



BRIEFING

The Financial Crisis: Is regulation cure or cause?

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Whenever there is a crisis, the parrot cries go up for more and/or better regulation. This paper examines today's populist demands for ensuring financial stability and security through regulation.

In order to do this effectively, we need to consider whether existing regulation mitigated the 2008 crash, or whether it had no impact. Indeed, we also need to ask whether and to what extent regulation may have actually caused or worsened the crisis. It is hardly news that legislation can have unintended consequences, sometimes having the opposite effect to the desired objective. And if existing regulation and regulators bear some responsibility for the disaster, can we really say that more regulation would have helped? This paper seeks to look forward, bearing these lessons in mind, to evaluate whether new regulation could have any impact, positive or negative, on future financial crises.

The paper opens with a discussion of whether its UK focus is justified. Some argue that the crisis is global and the UK problems are merely our share of worldwide problems originating in the USA. Of course the crisis does have a global dimension, and that will be addressed elsewhere but it also has a UK dimension, and we will argue that the UK is largely responsible for its own difficulties.

The paper then discusses how UK financial regulation helped cause the crisis. We do not suggest regulation was directly responsible; more that it indirectly fomented the crisis by providing the illusion of control. In that case, who were directly responsible? In various ways, we all were: banks, credit agencies, auditors and consumers. But to say everyone does not mean no one. Consumers behave like consumers and banks behave like banks; it is the job of those managing the economy and the financial markets to take that into account in providing stability. We show that culpability lies with the tripartite regulatory regime created by the UK Government to take responsibility for the financial health of the country, namely the Treasury, the Financial Services Authority and the Bank of England. Among those, the Bank of England appears to have had primary responsibility. Finally we look forward and suggest what changes should be made. We find that introducing new or revised regulations should play some part, but only a minor one.



Is the UK focus of this paper justified?

One could argue that the UK is simply caught up in a global financial crisis and that whatever we did or do locally is unlikely to have much impact on events driven globally. Some might also argue that there should be a single financial services market for the EU and that therefore causes and solutions should be considered at the EU level, with the UK merely implementing decisions and regulations made in Brussels. In the future that may be the case. However, the EU does not appear to be implicated in the UK's current financial and economic problems. By general consent, the international crisis began in the US.

The Carter and Clinton presidencies in the US introduced regulations, for alleged social reasons, to encourage bank lending to people with no hope of servicing their loans, still less repaying them. This resulted in the US "sub-prime" market and "toxic debt".¹ These bad debts were wrapped up in sophisticated mixed-bag, acronym-labelled parcels and sold to financial institutions in the US and internationally. These financial instruments were so opaque that by the time people started defaulting on their mortgages, no one knew the extent of the liability they, or others, were exposed to. Banks stopped lending money to each other, and the credit crunch began.

However, while the genesis of the downturn may be traced to the US, the British Government's consistently restated position, that the UK financial crisis was not of our own making, simply does not hold water. As Irwin Stelzer put it: "It seems Britain is the victim of a disease that originated in America, and magically crossed the ocean to infect perfectly healthy British banks — the very institutions that were writing mortgages valued at 125 per cent of the value of homes, issuing millions of credit cards and not checking financial statements of borrowers, all under the eyes of regulators."² The point is of course that whatever part of the crisis can be blamed on international factors, there remain plenty of home-grown aspects which made the UK uniquely susceptible to it.

This paper is concerned with these home-grown aspects, and the extent to which British regulation

has, directly or indirectly, contributed to the crisis. It then considers the changes that should now be made to protect this country in future and shows that we need more effective oversight, in the traditional sense, rather than further regulation. The UK's failures have not been due to a lack of regulation, but rather to UK organisations having poorly defined responsibilities and failing to carry them out.

How UK financial regulation helped cause the crisis

The 2008 crash had complex roots, notably the UK Government, banks, and individuals spending beyond their means over an extended length of time. One aspect was that the UK Government encouraged the poor to buy "starter" homes. It was only fair, it was claimed, for them to have the same access to debt as the more affluent sections of the community. Astonishingly, the UK government continues to encourage the acquisition of mortgaged starter homes even when the housing market is falling like a stone.

