from an ordoliberal perspective, one should not ‘look at regulatory regimes in quantitative terms’. As for dangers, ‘more regulation’ is generally reactive, behind the curve and regulatory and political fatigue must at some stage set in. Then, having lost a few regulatory battles, the industry would end up winning the war. Secondly, insofar as financial market regulation remains politically detached and professionally technocratic, it slips into global convergence, so remaining functionally an accomplice to forms of finance that tend towards similarity, connection and contagion.

This suggests a meta-principle against which progress should be measured: do arrangements articulate a single, technocratic structure or a citizen-chosen diversity? To dispose of facile objections at this point, the political process in the latter case would not be Athenian involvement of all citizens in drafting the minutiae of rules. Rather, the public debate would engage with questions of principle about the broad purposes of finance and about arrangements for dealing with risk, so dislodging regulators from their autonomy and directing their activities. This agenda goes far beyond accountability, which satisfies itself with post-hoc regulatory justification-giving (Dorn 2014). Political governance on financial markets would be as taken for granted as on social and moral issues. Some indications as to how this would work will be outlined below.

**Constitutionalising regulation: locally embedded or politically ‘offshore’?**

It is difficult to imagine future policy choices for financial market regulation except with explicit or implicit reference to the past – thus, in terms of continuity with, reform of or reversals of what went before. The recent past
is crowded with material on which to draw, which, in order of historical derivation, can be summarised as club regulation, crisis management, cultures of collaboration and, finally, more fundamental approaches to the reconstitution of financial market regulation.

The reader will recall the Anglophone (and particularly City of London) gift to the world: ‘club’ regulation as private regulation which was eventually dressed up in public clothing and then exported (Chapter 1). Club regulation became a target for stinging criticism, as being a neoliberal phenomenon, the claims of competency of which have been empirically falsified. On those grounds, one might assume that the club is gone forever, yet others speak of it reforming and widening itself (Helleiner and Pagliari 2011: 176). Thus, it continues to offer a reference point for some ensconced club members, who seek to maintain a leadership role as the club widens:

First, without a re-energized commitment from the European Union and the United States to focus the group of 20 (G20) agenda on international regulatory reform, the future of coherent global financial regulation is unclear [...] the United States and European Union must act expeditiously and collaboratively if they are to continue as leaders of financial reform on the global stage.

(Bowles and others 2013: 1)

Such declarations may evoke as much bemused headshaking as acclaim. Points of view on club regulation are varied, so one option could be to take it as the point of conceptual departure – so providing a discursive space in terms of club-maintenance (Bowles and others 2013), club-revitalisation or club-widening (Helleiner and Pagliari 2011).

However, the EU-US relations have never been entirely simple and may be getting more complicated. On the one hand, the commitment of US regulators to the pre-crisis agenda of a global, integrated financial services market continues. Observation of lobbying, think tanks and parliamentary meetings in Brussels suggest that the transatlantic regulatory dialogue continues to be constructed as an echo of the freely-expressed interests of large financial firms (see also Majone 2013: 390 on the preferences of leaders of various industries). US regulators take care to assure their European opposite numbers that they understand the constraints on the latter – including volatile public opinion in EU Member States, the role of the European Parliament (very heavily lobbied but still unpredictable), and public scepticism about financial markets, which austerity has done nothing to dampen. US officials maintain pressure on their EU counterparts to ‘preserve the global, dynamic nature of the market’ (on-the-record remarks of Brian Bussey, SEC, speaking at the meeting on ‘Regulating cross-border derivatives activity and navigating the transatlantic relationship’, Centre for European Policy Studies, Brussels, 7 May, from
author’s contemporaneous notes). In these terms the club is cherished by both its principal members.

On the other hand, we may be seeing club-dépassement, as the club comes under stress not only from external critiques (from outside the Atlantic axis, from a range of disciplines and also politically) but also from an unexpected direction: the US Government. In 2013 and early 2014, the EU and US were engaged in difficult negotiations over a proposed EU-US Transatlantic Trade and Investment Partnership (TTIP). Focusing here on the aspect of financial market regulation (European Commission 2014; Oliver and Donnan 2014), many US sources expressed ambivalence over the inclusion of such regulation within the TTIP, preferring to keep it in informal channels. The European Commission, by contrast, was very keen and pressed the US for such inclusion (European Commission 2014). The Commission argued that inclusion would create an institutional framework within which EU and US regulators would work together to ensure that rules are broadly the same. Also processes of consultation with the industry could be jointly managed, avoiding infliction of ‘significant uncertainty on the market’ (European Commission 2014: 2).

Interestingly, in the particular case of financial market regulation and the TTIP, the US Government had several grounds for reservation. A briefing report for Congress put matters in terms of the US not wishing to be too closely tied to the EU: ‘U.S. Administration officials reportedly have expressed reluctance to include financial regulation in the TTIP, in part, because of concern that it may interfere with ongoing discussions in multilateral forums, such as the G-20 and the Financial Stability Board’ (Akhtar and Jones 2013: 7–8). Moreover, coverage in the financial press suggested that the European Commission’s 2014 proposal raised the concern in Washington that: ‘Wall Street would seek to use regulatory convergence with Europe as a way of circumventing restrictions of the 2010 Dodd-Frank law’ (Oliver and Donnan 2014: 2). Similarly, a US lawyer who worked on the US legislation and witnessed firms’ attempts to influence it opined that inclusion of such regulation in the TTIP ‘would likely weaken, not strengthen, the forces of reform’ (Barr 2013).

From those novel but still mainstream perspectives, as well as from more critical points of view (Desai 2013), the club may no longer constitute a stable conceptual object and set of practices.

One alternative conceptual starting point to the club – or at least what might appear to be an alternative – might be provided by the image of financial market regulation as a permanent crisis management facility. Regulators, having to face up to the fact that their whole worldview (not just a few technical models) was incorrect, had to take action in the absence of a knowledge base. This was the case in 2008 (see Chapter 3) and again in the Eurozone from 2009 onwards (Chapter 4). Projected into the future, crisis management would represent a break with club regulation, insofar as the former entails learning by doing new things, rather than relying on or
marginally fine-tuning tried and tested formulae. However, crisis management would represent strong continuity with club regulation insofar as it entails the continuation and indeed a tightening of technocratic rule by experts (Engelen and others 2011). Crisis management adopts a tone and sense of urgency, allowing post-hoc justifications of actions taken (‘accountability’, Dorn 2014) but excluding democratic steering. For example, the thorny issues around bank resolution, if framed in terms of a deadline for resolution ‘over the weekend’, seem not to be conducive to public deliberation or wide participation in future decision-making – any more than were the central bank-facilitated decisions that led (for example in Ireland) to loading private creditors’ obligations onto public budgets. In this sense, crisis may at first glance seem to delegitimise expertise but it actually provides a field within which its autonomy may be regained and indeed heightened.

