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Responding to the Global Credit Crisis: The Politics of Financial Reform[1]

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This financial crisis emerged from an over-supply of financial innovation and an under-supply of financial regulation within the core advanced economies. Financial governance reform can focus on behaviour, acknowledge systemic implications and inherent limitations, and strive for more representation and accountability.

Keywords: credit crisis; financial reform; regulatory capture; booms

I. Sources of the Crisis

Permissive Regulation and Shadow Banking

This financial crisis emerged from an over-supply of financial innovation and an under-supply of financial regulation within the core economies of the Organisation for Economic Co-operation and Development (OECD). It differs from those of the 1990s as it originated within the beating heart of finance capitalism, the United States, rather than within emerging market or transition economies. As such, the sources of the crisis differ significantly from those of the 1990s associated with capital flight, currency mismatches in carry trade activities, or hedge fund mania. While some of those elements have been present in the current crisis, a key difference is the extent to which financial innovation and pro-cyclical lending blossomed in an environment of permissive regulation within the US and other, primarily anglophone, economies. For quite some time the US institutional environment for financial innovation, most notably investment techniques and schemes related to securitisation—the pooling of income streams from financial assets into a security for sale to investors—permitted a recycling of capital that simply made money work much harder. This was only the case, however, if the bulk of underlying assets within securitised pools continued to appreciate. The crisis emerged from the disappointment in expectations of endlessly rising residential and commercial property prices. Bank collapses have occurred in many advanced economies that enabled mortgage securitisation within their financial systems while also relaxing access to credit for those previously considered to be less creditworthy (Schwartz and Seabrooke 2009). In Australia, the United Kingdom, Denmark, Spain and Ireland, double-digit increases in real housing prices during some years within the 2002–05 period led to significant increases in personal indebtedness (Girouard et al. 2006). Compared to these economies, the US experience does not appear unusual. The difference in the US case is its sheer scale and

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the links to the international financial system, including its capacity to bring in significant amounts of foreign investment.

Within the US case, the role of housing markets was critical to the development of securitisation as the relative cost of credit for housing has gone down for some two decades. The role of government-sponsored enterprises, such as Fannie Mae and Freddie Mac, effectively quasi-public institutions until their placement under 'conservatorship', was important in providing institutional integrity to the system and gaining the confidence of domestic and international investors. In the 1990s Freddie and Fannie (along with Ginnie Mae, the oft-forgotten 'sibling') used mortgage securitisation to help the US achieve new levels of homeownership. However, the combination of increasing house prices and low real wage growth led to the exclusion of many potential homeowners from qualifying for 'prime' loans that were the bread and butter of Fannie and Freddie's business. Instead, under the Bush administration, a 'sub-prime' market flourished in an extremely permissive regulatory environment where banks were under less scrutiny and where non-bank financial institutions (NBFIs, or 'non-banks'), including brokers and insurance companies, aggressively entered the market. The prominence of non-banks within the US financial system for mortgage lending, combined with financial innovations in debt markets, created a 'shadow banking' system in which borrowing short term and investing long term became increasingly commonplace. Given that non-banks are generally non-depository financial institutions that range from pawnbrokers to casinos to insurance companies, their regulation is haphazard and know-your-customer information weak. As lending became more risky and the use of different schemes associated with mortgage securitisation more prominent, such as the combination of structured investment vehicles to borrow in short-term markets to invest in long-term mortgage-backed securities and collateralised debt obligations, the conditions for this financial crisis were established. Under these conditions not only was know-your-customer information weak, but there were positive incentives to avoid knowing. Put simply, the growth of shadow banking (a term coined by Paul McCulley from the investment firm PIMCO) permitted the expansion of liabilities considered equivalent to bank deposits, but without the regulatory oversight or capital adequacy requirements imposed upon conventional banks by national authorities and international agreements.

Where Did the Money Come From? Where Did it Go?

