

Chapter 5

Regulatory Capture

“The big banks wanted a level playing field so that they could grow within the national financial system and internationally”

To view the current crisis solely through a financial, economic or regulatory lens misses the important political dimension of financial regulation and financial booms. We suggest that regulatory capture is one possible explanation among many to help us understand what has occurred. In Chapter 1 we highlighted two main reasons why we regulate the financial sector over and above normal corporate law. First, there are information asymmetries between retail investors and professional financial firms and second, banks can be highly systemic. It follows from these market failures that the more systemic a bank is, the more regulated it should be; the better an institution proves to be at risk assessment, the less regulated it could be. Moreover, regulation should strive to put risks in the hands of those with the best capacity for those risks and regulation should be simple so that it would be easy to understand by consumers and administered by supervisors. In reality the opposite was the case.

Regulation favoured larger more interconnected and systemic firms over smaller, less systemic firms in a number of ways. Regulation was process-oriented not results-oriented. The bigger the database and the more sophisticated the computer models the more regulators were inclined to relax regulation and capital

requirements. Computer models were favoured and relationship banking was considered antique. Credit unions or other institutions with – in many, though not all cases – substantial credit knowledge of their clients and good records on delinquency rates, were considered to be more dangerous as a result of insufficient IT capacity. The compliance side of regulation also exhibited strong economies of scale, giving a competitive advantage to large banks.

The ability of a bank to forecast its own delinquency rates – results oriented regulation – played almost no role in assessing capital requirements. (This is why supervisors came out of the crisis revealing that they had inadequate knowledge of the business models of banks, how the banks they supervised made their money and what risks they took to make it. It seems to us that knowing how a bank makes its money, what risks it is taking to earn this profit and how good it is at taking this risk should be the very first task of a supervisor, not an optional extra.) Instead the focus was on a bank’s process, which, as explained above, gave big banks an advantage over small banks and drowned supervisors in details of process and not in an assessment of risk.

One of the strongest mantras of current regulation, still heard loudly today, is ‘the level

playing field'. But there is little fundamental argument for why we need to have the level playing field other than the general sense that playing fields should always be level. The big banks wanted a level playing field so that they could grow within the national financial system and internationally. This level playing field helped banks with their short-term funding to hold substantial amounts of illiquid assets and insurance companies with their poor capacity for credit risk to hold large amounts of credit.

Regulatory complexity is also an avenue of capture and financial regulation ended up being highly complex and legalistic. This partially led regulators to see supervision as an exercise in legal compliance rather than an assessment of risk and risk capacity. Capture also distorted the application of global rules by home country regulators. Captured national regulators became champions of their national banks abroad. London's light touch regulation was as much a statement of competitive intent as it was a statement of philosophy. The same could be said for the approach to regulation in New York, Reykjavik and Vienna.

It would appear that at the centre of the crisis stood those things that were the result of regulatory capture: relatively lightly regulated, systemically important, international and universal banks; the level playing field which allowed a gross misallocation of risk-taking and risk capacity; the abandonment of good risk assessment in favour of computer models; and complex regulation that was complied with to the letter, but not the spirit. Regulatory capture substantially contributed to the regulatory failure. It stands to reason that to avoid financial crises we must deal with regulatory capture.

The Politics of Capture

We suggest that capture was achieved through a number of avenues. This was not a case of illegal or irregular influence, however. The financial industry gave generously to all political parties across the board, and donors one day sometimes became policy officials the next day. The revolving doors have been turning most rapidly at the top of U.S. policy making and investment banking in recent years, but they turn in other countries too. If it were only this, the capture would have been

continuously contested and countervailing forces would have emerged more readily. The capture, however, was also intellectual. The revival of economic market ideas from the 1970s onwards was accompanied by an aura of respect and an intellectual inclination to recognise the superiority of these ideas. The tallest spires of academic finance generally, though not exclusively, supported the notion of efficient markets, reassessing the purpose of regulation and containing the ambitions of regulators.

Capture was helped by the emergent view that public agencies ought to be independent of politics. As part of this process, a policy role for the private sector was legitimised. Intellectual capture, in turn, also relates to the 'group-think' that has taken hold in the making of financial policy. Regulatory and supervisory arrangements are discussed and agreed in expert and apolitical terms, bringing like-minded individuals who, whether in the official, private or academic sphere, can reach common understandings based on shared training, practice and access to economic ideas. Both in the national arena and, increasingly, in the international fora around the Basel process, such networks are technocratic, informal, politically unaccountable and have a narrowly defined understanding of financial policy. They are also often de-coupled from other economic considerations or broader questions about the role of finance.

It is important to break 'group-think' and introduce new voices and interests to debates about financial regulation. But this report also accepts that reform efforts cannot be about the formal structure of policy-making arrangements alone – and that beyond the memberships of committees and institutions, the informal and intellectual dimension of governance and capture needs to be addressed.

