# Banking on Recovery

## Towards an accountable, stable financial sector

Forrest Capie
Geoffrey Wood
Richard Roberts
Kent Matthews
David B. Smith
Melanie Powell
Eugene Michaels
Syed Kamall
John McFall
Gerard Lyons

Edited by
Sheila Lawlor

**POLITEIA**

A FORUM FOR SOCIAL AND ECONOMIC THINKING

# POLITEIA

## A Forum for Social and Economic Thinking

Politeia commissions and publishes discussions by specialists about social and economic ideas and policies. It aims to encourage public discussion on the relationship between the state and the people. Its aim is not to influence people to support any given political party, candidates for election, or position in a referendum, but to inform public discussion of policy.

The forum is independently funded, and the publications do not express a corporate opinion, but the views of their individual authors.

**www.politeia.co.uk**

# Banking on Recovery

## Towards an accountable, stable financial sector

Forrest Capie
Geoffrey Wood
Richard Roberts
Kent Matthews
David B. Smith
Melanie Powell
Eugene Michaels
Syed Kamall
John McFall
Gerard Lyons

Edited by
Sheila Lawlor

**POLITEIA**

2016

First published in 2016
by
Politeia
33 Catherine Place
London SW1E 6DY
Tel. 0207 799 5034

E-mail: info@politeia.co.uk
Website: www.politeia.co.uk



ISBN 978-0-9564662-8-0

Cover design by John Marenbon

Politeia gratefully acknowledges support for this publication from

**Foundation for Social and Economic Thinking (FSET)**

Printed in Great Britain by:
Blisset Bookbinders
Roslin Road
Acton, London
W3 8DH

## THE AUTHORS

**Forrest Capie** is Professor Emeritus of Economic History at the Cass Business School City University and was editor of the Economic History Review between 1993-1999. His recent publications include *Monetary History of the UK* (Routledge, 2015) and The *Bank of England, 1950s to 1979* (Cambridge, 2012).

**Geoffrey Wood** is Professor Emeritus of Economics at the Cass Business School City University and of Monetary Economics at the University of Buckingham. He has served as a Special Advisor on Financial Stability at the Bank of England for the decade to 2004. Recent publications include *Monetary Unions: Theory, History, Public Choice*, with Forrest Capie (London, 2014).

**Richard Roberts** is Professor of Contemporary Financial History at King's College London and Director of the Institute of Contemporary British History. He specialises in financial and economic history. He recently co-authored, with Kynaston, D., *The Lion Wakes: A Modern History of HSBC* (Profile, 2015).

**Kent Matthews** is Professor of Banking and Finance at Cardiff University. His interests include macroeconomic modelling, monetary and credit influences on the economy and money and banking deregulation in developing economies. He publishes on bank competitiveness and performance covering the UK, GCC, Malaysia, China and Jamaica bank markets.

**David B Smith**'s work as an economist has been predominantly as a City economist in banks and security houses after which he was Visiting Professor at the Derby Business School. His publications include *Living with Leviathan: Public Spending, Taxes and Economic Performance* (IEA, 2006) and *Crisis Management? How British Banks Should Face the Future* (Politeia, 2009).

**Dr Eugene Michaels** is Senior Lecturer in Economics at Derby Business School. His work focuses on behavioural economics and its application to policymaking. He has co-authored with Melanie Powell *Behavioural economics: Using 'nudges' for promoting pro-environmental behaviours in the workplace* (forthcoming 2016).

**Dr Melanie Powell** is Senior Lecturer in the Derby Business School at the University of Derby. Her interests are in economics, behavioural economics and financial market behaviour. She has co-authored, with Matthews, K. and Parkin, M., *Economics*, 9th Edition (European, Pearson, 2014).

**John McFall (Baron McFall of Alcuith)** sits on the House of Lords EU Financial Affairs Sub-Committee having become a peer in 2010. He was Chairman of the House of Commons Treasury Select Committee (2001-10), MP for West Dunbartonshire (1987-2010) and subsequently served on the Parliamentary Commission on Banking Standards (2012-13).

**Dr Syed Kamall** has been an MEP for London since 2005 and has chaired the European Conservatives and Reformists group in the European Parliament since 2014. He sits on the Economic and Monetary Affairs and International Trade Committees in the European Parliament. He was a business economist before entering political life and is Visiting Fellow at Leeds University Business School. He has published on telecommunications policy.

**Dr Gerard Lyons** has been Chief Economic Advisor to Boris Johnson, the Mayor of London since 2013. He advises on economic and financial issues facing London. Before that he spent 27 years in senior roles in The City at Chase Manhattan, Swiss Bank, DKB and Standard Chartered. His publications include *The Europe Report: a Win-Win Situation* (2014), *London: The Global Powerhouse* (2016) and *The Consolations of Economics*, a Daily *Telegraph* Book of the Year, (paperback, Faber & Faber, 2015)**.**

**Dr Sheila Lawlor** is Director of Politeia and directs its economic and social policy programme. Her background is as an academic historian specialising in British 20th century history. For Politeia she has co-authored *The Financial Sector and the UK Economy: The Danger of Over-Regulation* (2013) and *Poverty or Prosperity: Tax, Public Spending and Economic Recovery* (2010)

# Contents

# Introduction: The Financial Crisis, the Banks and the Government's Response

Sheila Lawlor

The financial crisis of 2007/8 remains something of a mystery for many people. Why did it happen? Why did it come, apparently out of the blue? Or, as the Queen famously asked, 'Why did nobody notice it?'. Since the crisis politicians and economists have aimed to prevent another systemic failure of the financial sector affecting its different institutions - building societies, banks and the investment funds and services on which people and business rely. How they ask, can the adverse consequences for the whole economy and for people themselves, be avoided?

In Britain, the events which followed the run on the Northern Rock Building Society, including the failure of many high street 'brands', were seen as so serious that the then Labour government stepped in to bail out or recapitalize the troubled institutions, fearing the impact on the UK economy. On 8 October 2008 a rescue package of £500 billion in loans and guarantees was announced, of which £200bn would be made available for short term loans through the Bank of England's special liquidity scheme. A Bank Recapitalisation Fund was set up and HMG underwrote (temporarily) lending between British banks, guaranteeing a loan of £250 billion.

In this way, the government aimed to stabilize the system, restore confidence and provide short term loans and guarantees to back interbank lending. While Barclays, Standard Chartered and HSBC declined the public largesse, others, including the Royal Bank of Scotland Group and Lloyds/HBOS were major beneficiaries. The domestic taxpayers footed the bill, just as they would across Europe, from Ireland to Greece.

Thus, for the first time since the 1930s a financial crisis became the major focus for political activity and media interest. Since then, both causes and implications continue to be the subject of debate amongst politicians and economists. Politicians and the financial authorities are keen to prevent a recurrence, or at least to prevent a crisis on the same scale, an aim held in common with international regulatory authorities such as the EU and the Basel rules.

Pinpointing the most significant causes leading to the crisis has not been straightforward. Ministers, politicians from across the parties, parliamentary committees, officials, economists, financiers and voters all tend to emphasise different factors. Agreeing on a solution, therefore, was never going to be easy and the course for policy hardly clear.

There has, however, been a measure of agreement on the role of certain general factors. The system of overall governance and the management of individual institutions had suffered in the wake of the Bank of England Act 1998, which gave the Bank a new Charter and transferred the Bank's supervisory functions to the Financial Services Authority; the internal mechanisms for accountability at senior level within the industry and at individual institutions were lacking; the size of a number of banks led the authorities to believe that such institutions were 'too big to fail' on account of the dangers that might pose to the economy. It is also thought that the rewards to be won for certain activities had become disproportionate to risk, effort and longer-term success. Short-term remuneration systems geared round annual bonuses may also have clouded judgments about longer-term goals. The result was a climate of moral hazard – one which occurs when people take risks because others will be responsible for meeting the cost of the risk.

These and other factors played some part at a time of historically low interest rates over a long period. Some institutions and individuals succumbed to the temptation of engaging in high risk activities, 'high stakes' betting, without adequate levels of capital or reserves. Investment instruments became more and more complex* and mortgage backed securities including 'sub prime' mortgages are now seen to have triggered the crisis in the US. The trigger was the outward sign of an inwardly troubled status quo, one which had developed for a variety of reasons.

The authors of this volume analyse the significance of these and other factors leading to the 2007/8 crisis and consider their implications for policy. They consider whether the measures taken so far address the problems,

---

*Soon after the crisis, the former Governor of the Bank of England, Lord George, in referring to pinpoint where they have failed to do so and explain that in some cases the new regulations have made matters worse. The volume makes a number of proposals and recommendations for policy based on clear principles. If adopted by the authorities they would be good for people, good for the industry and good for the whole economy.

I

# The Old Lady of Threadneedle Street

## A good woman wronged

Forrest Capie and Geoffrey Wood

The latest financial crisis in Britain began in 2007. In the aftermath of that crisis there have been numerous enquiries and post mortems. In every one of these the Bank of England was criticised for its actions – sometimes those before, sometimes those during, sometimes those after – the crisis, and in some cases all three. The criticisms were well founded, but aimed in the wrong direction.

The behaviour of every individual and every company is influenced by institutions and laws. That is as true of the Bank of England's actions as it is of an individual deciding which side of the road to drive on according to which country he is in. The Bank of England's actions were heavily influenced by the setting and laws created by Gordon Brown when he was Chancellor of the Exchequer.

This short chapter argues that the Bank of England had learned in the nineteenth century how to deal with financial crises and indeed how to avoid them if they threatened. It learned the role of lender of last resort and it also learned techniques of crisis management. And while in the course of the twentieth century it may have forgotten some of the lessons and behaved in ways it should not have, the most important reason for its perceived failures in the recent crisis can be found in the regulatory framework within which it had to operate. That was framework introduced in 1998. The defects of this system are fully described below.

In the nineteenth century over the course of a number of financial crises the Bank of England learned and/or was cajoled by several commentators, notably Thornton, Joplin, and Bagehot into adopting the role of the lender of last resort. The essence of this role is that the principal issuer of the currency and central actor in the monetary system stands ready to supply the system with liquidity when needed. The need can arise in a fractional reserve banking system when some shock hits the system even when the banks are well behaved. Because of the nature of banking danger arises when short-term depositors suddenly wish to withdraw their funds for fears over their security. So long as the banks carry sufficient liquid assets they can cash these at the central bank and get all the cash needed to calm the fears of depositors. The banks learned how much liquidity they needed and the Bank learned how to act and it became clear that it would take the appropriate action in a crisis. These elements in themselves contributed greatly to avoiding crises. No part at all was played in this by government or the law.

The Bank also learned how to handle the failure of an important institution (such as Barings was in the 1890s, by which time it had become a large and well known bank, but one with exposure to volatile economies overseas).There the problem had become solvency rather than liquidity – it had become what might be called crisis management.

The Bank always responded to events, and took no part whatsoever in the business and management of other banks. Its role was intended to be a reactive one, and carrying out that role stabilised the system.

With the Bank's abilities developed on these lines and a banking system that had learned appropriate prudence there were no financial crises in England from 1866 to the mid-1970s. In the mid-1970s there was a secondary banking crisis that the Bank handled in a similar way to that of Barings in the 1890s. A 'Lifeboat' was floated, in the form of capital contributions from major banks to support the small failing banks, and the crisis was managed effectively.

The Bank had also, however, been taking actions of a different sort behind the scenes at various points in the twentieth century to save individual financial institutions in difficulties. It did this in the interwar years; in a sense too in the secondary banking crisis in the 1970s; in the less developed country (LDC) crisis of the early 1980s; and again in what became known as the small bank crisis of the early 1990s. It had drifted into this role - its growing prestige and power resulted in it taking responsibility for the reputation of the City, of the financial system. From Montagu Norman onwards the Bank worked behind the scenes to ensure that a picture of soundness and stability was presented. These actions seem to have contributed to the notion that the Bank stood ready to come to the rescue, by some means or other, of any financial institution in difficulty. It had been contributing to a climate in which moral hazard became established. So even before the 1990s the idea seemed to have taken hold that the Bank of England would not let a financial institution fail. Thus the message went out that risk would not necessarily have to be paid for, or if it had to be paid for would not cost a great deal. The consequences should not have been unexpected. When the price of risk was lowered more of it was consumed. In that sense (and because of its acting in a manner different from its successful, historic role) criticisms of the Bank's behaviour in the long run up to the crisis were legitimate. It had tried to protect the system in ways that were not in the longer run helpful. It had neglected its true role as lender of last resort.

But the main criticism of the Bank was misdirected. It should have been directed at the imposed regulatory framework. Following the new 'independent' regime for the Bank of England introduced by the Labour Government in the late 1990s the Bank was deprived of its customary supervisory and regulatory role. That was handed to a new body, the Financial Services Authority (FSA). Nevertheless, the Bank's mandate gave it responsibility for financial stability, although that was nowhere defined. And in addition it was a tripartite system with the third party being the Treasury. The vague and undefined and overlapping areas of responsibility were a recipe for confusion and denial of responsibility. The FSA became focussed on consumer protection rather than systemic stability. The Bank had lost the sources of information that would formerly have allowed it to monitor activities in the market and so was in no position to supervise/regulate when it was needed.

A classic earlier illustration of this multiple responsibilities problem was the experience with the Crown Agents. The Crown Agents were founded by the British government in the nineteenth century to act for the colonies as commercial and financial agents in Britain. In the late 1960s the Agents, while continuing to perform their traditional functions, began to engage in banking-related business on their own account. While this business grew rapidly they did not have the staff or expertise to assess the risks of such operations. They got into serious difficulties and were a threat to other parts of the financial system. The Bank then had responsibility for the banking system. However, the Bank said the Agents were not a bank and that the Treasury should deal with the problem. The Treasury said they were doing banking business and so the Bank was responsible. And so no one took responsibility and a mess ensued. When the Labour government introduced its regulatory changes it failed to note the lesson of that episode, that shared responsibility is usually no responsibility.

In the defective regulatory world of the recent crisis several wrong decisions were taken. One example was the knee-jerk response of imposing higher capital to asset ratios on the banks. It might well have been the case that a considered judgement was that the banks needed to have greater capital resources. But this was not the time to jump to action – leaving aside problems associated with regulators determining capital, or indeed determining how banks should decide it. The imposition immediately damaged lending that was in any case already under threat. This in turn retarded recovery. What looked like huge quantitative easing could not compensate for the contraction in bank deposits. Their growth was delayed and so recovery had to wait.

Additionally, some attention needed to be directed to the liquidity of banks. Where their liquidity position had formerly been strong by the 1990s it was in decline and was pitifully low by the time of the crisis. That diminished and perhaps even destroyed the Bank's ability to act as a lender of last resort.

There was a great deal wrong with the system but some improvements have since then been made. The Bank of England now has overall charge, and no longer has only indirect access to the information it needs. But it is still the case that the lessons have not properly been learned.

A thorough reform of the system so as to make stability more likely would have looked at the period in the past when the banking system was stable, and individual failures, on the few occasions when they occurred, did not threaten the stability of the system. What was distinctive about that past period was individual responsibility. The Bank of England monitored the quality of the assets commercial banks regarded as liquid, and exchangeable on demand at the Bank of England should they have a sudden need for cash. The Bank took responsibility for an aspect of the system in which they were inevitably concerned both day to day and in a crisis. But responsibility for capital lay with the banks themselves. Each bank individually chose the amount of capital it thought it needed in the light of its own judgement of the risks of its own business. They therefore had somewhat different capital ratios one to another, and in addition capital ratios were very much higher. Further, it was the custom of the Bank, as it did in the case of Barings in 1890, to arrange what was in effect an orderly closure of any institution which had run out either of capital, or of securities such that the Bank was willing to accept in exchange for cash. (All pre failure investors in Barings lost all their investment in it, and the bank was recapitalised by new investors.)