Government stoked the credit boom, perhaps in the knowledge that voting intentions are influenced more by spending, or the ability to spend, than earnings. Everyone was caught up in a classic bubble and, mindless of history, believed the good times would last forever. The UK in particular built up higher levels of personal debt than anywhere else in Europe.

This bubble was not directly caused by regulation, or any lack thereof. Rather, its roots lay in the prevailing belief that we could enjoy prosperity today and that our housing equity would take care of the debt tomorrow. Citizens were reassured by a government that claimed to have abolished "boom and bust" — or at least the "bust" part of that. At no time did the Government, or any of their major institutions, warn of dangers. On the contrary, they promoted the security of this new world order. The Government claimed that regulation, and the FSA in particular, would guarantee financial security. These proved to be illusions and thereby indirectly helped the fatal bubble to grow.

Some of the contributing factors from regulation and the regulators were:

1. Throughout the economy, traditional business was over-regulated. This removed market opportunities and reduced profitability, inadvertently driving enterprise towards new, unregulated and unsafe areas. This migration of enterprise strained those parts of the system least able to withstand it.
2. This is precisely what happened in the UK financial sector. The over-regulation of traditional financial services shifted enterprise towards the complex financial engineering of packages unknown to, unseen by, and not understood by the FSA or UK Treasury. Such was the scale of this shift, that even bank directors prided themselves for their inability to understand derivatives, Default Package Swaps and their like: "We have Cambridge PhDs for that, old boy". Their only concerns were that they were legitimate means of raising funds off balance sheet, i.e. outside the traditional debt to capital controls, and that they generated positive earnings.
3. People fell victim to the 'white coat illusion'. To explain: quality inspectors used to be considered responsible for quality, meaning it was their job and therefore no one else's. If there were problems with quality, conventional wisdom was to increase the size of the rule book and the number of quality inspectors. Yet in reality, quality is inversely proportional to inspectors. Having more quality inspectors actually reduces quality. In fact, everyone needs to feel responsible for quality and held to account personally. Over reliance on inspectors turns quality into someone else's problem. Regulations and regulators, notably the FSA, have had much the same effect.
4. In a speech to the Adam Smith Institute in October 2008, Richard Jeffrey, the Chief Investment Officer of Cazenove Capital Management, emphasized this point:

"Much of regulation incorporates a mass, if not a mess, of rules and regulations that amount, in effect, to micro-management of the way firms are structured and carry on their business. This is generally referred to as compliance. The danger for both

the regulators and the regulated is that they believe, in conforming to these rules – they convince themselves – that their overall business management and models have been validated. That is clearly not the case."

As Jeffrey continued:

"This situation will not be resolved if a raft of new regulation is introduced. Rather, regulators should focus on a rethink of their regulatory procedures and objectives. Regulation should be much less oriented towards process and much more focused on principles and outcomes. Regulators should be more concerned about where we are going, and whether that place is a sensible place to be, not how we travel there."

5. The FSA has a legalistic, rules-based approach, preferring to find reasons for inaction rather than blowing the whistle. It is like a policeman ignoring a burglary because the other side of the road is outside his patch. We need to distinguish here between "regulation" – creating a set of written, legalistic rules but not necessarily enforcing them – and "oversight", as once practised by the Bank of England, where dubious practice was called into question whether the subject of written rules or not. The Bank was concerned with the viability of the way the institution conducted its business as a whole and not whether the treasurer of some church flower fund had his passport checked when he opened an account for £20. In the present crisis, the FSA's defence for why they did nothing about UK subsidiaries of Icelandic banks was that they were technically outside their responsibility. Iceland is not part of the EU but what difference should that make if the British subsidiaries are trading on FSA turf? Hector Sands, CEO of FSA, has been forced to apologise for the FSA's failure to mitigate the bank crisis.⁴
6. Regulators lack a clear and simple remit. For example, the FSA's statutory objectives⁵ are:
 - a. market confidence: maintaining confidence in the financial system;

- b. public awareness: promoting public understanding of the financial system;
- c. consumer protection: securing the appropriate degree of protection for consumers; and
- d. the reduction of financial crime: reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

The first of these is the most interesting. The FSA is apparently not there to ensure that the financial system is worthy of confidence, only to promote confidence however unjustified that may be. In that context it is worth noting that the FSA and the Treasury announced, towards the end of October 2008, “a £2m press, radio and experiential campaign to reassure consumers about the current economic climate.”⁶ So that’s OK then.