The Politics of Booms

Political factors are also at work in making financial regulation and markets pro-cyclical as we have discussed in Chapters 2 and 3. In most jurisdictions supervisors have the power to tighten regulatory requirements to dampen a boom. But they do not. The Reserve Bank of India tightened regulations on lending for residential housing during the last housing

boom and was able to moderate its effects. The Spanish central bank has for several years imposed counter-cyclical provisioning. Chile and Colombia have had instruments to deal with the ebb and tide of international capital flows. But these are slim exceptions and they seem to be more accepted outside the Anglo-American world. More typical is the position of Alan Greenspan as Chairman of the Federal Reserve Board, who suggested that there is too much uncertainty as to whether there is a boom.

Responsible Credit and Welfare *Leonard Seabrooke*

There are clear reasons why we need to think through what we could call the political economy of international financial reform. We often discuss the link between the financial sector and the 'real economy' during periods of high financial stress. Beyond the idea of the real economy are real political and economic interests in how national financial markets relate to



national welfare concerns. The most obvious link between financial policies and social policies can be seen in how housing is financed, which is a reflection of how different societies see the need for housing. Political economy scholars call this a 'welfare trade-off'. In some countries citizens opt for high taxes and high welfare that provides social housing. Other societies favour low taxes and low welfare and then have to build assets over their life through housing and pension fund contributions. Governments and financial markets in low-tax economies have a clear interest in innovating to meet the political and economic need for housing.

It is no surprise, then, that mortgage securitisation emerged within the U.S., and that access to credit was politicised as

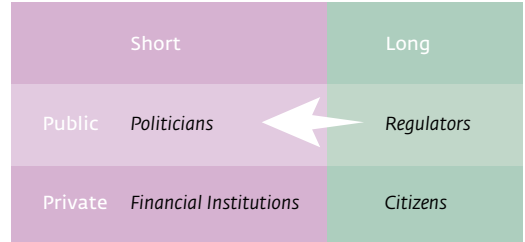
groups were excluded from credit access due to income or racial discrimination. In the U.S. access to credit for housing was, and is, a political good. Politicians have a clear incentive to increase credit for housing since those who miss out know that they are dependent on a weak welfare state. It is also not surprising that governments create institutional innovations to meet political and economic needs. The creation of the sibling institutions Fannie Mae, Freddie Mac, and Ginnie Mae (linked first to the 1930s depression and later to the civil rights movement) was to mediate the interests of private capital and public values. As we now know, the most recent U.S. property boom made it harder for many Americans to be 'prime' borrowers through the siblings and led to the boom in subprime mortgage securitisation. These securities attracted a lot of investment, from home and abroad, because they carried attractive yields while apparently being low risk as they were put into apparently uncorrelated, diversified packages.

At base, the now so-called 'toxic' subprime mortgage-backed securities are tied to Americans' welfare trade-offs. It is a priority for the U.S. government to restart securitisation as soon as possible because it performs a critical political and economic function within the American system. As such, President Obama will have an interest in saving securitisation since without it he may have an administration in which the community groups from which he claimed some of his political legitimacy have fewer chances to build assets through access to housing. What societies expect from their financial systems will constrain international financial reform. We should expect to see a lot of variety in how economies respond to the crisis. Such divergence may well be legitimate because it reflects different welfare trade-offs. An international financial crisis that arose from within democracies cannot be solved behind closed doors. We need to be aware that public expectations will shape international financial reform for good or bad.

This general reticence to act by regulators and supervisors relates to political pressure. In the middle of a boom, it is in no one's political interests to stop it. Politicians want the boom to last until the next election. The early phase of the boom, when it is best brought to a halt, has the characteristic of robust economic growth with low inflation. Policymakers misinterpret this as a sign that they have earned policy credibility and do not wish to suggest otherwise or do something that might change the character of the environment. Central bankers wasted many hours during the boom arguing that the circumstances of low-inflation growth and an apparently safe but expanding financial sector were due to increased policy credibility. In this environment, supervisors may not so easily stick up his or her hand and declare that we are in an unsustainable credit binge and easily argue that policy credibility, or other such institutional innovations, may have little to do with it.

We set out these issues in Figure 1. Politicians have an interest in being re-elected. The financial institutions have an interest in short-term profits to please shareholders. Ideally, the regulators have an interest in the long-term stability of the financial system. And citizens have an interest in the long-term stability of the system since they have heavily invested in it through pensions and, depending on the country, housing. This is especially the case in low-welfare economies, where citizens expect to build wealth over their life-cycle or through the family. In such systems we should expect to see groups that have been excluded from credit access to fight for it. In this context, a U.S. home-buyer who chooses to take up a subprime loan has not been irrational, but acting, given the expectations at the time, upon his or her long-term welfare interests, however aspirant they may be. Similarly, within such systems governments have a strong incentive to support and maintain securitisation that can aggressively recycle capital in order to provide credit to the masses. As long as there are investors, including countries with war chests of currency, to invest in such securities, mass credit provision is possible and asset bubbles become ever more likely.

