REFORMING THE CITY

Responses to the Global Financial Crisis

Edited by
Sam Whimster

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Stuart Fraser is the Chairman of the influential Policy & Resources Committee of the City of London. He was a former Chairman of its Planning Committee from 1997 to 2000. Stuart has worked in the City since 1963, becoming a Common Councilman in 1993. He is a Director of Brewin Dolphin Securities.

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John Kay is a leading authority on banking and finance and a columnist in the Financial Times. He is an advocate of narrow banking and is critical of the structure of UK's global banks. John is a visiting professor of economics at the London School of Economics and a Fellow of St John's College, Oxford. *The Truth about Markets* was published in 2003 and his latest book *The Long and the Short of It* was published in January 2009.

Nick Kochan is a writer on economic affairs and criminology. His book on money laundering, economic crime and terrorism, *The Washing Machine* (2005), has become a reference work for a number of law enforcement agencies and university departments. His more specific books on the Guinness banking fraud *The Guinness Affair* (1988) and on the Bank of Credit and Commerce International, *Bankrupt, The BCCI Fraud* (1991), were the fruits of early research into key banking scandals. Nick Kochan has also written a biography of Gordon Brown (1998) and he lectures widely and contributes to many media as a commentator.

Michael Mainelli leads Z/Yen, the City of London's leading commercial think-tank. Michael started as a research scientist later becoming a partner in a leading accountancy firm directing their consultancy work in the UK and overseas. He has worked in public, private and not-for-profit organisations, led several privatisations, was British Computer Society Director of the Year 2004/2005, and served on the board of Europe's largest R&D organisation - the MoD's 12,000 strong Defence Evaluation and Research Agency. Michael created the London Accord and the Global Financial Centres Index among other projects. Michael is

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John McFall is the Labour and Co-operative Member of Parliament for West Dunbartonshire, and chairs the House of Commons Treasury Committee. During his time as Chairman, the Committee has conducted high-profile inquiries into the financial and economic crisis, as well as issues such as financial exclusion, private equity, globalisation, and the economics of climate change. Elected in 1987, John McFall served as an Opposition Whip and Opposition Front Bench Spokesman on Scottish Affairs; from 1997, he served as a Government Whip and a minister in the Northern Ireland Office. He was elected Chairman of the Treasury Committee in 2001 and re-elected to this position in 2005. John McFall also chairs Strathleven Regeneration Company, a not-for-profit company he set up to generate employment opportunities in his constituency, and Clydebank re-built, a company set up to regenerate the Clydeside town.

Helen Parry is a consultant editor at Complinet. Before that she was a Reader in Law at London Metropolitan University specialising in financial services law and comparative regulation and financial crime in the US and UK. Helen was originally an academic criminologist specialising in white collar crime and has also worked with private sector investigatory agencies such as the International Maritime Bureau and the Counterfeiting Intelligence Bureau. In the 1980s and 90s Helen worked as a regulator in the derivatives industry, helping to implement the provisions of the 1986 Financial Services Act. She was the editor and contributing author of the Sweet and Maxwell *Law and Regulation Series* which included

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Jocelyn Pixley is Professorial Research Fellow at the Global Policy Institute and is based at Macquarie University in Sydney. The author of *Citizenship and Employment: Investigating Post-Industrial Options* (Cambridge University Press, 1993), *Emotions in Finance: Distrust and Uncertainty on Global Markets* (Cambridge University Press, 2004), she has published in journals such as *Theory & Society*, the *American Journal of Economics & Sociology* and the *British Journal of Sociology*, in collected volumes, in the quality press and is co-author of a third book (*The Double Life of the Family* Allen & Unwin 1997). She is also running a Festschrift on the work of Maria Markus of the Budapest School to be published in *Thesis 11*, and was recently a guest scholar at the Max Planck Institute for the Study of Societies in Cologne. Her current projects are on the sociology of risk and uncertainty, including comparative work on the world's major financial centres and the current credit crisis.

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Sam Whimster is Director of Research Programmes at the Global Policy Institute. He edited *Global Finance and Urban Living* (Routledge 1992), an account of London's first 'big bang'. His most recent project is working on social-economics and he holds an ESRC Fellowship to research archival material on Max Weber. He is the editor of the journal *Max Weber Studies* and author of *Understanding Weber* (2006).

Foreword

Stephen Haseler

This collection of essays derives from the presentations and contributions delivered at a major international conference, 'The Future of the City of London', which was held at the Bloomberg Centre earlier this year (2009). It was fitting that the Global Policy Institute of London Metropolitan University should have organised this conference. We are the only higher education research institute located in the 'square mile' and we have global political economy as one of our central research interests. Consequently I am particularly pleased to be able to publish the written-up contributions in this book edited by Professor Whimster.

The authors comprise a unique blend of international experts and academics, financial sector decision-makers (including bankers) and public policy-makers. We are particularly proud to

publish the contributions from the two main British political parties, the MPs John McFall and Mark Field. Both are refreshingly candid about the challenges that lie ahead – and, perhaps, a little off-centre from the official positions of their parties.

London's financial district was a strikingly successful product of the high globalisation era which is now coming to an end. Our institute has for some time been warning about the weaknesses in the previous global system and has been pioneering ideas about the new multi-polarity that is replacing the old global model. A growing understanding of the new geo-political and economic world we are entering will help 'the City' to adapt and prosper – and make a renewed and sustainable contribution to the British economy. The good news is that 'the City' is not a monolith and its very diversity may well be its salvation in these difficult times.