7. Regulation tends to be too late and too slow. “Markets and product innovation will always run ahead of regulation” say Booth and Mazzawi⁷, in the course of explaining, inter alia, why the relatively new Sarbanes-Oxley regulations have done nothing to prevent write-downs and instability (it’s mainly because they look backwards to published reports about the past).
8. Basel II is the international regime which supposedly governs financial services and is operated in the UK by the FSA. It says some sensible things but, according to Booth and Mazzawi, they are patchily implemented. More to the point, they focus on capital adequacy rather than liquidity and — as we now know — liquidity has been the central problem.
9. Regulatory sanctions are applied late and to companies, not individuals. Therefore individuals feel under no personal pressure to behave responsibly. Take Alliance & Leicester as an example. In October 2008 it was fined a record £7m for transgressions during 2005-2007. The Chief Executive during that period was Richard Pym, who conveniently left A&L in July 2007 with no stain on his record. A&L went under and the deposit business is now part of Santander. Mr Pym subsequently

popped up at Bradford & Bingley, which also hit the rocks (although the extent to which that can be blamed on Mr Pym is both unclear and beside this point, which is that sanctions need to be prompt and personal, not late and corporate).

In terms of personalities, we should not forget Sir John Gieve. When he was Permanent Secretary at the Home Office the accounts became chaotic over a long period. As Deputy Governor at the Bank of England he was responsible for liaison with the FSA. We now know that the failure of this linkage caused the Northern Rock disaster. Sir John subsequently left the Bank of England but remains a Director of the FSA. Ironically, he was previously in the Treasury, inter alia as Managing Director of Finance Regulation and Industry 1998-2001.

10. The Iceland saga has highlighted how credit rating agencies continued to give excessive credence to certain banks, and how investors continued to rely on those ratings, long after the riskiness of those banks was in the public domain. UK television broadcast warnings about Icelandic banks in April 2008 and yet maximum ratings continued to be awarded into September. This was due to the credit rating agencies following their own backward looking rules for setting ratings regardless of current or prospective realities.

Who, so far as the UK is concerned, caused the crisis?

Everyone (the Government, the banks, the FSA, auditors, credit agencies and the general public) has contributed to this financial crisis, much as they all say “not me gov.” It was remarkable to hear the incoming chief executive of the Royal Bank of Scotland whitewash the previous management and it is noteworthy that the outgoing chief executive will continue to be paid, and accumulate pension benefits, for three months after he allegedly left immediately and without compensation in October 2008.

The out-of-touch ratings of credit worthiness by the specialist credit agencies did not help. To maintain unrealistically high ratings for too long

and then over-react to bad news only encourages panic. A major contributing factor is that credit rating agencies are paid by those they are rating. Agencies are interested in repeat business and long term profitability and it is alleged that they therefore bias ratings to please their clients, rather than towards the interests of investors.¹⁰ This paper suggests that such a fundamental bias cannot be corrected by new regulation, as now proposed by the EU¹¹, and provides an alternative solution in the concluding section.

The responsibility of the British public in general is not further examined. Yes, we spent too much and borrowed too much. Yes, we were naïve. But regulation of human nature is unlikely to be productive. You cannot expect the public to behave other than as comes naturally any more than it is wise to expect cats to behave like dogs. It is, however, the role of government to construct an environment in which natural public behaviour does not imperil the financial stability of the country. To put it another way, there are no bad soldiers, only bad officers.

In much the same way, one can blame the UK crisis on those UK banks who were greedy and stupid. And yet, those responsible for overseeing the banks should know that some will always behave in stupid and/or greedy ways. Following the Barings collapse it became clear that the evidence of high bonuses and impenetrable packages was fully in the public arena for the supervisors to see.

