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RISK&REGULATION: CARR REVIEW
FINANCIAL CRISIS SPECIAL

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CARR on crisis

The financial crisis of 2008 is much more than financial. In addition to its profound economic dimensions, it is also a crisis of knowledge and ideas that demands a response from the social sciences. That response can no longer travel along well-defined channels. It requires us to reconsider prominent assumptions in our most respected academic disciplines. We need to go beyond traditional academic comfort zones. We must face new questions about risk and rewards, regulation and failure. The answers to these questions are likely to be found on, or beyond the boundaries of traditional academic disciplines. The world has changed, and our response needs to reflect that.

Over the last decade, the persistent call for genuine interdisciplinary research has become something of a cliché. But in today's radically changed world, the kind of work we do at CARR has become critically important. Beyond the tidy world of models, regulatory oversight and corporate governance structures, we now know that questions of trust and ethics, of expertise and responsibility, are fundamental to the very foundation of a market. This is not just about financial markets, because social life does not respect neat and reassuring distinctions. Recent events remind us dramatically of a sociological truth that reaches back to Weber and Durkheim: that the boundaries between public and private life, between politics and economy, can never be taken for granted.

This special issue of *Risk & Regulation* assembles some early reflections and reactions from CARR staff, addressing these intellectual challenges. They draw on our distinctive melting pot of expertise in accounting, law, political science, sociology, science studies and management. The topics covered go well beyond finance and the financial sector. The essays discuss the incoherence of ascribing blame to individual people or institutions when it is interconnectedness that we should be attending to. Some essays underline the importance of culture and values as the basis of all organizational life, and the socially constructed nature of failure. Others emphasize the dangers of rapid policy responses driven more by expedience than diagnosis, while some survey the transnational nature of the crisis, the limits of nation states acting in isolation, and the need to rethink regulatory practice so as to preserve the best elements of self-regulation.

CARR staff have worried about such themes for many years, without suggesting that one theme or approach trumps others. Now their ideas have a new relevance and traction. But we do not pretend to offer quick solutions. Any diagnostic process will be lengthy, any cures even longer. However, we expect policy changes will need to do more than re-calibrate the business-state relationship in a superficial way. Cultural change should be on the agenda, and this will demand greater policy openness to a wider range of the social sciences than has been evident to date.

The challenge for the social sciences in general, and for CARR in particular, is to look beyond the obvious scapegoats whose evaporation of authority has been so public. We need to understand what has been called the 'incubation period' of this crisis, one that may have lasted two decades if not more. The social sciences, including those most concerned with risk and regulation, have played a role in this, and cannot be regarded as mere innocent onlookers. CARR has both a great responsibility, and an important opportunity to address these issues. The essays that follow represent our first thoughts.

Bridget Hutter
Martin Lodge
Peter Miller
Michael Power

Social systems failure?

Trust and the credit crunch

CARR Director **Bridget Hutter** and **Nigel Dodd**

The financial crisis gripping today's world stems from systemic problems that cannot be attributed simply to individual or organizational failure, and to understand this systemic collapse we must focus on its social origins, in particular on the way it emerged in part from a breakdown in the social foundations of both markets and money itself. To do this, we need to appreciate the importance of what French sociologist Emile Durkheim referred to as a 'non-contractual element of contract'. Since economic institutions and activities are embedded in social, cultural and political structures, trust and confidence are crucial to conduct business, yet for this crisis we have witnessed a collapse of that confidence throughout the financial system. Looking back, we see now that the crisis was precipitated by misplaced trust – or complacency – at many different levels.

At the macro level trust accumulated in models and financial instruments developed during times of economic optimism, based on mistaken assumptions about the future. Times were good, and were expected remain so. It was no surprise to hear the then British Chancellor Gordon Brown tell a Labour Party conference in 2000: 'We will not put hard-won economic stability at risk. No return to short-termism; no return to Tory boom and bust.' Monetary policy reflected this confidence. Interest rates were low, consumers were encouraged to borrow and spend – as savers and investors looked offshore for a higher return on deposits, a process the Bank of England described as a 'search for yield'. Underpinning these trends lay misplaced confidence in the banks' ability to adopt prudent, responsible lending policies and remain solvent – but the ratio of their lending to capital was advancing into riskier territory, a so-called 'capital lite' model. Nevertheless, confidence in the ability of regulators to identify flawed business plans was high, and in their ability to do something when they did pinpoint problems – probably too much trust.

Today's problems are immense in scope, span different financial entities like commercial banks, investment banks and insurance firms, and across numerous countries. To search for explanations in a faulty business model alone is over-simplistic. This crisis is deep-rooted in the financial system structure, notably in a governance and regulatory apparatus that was based on ideological approaches stretching back at least as far as the 'liberalization' of markets during the 1980s. Since then the political climate has fostered deregulation, with politicians supporting light-touch rules and assembling meta-governance systems that assess performance regulators in terms of business interests rather than those of the consumer. Some key political decision-makers were openly hostile towards regulation; Prime Minister Tony Blair's 2005 Institute of Public Policy Research speech criticized financial regulators for inhibiting efficient business. Not surprisingly, the Better Regulation Commission 2006 report on 'Risk, Regulation Responsibility' reinforced this by concentrating on individual responsibility; and the absence of any reference to business responsibility was a glaring omission. Things had moved so far down this road that the Chair of the Financial Services Authority Adair Turner said the climate in itself had become an obstacle to effective regulation.

To complicate matters, information asymmetries were intensifying across the financial system. Knowledge shortfall has been a striking aspect of this crisis, suggesting problems extend well beyond the regulators and into relations between bankers and government, between banks and investors/depositors, and between bankers themselves. As tranches of so-called 'toxic' debt such as Collateralized Debt Obligations (CDOs) unravelled, the problems materialized out of the mist. Traditional assumptions about the ability of wholesale market participants to assess risk have been undermined because many relied on credit rating agencies rather than undertake their own assessments – and those rating agencies have proved to be less reliable than previously supposed. Moreover, legitimate questions arise about their rating objectivity, given that they operate in a competitive market and are paid for their assessments by the very firms that sell the securities the agencies review.

At the micro level, consumers trusted banks and advisors without appreciating such knowledge gaps existed. Low income and consequently risk-prone borrowers, tempted by home ownership and a solid earnings prospects, were actively encouraged by both lenders and governments to commit to large loans despite uncertainty about their ability to repay.

Free market economics, rooted in the 1980s, spawned financial institutions ready to satisfy these demands but within them we now recognize classic organizational control and governance problems that arise when misunderstandings spread about the risks being undertaken. Risk-taking incentive schemes injected perverse effects and unintended consequences and even boards of directors and senior managers – let alone depositors and investors – failed to comprehend the risk-taking activities of their staff as financial instruments developed that lacked the essential transparency needed for adequate managerial oversight.

Once doubt crept into the trust financial institutions had in each other the problems spread quickly. Liquidity evaporated as banks in the money markets asked awkward questions about potential counterparties and started to curb lending of their own cash reserves. Confidence dissolved with alarming speed when mere questions about liquidity transformed into doubts about solvency. A trust collapse in the whole system was inevitable; then words like 'contagion', later 'panic' were used to describe the spread and speed of the transnational confidence erosion.

We have yet to explore fully the significant transnational aspects of this crisis, which seem to have been underplayed in commentaries so far. Much is made of government (tax payer) 'bail outs' of banks in Britain and the United States, but many questions remain about how to define responsibility for failures that involve cross-border activity. Numerous transnational questions about how to handle the crisis still need to be addressed properly, including providing guarantees on cross-border inter-bank lending, recapitalizing banks with significant cross-border operations like Fortis and Dexia, and inter-state co-operation to offer blanket deposit guarantees despite the associated moral hazard problem. Clearly, finance needs agreed rules and standards for asset valuation, accounting and reporting to paint a full and balanced picture of banks' capital adequacy when they operate under different national regulatory systems.

Rebuilding and stabilizing the banking system at a national or transnational level demands re-established trust and confidence in the economic, social and political framework surrounding financial and banking activities. In the crisis so far, national governments and other state agencies such as regulators and central banks have been the key players, with governments trying to fill the wide

trust breakdown gap between banks by offering guarantees or assuming part-ownership of banks themselves. Politicians suggest these are temporary measures, designed to stabilize fiduciary elements in the banking and monetary system before the more fundamental work of rebuilding trust in the system as a whole begins – but a deeper, structural, problem looms over how we move forward.

While the financial and banking system is now indisputably global in scope, almost all the key rescue and support sources so far have come from national governments and state agencies and at this level there have been different national responses to the crisis, each of a distinctive regulatory style. So it seems difficult to envisage how a cross-border response might emerge, even if there was widespread agreement that the problems themselves are transnational. This means that we must acknowledge the systemic nature of the crisis and try to grapple with its causes on that level.

Experience tells us that risk failure events spark a blame culture that offers up individuals as scapegoats; system faults themselves are either ignored, denied or both. This resonates with the writings of the German social theorist Niklas Luhmann who argues that risk tends to be associated with detrimental decisions attributable to a decision maker. Therefore, individuals and their decisions become the focus of blame rather than the circumstances surrounding any risk event. But we cannot attribute a crisis this deep and widespread simply to the failures of some identified individuals. Such failings undoubtedly exist, but to explain away this financial meltdown as the consequence of just some individual culpabilities would be both mistaken and highly destructive – and would obscure the real lessons we need to learn.