I hope this book of essays stimulates debate in the coming era of reform and adaptation. I would like particularly to thank Sam Whimster for helping to organise the conference and driving the book through to final completion; also the staff of the Global Policy Institute, John Burbidge-King of Interchange Solutions, and Florence Quirici at the Bloomberg Centre for their help in making the conference such a success.

Stephen Haseler
Professor of Government,
Director, The Global Policy Institute.
11 October 2009

Introduction

Sam Whimster

NatWest is a high street bank – as is the Royal Bank of Scotland. The latter bank was something of a rarity on English high streets and it was a surprise when it took over the much more familiar and larger NatWest in 2000. Royal Bank of Scotland (RBS) is now a global bank, though the average NatWest customer will be scarcely aware of this as she checks her monthly bank statement, reviews the interest being given on an ISA and maybe the family's annual mortgage statement. In late September 2008 the Financial Services Authority started to monitor the flow of cash withdrawals from RBS and other 'high street' banks on an hourly basis, since many account-holders took the view that their money was no longer safe. If customers were to withdraw all their money, RBS would no longer be able to secure its assets, which as a global bank

were approaching twice the value of the UK's gross domestic product. RBS had lent money for credit cards, consumer loans, mortgages, property loans both nationally and internationally and its advertisement for these services were ubiquitous in the airports of the world; in addition it was experiencing large losses on its wholesale trading in financial instruments.

In the first quarter of 2008 the US investment bank Lehman Brothers Inc. posted profits of just under half a million dollars and reckoned to have assets and positions owned of around $1 trillion. Six months later, on 15 September, it filed for bankruptcy protection. By the morning of 18 September the US Treasury was injecting $105 billion into the money markets as a figure five times that amount was being withdrawn. The US banking system was hours away from running out of money and the international financial system was on the verge of collapse. The US Treasury immediately guaranteed all bank accounts to the sum of $250,000 and staunched the flow. In England on 8 October the Government made available £250 billion in various schemes to the banks and ten days later the Governor of the Bank of England revealed in a speech that the UK banking system had come within a whisker of collapsing.[1]

From September onwards the UK, the US and the Euro-zone government treasuries and central banks undertook a massive rescue operation as the world faced its first global bank run. The authorities slashed interest rates to nearly zero, they bought the equity of failing banks or forced them to merge with apparently solvent banks, they handed out state funds to restore liquidity of banks and financial institutions, they bought junk assets of those institutions, they guaranteed the banks against future losses and write downs, and in order to provide this funding on such a scale central banks created a credit line in their own ledgers – quantitative easing.

The Great Moderation – non-inflationary growth within a *laissez aller* economic system – of the late 1990s and the early years of

the 21st century had turned into the Great Disaster. Globalisation, as defined as a free trade, neo-liberal project, was experiencing the meltdown of its core mechanism – the financial system – and it is now having to contemplate a new political, fiscal and financial landscape as the Slow Recovery gets underway. William Keegan, the economic sage and journalist, reports (as we go to press) a central banker who thought the current stabilisation of the system had been achieved 'by an infinitely bold set of measures' and that Armageddon had been avoided at a risk to the taxpayer 'equivalent to 25% to 30% of GDP'.[2] The Governor of the Bank of England, Mervyn King, confirms that the situation is even worse for the UK: 'The sheer scale of support to the banking sector is breathtaking. In the UK, in the form of indirect or guaranteed loans and equity investment, it is not far short of a trillion (that is, one thousand billion) pounds, close to two-thirds of the annual output of the entire economy. To paraphrase a great wartime leader, never in the field of financial endeavour has so much money been owed by so few to so many.'[3] In Britain the Slow Recovery will entail the re-engineering of the financial system, a new economic strategy for the country, a new fiscal policy (some combination of higher taxes and lower expenditure), the sale of national assets (most probably to foreign buyers), and a re-oriented City of London.

'Reinvention – reform – revival' was the sub-title of a conference on the future of the City of London held at the end of April 2009, from which this volume resulted. Its authors cover a wide range of topics and questions, and a number of ongoing arguments and antinomies can be flagged up. First mention must be made of the City itself. Can it reform, renew and reinvent itself? If there were a jury sitting in judgement on this, it would still be out. On reform and regulation, the City, as Stuart Fraser of the City of London Corporation makes clear in his contribution, will not initiate reform unless there is a general international move-

ment for it. This is the classic dilemma described by game theory: the altruist who goes first will be taken advantage of by free riders. The way out of this dilemma, as the economist Mića Panić argues, is to have a pan-global system of regulation that will drive the free riders out of business. At the time of writing, global bankers under the leadership of Jacques de Larosière and the Financial Stability Board have put forward outline proposals for a gapless system of regulation at macro (prudential) and micro (firm) level and consistently upheld by national regulators. The Treasury Select Committee, as noted by John McFall, supports the Turner Review in calling for a European supranational agency to coordinate regulation. While this has been criticised in some quarters of the City (mostly 'hedge fund' lobbyists who are not quite up to speed on the costs of non-conformity) there is a gathering consensus at G20 summits that Europe and the United States will lead the way.

The restoration of trust is a first priority in any reform. John McFall speaks of the trust between banks and the public as having broken down. The public is disturbed by the possibility of their savings being put at risk and bewildered by why the government is committing so much public funding to rescue the banking system. Trust can only be rebuilt if there is greater transparency about what banks do and if high street banks end their risky venture into investment banking.