A third conceptual starting point for the future of financial market regulation would be the new forms of cooperation between regulators and market participants, and between regulators, within which ‘big data’ now plays a key and saviour-like role. Regulators have worked hard to develop a prudential theory and practice of crisis prevention. They have sought to replace their previous, outsourced and now delegitimised information assumptions, models and sources – including ratings agencies and backward-looking models of market dynamics – with new, contemporaneous, wider-reaching and empirically more detailed information sources and warning signals. It is assumed that real-time data (or near real-time), gathered through gateways such as market exchanges through which greater numbers of market participants are obliged to trade, scooped up into data repositories and open to regulatory inspection, will provide the fodder upon which regulatory judgment can feed (for various perspectives, see special issue of Journal for Banking Regulation 2013; for sceptical views, Riles 2011; and Chapter 5). Optimistically, such an approach to the rebuilding of a regulatory knowledge and competence might be seen as underpinning preparedness and capabilities for crisis prevention (intervention in the nick of time) and for crisis management (understanding the consequences of various resolution scenarios).

For those within regulation, new, wider and bigger datasets, deployed within conceptually less restricted paradigms, could be seen as being part of paradigm change – thus helping to re-establish the damaged epistemic boundary between that community and others. A combination of internal change and external activism might or might not prove politically durable. On the one hand, the re-erection of that boundary and renewed presentation of the associated claims to expertise and autonomy – even if backed up by bigger and better data – might be seen as suspicious by some citizens and politicians. On the other hand, global surveillance through big data has become ubiquitous and familiar to citizens, through the use of store cards, credit cards, online social networking, internet searches, etc. Citizens actively
enrol and collaborate in such programmes of surveillance and self-disclosure (Riles 2011: 562–63). What is normal for citizens in relation to themselves may therefore seem to them also to be normal in relation to financial market regulation: public comprehension of the basis of the new mode of regulatory knowledge-building may help to legitimise it.

A fourth way of reconceptualising financial market regulation could be constitutionalisation, which however can be a double edged sword. Going in the direction of democratisation are actions of the European Parliament in limiting the spread of ‘technical’ rule-making, as mentioned above. Going in the opposite direction is the creation of the new Eurozone mechanisms. The conferral of new powers on central banks, such as the ECB being made responsible for financial stability in the Eurozone, clearly goes in the direction of putting further distance between financial market regulation and citizens. However, the ECB stays within the EU legal order, being amenable by challenge before the ECJ and (to a limited extent) accountable to the European Parliament. The ESM, discussed in Chapter 4, goes much further. Its governance structure as an international organisation means that it has immunity from every form of judicial process (Kingdom of Belgium and others 2012: Article 27). The pre-emption of democratic scrutiny and legal challenge is an elite response to both democratic and legal challenges, notably before the ECJ and the German Constitutional Court (see German Law Journal 2013: whole issue; also Everson and Joerges 2013).

Clearly the crisis has initiated unprecedented degrees of public scrutiny, regulatory activism, political intervention and legal scrutiny. There have been some activist democratic and legal responses to ‘the realisation that the activity of governing is increasingly being exercised through transnational or international arrangements that are not easily susceptible to the controls of national constitutions’ (Loughlin 2010: 47). However, European political elites have sought to create new mechanisms that, whilst not being entirely beyond political influence, are intended to be beyond legal challenge. On balance, at the time of writing, European elites were definitely ahead, devising new forms of political and legal ‘offshore’, such as the new EU and extra-EU mechanisms and proposals for the TTIP (above), through which they and investors can act relatively unimpeded.

The coming years will show what purchase democracy will attain vis-à-vis financial market regulation. As of early 2014 when this text was written, a pessimistic scenario could easily be envisioned. Not so much a return to market self-regulation but certainly a revival of the latter’s fundamental condition of existence – the splitting off of financial market regulation from the political sphere, within which democratic processes are confined (recalling Chapter 1). The new mechanisms in the EU seem to deepen that historical division. Outcomes will depend on the evolution of the strategies
of economic and political forces, within countries and internationally, and interpretative framing of the issues. There remain good normative and functional arguments for democratic direction of financial market regulation, with which this book closes.

**Ends: taking stock**

Dani Rodrik has written that ‘global standards and regulations are not just impractical; they are undesirable. The democratic legitimacy constraint ensures that global governance will result in the lowest common denominator, a regime of weak and ineffectual rules’ (Rodrik 2013: 204). There is, however, a worse scenario, to which the present book points: the democratic constraint could prove too weak, yielding a strong international regime of common rules which, rather than being ‘ineffective’, exacerbates dangerous convergence and contagion tendencies in financial markets.

This points to an observation about global governance and about some developments within the EU, which is more commonly made within fields such as international relations, European studies, politics and law than within economics. The observation is conventionally phrased in terms of democratic deficits. In relation to financial market regulation, we have suggested that, given the historical and recent record, democratic pre-emption and exception may be better descriptors than democratic deficit. Whether the phenomenon is phrased in terms of deficit, pre-emption or exception, it has consequences that are serious in terms of systemic instability, distributive justice and political responsibility. Ironically, the democratic shortfall may be self-reinforcing, if populist reaction feeds into disillusionment with political institutions. If governance is moving offshore (see above) then such elites may think that such reaction is nullified: a dangerous as well as unpalatable scenario.

This book presents an alternative: politicisation of policy-making on and regulation of financial markets. This is advanced as a means of bringing greater diversity, stability and economic justice to financial markets. Considerations of functional effectiveness and normative justice go hand in hand here.