Belief in the *system* must be restored, and that will likely be painfully slow and uneven because trust and confidence are not the inherent properties of a person or an object like a market but are attributed by others. Both take time to assemble and the building process is hard to define and predict. Like trust in individuals, the abstract, impersonal, trust needed to operate a banking system cannot spread overnight, and is extremely difficult to rebuild once broken or breached. Trust has never been entirely blind or a simple leap of faith, and whereas trust in people tends to be reinforced or undermined by reputation, any trust in the financial system will demand oversight and accountability systems that can compensate for the credibility lost in today's crisis. That requires a period of careful and systematic reorganization. We therefore need to beware knee jerk reactions. Typically, we can expect a flurry of post crisis activity but it is essential to contemplate proper longer-term solutions, taking time to appreciate what has happened and reflect on the coming inevitable competing explanations and accounts.

Reorganization will undoubtedly take place at many levels ranging from financial organizations through the state to transnational arrangements. Sector level associations may well have an important role to play since they at least right now comprise a community of fate that needs to demonstrate it can behave responsibly and maintain conscientious oversight. Much is promised in the aftermath of any crisis, but it is sustainable change that is crucial.

Now is not the time for a regulation see-saw, moving first to strong, then back to weak, for example demanding a dramatic rise in capital adequacy then a relaxation in a few months time. There are many things to learn.

We must learn that the 'scientific' models of risk and business activity need to be underwritten and overseen by an ethos of responsible behaviour. We must learn that organizations need to re-assemble a sustainable trust and confidence structure across national borders and so bring Europe together. And we must learn that whatever we do, any solution has to embrace all the global players.

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"We must learn that organizations need to re-assemble a sustainable trust and confidence structure across national borders and so bring Europe together."

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When markets and models fail: rethinking risk, regulation and the state

CARR Deputy Director **Peter Miller**

We are watching the disintegration of the financial system. So said a *Financial Times* headline at the beginning of October. Over the following ten days, it turned out that this was not scare-mongering. Things worsened quickly, and journalists sought to describe in increasingly vivid terms what looked like the end of finance-based capitalism. In a short while, it seemed as if supplies of hyperbole might run out just like supplies of financial credit. Soon, though, the language of failure became monotonal, as did the images. Graphs depicting the collapse of financial markets around the world dominated our television screens, the front pages of our newspapers, and our computer screens. Each day they pointed ever downwards. The full meaning of globalization finally began to dawn on people, albeit in a discomforting fashion. Being connected and spreading risks, at times like these, means that we all sink together.

Everyone, it seemed, could be blamed. First in line, and unsurprisingly, were finance experts and financial economists, with their unswerving faith in markets and financial models. Their world was depicted as one of casino capitalism camouflaged in technical know-how and complex financial instruments, that few fully understood and few outside the sector cared about so long as the money kept flowing in, house prices continued to rise, and the bonuses for all that putative stress and skill continued to exceed even the participants' own wildly extravagant expectations. Those wedded to the ugly neologism 'performativity' saw their claims vindicated. The distinction this suggested between doing and describing, between making and mirroring, really did seem to be an apposite way of explaining the relation between economic and financial models and actual financial markets. For many, this begged the question of whether those who had developed these models were best-suited to clear up the mess.

Next in line, again unsurprisingly, were the regulators. The Financial Services Authority was unkindly dubbed the Falling aSleep Authority, for failing over many years to curb the excesses of a system that depended on risk-taking but expected it to be well managed. Lax capital ratios were touted as one possible cause, as were devices called Special Purpose Vehicles, whose very name might make ordinary folks wary to say the least. Ironically, and as is often the case, 'more' and 'better' regulation was held out by many to be the remedy. Although, of course, there were those who opted to put the blame in the other direction – badly judged intervention, or simply intervention *per se* was held to be the problem by those unable to even imagine that the fault might lie with them.

Following the regulators into the blame arena were those who devised performance incentives and bonuses, as well as those who received them. For these bonuses seemed to encourage and reward excessive risk-taking on a scale that few outside the financial services sector could even imagine. The word, short-termism, which had provided the leitmotif for describing western firms and entire economies during the 1980s, once again became common currency. On this occasion it appeared to be almost an understatement, coupled as it was with incentives that seemed at times perverse. For many, the distinction between 'rogue traders' and the rest began to seem increasingly blurry, as did the distinction (when applied to senior management) between legitimate reward for reasonable risk-taking, and pure greed. The title of Tom Wolfe's novel *Bonfire of the Vanities*, set in late 1980s New York, seemed truly appropriate when a Congressional oversight committee chairman questioned Richard Fuld, ex-CEO of Lehman Brothers, to ask if Fuld's repeated multi-million bonuses were 'fair', a question that few would have thought feasible or reasonable as little as a year earlier.

Next, after much discussion, the spotlight fell on financial accountants. The international accounting standard setters and their academic accounting supporters (mainly in the US) were to be blamed for something called 'mark-to-market' accounting. Only recently extended globally, this meant the application to banks' financial reporting of a rigid market-based mentality derived from financial economics. Rather than report the value of an asset on the basis of an estimate of its underlying worth, mark-to-market principles meant reporting it on the basis of its most recently traded market price. In the heated atmosphere of financial system meltdown, politicians eagerly assumed the role of accounting standard-setters, and sought to challenge mark-to-market accounting principles.

Without doubt, this is an incomplete list of the blame-worthy. But adding to it, with the aim of making it more complete, would only encourage the meretricious blame-shifting that is already starting to emerge. To seek to apportion blame among the above four domains or sets of actors would be to miss the point of the current crisis, and would reinforce the absurd compartmentalization of the worlds of policy, practice and pedagogy that obtains today. We have to start from the presumption that the crisis we are now witnessing is not one that is specific to the financial system. It is a crisis of an entire system of governing, as defined by Miller and Rose in their recent book *Governing the Present*. It is a crisis both of an interrelated set of *ideas* about what it means to govern appropriately, and a set of *practices* that seek to govern the operation of domains as diverse as financial markets and health care. It is a crisis that requires us to go beyond questions of whether 'more' or 'less' regulation is needed, and whether a particular individual or regulator was particularly culpable. To understand the nature of this crisis, we must start from the presupposition that it is systemic, and that those most centrally embedded in the financial system and financial markets are least equipped to grasp and analyse it adequately.

Much more is at stake than financial markets, models and institutions. If financial models, regulatory regimes, incentive systems and accounting principles can each have an impact on how the market performs, they themselves are symptoms of, or linked to, something else. And that something else is the *idea* of the market and its constituent practices, as distinct from the actual market itself. At times such as these, when politicians, regulators and self-appointed or formally accredited experts of the financial domain are busy pronouncing on the proximate causes of the crisis, it is worth stepping back a little.

As Albert Hirschman convincingly demonstrated in *The Passions and the Interests*, we can learn much about our present condition by reflecting on that dextrous transformation through which 'private vices' have been turned into accepted 'public benefits'. As he asks pithily at the outset of his book: 'How did commercial, banking, and similar money-making pursuits become honourable at some point in the modern age after having stood "epochs and empires crumble just as commercial concerns do when they lose their credit" (Robert Musil, *The Man Without Qualities*)

condemned or despised as greed, love of lucre, and avarice for centuries past?' His answer is in part derived from the history of ideas. He shows how the rationally conducted acquisition of wealth came to be categorized and implicitly endorsed as a calm (*doux*) passion that would be strong enough to triumph over a range of malignant ones. In the process, the notion of interests came to achieve today's current and rather limited economic meaning, as distinct from its earlier and broader meaning that included all human aspirations. To quote Hirschman again, this re-working of the distinction between the passions and the interests means 'capitalism was supposed to accomplish exactly what was soon to be denounced as its worst feature'.

Hirschman shows that this marvellous transformation of destructive 'passions' into 'virtues' is much more than a transformation of ideas concerning individual behaviour. What is at stake rather is a new turn in the theory of the state, an attempt to alter the very basis of statecraft. If the state is to be a civilizing medium, it should harness the passions rather than repress them, and should turn them into something constructive. This principle has long been at the heart of our system of governing, even if ways to make it operate through regulatory and risk management regimes have varied significantly.

But the current crisis calls this principle into question. In the space of just a few weeks, we have seen what happens when people stop believing. Only recently, 'nationalization' was a dirty word, designating a bad old past, and one that left a bitter after-taste. Suddenly, 'nationalisation' is a proud word – at least for a while, and until people start to pay for it. It now sits comfortably alongside words such as responsibility, security and society. This may only be temporary, but at least for a while it allows people to sleep easily at night, secure in the belief that the state is, after all, watching out for them. Thatcherism, in all its national variants, was just a bad dream after all. And we can hold our heads high as we walk to the Post Office to tuck away our savings somewhere safe, rather than invest them in risky assets – even if it turns out to be owned after all by the Bank of Ireland.

This is a remarkable transformation, and in such a short space of time. As the recriminations start, and government resolve is tested with respect to what counts as 'excessive' bonuses, the current and profound rethinking of risk, regulation and the state may itself be tamed. But politicians, practitioners and academics alike would do well to pause for just a moment to ask what tools are needed to make sense of the current crisis. Clearly, we must break down the comfortable compartmentalization that characterizes the worlds of policy and pedagogy alike. The academy has much to contribute, but only if it can get beyond mouthing the term 'interdisciplinarity' while failing to fully respect its meaning.

Those working at the interface between the academy and the world of practice need to think much more deeply about what systemic risk might mean. The term was coined to refer to the risks affecting an industry or set of organizations, but even this extended definition of risk now seems too narrowly construed. Typically, the chain or domino effect was viewed as one that linked institutions through flows of cash or credit. But the flows we need to understand are much broader than financial credit alone. Ideas, too, have credit. Or they do for a while, until their credit runs out also. That is where we stand now, and it is time for us to reassess both the ideas *and* the instruments that may help us avoid a repetition of the current crisis.

Peter Miller is CARR Deputy Director and Research Theme Director.

The death of **credit**, **trust** – and **principles** based regulation?

