



# **How inept regulation and poor policy decisions drove the financial crisis**

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## Executive Summary

It is vital to understand the true causes of the financial crisis if we are to avoid such crises in future. This report sets out a number of areas in which poor regulatory and policy choices drove the financial crisis.

### **The build-up to the crisis**

- For a variety of reasons – including falling prices of manufactured goods thanks to industrial development in countries such as China – inflation was low during the build-up to the financial crisis. This combined with a change in how inflation is measured, which ceased to indirectly include house prices, 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. All this led lenders to underprice risk and created an asset price boom.
- Regulation in the United States encouraged the relaxing of restrictions on home loans. Activist campaigns and regulations pressured banks to lower credit standards. At the same time, and in response to political pressure, the government-backed organisations Fannie Mae and Freddie Mac bought up 44 per cent of all subprime securities, providing an implicit guarantee to primary lenders who could therefore turn their long-term risk over to the government.
- Planning regulations in Britain and parts of the United States make house prices far more volatile. As the supply of housing is extremely inelastic, shifts in demand are almost entirely reflected in prices. Those changes in prices have clearly played a central part in creating the present financial crisis.
- There are incentives in the Basel accords to push lending off balance sheet. There are still weaknesses in this area and the IMF has described how there have been “strong incentives for moving even low-risk assets off the balance sheet”.
- The British Government has led by example, by borrowing considerable amounts and failing to reflect that on its balance sheet. Between future PFI payments, nuclear decommissioning, public sector pensions and Network Rail’s debt, Government liabilities were 129 per cent of GDP even before the recent wave of part-nationalisations. Despite that, they insisted that they were within the bounds of the Sustainable Investment Rule, which pledged the Government to keep debt at less than 40 per cent of GDP.

## **A poor response from regulators**

- Unclear and restrictive EU Directives limited the Bank of England's response to the crisis at Northern Rock. In particular, the Takeover Code and the Market Abuses Directive were felt to preclude an inter-bank rescue operation and covert lender of last resort assistance respectively. Mervyn King, Governor of the Bank of England, argued that these prevented effective support being given to Northern Rock.
- Deposit protection was not sufficient to give bank customers confidence. In particular, the time it takes for the Financial Services Compensation Scheme to pay out and failures to make other government payments promptly may have led depositors to believe their money would effectively be frozen for months in the event of a collapse.
- 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. Despite the ineffectiveness of regulatory oversight, compliance costs rose substantially for banks after the Financial Services Authority took over supervision.
- There had been concerns for some time before the crisis about problems at the Financial Services Authority. Prominent voices criticised a lack of quality staff and insufficient focus on systemic risk, but sufficient changes were not made.

## **How regulations exacerbated the crisis**

- Capital adequacy rules in Basel II are based upon borrower default risk – the chance that companies and mortgages will go bust. This means that capital requirements will tend to increase as an economy falls into recession and fall as an economy is expanding. Studies for the US Federal Reserve System confirmed that the rules are procyclical as far back as 2004. It is clear that the rules worsen financial crises.
- Common capital adequacy rules encourage firms to hold similar assets and respond in similar ways in a crisis. This amplifies herd behaviour. At the same time, common international rules mean that booms and busts in individual countries are likely to take place at the same time, increasing the amplitude of global credit cycles.
- 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. Had mark to market regulations been in place in the 1980s every one of the United States' ten largest banks would have become insolvent.
- Regulations, particularly restrictions on short-selling, did serious damage to hedge funds. This 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 being able to raise capital through issuing convertible bonds.

### **How similar problems can be avoided in future**

- Effective regulation can only be delivered with proper political scrutiny. As MPs careers are generally based on their responsibility for managing government departments, their scrutiny role is underappreciated and poorly fulfilled. Removing responsibility for public services from central government would help to restore the attention of MPs to the task of getting the right laws.
- The way the European Union operates makes scrutiny difficult and changes in direction slow. This is not conducive to getting the right regulations. The challenges of forming laws for 27 countries mean that scrutiny is seen as deeply inconvenient. Britain needs to move towards a relationship with Europe more similar to that enjoyed by Switzerland, with a greater ability to form its own laws.

## Introduction

*"For 30 years, greedy, callow, ignorant financiers, supported by no less callow politicians from all the political parties, have proclaimed the wonders of financial innovation and how proud we all should be of the City of London. The price tag for their behaviour is an economic calamity. We should never have bought such snake oil. The consolation in these dark times is that we never will again."*

- Will Hutton, the Guardian

With all of the pain of a financial crisis, it is very tempting to turn those in the media spotlight into a scapegoat, without thoroughly examining who really carries responsibility for the economic turmoil. As it is hard to impugn the motives of many who borrowed excessively, because they were often simply trying to provide a more comfortable home for their family, the bankers who made the loans have become the targets for public ire.

