Comment on the session on the risks and liabilities of financial markets

JESPER LAU HANSEN

In their excellent lectures, professors Macey, Alexander and Arner have provided us with a view of the risk and liabilities of financial markets as seen from the US, EU and Asia, respectively.

Prof Macey summons up the US experience of the Financial Crisis by emphasising the strong dynamics of political economics in the regulatory response, e.g. how regulators are governed by incentives as much as the private sector is and how this can result in various erroneous outcomes such as delaying recognition of bank failures, especially in districts of powerful Congressmen. This is an apt observation, because one of the more dangerous consequences of the crisis has been the widespread perception that the economic theories that underpin the market economy were somehow debunked by the very fact that a crisis could occur and occur on such a large scale and that state intervention and regulation are left as the sole reliable building blocks for the future. Manmade disasters have a way of making us loose faith in the rationality of our fellow man, but experience teaches us that we do so at our peril. At this time next year, Europe will mark the centennial of the outbreak of WWI. That even greater calamity was also seen at the time of its conclusion as a repudiation of patriotism to the extent that when it was needed again to overcome the menace of advancing National-Socialism, a left-wing internationalist as Georg Orwell could only lament in his *The Lion and the Unicorn* its demise among his comrades and call for its urgent restoration. We too risk jeopardising our future if we dismiss the notion of a competitive market economic supported by an efficient and innovative financial sector in favour of a tightly regulated economy governed by regulators.

Now this is not to argue that we should not regulate the market or that we should be blind to the obvious faults exposed by the crisis. Of course we should learn from our mistakes. The path of the law has always been experi-

ence, notably the lessons taught by exuberant folly and downright deceit. We learn, adapt and carry on by adjusting the law accordingly. To address the old canard directly: a market economy is described as *free* not because it is free of regulation, but because the market participants are free to make their decisions according to their preferences within the boundaries set up by law to ensure that all market participants enjoy the same freedom. It is a question of who decides: market participants or regulators? The extreme prosperity that we have enjoyed within a few generations, a prosperity that would have amazed our great-grandparents and which has only been dented by the recent crisis, was brought about by enabling such a free choice and by ensuring a competitive system that would reward risk taking and innovation. It is unnecessarily naïve to believe that regulators can continue this trajectory and remove risk all together, even if they were not motivated by petty causes such as pecuniary incentives, turf wars and private ambition; which of course they are.

Most of the economic observations that were valid before the crisis stand as valid today: people respond to incentives and wrong incentives will produce unwanted outcomes; risk and return are correlated; diversification will only work to the extent that risks are truly uncorrelated which is difficult in an increasingly interconnected world; and effective allocation of resources by private initiative requires transparency, whereas opacity exacerbates agency problems. Most of these insights are not confined to the financial markets, but reflects common human understanding. That standardisation of-the-rack is cheap and common, while tailor-made is nice but expensive is as true for buying a suit as it is for buying a derivative. We need to apply these understandings to refine financial regulation, not disregard them as discredited and obsolete. The importance of political economy in this is to remind us that they also apply to the behaviour of elected politicians and public sector regulators.

The caveats brought to our attention by Prof Macey also take centre stage in Prof Alexander's account of the regulatory response in the EU. A well motivated desire to combat extreme opacity in financial engineering by regulators such as the aptly named central banker Mervyn King appears to disguise a worrying intention to arm themselves with far-reaching measures based on purely discretionary powers. Apparently, consumer protection and other issues concerning conduct of business by financial firms is viewed as "rule-based and highly legalistic", which, we are given to understand, are no good in prudential regulation. Despite the cunning observation in the

Walker Report that no particular institutional design of financial supervision proved capable of preventing or even mitigating the crisis, many jurisdictions have changed theirs, just as the disappointed gambler rids himself of his unlucky shirt. In the UK, Mr King's empire was greatly expanded by the introduction of the twin-peaks model, which has left his central bank untouched and effectively on top of its two new dominions the PRA and the FCA. Considering this concentration of power, one must hope for the UK and the rule-of-law that it embodies that even prudential regulation will be at least to some modest degree ruled-based and legalistic.

Although a certain degree of discretion is probably indispensible in financial supervision as it is in any kind of human endeavour, it is important to remind ourselves that corruption – from the scruffy money-in-envelopes to the sophisticated back-scratching and quid pro quo – thrives on discretional public powers. One warning sign, as ominous as vultures circling over head, is the congregation of lobbyist, which represent one of the more civilised indicators of the corruptive effect of vesting discretionary powers with public officials; like the vultures they would not be there if there was nothing to achieve. As Prof Alexander points out, the culture alive within an institution is crucial to the performance of that institution and its ability to perform the tasks assigned to it. Whether it is on Wall Street or Threadneedle Street, to feel like a unrestrained Master of the University is bound to produce an unhealthy culture.