Julia Black

So who or what killed the credit boom?

An elaborate combination of the murder mystery game, Cluedo, and the political blame game of finding scapegoats is well underway. Behold the numerous suspects: central bankers, regulators, credit rating agencies, auditors, accountants, consumers, hedge funds, short sellers, mortgage brokers, and of course, the banks. Consider the range of possible locations, from Florida or anywhere in the United States, off-shore tax havens, bank boardrooms, to the offices of central banks or national regulators. Identify some of the potential weapons, monetary policy, inadequate modelling, poor oversight, inappropriate capital rules, and inadequate or inappropriate accounting standards.

So who were the culprits?

Were they central bankers, especially in the United States, with an over loose monetary policy that made money cheap and paid insufficient attention to asset bubbles?

Or did national regulators, using capital rules that turned out to be lethal, preside over a system of capital requirements that banks easily avoided, allowing fatal black holes to develop all along the credit chain, whilst having no proper plan for what to do when things went seriously wrong, and providing too little protection and reassurance to depositors?

Were they the gatekeepers, the credit rating agencies and accounting bodies who were meant to provide reassurance and transparency, and who instead provided false assurance and obfuscation? Did the weapons of the accountants inadvertently exacerbate the crisis after they tried to improve transparency through mark-to-market requirements?

Were the culprits consumers in the offices of mortgage brokers, fuelling their credit-based lifestyles and collaborating in the crime by over-stating their earnings?

Or was it the bankers in their notably grander offices, recklessly using the weapons of securitization and credit derivatives with unbridled optimism, driven by motives of greed and personal gain?

The answer is that all are guilty – this is not the work of a lone killer. The exact role played by each is yet to be fully analysed, but new regulatory structures are likely to be forged before the cocktail of causes is well understood.

What is striking at the moment is that politically, all options seem open. Nationalization has already arrived. A return to narrow banking seems entirely possible. Regulation of pay levels is a key political demand. Firmer ‘belt and braces’ capital rules embracing leverage ratios are currently under consideration.

Have we therefore also seen the death of economic liberalism? It has been injured, in that the tenet that ‘markets know best’ is currently seriously in question, and for many people markets have lost the legitimacy to regulate themselves. It is time to revise the previously accepted idea that governments have moved from ‘rowing’ to ‘steering’. In response to the credit crisis governments have moved from steering, to bailing out, then to rowing and ultimately to re-building the boats.

But that injury is unlikely to be fatal. Most governments have made it clear that they are reluctant shipbuilders and rowers and would prefer to return to steering as soon as possible, though with a firmer grip on the tiller. The philosophy that determines the relationship of the state and the market may have been temporarily adjusted, but it has not, yet, been fundamentally rejected.

However there has been another significant casualty of the financial crisis: trust. A collapse of trust *within* the markets precipitated the crash. A collapse of trust *of* the markets is now driving the regulatory agenda.

The collapse of trust will impact profoundly on the debates about the relationships between governments and markets. Prior to the financial crisis, there had been an on-going debate in the United States, the United Kingdom and the rest of the European Union between those in favour of principles-based regulation, and those who advocated a more rules-based approach.

Only last year the advocates of principles-based regulation were on the ascendance. A year later, people are asking whether the failure of regulators, notably the UK Financial Services Authority, to prevent the credit crisis is due to a principles-based approach. The difficulty with this argument is that the US Securities and Exchange Commission with its highly rules-based approach was equally unable to prevent the crisis that has led to the death of the US investment banks that it supervised.

But principles-based regulation, or more particularly the image it invokes, has suffered a potentially fatal blow. The rhetoric of principles-based regulation invokes a regulatory Utopia, in which regulation is targeted, focused and harmonized across jurisdictions, regulated firms enjoy the flexibility they need to run their businesses, and regulatory outcomes are achieved without undue cost. This is a world in which regulators have sufficient perspective and understanding of the problems that they face to identify the key issues on which they should focus, and sufficient agreement on principles and purposes to devise a common framework. It is a world in which regulated firms are given the flexibility and responsibility to develop their own systems for ensuring that the regulatory principles are adhered to, but in a way which means their businesses can operate efficiently and innovatively in a stable regulatory environment.

Principles-based regulation enjoyed strong political support, not only in the UK. It invoked a re-framing of the regulatory relationship from one of directing and controlling to one based on responsibility, mutuality and trust. Regulators and those they regulated would move from a directing relationship of telling and doing, to a relationship in which regulators communicated clear goals and expectations in principles and applied those principles in a predictable way. The regulated would adopt a self-reflective approach to developing processes and practices to meet the goals, and both would trust each other to fulfil their side of this new regulatory bargain.

What was killed in this crisis was not the desirability of this vision, but the possibility that the trust on which it has to be based could be re-formed in the near future, or even at all. The trust has gone, and no matter who, where or by what means it was killed, it will take a huge leap of faith to resurrect it soon.

Julia Black is a CARR Research Associate.

Cyclic dreams of a strong state

Jeanette Hofmann

Now that a meltdown of the global financial system seems to have been averted, public debate is focusing on lessons to be learnt, particularly ways to handle financial risks more responsibly. A crucial aspect of this debate concerns the future division of labour between public authorities and the financial sector. Demands are expressed for stronger regulation, enforcement and an extension of rules across borders, financial products and organizations, fuelled by a belief that the relationship between public oversight and the financial sector needs recalibration.

After years of growing confidence in the superiority of self-regulation, the new common sense suggests strong public oversight is needed to control financial sector risk management. During social or economic crises, the state as manager – and lender – of last resort often enjoys a sudden leap in faith. Even banks embrace strong regulation as the key for a functioning market, while subtly blaming slack public oversight for today's turmoil. Implicit in this call for a strong regulatory state is the assumption of an independent agency able to perform oversight in an impartial and detached fashion. However, the recent comeback of public authority as the guarantor of the common good begs the question of how realistic such Keynesian images of the regulator actually are.

Any longing for a strong regulatory state as a magic bullet could well be based on misleading perceptions of the relationship between regulator and the regulated. Seeking help from the government might overstate national autonomy in financial regulation. The course of the financial crisis has uncovered not only the enormous extent of the banking sector's cross-national integration and interdependence but also its hierarchical structure. Just like many other fields of transnational regulation, finance is characterized by a scarcity of rule-making centres and a contrasting high number of rule-taking countries. Stronger regulation may well need international coordination to be effective, limiting the national room for manoeuvre much more than has been acknowledged by recent public statements.

The image of a strong state might also overrate the autonomy and extent of public authority in another way. One of the ironic insights we owe to the 'principal agent' literature is that the information and expertise required to exercise external oversight is typically under the control of those being regulated rather than the regulator, so regulators depend to some extent on the regulatees' willingness to cooperate. Research into accountability relationships confirms this somewhat reversed power constellation. Rules designed to foster transparency and accountability turn out to be subject to negotiation and re-interpretation, not necessarily to circumvent or dilute rules but simply to make them work. The implementation of regulatory rules and standards and the relationship between any overseeing body and regulated entities requires frequent interpretation, and thus are likely to change over time.

This crisis provides ample illustration of the changing character of regulatory rules. The financial sector is described as a tightly regulated industry and in principle central banks and the financial service authorities have access to banks' vital information. However, blame for the credit crunch is placed now on a 'shadow banking system' that developed in public and circumvented regulated banking on a large scale. An important lesson of this financial system's crisis is that regulatory rules themselves are not very powerful tools; they are effective only to the degree that both sides embrace and support them. Without a sense of ownership on the part of the regulated, stronger regulation now might simply lead to more of the same, to new strategies of creative evasion. Likewise, new regulatory rules cannot compensate for an ambivalent government stance. After all, policies that encouraged citizens to 'realize their dream of owning a home' encouraged weak public oversight of existing risk management regulation.

Regulators and regulatees tend to establish deep interdependent governance arrangements; rather than conceptualizing them as independent, or even opposing actors they are better described as co-authors of regulatory regimes. Since major banks are important financial regulation players, governments regularly consult their representatives, for example, to ensure they accept regulatory provisions. Throughout the latest crisis, interaction between the financial sector, regulatory agencies, central banks and governments was so intense that the resulting financial rescue packages were collaborative efforts.

Set to this background, regulatory authority can be seen as the outcome of collaboration rather than an exclusive and stable resource for government action. Whereas the present crisis may well have affected the power distribution within the regulatory arrangements – in favour of public authorities – it most definitely will not end the principal interdependence between the regulator and regulatee.

So at first glance, stronger regulation and oversight might seem to be a reasonable response to the crisis but doubts arise over the long-term effects. The financial sector needs more changes, different changes, that take into account the elastic nature of rules, the financial sector's admirable innovativeness and the collaborative practice in regulation. One step along the road to redesigning the financial sector regulatory arrangement could be the integration of new actors and thus additional watchdogs. Over the last decade, supra- and international organizations, among them the World Bank, the World Trade Organization and the United Nations, have explored ways to enhance the quality and effectiveness of cross-border policy making, developing co-regulation and multi-stakeholder approaches that partially open the policy process to third parties including affected customers or users. Such approaches aim to increase legitimacy and transparency but simultaneously spread policy responsibility across regulatory environments. Today's financial wreckage suggests a critical analysis of the relationship between regulators and regulatees, including a recognition of the participatory reforms in other areas of transnational regulation.

Jeanette Hofmann is an ESRC Research Officer at CARR.

The risk management of nothing

Michael Power

Measured and temperate responses to crises are rare. The transition from emergency management back to business-as-usual is complex and challenging, during which diagnosis and prescription usually involve blame. So two big questions are being asked in late 2008; does the financial crisis reflect a failure of risk management, and are fair value accounting methods responsible for exacerbating instability and a loss of confidence?