Banking has been a heavily regulated industry for a long time, however, and it is important to study the policy framework that the financial services industry worked within. This study will show that regulations and policy decisions were instrumental in the build-up to the crisis, how institutional arrangements left regulators unable to respond effectively and how regulation exacerbated the problems created by the bursting bubble in asset prices.

The regulations and political decisions that played such a critical part in creating the present financial crisis need to be kept in mind. Otherwise, it will be far too easy for new regulations, designed to prevent a perceived crisis of greed being repeated, to wind up creating new existential threats to the banking system.

Identifying the institutional arrangements, regulations and policies responsible for this crisis will make it very clear that this wasn't simply a crisis created by greedy bankers but one that also resulted from political decisions taken without due care and attention.

**Chapter 1** examines the build-up to the financial crisis. It sets out how low interest rates encouraged risky behaviour on the part of banks and an asset boom. Regulations and political activism in the United States reinforced this by encouraging lending to risky customers. International banking regulation created a perverse incentive for risks to be moved off balance sheet and the British Government set an unfortunate example by taking on new liabilities and not reflecting them in the official debt figures.

**Chapter 2** sets out how institutional arrangements formed at European Union level and by the British Government prevented an adequate response from regulators to the financial crisis. EU directives and regulations



prevented effective measures being taken to rescue Northern Rock. The tripartite system, set up after the Bank of England was given authority to set interest rates independently, meant that no single authority was responsible for orchestrating a response to the broader financial crisis. The institution with the most direct responsibility for financial stability, the Financial Services Authority, performed poorly.

**Chapter 3** describes regulations – emerging from international agreements and implemented through EU directives – that exacerbated the crisis. Capital adequacy rules are pro-cyclical as they automatically loosen in good times and tighten up in a crisis. Mark to market accounting provides objectivity in normal circumstances but cannot function when markets in certain assets freeze up.

**Chapter 4** discusses, in general terms, how decision making might be improved to prevent future crises driven by the unintended, but predictable, consequences of regulatory and policy decisions. In particular, it will discuss how parliamentary scrutiny can be improved and argue that the EU's role in these areas should be ended.

**Chapter 5** concludes by arguing that the present crisis illustrates how important reform to restore parliamentary scrutiny and accountability has become.

Another TaxPayers' Alliance report, released in early October,<sup>1</sup> has provided a specific response to the £50 billion bail-out announced by the Government and set out other policy options that might relieve the financial crisis and limit the need for injections of taxpayers' money.

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<sup>1</sup> Sinclair, M. 'TaxPayers' Alliance Response to the Government's £50bn bailout', The TaxPayers' Alliance, Research Note 35, 8 October 2008

## 1. The build-up to the crisis

A major trigger of the financial crisis was the collapse of a housing bubble – particularly in the United States. This was built up over a period in which credit was easily available at low cost. Banks lent to borrowers who would, under normal circumstances, be seen as poor credit risks for the amount they were being loaned. Significant amounts of lending were kept off banks' balance sheets in special investment vehicles.

In a number of ways policy and regulation encouraged the development of excessive lending and the use of off balance sheet finance.

### 1.1 Low interest rates

In Britain and the United States, in particular, low interest rates encouraged the development of an asset bubble. Currency manipulation in East Asia, leading to a glut of savings, further reduced real interest rates in Britain and the United States.

Interest rates were low for a number of reasons:

- Inflation remained low in spite of low interest rates thanks to fortuitously benign conditions, including falling prices for manufactures due to industrial development in countries such as China.
- House prices did not feed into the Bank of England's interest rate decisions, because the inflation target did not include them after the switch from RPI-X, which covered house prices through housing depreciation and some other housing costs, to CPI. This meant that there was little attempt to calm rapidly rising house prices.
- Low interest rates formed a key part of the US response to a number of economic crises between the housing crisis in 1992 and the bursting of the dot-com bubble at the end of 2001. This gave rise to the notorious "Greenspan put", the belief that the Federal Reserve would always bail financial institutions out if they got in trouble.

More generally, low interest rates encourage both more borrowing and riskier lending, as riskier loans allow lenders to keep their returns up despite low interest rates. This was combined with a sense of security created by effective responses to crises such as the bursting of the dot-com bubble.