Regulation, however, is deeply problematic as many of the volume's contributors point out. Helen Parry observes that it is not exactly as though the United Kingdom lacked for regulatory law and for various reasons, including the regulator being more friendly mongrel to the bankers and quickly brought to heel by politicians, existing laws and rules are not enforced. Nick Kochan demonstrates that at the root of non-compliance lies tax avoidance and downright fraud as money is switched and re-rooted through the world's 'tax havens' leaving regulators and revenue

inspectors far behind. It is striking how quiescent the Serious Fraud Squad is, in contrast to the late 1980s and to the FBI and other civil actions being taken at this moment in the United States. Mark Field, in his chapter, calls for the appointment of high-calibre, respected professionals in the top posts of the regulatory system. US-style prosecutors should be introduced in place of a Serious Fraud Office, 'which lacks respect from the public and finance professionals. Nothing less will restore confidence from market professionals and trust from the public at large.'

Then there is the issue of the discipline of the markets. Reckless and badly managed firms should be weeded out in a competitive market situation, as John Kay, Michael Mainelli, Mark Field and others demand. This has not happened because were a failing firm like American International Group (AIG) or RBS to be allowed to fail, the financial system would go into a tailspin. The case of AIG is instructive because deals made by investment and conglomerate banks were not allowed to stand in their own right and be correctly priced in the market. Instead they were insured with AIG against possible failure. The risk was passed on, and not properly hedged, and the US government has had to pump in total $180 billion into the failing AIG. On receipt of this money AIG then paid out in full to the investment banks (Goldman Sachs, Merrill Lynch, Citigroup etc.) for their bad bets. Governments have become not only lenders of last resort – a crucial plank in private banking and finance – but also the insurer of last resort due to the private sector's inability to close their trades. John Kay's solution to this dilemma is to make it very clear in the future that when the British Government guarantees depositors, this provision will be made available only for those banks that abstain from wholesale investment banking. So-called 'narrow banking' would focus on payment systems and deposit taking, a reform that would be clearly understood and welcomed by the public.

Governments have been left holding a very large bill for banking and finance excess and recklessness. Viara Bojkova shows that the British government is, through its bank support measures exposed to those banks' total assets: a figure of 13.5% of 2008 GDP in this country and 5.5% in the United States. Canada, in marked contrast, has had to provide no such support or bail out for its banks, pointing up the moral that many advanced countries, not least in South East Asia, knew perfectly well how to retain the probity of their banking system. Continental banking systems like the United States and the Euro-zone can probably weather the worst of the storm, small states like Iceland and Ireland cannot. Where does this leave the City and the United Kingdom?

Stephen Haseler argues that an outward looking City, global in its ambitions, has now been shown to generate liabilities far in excess of the capacity of the UK's thirty-one million taxpayers to absorb system breakdown. This problem compounds when the tax contribution of the financial services sector – £203 billion for the period 2002 to 2007 – turns into a loss to be carried by the Government of perhaps more than twice that amount.[4] In coming to the rescue, the British state may well have weakened itself, and this raises the question of how large a hinterland such a banking system now requires. Either it should downsize, or else the United Kingdom should throw its lot in with the ECB, a truly continental-sized central bank. Sir Thomas Harris vigorously demurs from such counsels, seeing the City of London as a cosmopolitan and free-standing global financial centre still able to lead the world in providing new and affordable financial services. Saskia Sassen comes at the territoriality question from a different angle. The choice is not simply between some form of national hinterland and 'off-shore' status for financial centres. Rather, global cities like London have their own qualities – advantages and disadvantages – and dynamics. This multi-factored logic determines where international business is located

and which cities throughout the world will specialise in certain sectors. The urban geography of location is intrinsically fluid in the contemporary world. So, for instance, Shanghai has climbed 25 places in the current Z/Yen Global Financial Centres Index (September 2009) to reach tenth place ranking.

In the face of recent irrationality, Michael Mainelli poses the rationalist question: how would we know when finance was operating correctly? It is possible to identify the market failures and excesses. Both Jacques Reland and Sam Whimster, in their contributions, point out the massive redistribution of resources to the financial super-rich that occurs because of the cult of shareholder value and a system geared to sluice global funds into the pockets of the financial services industry's elite. Instead of devising pricing algorithms for derivatives, why, asks Mainelli, cannot financiers produce a bullet-proof scheme so that a twenty year old can be told how much she has to pay into a pension scheme and what its final outcome will be? The industry has lost touch with longer term time horizons, a point also eloquently expounded by the late Ralf Dahrendorf in an article published earlier this year. Dahrendorf also castigates the mentality of consumers fixated on immediate gratification and a pay-later attitude.[5]

In a similar vein, Jacques Reland lays out the case for institutional redesign of the capitalist firm, which has morphed from managerial capitalism to the financialisation of the economy. The latter reduces the time horizons of corporate strategy, which is now aligned not with company growth but with dividend payments to shareholders and the bonuses of the 'here today gone tomorrow' CEOs. The new strategy is to cut costs rather than make the productive investment that will provide for the wages of tomorrow. Jocelyn Pixley, after noting the social democratic deficit of governments having to make good the losses of private sector banks that still claim the right to be beyond the normal supervision of other sectors like transport and food and still claim

the necessity of high compensation, adds to the shareholder debate. Shareholders only have a claim on dividends and this is subject, in the recent period, to managerial determination. The shareholders who make the difference on the margin are the private capital pools (private equity and 'hedge funds') who pursue short-term strategies and short-selling tactics. The dilemma is that no one owns public companies. Therefore, Pixley argues, progressive corporate governance should be defined by principles of probity, sustainability and the banks' special role in democracies of funding creative social development for a 'fair' profit – and not by the narrow interests of board members.