First, in terms of legitimacy understood in efficiency terms, engaged citizens and political parties offer the best guarantee of unpredictability and diversity in financial market policies and regulation – so local democratic enactment is in accord with global public good. Needless to say, there is a considerable distance between this concept of the international public good and that entertained in pre-crisis years within elite technocratic circles, where the domestic political sphere was seen, at best, as an agenda-taker rather than an agenda-maker. However, the crisis stimulated more serious parliamentary scrutiny, media attention and citizen commentary. This opening up, together with some practical considerations, provoked repatriation of some aspects of financial market regulation (including subsidiarisation, discussed above as a
step in the right direction albeit an inadequate one). The vista of democratic scrutiny, public admonition (‘banker bashing’) and partial repatriation of regulation has been a nightmare for large international market participants. Such groups face something of a double whammy, involving a degree of structural dismembering and also a less ‘flat’, manageable and predictable regulatory environment. However, those outcomes are encouraging from the point of view of reducing over-connectedness, contagion, systemic crisis and public support for private risk taking.

Secondly, democratic processes offer the firmest normative footing for policy-making. If citizens have to eat the fruits of financial markets, then that is a good reason for them to have a strong say in what sorts of seeds are planted in their back yards. What sorts of financial services might suit them culturally and, indeed, morally as well as economically? If that sounds like a silly question, it is for two reasons: the political culture in advanced capitalist countries has bracketed off these issues, as being not political. In parallel with that, global networking amongst technocrats has resulted in these issues becoming detached from the national level at which processes of democratic politics operate.

Recontextualising financial market policies within the democratic sphere may be difficult to achieve. However, the means of doing so are clear.

**Means: revisiting 1918: democratising financial regulation**

Policy-making in the area of financial markets is a notable exception to the rule of democracy, right from the start of the universal franchise (Chapter 1). That exception emerges as the unfolding of stages in a political strategy, rather than as a historical accident. Within the UK, private regulation was the historical norm in relation to trade guilds, the financial markets in the City of London not being exceptions. The separation between trade regulation and sovereign powers survived the birth of democracy. The private banking regulator, the Bank of England, was eventually nominally clothed as a public body, without impact upon its functioning. Following the Second World War, self-regulatory bodies in other aspects of financial services were consolidated and also declared to be public: plus ça change, plus c’est la même chose.

The internationalisation of financial regulation distanced it yet further from democracy – the latter being based in states and having little purchase upon the global networks and bodies to which regulatory policy-making migrated. In relation to EU regulatory bodies, democracy had limited purchase; indeed, democratic deficit became deepened by the new extra-EU, intergovernmental mechanisms. Thus, international and EU regulatory modes and moods have been and remain technocratic, with agenda-setting and bargaining between an elite regulatory circle and representatives of the largest firms (having the necessary political ‘reach’ and capabilities needed to address
high-level fora). The resulting rules are not exactly tablets of stone, because they have to be implemented as regional or national legislation by other actors, at which point some variations may occur. Nevertheless, the agenda and the broad outlines of rules are bargained internationally, the subsequent room for manoeuvre by regional or national actors being somewhat circumscribed. More generally, regulatory thought is internationalised.

What is the implication of this? Financial market regulation cannot be redemocratised, because it was never democratised in the first place. Rather, it continues to be an exception from democratic governance, through a double movement of national exemption and international pre-emption. Those two streams of democratic exemption and pre-emption run deeper than that of democratic deficit. Whilst the latter might be conceptualised as being historically accidental, or as the work of unfinished processes, democratic exemption and exception result from political strategies. In the literature on national regulatory agencies and central banks as expert, politically independent bodies, democratic deficit/exemption/exception is problematised and sometimes legitimised through a discourse on ‘accountability’ – a system whereby regulators explain their decision-making, post hoc, rather than taking prior instructions. Such accountability might be thought by some to mitigate the lack of democratic direction. Here we do not enter into the accountability debate as such (Bianculli and others 2014; Dorn 2014), since we are not interested in legitimating independent regulation. On the contrary, we are interested in a democratic normalisation of this policy area.

The question of whether and how the conceptual and affective disruption experienced so far might be productively channelled into a real break – from technocracy and depoliticisation to democracy and widespread political engagement – should be kept centre stage. The possibility discussed here is a radical shift of direction, towards global diversity in financial market policy-making and regulation, driven by national and regional democratic processes. Politicisation of the issues – meaning not just public debate but also party political formulation of policy positions, to be put to the democratic vote – offers the best guarantee of diversity of, indeed unpredictability in, financial market regulation. Whilst such a vista may be nightmarish for large, cross-border market participants (‘big’ and ‘connected’), democratically-driven diversity should be regarded as an international public good.

Means: reviving historical debates on the purposes of finance

As the author knows from presentation at conferences, advocacy of democratisation of policy-making in respect of financial markets and their regulation can face three critical retorts, which can be summarised as ‘You must be kidding!’; ‘What exactly do you mean?’ and ‘You may be well intentioned but you are wrong’.
The first retort has been elicited for the author in certain specialist conferences, when he could observe participants’ reactions to the mention of democratisation. For example, in one conference, when another speaker made a reference back to the topic, along the lines of ‘I don’t know what you think about democratisation in this particular area . . .’, the heads of the majority of attendees rotated laterally. The author gained the impression that younger specialists found the notion especially incredible, indicating a degree of closure.

A more fundamental challenge is to be asked what exactly democratisation would mean. For example whether it would primarily input to policy-making on regulation of products, firms, counterparties, exchanges, venues, etc – and concretely what measures might be advocated? This is a tricky question to deal with, for four reasons. First, if mishandled it could very quickly lead to a highly specialist debate, from which most politicians, political party activists and citizens would soon de-tune. Secondly, ironically, the question invites the democracy-advocate to become a democracy-replacement unit, setting out his or her detailed and technical proposals. Thirdly, by taking the market, its present structures and functioning as points of departure, the question risks naturalising those features. Fourthly (and relatedly), it risks passing up the possibility of engaging first with the political orientations of lay constituencies and from there articulating visions of the broad purposes that should be served by financial markets – then exploring how regulation might realise those purposes.

The concept of starting with the politics is not hard to illustrate, briefly and indicatively. For example, for free marketers, such as some Republicans in the US, public policy regarding markets leans towards minimal state interference that would either restrict, shape or support capital – equally, no state bail-outs – leaving the industry to its own devices: neoliberalism remains strong even after the crisis.

Somewhat but not totally by contrast, centrists parties tend towards ‘more regulation’, seeking to safeguard and stabilise financial markets as drivers of industry, employment and hence sources of taxation. However, for centrist parties financial market regulation is a technical rather than a political task. Such parties honour the implicit post-1918 demarcation between finance and politics, which becomes explicit in the notion that regulation is outwith the zone of politics. In that specific respect, centrists do not quarrel with market fundamentalists. In the main the reregulatory and resolution agendas adopted following the crisis are centrist (Blyth 2013).