A combination of many different institutions looking to buy relatively risky assets, and a perception that the economy had become a generally less risky place, led to an underpricing of risk.<sup>2</sup> It should also be remembered that, throughout this period, the British Government were insisting that they had

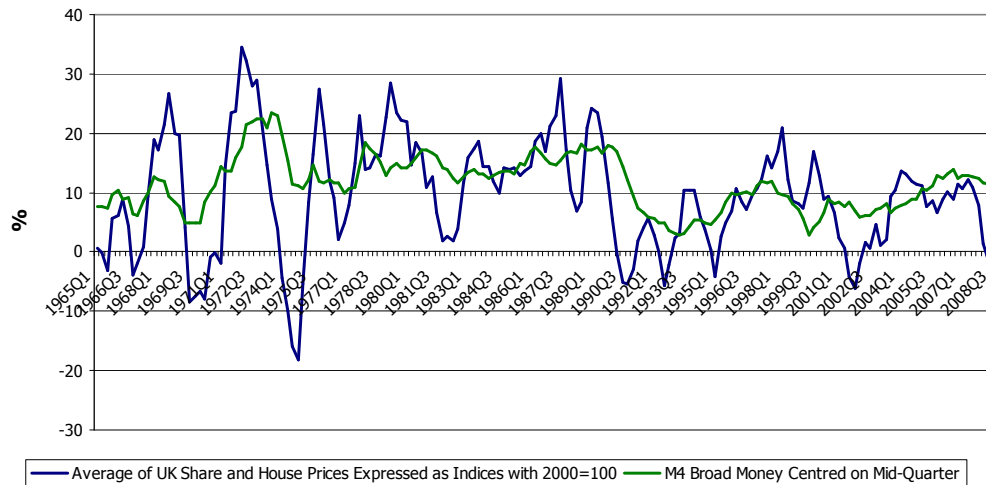
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<sup>2</sup> Goodhart, C. A. E. 'Explaining the financial crisis', *Prospect*, 31 January 2008

“ended boom and bust”. This clearly did not promote a more realistic view of economic risk.<sup>3</sup>

The graph below illustrates how UK asset prices tend to respond to loose monetary policy, often in an exaggerated fashion.

Figure 1: Annual increases in UK broad money and house and share prices<sup>4</sup>



There were also specific problems in the subprime mortgage market in the United States but these were driven by regulation and political pressure as well.

## 1.2 Regulation and activism in the United States that promoted subprime lending

A series of regulations and political campaigns in the United States aimed to increase rates of home ownership by encouraging the relaxing of restrictions on home loans:

- In the early 1990s political campaigns, particularly by the ACORN group, used the Community Reinvestment Act to block mergers if banks did not relax lending conditions. There was also political pressure: “ACORN protesters will break into private offices, show up at a banker’s home to intimidate his family, or pour protesters into bank lobbies to scare away customers, all in an effort to force a lowering of credit standards for poor and minority customers.”<sup>5</sup>

<sup>3</sup> Finkelstein, D. ‘No return to boom and bust, eh?’, *Times Online*, 19 September 2008

<sup>4</sup> House Prices: Department of Communities and Local Government, Share Price Index: FT Actuaries All Share Index, M4 Broad Money: Bank of England

<sup>5</sup> Kurtz, S. ‘Planting Seeds of Disaster’, *National Review*, 7 October 2008

- Fannie Mae and Freddie Mac buy then repackage and sell home loans made by other institutions, freeing the original lenders to make more loans. When President Bill Clinton took office they were viewed as key to his plans to expand home ownership. In September 1999 Fannie Mae eased credit requirements on loans that it would purchase from banks and other lenders.<sup>6</sup> By buying 44 per cent of all subprime securities they played a key role in facilitating the build-up of an asset price bubble.<sup>7</sup> Again, the ACORN campaign was instrumental in putting political pressure on Fannie Mae and Freddie Mac to relax standards.<sup>8</sup> Without the implicit guarantee provided by Fannie Mae and Freddie Mac allowing primary lenders to turn their long-term risk over to the government, lenders would almost certainly have been more conservative.<sup>9</sup>

It is clear that political pressure, far from restraining risky lending, actually encouraged foolish behaviour. The signal sent by this kind of political activity may well have been as important as the actual policies put in place. In Britain and the United States, government was trying to “encourage the risk takers”.<sup>10</sup>

### **1.3 Planning regulations that increase house price volatility**

Planning regulations may have contributed to house price volatility in Britain and in the United States:

- Planning regulations in Britain clearly constrain the supply, and therefore increase the price, of housing. House prices that homeowners struggle to afford even in good economic times are clearly more likely to fall sharply in a downturn. A report for Policy Exchange in 2005 argued that, by ignoring the role of supply in determining house prices, planners created high, and volatile, house prices.<sup>11</sup>
- In the United States, Nobel Prize winning economist Paul Krugman argued, also in 2005, that the US real estate market could be divided between “Flatland” and the “Zoned Zone”. In Flatland, the middle of the country, there are few restrictions on building homes and prices are subdued. In the Zoned Zone high population density combines with strict land-use restrictions to produce much higher prices and high volatility.<sup>12</sup>

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<sup>6</sup> Holmes, S. A. ‘Fannie Mae Eases Credit To Aid Mortgage Lending’, *New York Times*, 30 September 1999