Why did investors choose to place their trust in US markets for mortgage-backed securities? While in retrospect this may appear short-sighted, at the time the long period of growth and the historically low rate of default on home loans helped support foreign investment. Investors were attracted to relatively high returns in the long-term debt securities markets that received highly favourable credit ratings from agencies such as Moody's and Standard and Poor's. Foreign investment into these markets differs strongly from the 'agency' market, supported by the 'siblings', and the purely private market where sub-prime played an important role. In the agency market, where one third of investment is foreign, the dominant investors are China and Japan. In the quasi-public market, given the implicit—and then explicit—government support for the siblings, investment stimulated housing

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growth which then fuelled Chinese exports (and the so-called 'Wal-Mart effect'). In the private market the dominant investors are the Cayman Islands and the United Kingdom, through which US and European structured investment vehicles were extremely active and much more risk friendly in how they invested.

Given that information opacity has been identified as a key source of tension in this crisis, not least because it inhibits trust within the marketplace, thus exacerbating liquidity problems, who is viewed as the holder of genuine information is an obvious concern. The role of credit rating agencies in failing to identify the sources of the crisis, in particular, has been extensively discussed and criticised. The attention given to rating agencies, including by international institutions, may, in part, be a consequence of how the latter had been ignored prior to the crisis while rating agencies had risen in prominence. Certainly the Bank for International Settlements, for example, identified clear cracks in the US and international financial systems prior to the crisis (BIS 2003, 151). The OECD also pointed to how property booms within various systems had extended far beyond a regular business cycle and were unsustainable. The rating agencies' status within the US system as 'Nationally Recognised Statistical Rating Organisations' arguably provided them with a status of being quasi- but pro-market regulators. The spread of securitisation greatly assisted the ratings agencies' influence within the US financial system as a source of independent evaluation. More importantly, the Basel II accord, developed under the auspices of the Basel Committee, included 'External Credit Assessment Institutions' status that piggy-backed on the US recognition of agencies and further legitimated their role in international finance without considering how biased their evaluations were towards pro-cyclicality (Abdelal 2007, 194). In the end, the prominence of ratings agencies as a source of evaluation has been questioned by regulators and investors, who have lost a great deal of trust, or perhaps faith, in them. Such questioning may also reinforce distinct types of credit assessment and prudential regulation that are informed more by national and regional concerns.

Distinct types of financial system fuelled the crisis in different ways—a point often overlooked in discussions of international financial reform, which tend to look at banking systems or derivatives markets. In particular, the role of non-banks in the US case stands out when compared to other advanced economies. In 2005 around a quarter of outstanding loans to the household sector had been issued by non-banks, much more than the closest contender (Canada at around 16 per cent) and distinct from European countries where non-banks have a minor or insignificant presence (IMF 2008, 3). As we know now, the securitisation of income streams tied to borrowers with poor credit histories and with loans that could only be serviced during the economic boom left a raft of investors exposed. The increasing number of borrowers who could not, or chose not to, qualify under Fannie, Freddie and Ginnie conditions led to explosive growth in sub-prime markets after 2003 which also fed on non-bank lending. The securitised assets that followed this growth often contained loans of various creditworthiness grades, muddying their assessment (Schwartz 2009). As such, financial institutions that had used structured investment vehicles in short-term markets to buy long-term mortgage-backed securities and similar financial instruments became increasingly uncertain about the value of the assets supporting the securities. The lack of information on non-banks made matters worse. In such an environment of permissive regulation and opaque

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information, when sub-prime foreclosures doubled from 5 to 10 per cent between late 2006 and late 2007 the crisis began in earnest as a crisis of how to evaluate assets. For non-US regulators, the above characteristics also made the crisis appear especially American in origin and contagion.

II. Responses to the Crisis

Despite the presence of dense trans-governmental policy networks and institutions to oversee the international financial architecture, governments did not respond to bank failures and system-wide credit market turmoil with one voice. In the first phase of the crisis, up to the summer of 2008, responses by national authorities were twofold. The first type of response was a case-by-case approach to the predicaments of individual institutions, such as the bail-out and eventual nationalisation of Northern Rock in the UK, the Fed-supported buyout of Bear Stearns by JPMorgan Chase in the US and the bail-outs of Sachsen LB and IKB in Germany. The second type of response was in a systemic context, wherein central banks injected liquidity and key standard fora, such as the Financial Stability Forum, produced recommendations on 'Enhancing Market and Institutional Resilience' (FSF 2008). The industry itself exhibited some humility with the publication of an Institute of International Finance report on market best practice which focused on risk management but also questions of executive pay and the role of credit rating agencies (IIF 2008).

