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CURRENT ISSUES IN FINANCIAL REGULATION, AND THE RETURN OF THE POLITICAL ECONOMY

*John Nugee**

Since our previous Essay on the current issues in financial regulation, which we issued in March of this year (Nugee and Sven, 2011), the pace of regulatory and legislative activity has continued and increased. A more comprehensive picture of the future regulatory landscape for financial markets has started to emerge. The new EU-wide regulatory bodies, that were set up at the start of the year,[1] have become more established and are beginning to drive their agendas forward, while in the United States, construction and implementation of the various rules specified in the Dodd-Frank Act continues.[2] At both global and national levels, the banking and financial system is responding to regulatory requirements to raise more capital to ensure compliance with tighter supervisory regimes.

This activity is far from complete. The task that the authorities have set for themselves is ambitious in the extreme; the program of rewriting financial legislation already looks to be even more comprehensive than the only comparable re-regulation exercise the financial world has previously experienced, vis-à-vis, that conducted in the 1930s after the 1929 Wall Street Crash and 1933 Great Depression. But already it is possible to discern the general trend of future financial regulation, and the driving impetuses behind it.

This Article, therefore, takes the opportunity to step back from a blow-by-blow account of the various changes and enhancements to regulation to consider the broader picture. And in doing so, we observe not just a change in the scale and scope of financial regulation, but underneath that a fundamental change in the attitude of governments toward markets and finance itself.

THE "EXTRAORDINARY TWO DECADES" OF GLOBALIZATION AND FREE MARKETS

The scale of the financial collapse since 2007 has challenged almost every belief and certainty that the developed world held about the place of finance in society its methods of operation. The task facing the authorities is not only to restore order to the financial system and shore up its defenses against future crises, a task that is in its self hugely challenging,

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I am much indebted to my colleague Dr. Sven Kasper, European Head of state Street's Regulatory, Industry and Government Affairs (RIGA) Unit, for his extensive help and advice in the preparation of this essay. The thoughts expressed however remain my own and do not necessarily represent either those of State Street Corporation generally or the company's RIGA Unit specifically.

[1] The three European Supervisory Authorities, created on 1 January 2011, are the London-based European Banking Authority (EBA), the Paris-based European Securities and Markets Authority (ESMA) and the Frankfurt-based European Insurance and Occupational Pensions Authority (EIOPA).

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama In July 2010. The Act is not complete in itself; however, as in many instances it merely sets out the framework of legislation, leaving the details to be filled in by subsequent rules. It is these rules, by some counts numbering over 240, that contain the detailed regulatory requirements and specifications on which work continues.

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especially in Europe, but also to seek to understand how such a crisis could have occurred and whether there was a fundamental flaw in the construction of global finance. Indeed, many people, both in government and in society at large, would hold that after such a catastrophic crash, the imperative is to go beyond the reactive operation of repairing and restoring the system in its old form, and instead refashion and build it anew.

This stance of the authorities as pro-active agents of change is a significant departure from the orthodoxy of the period immediately prior to the crash. From around 1986 (after the UK's "Big Bang" deregulation) to 2007 regulators largely stood back from markets and on the whole applied a relatively light touch approach. However, it is important to realize that it is not the period since the crash which is unusual and a departure from standard practice, as much as the two decades before it.

Indeed, it is this period between 1989 and 2007 that future historians will look back on as the exception and contrary to the normal state of the world. This was a period of dominance by one country and one ideology; after the collapse of the Soviet Union and before the rise of China, the United States was dominant as few countries have ever been in history. The American creed of Freedom, Democracy, and Capitalism was largely unchallenged, certainly in the developed world, and in particular, the belief in Globalization and Free Markets as the best way to run the world's financial system gained almost universal acceptance, led in many cases by the Breton Woods Institutions.[3] Despite this widespread acceptance, neither of these states of affairs, dominance of one country and one ideology, is historically the norm. This situation has far-reaching consequences.