For green parties, the purposes of the financial industry, as with other industries, include transformations aiming to safeguard the planet and its ecosystems. That could mean special attention to modes of financing (and hence governance) of commodity producers and traders, and to financial instruments referencing foodstuffs, for example.
Finally by way of illustration, given a political constituency that is left wing in an old fashioned sense – that is to say not only concerned with redistribution but also with public ownership and control – then public ownership of some categories of financial entities or infrastructures, such as retail banks, would be an agenda item.

Needless to say, socialisation of banking per se (as distinct from socialisation of its costs!) would not be an easy road, for reasons that are legal as well as political. As is well known and as Daniel Seikel (2014) has recently described, in the early 2000s the European Commission’s Directorate General for Competition (DG-COMP) finally succeeded, after a long struggle with Germany, in breaking up regional and municipal public banking. Up to that point in EU law: ‘Banking was defined as an area of general interest that justified its exemption from the competition rules’ (Seikel 2014: 174). That allowed public ownership of banks or, where banks remained private but were politically felt to nurture important local or regional interests, explicit public guarantees. This provided German public banks with advantages vis-à-vis private banks. However, in 2001 DG-COMP succeeded in its long struggle with Germany to abolish its state aids and guarantees, with a transition period of four years. Similar action took place vis-à-vis banking in other Member States, although Germany was the tough nut that resisted being cracked:

Politicians, seeking to counterbalance the economic and political power of major private banks, fostered the Landesbanken to the point where these could compete directly with the dominant private banks. Thus, public banks have always been a thorn in the side of the private banks. Private banks could neither increase their shares in retail business nor compete against the low interest rates that the Landesbanken could offer to corporate customers. In the past, conflicts arose regularly, but never resulted in a liberalization of the German banking system. Until the 1990s, political power networks across the main political parties, Länder and municipalities sheltered public banks effectively against all attacks [. . .], until DG COMP sided with the private banks.

(Seikel 2014: 176–77)

The details of that story are not needed here. What is highly relevant and somewhat ironic is that, following the success of European Commission’s assault on public ownership/support, the crisis has showed us that public subsidy had effectively shifted to the large private banks (see Haldane 2010). For the US and the UK, that shift happened many years prior to the crisis (see Chapter 2), the crisis (or rather the bail-outs) simply making the fact of public support widely visible. For the continent, the European’s Commission’s success prompted a similar migration of support, from public to private banking, which is widely perceived to be too big and too connected to fail.
At the time of writing, authorities seek to abolish or at least reduce that public subsidy to private interests. The point for present purposes is that, although policy-makers may have discovered that banking may indeed constitute ‘an area of general interest’ (Seikel 2014: 174), EU law says otherwise. Whole or part public ownership of failed banks and public support for them following the crisis are construed as temporary expedients that are acceptable only until the banks concerned can get back on their feet or can be sold as the market recovers. Thus, there would clearly be legal as well as political headwinds to socialisation of any part of the sector as a matter of policy.

The purposes of the light political sketching attempted here is not to seek adequately to represent neoliberal, centrist, green and left political positions but rather, briefly, to illustrate the concept of starting with the politics and deriving the forms of market and hence regulation. This is the overarching strategy for democratisation, within which it is for political entrepreneurs and parties to identify and develop their favoured positions.

Their next move, seeking to sell these ideas to their core constituencies, generates a space for deliberation (Black 2009; Habermas 2013) between those constituencies, other socio-political groups and, indeed, the various interested private parties (small finance as well as big, other sectors as well as finance). If the political process is neither cognitively captured by transnational private interest groups, nor emotionally enraptured by finance in periods of economic growth (admittedly some big ifs), then the vicissitudes of political processes within countries should result in a motley patchwork of designs for financial markets and their regulation. That would create sufficient diversity and indeed discontinuities at a global level to reduce connectedness and similarities within these markets. Crises would still occur – that is the nature of capitalism and even more so banking; however, global contagion and systemic instability would be reduced.

**Not an easy sale**

As for how to sell the democratisation agenda, problems of strategy remain, which are related to problems of how to interpret the political record. With a focus on the UK and the City of London, Johal and others (2014), drawing on Engelen and others (2011), suggest that in the years immediately prior to the crisis a pervasive, Foucauldian form of power took hold, in which not only financiers themselves and their regulators were enrolled but also the population at large. (That observation is echoed at certain points in this book, through deployment of Anderson’s 1982 term ‘rapture’.) Johal and others (2014) describe such recruitment of the population as being the most recent of four forms of projection of power, through which the City evolved historically in the 20th century and early 21st century – earlier forms having been having been more tightly focused on relations between finance and
government (and sometimes involving evasion and frustration of the latter). One implication of that analysis would be that, prior to the post-war rise of neoliberalism, the wider population was, although aware of the financial sector, not politically implicated in it.

The present author is not sure about that. Some of the historical evidence touched upon in Chapter 1 indicates that, over the longer historical period of the 20th century, there has been some public engagement, taking a variety of forms, sometimes critical but at other times adulatory. When there was widespread complaint, it generally had to do with the City’s low interest in investment in UK industry (and hence employment) during its long decline (see Chapter 1). That said, until at least the early 20th century, the working and middle classes were favourably inclined towards finance, seeing it as part of Britain’s greatness, empire and wealth, with a (hoped for) trickle-down aspect. In short, the City may have cast its spell quite widely. If so, reading public enrolment as being only a recent neoliberal phenomenon may not be entirely merited: perhaps there is a wider research agenda here.

These historical issues are relevant in the context of contemporary appraisal of the possibilities for democratisation of policy-making in this area. If the universal suffrage of 1918 failed to achieve such democratisation, that might be due in part to the strength of the City in keeping its governance off the agenda (Johal and others 2014; Engelen and others 2011; and Preface and Chapter 1). On the other hand, if there has been a historical tendency for citizens positively to identify with finance, this may be part of an implicit giving of political licence to finance to operate outside democratic control. If pre-crisis demonstrations of that licence were built upon and reflected a historically deeper-seated social fact, then it is not going to shift easily. One should not be surprised if licence/enrolment/rapture become resurgent whenever explicit signs of crisis ebb.