Policy responses intensified in what can be seen as the second phase of the crisis, from September 2008, and were framed in explicit systemic terms. Bail-outs and takeovers were orchestrated, with the significant exception of the case of Lehman Brothers which underlined the difficulty of teaching market discipline amid a crisis. Cross-border co-operation was shown to work, as seen initially in the cases of Fortis and Dexia and the involvement of Benelux and French authorities, or fail, most notably in British, Dutch and Icelandic disagreements in the aftermath of the near failure and subsequent nationalisation of Landsbanki. The business model of investment banking itself was put into question, with Morgan Stanley and Goldman Sachs becoming commercial banks. Importantly, specific rescue plans were put in place, both in the US and Europe, making funding available to troubled institutions, or allowing for state-guaranteed lending, recapitalisation and the possibility of part-nationalisation. Restoring confidence in the system, in terms of ensuring liquidity, safeguarding large institutions and insuring deposits became the order of the day. At the same time, discussions of the effects of the crisis on the real economy, including welfare effects, became more central to analyses as the use of taxpayer funds was explained and justified, and the spectre of recession in many industrialised countries called for renewed attention to the links between financial stability and monetary policy and the wider role of central banks.

At the global level, the focus shifted to co-ordination and a (re)discovery of the institutions and fora available for managing crises and debating reform of the system. High expectations have been attached to the activities of the G20, the group bringing together large advanced and emerging economies, the role of the Financial Stability Board (formerly the Financial Stability Forum) was upgraded and the

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International Monetary Fund saw renewed interest in its activities and resources. Other standard-setting bodies such as the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions expanded their memberships, and have been producing technical advice and adjusting regulatory principles to remedy failings exposed by the crisis.

Focusing on Europe more specifically, several observations can be made. During the first phase of the crisis, the European response was characterised by complacency, with emphasis on the US as both the source and the key 'loser' in the crisis; the 'regional' experience of the UK and Switzerland as primarily affected within the European context pointed to the crisis as one of structured finance where less involved institutions would be immune. In practice, European authorities were slow to grasp the interconnectedness within the system and the effects on confidence. They were also slow to note that the types of lending and investment characterised as reckless within the US system were also undertaken by many of their own banks, explaining away problems experienced by European institutions in terms of incompetence.

Thereafter, the response to the crisis became an affair of states. There was little EU initiative and only limited early co-ordination among regulators and supervisors and, despite the crisis unfolding for over a year, the role of financial stability teams was marginal. Furthermore, the more co-ordinated action from October 2008 developed in extreme crisis conditions and under the auspices of key states (France and the UK), with EU-specific mechanisms and institutions acting as bystanders or nominally representing smaller states. Many pointed to the importance of key state leadership and questioned whether many of the EU's 27 members would have had the capacity to co-ordinate a response had they been in France's place as holder of the EU presidency at that time. This calls attention to three important characteristics of the EU financial system: (i) the possibility of disunity, as exhibited by much unilateral action with respect to deposit insurance (by Ireland, Greece, but also Germany) and the inherent incentives for 'beggar-thy-neighbour' policies when tensions between domestic politics and crisis management arise; (ii) the lack of formal EU competence in both financial regulatory issues and in terms of cross-border resolution, liquidation and burden-sharing; and (iii) important governance gaps at the EU level in linking up the European Central Bank and its functions with broader financial stability considerations in the euro area and beyond and, also, the role of the European Central Bank as a potential regional lender of last resort, as exemplified by the Hungarian liquidity deal of October 2008. More broadly, the European Commission remained one voice among many in the management of the crisis.