Such difficult questions demand a response because these practices are more than obscure technical fields. They have great significance for the representation and mediation of social and economic dangers and uncertainties, but their individual entity focus shines very little light on the interconnectivity risks which are now so evident.

In risk management, we need to wonder whether the promise of more safety in 'enterprise-wide' risk management, as developed during the 1990s, in fact deluded the very managers who were assembling organization-wide reviews to correct risk myopia – the so-called silo mentality – and to promote more efficient use of capital in financial institutions. Perhaps enterprise risk management (ERM) simply created a different myopia, one of distracting systems and controls? Such a question requires careful empirical investigation focusing on the epistemological balance in the design of risk management work, a balance between two very different orientations: rule-based compliance and the critical imagination of alternative futures.

Rule-based compliance lays down regulations to be met, and requires extensive evidence, paper trails and box ticking. All this demands considerable work and there is daily pressure to process regulatory requirements. Yet, despite that pressure, this is also a cognitively comfortable world, an inward-looking one of routine systems and controls, which can encourage a risk management style that saps energy from organizations, and is often of limited use other than to defend and manage reputations. This style persists because it offers regulated transparency in the management process. And, despite enthusiasm for principles-based risk management and regulation at the policy level, many risk and compliance people at the operational level preferred this less ambiguous and more rule-based world.

The 'critical imagination of alternative futures' is what financial regulators call stress testing, a less comfortable arena that creates ambiguity and then challenges core elements of business models. Because such core elements often form an organization's belief system, good stress testing may well heighten stress!

In a given scenario, participants from many disciplines in the organization track the future of potential decisions. Within the rule-based compliance model of risk management, small actions are needed to fix things and to give risk and compliance managers a sense of doing something. By contrast, stress-testing scenarios create uncertainty. Will the assumptions hold? What will be the reaction outside the organization itself? The alternative futures scenario becomes more of an invitation to deliberation rather than the creation of fact.

Both forms or styles of risk management are important, but the balance between them is critical. It has been suggested that rule-based compliance consumes 20 hours for every one hour spent on the more imaginative stress-testing scenario work. While such a claim needs further investigation, clearly the production of psychological and bureaucratic safety is of limited value in challenging business models, and only works in an orderly world. Yet crises such as those recently experienced in financial markets tend to lead to the reactive creation of tougher time-absorbing rule systems. This was evident in the case of the Sarbanes-Oxley legislation in the United States, passed rapidly in the wake of high profile corporate collapses. It is widely regarded as consuming enormous organization resources with questionable benefit.

The second focus area for debate is financial reporting. Late 2008 criticism of fair value accounting has reached the point where regulators have been forced to consider options ranging from modification to outright suspension. The ambition of fair value accounting is to measure and record assets and liabilities at latest market value, or some approximation thereof, and has a much longer history than current debate. The measurement basis for financial reporting has always been controversial and it may be that there is no unique way to represent the financial position and performance of a company.

Critics have drawn attention to the pro-cyclicality of marking banking assets to volatile and less-than-liquid market prices and, in reply, defenders of fair

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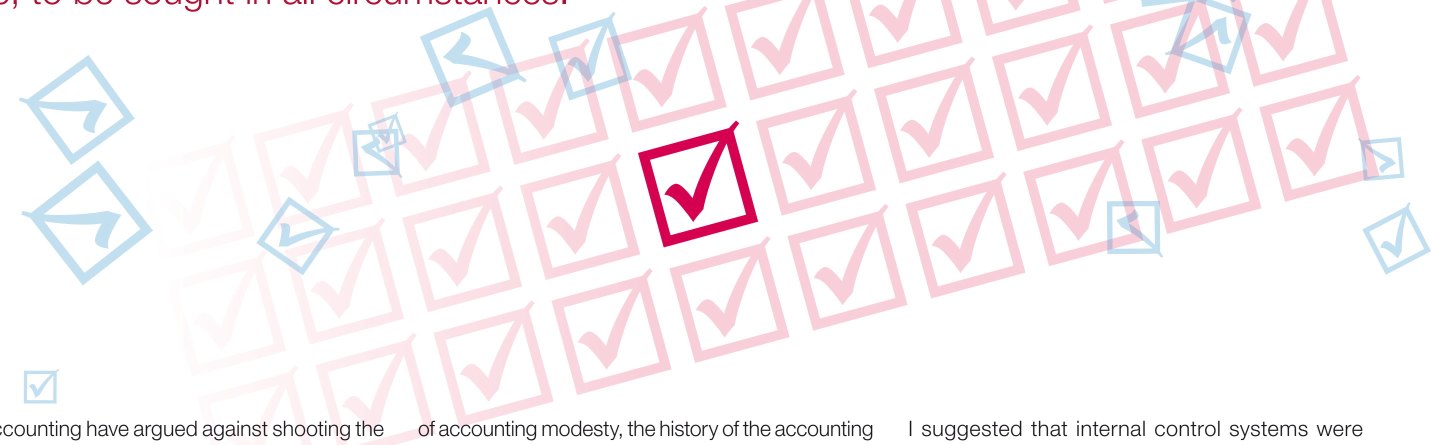

value accounting have argued against shooting the harbinger of bad news. Yet, beneath these highly visible exchanges in the charged atmosphere of late 2008 lie some critical and basic issues.

Most regulatory and legal systems rely implicitly or explicitly on a philosophy of disclosure, and no more so than accounting regulation. And yet there is more than a sense of transparency fundamentalism associated with fair value accounting. Recent events have demonstrated something that sociologists and economists have known for a while, namely that transparency is not an absolute social value, to be sought in all circumstances. While fair value accounting has exposed poor pension schemes, in other settings it may hinder negotiations, fail to give breathing space to distressed institutions and is highly destabilizing. And, if accounting regulators argue that it is not their business if capital rules are perversely affected, another aspect of this fundamentalism is visible ie. a lack of interest in unintended consequences.

Another serious concern is the way financial accounting systems and capital rules have become increasingly tightly coupled. As sociologist Charles Perrow has suggested in the context of technological systems, tight coupling may be a structural source of risk or 'normal accident' because of poorly understood interconnections. It follows that strategies to underpin resilient social and economic systems should try to dilute such tight interdependencies and design more loosely related practices.

Accountants have always had a strained relationship with markets. Financial accounting was at the centre of significant organizational reforms in both public and private sectors in the United Kingdom and elsewhere. Yet, despite this power as an instrument of change 'in the name of the market', financial accounting credentials as a market mirror have been regarded as dubious. The pioneering 1968 Ball and Brown study suggested that market prices were determined by many factors other than accounting, and that analysts use financial accounting as merely one information source. Despite this early evidence of accounting modesty, the history of the accounting measurement debate that culminates in fair value accounting reflects an immodest aspiration for realistic, market sensitive accounting.

By embracing elements of financial economics and modelling, fair value accounting transforms and weakens the historical and conceptual links with longstanding institutional values of auditability. Consequently, the auditability of model-based values for financial liabilities has triggered intensive, almost circular, processes of documentation in a game of risk-shifting ping-pong between auditor and the audited. More worrying is the underlying perfectionist disclosure requirement of which fair value accounting is a part. In a world of reconciliations and mixed measurements, financial accounting should prompt critical discussions about organizations. Perfectionism closes down those discussions by underlining the value at one point in time. Since that fails to satisfy, it intensifies disappointment with financial accounting.

So the current state of financial reporting spreads discomfort further than the fair value discussion. We have lived for decades with a regulatory 'disclosure paradox', which Anthony Hopwood identified, namely that the more organizations disclose about themselves, the less we know about them. Large financial organizations have been chronically obscure, even to their own senior management, and there seems to be nothing that the present accounting model can do about it. In seeking to overcome information asymmetries and agency problems, financial accounting has ironically created more barriers to the very thing it values – transparency. So the very idea of transparency as an institutional addiction deserves the closest scrutiny in the months to come.

Over the last 20 years risk management and financial accounting have occupied key positions as instruments of organizational governance. However, the current financial crisis suggests that social and systemic risks became invisible when they were absorbed by organization-specific internal control and accounting systems. In 2004, I suggested that internal control systems were effectively a state in miniature. Now the state has had enough and is reclaiming the ground which it has delegated, perhaps in an uneasy recognition that the expansion of risk management over the last 20 years was more a symptom than a cure.

Finally, we should not assume that this apparent failure in the instruments of neo-liberal governance is restricted to banking. Other critical infrastructure assets, such as energy and water, pose systemic risks of a different kind but with similar trans-organizational and trans-generational features – the very features which nationalization was intended to correct 60 years ago. We should not imagine that these fields are immune from the perils of the present disclosure-dominated governance system.

Reforms inevitably try to improve effectiveness but recent history suggests that the reform path for accounting and risk management is likely to intensify the rule-based environment of organizations, and so a search for more perfect charting of risk and performance will actually intensify the 'disclosure paradox'.

Unless we are very smart and courageous, this will be the inevitable crisis after the crisis.

Michael Power is a Research Theme Director at CARR.

Towards a new age of regulation?

Martin Lodge

As the current financial turmoil developed, near universal support has emerged for 'more regulation' but is this based on shared understandings or more a case of terminology divided by a shared language? Are we witnessing a new understanding of the regulatory state and new boundaries between state and market? And what are the implications for the study of regulation? This short article tries to formulate an answer.

What do we make of calls for 'more regulation'? During the crisis, politicians were criticized for abandoning regulation and in effect playing midwife to a financial market meltdown. Demands for 'more regulation' are growing cross-nationally and across the political spectrum, but can 'more regulation' be all things to all people?

These calls for 'more regulation' divide according to underlying intentions.