**Finally: international standard-setting, diversity and democracy**

Some commentators, whilst by no means positively advocating diversity in financial market regulation, have seen it as an empirical trend. As a result of its discreditation following the crisis, Western-led regulatory clubs are opened up to wider international membership and become less cohesive actors (see preceding pages). Commentators have explored some of the possible implications for ‘international standard setters’, such as the Basel Committee and Financial Stability Board (Helleiner and Pagliari 2011). It has been suggested, for example, that greater national or regional regulatory autonomy may not mean fragmentation; rather, it could be understood and to some extent managed at the international level as ‘cooperative decentralization’ (ibid: 196). In such a scenario, tasks falling to the international levels would
include ‘looser forms of cooperation such as principles-based international standards, information-sharing, research collaboration, international early warning systems, and capacity building’ (ibid: 196).

However, that apparently modest listing raises some issues of principle. For example, ‘information sharing’: what information and, more fundamentally, for what purposes (see pages above and Chapter 5)? Consider also information sharing in relation to ‘international early warning systems’. There is already a big impetus to collection and sharing of information about trading, through exchanges to data depositories to regulators, supported by legislation in the US and EU. This endeavour raises issues about interpretation (at what levels and against what objectives?) and about who makes the recommendations for action (and on what basis?). Encapsulating such issues in as neutralised terms as ‘information exchange’ hardly does justice to the political questions raised. Equally, ‘capacity building’ might sound anodyne to some; however; the mainstream political science literature on the role played by international organisations in country development suggests otherwise.

More critically and usefully, a report entitled ‘In Praise of Unlevel Playing Fields’, by the Warwick Commission on International Financial Reform, recognises that countries have ‘different national political priorities, financial structures and institutional capacities’. These should be safeguarded:

It seems heretical to argue against ‘level playing fields’, but in certain areas of finance, an unlevel playing field has merit. [. . .] We need a financial system that is robust to shocks, and that requires diversity, not homogenous behaviour derived from the blanket application of the same rules and standards on valuation, risk and trading. An unlevel playing field between countries is also desirable so as to best take into account different national political priorities, financial structures and institutional capacities.

(Warwick Commission 2009: 9)

The question of capacity ‘for what’ requires careful scrutiny in the context of a sensitivity to the risks posed by similarity. It is arguable what forms of techne could safely be adopted at the top, then routed down to regional and country levels and hard-wired in, so as to become universal templates for the development of regulatory institutions, skills and thinking. If an in-principle acceptance of democratic direction is accompanied by an in-practice programme of capacity building that assumes a common core, then the former may be trumped as the latter expands. Apparently ‘soft’ modes of international cooperation may have rather ‘hard’ effects, especially on thinking.

To make these observations is not to argue that information, capacity building and cooperation cannot be public goods. Rather, it is to point to some difficulties of defining, in a practical manner, their relation to democracy and diversity. Would this most practically be achieved top-down through elite networking and technical expertise; bottom-up through some representation
of democratic choices (which international organisations and it seems regional organisations have yet to find a way to facilitate); or via some mix of the two which, although messy, might remain more transparent and open? There are some serious intellectual and institutional design challenges here.

The underlying and enduring question remains how the structural division between democratic processes and financial market regulation can be eroded, possibly eventually being overcome, rather than being more deeply institutionalised. Historically, three opportunities to address this were passed by: first, at the time of the universal suffrage, when private regulation of financial markets side-stepped the realm of public politics; secondly, post-Second World War, when private regulation adopted a public guise at home and a networked persona internationally; and, thirdly, within the EU, recent signs have not been entirely encouraging, mechanisms being put in place to save the Eurozone and its banks whilst binding its citizens.

Internationally, countries are collectively now at a fourth potential pivot point. The progressive agenda concerns not only domestic application of the democratic process but also the difficult question of its projection upwards, from states to regional arrangements and international bodies. Interesting and important questions remain about the extraterritorial reach of national (and where applicable regional) rules. Conflicts over extraterritoriality could be seen in a positive light, as evidence that diversity is alive and kicking, in political and so also in market terms. Financial market regulation is not the only field in which issues of global/local governance, homogeneity/diversity and technocracy/democracy arise – international security, energy and environmental policies being others – but financial market regulation has now become a key site.
Bibliography


Búrca, G de and Weiler, J (eds), 2011, The Worlds of European Constitutionalism Cambridge: CUP.


Committee on Legal Affairs, 2010b, Opinion on the Proposal for a Directive of the European Parliament and of the Council Amending Directives [. . .] in respect of the powers of the European Banking Authority, the European Insurance and Occupational
Pensions Authority and the European Securities and Markets Authority, rapporteur Sajjad Karim (30 April) 216–87 in Committee on Economic and Monetary Affairs 2010 (see above).


Crisis CRESC working paper number 101 Manchester: Centre for Research on Socio-Cultural Change.


Habermas, J, 2013, Deliberative Democracy and Political Crisis lecture given at the Royal Netherlands Academy of Arts and Sciences, Amsterdam (5 November) video http://webcolleges.uva.nl/Mediasite/Play/22a74d4df835540fba3ccfc72c2372a001d.


Milne, R, 2011a, ‘Eurozone Legacy of Lehman’s fall paralyses Eurozone’ Financial Times (27 April) http://www.ft.com/cms/s/0/a0c9fee0–70ef-11e0–962a-00144feabdc0.htm.


Bibliography


Picciotto, S, 2011, Regulating Global Corporate Capitalism Cambridge: CUP.