We are told by the authorities that we now have in place what is said to be a system where banks, even large ones, can be closed in an orderly manner and their assets and liabilities moved smoothly to a new institution. If the authorities believe what they are telling us, there is now absolutely no reason that we should not revert to the system of the 19th and early 20th centuries that produced banking system stability in the UK. Indeed, there is no excuse for not doing so. Until banks are allowed to fail, fail in an orderly fashion just like any other firm, with spillovers prevented by the means that were used in the past, when Britain's banking system was stable, we will inevitably have more banking system failures.

II

# British Banking Crises

## From stability to fragility - and back?

Richard Roberts

The crisis of 2007-08 was the most extreme financial meltdown Britain has ever experienced. It featured the collapse of three out of five major British banks, three among the four smaller ex-building society banks, and a mutual, respectively, RBS, HBOS and Lloyds; Northern Rock, Bradford & Bingley, Alliance & Leicester; and Dunfermline Building Society. The impact on British GDP was a record downturn of 6.6 per cent in the wake of the crisis.

British financial history features numerous individual bank failures while the twentieth century also saw more than a dozen sterling currency crises. John Turner, author of *British Banking in Crisis* (2014), counts nine systemic banking crises since 1825, but he ranks only 1825-26, which saw a GDP downturn of 4.2 per cent, and 2007-08 as 'major' banking crises.[2] He classes the other bank episodes that resulted in smaller recessions as 'minor' crises. Nonetheless, for firms in the eye of the storm even the minor crises were harrowing and possibly lethal. In particular, the 1866 crisis saw the failure of the giant wholesale bank Overend, Gurney, an event whose collateral damage was akin to the demise of Lehman Brothers in 2008; it contributed to the failure of five joint stock banks (out of c. 110) and upwards of 180 small credit and finance companies.[3]

### Risk Dynamics and Shareholder Vigilance

Between the Overend, Gurney crisis of 1866 and the early 1970s, Britain was free of systemic banking crises though there were occasional individual bank failures brought about by mismanagement or fraud, notably the City of Glasgow Bank in 1878. A systemic banking crisis is one in which a run on the banking system, rather than an individual bank, potentially threatens the breakdown of the payments system, and hence the economic system. Mercifully, such systemic runs are highly exceptional events; Anna Schwartz, a notable American monetary economist, has characterised the

[2] John Turner, *Banking in Crisis: The Rise and Fall of British Banking Stability, 1800 to the Present* (Cambridge, 2014) p.62.
[3] Turner, *Banking in Crisis* pp.82-84; Michael Collins, *Money and Banking in the UK: A History* (Croom Helm, 1988) p.52; Sir John Clapham, *The Bank of England: A History* (Cambridge, 1944) vol. 2 p.270.

array of sensational but non-systemic financial phenomena often labelled financial crises, as 'pseudo-financial crises'.[4] Banking involves liquidity and maturity transformation on a fractional capital base and is thus inherently risky. Moreover, there are inherent incentives for bankers to increase the risk profile of a bank to increase profits by greater leverage and lending to borrowers who will pay a premium rate (i.e. riskier borrowers). Bankers receive most of the benefits when loans go right, while others – shareholders/depositors/taxpayers - bear the losses if they go wrong. If unchecked, this inherent risk enhancement dynamic eventually results in bank failures.

So how come more than a century of British banking stability? Turner stresses two successive checks on risk assumption by bankers. First, shareholder financial liability for bank losses, which had two phases. Prior to the 1880s most bank shareholders faced unlimited liability for bank losses, which was believed to provide reassurance to bank depositors about a bank's prudence and resources. Naturally this incentivised shareholders to take a keen interest in the sound management of their bank. Nevertheless, the City of Glasgow Bank failed in 1878 and 1,800 well-to-do shareholders were ruined. British banks promptly converted to limited liability, reassuring savers through high capital-to-deposit ratios including substantial uncalled contingent capital liabilities on the part of shareholders. This incentive to shareholder vigilance persisted through to the 1950s, though its bite was eroded by wartime inflation that inflated nominal deposits while capital was not increased; the average ratio of shareholders' potential liability in the event of failure to deposits fell from 33 per cent in 1900 to 3 per cent by 1950.[5]

## Financial Repression and Other Factors

The second check that perpetuated banking stability was the regime of 'financial repression' that pertained from the outbreak of war in 1939 to the

[4] Anna J. Schwartz, 'Real and Pseudo-Financial Crises', in Forrest Capie and Geoffrey E. Wood (eds), *Financial Crises and the World Banking System* (London, 1986) pp.11-12.
[5] Turner, *Banking in Crisis*, p.9.

1970s.[6] The objective was to reserve bank resources for the purchase of wartime and post-war government debt. The principal technique was 'requests' from the Bank of England (on behalf of the Treasury) to buy government bonds and bills, and to lend to key industries: in 1944, 83 per cent of deposits were invested in government securities; in 1958 still around half.[7] Banks were required to maintain a minimum balance of 8 per cent of deposits at the Bank and a 30 per cent liquidity ratio, which resulted, one way or another, in large holdings of Treasury bills. Although compliance by the banks was notionally voluntary, behind the 'requests' lay the spectre of nationalisation. The state direction of bank behaviour allowed little scope for the assumption of credit risk while the pattern of bank assets and the high liquidity ratios more than offset the risk from the long-term decline in capital ratios.

Other factors also contributed to Britain's hundred years of banking stability. Forrest Capie prioritises three of them: first, and crucially, the pioneering development by the Bank of England of the role of lender of last resort; second, the development by bankers of a prevailing culture of caution and public responsibility; and third, the provision by government of an appropriate regulatory environment.[8] The high level of concentration and large-scale branch networks of the British banking system that developed over the period 1890-1920 was also a stabilising influence. A quantitative study by Richard Grossman of banking during the Great Depression of the early 1930s covering 26 countries across Europe and North America seeks to explain why 12 countries, including Britain, did not have a banking crisis while 14 countries, including the US and Germany, did.[9] The structure of the banking system was a key determinant, stable banking systems typically featuring greater concentration, extensive branch networks and larger institutions.

---

[6] William A. Allen, *Monetary Policy and Financial Repression in Britain, 1951-59* (London, 2014) pp.181-193; Carmen Reinhardt and B. Sbrancia, 'The liquidation of government debt', NBER working paper no. 16893 (2011).
[7] Turner, *Banking in Crisis*, pp.181-2.
[8] Forrest Capie, 'British Financial Crises in the Nineteenth and Twentieth Centuries', in Nicholas Dimsdale and Anthony Hotson (eds), *British Financial Crises since 1825* (Oxford, 2014) pp.9-23.
[9] Richard S. Grossman, 'The Shoe That Didn't Drop: Explaining Banking Stability During the Great Depression', *Journal of Economic History*, vol.54, no.3 (September 1994) pp.654-682.

During the post-war Bretton Woods era from 1946 to 1973 banking crises were non-existent not only in Britain but across the developed world.[10] This was partly because of restrictions on bank risk-taking imposed in various countries in response to banking crises of the early 1930s or, as in Britain, the war, but also because of strong growth and macroeconomic stability under the international fixed exchange rate regime. Gary Gorton, writing about US banking, calls the era between the banking reform legislation of 1933-34 and 2007 the 'Quiet Period'.[11]

## Resumption of Banking Crises and Back to Stability?

In Britain, the era of financial repression in banking ended in 1971 with the introduction of a radical new regime designed to make banking competitive. Part and parcel of that process was a notable cultural shift in banking that took hold from the 1980s from saying 'no' to the active marketing of loans.[12] The role of generalist branch managers was downgraded and specialist credit officers came to the fore. In particular, the banks moved into mortgage lending hitherto the preserve of the building societies. Soon banking crises were back, though confined to fringe institutions: in the mid-1970s among the so-called 'secondary banks' (shadow banks) that borrowed in the wholesale money market and lent to the commercial property sector; at Johnson Matthey Bank in 1984; and there was the 'small banks' crisis' of the early 1990s.[13] But then in 2007 crisis moved into mainstream banking with the onset of what is often referred to as the 'Global Financial Crisis' - though in reality the 23 countries that experienced systemic banking crises were overwhelmingly European plus the US; the three exceptions were Kazakhstan, Mongolia and Russia.[14]

---

[10] Michael Bordo, Barry Eichengreen, Daliela Klingebiel, Maria Soledad Martinez-Peria, Andrew K. Rose, 'Is the Crisis Problem Growing More Severe?', *Economic Policy*, vol.16 no.32 (April 2001) p.57.

[11] Gary Gorton, *Misunderstanding Financial Crises: Why We Don't See Them Coming* (Oxford, 2012) pp.125-133.

[12] David Lascelles, *Other People's Money: The Revolution in High Street Banking* (Institute of Financial Services, 2005) pp.169-177.

[13] Michael Moran, *The Politics of Banking: The Strange Case of Competition and Credit Control* (London, 1984); Andrew Logan, 'The United kingdom's small banks' crisis of the early 1990s: what were the leading indicators of failure?', *Bank of England Working Papers* (2001).

[14] For instance, Ouarda Merrouche and Erlend Nier, 'What Caused the Global Financial Crisis? – Evidence on the Drivers of Financial Imbalances 1999-2007', *IMF Working Paper WP/10/265* (December 2010); Robert E. Marks, 'Learning Lessons? The Global Financial Crisis five years

Banking crises are regularly followed by a regulatory backlash and recent years have seen this in spades with a plethora of reform measures and proposals pouring from an unprecedented array of national and international bodies. Many of these are sensibly prudent in principle (though the devil is in the detail), notably higher capital and liquidity ratios that echo banking practice of earlier eras. Other proposals, restructuring along narrow banking lines of the pre-Big Bang era or the creation of new set of challenger banks, seem nostalgic or romantic rather than workable. Indeed the US is heading in exactly the opposite direction. An outcome of the crisis has been the acceleration of the emergence of an unprecedented set of major US universal banks. As the US recovery develops the foremost US universal banks are thriving and challenging European banks' capital market businesses.[15] Perhaps there are lessons for British and European banking from Britain's own notably successful universal bank HSBC?[16]

HSBC weathered the 2007-08 maelstrom better than most British banks; it did not require public funds and maintained strong prudential ratios that it boosted with a precautionary rights issue. This was despite Household, its US consumer finance subsidiary acquired in early 2003. Initially Household made significant contributions to profits, but then substantial losses; overall Household roughly broke even financially, but there were also the costs a big drain on management resources, morale and reputation. A silver lining of sorts was that problems at Household put HSBC's senior executives on crisis alert well ahead of other banks. Since many had experienced the Asia crisis of 1997-98 they were more familiar with crisis management than many other bankers. Moreover, the bank had a generally conservative culture and a strong deposit-base, had been restrained in the development of structured products, and had resisted shareholder activist calls to increase leverage. Furthermore, its operational and geographical diversification proved sources of strength. All in all, observed chairman Douglas Flint, the crisis showed that HSBC was 'not too big to fail, it was big enough to cope.'

---

on', *Journal of the Royal Society of New South Wales*, vol. 146, nos. 447 & 448 (2013) pp.3-16; Luc Laeven and Fabian Valencia, 'Resolution of Banking Crises: The Good, the Bad , and the Ugly', *IMF Working Paper WP/10/146* (June 2010) p.9.

[15] Federic Oudea, 'Europe needs homegrown bulge bracket banks', *Financial Time*s (11 October 2015).

[16] See, Richard Roberts & David Kynaston, *The Lion Wakes: A Modern History of HSBC* (Profile, 2015).

Do the factors that delivered a century of banking stability up to the 1970s offer any guidance as to how to ensure another lengthy era of banking stability? The most intriguing ones that are clearly absent or different today are extended shareholder liability and banking culture. John Turner, advocates either more stringent controls on banks, as in the era of financial repression, or a requirement that banks shareholders have more 'skin in the game' – or presumably both.[17] More control is certainly in train, though how coherent it is, what the unintended second-order consequences will be, and how long it will last are uncertain. A return to some form of shareholder extended liability in modern capital markets seems, well, fanciful. As for culture, there are two dimensions - management and governance. While it is unrealistic to expect a return to the banking culture of the 1950s, the various proposals to align behaviour and remuneration better with long-term performance (including penalties as well as rewards) must be along the right lines.

And then there is governance. There is always governance. A report covering 18 recent major corporate disasters by Cass Business School, *Roads to Ruin; A study of major risk events; their origins, impacts and implications* (2012), emphasised the key role of governance shortcomings: 'In every case the failings were essentially at board level,' said Professor Chris Parsons, one of the authors. 'There are other causal factors, but it was decisions taken, or not taken, at board level, which were really key to the result … In the cases we looked at there was actually precious little evidence that anyone had learned from it, and that any formal steps had been taken … that they had actually learned from previous disasters, which were very much the same … You would think it would be possible to put in places processes of some sort to deal with it. Maybe it's a generational thing. You get the cycle, the repeat story, and that always happens. There is always a call for more regulation and more control and so forth. Then very little happens for a while, and then people say "why are we spending all this money, it's disgraceful." And then

[17] Turner, *Banking in Crisis,* p.205.

the cycle repeats itself.'[18] Depressing, but probably prescient regarding banking too.

Housing loans were at the epicentre of the 2007-08 banking crisis. Over the last 60 years the primary business of banks in advanced economies has become residential real estate lending; in the 1950s it averaged 30 per cent of total bank lending; today almost 60 per cent, and a significant proportion of the rest is commercial real estate lending.[19] As banking business has become real estate lending so banks have become increasingly vulnerable to property cycles. This is a long-term trend and although the level may have peaked there is little reason to see it reverse since it suits the banks' business models as well as politicians in most democracies who are in hoc to the property cycle to generate feel-good electoral effects. So the next major downturn in the property cycle will probably generate a new banking crisis. But in the meantime the most likely source of a financial crisis that will impact on the banks is an emerging market financial crisis of one sort or another. It used to be thought that countries grew out of financial crises as they matured financially, but the crisis of 2007-08 proved that notion to be fanciful. Nonetheless, just as with Britain up to 1866, it is developing economies and financial systems that are most prone to crisis and are the most likely source of the next one. Brazil, Russia, India, China wherever – take your pick.

[18] Cass Business School, *Roads to Ruin; A study of major risk events; their origins, impacts and implications* (Airmic, 2012); Richard Roberts, *Did Anyone Learn Anything from the Equitable Life? Lessons and learning from financial crises* (ICBH, 2012) p.22.
[19] Oscar Jorda, Moritz Schularick and Alan M. Taylor, *The Great Mortgaging: Housing Finance, Crises, and Business Cycles*, NBER Working Paper 20501 (September 2014).

III

# Neither Anticipated nor Managed?

## The financial crisis, the response and lessons for the future

Kent Matthews

---

**Anticipating the Unanticipated**

In a visit to the London School of Economics in November 2008, the Queen asked the Director of Research about the global financial crisis, 'why did nobody see it coming?'. The question continues to resonate in policy circles, partly because the failure to see it coming has to some extent dictated the policy response. The reaction from regulators and policy-makers has been swift and impassioned along with a prolonged bout of 'banker bashing'. This seems unfair as bankers were in reality only the minor actors on this stage. This drama had a wide cast of villains of which bankers were part. There were also heroes but far too few; sadly, the economics profession was not part of that group.

This chapter will explore the background to the global financial crisis and review the factors that contributed to it. It will argue that while bankers played a part, they were in fact a small cog in a much larger wheel. The agents and institutions that make up the heroes and villains of the set piece will be examined and the reaction of the authorities that converted a crisis into a prolonged recession, explained. It will conclude by considering what lesson, if any, can be learned from recent developments and from the far longer period between 1825 - 2008 when Britain's banking system was envied for its systemic stability.

**The Perfect Storm: Fundamentals**

No one factor can be definitively identified as the cause of the financial crisis and the ensuing recession. The crisis was the result of a conflation of factors that has been described as the 'perfect storm': it included central bank policy, global imbalances as well as regulatory and banks-specific issues. The creation of the global financial crisis was the result of a number of forces coming together which can be identified as fundamental and short term. One important fundamental factor was the role of macroeconomic thinking and its influence on policy. The intellectual atmosphere in mainstream economics had been shaped by the adoption of new Keynesian macroeconomic models[20] that allow no direct role for monetary aggregates, balance sheets and bank credit.