The responsibility of auditors is more interesting. Technically they are responsible to shareholders, mainly other financial institutions and pension funds run by those institutions, and not to the public at large. This is something of a club where members are not supposed to embarrass other members. One financial columnist put the challenge directly: "Auditors have contributed to the crisis by accepting directors 'mark-to-market' valuations of trading assets, when some basic questions would have shown them that those directors (i) hadn't the remotest clue what was in the mortgage/loan package they had acquired; (ii) were utterly bemused by the nature of the complex derivatives on which their asset valuations rested; and (iii) knew that there was no market to 'mark' to."¹² It is very unlikely that anyone will sue these auditors as they are, since Enron,

too hedged around for litigation to be successful, but that does not relieve them of culpability. The fact that no firm of auditors pointed out the absence of imperial clothing indicates that the problem was systemic rather than attributable to any particular firm.

Whatever blame can be attributed to banks, credit agencies, auditors and the general public individually, it is clear that the problems relate to the financial market as a whole. We should therefore look to the tri-partite regulatory regime governing the financial sector and the economy. Collectively, they must bear overall responsibility for the collapse. We take the Treasury, the FSA and the Bank of England in turn.

The Treasury

One can argue that the whole financial structure, created by the Treasury in 1997, is responsible for the UK causes and consequences of the financial crisis being worse than those in other countries, notably other parts of the EU. A financial structure should be judged by results and especially its ability to weather a financial storm.

Culpability is implied by the UK Government's readiness to bail out investors in Icelandic banking groups. One does not pay out vast sums without implying some degree of liability. Few investors understood that the UK companies in which they were investing were excluded from the UK supervisory system, because they were subsidiaries of Icelandic groups. The cynics would say that it would have made no difference if they had been but the point is that the financial regulatory structure was patchy, unclear and ill-understood.

Furthermore, when individual banks are in trouble, like Northern Rock, it is unclear whether the primary responsibility for the preservation of financial stability lies with the FSA or with the Bank of England. In addition to this, the Bank of England claimed that it was unable to act due to conflicts with EU regulations which had been accepted by the Treasury. As senior member of the tri-partite regulatory regime, the Treasury should have made the rules clear and ensured they were followed. Banks should have been effectively supervised and not allowed to trade themselves into either insolvency or illiquidity.

More widely, the accumulating bubble fuelled by the public over-borrowing, riskily and only partially supported by property values, should have been apparent to the Treasury. The figures were published and compared with other countries, notably in the EU. Either the Treasury were incompetent or they were turning a blind eye to uncomfortable realities for political reasons.

The FSA

The role of the FSA is closely bound up with that of regulation. The FSA is largely responsible for introducing regulation and monitoring compliance. They have done this with box ticking and occasional retrospective fines when complaints have revealed misdemeanours. Where they have conspicuously failed, influenced by their ignorance of the markets they were supposed to be policing, is, as mentioned above, in ensuring that the banks' business models were sustainable. They have lacked foresight, oversight and every other kind of sight except hindsight. Their approach is legalistic rather than empirical, and looks backwards rather than anticipating the likely consequences of current practice.

In a sense, the FSA is so wrapped up in its own red tape that it is impotent. The more regulations there are, the more the FSA has to focus on box ticking and compliance.

Bank of England

When banks collectively are in trouble, as was the case in 2007/8, then the problem is "systemic" and responsibility clearly lies with the Bank of England. The Bank has two responsibilities: monetary and financial stability. For the second objective, the Bank's website suggests "Financial stability entails detecting and reducing threats to the financial system as a whole. Such threats are detected through the Bank's surveillance and market intelligence functions. They are reduced by strengthening infrastructure, and by financial and other operations."¹³ The FSA website confirms that "systemic" responsibility lies with the Bank of England.

It seems likely that the Bank has been so preoccupied with its first objective that it gave insufficient attention to the second. Note that there is a major difference between bank failure at the individual and systemic levels. If a single bank collapses but

the others are healthy, the other banks can absorb the shock without government intervention. If the other banks are similarly placed, or unhealthy, or the collapsing bank's problems are beyond the market resources, then the problem is systemic. And if it gets to that stage, the Bank of England has failed.