<sup>7</sup> Leonnig, C. D. ‘How HUD Mortgage Policy Fed The Crisis’, *Washington Post*, 10 June 2008

<sup>8</sup> Kurtz, S. ‘Planting Seeds of Disaster’, *National Review*, 7 October 2008

<sup>9</sup> Schiff, P. ‘Don’t Blame Capitalism’, *Washington Post*, 16 October 2008

<sup>10</sup> Speech given by the Chancellor of the Exchequer Gordon Brown at the Mansion House, London, 16 June 2004, <http://www.hm-treasury.gov.uk/1534.htm>

<sup>11</sup> Evans, A. W. & Hartwich, O. M. *Unaffordable Housing: Fables and Myths*, Policy Exchange, June 2005, pp. 36-38

<sup>12</sup> Krugman, P. ‘That Hissing Sound’, *New York Times*, 8 August 2005

In both the United States and Britain planning regulation has, for some time, been understood to increase house price volatility. As supply is made extremely inelastic, shifts in demand – including credit-fuelled speculative demand – are almost entirely reflected in prices. That volatility has clearly played a central part in creating the present financial crisis.

#### **1.4 Incentives in the Basel accord to push lending off balance sheet**

Since the inception of Basel I in 1988 banks have been increasingly moving assets off their balance sheets as a means to evade the capital requirements imposed by the Basel Committee.<sup>13</sup> That problem appears to have contributed to the present crisis:

- According to a recent IMF report, the Basel treatment of securitisation exposures such as asset-backed securities and credit derivatives provides “strong incentives for moving even low-risk assets off the balance sheet and inadequate capital treatment for securitization of high-risk assets”.<sup>14</sup> The Basel agreements made a significant contribution to the growth of off balance sheet lending.
- Basel II also has weaknesses in this area. The Basel Committee is in the process of actively reviewing its framework in order to strengthen the regulation of certain complex securitisation products and stress-testing requirements for risks arising from the return of off-balance-sheet products to the balance sheet, and the disclosure of such items.<sup>15</sup>

Clearly, if the Basel regulations have contributed to the development of off balance sheet lending they have played a part in the regulatory failure that made the present financial crisis possible.

Other criticisms of the Basel regulations include suggestions that it is procyclical. This issue will be dealt with in more detail later in this report.

#### **1.5 Government leading by example with off balance sheet borrowing**

At the same time as international regulations created an incentive to shift activity off balance sheet, the British Government evaded the fiscal rules it had set itself by keeping significant liabilities out of official debt figures:

- The Sustainable Investment Rule pledged the Government to keep debt at less than 40 per cent of GDP.

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<sup>13</sup> Whalen, C. 'Managing Risk: A Skeptic's View of Basel II', *The International Economy*, 22 September 2004

<sup>14</sup> Caruana, Jaime and Aditya 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

<sup>15</sup> Ibid.

- Table 1 shows official borrowing and other government financial commitments that would, outside government, normally be understood as debt. These include public sector pension liabilities, commitments under Private Finance Initiative schemes and the government guaranteed debt of Network Rail.

Table 1.5.1: Government liabilities<sup>16</sup>

Item	Debt
Public Sector Net Debt (including Northern Rock)	£633 billion
Future PFI payments	£110 billion
Nuclear decommissioning	£73 billion
Public sector pensions	£1,071 billion
Network Rail	£20 billion
<b>Total</b>	<b>£1,907 billion</b>
GDP	£1,473 billion
<b>% of GDP</b>	<b>129%</b>

- If the full range of government liabilities were included in official debt figures the Sustainable Investment Rule would clearly have been breached long ago.

Off balance sheet lending on the part of the Government sends the signal that evading rules in this manner is acceptable.

<sup>16</sup> Office for National Statistics, 'Public Sector Finances: First Release', August 2008; Institute for Fiscal Studies, 'Green Budget 2008', Table 3.3; Public Accounts Committee, 'Nuclear Decommissioning Authority – Taking forward decommissioning', Thirty-eighth Report of Session 2007-08, June 2008; Record, N. 'Sir Humphrey's Legacy: An Update', IEA, January 2008; Network Rail Limited, 'Annual Report and Accounts 2008'

## 2. Why regulators performed poorly

The regulated banking system functions on the basis that certain support will be available to banks, and their customers, when the system is in distress. It also relies upon regulation to limit the risks that banks take, and control for the moral hazard introduced through deposit protection and support from the central bank. A series of regulatory failures have meant that the proper authorities have been slow and ineffective in assisting the financial sector and did not control the building up of unsustainable levels of risk.

### 2.1 EU Directives limited the Bank of England's response to the crisis at Northern Rock

The crisis at Northern Rock saw the first run on a bank in Britain since the collapse of Overend and Gurney in 1866. After attempts to put Northern Rock on a stable footing, or find a private buyer, proved unsuccessful it was nationalised.