The acronym for these types of models is DSGE or Dynamic Stochastic General Equilibrium and they are steeped in the micro foundations of the representative agent. The working assumption is that the economy is reduced to a single representative agent that consumes the output that is produced by the single firm that is in turn owned by the consumer. Basically, the new Keynesian model can be reduced to three equations that describe the economy: an aggregate demand function that relates the (real) rate of interest to real GDP; an inflation equation that relates inflation to expected future inflation and real GDP, and a Taylor rule that relates the rate of interest to inflation relative to a target and real GDP relative to a target. These models endorsed the inflation targeting policy that had gained vogue status with central banks in the decade prior to the crisis. But, the policy of inflation targeting was an easy one to meet in the environment of positive supply shocks emanating from China. World consumer price inflation was held down by an excess supply of low value-added Chinese consumer goods along with the Peoples Bank of China policy of heavily managed exchange rates in much of the period leading up to the crisis, which meant that the RMB was not allowed to appreciate lowering the dollar price of Chinese exports in the world market.

Another fundamental factor was the global savings glut which depressed world interest rates. High savings countries like Japan, China and to a lesser extent also Germany, generated an excess supply of global savings which led to a low world real rate of interest. Central banks in general and the Federal Reserve in particular were happy to let interest rates fall. During 2001 US interest rates fell to well below what they should have done had they followed a Taylor rule.[21] Central banks oversaw low inflation but failed to register the credit boom and the rapid growth in the global money supply that was fuelling a worldwide asset price boom. As far as central banks were

[20] For example Smets F and Wouters R, 'An Estimated Dynamic Stochastic General Equilibrium Model of the Euro Area', *Journal of the European Economics Association,* 1(5), (2003) p.1123-1175.

[21] As argued by John B Taylor in his Hayek Memorial Lecture 2014, IEA.

concerned the policy of inflation targeting was a success in delivering low inflation, high growth and the conditioning of inflation expectations. However global asset price inflation was rampant: and by abandoning monetary targeting which had been the mainstay of central bank policy in the past, the central bankers had taken their collective eyes off the ball.

A third fundamental factor was the creation of the environment of Too Big to Fail - (TBTF). When this actually happened is difficult to pinpoint. However the Federal Reserve rescue of the hedge fund, Long Term Capital Management (LTCM) in 1998 was a signpost in the USA. That hedge fund had taken the wrong bets in the financial market, resulting in near insolvency by September 1998 and failure were it not for a Federal Reserve engineered bailout that involved the great and the good of Wall Street. While the bailout of LTCM did not involve tax dollars, the intervention of the Fed on the grounds that had the LTCM failed, the systemic effect could have brought down the financial system, created the moral hazard problem. This is thought to encourage the notion that the authorities must always be on hand to prevent the failure of large financial institutions. [22] In the UK, through a process of merger and acquisition, the banking market had become more concentrated and developed the attitude of TBTF.[23] Banks in the UK had grown large and through their complex interconnectedness had become too important to fail. It can be argued that the moral hazard problem associated with TBTF was the real reason for the high risk strategies adopted by the banking sector.

A fourth fundamental was the effect of international bank regulation.[24] The effect of such regulation in the form of Basel was to change the behaviour of banks. Prior to a common capital adequacy regulation and in the absence of deposit insurance, banks in the UK had higher risk-weighted capital ratios than those required by Basel I. The creation of a common but lower capital adequacy ratio reinforced the attitude of TBTF, and encouraged the growth of securitisation which ultimately led to the 'originate to distribute' business model of Northern Rock. One of the many reasons for the popularity of

---

[22] See Kevin Dowd's argument in Dowd K, 'Too Big to Fail? Long-Term Capital Management and the Federal Reserve', *Cato Institute Briefing Paper* 52, Washington DC (1999).
[23] Matthews K, 'Banking, the Law and a Free Economy', in *The Financial Sector and the UK Economy: The Danger of Over-Regulation*, (ed) Sheila Lawlor (Politeia, 2013).
[24] Ibid.

securitisation as a financial innovation was that no capital was required to be held against it. As a result it was an attractive strategy for boosting *Return on Equit*y (ROE) at a time when global competition was eating into profits from conventional balance sheet activity. Risky off-balance sheet activity grew under the guise of diversification and the build-up of systemic risk was not spotted by central banks. While Basel II attempted to address the unintended consequences of Basel I by requiring capital to be held against securitization, full compliance was never reached before the financial tsunami overtook us.

**The Perfect Storm: The tipping point**

The fundamental forces described above bred a host of short term factors. These combined to create the tipping point which culminated in the credit crunch and the global financial crisis. Importantly, because of their visibility, it was natural for the regulatory authorities to confuse cause with effect and to design policy that struck at the latter effect and not the former cause. While a number of short term factors can be identified – from the risk-taking behaviour of bankers, through to flawed credit ratings, the failure of Risk Managers, and the capture of Regulators, to name but a few, none can be assumed to be causative. Take the case of banker's bonuses; the popular view is that greedy bankers were rewarded for excess risk taking through bonuses that reflected the upside of performance but with no penalties on the downside.

With hindsight, regulators should have been aware of the conflict of interest of Rating Agencies evaluating the riskiness of the portfolios of the banks that employed them. Similarly, Risk Managers failed to provide adequate warning either because the tools they used were inappropriately applied or if they made warnings, they were ignored. The standard tool of risk management is Value-at-Risk (VaR) which answers the question 'what is the probability of daily losses being greater than a given figure?' This sounds good except that in good times the statistical methodology used for the calculation understates the probability of losses.[25] Risk Managers that braved the Board of Directors

[25] In statistical parlance, the distribution of returns of a portfolio degenerates during a 'bull' period. Basel II requires 250 working days of returns which in retrospect is not enough information to captures 'bad' times.

with warnings of dire consequences were often ignored or worse.[26] In the UK the separation of regulatory oversight from the Bank of England in the 1998 Bank of England Act, made the new regulatory authority (Financial Services Authority) ripe for capture.[27]

The sub-prime loans crisis and the collapse of Lehman Brothers in New York may have triggered the global banking crisis, but it was the coming together of the short term factors in the context of the perverse fundamentals, that was the real cause. No one single causal factor stands out and it can be argued that those that were singled out were not the cause but the effect. In his book David Smith, the economics editor of *The Sunday Times,* refers to a lecture by Charlie Bean the Deputy Governor of the Bank of England who stated that there were many culprits and 'As in Agatha Christie's *Murder on the Orient Express*, everyone had a hand in it'.[28]

**Regulation: A knee jerk reaction**

The reaction of the regulators was predictable. Bankers had not tried to hide their excesses in the decade leading up to the financial crisis and they in particular and banks in general were seen as the main culprits that brought down the financial system. However, as argued elsewhere[29] bankers were only behaving rationally in response to the incentives they faced.[30] Regulators took aim at banker's bonuses. The EU rules on banker's pay kicked in at the beginning of 2015 which bans banks from awarding bonuses of twice the base pay. In the UK 7-year claw backs have been introduced if a banker has been proved to be culpable in some form. While these regulations will affect banker behaviour, they are also detrimental to banking business

[26] The case of the sacked Head of Risk at HBOS in 2009, Paul Moore springs to mind ('Senior executive of HBOS sacked for warning of banking crisis' Andrew Porter, *Daily Telegraph*, February 10, 2009). On a personal note, the author challenged a speaker from the Asia Development Bank at a conference at the Hong Kong Monetary Authority in 2009 as to why they had not shouted louder warnings and the answer given was 'nobody wants to be a party pooper!'.

[27] 'FSA admits failings over Northern Rock', Jennifer Hughes, *Financial Times* (March 26, 2008).

[28] Smith D, *The Age of Instability*, (Profile Books, London, 2010) p.220.

[29] Matthews, K. and Matthews, O., 'Controlling Banker's Bonuses: Efficient Regulation or Politics of Envy', *Economic Affairs*, 30, 1, (March 2010), p.71-76.

[30] Understanding the incentives does not absolve bankers from responsibility. The misselling of PPI, the LIBOR and FX scandals are all symptomatic of a culture nurtured by excessive risk-taking.

and have resulted in excessive risk-reduction and bank lending. The argument that controlling banker's pays controls their risk behaviour is based on a causative link. Indeed much empirical evidence suggests a link between banker's pay and risk-taking. But it can be argued that the two variables are linked together by a third variable, which is the expectation of TBTF. In other words banker's pay and risk-taking are both *endogenous variables* caused by the moral hazard result of TBTF.[31] In the climate created by the fundamentals, banks designed remuneration packages that gave the bankers the incentives to take excessive risks.

A raft of other regulations have come out of the European Banking Authority and Basel III that are essentially designed to increase capital ratios,[32] liquidity ratios, and make the capital ratio responsive to the business cycle in the form of macro-prudential requirements. The long term implication of these regulations is to widen spreads and reduce the rate of bank asset growth. While it is arguable that this may be a desirable outcome in the long term, it has the undesirable short term effect of slowing bank credit growth and constraining the recovery. With the introduction of bank regulation, timing is all important: once announced, future policies affect current behaviour.[33] It is not expedient to constrain bank behaviour just when banks are needed to finance the recovery.

**Regulation: Lessons from the past**

Whether such regulatory intervention is desirable is questionable. To some extent, the Great Recession has resulted in a natural adjustment of the fundamentals. Economists are re-discovering Milton Friedman and are rebuilding the role of money into their macroeconomic models. The return to monetary targets would make macro-prudential requirements redundant as fast growing credit would result in a rise in the Bank Rate. Global imbalances and the savings glut continue to underpin low world rates of interest, but policy sentiment is changing. The Fed has now started the process of raising interest rates in the Western economies. Extensions to Basel II have closed

[31] For a close argument of this point see Matthews, K. and Matthews, O. (2010).

[32] The reaction of raising capital ratios is particularly ill thought through as British banks had Tier 1 ratios in 2006 in excess of what is proposed by Basel III. See Turner, J., *Banking in Crisis*, (Cambridge, 2014).

[33] Basel III compliance starts in 2019.

the avenue of using asset backed securitization as a means of boosting ROE and the simple application of VaR has been replaced with stress testing and 'expected shortfall'.[34] But this still leaves the last of the fundamentals, namely the TBTF problem which governments and regulators have not tackled because of the problems of designing a credible no-bailout policy.[35] The reality as expressed by Alistair Darling (the former Labour Chancellor during the crisis) is that the fear of systemic crisis means governments are reluctant to let even small banks fail let alone large ones.[36] Faced with this reality the question that arises is what type of policy minimises the risks from moral hazard and the risk shifting behaviour of the banks? To answer this we can turn to history and the structure of joint stock banking.

From 1825 up until 2008, the British banking system was envied for its systemic stability. One of the reasons for this stability was the presence of contingency capital (capital above and beyond that which shareholders have invested) either in the form of unlimited liability or uncalled capital from the shareholders[37] which acted as a break on excessive risk taking. Shareholder interest also acts as a break on leverage and the size of the bank. Limited liability has its advantages and a return to joint-stock banking may be too radical a move for many, but as a starting point the balance of risk sharing between the State and private shareholders can begin from there.

How to get there from here is no simple matter and it requires the alignment of shareholders' interests with mangers' as well as the balancing of risk sharing between the State and the bank. The political reality is that deposit insurance and TBTF will never be removed, and free banking, while desirable, is not on the agenda. Consequently market discipline has to play a stronger role in designing capital adequacy requirements than what is

[34] A measure of 'tail risk', which estimates the maximum loss a bank could face in the worst case.
[35] A no-bailout policy must be distinguished from the conventional 'lender of last resort' function of the central bank. Strictly, the LOLR function addresses a liquidity issue and is designed to help the banking system as a whole, whereas the no-bailout policy addresses solvency issues and relates to individual banks.
[36] Perman R, *Hubris: How HBOS wrecked the best bank in Britain*, Birlin (Edinburgh, 2013).
[37] Turner J, 'Holding Shareholders to Account: British Banking Stability and Contingent Capital', in *British Financial Crises since 1825* (Eds) N Dimsdale and A Hotson, (Oxford, 2014)

currently proposed in Basel III,[38] provide the proper signals for prompt corrective action by regulators, and create the correct incentives for managers to undertake proper risk management and corporate governance.

There are five strands to tackling the problem for which the backdrop should be the stability of the macroeconomic environment created by Central Bank policy.[39] First, a stable macroeconomic environment would remove the need for countercyclical prudential requirements. Second, the use of subordinated debt with a put option (ie the right) to sell back to the bank if the market price declines, would allow for risk to be priced into the yield ; and would also signal to both the market and the regulator that the bank has increased its risk exposure. Third, the increase in the risk premium on the sub-debt and the exercise of the put option would force banks to change their risk exposure or provide more capital at higher cost. Fourth, either of these actions would act as an early warning; and it would signal to the regulator the need for prompt corrective action. Finally, bonuses would be paid in bank issued Coco bonds (contingent convertible), which would reward managers when share prices rise but penalise them - by converting to equity - when share prices fall. The list may not be exhaustive; the volume of work by academic and policy authors may go far further; but at least such reform would be a start.

[38] A well-known suggestion is the use of subordinated debt with a put option clause is used as part of capital requirements. The yield on the sub-debt will price in risk and when the market deems the risk has increased holders of the sub-debt can exercise the put option. The bank either issues new sub-debt at the higher cost or reduces assets to meet the required capital ratio. This proposal was first made by L D Wall, ‘A plan for reducing future deposit insurance losses: puttable subordinated debt’. *Economic Review, Federal Reserve Bank of Atlanta,* (July/August) p.2-17.

[39] Monetary targets that take us back to the Friedman rule.

IV

# Monetary Policy and Financial Regulation

## Impact and interaction

David B. Smith

### Introduction

It is now accepted that economists had a ‘bad Global Financial Crash’ (GFC). Not only did they fail to anticipate the financial meltdown but, even worse, the dominant theoretical paradigm followed in central banks and academia meant that such events had been regarded as inconceivable. In contrast, monetary historians had a ‘good GFC’. In particular, they did not allow theories based on restrictive assumptions to gainsay the fact that monetary history has been littered with financial crises (see: Dimsdale and Hotson, 2014).

This chapter opens by considering the harmful role played by the Conventional Theoretical Macroeconomic Model (CTMM). This model dominated the thinking of rate setters before the crisis and remains influential today. It then contrasts the CTMM with the traditional monetary analysis, which had always recognised that adverse monetary developments could damage the wider economy. It then considers financial repression, the roles of regulation and other monetary ‘tools’, and their implications for private activity and concludes with a series of proposals for future policy.

### The Conventional Theoretical Macroeconomic Model (CTMM): A malign role

Despite its real-world failure, the CTMM has maintained much influence over monetary officials. Two key points about the CTMM are that: (i) it emerged from the US rational expectations movement of the 1980s, and (ii) it reflected an attempt by American economists to take the money supply out of theoretical models. It was these aspects of the CTMM which expunged the possibility of a financial crash from the mind set of central bankers. They also explain why financial regulators have not always grasped the macroeconomic consequences of their actions.[40]

[40] A fuller criticism of the CTMM – and the way it had induced tunnel vision into the Bank of England – was set out shortly before the crash in Smith (2007), while a briefer account appeared in Smith (2008).

To be more precise, the CTMM is typically expounded using three forward-looking dynamic equations.

- The first relates the present period's 'output gap' (a Keynesian measure of the pressure of demand) to its actual value in the previous period, its expected value in the next period, and negatively to the real rate of interest. This is defined as the current time period's official rate – for example, the US Federal Funds rate – less expected inflation in the next time period.[41]
- The second equation relates the inflation rate to the present period's output gap and a weighted average of inflation in the previous period and expected inflation in the next period.
- Finally, the official interest rate is determined by its equilibrium real rate, which used to be considered around 2 per cent before the GFC, together with expected inflation in the next period, the previous period's output gap and the deviations of the previous period's inflation rate from the official inflation target.