For some, 'more regulation' means establishing a completely different economic system, celebrating the end of a 'neo-liberal' one. This first group criticizes attempts to appoint more 'industry insiders' into regulatory positions, claiming that means little more than supporting failed institutions that floundered because of an over-reliance on shared assumptions between regulators and the regulated.

A second group sees 'more regulation' as a short-term remedy before markets resume their natural superiority over governments, regarding 'more regulation' as an important means to channel and control market activities but then quickly warn that 'too much' regulation will damage investor confidence; 'too much regulation' is said to encourage the 'exit' option to more lightly regulated markets, and also impedes innovation.

For a third group, 'more regulation' represents a way to enhance technocratic rationality, seeing change as a challenge to develop technocratic tools in a 'clean sweep' that will deepen intelligence and enforcement, using more resources – and inevitably higher salaries – to ensure 'good quality' regulation, albeit at a greater cost.

The fourth and final group sees 'more regulation' as an essential way to address the feeding frenzy of publics, journalists and politicians, but recognize that, despite good intentions, superior resources and counter-learning by regulation-evading market actors will confront any new regulatory activity and not prevent excess from returning.

Regulators, like militaries, are prone to fight wars with the interpretations derived from either previous wars, and right now it is far from clear which view will come to dominate, at the national or international level.

In any case, it is unlikely that all four views could agree on a toolset of 'more regulation' in anything other than a superficial way, and that also applies to 'more transparency', another expression that appears to enjoy universal endorsement. Transparency has been on the good governance agenda for two decades or more, but what exactly it means and how far disclosure requirements should go remain a matter of dispute. One point of potential contention is how to fuse 'more transparency' with demands for reduced administrative compliance costs.

The views of the market-endorsing regulation sceptics do not carry much weight right now and the failure of previous regulatory tools engenders little confidence in the ideas of those advocating new technocratic devices. So the race to define the content of 'more regulation' and 'more transparency' lies wide open and we are likely to witness a prolonged period of sustained debate.

If ambiguity mars calls for 'more regulation' what should we make of claims that we are witnessing a re-drawing of the boundary between the state and the markets? Until recently it was common to suggest we lived in the age of a 'regulatory state', characterized by extensive privatization of essential public services, a claim that looks dated in the light of the extensive banking system nationalizations; the so-called 'hollow state' seems to have developed substance rather rapidly.

Looking at the regulatory state's technologies and programmes today is to look at a landscape of tombstones. Risk-based regulation has failed both as a means to prevent systemic failure and as a programmatic idea. The technology failed because it could not diagnose properly the systemic risks that emerged in the financial sector even though regulators were extolling the superiority of their instrument toolkit. The risk-based regulation idea also failed because it assumed some risks simply did not need to be regulated; for example, the assumption that a few casualties would inevitably form part of an individualistic risk-taking society. But past months have shown that a fear of individual loss leads to collective, unforeseen, cascading effects leading to panic, and that politically it is not possible to allow individuals to suffer.

However, it is not simply enough to dismiss the past as a failure and move on to the next trick. We need a better appreciation of the limits of supposedly rational tools and a discussion on the prerequisites for such tools to operate. This relates to relations between regulator and the regulated, links between regulator and government and also to the way regulators themselves operate as organizations. Questions arise as to how organizations process complex information, how systemic risk parameters are updated, what risk assessment technology to use and the assumptions on which all this is based.

Given the way the regulation agenda is now becoming overcrowded, just what 'better regulation' prescriptions will emerge is far from certain. History is littered with political commitments to 'risk-based regulation'. For example, Gordon Brown, then Chancellor of the Exchequer, in a November 2005 speech, proclaimed that the 'correct modern model of regulation [is] the risk-based approach'. Just what conversion is now underway is uncertain but it would be a remarkable sign of inertia if the 'better regulation' agenda was unaffected, particularly that endorsement of risk-based approach.

Despite the bankruptcy of the regulatory state's programmatic and instrumental technologies, it is still too early to predict burial. Calls for a 'clean sweep' in regulatory instruments and institutions seem to be contained within the financial markets domain and fundamental underlying factors have not changed. Phenomena associated with the Great Depression and hyper-inflation that led to the collective redistribution consensus have so far thankfully been avoided. The challenge for the contemporary regulatory state will be to deal with both today's interdependence and contagion effects and then combine the preference for individualism with a preference for insurance. We want to be secure from risk without too much prescription and don't want to cross-subside the risk-taking behaviour of our neighbours.

Finally, what does this financial crisis and calls for a new financial architecture mean for the academic study of regulation and risk? Have academics been asleep on the job and are they now required to radically revise their reading lists? Are regulation scholars in the same position as communism researchers in the post-1989 world? The scope for self-flagellation covers not just bankers and regulators and but also academic observers.

Arguably, academics have concentrated too much on the private sector's capacity and motivation in self-regulation, or the effectiveness of regulation 'beyond' the state. Perhaps too much fascination focused on labels and descriptions of institutional change rather than critical analysis. And some may want to reconsider views on the balance between 'market failure' and 'government failure', or whether such comparisons are helpful.

Nevertheless, regulation as an academic subject was not asleep at the wheel because the study of unintended consequences and inevitable failures featured in research over the last few decades – not just at CARR. However, such thinking was often politely dismissed as 'unhelpful' or 'untimely', playing a similar role to that of a chorus in a Greek tragedy. Just what caused contemporary events and discussion on continuing regulatory responses will occupy social scientists for years to come, but so far little suggests that the key regulation literature assumptions need revision.

Clearly, national responses have demonstrated a typical 'retreat' pattern over time – from denial to partial adjustment, then to transformation – and seem, as expected, to focus on national economic and political interests. As research would predict, current evidence suggests national calls for 'international regulation' lean towards individual economic interests and that governments, regulators and financial institutions all struggle with patchy information while engaged in predictable blame avoidance and blame management.

So, despite the momentous developments in the financial market and the wider global economy over the past few months, calls for 'more regulation' are hardly building grounds for a consensus on where the boundary lies between state and market. Instead, major differences in many underlying assumptions mean a stable, sustainable regulatory response, at a national, European or international level is not likely.

And since it is too early to suggest the 'end' to the regulatory state, despite the spectacular failure of some of its key technologies and programmatic ideas, the study of regulation is far from bankrupt but perhaps set to reconsider the future contribution of 'unhelpful' research in 'real world' policy-making.

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A new Bretton Woods: risk regulation stripped bare

Frank Vibert

Crisis in the international financial markets has prompted calls for 'a new Bretton Woods', a reference to the 1944 conference that established the International Monetary Fund, the World Bank and the rules for post war economic and financial behaviour. These demands for renewal imply that today's institutions and rules for international finance need a fundamental overhaul and that the risk-based approach to financial regulation has failed.

US President Bush has agreed to a series of summits to seek agreement on reform principles, starting with decisions on what to place on a reform agenda. This article looks at the potential agenda items, starting with radical approaches to financial facilities that may be required, then to more technical suggestions that relate to the qualities that may be missing, and finally, to questions that relate to the institutional architecture itself.

Facilities – Rescue packages assembled in numerous financial centres are already on an eye-popping scale, with both national treasuries and central banks having to offer enormous lifelines. Now the issue is whether the world needs a global lender of last resort to which national treasuries or central banks could turn. Perhaps too, it is time to review credit enhancement roles for international institutions because governments had to offer guarantees to unfreeze different parts of the financial markets, not only the United States mortgage market but also activity in interbank money and corporate commercial paper. Also, widespread concern about the implications of any failure in the insurance enhancements the markets offered, notably the credit default swap, remain with us. But to move down these roads, perhaps the financial policymakers need to create the new attractive international reserve asset talked about for so long, since no asset class looked particularly safe in this crisis. The creation of a safe haven, sheltered from financial market turbulence, could address the churning that took place when investors looked for safe havens to place their funds at a time when the relationship between the dollar and commodity prices was unstable.

Qualities – Some comments on the need for a new Bretton Woods focus not so much on financial facilities as on qualities that seem to be missing in the existing system. One prominent suggestion is to provide the world with a better 'early warning' or surveillance system, another champions 'better coordination' between the institutions that set international market regulations, and a third suggests action to set standards for normal market behaviour, to address a perception that poor ethical standards triggered the crisis.

Within these general categories lie more specific calls for closer surveillance of particular parts of the market such as ratings agencies, closer supervision coordination in the case of large multinational financial groups, or for greater transparency in opaque areas such as the world of hedge funds, over-the-counter trading and tax havens. Any discussion around institutional change will look at membership issues in key rule setting and coordinating bodies'.

Risk interpretation – All this effectively provides a sharp commentary on the shortcomings of the risk-based approach to financial regulation. The idea that facilities are missing accentuates a fundamental reservation about risk-based approaches, suggesting any such system would be prone to failure and therefore regulatory systems must provide for failure. The desire for greater coordination, or for more transparency, points towards system gaps that might need to be filled. However, the question of ethical behaviour underlines a more radical critique. This essential issue concerns the role of regulation in changing behaviour, and financial regulators have not proved very good at this because they look for 'structural remedies' to introduce competition or to unbundle services where conflicts of interest arise, and such structural remedies did not change attitudes in the face of strong market incentives. Behavioural issues are fundamental to early warning systems yet have foundered in the past because forecasting systems involve significant errors and margins of appreciation since creditors and debtors have different incentives to adjust to warnings and because such warnings can become pro-cyclical.

Proper preparation for a successful conference will not be easy because of the tension between a technocratic approach involving small numbers of professionals and a more political approach involving all countries. At the original Bretton Woods conference John Maynard Keynes, the chief British negotiator, complained about the number of countries invited, feeling at least 21 of the 44 attending had 'nothing to contribute'. He grumbled privately about 'the most monstrous monkey-house assembled for years'.

