Guest Editorial

Rebuilding the credibility of markets and regulators

The financial crisis has decimated the public's trust in regulators, banks and financial markets. Surveys show that nearly 80% of people blame regulators for the crisis, but the disapprobation is heaped on them and on the banks in almost equal measure. Meanwhile, investors are pulling out of the equity markets and reverting to cash, or even withdrawing from the financial markets completely. Sales of reinforced safes have apparently never been higher.

Lack of confidence in regulators, banks and markets would not be so critical if financial markets were somehow self-contained. Yet, as the crisis is clearly demonstrating, the real economy needs the financial system to function, and needs governments and regulators to ensure that it does so. Although in the short term most of the political attention is currently focused on designing fiscal policies and other macro-economic tools in an attempt to limit the severity of a recession, in the medium term attention will have to turn to rebuilding confidence in regulators, in the markets and in the governance of banks themselves.

Rebuilding confidence means rebuilding credibility. Rebuilding the credibility of regulators means restoring trust in their ability to monitor and contain the risk-taking of financial institutions. Restoring that trust is critical, but it will take more than the production of new codes on liquidity or exhortations on financial institutions to improve their risk management to achieve this. This is not to say that new rules are not needed. The crisis has revealed that there were failings in the rules – insufficient attention to liquidity, the lack of oversight of the credit derivatives markets, failings to regulate the mortgage advisory and sales processes, particularly in the United States – all are examples of where new rules are needed. But new rules, while necessary, are not sufficient, for the crisis has revealed three further critical and systemic weaknesses, all of which need to be addressed if confidence is to be restored.

The first weakness has been well recognised, and this is that although financial markets are global, regulation is still firmly national, despite the plethora of international codes that exist. The realisation of the ambition of global regulation may have receded further following the experience of the Lehmans' insolvency, which saw US discrimination against foreign creditors, and which may reduce the willingness of national regulatory authorities to rely on foreign liquidity in the future. The international framework of financial regulation is highly fragmented, lacks any clear lines of authority and so is fatally slow to respond either to emerging signs of problems or to crises when they occur. There is no mechanism for ensuring that national regulators take macro-economic considerations into account in their regulation of individual firms. There is no means of collating information on the activities of global financial institutions or the "hidden" markets of the shadow banking system. There is no one body with undisputed authority to lead policy-making in this area, or to insist that national regulators perform their tasks to a certain standard.

Addressing these structural weaknesses is a matter of institutional design and political will. It is a difficult task, but not as hard as addressing the second and third systemic weaknesses in financial regulation. These are that crisis has shown that regulators lacked both an understanding of the real dynamics of the markets and of the concentrations of risk that were developing, and the confidence or ability to challenge banks, and others, about the levels of risk they were taking.

Regulators were not alone in lacking a clear understanding of the overall nature of the distribution of risks. It is becoming increasingly clear that financial institutions themselves were unaware of the nature and extent of risks to which they were exposed. However, regulators, unlike individual financial institutions, are in a position to develop an aggregate view of the markets, even if they can never know as much about the exposures of an individual financial institution as that institution does itself. Further, those that did have some awareness or did raise questions – and some central banks had been issuing warnings for some time – were insufficiently heeded.

Ensuring that regulators develop a fuller understanding of the dynamics of the markets requires rebuilding their capacity and, in some cases, redrawing their competences. Rebuilding capacity needs both skills and resources. Financial regulators need to reskill and restaff, and that will be costly, for they are competing for staff with financial institutions who can offer significantly higher pay packages (subject, of course, to the new regulatory ambition of constraining remuneration).

The real challenge for financial regulators, however, lies in addressing the third failing revealed by the crisis: that they did not adequately contain the risk-taking of banks. A key role of financial markets is to create and distribute risk. A key role of financial regulators is to contain those risks such that they do not impose systemic damage on the system as a whole. But to what extent should regulators contain the risk-taking of financial institutions? If regulation, either in its design or in its implementation, is too risk averse, it will inhibit innovation and competitiveness. Being too ready to pick up the pieces can also lead to moral hazard, and thus inadvertently exacerbate risk.