This framework appealed to central bankers because it mirrored their normal operating procedure of setting the short-term rate of interest. It also allowed officials to believe that they could hold both inflation and the deviations of output about its trend in reasonably tight bands using just the official interest rate. However, this depended on: (i) inflationary expectations remaining tethered; (ii) the equilibrium real rate of interest being stable and measurable, and (iii) the output gap also being quantifiable in practice. The 'two birds with one stone' aspect of the CTMM was particularly appealing to the US Federal Reserve, with its dual mandate to control employment and the price level. Theoretically, it should have been less attractive for pure inflation-targeting authorities such as the Bank of England, who simply seem to have succumbed to transnational central banker 'groupthink' on such issues.

Both the GFC and the weak subsequent recovery should have dented the credibility of the CTMM. The CTMM's limitations also meant that central banks had no useful decision–making framework to guide them after the GFC occurred. As a result, at the nadir of the crisis central bankers had

[41] The next period is employed to incorporate forward-looking expectations into the analysis. It might help to think of one period as being a quarter or, possibly, a year.

largely to make it up as they went along.[42] Nevertheless, officials still appear to be thinking within the CTMM box today. This can be seen from Mark Carney's attempt, after he became Governor in November 2012, to use Labour Force Survey (LFS) unemployment as a proxy for the output gap. Once joblessness fell more rapidly than had been anticipated, the official emphasis switched to 'economic slack' as a portmanteau measure of the pressure of demand. However, this concept was so loosely defined that it provided no constraint on the Bank of England's freedom to set rates wherever it chose.

**Traditional Monetary Wisdom: The contrasts**

The fact that economic slack is not objectively measurable undermines the entire logical construct of the CTMM and also makes it difficult to hold the central bank to account. In addition, the CTMM incorporates a 'single golf club' model of monetary policy, which is less sophisticated than the approach taught on money and banking courses several decades ago. The traditional approach was mainly concerned with the supply of money, how this affected the wider economy, and how buying and selling government securities and imposing constraints such as liquidity ratios, could be employed to achieve official aims.

In practice, the authorities have been forced to re-invent many of these traditional tools *ad hoc* but have not done so within the intellectually consistent framework that characterised the traditional approach. Furthermore, the policy tools concerned – especially the regulatory ones – have often been misapplied and/or introduced at the wrong time. Inappropriate regulatory initiatives have thus undermined other policy objectives and slowed economic recovery.

Quantitative Easing (QE), for example, is what once would have been called an expansionary open market operation. QE was initially, and rightly, introduced to shore up the broad money supply when it was threatening to collapse, notwithstanding the claims of US right-wing Republicans that the

[42] They did a reasonably good job, even so. However, the crisis in Britain might have been ameliorated if the Bank of England had reacted more powerfully when Northern Rock got into trouble.

Federal Reserve's QE represented a return to Weimar finance and potential hyperinflation.

However, QE is only non-inflationary when bank balance sheets are contracting, perhaps, in a financial panic or when private-sector lending is being crowded off the asset side of an unchanged balance sheet. Once most bank lending is to the government, extra loans to the public sector boost bank assets on a near pound-for-pound basis. Because bank liabilities have to match their assets, the rise on the assets side of the balance sheet leads to a matching increase in bank liabilities – i.e., their deposits – and, therefore, in the broad money supply. This is the 'monetisation' point at which inflation (and, in extreme cases, hyperinflation) starts taking off.

During the heyday of open market operations, most nations pursued balanced budgets in peacetime, government spending was a far smaller share of GDP than it is currently, and the gold standard (or the Bretton Woods quasi-gold standard) ensured that there was no longer-term inflationary risk. Unfortunately, none of these conditions apply today. Furthermore, QE has allowed politicians to put off the fiscal retrenchment needed to stabilise the long-term public finances in the face of aging populations and permitted ministers to spend more fecklessly than they might have done otherwise.[43] Any further tranches of QE, therefore, need to be treated with intense suspicion.

### Prudent Oversight or Financial Repression?

'Financial repression' describes a situation in which regulatory balance sheet constraints – such as mandatory government debt ratios – are imposed on banks to force them to increase the proportion of their assets allocated to government debt and reduce the share allocated to private-sector lending. The intention behind financial repression is to allow the state to spend beyond the upper limit of taxable capacity – which is, probably, 37 per cent to 38 per cent of GDP – while leaving total bank liabilities and the broad money supply unchanged.

[43] Mr Osborne's 25th November 2015 Autumn Statement, which relaxed previous spending targets partly because of a downwards revision to projected debt interest, is an example.

Financial repression was particularly important during the two world wars. The problem facing today's monetary commentators is that there has been a sharp increase in bank regulation at a time when governments have been spending near record peacetime shares of GDP, running large budget deficits, and seeming to misappropriate the proceeds to buy votes and enrich their supporters.

Thus, it is unclear whether the post-GFC regulatory push represents a praiseworthy attempt to reduce future financial instability or a cynical misuse of regulation to allow the political and bureaucratic classes to go on living beyond the nation's means.

It was long accepted by British monetary economists that it was the imbalance between the supply of money and the demand for money that determined private sector activity and the price level (e.g., Robertson, 1928). In this context, the supply of money is determined by the budget stance, funding policy, and the regulatory constraints on commercial banks, while the demand for money reflects the relative return on holding bank deposits compared with domestic and overseas assets, as well as expenditure on real goods and services. In the long run, the main effect of monetary conditions should be on the price level, not activity. However, in the short run of, say, up to two-and-a half years, many people would accept that monetary conditions can affect real activity and employment, even if some proponents of the rational-expectations approach might still deny this.

**Money, Interest Rates and Activity**

Arguably, the best proxy measure for the short-run impact of monetary policy on private activity is: (i) to use the growth of real broad money for the positive supply of money effect, and the (ii) the real short-term rate of interest paid on bank deposits to pick up offsetting shifts in the demand for money. The bulk of the UK $M4^{ex}$ broad money definition has paid interest since the early 1970s. As a result, interest-rate induced shifts in the demand for money have affected the relationship between the money supply and the wider economy for several decades.

**Table: Year-on-Year Growth of Real Broad Money Supply and Real Interest Rates 2007 to 2015**

| | **Annual Increase in OECD Real Broad Money Supply (per cent)** | **'World' Real Three-Month Interest Rate (per cent)** | **Annual Increase in UK M4$^{ex}$ Real Broad Money Supply (per cent)** | **UK Real Three-Month Inter-Bank Interest Rate (per cent)** |
|---|---|---|---|---|
| ***Annual Averages*** | | | | |
| **2007** | 5.9 | 4.2 | 7.8 | 3.7 |
| **2008** | 5.0 | 3.3 | 2.0 | 1.9 |
| **2009** | 6.2 | 0.9 | 0.5 | -1.0 |
| **2010** | 1.1 | 0.5 | -1.6 | -2.7 |
| **2011** | 2.2 | 0.7 | -2.6 | -3.7 |
| **2012** | 3.7 | 0.4 | 1.2 | -2.0 |
| **2013** | 3.6 | 0.2 | 1.9 | -1.9 |
| **2014** | 3.2 | 0.2 | 2.6 | -0.9 |
| **2015** | 5.6 | 0.1 | 4.0 | 0.6 |
| ***Quarters*** | | | | |
| **2015 Q1** | 5.4 | 0.1 | 3.9 | 0.5 |
| **2015 Q2** | 5.8 | 0.1 | 3.7 | 0.6 |
| **2015 Q3** | 5.8 | 0.2 | 3.9 | 0.6 |
| **2015 Q4** | 5.5 | -0.2 | 3.6 | 0.5 |

*Sources: OECD and Bank of England data banks, UK Office for National Statistics (UK CPI) and Financial Times (nominal daily interest rates).*

The practical problem is measuring the relative size of the monetary and interest rate effect on third variables, such as household consumption or stock building. However, it is possible to quantify these effects using the statistical technique of multiple regression analysis.[44]

Recent figures suggest that the growth in real broad money balances in the OECD as a whole, and Britain in particular, has now picked up, partly because of the temporary disinflationary effects of cheaper commodity

[44] My Beacon Economic Forecasting (BEF) macroeconomic model contains several such relationships, for example.

prices, while the real interest return from holding bank deposits does not look attractive by historical standards. This suggests that future private demand growth could prove more satisfactory than many forecasters are expecting. However, monetary policy can only act on the private sector of the economy, not the government sector, which has no demand for money and can always create money at will if the central bank collaborates.

**Re-instating Money in Theoretical Models: The regulatory implications**

Once it is accepted that monetary policy operates through both the supply of money and the short-term rate of interest – which influences the demand for money – the macroeconomic consequences of financial regulation take on a new significance. The natural tendency for politicians, central bankers and other regulators is to relax unduly in the boom, when default rates are low and things appear to be going well, and to over-tighten after the crash. This is broadly what occurred in both Britain and the US from 2000 onwards.

However, from a macroeconomic perspective, this behaviour is perverse and damaging. Being unduly relaxed in the boom and tightening in the downturn exacerbates the underlying boom-bust credit cycle. One specific reason is that there is a strong correlation between credit growth and the increase in broad money, even if the relationship is not exact. To the extent that advocates of the CTMM recognise the banking sector as an influence on activity, they have concentrated solely on the supply of credit. However, the traditional analysis suggests that the money supply has to be aligned with the demand for money in equilibrium, so that credit is mainly important for its effects on the stock of money in the long run.

Excessively tight financial regulation since 2008 has weakened the subsequent recovery (Smith, 2008 and Lawlor, 2013). The risk now is that Mr Osborne is trying to ease the regulatory pressure on money and credit when the cyclical recovery is maturing, the animal spirits of lending officers are rising, there are signs of excess in the property market and the UK is running large deficits on its public finances and balance of payments.

**Financial Regulation: The microeconomic aspects**

The UK financial sector is a massive creator of wealth, employment, exports and tax receipts. But it also diverts resources from other areas of the economy. From a wider social perspective, there is a theoretically optimal size of the financial sector. This occurs when the marginal social return from extra investment in banking and finance equals the marginal social opportunity cost of the resources concerned. Regulations that bear down unduly on the financial sector, leaving it below its optimal size, correspondingly impoverish society. However, pure financial speculation is of little social benefit, even if speculators can only trade profitably if their activities take markets towards their equilibria.

Public choice theory suggests that politicians, central bankers and financial regulators act in their own interest and not for the benefit of society. The interests of regulators are best served by having masses of complex legislation, because this maximises the size of their bureaucratic empires, and a cartelised industry centred on the national capital because this involves less foot slogging than a highly scattered and regionally diverse one. The public interest probably requires a competitive industry with a strong regional element, especially where small and medium enterprises (SMEs) are concerned. However, while the optimal size of bank for individuals and SME customers is quite small and local, the optimal size of bank for large multinational corporations may be large and international.

**Implications for the future**

- The three dimensions to monetary policy – Bank Rate setting, funding policy and financial regulation – should be pulling in the same direction. That, however, has not been the case. Regulatory policy was unduly lax before the crash but over-restrictive subsequently, leading to sluggish monetary growth and a lack-lustre recovery.
- The dominance of theoretical models, which ignored the money supply and the banking sector, and reduced monetary policy to setting the official interest rate, has contributed to the poor co-ordination of the different aspects of monetary policy.
- By contrast, the traditional monetary approach rightly emphasised the gap between the supply of broad money and the demand to hold money as crucial influences on the wider economy. It emphasised that the correct way to use reserve ratios was to raise them during a

boom and cut them during a recession. This is the opposite of how the authorities have operated in the 21st Century.

- Today's conventional macroeconomic approach ignores the interface between fiscal and monetary policy and the massive role of the government in modern western economies. In the long run, monetary policy can only influence nominal magnitudes, not their split between prices and output. The output level at which the economy settles depends on the post-tax incentives facing the private sector to supply goods and services after regulatory costs and other interventions are taken into account.
- QE has blurred the distinction between monetary and fiscal policy, a distinction used to justify granting operational independence to the Bank of England. If the transfers of wealth from savers to borrowers (including the government) caused by post-2008 monetary policies had been done through conventional fiscal policy, parliamentary approval would have been needed and possibly a high political cost might have had to be paid.
- It is impossible to distinguish the current policy mix from wartime financial repression. The British state is currently spending well above the upper limit of taxable capacity and was absorbing a share of GDP comparable to the peak costs of fighting World War I when the Labour government left office in 2010.
- Where regulatory policy is concerned the choice is between establishing a self-governing structure for the banking industry, which could be left to run itself, and the usual self-feeding escalation of socialistic controls. The necessary conditions for taking the market-liberal route are: (i) deposit insurance should be limited to, say, 90 per cent; (ii) all management contracts should become void when a financial institution has to be bailed out, and, finally, excessively market-dominant banks should be broken up into smaller competing institutions.
- There is a strong case for imposing liquidity requirements on the banking system. However, there is less justification for imposing capital requirements. One reason is that the minimum capital ratio is likely to become a ceiling, not just a floor. Another is that capital requirements encourage people to game the system. Finally, a one-

size-fits-all policy makes the system as a whole dangerously vulnerable to cumulative collapse.

The severity of the lost potential output (compared to previous trends) since the GFC cannot be explained by the crash alone. Instead, it partly reflected sharply increased government spending burdens after 2000. However, the populist and highly distortionary policies implemented since the GFC have caused a second round of unwarranted supply-side damage.[45]

## References

Crafts N and Fearon P**,** *The Great Depression of the 1930s: Lessons for Today* **(**Oxford, 2013) ISBN 978-0-19-966318-7.

Dimsdale N and Hotson A, *British Financial Crises since 1825* (Oxford, 2014) ISBN 978-0-19-96866-1.

Lawlor S, *The UK Financial Sector and the UK Economy: The Danger of Over-Regulation* (Politeia, London, 2013).

Robertson DH, *Money* (1928), reprinted in Capie F and Wood GE (eds.) *The Development of Monetary Theory 1920s & 1930s, Volume 2,* Routledge, London 2000, ISBN 0-415-20153-5.

Rowley CK and Smith N, Economic Contraction in the United States: a Failure of Government, The Locke Institute, Fairfax Virginia, in association with the Institute of Economic Affairs (London, 2009) ISBN 978-0-255-36642-7.

Smith DB, *Cracks in the Foundations? A Review of the Role and Functions of the Bank of England after Ten Years of Operational Independence,* Economic Research Council, Research Paper no 23 (London, May 2007) www.ercouncil.org.

Smith DB, *Crisis Management? How British Banks Should Face the Future* (Politeia, London, 2008).

[45] The same happened in the US in the 1930s. President Roosevelt's New Deal did grave constitutional damage and hampered the recovery. See Rowley and Smith (2009) for the full horror story. More on the 1930s can be found in Crafts and Fearon (2013).

V

# Behavioural Finance and Financial Regulation: Something old or something new?

Eugene Michaels and Melanie Powell

Since the financial crisis of 2007/9, many economists, government policy makers and those who lead the sector, have continued to reflect on the cause for the crisis and how regulation can prevent a recurrence.

This chapter examines how behavioural economics can be used to develop and evaluate regulation in financial markets and considers the extent to which it should be treated as an alternative to the traditional market failure policy framework. Already behavioural economics has been used to inform and develop health, education and environmental policy. However financial regulators have only recently adopted this alternative approach. What does the evidence on behavioural finance reveal and what do the debates tell us? Why have financial regulators begun to examine such matters as regulator bias and paternalism?

We consider the above questions, bearing in mind that the new focus of financial regulators has been prompted in response to the crisis. It proposes that liberalism and efficiency will continue to be central to financial market activity and to the link between financial regulation and contract in law. Behavioural finance should be seen as an added tool in tackling market failure, more 'market failure plus' than a radical 'change of mindset' in the current regulatory drive to avoid future crisis.

## Out with the Old, In with the New

The traditional view of financial regulation is based on the normative micro-economic model. Perfectly working markets with no market failure lead to an efficient outcome because markets maximise value by distributing goods and services to those who value them most. The model assumptions of competition and full information, amongst others, ensure no market failure and allow policy makers to compare real markets to the model to identify where a policy change could reduce market failure and improve market efficiency. An efficient financial market with no market failure would not suffer recurrent crises, but where the market fails, regulators can fix crisis problems with the right regulation. As a result, post-crisis financial regulation has focused on improving competition in the banking sector and avoiding the problems of asymmetric information, where one party has better information than another. This includes ring-fencing retail banking to avoid adverse selection, where good banking practice is driven out by bad, and avoiding moral hazard, where everyone takes more risk, knowing the risk is transferred to another party. (ICB, 2011 and Kay, 2012).