Today global rule changes may demand the support of many of the world's 190 countries and it will be hard to limit the size of any preparation group. The last attempt at comprehensive reform (the Committee of Twenty on International Monetary Reform in the 1970s) tried to address this tension by establishing technical groups in key areas under the auspices of the IMF, but that ended in failure.

A long and difficult road lies ahead.

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Credit rating agencies

and the faulty marketing authorisation of toxic products

David Demortain

If one thing differentiates the current financial crisis from previous ones, it is the fact that it has its roots in financial innovation. The nature of financial innovation is now well understood. A financial engineer would assemble thousands of residential mortgages and bundle them into new securities, some called collateralized debt obligations (CDOs) that would include both good and bad credit-risk mortgages from several parts of the country. This aimed to spread the risk of default across a range of investors.

Given that crisis commentaries drew analogies between financial products and health products, CDOs soon became 'toxic', supporting demands for finance to be regulated just as much as food, pharmaceutical or consumer products. Pascal Lamy, the Director-General of WTO, illustrated this by declaring, 'Finance is one of the last "black holes" of globalisation. … A sick bovine or a hazardous lighter cannot cross borders; a toxic financial product still can.' How appropriate is this comparison to identifying the cause of the crisis and possible reform?

In this crisis, the world of finance is experiencing what the pharmaceutical world has known for a while, that products can cause 'serious and rare' adverse events that are hard to detect. Crises are occasions that have the power to force us to recognize the existence of events to which we were culturally and epistemically blind. They turn 'unknown unknowns' into 'known unknowns'.

The seminal discovery that medicines can cause adverse reactions was made with a substance called thalidomide. Until the 1960s it was not conceivable that molecules that cured could also kill. The term 'adverse drug effect' did not even exist. So the prescription of thalidomide to pregnant mothers, causing several thousands of fetal malformations around the world in the early 1960s, produced the undeniable and tragic lesson that products that cure might also seriously damage health. Now the sub-prime crisis is set to be to finance what thalidomide was to pharmaceuticals. The toxicity of supposedly efficient CDOs did not appear before they were sold, their potential for harm hidden. Because they were widely distributed, the damage across financial markets was deep. The crisis thus anchors a belief that products do carry risks that need to be detected before they become too widespread and thus 'systemic'.

The thalidomide case justified mandatory marketing authorization, so every substance now undergoes tests and trials to ascertain efficacy and safety before entering the market. The closest thing to that in the financial markets is the rating of products by credit rating agencies. The crisis has uncovered their inability to be anything close to a reliable filter for unsafe products. They failed to identify the possibility that different quality debts within the CDOs might be as vicious as a combination of several drugs. They underestimated the risk of household mortgage defaults after a widespread drop in house market values.

But such a comparison may not properly identify significant differences between the world of finance and pharmaceuticals. Effective risk control not only depends on the quality of pre-marketing evaluations. It also relies on common knowledge, which emerges from the sharing, and circulation, of information between networks of interested parties, from product manufacturers through regulators to consumers. Pharmaceutical regulation is organized in a way that achieves this. Firstly, manufacturers must produce and release information about their products according to agreed norms and protocols so that the reliability of this information can be assessed. Secondly, scientific experts verify the information on behalf of regulator using clinical trials and on the basis of these evaluations set standards and specifications about the product's properties that can be published in leaflets, labels and letters to doctors. Surveillance systems thereafter collect information from patients and doctors about any adverse reactions the products cause.

Such a process can fail because it might well be that pharmaceutical companies withhold information or make it difficult to interpret. Scientific experts and regulators may be 'captured' or doctors fail to notify observed adverse events. However, sociological research shows that cadres of medical scientists do foster common knowledge. Individually, they may not be independent from manufacturers, and some indeed work for them, but as medical professionals, they are linked to the various interested parties in the regulatory domain, ranging from regulatory agencies to professional bodies, clinical research organizations, patients and international standard-setting arenas.

Such experts are driven by a public willingness to improve collective knowledge of products rather than by a private or commercial will to distribute them. They are instrumental in making common knowledge circulate. They organize to study large populations, centralize dispersed signals and undertake to evaluate knowledge for others, which is important since information about risks is always sparse, incomplete and ambiguous. These collectives maintain the knowledge of safety issues by collecting, storing, comparing and classifying adverse events and such information serves to test new ways to detect risks before they materialize in patients. By reviewing past failures such as non-detected serious adverse drug reactions, they try to create new protocols to improve detection in the future, so they function much like academic colleagues, exchanging news, deliberating and cross-examining their work in conferences, publications and informal communications.

It is quite obvious that the world of finance does not generate such common knowledge. Rating agencies' triple-AAA gradings concealed rather than conveyed risks. By advising banks on how to securitize assets, the agencies co-manufactured 'toxic' products and were not in a position to independently assess them for safety. They employed a small knowledge base, not taking into account historical trends of household default on mortgage payment.

As this crisis demonstrates, the most dramatic risks are systemic ones. The management of such systemic risk requires the sharing of information. Neither the rating agencies, regulators, and even the academic and professional corps of financial economists have provided the collectives that would be needed to make this happen, nor did they demonstrate the sense of public service that would inspire the creation of a common knowledge.

The analogy that depicts financial products as toxic undoubtedly encourages reform. But the most needed changes that this comparison would suggest might also be the most ambitious and unrealistic of all.

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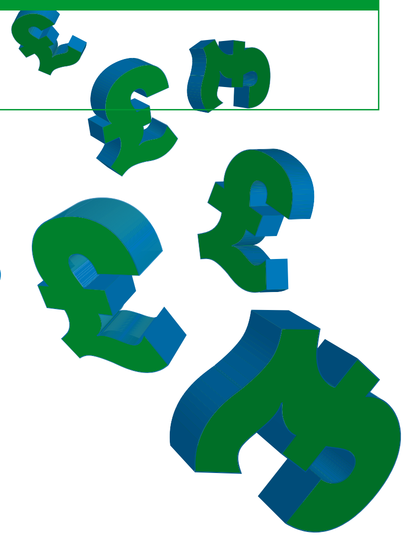

Responsible lending and borrowing: *targeting the wrong problem?*

Sharon Gilad and **Morag McDermont**

In the last 30 years developed economies have shifted from welfare spending and services towards regulatory shaping of service provision by non-state entities, whilst trying to alleviate regulatory burdens through competition, consumer choice and reliance on industry self-regulation.

The US sub-prime mortgage debacle and the subsequent credit crunch propelled to the fore the limitations of this neo-liberal regulation model, prompting demand for heavier state regulation to restrain profligate lenders and irresponsible borrowers. We argue that while tougher regulation may tackle 'irresponsible' lending and borrowing, it cannot cure the underlying disease – the need of households on low and unstable incomes for affordable finance and flexible housing solutions. We analyse this argument in the context of the UK housing and sub-prime retail mortgage market.

The UK housing and mortgage market is a classic example of welfare state retreat. In 1979 over 40 per cent of the British population were local council tenants but today even the very poor are frequently rejected social housing because of a lack of supply. Social housing scarcity is the outcome of deliberate policies, including the Thatcher government's introduction and vigorous promotion of council tenants' 'right-to-buy', pressure on councils to sell housing stock and sparse social housing construction under both the Conservatives and New Labour. In the new millennium this scarcity coincided with rapidly rising housing prices stimulated by historically low interest-rates and the previous deregulation of the mortgage market, all of which promoted expansion in mortgage lending.

The sub-prime mortgage market expanded since the mid 1990s, and received a further boost with the above-mentioned increase in house prices and lending. Some of today's sub-prime mortgage borrowers are people who previously would have been serviced by the prime market and their exclusion is due to prime-mortgage lenders' adoption of stricter individual credit-scoring criteria after the previous housing bubble burst in the 1990s. In other cases, the sub-prime market expands access for households on low and unstable incomes (eg. part-time and fixed-term employees). Overall, the expansion of sub-prime mortgage lending is associated with the exclusion of nearly 25 per cent of the adult population from the prime market (Burton, D., Knights, D., et al. 2004, 'Making a market', *Competition and Change* 8). The actual and perceived risks of this market, coupled with limited competition when compared with the standard mortgage market, results in higher interest rates and charges. It is within this politically, socially and economically-carved environment that the risk of 'irresponsible' lending and borrowing transpires.

The Financial Services Authority (FSA) has been responsible for regulating mortgage lending since October 2004. FSA mortgage regulation requires firms to disclose extensive information to potential borrowers about the main characteristics of the mortgages offered. In addition, when offering advice, financial advisers must ensure mortgages meet a client's needs and their ability to repay the loan. For their part, borrowers are advised to assume 'responsible borrowing'. These provisions seek to expand consumer choice, bolster mortgage advice professionalism and ultimately to improve services. However, mortgage regulation has been unsuccessful in the sub-prime market.

Information disclosure (presuming borrowers understand it) offers little help to sub-prime borrowers who face restricted choice. FSA-commissioned research found that borrowers relied heavily on mortgage advisers' advice and picked the cheapest option available given their circumstances rather than 'shopping around'. They were not deterred by the risk of not being able to repay a loan if their circumstances changed, because their focus was on satisfying acute short-term needs. On the lending side, the FSA's review of mortgage regulation found that lenders' assessments of borrowers' financial capabilities often relied on doubtful self-certified incomes.

Tighter regulation and today's risk aversion among both lenders and investors, together with the way this is filtering into firms' internal controls, could now tone down such 'irresponsible lending' in both the regulated prime and sub-prime mortgage markets, but for many consumers such reduction in the scope of sub-prime mortgage provision could mean limited access to any sort of credit. More likely, tighter regulation will induce further expansion of unregulated sub-prime mortgage and credit, so effectively exploiting such borrowers even more in future.