Bibliography 171


Tarr, D, 2010, Lehman Brothers and Washington Mutual Show Too Big to Fail is a myth – a myth that prolongs the recession and retards growth SSRN http://ssrn.com/abstract=1533522.


accountability 30, 99, 134–5, 138, 141
accountancy firms 21, 57
accounting 71; improper 57; off-balance sheet vehicles 61, 118; on-balance sheet debt 61; standards 45
Acharya, V 29–30
Adoboli, Kweku 41
aesthetics, cosmopolitan 24–5
Ahold 57
AIG (American Insurance Group) 5, 31, 32, 33, 34–6, 37, 46, 58, 70, 117
Akerlof, G 31, 50
Akhtar, S 140
Alexander, K 86
Amagerbanken 43, 73
Anderson, J 64, 148
AOL Time Warner 57
arbitrage, jurisdictional 5, 61, 66, 67–72
aristocracy 8, 10, 11
Arup, C 81
austerity, public 73–4, 77, 102, 130, 139
Avgouleas, E 80
Ayotte, K 37
Ayers, I 80
Bai, L 86
bail-outs as policy 28–9, 49–50;
attractions of ‘too connected to fail’ (TCTF) 29–31; bankruptcies no more disorderly 36–9; firewalls within banking groups 44–5, 49;
‘market for lemons’ in policy concepts 31–2; normalisation of bail-outs in US 33–6; political rhetoric: making of Lehman Brothers story 32–3; problems and prospects: connectedness, similarity and contagion 41–4; ‘scarcely a ripple’: failure with reassurance 39–41; special resolution regimes: reimagining Lehman 45–9
Bair, S 47
Baldwin, R 80
Bank of America 36
Bank of England 3, 9–10, 12–14, 18, 19, 21, 23, 26; euromarkets 15, 69–70; European Community/Union 14, 16–17, 20; Financial Policy Committee (FPC) 124; interest rate policy 63; policy agendas: international and regional negotiation 16–17, 18; scandals 19–20; status of bank supervision within 20; supervision of BCCI 39; systemic risk regulation 120
Bank of New York Mellon 36
bankruptcies see bail-outs as policy
Barclays 35, 47
Barings 10, 31, 39, 40, 41
Barr, M 140
Basel accords 43, 116–17, 119; capital adequacy rules 61
Basel Committee on Banking Supervision 6, 17, 62–3, 149
BCCI (Bank of Credit and Commerce International) 19, 20, 31, 39–40, 41
Bear Stearns 28, 31, 34, 35, 40, 42, 122
Beck, U 54
hard to overcome 132–3; limits of subsidiarisation: less connected but still too similar 133–5; means: revisiting 1918 144–5; means: reviving historical debates on purposes of finance 145–8; not an easy sale 148–9; terms of debate 137–8

Denmark 43, 73
depoliticisation 5, 6–7, 12, 14, 18; convergence, contagion 64–6
depositors, protection of 28, 29, 34
deregulation 5–6, 31, 57, 62, 66, 74
derivatives 40, 41, 61, 63, 70; credit default swaps (CDSs) 34–5, 37, 58, 70, 94, 117

Desai, R 140
Dewing, I 21
Diamond, Bob 48
Dierick, F 61
Dorn, N 64, 72, 98, 138, 141, 145
Draghi, Mario 49, 93
Dragomir, L 67–8, 69
Drexel Burnham Lambert 39, 40, 41
Duff, A 86
Dunfermline Building Society 46, 123–4
Dyson, K 73, 80, 98

Earlier Burden Sharing Model 128, 129
economic analyses of public policy 122
Eijffinger, C 92
Engelen, E 6, 84, 111, 141, 148, 149
Enron 57, 118
Eppink, Derk Jan 92
Ertürk, I 30
Eurodollar market 14, 15
euromarkets 14–15, 19, 20, 68, 69–70
European Banking Authority 98, 103
European Central Bank (ECB) 30, 44, 48–9, 78, 82, 90, 101, 107, 142;
Lisbon Treaty 104–5; Longer Term Refinancing Operations (LTROs) 92–3; Single Supervisory Mechanism (SSM) 98, 99–100, 103
European Community/Union 24, 65, 71, 77–8, 114, 119, 120–1, 133, 137, 144–5; Bank of England 14, 16–17, 20; bank stress-tests 48–9, 116; co-decision procedure 84;
Commission 17, 18, 29, 44, 48, 81, 82, 86, 87, 88–9, 95, 96, 140, 147; constitutionalisation 138–40, 142–3; Council 82, 83–4, 87, 88–9, 95, 102, 103; credit rating agencies 62, 85–7, 91, 106, 114; democratic deficits 76, 126, 144; European Council 91, 94; Lamfalussy framework 83–4; Lisbon Treaty 104–5; monetary union 14, 15, 16; Parliament 48, 82, 83–4, 87–9, 94, 95, 98, 101–2, 103, 104, 106, 139, 142; private-public regulatory nexus, approaching 78–81; public-private regulation 82–5; quo vadis EU? 104–8; regulation after markets: ‘mechanisms’ 97–100; resolution, distribution and democracy 125–6; single market, EU authorities, stability: ECJ case C-270/12 93–7; socialisation of banking 147, 148; special resolution regimes (SRRs) 46; ‘technical delegation’ and parliamentary control 87–9; Treaty on the Functioning of the European Union (TFEU) 82, 87–8, 89, 94–5, 96, 99; UK membership 15–16
Eurozone 29, 30, 44, 47, 49, 59, 72, 78, 90, 113, 127, 142, 151;
European Stability Mechanism (ESM) 78, 98, 100–4, 105, 106, 107, 126, 127, 128, 142; regulation after markets: ‘mechanisms’ 97–100; regulation as crisis management: ‘burden sharing’ 90–3; responses in wake of 2008 73–4; Single Resolution Mechanism (SRM) 98, 103–4, 105, 130; Single Supervisory Mechanism (SSM) 95, 98–100, 103, 105
Everson, M 142
experts, rule of 6, 136
extraterritoriality 151