Financial market efficiency also requires ‘rational’ choice by agents in the economic model. However anomalies do occur and there is some debate amongst economists about why. For example, the Efficient Market Hypothesis, a key financial economic idea, assumes all agents use all available or accessible financial market information together with probability decision rules to maximise their expected utility or psychological satisfaction from any financial decision. If the hypothesis is correct, current prices in financial markets are correct and no assets could be over or underpriced. However, the continuing evidence on financial market crises suggests incorrect pricing, or anomalies abound (Shiller, 2003). Some economists argue that anomalies such as momentum, where assets with past good returns continue to outperform, result from rational choice in markets with market failure, particularly asymmetric information. Others argue anomalies arise because people make ‘irrational’ choices like those suggested in alternative psychological bias models. Irrational choices, affected by emotion and sentiment, lead to choices with predictable biases away from the efficient economic model choice. Whilst there is a debate about whether these competing explanations can be integrated, behavioural bias models are now part of the new financial regulation debate, and sentiment, previously identified by Keynes and Minsky, has re-emerged as a factor driving financial crisis.[46]

Behavioural finance is based on the psychological models of choice derived from the work of Kahneman and Tversky (1974). These models of irrational choice take into account human limitations in using and processing complex information required for rational choice. Even with full information, most

[46] For further reading the debate on market failure versus behavioural bias explanations of anomalies see Buffa et al. (2014), Nosfinger, (2008), Podolski (2012), Ross (2014), Shu and Chang (2015), Turner (2010) and on behavioural bias in crisis see Avgoulias (2009) and Shefrin and Statman (2011).

people cannot use probability rules correctly to maximise their utility and they look for ways to simplify complex financial decisions (Simon, 1992). In behavioural finance models, people are assumed to use simple 'rules of thumb', called heuristics, instead. For example, a representativeness rule leads to financial decisions based on simple stories such as 'house prices always rise', which seem to represent the complex decision about what drives the asset price. When it is difficult to place a value on an asset, the anchoring and familiarity rules lead people to anchor their value on a salient or easy to recall value that may be irrelevant. These simplified decision rules lead to persistent or predictable biases away from the efficient choice in financial markets that can drive bubbles and crashes.

The last financial crisis has been linked to many behavioural biases identified in behavioural finance models. Irrational choice can lead to herding and groupthink, known as convergence bias, as investors and company bosses copy the behaviour of people around them rather than making rational choices. In a bull market, these agents also tend to ignore clear evidence against their current belief, known as confirmation bias, and forecast future prices using past rising trends, known as extrapolation bias. These biases drive momentum and overconfidence in financial markets as agents overestimate their ability and self-control, thinking they will sell before prices peak. Irrational choice also leads agents to overvalue current benefits and undervalue future costs in financial decisions. This present bias leads them to take on too much risky debt in a boom. Another important bias is loss aversion, where agents give greater weight to a given loss than to an equivalent gain. This could explain why traders and bankers took ever greater risks as potential losses loomed in the recent crisis.[47]

Turner (2010), the former head of the UK Financial Services Authority (FSA), argues the insights from behavioural finance should shape post-crisis financial regulation. He suggests regulators start with non-paternalistic policy including measuring and publishing financial bias information, educating agents and providing information to counteract bias and help to achieve a more efficient outcome. Another alternative is designing specific policy to

[47] For an introduction to behavioural bias models see Deaves et al. (2010), Lunn (2013), Shefrin (2010) and Nyberg (2011). For more on specific biases see Piazzesi and Schneider (2009), Jlassi et al. (2013), Della Vigna (2009).

counteract biases and push financial choices towards the efficient outcome. This is what Sunstein and Thaler (2008) call a policy 'nudge'. Nudge policy would be non-paternalistic, if agents agree rationality is best but just cannot achieve it. However, nudge policy would be paternalistic if agents are just not able to see what a rational financial choice should be (Ross, 2014).

Financial regulators have begun to use behavioural theory and evidence to develop financial regulation. In particular, the UK's financial conduct regulator is integrating behavioural theory into its analysis of financial regulation, and US and UK regulators have turned to it for framing pension policy. The UK Financial Conduct Authority (FCA) plans to integrate behavioural theory within its traditional market failure analysis of financial regulation.[48] For example, recent evidence shows people buy insurance against small losses at prices well above cost of provision (Gabaix and Laibson, 2006). Baker and Seigelman (2013) use biases to explain this and argue that enhanced disclosure regulation has no effect, banning point of sale offers only works in some circumstances, and creating new on-line markets for insurance is better than price regulation when bans are ineffective. The FCA has now conducted new research to examine these regulatory proposals.[49] Following Sunstein and Thaler's (2008) suggestion that other biases such as procrastination, inertia and regret may lead to inefficiently low levels of pension take-up, US and UK regulators have now built automatic enrolment into new pension regulation as a non-paternalistic policy to enhance take-up.

### Bias, Regulation and Politics

Although research advances have made identifying the prevalence of biases easier, tackling their influence effectively is not so easy. Behavioural economics research has proved that even highly-intelligent and well educated individuals are prone to errors of judgement and are subject to systematic biases and use heuristics that prevent them from behaving in their own long-term interest (Lunn, 2012). The corollary justifies expanding the scope of paternalistic regulation employed for individuals' own good by directing how and when choices are made, by using nudges or by using regulations with debiasing effects (Jolls and Sunstein, 2006). However, despite the mounting

[48] For a good review of behavioural finance policy from the FCA see Erta et al. (2013).
[49] A full discussion from the FCA can be found in Iscenko et al. (2014).

robust evidence against the standard rational economic model, the anomalies identified are far from universal (Issacharoff, 1998; Jolls and Sunstein, 2006) – i.e. no one is behaving irrationally all the time. This has led economists and lawyers to argue for the design of ‘asymmetrically paternalistic regulation’ (Camerer et al., 2003) aimed at countering potential inbuilt bias, that would be beneficial to those with bounded rationality and will-power but harmless to rational, sophisticated, decision-makers.

Whereas traditional free market regulatory strategies such as enhanced disclosure have failed (Ben-Shahar and Schenider, 2011), good examples of asymmetrically paternalistic intervention have succeeded. The use of default rules (selecting the ‘best option’ for most people as a default), framing of information, cooling-off periods and restricting and simplifying choices has proved successful in insurance, pensions and saving, consumer credit, asset portfolio allocation and other areas.[50] Concern about whether such interventions are impinging on individuals’ freedom of choice have led to the conceptualisation of ‘benign paternalism’ (Benjamin and Laibson, 2003) or ‘libertarian paternalism’ (Sunstein and Thaler, 2003) where regulatory instruments preserve the individuals’ ability to choose for themselves. Yet, the prospect of this alluring ‘third way’ is debated as it lies in the tension zone between social science aspirations and political realism, where there is only an illusion of choice and the full implications of welfare maximisation are not fully analysed (Bubb and Pildes, 2013). This third way, like all the others is still subject to short-run political manipulation.

Accepting these ‘real people’ limitations calls into question existing regulation drafted on the traditional basis of informed and rational choice, self-control and consistent time preferences. It also raises the question of whether there could be a better or more accurate analysis of the effects of the laws[51] and a revision of the regulations drafting process that incorporates behavioural economics remedies. Nevertheless, there are difficulties in

[50] For a full discussion and evidence see Camerer et al. (2003), Baker and Sigelman (2013), Benartzi and Thaler (2003), Iscenko et al. (2014), Johnson et al. (1993), Lusardi at al. (2009) and Ratner et al. (2008).

[51] For a discussion on the analysis of regulatory laws see Bernheim and Rangel (2005), Greenstone (2009), Jolls et al. (1998), Sunstein (2013) and Sunstein and Thaler (2003) and on the regulation drafting process see Obama (2015), Office of Fair Trading (2010) and Oxera (2013).

operationalising the insights from behavioural economics owing to the varying impact on human behaviour of even successfully-proven debiasing mechanisms (Issacharoff; 1998). For instance, selecting the ‘best level’ for the default choice for employees’ savings is difficult when facing procrastination and different optimal saving rates (Choi et al. 2003); instead, the alternative of requiring individuals to make ‘active decisions’ might be preferable (Carroll et al. 2005).

Behavioural economics highlights that whilst regulators are exposed to political influence from pressure groups and regulatory capture (Becker, 1983; see public choice theory), they are also real individuals, subject to the same bounded rationality, biases and heuristics they are trying to regulate away.[52] The enthusiasm with which governments are rushing to embed behavioural science insights into financial regulation[53] may be caused by biases such as availability (the salience of behavioural economics research output and overestimating the errors made leading to and during the crisis), overconfidence (underestimating the chances of their biases influencing policy-making, overestimating the success of their policies) and present bias (excessive short-run focus linked with political cycles). The first step in the application of behavioural economics insights must be on debiasing the regulators and minimising the drivers of inefficient regulation.

Given that governments are the result of individual choice during elections, the assumption that governments are benevolent, corruption-free, and ‘reliably rational and farsighted enough’ (Benjamin and Laibson, 2003: p 8) to dependably act in their citizens’ best interest is also questionable. Further, social effects of government action may worsen following policy intervention. Even if regulations prove effective, they will change incentives on human behaviour with unexpected consequences such as the emergence of new biases/errors.[54] There is a clear need to evaluate the effectiveness of the new behaviourally-enhanced regulatory toolkit against traditional and purely

---

[52] This debate can be followed in Barr et al. (2008), Benjamin and Laibson (2003), Cooper (2013), Cooper and Kovacic (2012), Erta et al. (2013), Issacharoff (1998) Jolls et al. (1998) Jolls and Sunstein (2006) and Juurikkala (2012).
[53] Evidence of this rush to behavioural policy can be found in Erta et al. (2013), European Commission (2013), Obama (2015), Office of Fair Trading (2010).
[54] This debate is well discussed by Bubb and Pildes (2013), Jolls et al. (1998) and Jolls and Sunstein (2006).

behavioural financial policy measures. This may not be possible (Lipsey, 2007: 356), and even if it is, regulators' confirmation bias will make it difficult to objectively interpret the complex evidence, when the political stakes are high.[55]

Despite criticisms, policy evaluation relies on cost-benefit analysis developed from the welfare economics framework and this may not be the appropriate evaluation technique for policy derived from behavioural insights.[56] One solution proposed to address regulator bias is to establish 'an internal adversarial process' (Cooper 2013: 3), where a welfare-focused team of economists or a panel of peers reviews the policies generated by the regulators. However, this could yield complex, inconsistent bodies of financial regulation, raising regulatory costs and increasing the burden of compliance (Juurikkala, 2012).

The recent financial crisis has focused academic and regulator attention on using behavioural economics to develop policy responses in financial markets. Whilst behavioural economics is based on the descriptive approach of psychology and prospect theory, it is now being adopted as an additional tool within the traditional normative market failure approach of achieving financial market efficiency. Regulators are thinking that correcting the identified bias with an appropriate 'nudge' or 'incentive', will move behaviour towards economic efficiency, in the same way that the correct market failure policy can make markets more efficient. The market failure approach to policy relies on rational choice to work, but the behavioural approach shows that bias means individuals choice is not rational and in some cases, cannot be corrected.

**Changing Course for the Future?**

The evidence from the past 50 years shows that in a less than best world, with too few policy tools to correct all market failures – adding extra layers of regulation creates unintended incentives, making markets less efficient. In the future, adding extra layers of behavioural policy to existing market failure regulation may compound the effect in financial markets. Also the recent

[55] See Juurikkala (2012) and Cooper and Kovacic (2012).

[56] The cost-benefit and policy evaluation debate can be followed in Posner and Adler (1999), Seinden et al. (2006) and Sunstein (1999).

crisis highlights the inadequacy of financial regulators who have the same limitations and biases as other agents.

Whilst behavioural insights have given new impetus to paternalistic financial market regulators, the rush to the new policy approach (Obama 2015; European Commission 2013) indicates political as well as regulator bias and puts a question mark over the ability of democracy to generate socially efficient outcomes. These factors mean there will be more unknown unintended consequences from the new approach, with a greater need to evaluate alternative financial regulation using the only available tool - cost-benefit analysis - built on the assumptions refuted by behavioural insights. Behavioural bias is seen as a new form of market failure in financial markets, which can be addressed by creating regulation to achieve normative social welfare maximisation. However, this 'market failure plus' approach is the antithesis of the descriptive, positive framework from which behavioural finance was derived.

The discussion has shown how behavioural insights have led to policies such as overt default rules in workplace pension enrolment and covert default rules like RU64, where advisors recommending private non-stakeholder pensions must state the benefit over stakeholder pensions, making the latter the hidden default. The existence of RU64 also highlights how sensitive choosing a default can be, especially when the interests of the parties involved do not align. In this case, how the default choice is framed becomes crucial. There are risks in these new layers of financial regulation: e.g. the risk of inefficient regulation owing to increased complexity, the risk of regulators/politicians manipulating individuals through their biases, and the risk of bias in regulators. Whilst some regulators including, the UK FCA, have designed an 'integrated analysis' to build new policy and examine the risks, including proposals for comparative policy analysis, none have addressed the issue of regulator bias.

Although there is no clear way forward, our discussion suggests financial regulators should be more transparent when using behavioural policy and must be open to debiasing criticism. Regulators need to state the normative policy goal in terms of improved efficiency as this is still the underlying goal. They should create open forums for specialist and public evaluation of available evidence. This should include the evidence on political, as well as pressure group and regulator manipulation of proposals. The effects of limiting individual choice should also be analysed and the potential for monitoring and managing unintended consequences be considered.

## References


Avgoulias E, 'The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of New Orthodoxy', *Journal of Corporate Law Studies* , Vol. 9, No.1 (2009) pp. 23-59. http://www.tandfonline.com/doi/abs/10.1080/14735970.2009.11421534

Baker T and Siegelman P, 'Protecting Consumers from Add-On Insurance Products: New Lessons for Insurance Regulation from Behavioral Economics', *Connecticut Insurance Law Journal*, Vol. 20 (2013) pp. 13-1. http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1440&context=faculty_scholarship

Barberis N, *Psychology and the financial crisis of 2007–2008, forthcoming,* in: M. Haliassos (Ed.) Financial Innovation: Too Much or Too Little? (Cambridge, MA, 2013). http://faculty.som.yale.edu/nicholasbarberis/cp10.pdf

Barr M, Mullainathan S and Shafir E, *Behaviorally Informed Financial Services Regulation, Asset Building Program Policy Paper* (Washington DC: New America Foundation, 2008). https://www.fdic.gov/about/comein/behaveApril1a.pdf

Becker G, 'A Theory of Competition Among Pressure Groups for Political Influence', *The Quarterly Journal of Economics*, Vol. 98, No.3 (1983) pp. 371-400. http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.359.7578&rep=rep1&type=pdf

Ben-Shahar O and Schneider C, *The Failure of Mandated Disclosure*, University of Chicago Law and Economics, Olin Working Paper No. 516; University of Michigan Law and Economics, Empirical Legal Studies Center Paper No. 10-008 (2011). http://ssrn.com/abstract=1567284

Benjamin D J and Laibson D, *Good Policies for Bad Governments: Behavioral Political Economy*, Presented at the Federal Reserve Bank of Boston's Conference on How Humans Behave: Implications for Economics and Economic Policy (Cape Cod, 10 June 2003). https://www.bostonfed.org/economic/conf/conf48/papers/benjamin_laibson.pdf

Benartzi S and Thaler R H, 'Save More Tomorrow™: Using behavioral economics to increase employee saving', *Journal of Political Economy*, Vol. 112 No1, Pt.2 (2004) pp. S164-S187. https://faculty.chicagobooth.edu/Richard.Thaler/research/pdf/SMarTJPE.pdf

Bernheim B D and Rangel A, *Behavioral Public Economics: Welfare and Policy Analysis with Nonstandard Decision-Makers*, NBER Working Paper No. w11518 (2005). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=776006

Bubb R and Pildes R, *How Behavioral Economics Trims Its Sails and Why, Harvard Law Review*, Vol. 127, NYU Law and Economics Research Paper No. 13-29 (2014). http://ssrn.com/abstract=2331000

Buffa A, Vayanos D and Woolley P, *Asset Management Contracts and Equilibrium Prices*. Boston University School of Management Research Paper No. 2492529 (2014). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2492529##

Camerer C, Issacharoff S, Loewenstein G, O'Donoghue T and Rabin M, 'Regulation for Conservatives: Behavioral Economics and the Case for 'Asymmetric Paternalism', *University of Pennsylvania Law Review*, Vol. 151 (2003) p. 1211, 2003; Columbia

Law and Economics Working Paper No. 225. http://ssrn.com/abstract=399501

Carroll G, Choi J, Laibson D, Madrian B and Metrick A, *Optimal Defaults and Active Decisions*, NBER Working Paper No. 11074 (2005). http://www.nber.org/papers/w11074

Choi J, Laibson D, Madrian B and Metrick A,. 'Optimal Defaults', *The American Economic Review: Papers and Proceedings*, Vol. 93, No.2 (2003) pp. 180-185.

