

# Financial regulation goes global

## Risks for the world economy

Matthew Sinclair and Dalibor Roháč | December 2010 | Briefing Paper

A joint paper by Legatum Institute and TaxPayers' Alliance

### Executive Summary

Around the world politicians and officials are advancing major new regulations of the financial services industry. Those regulations are a response to a major financial crisis, but real care needs to be taken to ensure that they help avoid future crises, and won't precipitate or exacerbate crises instead.

- Regulations and poor policy choices played a significant role in driving the financial crisis: stoking the asset boom, failing to respond effectively when it turned to bust and then exacerbating the crisis.
- The increased internationalisation of financial regulation risks amplifying future global booms and busts. Global regulations lead to global crises as organisations are encouraged to hold similar assets and respond in similar ways when things go wrong. As a result, the new regulation could increase the systemic risk to the world economy.
- Attempts to focus regulation on the institutions that contribute the most to systemic risk carry their own risks. If institutions understand that

they are seen as "too big to fail" then that will encourage excessive risk taking.

- Despite attempts to address the issue, the Basel regulations may still be procyclical, imposing more onerous requirements on institutions at times when the system is in trouble.
- Some measures proposed, like attacks on tax havens and hedge funds, are motivated by other agendas and do not actually address the problems that led to the financial crisis.

There is an important debate over whether or not effective "macro-prudential" regulatory policy is possible. However, the policies introduced since the financial crisis do not live up to that standard. Some of the measures announced are disingenuous political posturing while others continue existing mistakes partly responsible for the problems we are facing today. It is entirely possible that the new regulations being implemented could hurt established financial centres like the City of London while increasing the frequency and strength of global financial crises.

## I. Introduction

It has become customary to see the financial meltdown of 2008 as a result of “greed” and insufficient regulation of the financial services industry. That is a mistake. Regulations and policy decisions contributed to the crisis in a number of ways.

If one understands the financial crisis as a result of too little regulation, rather than the wrong regulation, it leads to further mistakes. It leads politicians and the public to focus on getting more regulation, rather than addressing the actual challenge which is to get the right regulation.

There is a real threat that new regulations could increase the number and severity of financial crises. That would mean more shareholders wiped out, more jobs lost in recessions and maybe more bailouts. It is vital that policymakers carefully consider the effects of the measures they are taking to avoid that happening. If we do not learn the right lessons from the current crisis, and bring about the next one, that will be a terrible and expensive failure.

Section 2 of this paper outlines the role that financial regulation played in bringing about the financial crisis of 2008. Section 3 provides an overview of the regulatory measures that are currently being adopted in the United States and in Europe, and how they are being coordinated. Finally, Section 4 explains why the new regulation of financial markets increases, rather than mitigates, the systemic risk present in the world's financial system.

## 2. Financial regulation and the present crisis

The starting point for any analysis of the recent instability of the financial sector has to be an acknowledgement that the system can be quite stable.

The British banking system, in particular, was mostly stable in the 20<sup>th</sup> century. The last serious deposit bank failures were in 1878, when the City of Glasgow Bank and the West of England & South Wales District Bank failed.<sup>1</sup> For that reason, we should be cautious about generalising from the present crisis to argue that the system is fundamentally unsound. Rather we should try to identify the specific factors – whether they are institutional, regulatory or monetary – that led the banks and financial institutions to take a series of unsound decisions.

---

If we do not learn the right lessons from the current crisis, and bring about the next one, that will be a terrible and expensive failure

---

In a November 2008 report the TaxPayers' Alliance set out a number of ways in which regulatory and policy mistakes had contributed to the crisis and exacerbated it.<sup>2</sup>

For a range of reasons – including strong productivity gains in the West and industrial development in countries such as China – in the build up to the crisis inflation was low, although monetary policy was expansionary. This combined with a change in how inflation was measured – which ceased to indirectly include house prices,<sup>3</sup> to produce low interest rates. Low interest rates encouraged more borrowing and riskier lending. At the same time, a perception that lasting economic stability had been achieved was encouraged by governments creating a false sense of security with claims to have “ended boom and bust”. All this led lenders to underprice risk and created an asset price boom.<sup>4</sup>