The major drain on Northern Rock's balance sheet was a £15.3 billion decrease in customer accounts created by the run, whereas the reduction in wholesale funding only accounted for £4.4 billion.<sup>17</sup> A depositor panic following the announcement of assistance from the Bank of England was therefore instrumental in turning the bank into a basket case that needed to be put into administration or nationalised.

Mervyn King, Governor of the Bank of England, cited two pieces of European legislation that prevented effective assistance being given to the bank in evidence to the House of Commons Treasury Select Committee.<sup>18</sup>

- The Takeover Code had been a voluntary code but gained legal force when it was implemented as an EU Directive in 2006. In previous crises the Code had been ignored; in the case of Northern Rock it was felt by the Bank of England to preclude the Bank organising an inter-bank rescue operation.
- The Market Abuse Directive is supposed to prevent insider trading by making sure that relevant information is released to the public. Prominent commentators and the European Commission itself have suggested this should not prevent a central bank providing covert assistance. Unfortunately, the Directive is deeply ambiguous and the Bank of England was advised that assistance could not be covert under its terms. This meant that assistance took place in public and undermined confidence in Northern Rock, contributing to the run.

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<sup>17</sup> Congdon, T. *'Northern Rock and the European Union'*, Global Vision, June 2008

<sup>18</sup> House of Commons Treasury Select Committee, *'The August 2007 Inflation Report'*, Uncorrected Transcript of Oral Evidence, HC999-i, 20 September 2007

Though Northern Rock does appear to have maintained a very risky business model, and may have simply been unsustainable, it is still extremely troubling that the Bank of England felt hamstrung in its efforts to support the bank. It must be concluded that European Directives are producing legislation that is simultaneously unclear and restrictive, and which has prevented the Bank of England responding adequately to assist banks, such as Northern Rock, when they get into serious trouble.<sup>19</sup>

## 2.2 Weak deposit protection

Before the crisis at Northern Rock, weak deposit protection meant that bank runs were a rational response to fears that a bank might go bust and customers who hadn't withdrawn their funds would suffer a significant loss.<sup>20</sup> There are still weaknesses in the system:

- The Financial Services Compensation Scheme aims to process claims in six months.<sup>21</sup> This is a considerable amount of time for a depositor to have to wait to be able to access the funds in their account.
- The Government's ability to promptly deliver financial assistance may not be trusted. As of May 2008 around 9,000 farmers were owed a total of £190 million in payments that were meant to arrive in 2007 and some were told that they would not receive payment until November 2008.<sup>22</sup> In that context, it should not be surprising that people see a Government commitment to recompense them in a crisis as suspect.

Former Governor of the Bank of England, Lord George, has suggested that strengthened deposit protection might be necessary on "social as well as financial stability grounds."<sup>23</sup>

## 2.3 The tripartite system

In May 2007 one of the authors of this report argued that broad money growth suggested that the country was undergoing a credit boom, and might be vulnerable to a credit bust, and that this might be due to an inadequate institutional framework.<sup>24</sup> He set out a number of reasons for restoring responsibility to the Bank of England for regulation of those deposit taking institutions whose deposit liabilities are counted in the M4 broad money supply definition.

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<sup>19</sup> Congdon, T. *'Northern Rock and the European Union'*, Global Vision, June 2008

<sup>20</sup> Wolf, M. 'From a bank run to nationalising deposits', *Financial Times*, 18 September 2007

<sup>21</sup> Financial Services Compensation Scheme, *'Deposit claims FAQs'*,  
[http://www.fscs.org.uk/consumer/faqs/deposit\\_claims\\_faqs/](http://www.fscs.org.uk/consumer/faqs/deposit_claims_faqs/)

<sup>22</sup> Northern Echo, *'Thousands of farmers still waiting for funding'*, 8 May 2008

<sup>23</sup> George, E. *'Banking on Stability: A framework for economic success'*, Politeia, 11 August 2008

<sup>24</sup> 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

There are several ways in which the tripartite system leaves the Bank of England without the detailed information needed to maintain financial stability, at the same time as transferring responsibility to the Financial Services Authority and increasing compliance costs:

- Removing regulatory responsibility from the Bank weakened its intelligence network and reduced its ability to properly assess whether lender of last resort actions were appropriate or not. Liam Halligan, Chief Economist at Prosperity Capital Management, has argued that leaving the Bank of England in charge of financial stability but denying it detailed knowledge of individual banks left the Bank “flying blind”.<sup>25</sup> This problem was also noted by the British Bankers’ Association in 2002.<sup>26</sup>
- Transferring supervisory responsibilities to the FSA may have led to a noticeable increase in administrative costs. A study by Europe Economics, on behalf of the FSA, found that firms were bearing additional compliance costs equivalent to 1.6 per cent of non-regulatory operating costs.<sup>27</sup>

The present crisis appears to vindicate the view that the tripartite structure is not conducive to effectively preventing or responding to a financial crisis.