The Bank's preoccupation with inflation and interest rates may also have been misleading because the increase in property values was excluded from their index. Interest rates were too low to prevent the property part of the bubble expanding. In retrospect, critics of the then Chancellor's decision in 2003 to replace the RPIX target (which includes property prices) with a CPI target (which doesn't) have been proven to be correct.

Given the wide spread of contributing factors from banks, credit agencies, auditors, the Treasury and the FSA, it may seem unfair to point the finger particularly at the Bank of England. But the cold fact remains that their second responsibility, alongside monetary stability, is the stability and viability of the financial sector as a whole. In this they have visibly failed.

Blame, however, is not necessarily constructive and we should now look forward to the changes that should be put in hand.

What changes now should be made?

Greater transparency?

Conventional wisdom suggests that the problems triggered by the financial crisis would have been reduced with more transparency. Like regulation in general, this seems to be more a matter of faith than evidence. The 20th century certainly saw a considerable increase in transparency from the first mandatory publication of balance sheets in 1906 onwards. But almost all that transparency related to reporting the past, e.g. what was done and what were the results. Most would argue that such transparency has been helpful. For example, the publication of directors' remuneration is usually the first thing small shareholders turn to.

Some now argue that transparency should include future intentions and outcomes. The trouble is that directors do not know their future intentions, still less the outcomes.

They know their present intentions but they may be different tomorrow and certainly different by the time of publication. In a competitive market, directors cannot undermine their marketing by transparency any more than generals can tell opposing commanders what their battle tactics will be.

In any case, how would public exposure really help? The only people who need such information are those charged with policing the market: the Bank of England and the FSA. They can already obtain all the information they need through confidential discussions with the financial institutions.

More regulation?

The main conclusion from this paper is that regulation, or the alleged lack thereof, was indirectly to blame for the crisis through providing the illusion of control and involving banks and the FSA in endless detailed matters that distracted them from the big picture. Furthermore, regulation of conventional financial services drove banks into unknown areas, notably the use of financial packages, securitization and complex derivatives, which ultimately proved unsafe.

On this evidence it seems extremely unlikely that improving regulation can provide more than modest help in future. Of far greater importance is that the Bank of England, the FSA and credit agencies should do the jobs they are supposed to do. Individuals are already well rewarded with bonuses and honours when they do their jobs well, and that should now be balanced by personal sanctions when they fail. Corporate fines, especially in the case of publicly owned companies are simply passed on to consumers and taxpayers. Bonuses in principle are needed to offset the organisation's natural tendency toward risk avoidance and are balanced by the risk of employment loss. The FSA is to be commended for making executive changes, albeit slowly and under pressure, following the Northern Rock failure. At top levels, however, it is grossly inequitable for thousands of low paid workers to lose their jobs and pension rights when the executives who caused the corporate failure to enjoy comfortable retirement with the bonuses paid out during the years of malpractice and full pension rights.

Other recommendations

Beside that the above, some structural, but not regulatory, modifications should be put in place. The following are suggested as an initial list for debate:

1. At present, as the Northern Rock case showed, responsibilities for policing the market at the individual bank level are unclear. The existing division of responsibilities between the Treasury, FSA and Bank of England is unsatisfactory; the borders need to fit together, to be coherent and clear.
2. Assuming, as seems likely, the FSA is not abolished, then responsibility at the individual bank level should be clearly given to the FSA, leaving systemic responsibility with the Bank of England. To revert to the Bank undertaking this role would involve, in effect, three sets of "auditors" for each financial institution: their regular auditors of the accounts, the FSA (for compliance) and the Bank (for financial viability). This would be excessive. Accordingly, the FSA should report any concerns with individual institutional viability immediately to the Bank so that the Bank can build up a systemic picture. Obviously, any relevant information gained by the Bank at the individual level should also be relayed to the FSA.
3. The first objective of the FSA should be changed from "maintaining confidence in the financial system" to "ensuring that the financial system is worthy of confidence". And that responsibility passed to the Bank of England as part of its systemic role.
4. Where the FSA, as a result of confidential discussions with a bank, considers that it is still heading for the rocks, i.e. seems likely to become insolvent or illiquid, its misgivings should be shared with the credit rating agencies who may, of course, take a different view.
5. The FSA's legalistic, pedantic view of regulation should be replaced by "oversight", i.e. monitoring the business as a whole. Traditional markets had few regulations but wide latitude for the market supervisor to step in quickly to deal with malpractice, or dubious practice.