Cooper J C, 'Behavioral Economics and Biased Regulators', Mercatus Center At George Mason University (November 2013). http://mercatus.org/publication/behavioral-economics-and-biased-regulators

Cooper J and Kovacic W, 'Behavioral economics: Implications for regulatory behaviour', *Journal of Regulatory Economics*, Vol. 41, No. 1 (2012) pp. 41-58. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1892078

Deaves R, Luders E and Schroder M, 'The dynamics of overconfidence: evidence from stock market forecasters', *Journal of Economic Behavior & Organization*, Vol. 75, No.3 (2010) pp. 402–412. http://www.sciencedirect.com/science/article/pii/S0167268110000831

DellaVigna S, 'Psychology and Economics: Evidence from the Field', *Journal of Economic Literature*, Vol. 47 (2009) pp. 315–372. https://www.aeaweb.org/articles.php?doi=10.1257/jel.47.2.315

Erta K., Hunt S, Iscenko Z and Brambley W, *Applying behavioural economics at the Financial Conduct Authority*, Financial Conduct Authority Occasional Paper No.1 (2013). https://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-1.pdf

European Commission, *Applying Behavioural Insights to Policy-Making, Joint Research Centre*, Institute for Prospective Technological Studies (Luxembourg: Publications Office of the European Union, 2013). http://ftp.jrc.es/EURdoc/JRC83284.pdf

Gabaix X and Laibson D, 'Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets', *The Quarterly Journal of Economics*, Vol. 121, No. 2 (2006) pp. 505–40. http://pages.stern.nyu.edu/~xgabaix/papers/shrouded.pdf

Greenstone M, *Towards a culture of persistent regulatory experimentation and evaluation*, in D. Moss and J. Cisterno (Eds.) New Perspectives on Regulation, The Tobin Project (Cambridge: MA, 2009) pp. 111 – 125.

ICB (2011). Independent Commission on Banking, Final Report, September 2011, http://webarchive.nationalarchives.gov.uk/20131003105424/https:/hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf

Iscenko Z, Duke C, Huck S and Wallace B, *How does selling insurance as an add-on affect consumer decisions* FCA Occasional Paper No. 3. Financial Conduct Authority (2014). Https://www.faca.org.uk/our-fca/documents/occasional-papers/occaisional-paper-3

Issacharoff S, Can There Be a Behavioral Law and Economics? *Vanderbilt Law Review*, Vol. 51, No. 6 (1998) pp. 1729-1745.

Jlassi M, Kamel N and Mansour W, 'Overconfidence behavior and dynamic market volatility: evidence from international data'. *Procedia Economics and Finance*, Vol 13 (2013) pp. 128 – 142. http://www.sciencedirect.com/science/article/pii/S2212567114004353

Jolls C and Sunstein C R, 'Debiasing Through Law', *Journal of Legal Studies*, 35 (2006) pp. 199-241 http://www.law.yale.edu/documents/pdf/Debiasing_Through_Law.pdf

Jolls C, Sunstein C R and Thaler R H, 'A Behavioral Approach to Law and Economics', *Stanford Law Review* (July 1998). http://www.law.harvard.edu/programs/olin_center/papers/pdf/236.pdf

Johnson E, Hershey J, Meszaros J and Kunreuther H, 'Framing, Probability Distortions, and Insurance Decisions', *Journal of Risk and Uncertainty*, Vol. 7, No. 1 (1993) pp. 35-51. http://ssrn.com/abstract=1424065

Juurikkala O, 'The Behavioral Paradox: Why Investor Irrationality Calls For Lighter And Simpler Financial Regulation', *Fordham Journal of Corporate and Financial Law*, Vol. 18 (2012) pp. 33-94. http://fordhamcorporatecenter.org/files/2013/01/Juurikkala-Article.pdf

Kay J, *The Kay Review of UK Equity Markets and Long Term Decision Making* (2012). https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

Kahneman D and Tversky A, 'Judgment under Uncertainty: Heuristics and Biases', *Science*, Vol.185 (1974) pp. 1124-1131. http://psiexp.ss.uci.edu/research/teaching/Tversky_Kahneman_1974.pdf

Lipsey R, 'Reflections on the General Theory of Second Best at its Golden Jubilee', *International Tax and Public Finance*, Vol. 14, No. 4 (2007) pp. 349–364. http://link.springer.com/article/10.1007/s10797-007-9036-x#page-1

Logue K D and Baker T, 'Mandatory Rules and Default Rules in Insurance Contracts', *Law & Economics Working Papers*, No. 86 (2013). http://repository.law.umich.edu/law_econ_current/86

Lunn P, *Can Policy Improve our Financial Decision-Making?* Renewal Series Paper No. 8, Economic and Social Research Institute (ESRI) (2012). http://www.esri.ie/pubs/EC008.pdf

Lunn P, 'The Role of Decision-making Biases in Ireland's Banking Crisis', *Irish Political Studies*, Vol. 28, No. 4 (2013) pp. 563-590. http://dx.doi.org/10.1080/07907184.2012.742068

Lusardi A, Keller P and Keller A M, *New Ways to Make People Save: A Social Marketing Approach*, NBER Working Paper No. 14715 (2009). http://www.nber.org/papers/w14715.pdf

Nosfinger J, 'Household behavior and boom/bust cycles', *Journal of Financial Stability*, Vol. 8, No. 3 (2008) pp. 161– 173. http://www.sciencedirect.com.ezproxy.derby.ac.uk/science/journal/15723089/8/3

Nyberg P, *Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland*, Commission for Investigation into the Banking Sector in Ireland (2011). http://www.bankinginquiry.gov.ie

Obama B, *Executive Order - Using Behavioral Science Insights to Better Serve the American People*, Office of the Press Secretary, The White House (15 September 2015). https://www.whitehouse.gov/thepress-office/2015/09/15/executive-order-using-behavioral-science-insights-better-serve-american

Office of Fair Trading (OFT) *What Does Behavioural Economics mean for Competition Policy?* Office of Fair Trading, 1224. Crown Copyright (2010). http://www.oft.gov.uk/shared_oft/economic_research/oft1224.pdf

Oxera , *Behavioural Economics and its Impact on Competition Policy: a Practical Assessment with Illustrative Examples from Financial Se*rvices, prepared for ACM, (May 2013). www.oxera.com

Piazzesi M and Schneider M, 'Momentum traders in the housing market: survey evidence and a search model', *American Economic Review, Papers and Proceedings*, Vol. 99, No.2 (2009) pp. 406–411. http://web.stanford.edu/~piazzesi/search.pdf

Podolski E, 'Regulating Synthetic Securitisation Following the Global Financial Crisis', *The Australian Economic Review*, Vol. 45, no. 1 (2012) pp. 14–28.http://web.a.ebscohost.com.ezproxy.derby.ac.uk/ehost/pdfviewer/pdfviewer?sid=ae72daba-9850-4b56-b401-93eab8742afd%40sessionmgr4005&vid=1&hid=4106

Posner E and Adler M D, *Rethinking Cost-Benefit Analysis*, John M. Olin Program in Law and Economics Working Paper No. 72 (University of Chicago Law School, 1999). http://chicagounbound.uchicago.edu/law_and_economics/427/

Ratner R K, Soman D, Zauberman G, Ariely D, Carmon Z, Keller P A, Kim B K., Lin F, Malkoc S , Small D A and Wertenbroch K, 'How behavioral decision research can enhance consumer welfare: From freedom of choice to paternalistic intervention', *Marketing Letters*, Vol. 19, No.3–4 (2008) pp. 383-397.

http://apps.olin.wustl.edu/workingpapers/pdf/2008-07-014.pdf
Ross D, 'Psychological versus economic models of bounded rationality', *Journal of Economic Methodology*, Vol. 21, No. 4 (2014) pp. 411-427. DOI:10.1080/1350178X.2014.965910
Sienden A, Kysar D A and Driesen D M, *Cost-Benefit Analysis: New Foundations on Shifting Sand*, Faculty Scholarship Series, Paper 373 (2006). http://digitalcommons.law.yale.edu/fss_papers/373
Shefrin H and Statman M, *Behavioral Finance in the Financial Crisis: Market Efficiency, Minsky, and Keynes*, Santa Clara University Research Paper (2011). http://www.russellsage.org/sites/all/files/Rethinking-Finance/Shefrin%20Statman%2001272012.pdf
Shefrin H, *How psychological pitfalls generated the global financial crisis*, in: L. B. Siegel (Ed.) Voices of Wisdom: Understanding the Global Financial Crisis. Charlottesville: Research Foundation of CFA Institute (2010).
Shiller R J, 'From Efficient Markets Theory to Behavioral Finance', *Journal of Economic Perspectives*, Volume 17, No. 1 (2003) pp. 83–104. http://aida.wss.yale.edu/~shiller/pubs/p1055.pdf
Shu H and Chang J, 'Investor Sentiment and Financial Market Volatility', *Journal of Behavioural Finance*, Vol. 16 (2015) pp. 206–219. DOI: 10.1080/15427560.2015.1064930
Simon H, *Economics, Bounded Rationality and the Cognitive Revolution*, Elgar (Aldershot, England, 1992).
Sunstein C R, *Cognition and Cost-Benefit Analysis*, John M. Olin Program in Law and Economics Working Paper No. 85 (University of Chicago Law School, 1999). http://chicagounbound.uchicago.edu/law_and_economics/109/
Sunstein C R, 'The Regulatory Lookback', *Boston University Law Review* Vol. 94 (2013) pp. 579-602. http://ssrn.com/abstract=2360277
Sunstein C and Thaler R, 'Libertarian Paternalism is Not an Oxymoron', *University of Chicago Law Review*, Vol. 70, No.4 (2003) pp. 1159-1202.
http://faculty.chicagobooth.edu/Richard.Thaler/research/pdf/LIbpatLaw.pdf
Sunstein R and Thaler C, *Nudge: Improving Decisions about Health, Wealth and Happiness*. (Newhaven CT: Yale, 2008).
Turner A, *Behavioural Finance Regulation, Centre for Economic Policy Research Commentary*, VoxEu debates, CEPR (2010). http://www.voxeu.org/debates/commentaries/behavioural-financial-regulation

VI

# UK’s Financial Services and the EU:

## What should the framework be?

Syed Kamall

The slew of financial regulation emanating from Brussels since the financial crisis has focused much attention on the relationship between the UK financial services sector and the European Union (EU).

As a Member of the European Parliament for London and a member of the influential Economy and Monetary Affairs committee of the European Parliament, I have spent much time over the last few years scrutinising EU legislation that has a direct impact on financial services in the UK. As leader of the European Conservatives and Reformists (ECR), the third largest of the eight political groups in the European Parliament, I have also been helping the British government in discussions with EU leaders as it negotiates changes to the UK relationship with the EU. The subject of the UK’s financial services industry has inevitably been discussed.

The regulation of financial services by the EU is currently in a state of transition. Lord Hill, the current Commissioner for financial services, in contrast to his almost hyperactive predecessor Michel Barnier (who was once accused of wanting to announce a new regulation every week), stunned his officials by asking whether their proposals are needed and to consider the impact of new regulations. The slow launch of the Capital Markets Union, which aims to unlock alternatives to bank financing, give savers more investment choices and establish a genuine single capital market in the EU, is a signal that the European Union is moving beyond the 'knee-jerk' rush to regulate that characterised the years immediately after the financial crisis.

The aims of the EU financial services legislation have clearly shifted from focusing on stability and reducing risk - under the 2009-14 European Commission of Jose Manuel Barroso - to economic growth and jobs under the current Juncker Commission.

This shift in focus to growth, access to finance and a shakeup of traditional financial services culture will have an impact on UK financial services and hopefully offer opportunities.

While the emphasis on growth is welcome, if EU and UK financial services regulation is to evolve successfully, the focus should be on four elements: future proofing; global outlook; relevance to those affected and horizontal legislation.

### Future Proofing

One of the problems with any set of regulations is its ability to adapt to changing markets or technology. Sometimes new services or products make existing laws seem inadequate. In contrast, over-zealous regulation could kill off potentially exciting new services or products. The speed of change makes regulation even more challenging. To paraphrase Marco Rubio, 'It took the telephone 75 years to reach 100million users, while it took Candy Crush only 1 year to reach 100 million users.'

The booming FinTech sector opens up new opportunities for investors, savers and consumers, but may also create new risks. While arguably, legislators and regulators have not yet resolved the riskiness of banks, we also need to look ahead to potential risks from new products, services and players in financial services.

Where FinTech firms operate as intermediaries between buyers and sellers, how do we ensure they do not take on systemically relevant - that is too much - risk? While governments and businesses are rightly concerned about cyber security, how do we ensure that the opportunities created by the use of virtual currencies do not lead to civil unrest were there to be outage or closure.

### Thinking Globally

For many Britons, it is only natural to argue that the EU should think globally when adopting financial services rules. However, the thinking within in EU institutions can sometimes verge on pure protectionism.

For example, the first draft of the Alternative Investment Fund Managers Directive (AIFMD) (2011) proposed that EU investors should only be able to invest in funds domiciled in the EU with EU fund managers and EU depositories. When it was pointed out in the European Parliament that this would reduce investment opportunities, a French MEP responded that the EU with a population of 500 million was a large enough market. This response not only dismissed the much larger population of 6.5 billion people outside the EU, but also the knock on effects of fewer investment choices and lower returns for investors in EU countries. Fortunately, the directive that emerged was less protectionist but the issue of access to funds in non-EU countries still remains unresolved. If not concluded, some funds may be split into mirror funds with investors outside the EU potentially enjoying higher returns.

Surely, we want our investors and entrepreneurs to have access to markets across the world and if the British people vote to remain in the EU, we will need to tackle the 'little European' mentality that exists in some national capitals and in parts of Brussels.

**Relevant, Focused and Right**

One of the biggest complaints about financial legislation is that it often makes life more difficult for those working in the industry and for savers and investors. However, when politicians meet financial services firms to learn about the way they work and better understand the potential consequences for those affected, they are accused of being too close to lobbyists.

When MEPs were considering the contents of the 'key information document' (KID) to be given to potential investors, as part of the Packaged Retail and Insurance based Investment Product (PRIIPS) directive, at one point, the discussion turned from the content to the layout of the document. Unfortunately, an NGO in favour of ever more financial regulation had produced mock up 'key information documents' (KIDs) which some MEPs were keen to champion. However, no-one had actually tested these documents on potential investors and while there were many well-intentioned politicians sat around the table, none had a background in graphic design. After much back and forth, eventually it was agreed to leave the final design to those with specialist knowledge of the field who would base their designs on the feedback from user panels.

This illustrates the circumstances in which legislators and regulators should seek the advice of specialists with expertise in the field as well as users of the product wherever possible in order to remain focused on those who will ultimately be affected.