Such are the inherent limitations of neo-liberal regulation, which fails to deal with vulnerable households' limited access to affordable housing and finance. Regulators could ameliorate the problem by challenging lenders' rigid consumer profiling and improve prime market access. Yet no amount of regulation can alter the fact that, for a large proportion of the population, being a home-owner is a precarious commitment. In the post-industrial era, cyclical unemployment and increasing use of short-term contracts and agency work, all make it harder for households to sustain a steady income. The problem with current arrangements is that sub-prime mortgage borrowers face an all-or-nothing choice between coping with unaffordable loan repayments and losing their home.

"...what is needed are legal frameworks that enable households to vary their status as owners/ tenants depending on circumstances..."

Whilst schemes that allow households to be part owner/part tenant already exist ('shared ownership' schemes have been run by housing associations since the 1970s), what is needed are legal frameworks that enable households to vary their status as owners/tenants depending on circumstances – the flexibility to become a tenant or part-owner of their home, in event of redundancy, reduced hours or caring responsibilities. Such solutions will enable households to maintain their home, as tenants rather than home owners, at times of crisis. However, such flexible arrangements which have *social* objectives, we would argue, are best located in the state or not-for-profit sectors if only because they are unlikely to attract private investors given their inbuilt uncertainty. Consequently, such solutions will inevitably involve increasing state funding for social housing – a difficult step for budget-stretched economies.

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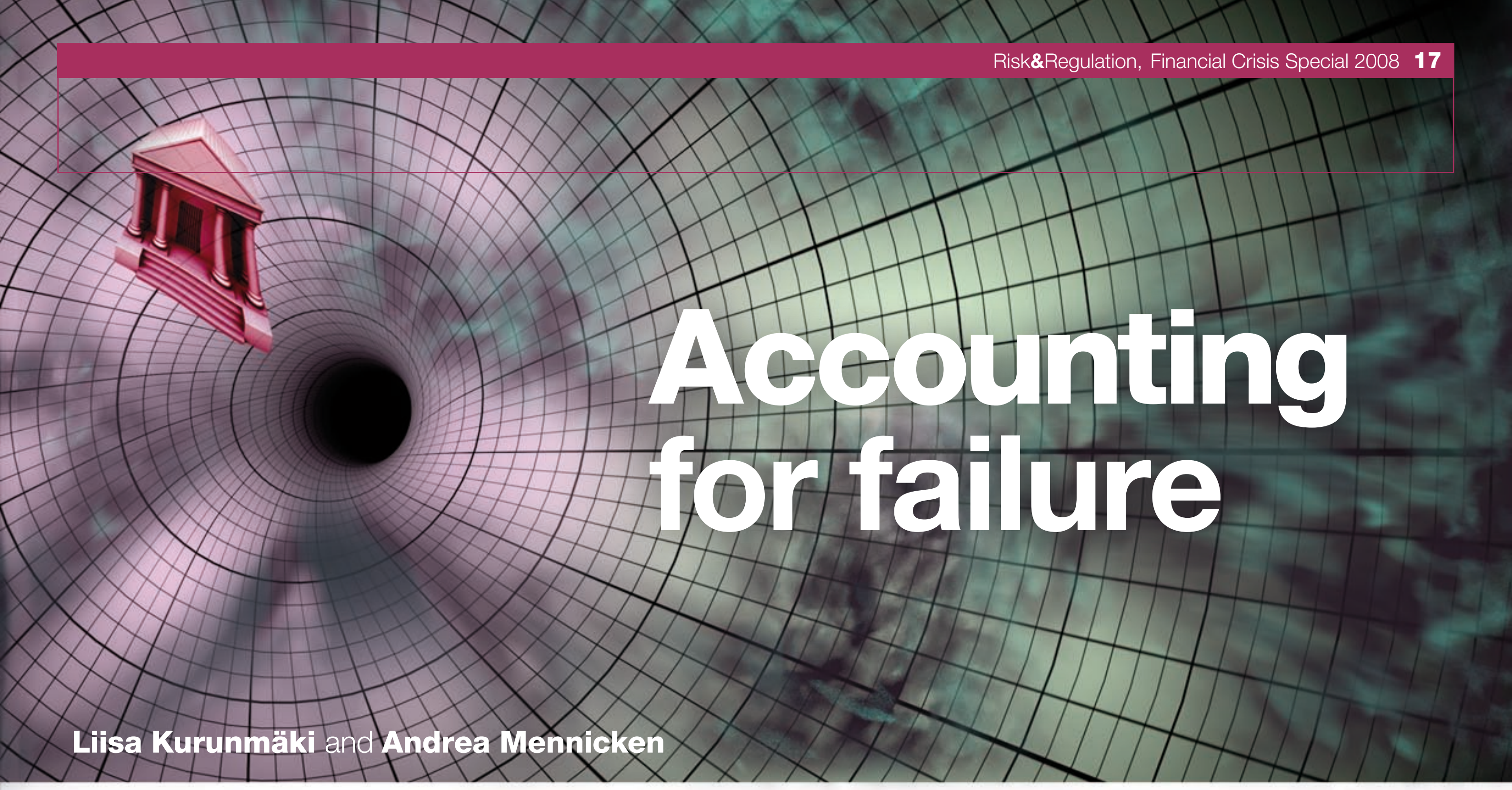

Accounting for failure

Liisa Kurunmäki and **Andrea Mennicken**

The financial crisis has shunted financial regulation and risk management into the spotlight. But it should also cause us to reflect on the very notion of failure itself. For the crisis draws attention not only to the fragility of markets, and the importance of trust and organization for their stabilization. It highlights also the precarious and negotiated nature of failure, and connected ideas of free market competition. To many, particularly those who strenuously opposed 'excessive regulation', matters are simple: the rules of the market game dictate that companies should be allowed to fail, and market effectiveness can only be assured when the fittest survive and the unfit and the incompetent fail. But who or what defines failure?

The archetype corporate financial failure is insolvency. But recent developments have shown that corporate financial failure can hardly be considered an objective state of affairs. Definitions of failure, it turns out, are as much a political as an economic matter. Failure is negotiable, deniable, and reversible. It is constituted out of various expert claims and modes of judgement, and increasingly politicized. Research on bankruptcy by Peter Miller and Michael Power has demonstrated that company failures never did display the objectivity often attributed to them, and today that is even more the case. As exemplified by the recent threat of meltdown of the global financial markets, in domains where failure is considered politically and operationally unacceptable at an organizational or systemic level, logic other than those of the market are brought into play.

In the wake of recent events, and on a selective basis, large banks and other financial institutions have been protected from market discipline. These organizations were considered 'too big to fail'. Here, too much seemed to be at stake. But how much is too much? Size arguments come into play naturally, but understanding the impact of a large failure on an entire industry or the economy is extremely difficult and almost impossible to calculate.

While many risk regulation regimes centre on the notion of 'failure', they allow for considerable negotiation as to what constitutes failure, and what the key metrics are that allow it to be pronounced. Calculative technologies of accounting do not provide definite financial norms, but instruments around which complex processes of negotiation of possible outcomes can take place. So failure is not a specific, well-defined condition, but a *process* agreed step by step with stakeholders such as lenders, trade creditors, shareholders, government agencies and regulators. During such negotiations, the roles of markets and of governments are re-thought and the boundaries between politics and markets re-drawn.

In financial markets, ideas of deregulation and free market coordination are now under scrutiny and the boundaries between the private and the public have become porous; markets are no longer seen only as a way to promote choice and efficiency, but also as beasts to be ordered, tamed and civilized.

Yet, the inability of formalized risk management and regulation apparatus to anticipate or prevent systemic risks in the financial sector have not led to their abandonment. Instead, they have resulted in calls for their amplification, in the same way as the perceived failings of accounting and auditing typically lead to calls for their intensification. While we see more intense demands for tighter risk regulation in the financial sector, renewed emphasis is also placed on accounting because of the desire for 'transparency' and better ways to make financial risks 'visible' and 'calculable'.

At first glance, the system of regulating and governing by accounting numbers sounds reasonable. For who can object to more transparency or the benefits of rewarding efficiency? Accountancy's calculative expertise plays a potentially significant role in certifying, adjudicating and intervening in failing organizations, not just in the commercial sector. Encouraging the free market game has long been a central aspiration for those keen to reform the public sector, with 'conceptions of failure' based on private sector models actively promoted and already embedded in some areas.

Take as an example health care and the proposed ways to administer failed Foundation Trust hospitals according to the protocols of an Insolvency Act devised for an entirely different purpose. Whether or not one endorses public sector reform through the adoption of private sector models, at the very least one might ask if the 'fit' in this case is likely to be snug. For the question of what constitutes failure in the health care sector is even less straightforward than defining or negotiating organizational failure in the corporate field. The events of recent memory show that private sector practices advanced in the name of the market may not readily offer the solutions desired.

More importantly, perhaps 'failure' should be carefully distinguished from 'failing'. Rather than focusing only on a moment of failure, with its attendant matrix of rules, rights and duties pertaining to assets, and elaborated in company insolvency legislation, regulatory attention should focus more on the process that *precedes* the moment of failure. To understand the process of *failing* means starting the analysis before the moment of failure arrives. We need to understand the range of events, practices, claims and instruments that define the process by which an organization is considered to have failed, and becomes subjected to a panoply of rescue and reconstruction practices specified by regulatory agencies. More attention needs to be paid to the *dynamic* of failure, its specific operational conditions and the incentive systems and investment cultures that promote it. While the moment of failure is itself complex and negotiated, the process of failing is considerably more so. *Failing* deserves much more attention than it has received to date, not least because it might help us avoid disasters like the one we are currently experiencing. It also deserves attention in the context of a world that has been stood on its head, in the sense that failure regimes for hospitals now appear to be tougher than those pertaining to banks.