Furthermore, what is surely the most important feature of prudential regulation is the decision to let a bank default. There can be no competitive market economy if in fact an enterprise cannot be put out of business. So either we design a resolution system capable of letting a bank default in an orderly fashion or we must nationalise them. Put this way, the banks are probably going to be more inclined to accept regulation of this kind, although they will inevitably fuss about the details. But as Prof Macey tells us of the US, the decision to effectively kill of a bank, especially a large bank or a bank considered large in its neighbourhood, is among the decisions most fraught with the risk of political interference. Will a system of prudential regulation based on discretion be able to withstand that and produce the orderly resolution required, or are clear rules and a legalistic approach needed to steel the supervisors to do what is considered politically unsavoury?

In the EU, the institutional re-design of supervision was less drastic than in the UK but all the more quick. Within a year of the publication of the De Larosière Group's report, a new supervisory system had been set up, although

mostly by using existing blocks refitted to the new system. Besides introducing a new macro-supervisory level, ESRB, the design builds primarily on the pre-existing 3L3,[1] which were now elevated to become European Supervisory Authorities (ESAs) and intended to both coordinate micro-supervision and feed into macro-supervision as part of the ESRB. Unfortunately, according to the Meroni doctrine EU law does not accept "authorities" that are not explicitly mentioned in the treaties and consequently the ESAs are mere agencies with no specific power to legislate; they can only draw up proposals. Although the regulations establishing the ESAs are quite clear in their intent to make the European Commission a mere rubber stamp on technical standards provided by the ESAs,[2] the Commission has continuously reasserted its legislative prerogative. Seriously understaffed and insufficiently funded, the ESAs are left to rely on the national competent authorities (NCAs) that they were supposed to supervise and to further aggravate their precarious position they are also left out of the legislative deliberations on level 1 and thus often faced with unreasonably short implementation deadlines once legislation is passed on level 1 to make their proposals for level 2 technical standards. The on-going review of the new financial supervisory system is likely to reveal disappointment with the ESAs and may recommend institutional changes, but it remains unclear whether the current system was ever given a real chance to work.

Another and equally important change to the regulatory response in the EU has to do with legislation. The two-tier approach known as the Lamfalussy procedure, whereby legislation on level 1 may authorise delegated or implementing acts on level 2, was adopted into the new Lisbon Treaty that entered into force on 1 December 2009. That was in the midst of the crisis, but the origin of the procedure was definitely ante-diluvian going back to the more sanguine years at the beginning of the Millennium. The crisis, however, has completely changed the way this procedure is now used. Under the battle cry of a Single Rule Book, entire swatches of financial regulation are being replaced by directly binding EU law in the form of regulations ostensibly to prevent regulatory arbitrage. This makes sense in certain areas and to some extent, unfortunately, it may be taken much further than that. Especially worryingly is the fact that the European Parliament, by now the most eager

[1] This signifies the three level-3 committees, CESR, CEBS and CEIOPS, established according to the Lamfalussy procedure.

[2] European Parliament and Council Regulations No. 1093/2010 (EBA), No. 1094/2010 (EIOPA) and No. 1095/2010 (ESMA). The three regulations are highly identical.

and well organised of the treaty bodies to wield legislative powers, appears to put into level 1 regulations the kind of detail that was envisioned for level 2 standards if at all. The devil is in the detail and so is the Parliament; often with a political zeal that appears to be inversely related to its public support as demonstrated in the direct Europe wide elections that are due again next year.

This avalanche of directly binding, highly detailed and very comprehensive EU legislation may present the salvation of the endangered ESAs. Rather than assuming the role as their federal master as was once likely, the national NCAs may come to view the ESAs as their best option to organise themselves and accommodate the many new rules while at the same time using the quasi-legislative powers afforded by the ESA-regulations to exercise at least some influence on the Commission. The support by the NCAs will be welcomed, because it is likely to be transmitted from the NCAs to their political masters in the Council and at a time when the Parliament appears to have lost interest in the ESAs in lieu of legislating directly on level 1, this may ensure their continued existence.

From Prof Arner we learn of the on-going financial integration in Asia, an area increasingly dominated by the resurgence of China as the Region's main power. Although growth has been titanic, the financial underpinnings remain somewhat behind the curve compared to the US and EU. The presence of Asian powers in global venues of the old Western economies such as the G20, which is probably more justified by their industrial output than by the capacity of their financial industry, results in obligations to address problems that must appear to them as being of a "first world" character such as bringing derivatives trading onto exchanges. There is a distinct risk that focusing on this kind of conceptual import may shroud domestic financial problems that needs to be addressed, eg. non-bank lending also know more derisively as shadow banking. This is to a large extent a problem of conceptualisation, because what makes it shadowy is regulators and legislators inability to fully grasp the extent by which financing is provided by various actors from those with surplus liquidity to those in need of investment. It is a well-know problem in both the US and the EU, but it would appear that it is different in its Asian setting and requires a domestic response.

A more polite Chinese curse is to wish for a person to live in interesting times. We are definitely living in very interesting times. The fact that the recent session of the ruling Communist Party in China ended with a commitment to apply and rely on the market wherever possible at a time, when

the market is viewed with disdain in both the US and the EU, indicates that they will continue to be interesting.