Having exposed the weaknesses of cross-border arrangements, the crisis pressed EU leaders to reconsider supervisory responsibilities. A specially appointed group chaired by Jacques de Larosière advocated in a report (High Level Group on Financial Supervision in the EU 2009) a series of steps to a less schizophrenic European approach, including co-ordination on systemic issues through the European Systemic Risk Council (under the aegis of the European Central Bank) and the establishment of 'colleges of supervisors'. These measures are intended to bring much missed co-ordination and consistency in the oversight of large European

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financial institutions and have been positively met by the private sector. It is widely acknowledged that the crisis offered an opportunity for consolidated supervision of cross-border institutions within the Eurozone in particular and a likely end to the contradictions arising from a single currency and cross-border banking system on the one hand and a nationally fragmented supervisory environment on the other. Early Europe-wide consensus was enshrined in the de Larosière report but concrete agreement has been less strong. This could yet limit the ability of the EU to provide an alternative coherent regulatory framework for financial activity.

III. Next Steps and Obstacles for Improved Financial Governance[2]

This financial crisis, as with most previous ones, emerged due to a combination of factors both at the micro and the macro level. The provision of credit to borrowers in the US and elsewhere was often reckless. But that credit boom would not have been possible, at least not to the same extent, if foreign capital had not flowed into the US, Iceland and other countries with large, persistent current account deficits. But while reform of financial governance needs to address both the micro and the macro levels, we judge it important that reform efforts focus on behaviour, not instruments, take systemic implications seriously, acknowledge the inherent limitations in the politics of reform and strive for a more representative and accountable global financial governance framework. A plethora of reform proposals have been put forward over the past 18 months,[3] some focusing on governance issues and some on more technical aspects, some produced by official bodies and others by financial experts or academics, some narrowly national or regional and others encompassing global recommendations. Below, we outline certain areas that we believe merit special attention.

Reform Areas

It would be naïve to believe that financial crises can be prevented; they can however, become less frequent, less deep, less systemic and less detrimental to the real economy.

Micro and Macro-Prudential Regulation. Pursuing more regulation for regulation's sake appears counterproductive. What is needed is better, more focused regulation. Debates on the right balance between micro-prudential regulation, targeting individual institutions and instruments, and macro-prudential regulation of the financial system are relevant in this context. Macro-prudential regulation recognises the risks to the entire financial system posed by the collective behaviour of financial institutions across the credit cycle; the mismatch between risk-taking and risk capacity within the financial system and the failure of highly interconnected firms. The crisis exposed existing risk management methods as faulty as, in striving to make themselves safer, banks, and other highly leveraged financial institutions, behaved in a way that collectively undermined the system. Macro-prudential regulation addresses this.

The Credit Cycle and Counter-Cyclical Regulation. Crashes are not random; rather, they follow booms. The degree to which the credit cycle is a source of endogenous

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risk relates to the degree to which valuation, risk assessment and behaviour are driven by market prices, as was the case in the run-up to the crisis. This came as a result of mark-to-market valuation of assets but also the development of regulation that encouraged market-based measures of risk for capital requirements, such as credit default swap spreads in internal credit models or price volatility in market risk models; or as a result of external credit ratings, which have tended to be correlated, directionally at least, with market prices. It is also important to enable regulators to get tougher with the financial sector during a boom and handle an unsustainable credit binge that needs reversing. For political reasons, supervisory discretion alone is unlikely to allow this and thus a rules-based framework would be more appropriate.

Risk Allocation. Risk comes in several forms; there are credit, liquidity and market risks, for instance, and different parts of the financial system have different capacities to hedge each type of risk. The notion that there are 'safe' instruments to be promoted and 'risky' ones to be banned creates a false sense of security; instead, what matters is the risk inherent in behaviour. To this end capital requirements need to be sensitive to an institution's capacity to hedge the kinds of risks it holds. To make the financial system safer is to encourage each type of risk to flow to where there is a capacity to hold it, differentiating between banks, insurers or pension funds.

Systemically Important Institutions. The financial crisis highlighted the special role that financial institutions play and are seen to play within economies. Focus, in particular, has been placed on the systemic importance of particular institutions (banks or otherwise), citing size and interconnectedness as key factors making them 'too big to fail'. Crisis management has, if anything, produced more of those institutions. Consolidation within the financial industry has created, in some cases, even greater financial conglomerates, while reform proposals have been mostly timid on the issue. By opting to support bail-outs and buyouts, financially and politically, state authorities have put themselves in a position where their regulatory credibility has been seriously challenged, and the finances of the state significantly affected. A more appropriate risk allocation would go some way towards allowing both regulatory standards and financial innovation to develop in a context that does not privilege large financial conglomerates alone.