Reland also makes the point that short-term depredation is leading to the gradual decline of the economic prosperity and the power of the West. This is amply confirmed by Professor Xuecheng Jing's article which charts the rise of sovereign wealth funds and in particular the Chinese Investment Corporation which disposes over a US $200 billion fund. In the case of these funds, interestingly, we do know who owns them: sovereign states. In this sense they do have to have an explicit policy and rationale, i.e., they have to be seen to behave responsibly and seek long term stability for the firms in which they invest. Chris Dixon pursues one of the thematics of the Global Policy Institute: are we seeing the 'universalist' vision of globalisation fragment into regional blocs – a process accelerated by the destruction of northern hemisphere wealth? South East Asia came out of its financial crisis of 1997 fully resolved not to relive the experience by instituting deep financial reforms and stabilising economic policies, and they have avoided much of the financial services carnage now being experienced in the West. Their economies are characterised by high savings rates, growing manufacturing and services sector and large investments in higher education and R&D. The City of London still stands high with Asian countries. In 2008 London financial institutions were the largest financiers of

emergent markets and the London Stock Exchange accounted for 30% of Sukuk listings, the second largest market after the Dubai Nasdaq. The challenge for the City is to re-affirm its business acumen in the face of its current loss of esteem, demonstrate its openness in the face of incipient protectionism, and most of all understand that emergent markets will no longer conform to the neo-liberal economic paradigm.

Sam Whimster takes up a theme recently aired by the Lord Turner, Chairman of the Financial Services Authority, that the sector has grown to be larger 'than is socially optimal'.[6] How, then, does one discriminate between wealth-creating and society-enhancing activities and those that achieve the opposite? One answer, as Jocelyn Pixley reminds us, is to follow Joseph Schumpeter's observation that when banks grant credit they are creating an economic network of new deposit holders. But what has been happening in the giant banking and finance conglomerates is the internalisation of transactions sheltered from the discipline of market pricing. Within wholesale investment banking 'money machines' have been created which take little or no notice of the social function of banking. This process is a pathology of an otherwise healthy knowledge society – whose directionality points towards free informational goods – that has been appropriated by bankers for the maximisation of private interest. The argument is illustrated by a case-study of Lehman Brothers Inc. based on a complaint filed by the Investment Division of the State of New Jersey v. Fuld et al.

Coming back to the conference theme: where does the City go from here? 'The City' as Stuart Fraser pointed out is shorthand for the financial services sector. In London it stretches from Mayfair to the City itself and on to Canary Wharf. Though the City of London is a constitutional entity (retaining elements of medieval self-government) the number of banks and financial institutions operating in London is contingent on factors beyond its control.

Now that liquidity has dried up and the trade in structured debt greatly diminished, foreign banks are disappearing entirely or greatly reducing their workforce, with the loss of jobs in the City since their peak in 2007 reckoned at 49,000.[7] The advantages of 'light-touch' regulation are unlikely to return as the reform initiative passes into the sphere of international summitry. As the Conservative politician Sir Anthony Beaumont-Dark noted in regard of the Parkinson-Goodison agreement of 1983, a nation that cedes control of its core financial institutions places its destiny in the hands of outside interests.[8] This problem compounds for the UK economy, whose political and economic elites based their strategy on the comparative advantage of financial services. In 2007 the City of London was beginning to think of itself as a semi-independent city state with the rest of the United Kingdom reduced to a necessary and sometimes trying adjunct. The politics of the present situation suggest a reversal, bearing in mind that there are whole regions of the UK which have precious little private sector economy remaining.

The 'reinvention' aspect of the City offers some hefty challenges as well as prospects. Lord Turner recently commented that the City is still in the business of offering financial services of a professional quality for which there is a demand in the real world. These basic services – money payment systems, insurance, bond and equity issues, pension fund management, and not forgetting reliable credit on sustainable terms – will grow in scope, especially internationally. The biggest challenge, however, is to move from the 'naughty corner' of short-termism and the misallocation of financial capital on a gross scale to the medium term demands of climate change, population growth and resource depletion. Here future capital costs should be priced by the bond markets and this information provided for publics and policy-makers so that they are able to act responsibly. Likewise, the political class will have to reassert their authority over the banking and finance sector in order to carry through the necessary reforms.

Notes

1 Reported by Robert Skidelsky, *Keynes. The Return of the Master* (Allen Lane, London, 2009): 9-10.
2 William Keegan, *The Observer* 11 October 2009.
3 Mervyn King, 'Speech to Scottish business organisations, Edinburgh', 20 October 2009.
4 These figures are presented in 'An alternative report on UK banking reform', Centre for Research on Socio Cultural Change, 2009: 32-3.
5 Ralf Dahrendorf, 'Nach der Krise: Zurück zur protestantischen Ethik?', *Merkur*, 720, May 2009.
6 Adair Turner, interviewed in *Prospect*, September 2009.
7 Figures compiled by the Centre for Economics and Business Research, October 2009.
8 Quoted in *Global Finance and Urban Living*, edited S. Whimster and L. Budd, (Routledge, London, 1992):182-3.

1

The Future of the City: A Policy-Maker's View

Rt. Hon. John McFall

The House of Commons Treasury Committee, of which I am the Chairman, has spent the past two years almost exclusively asking questions about the current financial crisis. Our first inquiry, completed in early 2008, was the first major inquiry of its kind in the UK. This was followed by an inquiry into banking reform, ahead of the introduction of the Government's Banking Bill late in 2008.