The lack of a viable alternative to the Free Markets standard created a dynamic that favored one particular approach to the exclusion of all others which, therefore, was unchallenged and unconstrained. Left to ourselves, it is human nature to extrapolate; we tend to think in a linear fashion, and there is a common belief that "if X is good, then more of X is even better." But in a world which appears to be non-linear, such linear thinking tends to lead to excesses, overshooting and suboptimal outcomes. Food is good, but too much food can lead to obesity. Transparency is good, but too much can lead to paralysis. And freedom is good, but too much can lead to anarchy. Markets of course notoriously overshoot and so, on the evidence of the recent crisis, so can ideologies. An ideology which is wholly unchallenged seems likely to run to excess and thereby expose it inherent flaws and failings. The result, as we have seen, is that mostly unchallenged and left mostly to themselves some financial institutions and their practices ran increasingly out of control, and in 2007-2008, the financial system blew up.

SOCIETY'S RESPONSE: THE RETURN OF GOVERNMENT AS PRO-ACTIVE AGENT

Society's response to the financial crisis has been characterized by three phases. First, it displayed shock and disbelief at the scale of the collapse; second, anger at the cost of the rescue; and third, a deep and ongoing desire for action against what many see as "an

[3] For example, the IMP's adherences to the belief that exchange controls on the capital account are always and at all times to be avoided if possible, a belief which was an absolute article of faith for the Fund right through the Asian crisis in 1997-98 and the early 2000s. It is only quite recently that the IMF has nuanced its position, and accepted that in some circumstances, controls can be beneficial.

immoral industry."[4] After the initial period of crisis –resolution and fire-fighting, the political class had no option but to respond to society's feeling and electoral pressures. The political response has been to seek to regain the initiative and reflect society's deep concern at the way the financial industry had developed, and both the scale and the speed of that political response reflect the intensity of public opinion.

As a result authorities are developing a (pro-) active agenda for the financial sector, seeking to shape events, markets and the industry as a whole rather than merely reacting, and using regulation to achieve political ends rather than merely stability-orientated ones. The wholesale attempts in the European Union in particular to control, or in some cases, completely outlaw such diverse elements of the markets as the activities of the credit rating agencies, short selling, high frequency trading hedge funds, shadow banking and the like go far beyond "restore and repair," and speak of an agenda to radically change and reshape markets and the way they operate. In our view, the full extent of this ambition is not yet widely enough recognized within the financial sector.

The scope and ambition of the proposed legislation is impressive, and initiatives such as the Volcker Rule, which seeks to curtail proprietary trading and sponsoring of "hedge funds" by banks, and the recommendations of the Vickers Report in the UK,[5] aim to make structural changes to the industry on a par with those made by the 1933 Glass-Steagall Act in the United States. With such an agenda, it is inevitable that some government actions and decisions will be controversial, and it is also inevitable that they will not all be successful. Some legislation will be hurried and muddled, others will have unintended consequences and there is an overall risk of fragmentation of global financial markets and, as a result, regulatory arbitrage (Nugee and Sven, 2011).[6] But the financial community will be mistaken if it thinks it can resist the broad thrust of government's intentions by arguing too precisely about the details.

CONSEQUENCES FOR MARKET PARTICIPANTS AND INVESTORS

The first and most obvious consequence of the return of government as pro-active agent, what we might call the Return of the Political Economy, is that with it we have seen the Return of Political Risk. This, the risk that unpredictable actions by governments might radi-

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[4] Psychiatrists will recognize this as the standard three-stage reaction people have to major setback or personal tragedy – denial, anger, response. The denial, and especially the anger, are necessary to energize people into action to counter the disaster they have suffered.

[5] The Volcker Rule, which among other things prohibits proprietary trading and sponsorship of certain hedge funds and private equity funds by banks, is one of the numerous new requirements enacted a s part of the Dodd Frank Wall Street Reform and consumer Protection Act (the "Dodd-Frank Act"). As with a number of other provisions in the Dodd-Frank Act, key details related to the "Volcker Rule" have been delegated to US regulatory agencies, who are currently in the process of drafting proposed, and ultimately final rules. The Independent Commission on Banking chaired by Sir John Vickers published its final report on 11 September 2011. Amongst other things, the report recommends that, by early 2019, U.K. retail banking activities should be ring-fenced into separate subsidiaries and that both ring-fenced banks and wider financial institution groups should be subject to capital requirements that are stricter than those required by Basel III standards.