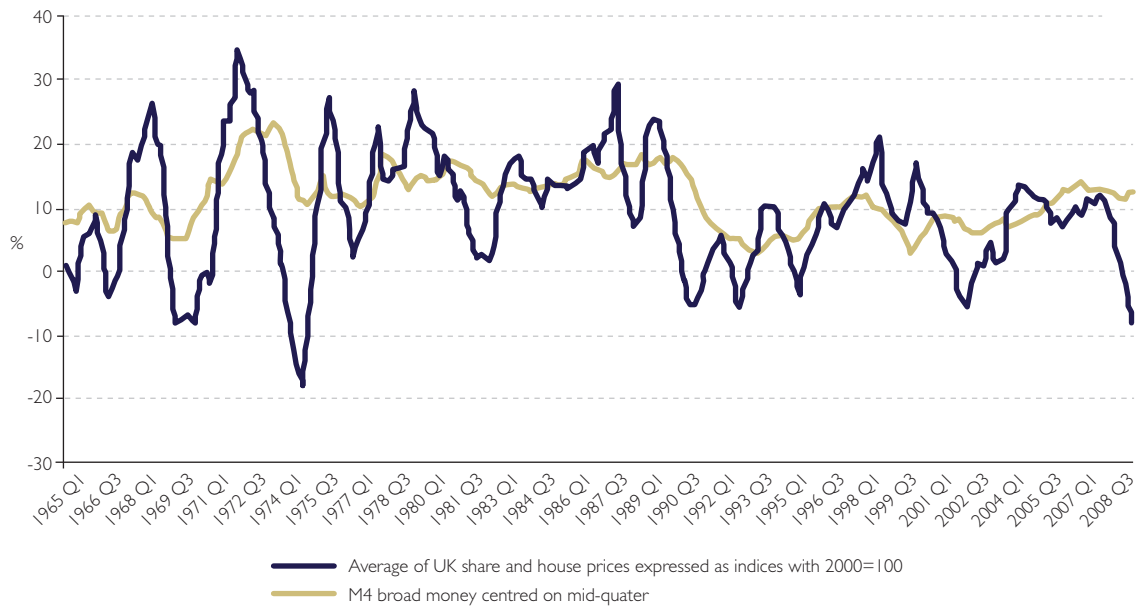
---

1 Capie, F. M. *Have the Banks Failed British Industry*. Institute of Economic Affairs, Hobart Paper 119, July 1992.

2 Sinclair, M., D. Petrova & D. B. Smith *How inept regulation and poor policy decisions drove the financial crisis*, The TaxPayers' Alliance, November 2008. Available at: [http://www.taxpayersalliance.com/home/files/how\\_inept\\_regulation\\_and\\_poor\\_policy\\_decisions\\_drove\\_the\\_financial\\_crisis.pdf](http://www.taxpayersalliance.com/home/files/how_inept_regulation_and_poor_policy_decisions_drove_the_financial_crisis.pdf)

3 Pimlott, D. 'Move to include cost of housing in CPI', *Financial Times*, 3 November 2010.

4 Goodhart, C. A. E. "Explaining the financial crisis." *Prospect Magazine*, 31 January 2008.



The above chart shows how asset prices tend to follow, but exaggerate, movements in M4 Broad Money, it shows why monetary policy is significant in driving booms and busts in asset prices.

The specific crash that precipitated the crisis was in housing. Planning regulations in Britain and parts of the United States increased the volatility of house prices.<sup>5</sup> As the supply of housing is extremely inelastic in most of Britain and coastal areas in the United States, shifts in demand have almost entirely been reflected in prices.

The housing bubble was further inflated by regulation in the United States that encouraged the relaxing of restrictions on home loans. Activist campaigns and regulations pressured banks to lower credit standards.<sup>6</sup> At the same time, and in response to political pressure, the government-backed organisations Fannie Mae and Freddie Mac bought up 44 percent of all subprime securities,<sup>7</sup> providing an implicit guarantee to primary lenders

who could therefore turn their long-term risk over to the government.

In the area of financial regulation, the Basel accords provided incentives to push lending off balance sheet. The IMF has described how there have been “strong incentives for moving even low-risk assets off the balance sheet”.<sup>8</sup> As we argue in the following sections, these incentives are here to stay even after the regulatory reforms suggested by the G20.

Once the crisis got underway, regulators struggled to respond effectively. In Britain, for example, the tripartite system meant that the Bank of England lacked the information needed to properly assess whether lender of last resort actions were appropriate or not. As early in April 2007, the economist David B. Smith warned that this was likely to become a problem.<sup>9</sup>

Despite the ineffectiveness of regulatory oversight, compliance costs rose substantially for

5 Evans, A. W. & O. M. Hartwich. *Unaffordable Housing: Fables and Myths*. Policy Exchange, June 2005, pp. 36-38. Krugman, P. “That Hissing Sound.” *New York Times*, 8 August 2005.

6 Kurtz, S. “Planting Seeds of Disaster.” *National Review*, 7 October 2008.

7 Leonnig, C. D. “How HUD Mortgage Policy Fed The Crisis.” *Washington Post*, 10 June 2008.

8 Caruana, J. & A. Narain. *Banking on More Capital: The Subprime Crisis Has Made Basel II Implementation More Important and Challenging*. IMF Publications, Vol. 45, No. 2, June 2008.