We have recently completed a further, much longer inquiry, taking evidence from an extraordinarily wide range of sources. These included ministers, regulators, financial institutions, experts, stakeholders, consumer organisations, credit rating agencies, and a host of others – and, most importantly, from the public themselves. This has given us a very broad view of the financial

and economic situation – and it has convinced me that, to restore the financial sector to health, there must be a partnership approach between politicians and the industry itself.

The role of finance

Today, our society relies on financial services. As recently as the 1970s, it was common for a person not to use any financial services at all – not even a bank account. This is no longer the case. During my chairmanship, the Treasury Committee has championed the cause of financial inclusion, conducting a number of wide-ranging inquiries. We have found that nowadays those who are excluded from financial services – often due to low income or lack of financial capability – can face significant barriers to employment and enterprise, and increased costs for basic goods and services. In short, they can become excluded from society. Our economy too requires a vibrant financial sector. Hundreds of my constituents and members of the public have written to me, to ask why the banks had to be bailed out using billions of pounds of their tax money. In response to them, I have compared the financial sector to the heart, pumping the financial blood around the economic body. Without finances, businesses cannot invest and grow. A collapse in the banking system causes a thrombosis, putting our jobs and prosperity at risk. In today's world, a financial crisis necessarily leads to an economic crisis. But during the Treasury Committee's latest inquiry into the banking crisis, we have learnt just how far retail banks have strayed from the activities of a traditional 'Captain Mainwaring-style' bank. The banks that have failed have increasingly got involved in investment banking, traded complex financial instruments, and came to rely on sources of funding other than savers. Rather than keep customers' money safe, banks have been permitted, and even incentivised, to take risks with it.

So banks have strayed some considerable distance from their traditional role – they were perhaps not doing what the public thought they were doing. I asked a number of witnesses to our inquiry, whether they thought banks had fulfilled their Oxford English Dictionary definition: 'an establishment for the custody of money received from, or on behalf of, its customers. Its essential duty is the payment of the orders given on it by the customers; its profits arise mainly from the investment of the money left unused by them.'

This is potentially serious for the future of the financial sector – and, therefore, for our society and our economy. A social contract has existed between the financial services industry and the consumer. Whilst banking and finance continued to serve the public's needs, by providing the basic services on which we all rely, its excesses were tolerated, even celebrated. But the industry has found itself in a position where it cannot carry out this utility function. The contract has broken down.

In this article, I will give an overview of three areas on which both policymakers and industry leaders will need to concentrate to secure the future of the UK financial industry: improving regulation; managing government intervention; and restoring public confidence in the industry.

Better regulation

From a legislator's point of view, the biggest question for us to answer is, how can we avoid a repeat of this crisis? We must ensure that, in the future, fires are prevented or doused out quickly, rather than being allowed to destroy everything. Better regulation will of course be a major part of the answer to this question. The idea that markets are self-correcting, which previously held sway across the City and at the Financial Services

Authority (FSA), has been discredited; financial institutions are seen to have acted in a way that, ultimately, were not in their own interests. There is a widespread consensus that regulation will have to extend to areas where it was previously assumed that the institutions themselves knew best.

The change of direction in the thinking at the FSA, as set out in Adair Turner's review, is therefore welcome. The FSA has recognised explicitly that it relied too much on markets to self-correct. It will now regulate more intrusively. It intends to oversee actively the running of financial companies, assessing business models for the risks they pose to the business itself and to the wider financial sector. It will oversee appointments of directors, ensuring they have the correct qualifications and experience. Remuneration of executives will be assessed for the risks it could pose to companies. And it would like to introduce more stringent regimes for capital and liquidity.

Regulation will also become more extensive. We should expect financial institutions which were previously only lightly regulated, to be brought firmly under full FSA supervision. The Turner Review called for firms to be regulated according to economic substance, rather than legal form. We have realised over the past year that non-bank institutions can be systemically important, even to the same extent as the banks themselves. The regulatory authorities therefore have an obligation, as they do with banks, to ensure that these institutions do not pose a threat to the rest of society.

Given the intense pressure on politicians to 'fix' the financial crisis, there is understandable concern that the Government will go too far, and that regulation will become heavy-handed. This must be avoided. Financial services are important, and particularly so for the UK economy. While we have a moral obligation to ensure that similar crises are prevented, as far as possible, in the future, we must not stifle innovation and growth.

The current debate has turned to the UK's regulatory institutions (the so-called 'tripartite authorities'). Is there a need to alter the institutional structure to improve regulation? The Treasury Committee's first report into the financial crisis, in early 2008, was clear on the need for greater overlap between the institutions. Whilst all three institutions came to the Committee and said they had done their own job, there was a lack of coordination and exchange of information between them. On the failed bank Northern Rock, for example, a number of representatives of UK financial institutions told us that they had been aware that the bank was an outlier in the industry, and that its business model was clearly unsustainable. Yet none of the tripartite authorities responded to this.

The Treasury Committee's recommendation was for a post to be created at the Bank of England – a Deputy Governor for Financial Stability – that would be given sweeping powers to investigate and take action on systemic threats, for example the power to request information from the FSA on an individual institution. We also recommended that, whilst the FSA would continue to supervise financial institutions, the power to declare a bank 'failed' and begin the resolution regime should lie with the Bank of England. A permanent tripartite committee would also need to be created. The Government has not accepted these recommendations, but the Committee will continue to monitor the extent to which the tripartite authorities cooperate on issues of financial stability.