Fannie Mae 34, 35, 37
Ferran, E 80, 81, 83
Index

Financial Services Authority (FSA) 14, 19, 21–3, 26, 118; Barclays 47; ‘principles-based’ regulation 19
Financial Stability Board 140, 149
firewalls within banking groups 44–5, 49
First World War 10, 12, 13
Flannery, M 29
Fontnouvelle, P de 61
Fortson, D 20–1
forum shopping 65–6
France 8, 90, 92
Frank, Barney 132
Freddie Mac 34, 35, 37
free trade 15, 16
front-running, political 17
Froud, J 113, 122
G20 133, 139, 140
Gai, P 119
Galbraith, J 58
gaming 44, 74, 83, 111, 118
GE 33
Geithner, Timothy 31, 90–1
Gerding, E 56, 62
Germany 11, 90, 92, 101, 142, 147
Gianviti, F 113
Gifford, C 16
Giles, C 63
Gilligan, G 8
Glass-Steagall debate 44, 45
global systematically important financial institutions (G-Siifs) 41–2, 46, 118–19, 122
globalisation 16, 68, 71, 75
Goldman Sachs 34, 36
Goldstein, M 29, 90
Gordon, J 32, 42
Grant, J 24
Greece 72, 90, 91–2, 106, 113, 127
Gros, D 30, 47, 130, 132
Grossman, E 83, 84
Habermas, J 148
Haldane, A 45, 48, 111, 114–15, 116, 122, 135, 147
Hayek, F 112
HBOS 46, 123
hedge funds 30, 34, 38, 127
Helleiner, E 12, 67, 68, 113, 139, 149
Hellwig, M 54, 62–3, 64, 117
Helwege, J 42
herding 64–5, 75
Herring, R 39–40
Honohan, P 56
Hood, A 38
Hopkins, A 8
Howarth, D 97, 99
Hungary 106
Hunt, T 11
industry, investment in 11, 149
information: asymmetry 31–2, 80, 81, 89; contagion 42; see also knowledge; models
infrastructure investment 11
insider trading 72
insolvencies see bail-outs as policy
Institute of International Finance (IIF) 91, 92
International Derivatives and Futures Association 35
International Monetary Fund (IMF) 14, 18, 106, 113, 119, 127; bondholder ‘haircuts’ 30
International Organisation of Securities Commissions (IOSCO) 17
international relations 16, 58, 143
Ireland 29, 30–1, 72, 90, 113, 116, 126
Italy 72, 92
Janeway, W 18
Japan 17, 64
Jeng, D 72
Jenkins, P 91, 118
Johal, S 10–11, 22, 148, 149
Johnson, C 69, 138
Johnson Matthey Bankers 19–20
JP Morgan 34, 36
Index

JP Morgan Chase 55
jurisdictional arbitrage 5, 61, 66, 67–72

Kaltenthaler, K 30
Kersbergen, K van 80
Kerviel, Jérôme 41
Kißer, K 95
King, M 63
King, N 135
Knill, C 79
knowledge: cognitive capture 64, 71, 82, 137; from technical knowledge to political preferences 135–6; transparency, limits and distractions of see separate entry; see also information; models
Krainer, R 46
Labour Party/Government 14, 20, 22, 23, 26; sterling crisis (1967) 14; sterling crisis (mid-1970s) 18
Laiki Bank 73
Lambie, G 15, 18
Lamfalussy, A 80, 84
Lanchester, J 119
Landsbanki Islands 37
Larson, R 64
Lastra, R 100
law and economics 122
Lawson, N 20
Leathers, C 49
Lee son, Nick 40, 41
Lehman Brothers 5, 28, 31, 32–3, 34, 35, 36–8, 39, 41, 42, 50, 71, 117, 122; special resolution regimes: reimagining 45–9
Levi, M 57
Lisle-Williams, M 9–10
Lloyds TSB 46, 123
Long Term Capital Management (LTCM) 39, 40–1
Lord, C 102
Loughlin, M 142
Lowenstein, R 56
Lütz, S 12–13
McBarnet, D 83, 118
McConnell, P 72
Macey, J 71
McGuire, K 39
MacKenzie, D 40–1, 111
macro-prudential regulation 132–3
Madoff, Bernard 54–5
Mainelli, M 120
Majone, G 139
Major, A 66
manufacturing, British 11, 18
market manipulation 72
Markham, J 57
Martimort, D 64
Mattli, W 79–80
Merkel, Angela 92
Merrill Lynch 42
Michie, R 5
Milken, Michael 40
Miller, D 137
Milne, R 30, 43, 92
Milward, A 16
Minsky, H 57–8
mis-selling 72
Mizen, P 60, 61
models 30, 41, 42, 53, 55, 65, 66, 93–4, 105, 114, 132; BCCI 40; credit rating agencies 85, 86, 113–14, 117, 119; Drexel Burnham Lambert 41; European Central Bank (ECB) 93; from models to judgment 74–5, 130; Long Term Capital Management (LTCM) 40–1; newly emerging regulatory knowledge 121–2; ‘originate to distribute’ model of financial trading 58–9; proprietary information models 23, 24–5, 26, 117, 119; regulatory forbearance and use of private models 60–4
Moloney, N 93, 94, 95, 113
Moody’s 56, 86
moral hazard 28, 29, 30, 35, 38, 42–3, 44, 49, 118, 119, 122, 131, 135
Moran, M 6, 10, 16–17, 21, 22, 63, 113
Morgan, K 30
Morgan Stanley 36
Morgenson, G 58
Morris, J 132
mortgages 56, 58–60
Mügge, D 85
Münchau, W 91
national parliaments 16, 95, 99, 106
Nationwide 46, 124
neoliberalism 74, 78, 96, 104, 112, 137, 139, 146, 149
new international economic order 12
Northern Rock 22