9 Smith, D. B. *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, 30 April 2007.

banks after the Financial Services Authority (FSA) took over supervision.<sup>10</sup> Although there was no absolute lack of regulation or regulators, there were longstanding concerns about serious problems at the FSA prior to the crisis. Prominent commentators criticised a lack of quality staff and insufficient focus on systemic risk, but sufficient changes were not made.<sup>11</sup>

---

There is substantial evidence to back the conjecture that regulatory and policy mistakes made a substantial contribution to the present financial crisis

---

Once the crisis was underway, a number of regulations amplified it. Mark-to-market regulations rely upon the market to provide a price for an asset and cannot function when that market temporarily ceases to exist, as the market for many assets did at the beginning of the financial crisis. In fact, there is evidence that, had mark-to-market regulations been in place in the 1980s, every one of the United States' ten largest banks would have become insolvent.<sup>12</sup>

The immediate regulatory response also made things worse. Restrictions on short selling hurt hedge funds.<sup>13</sup> That not only damaged the funds themselves but exposed troubled banks to further risks and closed off some means of funding, in particular by preventing banks from being able to raise capital through issuing convertible bonds.

Overall, there is substantial evidence to back the conjecture that regulatory and policy mistakes made a substantial contribution to the present financial

crisis. For that reason alone, it is extremely important that serious attention is paid to the possibility that new regulations will bring about or exacerbate future crises.

### 3. After the crisis: What policies are being put in place?

The post-crisis evolution of regulatory regimes around the world has proceeded in a coordinated fashion, with G20 meetings and the Basel committee setting much of the tone for regulatory initiatives in the EU and the US.

The London G20 Summit in April 2009 set a general course of action which has since been followed by policymakers and regulators, expressed in a communiqué released at the end of the summit.<sup>14</sup> Understandably, the G20 agenda is very complex and touches on a large number of regulatory issues. As a result, the implementation is proceeding slowly. On an institutional level, the Financial Stability Forum was transformed into the Financial Stability Board (FSB), with a broader mandate to serve as a standard-setting body for national regulators.

On a substantive level, the proposed changes are extraordinarily varied. They emphasise regulating and overseeing the operations of hedge funds; putting in place "tough principles on pay and compensation"; improving capital adequacy rules; submitting credit rating agencies to closer scrutiny; and taking action against tax havens and banking secrecy.

The leaders at the G20 expressed interest in taking action against "non-cooperative jurisdictions, including tax havens." That includes enforcing a higher degree of financial transparency and exchange of information. They also pledged action against countries trying to attract mobile

---

10 Europe Economics. *Costs of Compliance*. June 2003.

11 *The Banker*. "BBA's Unhelpful Criticism Of Financial Services Authority." 1 June 2002; *The Economist*. "Regulator, heal thyself." 20 January 2005; Moulton, J. "Financial Crisis: UK bail-out plan is too little, too late." *Daily Telegraph*, 8 October 2008.

12 Isaac, W. M. "How to Save the Financial System." *The Wall Street Journal*, 19 September 2008.

13 *The Economist*. "Collateral damage." 9 October 2008.

14 Available at: <http://www.londonsummit.gov.uk/resources/en/news/15766232/communique-020409>

tax bases by setting their tax rates at a competitive level. The communiqué says: “We stand ready to deploy sanctions to protect our public finances and financial systems”.

However, the most important parts of the G20 agenda are the proposed changes to capital adequacy rules. The rules set up by the Basel Committee and adopted by most major financial centres – known also as Basel II – are to be updated and strengthened with a stricter definition of capital and more stringent capital requirements. Basel III will be phased in during a long period stretching from 2011 until 2019. The key changes will be:

- The share of common equity required will be increased from the current minimum of 2 percent to 4.5 percent. There will be a stricter definition of common equity.
- This will be complemented by a new conservation buffer of 2.5 percent, for a de facto requirement of 7 percent.
- The overall share of tier I capital will be increased from a minimum of 4 percent to 6 percent. The definition of tier I capital will exclude some of the more complex financial products.
- There will be a new counter-cyclical buffer of capital of 0-2.5 percent to be accumulated in times of credit expansion and released in financial stress.
- The risk-based measures of capital adequacy are going to be complemented by a simple leverage ratio of 3 percent.
- Financial regulators have been urged to pay more attention to the macroeconomic dimension of financial regulation.<sup>15</sup> This reflects a shifting consensus in the academic literature. Academic experts increasingly argue that regulators should focus on making the financial system safe, rather than on making each individual financial institution safe. In the revised standards being prepared by the FSB, systemically important institutions will be required to demonstrate a higher loss-absorbing capacity.