[6] In this paper we argued that amongst other things, the regulatory response to the financial crisis could lead to a less globalized world. Whilst potentially increasing fragmentation is seen as something at least to regret, we suggested that it is perhaps better to see it as both a natural consequence of the increasing diversity of the world economy, and also, while entailing economic inefficiencies and limiting the most optimal allocation of capital, not without its advantages and opportunities.

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cally change the outlook for investors and the value of their assets, may now be higher in the Developed World ("DW") than in the Emerging World ("EW"). Many EW countries now not only offer better debt dynamics (lower deficits, lower debt-to-GDP ratios) and credit risk than DW countries, but also more stable politics and lower political risk.[7]

This will pose a challenge to investors, as it is unlikely that returns on DW assets will fully reflect their increased risk. Indeed, with inflation and national solvency concerns rising in the peripheral DW, while in contrast monetary policy continuing to be lax, the risk-return equation on DW sovereign bonds does not seem inherently attractive and the implication is that EW sovereign bond markets look increasingly attractive both on an absolute basis and even more so on a risk adjusted basis. The attractiveness to investors of DW debt is further weakened and questioned by the lesson from the crisis that DW debt instruments, despite their presumed status in current regulation, are not risk-free. They are unlikely to retain the "risk-free asset" status, with likely implications on investors' demand.

A second consequence of government action to re-regulate the financial system is that profitability in the financial sector is likely to be heavily impacted. The most obvious conclusion of the return of tighter regulation is that returns on equity in the financial sector will be squeezed, as higher capital and tighter lending conditions reduce the return on core activities and regulatory restrictions reduce the opportunities for proprietary trading.

This should not be exaggerated though. Returns are likely to remain healthier than the more strident critics of the bankers would suggest, especially when considered on a risk-return basis, though it will be interesting to observe whether investors are able to effect any change in the split between returns to executives and returns to shareholders. What does seem likely, however, is that the super-cycle of rapid growth and very high profits which the sector enjoyed for the 20 "extraordinary" years (1986-2007) driven by financial engineering will decline. This is to be expected; it was not natural for the financial sector, a service sector, to grow at 15% a year nominal for so long while the economy it served only grew at 5% a year nominal.

One outcome for investors is the likely decrease in the attractiveness of bank assets, and a re-rating of bank equity. To a certain extent this is already happening, especially in Europe where bank shares are trading at levels compared to book that are a fraction of what they were only 2-3years ago, let alone before 2007. A more interesting consequence might be a reduction of the role of the banking sector in much of European corporate finance will increasingly resemble its U.S. equivalent, with a much larger role for corporate bonds and commercial paper. If so, it is quite probable that the European authorities will not stand in the way of such a move and, scarred as they are at the moment by an over-large and over-fragile banking system, they may even welcome it. Interestingly, over recent months, we have seen some asset managers attempting to fill the funding gap for the real economy by providing credit and funding through different structures and vehicles. It remains, however, to be seen

[7] For example, consider the changing conditions in the European government bond markets, where in the last 18 months investors have faced "voluntary" debt exchanges variously proposed at a haircut of 21%, 50% or more, the lack of clarity about whether these constitute a default for the purposes of the CDS market, the rapidly changing exchange margin requirements for holders of some government bonds, the uncertainty over the extent of ECB buying of government bonds under the Securities Markets Program, the possible introduction of Collective Action Clauses in 2013, and so on. And all of this is in what has traditionally been seen as the safest and least volatile of markets.

what impact upcoming regulatory initiatives on "shadow banking" are going to have on these efforts.

The theory that banking systems are made safe by making each individual banking institution safe has been the standard approach of bank regulators for over 30 years. Increasingly this looks like a self defeating mantra. Indeed, one of the main consequences of tighter regulations and ever higher capital requirements seems to be to make the banking industry more concentrated and inter-connected, with the unfortunate result that if and when a bank does fail, the knock-on effects on other banks are very large and may bring some of them down too.