Recent proposals have suggested that the Bank of England should be given the right to supervise most financial institutions in the UK. Whilst the Treasury Committee supported the transfer of certain new powers to the Bank, we did not call for a wholesale restructuring of the tripartite system. This would be a move away from greater overlap and coordination between the authorities, and a move towards greater centralisation of power in a single body.

Finally, regulation needs to become more international. Many in the City react with suspicion to this idea, fearing it could lead to more stringent regulation. This is why we must not move away from having strong national regulators, accountable to Parliament (though I would point out that, given the changes already proposed to UK financial regulation, London may not always be able to rely on a regulatory advantage in the future).

But nor can we escape the need for more cooperation between regulators. We have seen that when international banks fail, there is a need for a quick international response. The chaotic collapse of the Icelandic banks resulted in huge problems for many customers – not to mention severely strained relations between Iceland and the UK – because of the lack of coordinated action. The Turner Review supported calls for a European supranational agency which would coordinate national regulators. Since the EU is a solid, pre-existing foundation on which to build such a coordinator, this makes sense – although we must continue to look for ways to build wider cooperation, given the global nature of today's financial industry.

Government intervention

An important question concerning the future of the financial industry is the nature of Government intervention in the sector. What will be the impact of this? State ownership of banks has some serious potential pitfalls. Most obviously, there is a concern that the nationalised and part-nationalised banks will not lend prudently in all cases, but may be persuaded to back politically attractive, though commercially unviable, causes. This could work to the detriment of the shareholders – including the taxpayer. The Government has recognised this risk, and set up a company, UK

Financial Investments, to manage the banks 'at arm's length'. As yet, it is difficult to say whether UKFI are an effective mechanism for doing this; the company's exact mandate, and its relationship with the Government, are still unclear.

State intervention can also distort competition. We have seen already that consumers have fled to safety in state-backed institutions, such as National Savings and Investments. In March 2009, the Office for Fair Trading reported that Northern Rock had caused no significant market distortion. However, the nationalised bank has since changed its strategy; instead of continuing to shrink and shed customers, the bank has since been instructed to significantly increase lending. Whilst this was the right thing to do – the biggest barrier to an economic recovery is currently still the lack of finance – we will need to continue to monitor the effect of this action on the market.

How long will the Government remain directly involved in finance? I believe this may continue for some time. We have seen customers flock to state-backed institutions. This may be part of a wider change: consumer awareness is now more heightened than ever. Terms such as 'deposit protection', 'capital requirements', and even 'quantitative easing' are appearing on the front pages of newspapers, rather than the business pages. I know from talking to my constituents that they are spending more time looking at their own 'due diligence' before using financial services. Customers will now vote with their feet for the institutions they trust the most. In addition to this, as I have mentioned, the Government has found it useful to have ownership of banks during the current crisis. Through Northern Rock, RBS and HBOS, the Government has been able to increase lending to customers and businesses to a certain extent, particularly in the mortgage market, when private banks were unable to do so. We have seen how devastating a collapse in provision of finance can be to the wider economy; it may prove useful for the Government

to have ownership of a bank, ready for future emergencies. The banking crisis has perhaps given an impetus to the (pre-existing) plans of the Post Office to become a universal, public-sector provider of financial services.

More widely than this, there is now a widespread recognition that all banks which are 'too big to fail' are relying on an implicit state backing. We have seen a situation where banks' profits were privatised, but their losses were nationalised. Future governments may now feel that, in return for this guarantee, they can make more demands on large banks to behave in the best interests of the public.

Restoring trust

I have briefly touched on the issue of public trust. This is one of the most important issues that the financial sector will now have to face. The bond of trust between the public and the financial industry has been broken. Banks got themselves into a situation where they could not fulfil what the public saw as their basic functions – safeguarding money and making loans. Part of our effort to restore trust will come from the public sector, as I have discussed, by improving regulation. But further efforts will have to come from the industry itself.

One of the most damaging accusations to be levelled at the industry, was that financial bosses and traders did not know what they were doing. The Treasury Committee's inquiry in 2008 found that many investors had bought assets they had not fully understood. Indeed, due diligence became almost impossible as assets became more complex. We were told that many investors began to rely instead on credit ratings – seeing a triple-A rating as a 'green light' to invest. Perhaps worse than this, many bank directors were seemingly unaware what was going on lower down in

their own companies. So corporate governance appears to have failed in many cases. Financial institutions will need to demonstrate that their directors are truly scrutinising the company and its executives. It is the role of investors, rather than the Government, to ensure that this is the case.

We have also seen that the way financial sector directors and employees are paid, has a direct effect on the trust that people have in them. So restoring trust also means looking at remuneration structures across the industry. Senior bankers will need to demonstrate that their pay is not based solely on short-term profits, but that it reflects the long-term value they create, both for the company and for the wider economy. Related to this, the disconnect between the earnings of those at the top of banks, and the earnings of 'front-line' staff in branches and offices, may need to be addressed. If we are to restore trust, then directors must be able to justify their pay, not only to shareholders, but also publicly.

This does not appear to have happened; the new chief executive of the Royal Bank of Scotland, a bank still under majority ownership of the British Government, has recently received a pay deal which looks rather like the typical pay deal at the height of the financial boom. My Committee will continue to monitor developments on executive pay in financial institutions. Furthermore, the remuneration of those who sell retail financial products, including financial advisors, will need to inspire confidence. The Treasury Committee in 2004 recommended a move away from commission-based selling, to one where the interests of sellers and customers were more closely aligned. We continue to hear accusations of mis-selling around retail financial products, often related to the payment of commission. While I believe that the vast majority of financial advisors and retailers do an excellent job, there may always be some suspicion around commission-based selling. The FSA

seems now to have agreed with the Treasury Committee's position, and is expected to ban commission-based selling in its forthcoming Retail Distribution Review.