- There will be new global minimum liquidity standards for internationally active banks, including a 30-day liquidity coverage ratio and a long-term structural liquidity ratio.

By amending the Capital Requirements Directive (CRD), the European Union has de facto adopted the Basel III package. Actually, the CRD goes beyond Basel by dealing with the issue of executive pay and imposing a cap on cash bonuses. Moreover, in September 2010, the European Parliament passed a package radically reforming the EU's system of financial regulation by creating three new watchdogs and the European Systemic Risk Board – a European counterpart to a similar organisation created under Obama's financial reform bill. The three oversight institutions created by the reform will not have direct powers – with the exception of regulating credit rating agencies and in emergency situations. Instead, they will provide harmonised rules that will apply to all national supervisors.

---

The rules will require fund managers to be registered within the EU and in order to market their funds in the EU they will have to obtain permission from the regulator in the country where they are established

---

Hedge funds in the EU will be subjected to further regulation under the Alternative Investment Fund Managers Directive (AIFM). The rules will require fund managers to be registered within the EU and in order to market their funds in the EU they will have to obtain permission from the regulator in the country where they are established. Managers based outside of the EU

<sup>15</sup> Wellink, N. Chairman of the Basel Committee comments to the 16th International Conference on Banking Supervisors. Available at: <http://www.bis.org/speeches/sp100922.pdf>.

will be prohibited from marketing their funds in the EU unless a variety of fiscal and regulatory requirements are satisfied. Among other things, the AIFM directive requires managers to deposit all cash and assets with an EU-based bank.<sup>16</sup>

In September 2010, the Commission prepared a proposal for regulating short-selling, with powers delegated to regulators who could restrict or ban short-selling in specific situations.<sup>17</sup> Otherwise, transactions involving short-selling will have to be clearly labelled as such and investors will also have to disclose their short position to the regulators and to the market.

In the US, most of the regulatory change has been achieved through the introduction of the massive 2,300-page *Restoring American Financial Stability Act*, prepared by the Obama administration. This complex piece of legislation introduces a number of changes aiming at tightening the existing financial regulation and at empowering regulatory agencies. It creates a consumer protection watchdog, charged essentially with ensuring that consumers cannot be tricked by financial institutions into contractual arrangements that will later prove deleterious. Overall, the bill attempts, at least nominally, to discourage excessive complexity in financial products and introducing transparency into banking – to the extent that this is possible through a very complex and rather non-transparent statutory change. The bill also introduces the Volcker rule, to be fully applied by 2022, prohibiting proprietary trading investment.

The bill again targets hedge funds as business entities to be regulated in the future. Those who manage more than \$100 million will have to register with the Securities and Exchange Commission (SEC) and will be subject to monitoring. Likewise, executive compensation is another issue that is a high priority for American policymakers: under the new rules the SEC will review compensation packages and seek ways of relating them to stock performance.

## 4. How internationalised regulation can lead to a new crisis

We are witnessing a movement towards tighter regulation of world financial markets and also towards regulation that is more closely harmonised across the leading industrial economies. That is no accident, as the G20 communiqué pledged that:

“We each agree to ensure our domestic regulatory systems are strong. But we also agree to establish the much greater consistency and systematic cooperation between countries, and the framework of internationally agreed high standards, that a global financial system requires.”

Policymakers seem to believe that insufficient regulation, not just ineffective regulation, is to blame for the financial crisis. Moreover, they also want regulations to be more consistent across different countries and intend to further internationalise financial regulation.

However, there are a number of weaknesses, in principle and practice, with the regulations that have been proposed, that might mean they exacerbate future periods of boom and bust.

### 4.1 Global regulations create global crises

The central argument in favour of supranational regulation is the possibility of financial contagion. Policymakers do not want their own financial systems put at risk by regulatory failures elsewhere. However, with the present crisis emerging in major developed economies, it is hard to justify the sudden focus on the possibility of contagion. Many countries, such as Canada, did maintain stable financial systems despite collapses elsewhere. The contagion from the subprime crisis in the United States was a serious problem only because financial sectors in other major economies had made similar mistakes and become very vulnerable.

<sup>16</sup> For more on the AIFM Directive, see Persson (2009): *The EU's AIFM Directive: Likely impact and best way forward*. Available at: <http://www.openeurope.org.uk/research/aifmd.pdf>

<sup>17</sup> Available at: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1126&format=HTML&aged=0&language=EN&guiLanguage=en>

To be sure, an economy will suffer if its trading partners get into trouble. There will be a smaller market for their exports, imports might become more expensive or more difficult to get hold of, and supply chains can be disrupted. But that can happen for a range of reasons: a bad harvest, war, internal political strife, a recession not driven by a financial crisis. The financial sector is not unique in that regard.