The result is an escalation of the problem of banks being Too Big To Fail, and there are those in the financial sector who believe that a better approach might be not to try to make bank failure impossible, but instead to seek to make it irrelevant, at least to the wider system (Haldane and May, 2011). A banking system with a much larger number of smaller, less inter-connected members might be more salient to the failure of any one of its members, and therefore, systemically safer for investors.

A third consequence of the increased regulation of banks, alas not so beneficial, is that it creates artificial regulatory barriers to entry and exit. A healthy market needs new comers who bring in new capital and new ideas, and needs also to allow failed institutions to depart as the natural consequence of inadequate or unsuccessful business modes. But banking remains an industry where both entry (i.e. a new bank) and exit (i.e. a failed bank) are extremely rare, and the ever more voluminous and onerous corpus of regulatory requirements looks set to remain a huge and growing barrier to entry.

In this sense, it is possible that the more demanding capital requirements in Basel III and CRD4[8] will disappoint. They are both based on an approach to bank regulation that proffer that barriers to entry need to be lowered and the possibility of exit (i.e. failure and bankruptcy) needs to be made more real.[9]

One unexpected and unintended consequence of the regulatory response to the crisis, with inevitably increased costs for all, is the negative impact on savings, in general, and more specifically on accessibility of savings vehicles and pension savings. The above described low interest and low economic growth environment combined with a significant number of extensive and burdensome new regulatory initiatives will impact the operating cost basis of the financial services industry, including pension funds. The result is likely to be lower returns on pension savings and a widening of the pension gaps, reluctance by consumers to save given the minimal returns, and a possible reduction in the choice and availability of invest-

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[8] The Basell III Accord was formally adopted by the Basel Committee on Banking Supervision ("Basel Committee") in December 2010. It is designed to strengthen the resilience of the global banking industry in the face of financial or economic stress, and incorporates both a capital and a liquidity framework. The key goals of the capital framework are to raise the quantity, quality, consistency and transparency of regulatory capital, enhance risk coverage and sensitivity, and supplement risk-based capital requirements via the introduction of a harmonized leverage ratio. The accord also establishes new liquidity standards for global banks. It is subject to a phased implementation beginning in 2013 and ending in 2019. The fourth alteration of the European Capital Requirements Directive (CRD IV) was published in July 2011 and aims at implementing the Basel III accord in the EU. The European proposal consists of a Directive and a Regulation, with the latter intended to establish a Single Rule Book for EU financial services institutions is directly applicable in EU Member States.

[9] This statement explores precisely the point about the failure of its members. Hence, it argues for less homogeneity in banking systems and a greater number of participants, each of which might individually be more fragile but less able to bring the whole system down.

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ment products as firms react to the regulation by reducing the number of products and limiting access to them.

Finally, it is possible that the advent of more supranational regulation will at last start to address the conundrum of how to regulate a global industry through mostly national rules and with almost exclusively national financial underpinning should institutions fail and need financial support. At the moment, this remains a real issue, and many at the nation state level are nervous about sharing what is still seen as a sign of national sovereignty. However, with governments in much of the developed world showing increased signs of fiscal fragility, the time may be right for them to overcome their concerns and pool resources for the common good. For investors, especially those, for example, with memories of losses due to the failed banks in Iceland (where the resources of the state were simply inadequate to back-stop their banks, and creditors consequently suffered real loses), this move would indeed be welcome.

CONCLUSION

The response of the authorities to the crisis in the global financial system in 2007-2008 has gone through a number of phases: fire-fighting at first, to stem the collapse, then deep analysis as to what went wrong, and finally action to increase the effectiveness of regulation. This action looks to be designed not just to repair and restore the financial system and its defenses, but increasingly one can detect a much more ambitious agenda to reshape the financial sector completely. The authorities, it seems, are no longer content to act just as managers of risk for stability orientated ends, but are increasingly pro-active agents of change, using regulation to achieve political ends. The Political Economy has returned.

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