To restore trust, we will also need to make the financial system more transparent. Of course, for the public and markets to have more trust in financial institutions, they must be able to see that changes are being made. But, more importantly, transparency is also a pre-requisite for better regulation. A lack of transparency has allowed many financial institutions to escape full regulatory oversight. So-called 'shadow banking' institutions were lending more, in 2007, than the 'traditional' banking sector. Yet they were barely regulated, and not covered by traditional protections such as deposit insurance or the Bank of England's emergency facilities. During our latest inquiry into the banking crisis, Hector Sants told the Treasury Committee that shadow banking institutions 'are not as transparent to the regulators as they should be. So we support ensuring that firms cannot use these types of devices to escape the oversight of the regulator.'

Transparency is also vital in retail finance. There is a danger that banks, and other providers of retail products, could respond to the crisis by reverting to 'hidden charges' or other such practices. Indeed, the Treasury Committee has found on its regional visits that for small businesses, 'hidden' and one-off charges, such as arrangement fees, had risen sharply, even while banks continued to advertise low interest rates. The small business owners we spoke to expressed a clear preference for higher interest rates than for an increase in opaque charges such as these. Some banks have also made news headlines for introducing new bank accounts with vastly increased hidden fees and penalties. Given the breakdown of trust in the industry, and the availability of state-backed retail finance options, these practices could be counterproductive. Customers will choose the institutions they trust the most.

Conclusion

It is true that, after we recover from the current recession, the financial sector will likely constitute a smaller percentage of UK GDP. Mervyn King, Governor of the Bank of England, pointed out to the Treasury Committee that financial services in the future will likely employ fewer of our highly-skilled workers. Those mathematicians and engineers may go elsewhere, and other sectors of the economy may grow to fill the gap left by the contraction in financial services.

Nevertheless, the City will continue to be a major contributor to the UK economy – not to mention the UK exchequer – for the foreseeable future. Whilst there is a need to avoid a knee-jerk reaction, regulation is likely to become tougher in the UK; London will need to rely less on its regulatory advantages, and more on its competitive advantages. In addition to this, a public-sector presence in financial markets – particularly retail finance – may be a long-term feature.

I do not believe that changes in the financial sector can be brought about entirely through legislation. Legislation is necessarily behind the curve (the Consumer Credit Act, for example, was unchanged between 1974 and 2005, despite the introduction of CDOs and all manner of new financial products – not to mention computers and mobile phones!). What is needed, therefore, is an exchange between the industry and politicians. It is vital that the financial industry steps up to the challenge of regaining the trust of the public.

2

The Future of the City of London: Reinvention, Reform and Revival

Stuart Fraser

We can do the Reading, the Righting and the Rithmatic! Now we have to do a new set of Rs – Reinvent, Reform and Revive – this is the City Challenge over the next few years.

Can we do it? Yes we can! But we need to fight our corner and work in partnership with the government of the day if we are to succeed. Of course as the City of London Corporation's Chairman of Policy I am *slightly* biased.

The last two years have been difficult and challenging ones for the City – and I am using the term as a brand name for the whole-sale financial and business services sector spread across the UK, whose hub and focus is here in the City of London at the heart of London. The challenges are far from over. The brand name is tarnished. Bankers naturally have borne the brunt of vilification

and damnation. Bonuses have become a dirty word and a high salary must mean that somebody is being ripped off.

There is much talk of restructuring the British economy to make it less dependent on financial services – perhaps a return to government intervention in the economy and adopting a system of 'national champions' and 'protected industries'. This has been tried in the past with disastrous results leading to a long-term decline in Britain's global competitiveness and its becoming the 'sick man of Europe'. Instead the government's job should be: to encourage enterprise; put into place effective and consistent legal, regulatory, monetary and fiscal policies; to ensure the physical and educational infrastructure is as good as possible; and then to stand back and watch the economy re-balance itself. Of course, it doesn't always work like that. And the banking crisis will inevitably provoke changes in the size and shape of the financial sector.

Those of us who are advocates for the City's future *do not* start by saying that it is all going to be fine and the good times will come back as they were. We accept the 'reinvent and reform' labels. And we accept the term 'rebalance' as well.

London has prospered and will prosper again not just because the City will revive but because international finance is one of a number of overlapping and mutually supporting 'clusters' here. They include:

- Higher education and professional training;
- Design and the creative industries;
- Sport and entertainment;
- Culture;
- Medicine;
- A world – renowned legal system;
- Access to the best professional services;
- And, most importantly, a culture of openness to ideas and diversity.

These are all parts of the offer that make London a great place to live and do business.

A future for the City depends on London continuing to welcome the world – from the Chinese MBA, to the Gulf billionaire, to the Hungarian heart specialist. And we must not close the door even on foreign bankers! So the need to control numbers must be balanced by the need to reinforce these existing clusters. We need to tap the international pool of talented people – who are also customers – and to keep ourselves tied in to the world economy.

Turning now to reform. This hinges on regulation. I will start, and probably finish, by saying that the sustainable answer is not *more* regulation but *better* regulation. The US sub-prime crisis started in one of the most intensively regulated banking sectors in the world.