A Revised International Framework. For years, OECD countries showed remarkable complacency with respect to the reform of the international financial architecture. Financial crises have been happening elsewhere, and policy-makers in industrialised countries saw little, if any, need to consider reform processes. This situation has now clearly changed. At the same time, the crisis exposed the lack of a credible and legitimate institution that could provide a noticeable early warning system, guidance, crisis management and authority. And while many discussions have in the past focused on reforming the Bretton Woods institutions and, more recently, much has been made of the role of the G20, a reformed Financial Stability Board (FSB) is the most obvious candidate to be at the centre of international co-operation.

Many of the FSB's mandated functions are key in this respect: conducting early warning exercises; assessing vulnerabilities in the financial system; promoting

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co-ordination and information exchange among financial stability authorities; monitoring and advising on market developments and their implications for regulatory policy, as well as on best practice in meeting regulatory standards. FSB members are also required to commit to peer review and to some broad principles such as the pursuit of the maintenance of financial stability and the enhancement of the openness and transparency of the financial sector. They have also agreed to implement some key existing international financial standards. To be truly effective in fostering information exchange, capacity-building and principles-based regulatory co-ordination, however, the accountability of the FSB would need to be further widened. This has potential membership implications (there is no representation for the poorest nations in the world or, indeed, small- and medium-economy countries) and also requires a clearer formal accountability or reporting mechanism to a more universal institution (which may imply an IMF-style constituency system). Such a mechanism would also ensure a greater degree of policy coherence in the standards promoted across the board by relevant financial and economic institutions.

The Politics of Reform

Diverging Interests: Is There a Consensus on What a New Regime Should Look Like? The financial crisis has not wiped out specific interests of individual countries. It is naïve to assume that as a consequence of the current turmoil, governments in the OECD and beyond have suddenly developed a consensus on what to do. Recent activism suggests merely that many governments agree on the need to do something. It may, for example, be unrealistic to expect the US to agree to a comprehensive re-regulation of financial markets. A brief look at recent US economic history reveals a strong resilience of those in favour of the regulatory status quo. The close connection between Wall Street, the US Federal Reserve and the US government has been criticised many times, without resulting in any substantial change. In 1998, the American trade economist Jagdish Bhagwati criticised the 'Wall Street Treasury Complex' (Bhagwati 1998). Despite some support for Bhagwati, policies in the US remained unchanged. Unless a structural change occurs that severs these long-established links, any hopes for a significant reversal of US financial regulatory policy are premature. The extent to which the crisis has opened the way for broader acceptance of reform within the public and private sectors alike remains to be seen. Taking a more global view, it is also apparent that though regulatory reforms are under way, the reforms advanced are more about tweaking the system than changing it in a substantial fashion. Reform ideas are originating from the same governance networks in charge prior to the crisis and this supply of reform ideas is defining what is possible in terms of reform recommendations and policy implementation (Tsingou 2010). This is not to underestimate the space that has indeed opened up for a more critical analysis of the existing financial governance framework and practices, but to point out that with the urgency of the response receding, policy ideas are generated and promoted in increasingly technical terms and it is the same practitioners of finance that are setting the parameters of what is possible and appropriate.

Closing the Loopholes. One of the most important questions in the debate on future financial governance concerns the handling of potential stumbling blocks. This

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relates to the role of offshore financial centres but also concerns OECD countries, especially the US. There is no guarantee that the US will be interested in enacting substantial reform. In such a scenario, does the rest of the world have policy options about pursuing a new multilateral regime for international finance without US support? The importance of the financial sector for the US economy and the reluctance of US policy-makers to re-regulate after previous crises suggest a cautious approach.