And the trader had similar latitude to move his pitch to a more suitable market. It is not obvious that replacing separate supervisors of specific financial services markets by a single, monolithic, and arguably too-big-for-its-own-good, FSA has been beneficial.

6. The Bank of England, or the FSA keeping the Bank informed, should review the audits of the major banks and those financial institutions which the FSA highlights as having potentially non-viable business practices.
7. Similarly, the Bank of England, or the FSA keeping the Bank informed, should review the validity of credit ratings for banks. To a greater extent, credit agencies should base ratings on current and prospective data. Where ratings are not in accordance with the information available to the Bank/FSA, the agencies should be called in for discussion of the methods and conclusions.
8. Subsidiaries of foreign companies, and foreign credit rating agencies, should be regarded as wholly British companies for the purpose of regulation, control and oversight. Where foreign companies are directly trading in the UK, i.e. without UK subsidiaries, all their communications should carry warning labels to the effect that they do not come under UK supervision. Such warnings would allow the consumer of financial products to exercise an informed choice.

Conclusion

Let us conclude with a metaphor from another kind of regulation: street signage. Some have been suggesting that street signage, barriers, road markings and the like are so excessive as to be counter-productive. One cannot regulate drivers into driving well but one can distract them from driving well. When all the street signage was swept away in Kensington High Street, the traffic flowed better, pedestrians could move more easily and accidents reduced.

This seems likely to apply to financial regulation. Yes, we need some, but the primary focus should be on individuals doing the jobs they are paid to do. We should recognise that the collapse was primarily the fault of a dysfunctional tri-partite regulatory regime, and particularly the Bank of England within that. We should reform their roles and ensure they carry them out. It may prove beneficial for the National Audit Office to monitor that performance.

End Notes

¹ See Dr Eamonn Butler, "Don't knock the system: politics caused this crisis of capitalism," *The Scotsman*, 6 October 2008 and Dennis Sewell, "Clinton democrats are to blame for the credit-crunch," *Spectator*, 4 October 2008, p.14. Similar social pressures, though less regulated in the UK, for the less affluent to get onto the property ladder fuelled by the expectation of ever rising property prices above inflation.

² "Banks" will be used as a term for all financial institutions whether banks or not.

³ Irwin Stelzer, "The Tory quest for a fiscal Holy Grail is doomed," *Spectator*, 8 November 2008, p.22

⁴ Miles Costello, *The Times*, Thursday October 16, 2008, p.40

⁵ FSA website accessed 23 October 2008

⁶ *Marketing Magazine*, 22 October 2008, p.4

⁷ Geoff Booth & Elias Mazzawi "Black Swan or Fat Turkey", *Business Strategy Review*, Autumn 2008 (19, 3), pp.35-39

⁸ Jimmy Burns "MPs attack Home Office for its 'spectacular' accounting failure," *Financial Times*, 1 February, 2006

⁹ BBC Today programme, 5 November 2008

¹⁰ Gretchen Morgenson "Credit Rating Agency Heads Grilled by Lawmakers," *New York Times*, 23 October 2008

¹¹ Aoife White "EU clamps down on credit rating agencies," *Associated Press*, 13 November 2008.

Nikki Tait "Brussels set to clamp down on ratings agencies," *Financial Times*, 13 November 2008

¹² Beth Holmes and Penny Sukhraj "The Blame Game," *Accountancy*, November 2008, p.25

¹³ <http://www.bankofengland.co.uk/about/corepurposes/index.htm> accessed 26th October 2008