#### **2.4 Problems at the Financial Services Authority**

The Financial Services Authority has responsibility, within the tripartite arrangements, for supervising particular banks.

An Internal Audit review by the FSA identified four key failings in the case of Northern Rock:<sup>28</sup>

- *"A lack of sufficient supervisory engagement with the firm, in particular the failure of the supervisory team to follow up rigorously with the management of the firm on the business model vulnerability arising from changing market conditions.*
- *A lack of adequate oversight and review by FSA line management of the quality, intensity and rigour of the firm's supervision.*
- *Inadequate specific resource directly supervising the firm.*
- *A lack of intensity by the FSA in ensuring that all available risk information was properly utilised to inform its supervisory actions."*

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<sup>25</sup> Halligan, R. 'We're paying the price for Gordon Brown's fair-weather policies', *Daily Telegraph*, June 2008

<sup>26</sup> The Banker, 'BBA's Unhelpful Criticism Of Financial Services Authority', 1 June 2002

<sup>27</sup> Europe Economics, 'Costs of Compliance', June 2003

<sup>28</sup> Financial Services Authority, 'FSA moves to enhance supervision in wake of Northern Rock', 26 March 2008

These resulted in Northern Rock being allowed to waive the standard "Risk Mitigation Programme" despite having a capital shortfall and a series of other problems. Failures at the FSA have not been confined to Northern Rock, however:

- As far back as 2002 the British Bankers' Association criticised the Financial Services Authority for being too focussed on regulating the banks' conduct of business to the detriment of prudential regulatory rigour, and failing to pay sufficient attention to systemic risk.<sup>29</sup>
- In 2005 The Economist newspaper reported that the Financial Services authority lacked "sensible procedures and competent staff; and credibility so that wrongdoers are properly punished and others deterred." Further, the newspaper argued that the sharpest criticisms of the FSA, that it "has plenty of staff but an insufficient aggregate IQ", contain an element of truth.<sup>30</sup>
- There are widespread concerns that a lack of analytical rigour at the FSA may have contributed to the current crisis. These are well summed up by Jon Moulton, head of the Alchemy private equity group:<sup>31</sup>

*"The FSA has more to answer for – it substituted the analytical approach of the Bank with walls of process. Producing and processing Risk Analyses and checklists was ample satisfaction for the FSA when action was needed urgently."*

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<sup>29</sup> The Banker, 'BBA's Unhelpful Criticism Of Financial Services Authority', 1 June 2002

<sup>30</sup> The Economist, 'Regulator, heal thyself', 20 January 2005

<sup>31</sup> Moulton, J. 'Financial Crisis: UK bail-out plan is too little, too late', *Daily Telegraph*, 8 October 2008

### 3. How regulations exacerbated the crisis

Regulations have played a significant part in making the financial crisis as severe as it has been. They appear to have been instrumental in turning the deflating subprime mortgage market in the United States into an existential crisis for the banking system.

#### 3.1 Procyclical capital adequacy rules

New capital adequacy rules introduced in Basel I encouraged a shift in the asset side of bank balance sheets from lending to the private sector in favour of owning government debt. This induced a global credit crunch and was a major cause of the unanticipated global recession of the early 1990s. The rules were subsequently refined as part of the Basel II accord and are now widely thought to be procyclical:

- Under Basel II, capital requirements for banks are based upon borrower default risk – the chance that companies and mortgages will go bust. That means that capital requirements will tend to increase as an economy falls into recession and fall as an economy is expanding.<sup>32</sup>
- A study for the Board of Governors of the US Federal Reserve System in 2004 simulated how capital requirements would function in a stylized economy. The study found that Basel II would be procyclical.<sup>33</sup>
- Charles Goodhart, from the London School of Economics Financial Markets Group, argues that the Basel II regulations give each bank a clearer, and better defined, picture of their individual risk position. While doing that, unfortunately, the regulations exacerbate the bigger problem of 'endogenous risk' – as the interactions between banks amplify a crisis. The regulations make the system as a whole less stable.<sup>34</sup>

By easing while the economy grows, and allowing an asset bubble to develop, and then tightening severely when conditions turn for the worse, the Basel II capital adequacy rules have clearly contributed to the scale of the financial crisis.

#### 3.2 Increasing homogeneity in financial markets

Common capital adequacy rules, while increasing transparency, may have led to serious problems by encouraging homogeneity in investment strategy and the undertaking of risk, leading to a high concentration of risk. This is dangerous because it increases the amplitude of global credit cycles if every

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<sup>32</sup> Gordy, M. B. & Howells, B. *'Procyclicality in Basel II: Can We Treat the Disease Without Killing the Patient?'*; Board of Governors of the Federal Reserve System, 12 May 2004

<sup>33</sup> Ibid.