---

### The objective should be to strike a proper balance between standardisation and diversity in regulations

---

There is also concern about a “race to the bottom”. As Stephen G. Cecchetti – Economic Adviser and Head of Monetary and Economic Department at the Bank for International Settlements – wrote, it is felt to be necessary to “make sure national authorities are confident that they will not be punished for their openness”.<sup>18</sup> Concerns that countries will be punished for proper regulation are overblown. There are powerful network effects in financial services that mean many institutions are located in places like New York, London and Frankfurt despite those locations having high costs. While smaller institutions like hedge funds may move more lightly, big banks and other systemically important institutions need to be located in a major financial centre. At the same time, they do attach some importance to a reliable financial system. Countries are more likely to be punished for bad policy – e.g. the new 50 percent top tax rate in the United Kingdom – than for measures genuinely necessary to ensure financial stability.

At the same time, the coordination of regulatory policies creates new risks and exacerbates crises. Common capital adequacy rules, while increasing transparency, also encourage homogeneity in investment strategy and undertaking of risk, leading to a high concentration of risk. That means that global regulations can be dangerous because they increase the amplitude of global credit cycles. If every country is in phase, systemic risk is higher than in situations where there are offsetting, out of phase, credit booms and busts in individual countries. The situation is akin to a monoculture, a lack of diversity makes the whole crop more vulnerable.

The Basel rules use a similar risk assessment framework across a broad range of institutions which encourages them to hold similar assets and respond in similar ways in a crisis.<sup>19</sup> Consequently, instead of increasing diversification of assets and minimising risk, herd behaviour is amplified.<sup>20</sup>

The recession that followed the financial crisis was undoubtedly sharper because it was global. That meant countries were hit simultaneously by their own crisis and a fall in global demand hurting export industries. There were also more simultaneous pressures on global financial institutions. Global regulations, reducing diversity in investment decisions and behaviour in a crisis, will tend to produce global crises when they go wrong. As a result, internationalising regulations increases the danger to the world economy.

The objective should be to strike a proper balance between standardisation and diversity in regulations. Unfortunately, there are reasons why politicians might go too far in standardising regulations. Politicians in countries with burdensome regulations are tempted to force others into adopting equally burdensome measures, in order to prevent yardstick competition and limit the ability of firms and individuals to vote with their feet. A well known example of this is attempts to

---

18 Cecchetti, S. G. “*Financial reform: a progress report.*” Remarks prepared for the Westminster Economic Forum, National Institute of Economic and Social Research, 4 October 2010.

19 Eatwell, J. *The New International Financial Architecture: Promise or Threat?* Cambridge Endowment for Research in Finance, 22 May 2002.

20 Danielsson, J. & J.-P. Zigrand. *What Happens when You Regulate Risk? Evidence from a Simple Equilibrium Model.* April 2003.

curb tax competition by organisations such as the OECD and the European Union. Finally, for some, international summits are more comfortable than messy, democratic domestic politics.

#### 4.2 Macro-prudential regulation and the false promise of Basel III

The economic profession's understanding of the role of financial regulation is shifting from an insistence on micro-prudential regulation to measures which take into account the systemic risks involved in finance. The new paradigm suggests that a policy approach that tries to make the system safe by making each of the individual financial institutions safe is doomed to fail because of the endogenous nature of risk and because of the interactions between different financial institutions.<sup>21</sup>

Many of the proposed regulatory changes seem to be inspired – at least in part – by the idea that macro-prudential regulation will require a move away from a regulatory regime that does not take into account the endogenous nature of risk. Unfortunately, the form that the international harmonisation of regimes of financial regulation is taking fails to mitigate excessive leverage in good economic times.

A related question is whether the endogenous nature of risk enables this new regulatory paradigm to succeed at all. Most importantly, caring about systemic risk requires the regulator to identify – explicitly or implicitly – those financial institutions that are systemically important – either individually or in “herds”. Provided that this information can be discovered by the banks or becomes common knowledge, systemically important institutions will know that they will not be allowed to fail. This would create a large moral hazard problem and could represent a key structural flaw that compromises the whole idea of macro-prudential financial regulation.

At the same time, there might be no need for shifting regulations in the macro-prudential direction, especially if the crisis is the result of regulatory and policy failure as set out in Section I. Policymakers would just need to abstain from policies similar to those that fuelled the boom leading to this crisis. Of course, a greater need for macro-prudential policy and avoiding specific regulatory and policy failure are not mutually exclusive. It is easy to imagine a regulatory environment that combines more attention to the macroeconomic dimension of financial markets; a more prudent monetary policy that becomes contractionary during periods of rapid economic expansions, and sectoral policies that do not encourage asset bubbles.<sup>22</sup>

However, the regulation of financial markets is taking a path that could exacerbate future booms and busts – in sharp contrast both to the declared intentions of policymakers and to the underlying idea of macro-prudential regulation.