**Horizontal Legislation**

With so much EU legislation post-crisis, we often find ourselves part of an almost 'domino effect' where when one piece of legislation is agreed, it becomes clear that another will have to be amended in order to ensure compatibility or remove new inconsistencies. For example, new rules on depositories introduced in AIFMD led to the UCITS V* proposal to take account of changes to depository liability as well as a proposal on short selling and uncovered bonds. This may keep MEPs and EU officials busy and is great for business in Brussels, but is it really the best way to legislate?

Could the EU look at a more horizontal approach, where interlinked legislation affecting different parts of the financial services industry is agreed alongside each other rather than continuing to topple regulatory dominoes?

**What Problems Are Being Tackled? Why?**

One of my favorite quotes about EU financial regulation in response to the crisis is ‘When a fight breaks out in a bar, you don't hit the person that started the fight; you hit the person you have always wanted to hit!’ In the immediate aftermath of the crisis, the European Commission rushed out proposals on hedge funds and private equity even though the crisis was caused by problems with the banking sector, financial instruments such as CDOs and CDSs and bad debt. This agenda, driven by the desire of French and German governments, European Commission officials and MEPs to hurt hedge funds and private equity has left problems unsolved.

Ultimately, issues such as no taxpayer bail outs for failed banks, directors accepting responsibility and questionable accounting standards, which should have been tackled immediately, unfortunately remain open.

* Undertakings for Collective Investment in Transferable Securities Directive.

# VII
# Unfinished Business*
John McFall

## The Crisis. Questions for Parliament

The financial crisis of 2007-8 and its aftermath continue to be the subject of the policy debate. Its contributing factors were examined by a number of parliamentary committees of both houses of Parliament. These included the House of Commons Treasury Committee, which I chaired until 2010 and the joint Parliamentary Commission on Banking Standards, to which I subsequently belonged as a member from the House of Lords. [58] As parliamentarians, we had a particular responsibility for considering the elements which led to the crisis and how policy could prevent a recurrence.

There was little disagreement across the Parliamentary and political spectrum about the consequences of the crisis and the failure of the banking sector. Not only did taxpayers, customers and the economy suffer, but the reputation of the financial sector was damaged and trust in banking was seriously undermined.

Going to the heart of the different enquiries was the underlying question of what, fundamentally, was wrong with the system? How could a recurrence of such developments be prevented? How could the damage caused to the financial sector itself, to the economic life of the country and the people who contribute to it be avoided in the future? Such questions continue to lie behind the discussion and policy debate.

Unless the events of 2008 are seen as part of a global crisis, it is hard to make sense of what happened or of the deep malaise in the world economy.

---

*This chapter draws on the published records noted below:
I am grateful to the official publisher The Stationery Office, TSO, for permission to refer to the following documents.
House of Lords, Bank of England and Financial Services Bill, 26 Oct. 2015 http://www.publications.parliament.uk/pa/ld201516/ldhansrd/text/151026-0002.htm
House of Lords debate, 2015, vol 765, cols 1043-1084.
http://services.parliament.uk/bills/2015-16/bankofenglandandfinancialservices/stages.html
*Report: Changing banking for good*, The Parliamentary Commission on Banking Standards. HL Paper 27-I, HC 175-I*, Published June 2013, by authority of the House of Commons, London: The Stationery Office Limited.

Although different emphases can be put on the role played by one factor or another, there is broad agreement that certain developments were particularly significant. In particular the lack of personal responsibility in the industry, including by senior people, and of an adequate system of accountability and sanctions is seen to have played a part. There was a disconnection too between the risks and rewards in the banking sector, an absence of proportionality and not enough focus on the longer term benefits in the balance of incentives. In all of these failings the actions of regulators and governments had contributed to the decline - they were one step behind the economy and still appear to be.

There has also been broad agreement on what problems need specifically to be tackled as a priority and what sort of arrangements might be introduced. The general sense has been that if future crises are to become less likely, the framework within which banks operate must change and a new culture of professional ethics fostered. This would need, as the Parliamentary Commission on Banking Standards proposed, better, but not necessarily more, regulation. Professionalism is at the core of the problem: what is now needed are institutions that can be run by people professionally competent in banking. So far we have not even begun properly to address what professionalism means in this industry.

**The Policy**

The Parliamentary Commission on Banking proposed that certain high responsibility roles in the banking system should be allocated to specific people. These designated people should be held accountable for decisions about standards in the bank. It recommended also that the system should be underpinned by licensing arrangements which would allow that those guilty of harm be subject to sanctions (enforcement powers). A new criminal offence should be introduced with the possibility of a custodial sentence for those who behaved recklessly in managing the bank.

As a member of the Parliamentary Commission on Banking Standards I supported such recommendations. In addition to such recommendations I have proposed that a professional regulator along the lines of the medical or legal professions be introduced.[59] Along with others, including Mervyn King, former Governor of the Bank of England, I have recommended that the banks be split between retail and investment. Not only would such a separation promote safe retail banks which avoid the ‘casino’ activities that contributed to the crisis, giving people who only use banks’ retail services a different type of bank. It would be a more transparent, effective and efficient system and allow a workable framework for protecting retail banks without bailing out investment banks. It would, incidentally, deal with the conundrum of ‘too big to fail’.

Although some of these proposals have in principle won a measure of broad agreement, policy has lagged or remains patchy or cumbersome. There has been some structural reform and changes to improve the system of accountability and tackle questions of governance. These include such propositions as the ring fencing of banks’ retail activities, greater senior individual accountability, greater transparency in the industry and a more proportionate link between risk, achievement and reward.

Nonetheless there are significant gaps. The problem of separating different banking functions remains despite the ‘ring fence’; so does the problem of size and whether the structures have become ‘too big to manage’. There are difficulties too about the accountability system for senior managers. And in terms of governance, there are reasons for concern about the system both proposed and in place for the Bank of England, which since 2010 has been treated as part of the ‘solution’ and invested with ever greater powers. Here too there appears to be inadequate mechanisms for accountability. All in all opportunities have been missed for *better*, as distinct from *more*, regulation which could prevent a recurrence. Even in the current Bank of England and Financial Services Bill 2015-16 (introduced in the House of Lords in October 2015 and now passing through Parliament) there is scope to put things on a better footing. Here I would like to concentrate on four such issues: the separation of banking; too big to manage; the accountability of top bankers; the governance of the Bank of England.

[59] Hansard, House of Lords, 15 Sep 2011, Cols 909-911.

**Unfinished business**

*The separation of banking***.** The policy of separation has been much needed. Like others, I was prepared to go along with the concept of ring-fencing to give it a chance. However the evidence was and remains that it was impossible to separate retail from investment; that the culture as between retail and investment is different. The retail bank must be customer focused whereas the investment bank is trading and anonymous, one from which personal relationships are eliminated and unimportant, a permanent distinction highlighted by the then Barclays Chairman, Sir David Walker. He had initially supported ring-fencing, but within a year he decided that it had had its day in 2015.[60] Paul Volcker, the former Chairman of the Federal Reserve (1979-1987), explained the problem to our Committee: that there would be two boards, that the legal responsibility would be on the holding company directors and that it was unrealistic to expect these not to have an unremitting interest in responsibility for the retail. Such questions and those of independence, which continue to be highlighted by the banks lobbying of the Governor of the Bank of England, have still to be tackled; they have not been dealt with by the Bank of England and Financial Services Bill, 2015.

A policy of separation would also go some way to tackling the other problem of ‘too big to manage’.

*Too big to manage*. Although the focus since 2007/8 has been on ‘too big to fail’ because big bank failure can damage the economy and governments therefore turn to taxpayers to bail out the banks, there is another side to the matter. Are big institutions ‘too big to manage’?

Size is a serious factor. The combined total of assets of 28 global banks which was $38 trillion in 2006 (an average of 1.4 trillion per bank) had grown to $50 trillion in 2013 (an average of $1.8 trillion for each bank). If one trillion seconds amount to 32,000 years, that’s a great deal of money. It is therefore no surprise that many of those in charge of the banks fail to understand the issues for individual institutions. Are the banks therefore too big to manage? HSBC chairman, Douglas Flint, responded to the query

[60] James Quinn, ‘Former Barclays chairman: Bank ring-fence is redundant and should be scrapped’, *The Daily Telegraph*, 2 June 2015.

whether HSBC too big to manage, 'That is a good question' - leaving the answer in the air.

*Accountability – Senior Managers.* The Parliamentary Commission on Banking Standards identified a very clear problem of accountability at the top. 'Top Bankers', we said 'dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision making. They then faced little realistic prospect of financial penalties, or more serious sanctions'.[61]

This problem has not yet been addressed. In the Bank of England and Financial Services Regulation Bill 2015-16, plans have been dropped to reverse the burden of proof which would have forced senior managers if there was wrong doing on their watch, to show they had done the right thing. The responsibility for proof is being handed back to the regulator who must prove before bringing disciplinary proceedings, that a senior manager had not taken steps. In practice, as the former regulator Martin Wheatley put it, there is an accountability firewall within institutions. (*Chief executive, FCA, 2011-2015). Given that such a system did not work in the past, indeed failed in spectacular fashion, there is no reason to believe it can work in the future. Another regulator, Sir Howard Davies, now chairman of the Royal Bank of Scotland, illustrated the problem in 1998. As chief executive and chairman of the FSA which presided over much of the subsequent crisis, he suggested that one of the least appealing features of a number of scandals was the implied failure of the system in which junior managers lost their jobs when things went wrong, but senior managers were not held to account.[62] Davies nonetheless believed that the arrangements for personal registration in which specified individuals at the top of the firm would have clear responsibilities for risk management and compliance and the proposals that he put into place meant that they could be held fully accountable.[63] That did not seem to happen and in the course of the PPI mis-selling the failing was highlighted, as it was at the time of the Barings collapse.

[61] *Changing banking for good*, p 8.
[62] Howard Davies, *Are Words Still Bonds: How Straight is the City?*, Speech at the Securities Institute Ethics Committee, London, 2nd November 1998.
[63] Howard Davies, Speech at the Egon Zehnder International Insurance Symposium, Munich, 26 April 2001.

The mis-selling and misconduct of PPI (lasting 15 years or more) cost UK banks £40 billion in fines and redress, a figure which represents more than three times the cost of the London Olympics. To this day nobody except the chief executive of 'Land of Leather' appears to have been held to account. He was disciplined by the FCA for mis-selling but remains the only senior manager to have been. The message therefore seems to be that those who mis-sell in a sofa shop will be punished but those who mis-sell in the financial system, despite its vital role in the whole economy, will be safe!

**Governance, accountability and the Bank of England**

To these weaknesses in the system should be added another. In the governance arrangements for the Bank of England which have emerged since the crisis there is an absence of constitutional accountability. The Bank's responsibilities and remit have gone through many changes since the 1990s and more are proposed under the current Bill.

Take one example, the proposal that the Bank would act as the Prudential Regulation Authority taking on the PRA's responsibility for the microprudential regulation of the solvency of banks. That would mean that the arrangements for the PRA under the 2012 Financial Services Act, (following the failure of the predecessor FSA), will change. However is it sensible to downgrade the PRA to the status of a mere committee not a subsidiary of the bank? There is a good case for it to work as a separate authority given that recent experience since 2008 and earlier indicates that a free standing PRA, with its own rule book, is needed. There is a danger that one result of such a change will be an even more powerful governor of the Bank.

The proposal to downgrade the PRA prompts a fundamental question, about the structure of the Bank, whether it is becoming more opaque, more unwieldy and less fit for purpose. How far have changes to its remit improved or undermined performance? What has the impact of QE really been? How accountable has the Bank been and to whom, for adding £15,000 more debt to every person in the UK? Who pays it? Such questions point to the need for a stronger system of governance, for checks and balances in the Bank itself and for ensuring the right system of accountability. It should allow the central bank to operate independent of the politics of the day and to follow its remit, and yet, to be fully accountable to Parliament and society itself.

**Conclusion**

Shortly before Lehmans crashed, the IMF, Goldmans and JP Morgan all had the US economy accelerating. In fact, there is and has been systematic failure of the global system accompanied by a profound misunderstanding by most financiers and economists of how the world economy works. Because they knew but little of the overall financial system, they failed to comprehend its systemic weakness. There was little sense of the whole.

According to the IMF in April 2006:

> 'There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped to make the banking and overall financial system more resilient … ' (IMF Quarterly, April 2006). [64]

In February 2006, Tim Geithner, who was President of the Federal Reserve Bank of New York (2003-09) and subsequently US Treasury Secretary (2009-13), said:

> ' … we are now in the midst of another wave of innovation in finance. The changes now underway … the rapid growth in instruments for risk transfer and risk management, the increased role played by nonbank financial institutions in capital markets … and the much greater integration of national financial systems … provide substantial benefits to the financial system. Financial institutions are able to measure and manage risk much more effectively. Risks are spread more widely, across a more diverse group of financial intermediaries, … contribut[ing] to … improvement in the financial strength of the core ... intermediaries and in the overall flexibility

[64] IMF, *Global Financial Stability Report: The influence of credit derivative and structured credit markets on financial stability*, April 2006.
http://www.imf.org/External/Pubs/FT/GFSR/2006/01/pdf/chp2.pdf

and resilience of the financial system ….' (Timothy F. Geithner, February 28, 2006).[65]

Here in Britain what we have managed to do is restore the same system but with a few bells added. Moreover the Government's decision to secure all private debts of the banks, has imposed a burden of unknown magnitude on future generations of tax payers. It has also caused populism to take hold globally.  If we fail to apply ourselves to fully fixing the systematic failures within the current system that populist reaction may prove fatal for the cohesion of the social fabric of society.

[65] Timothy F. Geithner, President and Chief Executive Officer, 'Risk Management Challenges in the U.S. Financial System', Remarks at the Global Association of Risk Professionals (GARP) 7th Annual Risk Management Convention & Exhibition in New York City, February 28, 2006. https://www.newyorkfed.org/newsevents/speeches/2006/gei060228

VIII

# The City and its Global Future:

## What next?

Gerard Lyons

What about The City and the U.K. financial services industry? What lies ahead? What will be the impact of either remaining in the European Union (EU) or of Brexit, a British exit from the EU?

**The City – A UK success story**

The City of London has proved to be a remarkable success story. Over decades, if not centuries, it has continued to reinvent itself. Despite the ups and downs of the economic and political cycles or the changing financial climate, the City has remained always at the forefront of global finance. When other competitors have moved ahead, it has adapted and changed. Indeed, this year marks the thirtieth anniversary of 'Big Bang', when financial deregulation triggered a sea change in The City. Almost overnight, it became international and modern, while at the same time retaining many of its unique and successful traditions. Since then the City has retained a cutting, competitive edge.

The UK financial sector covers a huge range of areas, many of which are international and so could be located anywhere. These include banking, insurance, equity and bond markets, fund management, commodities trading, maritime services as well as legal services, professional and business services, accounting and management consultancy.

Importantly, London remains responsive to new ideas and has managed to position itself well in growing markets such as Islamic finance, sovereign wealth, the offshore Chinese currency market, in carbon markets and dispute resolution. Even the increase in global regulation is a growth area for London. It really is impressive and highlights London’s global reach.

The City's success cannot be seen in isolation from the attraction of London as a location in which to work, live and play. The 'London Vibe', as it is sometimes called, reflects the capital's dynamism and attraction as a creative and cultural hub. The English language and unique time zone are also favourable attractions for London as a financial centre.

London's population has seen a truly international shift in recent decades. Since the 1991 census, the numbers born overseas that now live in London have increased by two million, so that now, 38 per cent of London's population has been born overseas, placing it on a par with other major international cities like New York and Singapore. Recently a report by Deloittes pointed out that London has the highest number of people working in high skilled, knowledge based sectors of any city. This number has risen in recent years, and now stands at 1.47 million, versus 1.2 million in New York. The next closest in Europe is the 0.63 million in Paris. New York has slightly more people working in the financial sector, highlighting where the main competition to The City comes from. London's financial sector benefits from a diverse hinterland including areas such as law, tax and consultancy, among others. Having access to people with the right skills is vital for continued success.