<sup>34</sup> Goodhart, C. A. E. *'The Regulatory Response to the Financial Crisis'*, CESIFO working paper no. 2257, March 2008

country is in phase, compared with situations where there may be offsetting, out of phase, credit booms and busts in individual countries.

Basel II applies a very similar risk assessment framework across a broad range of institutions and as such it encourages them to hold similar assets and respond in similar ways in a crisis.<sup>35</sup> Consequently, instead of increasing diversification of assets and minimising risk, herd behaviour is amplified.<sup>36</sup>

This increases systemic risk by making it more likely that a particular crisis will affect the entire financial system, and not be contained within particular firms.

### 3.3 Mark to market

Mark to market regulations are designed to ensure that valuations of assets are fair and comparable across different companies and countries. Unfortunately, as they rely upon the market to provide a price for an asset, they cannot function when that market temporarily ceases to exist:

- At the beginning of the financial crisis the market for mortgage backed securities seized up and only fire-sales were taking place. The vast majority of mortgages, corporate bonds and structured debts are still performing but firms, that are otherwise solvent, are being forced to price them to fire-sale values by mark to market rules. This makes those firms vulnerable to collapses in confidence and forced liquidation.<sup>37</sup>
- Every one of the United States' ten largest banks would have become insolvent in the 1980s had mark to market regulation been in place.<sup>38</sup>
- Mark to market regulation has been enacted in the UK through EU directives. UK authorities, therefore, cannot suspend it in order to quickly address a crisis.<sup>39</sup>

While mark to market rules can ensure honest valuations when the market is functioning, they produce unrealistically low values when the market freezes up. Mark to market regulation has combined with capital adequacy rules to create a deeply pro-cyclical international regulatory framework.

### 3.4 Undermining hedge funds

A series of regulations have created significant difficulties for hedge funds and prevented them playing a part in assisting a recovery. The Economist newspaper recently set out a number of ways that new regulations have

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<sup>35</sup> Eatwell, J. 'The New International Financial Architecture: Promise or Threat?', Cambridge Endowment for Research in Finance, 22 May 2002

<sup>36</sup> Danielsson, J. and Zigrand, J-P. 'What Happens when You Regulate Risk? Evidence from a Simple Equilibrium Model', April 2003

<sup>37</sup> Wesbury, B. 'How to Start the Healing Now', *The Wall Street Journal*, 1 October 2008

<sup>38</sup> Isaac, W. M. 'How to Save the Financial System', *The Wall Street Journal*, 19 September 2008

<sup>39</sup> Booker, C. 'The EU's role in our financial crisis', *Sunday Telegraph*, 5 October 2008

made life difficult for hedge funds and, in doing so, undermined financial stability more broadly:<sup>40</sup>

- Convertible bond arbitrage is a strategy whereby hedge funds take advantage of underpriced convertible bonds, as too low a value is generally put on the right to convert them to equity, by buying the bonds and shorting the shares in the same company. The United States Securities and Exchange Commission's ban on shorting more than 900 stocks meant this strategy could no longer function and convertible bond prices plunged. This had the perverse effect of cutting off one way banks might have raised capital from the private market, issuing convertible bonds.
- Restrictions on shorting also disrupted statistical arbitrage models, computer models that are used to look for, and exploit, anomalies in the market. This disruption increased the cost of trading, made the market less liquid and has added to share price volatility. They have also discouraged fundamental, long-term, holders of bank stocks as they can no longer insure themselves against capital risk by taking an offsetting short position.
- Long-short equity funds that rely on the stock picking ability of their managers have also suffered as the strategy of shorting banks and buying commodity related stocks was disrupted. The funds have had to cut back their long positions as well as shorts. This has led to falls in the share prices of commodity companies.

Regulation intended to protect banks, by making it illegal to short sell their shares, may have harmed the chances of their recovering. Losses at hedge funds, due to new regulations, have led to their funding drying up and meant that hedge funds cannot buy now that prices have fallen. Beyond that, if hedge funds start to fail, and have to sell assets, that will hurt struggling banks.

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<sup>40</sup> The Economist, *'Collateral damage'*, 9 October 2008

## 4. How similar problems can be avoided in future

Constructing a new regulatory framework that will avoid creating crises in the future will be a substantial process. For that reason, this paper will not present a particular policy solution but, instead, set out the institutional changes that might mean future legislation is more effectively scrutinised. Proper scrutiny of new and existing laws would help ensure that future crises aren't driven by the unintended consequences of whatever new regulation emerges from the current problems.

### 4.1 Political scrutiny

Effective regulation can only be delivered with proper political scrutiny. Unfortunately, centralisation in Britain means that legislators are asked to manage public services. A politician's career is dependent on their credibility as a potential senior manager of a large government department.