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A bonus 'culture'?

Paul Willman

'I think there's an element of the bonus system that is unacceptable. When you get bonuses and salaries based on short term deals that have no relationship to long term performance then you have to look again at what the system is doing.' (Gordon Brown, 21 September 2008)

Entertaining frauds aside, highly leveraged remuneration in financial markets has not troubled the regulators much. It is not new, books and movies about it were common from the 1980s and bonus cycle distortions in housing and Aston Martin markets have been a feature of the London financial institutions since the Big Bang in 1984.

The Bank of England, the Financial Services Authority and journalists occasionally pondered the implications for risk exposure and the way high bonuses were based on annual rather than longer-term performance, but no serious regulatory action emerged. For sure investment banks have worried about inflated salary costs, but the serious first mover disadvantages expected to follow from abolishing bonuses deterred individual firms from action; abolitionists feared they would suffer the same financial fate as their victims. Employee bonuses were simply shares in the industry's profits and bonus abolition was never seriously tried.

Now, a combination of large bonus payments and substantial financial losses within institutions has encouraged rather different attitudes. How can people be rewarded for making losses? Why should bonuses be paid from the public money now shoring up many investment institutions? What, to paraphrase the British Prime Minister, is the system doing?

One can object to the term 'culture' and argue that bonus payments are not just part of a belief system within financial institutions. They define its core, indeed in some cases sole, human resource practice. Our analysis of trading floors in the late 1990s found within extremely wealthy investment banks marginalized human resources departments that sat beside a rudimentary screening process for traders, a complete absence of management training and a hire-and-fire approach to success and failure. The link between the individual profit or loss of a trader, his or her bonus payment, internal reputation and external market prospects was a totemic fact of trader employment. Bonus maketh the man, and maketh other more sophisticated management processes irrelevant.

However, culture did indeed heavily influence the operation of this particular application of pay for performance, notably in what remained unquestioned. The bonus year was the industry crop cycle. 'Pay-for-performance-101' advises the distribution of awards close in time to the rewarded acts, but few deals take a year to mature and normal practice is to collect profit on shorter-term deals for the bonus total. Bonuses thus become similar to medieval Church tithes; encourage shareholders to focus on the other 90 per cent at the year-end and everyone is happy. There were no rollovers; staff keep a year-one bonus even if they made less, or a loss, in year two. Conversely low profits and a low bonus in one year did not drag down any bonus in year two. Although profit or loss is the main bonus driver, institutions retain bonus discretion until the year-end, to retain some behavioural control and to serve aims other than rewarding performance, such as retaining key skills. Also, bonus payments are individual. Team-based bonuses are rare and the system is competitive rather than collusive. Finally, bonuses have historically been high and it does not take many good bonus years to achieve financial security.

These are accepted contingencies rather than essential elements of bonus pay. They are part of what makes the use of incentives in the financial services industry distinctive and, perhaps, dysfunctional. They also launch a number of consequences. First, if the bonus manages the trader, the manager does not have to do so and there is little incentive to develop managerial skills. And if the trader is making money things must be OK. Second, if bonuses based on arbitrage opportunities are the bulk of earnings, there are limited incentives for information sharing. Third, if rewards for success are high and failure severe, there are few generators of occupational longevity. In four major institutions in 2000, we found no trader and very few trader managers who remembered the crash of 1987. The bonus system may not generate institutional amnesia, but it does reinforce it.

Trading in markets is often characterized as competition between individuals, suggesting it is a jungle and the biggest cat wins, but agents create most financial market trading; certainly the theory behind bonus system design is agency theory. Arguably the metaphor from the animal kingdom is not big cat strife but, more mundanely, a sheepdog trial. The trader (sheepdog) must not be so risk averse as to lose the sheep but not so aggressive as to eat them. Perfect the monitoring and incentives system and you finish with both dog and sheep.

Now, there is an argument that agency theory, from Taylorism to its application to chief executive's pay, is a strong candidate for the most counter-performative economic theory of modern times. Relying on controlled self interest often appears to generate precisely the kinds of gaming opportunism the theory seeks to avoid. In this case in particular, believing that higher risk yields higher returns and then incentivizing returns puts a very heavy emphasis on the efficacy of controls. Yet this is an industry in which the first line of defence – line management – is not well trained and in which the large institutions typically call their own fouls since most regulation takes place in settlements and compliance departments within trading firms. What this system does not appear to be doing is to safeguard the interest of investors and what it does appear to do is to sustain high rewards for participants in the most unlikely conditions.

Perhaps, too, it is sustaining a continuing vulnerability in the financial industry to the latest Ponzi scheme.

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What finance could learn from rocket science

John Downer

Half a century ago, NASA's leading engineers devised a radical solution to the problem of reliability in ultra-complex systems, that emphasized social reforms over technical innovations. With the markets collapsing and the reliability of so many financial institutions now in question, are there useful lessons from America's rocket scientists?

In the early years of the space race, America's rockets failed repeatedly and ignominiously: exploding on launch pads or careening towards downtown Orlando instead of Outer Space. It was a very public Cold-War crisis, and not one the administration could mask with cosmetic but ineffectual reforms.

The problem lay in the rockets but the solution, when it appeared, was not in the blueprints, it was in the culture of US manufacturing. NASA's machines functioned perfectly on paper, but actually building them called for a level of diligence, care and professionalism that manufacturers found unsustainable.

NASA needed assembly plants organized around a paradigm of excellence instead of efficiency and staffed with the skilled craftsmen that Ford, Taylor and their disciples had long been keen to marginalize, so they launched a far-reaching effort to reshape the culture of American rocket production. They arranged competitions between workers and offered generous cash incentives linked to performance targets; astronauts visited fabrication plants distributing posters and awarding decals to exceptional workers; contractors were encouraged to abandon old factories in what became the 'rust belt' and relocate to the coasts where they could recruit and accommodate a new type of workforce; the space agency re-drew lines of authority, so that quality-assurance specialists, previously peripheral to the manufacturing process, could halt entire production lines.

These reforms almost doubled the already stratospheric cost of building rockets, but the failures ceased and Armstrong was on the moon.

Now the financial system is failing catastrophically and commentators have again been quick to call for new blueprints. The coming months will no doubt bring a wealth of proposals for new rules, regulations and standards, but instead of embracing too many of them perhaps we should look to NASA and remember that seemingly technical problems sometimes yield better to non-technical solutions.

No doubt new regulations could be useful, but the crisis caught out many regulatory regimes, which suggests that regulations alone are a poor bulwark against major risks. Ever since Max Weber discussed the importance of 'trust' among stock traders, ethnographers of financial institutions have suggested that bankers ultimately depend on intangible criteria such as instinct and intuition to make decisions, even while they couch their risk choices in the language of rules and formulae.

Indeed, social epistemologists have long argued that this is necessarily the case. Finance cannot be governed by formal rules and accounting, they argue, because both lean heavily on interpretation. As Wittgenstein made clear, no rule – technical, scientific, or financial – can escape the vagaries of interpretation: they are all, in sociological parlance, 'interpretively flexible'.

Technical specifications could not govern rocket production completely, and financial regulations cannot control banks perfectly. If we understand rules as guidelines that operate in a social context, then we can view problems less as a function of the rules themselves than of the people who use them. Where there is interpretation, we should look to the interpreters.

Fiscal rules and regulations, the blueprints of finance, exist in a distinct cultural context, where adherence to their 'letter' always leaves extensive scope for action, yet we rarely question that context directly. Innovations like securitization transformed finance over the last two decades, raising its efficiency in many ways, but also creating complexity and inscrutability. This 'modernism of money' has brought new challenges, and navigating them successfully perhaps requires a new breed of banker with different competencies and a new culture of banking with revised conventions.

Corporations and professions undoubtedly do have distinctive cultures, and clearly some mores, norms and customs are better suited to certain endeavours than others. Successful art collectives have different values than effective nuclear submarines, for instance. It is perfectly legitimate, therefore, to ask if the culture of modern banking became unfit for purpose as the tools and functions of banks evolved.

Many observers have suggested that the current generation of bankers became overconfident and took reckless risks in pursuit of high rewards: a view that echoes widespread perceptions of the financial services industry. Tom Wolfe famously characterized investment bankers as buccaneers on the high seas of laissez-faire capitalism: self-styled 'Masters of the Universe'. All such stereotypes are caricatures, of course, and many of the larger banks have worked hard to confound Wolfe's portrait in recent years. Yet it seems almost willfully imperceptive to deny an excessive 'risk appetite' in the modern financial establishment, and logical to associate this as much with the cultural norms that pervade financial institutions as with the rules that govern them.

So, in a world where rules and regulations are inevitably inadequate, perhaps the Financial Services Authority (FSA) might better serve the interests of risk management by reforming the 'softer', cultural, dimensions of the financial world, as well as promulgating new standards. For if a more measured, introspective and risk adverse culture of banking were to rise from the ashes of a 'bonfire of the vanities' there might be lasting and discernible benefits for the financial system.

This, of course, begs the question of how regulators could conjure such a phoenix when The City has long considered audacity an asset. Reforming entrenched cultures is difficult, as NASA discovered. Practices are intractable; governments cannot legislate for virtue and companies guard their corporate cultures jealously.

Nevertheless, corporate cultures are malleable. Indeed, there exists an entire industry dedicated remoulding them. The scale of the crisis should inspire some harsh introspection, which is important because cultural reforms inevitably emerge from within. Regulators are not without influence, however, the FSA's emphasis on 'principles-based regulation' is constructive, as is their recent caution against pay deals that reward short-term profit-seeking.

It would be naïve to suggest that cultural changes are easy, cheap or painless, but NASA's experiences suggest the dividends could be stellar.

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