Ensuring that regulation is appropriately calibrated is fiendishly hard. Getting political buy-in for the assessments that regulators make is just as difficult. Regulators argue, rightly, that any calls they may have made for financial institutions to restrict their risk-taking behaviour prior to the crisis would have lacked any political support and been seen as an unwarranted intrusion into the running of those institutions. In contrast, in the current political climate, no

intrusion is likely to be seen as too great, no regulatory policy considered too risk-averse.

There is no obviously simple answer to the question of how and to what extent financial institutions' risk-taking should be contained by regulators, which is why they need sufficient flexibility and discretion to determine that issue on a dynamic basis. However, rebuilding confidence in regulators requires them to demonstrate that they have the skills, capacities and confidence to make and enforce these assessments appropriately and transparently, and they will not again be cowed by the formerly apparent infallibility of the markets. Even if they do not act to contain certain risks, they should at least be fully apprised of what these risks are. There should be an ambition of "no surprises" and of ensuring that there are adequate systems in place to deal with failures when they arise.

Regulators are not the only ones to blame for the crisis, however. The markets themselves have exhibited significant failings. Private law arrangements between players in the wholesale markets have clearly proved inadequate either to distribute or to contain risks in the ways that the parties to them might have intended or assumed. Investors in the wholesale markets have failed to conduct sufficient due diligence into the products they were buying, relying excessively on the credit-rating agencies. The over-the-counter (OTC) markets for credit derivatives have not managed to contain counterparty risk in the face of extreme liquidity constraints, leading to calls for the development of infrastructural arrangements, notably a clearing house, to perform this role. Techniques, such as margin requirements, which were meant to act to a degree as risk "buffers", turned into risk transmitters as markets collapsed. The collapse of Lehmans is sending reverberations around the world, and in the UK counterparties to Lehman Brothers International (Europe) are discovering that their contractual rights and client assets are not as reliable as they had assumed. On the one hand, a systemically disruptive backlog of unsettled OTC cash equity trades in CREST this autumn highlighted the absence of reliable close-out procedures for OTC trades. On the other, the continuing inability of prime brokerage clients to recover their long positions demonstrated the legal and operational exposures where client portfolios are delivered as part of complex collateral structures. Rebuilding confidence in the markets requires those markets to demonstrate that they are more competent to regulate themselves either collectively or through bilateral contracting arrangements than the crisis has revealed them to be.

Finally, the banks themselves need to rebuild their credibility as institutions that can adequately manage their own risk-taking. Banks' most effective defence to calls for more intrusive regulation is to demonstrate that their internal corporate governance systems are up to the task. This role ultimately lies with the boards and the shareholders. Both have failed to perform their governance functions adequately. The role of non-executive directors has recently been trenchantly criticised by Paul Myners, and their capacity and ability to perform their role clearly needs to be reviewed and strengthened. Shareholders have preferred to vote with their feet, enjoying the dividends as they rolled in, and walking away as the troubles began. Both have agreed to and presided over remuneration structures which clearly incentivised short-term risk-taking. Neither has acted as the internal brake that it should have. Rebuilding confidence in banks requires a demonstration that these internal control mechanisms are adequate and appropriate to the tasks that are placed upon them. It remains to be seen whether boards have learned their lessons and whether the government will perform any better as a shareholder than the private shareholders it succeeds.

In short, credibility and confidence in regulators, markets and banks has been damaged, yet confidence is essential if financial markets are to function effectively, and if investors and voters are to participate in them. Rebuilding that confidence is a complex task, and is not one which can be accomplished quickly or simply, but it is essential nonetheless. To this end, the LSE's Law and Financial Markets Project (www.lse.ac.uk/collections/law/projects/lfm.htm) will be convening a conference on Rebuilding Confidence in Markets and Regulators in March 2009 to explore how confidence and credibility can be restored. ■

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Law Department, London School of Economics; I thank Joanna Benjamin for her valuable comments – all the usual responsibilities remain mine.