Regulatory Capture. Political economy issues are seldom discussed alongside the legal and technical 'nuts and bolts' of financial regulation, but in practice they cannot be separated. One way to understand the current approach to banking regulation is to consider that regulatory capture by large banks as a key feature of the existing approach to regulation was of disproportionate benefit to them, in particular capture of an intellectual nature. Such capture was helped by the emergent view that public agencies ought to be independent of politics. As part of this process, a policy role for the private sector was legitimised. Intellectual capture, in turn, also relates to the 'groupthink' that has taken hold in the making of financial policy. Regulatory and supervisory arrangements are discussed and agreed in expert and apolitical terms, bringing like-minded individuals who, whether in the official, private or academic sphere, can reach common understandings based on shared training, practice and access to economic ideas. Both in the national arena and, increasingly, in the international fora around the Basel process, such networks are technocratic, informal, politically unaccountable and have a narrowly defined understanding of financial policy. They are also often decoupled from other economic considerations or broader questions about the role of finance.

It is important to break 'groupthink' and introduce new voices and interests to debates about financial regulation. Hence, reform efforts cannot be about the formal structure of policy-making arrangements alone—beyond the memberships of committees and institutions, the informal and intellectual dimension of governance and capture needs to be addressed.

The Politics of Booms. As discussed above, regulators and supervisors find it difficult to act decisively during a boom as a result of political pressure. In the middle of a boom, it is in no one's political interests to stop it. Politicians want the boom to last until the next election and the early phase of the boom, when it is best brought to a halt, has the characteristic of robust economic growth with low inflation. Policy-makers misinterpret this as a sign that they have earned policy credibility and do not wish to suggest otherwise or do something that might change the character of the environment. In this context, supervisors may not so easily refer to an unsustainable credit binge.

Right-Sizing Finance. One final, but important, consideration is the size of the financial sector. Large or mid-sized economies like the US, the UK or Switzerland are deriving 20 per cent or so of their GNP from financial sector activities, when finance, like law and accounting, should be about facilitating economic investment. A large financial sector is fed by short-term activity and can draw interest away from the long-term savings and investment that are vital for the prosperity of households and economies. In crashes the negative externalities from a large financial sector are even worse and can destabilise the economy. A large financial

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sector may exert too much political influence on the bail-out and such a bail-out may be so large as to force governments to slash discretionary spending, disproportionately impacting those most vulnerable. Some voices are now being heard in the public sector about what might be an appropriate size of the financial sector (Haldane 2009) but overall proposals are timid.

IV. Conclusion

In this piece, we have analysed the development of the crisis, the response with a special stress on Europe, potential remedies and obstacles. Against this background, any debate on future financial reform will have to be based on an analysis of policy options in which questions of power politics are placed upfront. Discussions of international financial architecture must be tempered by considerations of political will. Susan Strange reminded us 25 years ago in *Casino Capitalism* of what key interests lie behind practical international financial reform:

> The only alternative to an international authority is a national one. The only national authority in any sort of position to influence the behaviour of major banks and financial institutions, and to set rules governing the major markets for credit, is that of the United States (Strange 1986, 165).

The chance of a serious institutional overhaul under the Obama administration is far from certain and piecemeal national responses may yet take precedence over internationally co-ordinated action. This is especially the case in the absence of a single European voice. Curbing financial excesses may be relatively easy in the short and medium term as national authorities assert themselves, but the ongoing challenge is to develop a regime that will be stable enough once the appetite for risk re-emerges.

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Notes

1. This piece revises previous work on responses to the crisis, published as a policy brief in the context of the EU-funded project 'Global Governance, Regionalisation and Regulation: The Role of the EU' (GARNET Policy Brief no. 8—co-authored with Heribert Dieter).
2. This section draws extensively on the work of the Warwick Commission on International Financial Reform (2009) on which the authors served as Director of Studies and Commissioner, respectively.
3. These include the FSF report on broad standards and the IIF report covering market practices, but also reports by the Counterparty Risk Management Policy Group (a private sector initiative on market practices and systemic risk), the Group of Thirty (an independent report on financial stability), the Geneva Report (a technical expert report on financial regulation), the report of the High Level Group on Financial Supervision in the European Union (known as the de Larosière report) and the Turner Review (produced under the auspices of the UK Financial Services Authority). To these assessments and recommendations have been added several formal pronouncements, as in the context of the G20, as well as guidance documents by existing standard-setting bodies.

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