**In or Out of the EU? The Eurozone conundrum, current constraints**

What then of the EU debate? It is important to stress that we should not fool ourselves that the City is somehow safe in the EU. During the recent negotiation, the UK did not achieve a veto to protect itself from greater control by the eurozone and from the decisions of the European Court of Justice. In recent years there has been increased tension between the eurozone and non-eurozone members, with the European Court of Justice having to decide on areas of contention. In these situations the ECJ has to decide between the single market (which includes the UK) versus the eurozone (which doesn't).

In one case, in 2015, following concerted political effort, the ECJ decided in favour of the single market and wider EU, by allowing euro clearing to take place outside of the eurozone and in London. While this was a significant victory, it followed a trend in which the UK has witnessed a declining ability to influence the regulatory environment for the financial sector, in areas such as the bank bonus tax, financial transactions tax and a ban on short selling.

Remaining in the EU does not resolve the issue. In the future it is likely that the eurozone will centralise further, ensuring that the ECJ will have to decide again in the future on areas of contention. Protecting the City was considered one of the most important aspects of the Prime Minister's renegotiation, but the legal opinion is that water tight protection was not achieved. The fact that Lord Hill is the European Commissioner with responsibility for financial issues does not alter the substance of this.

**Current Constraints.** According to the 2014 UK Government competency review on the financial services, 'Over the last ten years, there has been a roughly ten-fold increase in the volume of EU law on financial services'. The same competency review also highlighted the extent of EU intrusion into retail markets. The following example from the UK pensions funds industry provides a clear example, around 61 per cent of defined benefit schemes in the EU as a whole are in the UK and 24 per cent in the Netherlands. The National Association of Pension Funds commented that, 'It seems wholly inappropriate that the 20 plus Member States with less than 1 per cent of defined benefit liabilities should, collectively, have a greater say in relation to supervision and funding requirements for those liabilities than the UK and Netherlands; even Germany and Ireland have only 4 per cent and 2 per cent respectively'.

**London: A global centre and a European giant**

Thus, within the EU, the future challenges are clear. Notwithstanding this, it is hard to imagine London not being the main financial centre in Europe, regardless of whether the UK is in or out of the EU. The following points explain why:

Seventeen years ago, at the time of the sterling/euro debate, the fear was that if the UK did not join the euro then London would lose out to one of its perceived rivals of Amsterdam, Frankfurt or Paris. Now, it is hard to imagine any of these being seen seriously as a rival to the City, even though Paris is now sometimes mentioned. Rather, in recent years, global finance has become concentrated in a few centres across the globe. As a result London's rivals now are seen as being New York, Singapore or Hong Kong.

Current consensus thinking is that London could suffer in two ways from Brexit. It could lose passporting rights, the impact of which would vary and depend upon a firm's particular business model. Or it might be that the ECJ decision on euro clearing is reversed, and that this business would move to somewhere in the eurozone, perhaps to Luxembourg or Paris.

While this has to be taken seriously, the impact may be more marginal. Moreover the business and policy environment can change, as it has done frequently in finance, and usually in the direction of greater concentration.

And in this context the following points are valid:

London is so much more competitive than any other financial centre in Europe, with its concentration of skills, knowledge and expertise.

More regulation is being set at an international level, globally and beyond the EU which is important because London's competition is global. Ultimately there would be increased independence for The City but it would still be subject to UK regulation based on internationally agreed policies set by bodies such as the Financial Stability Board (FSB), Committee on Payments and Market Infrastructure (CPMI) and International Organisation of Securities Commission (IOSCO).

**For the Future: Changing the terms of the debate**

Were the UK to leave the EU, the UK authorities could in their negotiation aim to change the terms of the debate, become more proactive in forcing the new agenda rather than passively waiting to see what comes out of the Article 50 negotiation. In some respects we could learn from the Americans. Their dominance means they have securities regulation that forces firms and individuals to have a US presence or qualifications to do business there. The extent to which London dominates European finance means we could seek such an 'a la carte' menu here. With the European Union needing to develop their capital markets, this has to play into London's hands. This could all be part of any post EU negotiation.

CityUK, the financial services group, continues to highlight that 2.2 million people work in the financial industry across the country, and not just in the Square Mile. One has to ask how these will be impacted by Brexit? Does the fact that their activity combines a combination of retail, back office and other business areas such as asset management make them resilient in the face of Brexit? The answer is likely to be yes. Also, would Dublin, as the English speaking nation in the EU see an influx of back office activity? Likewise, could some of the back office and other areas suffer even if we remain in the EU as rising migration adds to upward pressure on housing and other costs, and in turn leads to some business relocating elsewhere? While these questions need to be asked, it is likely that automation suggests these jobs are as likely to be carried out by computers, in any low cost centre, although I would expect them to remain in the same time zone.

The reality is infrastructure of the financial industry is not easily replicated, which explains that while there are other financial centres across Western Europe, such as in Dublin, Luxembourg or Geneva, they are in specialised areas.

As the UK Government's competency review says, the figures speak for themselves:

> ‘The UK is the largest centre for cross-border borrowing, with 251 foreign banks operating across the UK in March 2011, more than in any other country worldwide, and around half of all European investment banking activity conducted in London. The UK insurance industry is the largest in Europe and third largest in the world, after the US and Japan. With an estimated £5.2tn of assets under management at end-2012, the UK is the largest asset management centre in Europe with around 36 per cent of the European market and the second largest centre in the world. The UK is the second largest global centre for hedge fund managers and pension fund assets after the US. And the UK is the largest centre of foreign exchange and OTC interest rate derivatives activity, with 41 per cent and 49 per cent of global turnover respectively in April 2013.’

Finance increasingly knows no borders. This should cement London's strong position. Technical change also threatens to see the emergence of new, disruptive technologies. Fortunately for the City, London is at the forefront of the financial technology, or Fintech, Revolution. Just as it has embraced change in the past, London looks set to adapt and change, as well as play to its global strengths in the future.

# IX
# Conclusions, Recommendations and Proposals

Sheila Lawlor

## Reassessing the crisis and response

In reassessing the crisis and its causes, the authors highlight certain factors:

(i) The institutional stability of the sector from the 1870s to 1970s and the underlying reasons contrast dramatically with the turbulence of recent developments.

The authors explain how questions such as 'risk' were managed in the earlier period, how shareholder vigilance worked and the role exercised by 'financial repression' (designed to reserve bank resources to buy war-time and post war government debt). It becomes clear that certain factors were useful in entrenching the historic stability of the banks: the role played by the Bank of England as lender of last resort, the development by bankers themselves of a culture of caution and public responsibility and the role of government in achieving a regulatory environment that worked (Capie & Wood, Roberts, Matthews).

(ii) The 'causes' or contributing factors to the 2007/8 crisis are analysed under a number of complementary headings. On some, there has been common agreement; others highlighted here by the authors may not have featured so significantly in the policy debate.

The pattern which emerges is one of many variables e.g. the climate of moral hazard, the shift to the active marketing of loans in the 1980s, the downgrading of generalist branch managers in favour of credit officers and the move by banks into mortgage lending, hitherto the preserve of building societies, are illuminated as part of the whole (Roberts, Capie and Wood).

Other factors are also highlighted including those which may have had less of an airing outside specialist academic debate. These include the savings glut; the failings of international regulation (Matthews, McFall); the use of an inflation targeting approach that, bizarrely, did not take adequate account of monetary indicators (Matthews, Smith) and which, even more bizarrely, continues to influence official thinking today. Moreover, the omens foreshadowing a crisis could be seen for over two decades, stretching back to the 'small banks' crisis of the early 1990s, then to the 2007 mainstream banking crisis and even to signs ever since the early1970s of the link between banking and housing crises (Roberts).

**Current policy: Failures and impact**

The authors explain where the policies are inadequate or damaging to the whole economy, or where the consequences may have potentially grave implications for future stability, success and democratic accountability. The policy response by HMG, the EU and the regulatory framework known as Basel III not only avoided tackling some of the real problems, but introduced new and further obstacles to the recovery of an economy rendered fragile by the crisis. Much regulatory activity also failed to tackle (or entrenched) structures which lacked transparency and accountability. The analysis of two parliamentarians from the British and the European Parliaments, with specialist knowledge and experience, adds to and bears out the academic analysis, providing a telling reminder that nothing significant has changed (Matthews, McFall, Kamall).

**In particular the following problems remain:**

**Banks are still 'too big to fail'**. The policy of 'ring fencing' has not been seen as a success; the mechanisms to ensure greater accountability by senior managers lack teeth. And further problems and obstacles have crept in (McFall).

**The regulatory response**, including the demand for higher capital and liquidity ratios may in principle have much to be said for it. But much depends on the practical detail (Roberts, Matthews). The timing was ill judged at a time when the economy was particularly fragile, prolonging and exacerbating the downturn. (Matthews).

**The European Banking Authority and Basle III's regulations to increase capital and liquidity ratios will have long-term implications that are not evidently desirable.** These include reducing the rate of bank asset growth, which has the effect of slowing bank credit growth and constraining recovery

(Matthews). And while the case for imposing liquidity requirements may be strong, there is some debate about whether imposing capital requirements is justified, because capital requirements can encourage people to ‘game’ the system (Smith).

**The regulators’ targeting bankers’ bonuses may indeed change behaviour**, but they are detrimental to the banking business and have resulted in excessive ‘risk reduction’ and credit rationing. The two variables (pay and risk taking) are linked together by a third variable ‘too big to fail’ (Matthews).

**The adoption of ‘behavioural’ measures into the regulatory process introduces greater risks of regulation being inefficient**. It increases complexity and the risk of regulators and politicians manipulating individuals through their biases and the risk of bias in regulators (Powell and Michaels).

**Power has been concentrated in the hands of the Bank of England and its structure could make things more opaque and without adequate transparency.** Decisions taken by the Bank can avoid proper scrutiny, e.g. on the role and impact of QE, on whether and to whom the Bank is accountable (McFall), on adding £15K more debt to every person in the UK and on who will repay it? (McFall). If such wealth transfers from savers to borrowers happened under fiscal policy, parliamentary approval would have been needed (Smith).

**The wrong ‘targets’ have been picked not merely by HMG, but by the EU’s Commission**. For example proposals were rapidly issued after the crisis to restrict hedge funds and private equity, even though the crisis had been largely confined to the banking sector and financial instruments such as CDOs and CDSs and bad debt (Kamall). The agenda was driven by the French and German Governments, EC officials and MEPs to hurt the hedge funds, but has left the really important problems unresolved (Kamall). As a result, problems that should have been tackled, such as no taxpayer bail outs for failed banks, directors accepting responsibility, and questionable account standards, remain open’ (Kamall).

**The EU framework makes the legal framework for the UK financial sector uncertain**. The sector is subject to the rulings by the European Court of Justice. The underlying trend has been the declining ability of the UK to influence the regulatory environment for the sector (Lyons). In the prime minister's recent negotiations protecting the City was seen as a central aim, but legal opinion indicates that that has not been achieved (Lyons).

**EU Regulation has increased tenfold in the last decade.** There has been a ten-fold increase in volume of EU law on financial services in the past decade with extended EU intrusion into retail markets. In one instance of pension provision critics have noted that 20 countries with only 1 per cent of defined benefit schemes had greater say than the UK with 61 per cent or the Netherlands with 24 per cent.

**For the Future:**

**Looking ahead, the authors propose a clear course based on the following principles to guide successful policy for the future**:

I. The overall system of governance is central from board level (Roberts) to the Bank of England, as are the overall structures for accountability from the Bank of England to senior managers. These need to be put in place (McFall).

II. 'Too Big to Fail' must be tackled. For some authors it must be restored to the priority agenda (McFall); for others alternative solutions should be considered such as ensuring that market discipline plays a stronger role in designing capital adequacy requirements (Matthews) and allowing failure 'in an orderly fashion' (Wood and Capie).

III. Shareholder interests should be aligned with managers' and ways of promoting risk-sharing between the state and private shareholder sought (Matthews). Moving to the better alignment of behaviour and remuneration should go with long term performance (including penalties and rewards) (Roberts). While the proposals to align behaviour and remuneration better with long term performance seem in principle to be in the right direction, the practical framework will be central if problems are to be addressed (Powell and Michaels).

IV. Lessons can be learned from banks which weathered the crisis, e.g. the existence of a conservative culture, a strong deposit base, restraint in developing structured products, resistance to shareholder activist calls to increase leverage, one example being HSBC (Roberts).

V. The official bodies should adopt as a priority economic models which take adequate account of monetary indicators, and not just the official interest rate. Unless we restore monetary stocks to their central place in economic modelling, we may face subsequent upheaval again (Smith).

VI. Policy makers should make more transparent the link between traditional market failure policy and their use of behavioural insights. Transparency will lessen political pressure and special-interest group manipulation (Powell and Michaels).

VII. The arrangements for regulation should include steps to identify and reduce the impact of regulator and political behavioural bias. Scrutiny by the public and those with specialist knowledge and experience will lead to less distorted policy outcomes (Powell and Michaels).

VIII. The system must allow for regulator bias to be tested particularly in the case of policies open to regulator or politician 'bias' and manipulation – some of which are now being adopted in law and regulation (Powell and Michaels).

IX. In the event of Britain voting to leave the EU, the UK authorities should become more proactive to promote the new agenda for the financial sector, rather than awaiting the outcome of Article 50 discussions. Lessons should be learned from the US - their securities regulation obliges firms and individuals to have a US presence or qualifications to do business there. London's dominance of European finance should allow it to seek an 'a la carte' menu (Lyons).

**Subscribe to Politeia's Publications!**

For £35 a year (£30 standing order) you will receive an electronic copy of each of our publications, plus hard copies of two new publications on request, and, if you wish, free hard copies of your choice from our back catalogue. You will also receive advance notice and invitations to Politeia's conferences and flagship events, with guest speakers from the UK and overseas.

More information can be found on our website: www.politeia.co.uk. Or, write to the Secretary, Politeia, 33 Catherine Place, London SW1E 6DY or at info@politeia.co.uk

**A Selection of Recent and Related Publications**

Dumbing Down the Law – The SRA's Proposals for Legal Education
*Anthony Bradney*

The British Bill of Rights: Protecting Freedom Under the Law
*Jonathan Fisher QC*

Paying for the Future: Working Systems for Healthcare and Pensions
*Ludger Schuknecht, Matthias Dauns, Werner Ebert*

Working Welfare: Contributory Benefits, the Moral Economy and the New Politics
*Frank Field*

QE for the Eurozone - What does this mean?
*Tim Congdon*

The UK Government Spending Ratio: Back to the 1930s?
*David B Smith*

The Financial Sector and the UK Economy: The Danger of Over-Regulation (Vol I)
*J. McFall, K. Matthews, P. Minford, D.B. Smith and others*

Magistrates Work! Restoring Local Justice
*Stanley Brodie, John Howson, Simon Reevell*

What's the Point of the Human Rights Act?
*Dinah Rose QC*

Crises Managed: Monetary and Fiscal Frameworks for the Future
*Michael Bordo and Harold James*

Zero-Plus: The Principles of EU Renegotiation
*Martin Howe QC*

History in the Making: The New Curriculum, Right or Wrong?
*David Abulafia, Jonathan Clark and Robert Tombs*

The financial crisis of 2007/8 and its causes still loom large in the debate about Britain's economy and its recovery. While politicians and economists agree on some of the main contributing factors and the broad principles needed to guide future policy, there is less certainty about next steps. How should the law be shaped? Are the UK government and its European counterparts on the right tracks?

In this volume, some of Britain's leading UK economists and politicians in the field, reassess the crisis, the regulatory response and the wider implications. They contrast the turbulence of recent decades with the stability of the preceding century; they discuss the different factors leading to the crisis, including some hitherto largely ignored; and they show where the official response has been and continues to be flawed, badly timed and damaging.

They recommend where the government should change its focus, and they propose a clear set of principles and a practical course for a stable, prosperous and successful global industry.

**POLITEIA**

**£10**