Fig 1: Political Time Horizons and Financial Regulation



Politicians are able to ride on the growth spurred by easy credit that heightens their re-election chances and they seek to prolong that growth through various tricks (such as when U.K. authorities, during the boom, removed housing costs from the Consumer Price Index). During the boom, citizens who were not already invested in the pensions and/or housing markets became increasingly nervous about being left behind, and took on new levels of personal indebtedness to get in the game. In the U.S. system this led to both subprime and no-equity mortgages, while in systems with sturdier welfare, it led to world-beating levels of personal indebtedness (as in Denmark and the Netherlands).

Regulatory Solutions to Multilevel Political Problems

Mark Blyth

Regulators face a particular problem in that much of what we wish to regulate may have no regulatory solution. Instead what we face are political problems looking for regulatory solutions. Such difficulties present themselves on three levels. The first level is that of the global economy. For some analysts, critical in generating the current crisis are the global financial imbalances between the U.S. and the East Asian economies.



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The second level where such problems appear lies at the level of the national financial systems. Here we encounter demands for the regulation of institutions such as Credit Rating Agencies (CRAs), Government Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac, or the major Banks themselves in terms of their size and leverage ratios. While demands for the regulation of these institutions seem both reasonable and rational in the wake of the crisis, the reform of such institutions is also bound up with political questions. The CRAs were blamed for having a conflict of interest at the heart of their operations. For the GSEs the problem was seen as poor underwriting and a dearth of good borrowers leading to the issuance of mortgage securities that were both over valued and far more correlated than advertised. Finally, that the major banks were too big and over leveraged is not in doubt. So, what can be done? For the CRAs the regulatory solution proposed is either a public agency to oversee the private ones, or a whole new business model for the industry. But if you are still relying on the CRAs to rate the securities the state is relying upon to stabilise the financial sector as a whole, why would the state wish to reform the system? For the GSEs the regulatory solution was to abolish them. But closing them down would likely lead to shrinkage of the U.S. mortgage market and through that, reduced securitisation, global liquidity and financial access. Finally, the same banks are both 'too big to fail' and 'too big to bail'. But with them being implicated in 20 percent of GDP and nearly 30 percent of gross value added in the U.S., their abolition or shrinkage would come at a heavy price. Now, add to this that any and all legislation has to pass by a Congress or similar democratic body, that there is no downside to the upside of a bubble for politicians, and that bureaucracies can suffer regulatory capture, and we can see how the politics of reform once again supervene in the design and execution of effective regulation.

So what are we left with? The third level is the level of markets themselves. Here we

must deal with actual financial products implicated in the crisis. Currently, one particular set of instruments are highlighted; derivatives contracts, especially Credit Default Swaps (CDS). Such instruments were seen to be critical elements in the elaborate daisy-chain of risk that brought down AIG and that facilitated massive public interventions to shore up the global financial system. Consequently, politicians across the world seek to regulate their use far more than before. But are we likely to try and regulate these instruments because they can be regulated, rather than the fact that they should be regulated?

The following considerations are worth bringing to bear on this question. First of all, while it is true that such instruments can be used for speculation as well as hedging, it is in practice often difficult to distinguish between the two positions. Do we really want to limit hedging in order to reduce risk? Second, while the banks that sell these instruments are self-interested actors who reap huge profits from their sales, their claim that too much regulation will stifle innovation and growth needs to be taken seriously. The problem of coming down on one side or the other of such a claim is that it is very hard to test the proposition empirically. Establishing econometrically that over-the-counter products add to growth is as difficult as showing that they take away from growth. Their production certainly generates fees, but given the skewness of the income distribution in the U.S. and in the returns to finance in general, it is not clear that they add much to the growth of the economy more broadly construed. In short, banning such instruments, or posting them on exchanges or establishing a central clearing counterparty (CCP) or increasing trade reporting may be the regulatory solution we reach for because that is the one we can achieve rather than what really needs to be addressed. This is possible. And this is precisely what political solutions should focus on.

We believe that there are a number of ways of responding to the political pressures we discuss above. First, regulatory policy should be more rule-based or discretion needs to be more constrained, especially in response to the credit cycle. The regulation of capital, leverage and liquidity needs to be tightened in the boom and loosened in the crash. This is best done according to a simple rule, (see Chapters 2 and 3 for examples of counter-cyclical rules and Chapter 8 for a further discussion of rules versus discretion) where policymakers can decide not to follow the rule, but only if they set out the logic of their inaction to the public.

Second, the locus of regulation needs to be more host-country than home country. This is the best defence against a national regulator interpreting global rules in a permissive manner in order to give his local banks a competitive advantage abroad. Host country regulation will also provide emerging market economies with greater policy space to deal with the macro-prudential aspects of the cycle of cross-border capital flows.

A host country regulation system locates the source of authority within a national system. By contrast, a home country regulation system permits financial institutions to be regulated from afar and runs the risk of allowing disruptive economic outcomes within the host. We also suggest that host country regulation permits national and regional variations that provide useful and necessary variety and differentiation within financial markets. From a political economy perspective, this is necessary not only to enhance diversity, investment, and growth, but also to address political considerations. We return to this issue in Chapter 9.

The third more direct response is to have as a deliberate policy the ‘right-sizing’ of the financial sector, financial institutions and financial activity. We now turn to this idea.