---

The regulation of financial markets is taking a path that could exacerbate future booms and busts – in sharp contrast both to the declared intentions of policymakers and to the underlying idea of macro-prudential regulation

---

Our criticism of the Basel rules and of the harmonisation of financial regulation needs to be distinguished sharply from the concerns raised by the banking community, which usually point out the costs that would be involved in raising capital adequacy standards. The Institute of International

---

21 For an exposition of the ideas behind this approach to financial regulation see Hanson, Kashyap and Stein (2010): “A Macroprudential Approach to Financial Regulation,” *Journal of Economic Perspectives*, forthcoming.

22 In this endeavour, targeting nominal GDP instead of inflation might be instrumental, as Scott Sumner, David Beckworth, George Selgin and others have argued.

Finance, for instance, has conducted a study of the effects of likely regulatory reform on the broader economy.<sup>23</sup> The models used by the study are based on a relatively simple logic. Higher capital ratios require banks to raise more capital, putting an upward pressure on the cost of capital. In turn, this increases lending rates and reduces the aggregate supply of credit to the economy, lowering aggregate employment and GDP.

On that basis, the paper estimates the costs of adopting a full regulatory reform at an average of about 0.6 percentage points of GDP over the period 2011-2015 and an average of about 0.3 percentage points of GDP for the ten year period, 2011-2020. With a different set of assumptions, the Basel Committee estimates the costs to be much smaller. But whether this is a cost worth bearing depends on what the regulatory reform would achieve. If the output gap is a price to pay for an adequate reduction in the likelihood of future crises – and a reduction in the amplitude of business cycles – then it might be worth paying. Unfortunately, the regulatory reform which we are likely to get is unlikely to achieve that.

Firstly, in spite of claims to the contrary, much of the re-regulation simply increases the procyclicality which was characteristic of banking regulation under Basel II. Indeed, Basel III increases the requirements for tier I capital to a minimum of 6 percent and the share of common equity to a total of 7.0 percent. And *on top of that* it introduces a countercyclical buffer of 0-2.5 percent. Yet, that buffer cannot offset the procyclical effect of the increased capital requirements.

We should stress that the problem with Basel III rules is not the absolute size of capital adequacy requirements but the fact that they are based on the borrower's default risk. Hence, riskier assets need to be backed by a larger capital buffer than less risky ones. During times of crisis, the overall riskiness of extending loans increases and banks will therefore

have an incentive to increase the amount of capital which they are holding relative to the total size of their risk-weighted assets. An extreme reaction to economic downturn would thus consist of dumping the riskier assets on the financial market, in the hope of restoring the required capital adequacy ratio, exacerbating the economic downturn and possibly triggering a credit crunch. Conversely, in good economic times, when the measured riskiness of individual loans has decreased, banks will be tempted to hold less capital relative to their other assets and will thus be tempted to fuel a potential lending boom.

---

If the output gap is a price to pay for an adequate reduction in the likelihood of future crises – and a reduction in the amplitude of business cycles – then it might be worth paying

---

A related issue is that current measures of risk – which are used as the basis for the risk-weighted capital adequacy rules – are highly imperfect. In a nutshell, highly-rated assets can be leveraged much more heavily than riskier assets, which is a problem if those ratings are not necessarily accurate. Lending to triple-A-rated sovereigns still carries a risk-weight of zero. As the present fiscal crisis in Europe suggests, exposure to triple-A-rated debt is certainly not risk free.

Basel III complements the capital adequacy rules by simple – not risk weighted – leverage ratio limits. However, looking at the past data, there is little reason to believe that these will be effective in preventing future crises. In fact, risk-adjusted and simple balance sheet leverage ratios both show stable bank leverage until the onset of the crisis.<sup>24</sup>

23 IIF (2010). *Interim Report on the Cumulative Impact on the Global Economy of Proposed Changes in the Banking Regulatory Framework*. [http://www.ebf-fbe.eu/uploads/10-Interim%20NCL\\_June2010\\_Web.pdf](http://www.ebf-fbe.eu/uploads/10-Interim%20NCL_June2010_Web.pdf)

24 See Joint FSF-CGFS Working Group (2009). *The role of valuation and leverage in procyclicality*. <http://www.bis.org/publ/cgfs34.htm>

Similarly, mark-to-market valuation practices are very problematic for assets where markets have become illiquid, and yield valuations that are both very low and uncertain. In times of crisis, this can give rise to serious consequences for companies that report mark-to-market valuations on their balance sheets. For that reason, mark-to-market valuations can exacerbate the effects of economic downturns.