off-balance sheet vehicles 61, 118
Oliver, C 140
on-balance sheet debt 61

Pagliari, S 137, 138
Partnoy, F 62, 85, 117
Paulson, Henry 35
Peckham, R 135
Peeters, J 22
Pemberton, Leigh 16
pension funds 59, 60, 62, 128
performance-related pay and bonuses 57
Picciotto, S 63, 75, 79, 120–1
policy agendas 16–17, 18
political front-running 17
political parties 146–7, 148
Ponzi finance 68, 70; not as exception but as rule 57–8; risk appetite, contagion and 53–6
Portugal 72, 92, 113
Posner, E 80, 81, 85
Pratt, A 62
precautionary principle 54, 97, 129
Preda, A 7–8
Prentice, R 61
prudential regulation 74, 75, 97, 106, 111, 112, 115, 123, 124–5, 129, 131; macro- 132–3
Prudential Regulation Authority 124
public austerity 73–4, 77, 102, 130, 139
public subsidy to banks 42, 44, 48, 90, 92, 125, 126, 131, 135, 147–8
Quaglia, L 80
Quinn, B 31
‘race to the bottom’ 68–9
Randell, C 45
Reagan, Ronald 57
receivership 47
recession 12, 14
referenda 65, 73
regulatory arbitrage see jurisdictional arbitrage
regulatory capture 63–4, 71, 80
regulatory complicity and forbearance 58–60, 70; use of private models 60–4
rereregulation 6, 31–2
Rhodes, R 80
Riles, A 64, 67, 75, 112, 133, 141, 142
ring-fencing: firewalls within banking groups 44–5
risk appetite, Ponzi finance, contagion 53–6; Ponzi finance not as exception but as rule 57–8
Rodrik, D 143
Ross, D 11
Russia 10
Salmon, F 127, 128
Santander 46, 124
Schoenmaker, D 46
Schooner, H 14, 19, 20
Schumpeter, J 38
Securities Investment Board (SIB) 14, 18, 19, 21–2
securitisation 58–9
Seikel, D 147, 148
Self-regulatory Organisations (SROs) 21–2
Senior Supervisors’ Group 37
short selling 94
Siems, M 138
Sikka, P 57
Silva, Y 34, 36
Sinclair, T 117
Singer, D 68, 71
Singh, D 46, 124
Sjostrom, W 58
Slovenia 72
small and medium-sized firms 121
sovereign bond markets 41, 91–2, 119
Soviet Union 13, 16
Spain 72, 90, 92, 113
special resolution regimes (SRRs) 114, 123–4, 125; Eurozone: Single Resolution Mechanism (SRM) 98, 103–4, 105; public information requirement for resolution 124–5; reimagining Lehman 45–9; resolution, distribution and
democracy 125–6; resolution, technical debate and democracy: political menu? 126–9
Spendzharova, A 81
Spiegel, P 91
Standard & Poor’s 91
status groups 7–8
sterling crisis: (1967) 14; mid-1970s 18
Stiglitz, JE 117
stress-tests, bank 48–9
sub-prime securities 56, 58–60, 78;
AIG 35–6, 70; Bear Stearns 34
subsidiarity 126, 134–5
Supermajority Collective Action Option 127, 128–9
Swinburne, Kay 17, 84
systemic risk 28, 29, 30, 40, 53, 113, 114, 115–16, 120, 121–2, 132; homogeneity among risk management strategies 62
Taleb, N 121
Tarr, D 37
taxation: tax-deductibility of debt 45
Taylor, J 36
Thatcher, Margaret 16, 18
Thompson, C 49
Tomkin, J 100
‘too big to fail’ (TBTF) 28, 42, 48, 118–19, 122
‘too connected to fail’ (TCTF) 118–19, 122; bail-outs as policy see separate entry
‘too important to fail’ (TITF) 79
‘too similar to fail’ (TSTF) 40, 41–2, 64–5, 135
transparency, limits and distractions of 111–12; bank resolution as focus for policy and information 122–4; context 112–14; debating complexity 114–16; legal transparency 125; market information as public straitjacket 121–2; public information requirement for resolution 124–5; resolution, distribution and democracy 125–6; resolution, technical debate and democracy: political menu? 126–9; trading data as knowledge flooding 116–21
Treasury, UK 18, 120, 124; euromarkets 15
Treasury, US 47, 72–3
Tridimas, T 88
Tsingou, E 66
Tucker, P 43
Turner, A 43–4, 45, 72, 113
Tyco 57
United Kingdom 59, 73, 104, 121, 124, 137; Bank of England see separate entry; Banking Act 2009 46, 123; bondholder ‘haircuts’ 30; ECJ Case C-270/12 94–7; Financial Services Authority (FSA) see separate entry; history of UK’s regulatory regime see separate entry; London-based activities of US firms prior to 2008 69, 70–1; on-balance sheet debt 61; ‘principles based’ regulation 61; public subsidy to banks 42, 44; Single Supervisory Mechanism (SSM) 98–9; special resolution regimes (SRRs) 46, 123–4, 125; Vickers Commission 44–5
United States 8, 13, 14, 18, 25, 59, 65, 72, 132, 137; anti-money laundering policy 39; bail-outs as policy see separate entry; constitutionalising regulation 138–40; credit rating agencies 62; Dodd-Frank Act 24, 47, 86, 133, 140; euromarkets 69, 70; European Community/Union 16, 81, 86; Eurozone 30–1, 90–1; exchange controls 15; Federal Deposit Insurance Act 1950 (FDIA) 33, 34, 35; Federal Deposit Insurance Corporation (FDIC) 46–7; Federal Reserve 33, 34, 41, 47; Housing and Economic Recovery Act 2008 34; Madoff 54–5; mortgage fraud 56; New Deal 12; on-balance sheet debt 61; responses in wake of 2008 72–3; ‘rule based’ regulation 61; Secretary of the Treasury 47; Securities Exchange Commission (SEC) 55; special resolution regimes (SRRs) 46, 123, 125; Troubled Assets Relief Program (TARP) 32–3, 34, 36; Volcker Rule 44
universal franchise 12, 18, 149, 151
Utzig, S 86
Verhofstadt, G 101
<table>
<thead>
<tr>
<th>Term</th>
<th>Page(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vickers Commission</td>
<td>44–5</td>
</tr>
<tr>
<td>Vogel, S</td>
<td>4</td>
</tr>
<tr>
<td>Volcker Rule</td>
<td>44</td>
</tr>
<tr>
<td>vulture funds</td>
<td>127</td>
</tr>
<tr>
<td>Walker, D</td>
<td>11</td>
</tr>
<tr>
<td>Wall, L</td>
<td>34</td>
</tr>
<tr>
<td>Wallison, P</td>
<td>44</td>
</tr>
<tr>
<td>Walzer, M</td>
<td>73</td>
</tr>
<tr>
<td>Waste Management</td>
<td>57</td>
</tr>
<tr>
<td>Waugh, P</td>
<td>63</td>
</tr>
<tr>
<td>Weber, M</td>
<td>7, 8</td>
</tr>
<tr>
<td>Weber, R</td>
<td>134</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>36</td>
</tr>
<tr>
<td>Westrup, J</td>
<td>21</td>
</tr>
<tr>
<td>White, L</td>
<td>62</td>
</tr>
<tr>
<td>wholesale financial products</td>
<td>61</td>
</tr>
<tr>
<td>derivatives</td>
<td>see separate entry</td>
</tr>
<tr>
<td>Wigglesworth, R</td>
<td>127, 128</td>
</tr>
<tr>
<td>Williamson, P</td>
<td>11</td>
</tr>
<tr>
<td>Wolf, M</td>
<td>45, 61, 131</td>
</tr>
<tr>
<td>WorldCom</td>
<td>57</td>
</tr>
<tr>
<td>Wray, L</td>
<td>58</td>
</tr>
<tr>
<td>Xerox</td>
<td>57</td>
</tr>
<tr>
<td>Xhaferri, Z</td>
<td>89</td>
</tr>
<tr>
<td>Young, K</td>
<td>71</td>
</tr>
</tbody>
</table>