After taking out the Government (around 100 MPs) and their shadows in the opposition parties (and those who hope to imminently attain such a position) there are few MPs whose primary focus is on scrutinising legislation. The media respond to this by reporting primarily on MPs' personal qualities or tangible record, whether they have the character and ability to do a relatively good job running a central government department.

Only radical action that removes responsibility for public services to individuals or local government can return the focus of MPs to properly scrutinising the actual and potential effects of laws. That would make future crises created by the unintended consequences of regulations less likely. How such a decentralisation of power might be achieved has been discussed at length elsewhere.<sup>41</sup>

### 4.2 End the EU's role

The way the European Union operates makes scrutiny difficult and changes in direction slow.

With 27 countries in the European Union it is extremely difficult to form policy that can apply in all the member states, as changes intended to satisfy one member state might easily upset another. This makes scrutiny of proposed laws deeply inconvenient and breeds a lack of respect for proper democratic procedure within the European institutions.

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<sup>41</sup> Barbour, P. F. *'How politicians can get themselves out of management and keep democratic control'*, The TaxPayers' Alliance, January 2008; Carswell, D. & Hannan, D. *'The Plan: Twelve months to renew Britain'*, September 2008



Britain's economy is unlike that of other European nations, particularly in having an unusually large financial services sector. Being able to form the right regulatory framework for financial services, and make changes quickly in a crisis, is particularly crucial for the British economy. For that reason, Britain cannot afford the slow moving and inscrutable processes that govern the European Union.

One possible solution is that Britain should move towards a relationship with the European Union like that enjoyed by Switzerland, with a free trade agreement but otherwise independent government.<sup>42</sup> That country is similar to Britain in also having a large financial services sector and offers a model for how we can maintain free trade with Europe but enjoy the independent government that would allow us to form appropriate and timely policy, particularly for the crucial financial services sector.

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<sup>42</sup> Lea, R. et. al. *'Defining a new relationship with Europe'*, Global Vision, October 2007

## 5. Conclusions

*"The Great Depression, like most other periods of severe unemployment, was produced by government mismanagement rather than by any inherent instability of the private economy."*

– Milton Friedman, *Capitalism and Freedom*

*"Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."*

– Ben Bernanke, November 2002

For decades after the Great Depression, it was generally understood to be the result of some inherent instability in capitalism. Now, while there is still a heated debate over the causes of the Depression, a far greater role is generally assigned to policy mistakes at the central bank and in government.

Understanding the causes of the present crisis is vital to forming policy that will prevent unnecessary crises in the future. There is, therefore, a vital debate to be had over whether the main cause of the financial crisis was some human failing on the part of greedy bankers or flaws in the regulatory framework.

Banking is, and has been for some time, a highly regulated activity. Banks enjoy implicit or explicit deposit guarantees, lender of last resort facilities from central banks and a variety of other supports such as government sponsored Fannie Mae and Freddie Mac in the United States buying up mortgages on the secondary market. In return, their lending is normally regulated in some way to ensure they do not take too many risks. Beyond that, central banks affect the supply and demand for capital through setting base interest rates.

Most bankers went into their industry seeking to make money; that is not new, avoidable or necessarily problematic. The free market functions to channel people's desire to improve their own position to the common good. In regulated industries, the range of controls and inducements offered also need to produce the right set of incentives such that bankers' pursuit of their own self-interest does not produce an unstable financial system.

It is important to remember that the British banking system, in particular, has historically been very stable. 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>43</sup> This stability persisted for well over a century despite

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<sup>43</sup> Capie, F. & Collins, M. *'Have the Banks Failed British Industry'*, Institute of Economic Affairs, Hobart Paper 119, July 1992



numerous crises in the real economy (and financial crises in other countries) and banks and their staff wanting to maximise their earnings. Only this latest crisis has seen a collapse of the British financial system to such an extent that large swathes of it are being nationalised in whole or in part.

This paper sets out what has changed. A series of regulations and policy choices that encouraged an unsustainable boom in lending; created authorities unable to act as they were hamstrung by EU rules and unsure when to act thanks to institutional division; and exacerbated the crisis by tightening controls on lending once it got under way.

There is clearly a need for ongoing work to construct a new regulatory framework that will avoid this crisis being repeated. However, getting new policy right will first require the recognition of the true origins of the present crisis. We will then need to make sure that critical decisions are no longer made without proper public and political scrutiny, or farmed out to the inscrutable and clumsy European Union. That way we make it less likely that policy and regulatory reforms will sow the seeds of future crises.



The TaxPayers' Alliance is Britain's independent, grassroots campaign for lower taxes and better government. The TPA has 15,000 supporters across the country, is backed by some of the UK's best-known business people and opinion formers and generates more media coverage than any other independent political organisation in the UK.

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