Furthermore, Basel III will contain new, stricter, definitions of common equity, Tier I capital and capital at large. In principle, there is nothing wrong with being pickier when selecting the capital assets to use as a buffer when running a bank. It might indeed be prudent to use only common stock and not preferred stock and/or debt-equity hybrids that are permissible under Basel II. However, imposing a common notion of capital on banks and financial institutions worldwide is more likely to make their portfolios similar and will therefore increase the co-movement existing between their liquidity – or lack thereof – at any given point in time.

---

The corollary is that overly tight regulation can create a situation in which much of the actual financial activity is taking place outside of the government supervision which is intended to curb their alleged excesses

---

A common definition of capital and a similar composition of bank capital across the world will also create incentives for regulators to synchronise monitoring. Such moves are already on their way within the EU – especially in the light of the establishment of common institutions for financial regulation – in spite of the fact that the business cycles

in different parts of Europe are not synchronised.

Finally, we should recognise that tighter financial regulation has its unintended consequences. In the past, we have witnessed companies' moving complex, highly leveraged, instruments off their balance sheets. Much of the financial activity moved – both geographically and sector-wise – to areas which were less heavily regulated. This included moving activities away from the banking industry into, say, hedge funds. And this also includes moving financial activities to jurisdictions that are friendlier to the financial industry. According to the Financial Times<sup>25</sup>, in the past two years, almost 1,000 hedge fund employees moved from the UK to Swiss cantons, seeking regulatory and fiscal predictability. Insofar as the move towards harmonised financial regulation is imperfect – and so long as there remain jurisdictions and areas of finance that are regulated less heavily – there will be a relocation of financial activities towards these jurisdictions and areas of activity. The corollary is that overly tight regulation can create a situation in which much of the actual financial activity is taking place outside of the government supervision which is intended to curb their alleged excesses.

#### 4.3 Crisis as alibi, symbolic politics

Many of the measures that are part of the G20 agenda are completely irrelevant to any ambition one could possibly have to mitigate systemic risks in the world economy. For instance, the idea that “tax havens” and banking secrecy are among the issues that contributed to the financial crisis is completely unfounded. If anything, tax competition could curb some of the excesses of the big, fiscally irresponsible, welfare states by making it difficult for governments to impose too onerous fiscal burdens on mobile tax bases. It is thus clear that for politicians in high-tax countries, the present crisis has served as an alibi to push forward a variety of measures which they have demonstrated an interest in implementing but lacked a plausible justification.<sup>26</sup>

25 FT. “Hedge funds managers seek predictability,” October 1, 2010. Available at: <http://www.ft.com/cms/s/0/557f55d4-cd93-11d1-9c82-00144feab49a.html>

26 Indeed, the OECD has been running its program on harmful tax practices since 1998.

In many respects, regulating short-selling is similar. Short-selling cannot be blamed for the financial crisis, just as it cannot be blamed for the Greek debt crisis that occurred earlier this year. Indeed, short-selling is critical in reflecting new, often pessimistic, information about the asset in question into a market price. Enabling European regulators to prohibit short-selling in specific situations – presumably in situations when doubts arise about the ability of a European country to repay its debt obligations – will do nothing to address the underlying problems of fiscal irresponsibility. It is just an illustration of a mentality that pretends that shooting the messenger is an appropriate response to the fiscal problems of the Eurozone. The direct cost of this policy is that it will introduce noise into the functioning of financial markets and will make them process new information less efficiently.

Besides taxation and short-selling, there have been coordinated moves to regulate hedge funds, both in the United States and in Europe. While this might make sense from a macro-prudential perspective, particularly if it is the case that some of the hedge funds are of systemic importance, we should recognise that hedge funds were the victim, not the perpetrator, in the recent crisis.

There have been a series of measures that governments have been eager to take for a long time and for which the crisis provided a convenient ad hoc justification, that are now part of the coordinated re-regulation of financial markets in the United States and in Europe. This includes, for instance, the creation of systemic risk boards – as if creation of such institutions would in itself be an improvement over the present situation. Creating a new bureau does not endow the regulators with a superior model of the economy and certainly does not mean that they will be able to do better forecasts than the regulators of the past.

