Financial Regulation That Might Have a Chance of Working

Regulation of financial services has been an unmitigated policy disaster. Ed Kane has already described the demand for more regulation as being akin to seeking the hair of the dog after a good night out. The metaphor I prefer is that of the mediaeval sorcerer who, when his magic does not work, advocates more of the same. If only you had had shown more faith! The story ends only when the sorcerer is driven from the gates of the town.

And that is where we are with financial regulation today. We have a system which is at once extensive and intrusive, yet captured by the industry and ineffective at achieving its policy goals.

In what I say today, I wish to emphasise the goals of effective capital allocation and the promotion of financial stability. A further important objective of financial regulation w is the prevention of fraud. It is the nature of finance that it is attractive to people who wish to help themselves to other peoples money. These are not the only purposes of financial regulation, But they will do for today. I shall argue that the effective allocation of capital and financial stability are closely bound up together. The fragility we see is very largely the product of deficiencies in way the capital allocation process has developed.

There are two principal strands of regulation. The first is the deposit channel, which transmits short term , primarily into mortgage finance. The deposit channel is the subject of banking supervision. The investment channel transforms longer term savings into corporate assets, real estate and infrastructure. It is governed by the securities market regulation.

Common reasons lie behind the failure of both mechanisms of regulation. They have both come to rely on detailed prescription of behaviour in the finance sector, which has failed for the reasons central planning has failed more generally. The centre lacks either the information of competence to discharge its responsibilities, and its activities are gamed by sophisticated players with better access to local information. The regulatory process ends up chasing its own tail as it attempts to devise evermore complicated rules to achieve its underlying objectives. Financial regulation is only likely to succeed, if, like successful regulation elsewhere, it focuses on the structure of industry and firms rather than the prescription of conduct and is targeted directly on the specific objectives with the regulatory regime seeks to achieve.

What are the origins of the failures of banking regulation which led to the financial crisis of 2008?Globalisation, technical change, and ideology combined together to undermine the basis of the informal regulation, particularly evident in the UK, which had served the world tolerably well since the great depression. That informal structure was replaced by purportedly objective rules, which promoted extensive regulatory arbitrage, and outsourced the risk management of financial institutions to regulators who could not discharge the extensive responsibilities which this shift placed upon them.

The investment channel saw the adoption of a model which focused on the plumbing of public securities markets, creating a self referential world which in Europe was aptly described in the acronyms of its two principal directives, the market abuse directive (MAD) and the markets in financial instruments directive(MIFID). No one noticed that in the meantime the traditional rationale public securities markets with extensive secondary market trading had largely disappeared.

These markets had come into being in the second half of the 19th century, in the first instance to finance railways and railroads, and subsequently large manufacturing plants such as those of breweries and auto assembly lines. Equity markets met the needs of large corporations which were capital intensive and whose plant was specific to the particular purposes for which they were used. There is not much you can do with railroads or breweries other than use them for the objects for which they are intended. Equity markets garnered the savings needed to finance such plants in small sums from widely dispersed private individuals.

By the beginning of the 21st century however, the modern corporation was cash generative at an early stage of its life, typically by the time at which it became large enough to secure a quotation on public markets, These new knowledge businesses needed little capital of any kind, and that they did require was generally fungible; computers and offices not specific to the particular business, Consequently they need not be owned by the business concerned and typically were not. Most savings in the investment channel today are into mediated by large asset managers.

Perhaps the most important recent insights into the nature of resilience in complex systems others of the organisational sociologist Charles Perrow,, who has attribute fragility to tight coupling and interactive complexity. Lehman was, relative to the financial system as a whole, neither large nor essential; if it was a <u>systemically</u> important financial institution it was not an i<u>mportant</u>

financial institution. But modern finance has developed in ways that exemplify tight coupling -at Lehman through the extensive use of overnight financing - and interactive complexity - at Lehman through the existence at the time of its bankruptcy of millions of outstanding contracts.

So what is to be done?. We need to return to world of short simple chains of intermediation. I want plain vanilla banks, which take deposits and make loans. A world populated by large asset managers, with concentrated positions and focused portfolios, who are capable of establishing trust relationships between savers and companies, and w ho are themselves capable of providing the rather modest liquidity requirements of savers in the investment channel, Asset managers who relish the kind of activities that are today excluded by our insider rules.

We need to protect savers from conflict-of-interest by functional separation. The modern investment banking engages in market-making, securities issuance, corporate advisory activities, asset management, and own account trading, and only the briefest of thought is necessary to see that each of these activities conflicts with every other. That requires a return to fiduciary standards of behaviour which eliminates the concept of eligible counterparty, acknowledges responsibilities of prudence and loyalty throughout the investment chain, and accepts that everything in the investment channel is in reality other people's money.

I emphasised at the beginning of this talk the need to draw lessons from more successful regulation of other industries. Coming from London, it is chastening to observe that if London casinos had even been accused of the various malfeasances to which London banks have admitted, the individuals concerned would have been barred from the industry, and the businesses concerned required to transfer their operations other corporate entities within short order. We need to promote firmly the culture of personal responsibility, and to remove what I have described as the "shocked and appalled" who defence, In which senior executives escape liability for the actions of the subordinates by denying knowledge of their activities.

We need not more government involvement in the finance sector but less. That means moving to end the concept of lender of last resort, And even beginning to ask questions about the rationale of monetary policy. Is it in fact the case that controlling the economy through the finance industry by the manipulation of credit availability and interest rates is a means either of promoting the efficiency of the finance sector or effectively securing monetary stability? .

We should recognise the seriousness of the issues. The six years since the global financial crisis have seen the development of unfocused public anger towards the finance sector. The dangers of demagogic politicians exploiting this anger to subvert established political institutions mean that the failures of financial regulation risk becoming failures of the democratic system itself.