Likewise, the creation of consumer protection boards is unlikely to have a significant effect, besides creating a false sense of security among the general public. After all, the crisis was not caused by uninformed consumers' falling prey to – say – credit card companies. While instances of individuals making bad decisions regarding their indebtedness certainly exist, they were in most cases a rational response to the wider institutional environment in which they were operating, and which made it worthwhile, for instance, to use one's house as a piggybank. Furthermore, there is evidence that some of the measures aiming at protecting consumers can in fact exacerbate moral hazard and strengthen the incentives for irresponsible behaviour.<sup>27</sup>

Finally, the issue of executive pay is high on the list of priorities for policymakers across the globe, again without a credible explanation of how that would contribute to the prevention of future crises. Major proponents of macro-prudential regulation – such as the authors of the Geneva report – argue that there is very little reason for regulators to get involved in the decisions of private firms over executive compensation. Rather, as Charles Wyplosz says, “macro-prudential regulation will push banks to develop incentive packages that are more encouraging of longer-term behaviour.”<sup>28</sup>

## 5. Conclusion

The regulatory response to the crisis is based, in our view, on a misperception of the factors that led to the accumulation of problems which unravelled in 2008 and 2009. The crisis is blamed on insufficient regulation and exuberance of the financial sector. As a result, it is natural to call for more regulation and a closer monitoring of the financial industry and for identifying and tackling systemic risk as it occurs.

27 We discuss the specific case of the CARD Act in the United States in Rohac, D. (2010). “The high costs of consumer protection.” *The Washington Times*, September 3, 2010.

28 Wyplosz, C. (2009). “The ICMB-CEPR Geneva Report: The future of financial regulation.” *VoxEU*, January 27, 2009. <http://www.voxeu.org/index.php?q=node/2872>

However, this view ignores the role played by government policies – especially the variety of measures aimed at promoting home ownership among low-income groups and also the monetary expansion of the early 2000s. This view also ignores the complicit role of procyclical financial regulation which exacerbated the expansionary phase of the cycle and therefore made the downturn all the more painful.<sup>29</sup> Understanding the role played by government policies in generating systemic risk within the financial sectors suggests that simple tightening of the existing regulations, and their harmonisation, is not going to address the factors that led to this crisis and that can potentially lead to the next financial meltdown.

---

It is urgent that policymakers rethink their approach towards financial regulation in a way that would be conducive to sound financial practices and economic growth

---

In spite of the rhetoric, the current regulatory moves just strengthen the procyclical nature of capital adequacy rules that form the basis of the Basel framework. Furthermore, it is worth stressing that the regulatory response to the crisis was not only based on a mistaken view of its causes, but it was also driven by political considerations. While this discussion falls outside of the scope of a narrow evaluation of the likely effects of regulation on financial and economic outcomes, it is worth stressing that, in the aftermath of the crisis, politicians have been acting to channel public anger and frustration with the ongoing recession away from themselves and onto the financial sector. This led them to promote a set of policies that might be politically satisfying but do not address the true causes of the crisis.

We hope that this study will contribute to a better understanding of the dangers involved in making the regulatory environment more procyclical and more uniform across the globe. In our view, it is urgent that policymakers rethink their approach towards financial regulation in a way that would be conducive to sound financial practices and economic growth. While we do not outline what a desirable set of policies should look like, it is clear that the current wave of intensive financial regulation is harmful, costly and potentially dangerous for the world economy.

### Acknowledgments

We are thankful to David B. Smith and Pascal Salin for valuable comments and suggestions.

Copyright © 2010 Legatum Limited

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical including photocopying, recording or any information storage or retrieval system, without the prior written permission of the copyright holder. Please direct all enquiries to the publishers.

#### Legatum Institute

11 Charles Street, Mayfair  
London, W1J 5DW  
United Kingdom  
T +44 (0)20 7148 5400  
F +44 (0)20 7148 5401  
[www.li.com](http://www.li.com)  
[info@li.com](mailto:info@li.com)

#### TaxPayers Alliance

55 Tufton Street  
London, SW1P 3QL  
United Kingdom  
T +44(0)845 330 9554  
[www.taxpayersalliance.com](http://www.taxpayersalliance.com)  
[info@taxpayersalliance.com](mailto:info@taxpayersalliance.com)



<sup>29</sup> See M. Sinclair, D. Petrova & D. B. Smith: *How inept regulation and poor policy decisions drove the financial crisis*. TaxPayers' Alliance. Available at: [http://www.taxpayersalliance.com/home/files/how\\_inept\\_regulation\\_and\\_poor\\_policy\\_decisions\\_drove\\_the\\_financial\\_crisis.pdf](http://www.taxpayersalliance.com/home/files/how_inept_regulation_and_poor_policy_decisions_drove_the_financial_crisis.pdf)

Financial support for this research paper was provided by the Politics and Economics Research Trust (charity number 1121849). Any views expressed in this paper are those of the author and not those of the research trust or of its trustees.