There, here, and in many other centres the regulatory system failed. We, as Lord Turner put it, 'were concentrating on the plumbing and not the business model'. None of this is intended, however, to get the financial services sector off the hook. There have been major failures too in governance, in strategic and risk management, and in business judgement. This does not apply, however, across the board and we should be careful not to undermine sound businesses and sectors by wild generalisations. But the financial services player who expects things to revert to where they were pre-Lehmans, pre-AIG, pre-Northern Rock, is living in a fool's paradise – a phrase that can indeed be used deliberately.

Lord Turner's review, published in March 2009, sets out a way forward. Capital strength, operational liquidity and much fiercer assessments of risk are at its core. Non-banking institutions which behave like banks, or look as if they pose the same systemic risks as banks, will be regulated like banks. If it quacks it is a duck!

Policy-makers will have to continue to deal for some time with the presence of toxic assets – the IMF now estimates that there could still be up to $4 trillion – four trillion dollars – of these in

the global banking system. Less than half of these exposures have been recognised in banks' balance-sheets. Hence unless the world economy recovers much more quickly than expected, making the exposures less 'toxic', the need for further state support of the global banking system cannot be ruled out. With that comes state ownership, and the British and US governments, in the longer term, do not want to be majority shareholders in massive financial institutions. But with ownership comes the need to plan and it is clear that the institutions that are returned to private ownership at some stage in the future may well be of a different size and shape.

Mention has already been made of the UK's need to show openness to the global pool of talent. We must also be open to a more 'international' regulatory system but at the same time not be frightened to argue our corner. Although we are against a single European Union regulator, we certainly believe in closer co-operation on 'supervision' and accept that liquidity levels and prudential standards may have to be set at a European level.

The City remains internationally owned, staffed and managed. It is therefore essential, as it reforms and reinvents itself, that regulatory co-operation and the acceptance of common principles is a global rather than just a European matter. Transatlantic convergence is vital and I have already been to New York and Chicago to put over this message and will have visited Washington this summer – 2009. But it goes beyond the Atlantic. We must build and agree common standards and build common approaches with the new financial centres of the Gulf, South Asia, China and the Pacific Rim.

Some commentators say that the crisis will bring about an irreversible eastward shift in the global economy. Actually that was happening before the crises and is inevitable in the long-term. But among the 'old' financial centres, London has the least to fear. Money will still flow from West to East and as savings build in the East so new markets for financial services will

develop. In time that flow of funds will be more bi-directional. We have seen in the recent past Indian and Chinese firms expand abroad. Opportunities will abound.

In the City we have continued to foster a web of financial, educational, and cultural connections with the new centres. We see ourselves as the hub part of a global hub and spoke system. The web needs to enfold regulation as well. Again, not a single over-arching agency – but a collegiate approach, common standards and ready sharing of information. An institutional failure in Mumbai, or Manila, or Mexico City, can have a dramatic impact within hours on firms in Moorgate – or Mayfair. This is why the City Corporation is supporting the work of the new International Centre for Financial Regulation to the tune of one million pounds. Plotting a future global system needs consultation, thought and vision – kneejerk reactions to media headlines are not the right way to start.

What, then, are the prospects for revival? If governments and supra-national institutions succeed in putting the right policies into place, and if private businesses and individuals follow, then global trade will start to grow again and with it the demand for trade finance and maritime services. Beyond this, revival needs innovation. Clearly there will be huge scope in the future to finance the development of clean energy, to build a global system of carbon–trading, to look to the financial and economic implications of a world after 'peak oil'.

My concluding contention is that 'the City' is good at innovation. If we *reinforce* its pools of talent, if we accept *rebalancing* and *regulatory reform*, then we can continue to innovate and over time, we can *revive*.

3

The Crisis and the Taxpayers

Viara Bojkova

The crisis has led to a radical re-evaluation of the role of the state in supporting the markets. There is a growing consensus that public institutions have to intervene when the markets fail. This 'rediscovery' of the state has been particularly striking amongst leading economists and has been most clearly spelt out by Paul Krugman in his recent London School of Economics lectures 'The Return of Depression Economics'. This short paper concentrates on one aspect of the return of the state: the extent, to date, of the banking sector's dependence on government intervention.

In the first two years of the banking crisis governments have tried to mitigate the crisis through the application of a range of schemes. These differ across countries depending on the extent of the banking sector's problems. Here the analysis is confined to

available financial information and does not enter into questions of insolvency and banks' lack of liquidity. What the analysis does show in a striking way is the differing vulnerability of the state and taxpayers in different countries. The primary focus of this analysis is the situation in the UK banking sector. This is compared to the similarly distressed situation in the US – though with some significant differences. A third and virtuous country is Canada, whose economy also has a heavy dependence on its banking sector, yet presents a clear contrast to both the UK and the USA. Banking virtue has not protected Canada from the decline in GDP, which is largely a reflection of close links with the US, but at least the Canadian fiscal deficit will be spared the involvement with bank bailouts (see Table 1).

1. The banking system in comparative perspective

The results of the comparative analysis are presented in Table 1.

Table 1: Comparative figures

	UK	US	Canada
Top 5 banks' assets as a percentage of national GDP in 2008	402%	58%	169%
Government funding of banks as a percentage of GDP in 2008	3.45%	1.60%	0%
Central Banks' Liquidity scheme (% GDP 2008)	12.80%	12.26%	less than 1% per auction
Reported write-downs in 2008 as a percent of national GDP in 2008	4.59%	3.57%	0.8%
Tier 1 Capital Requirements as a percent of Risk Weighted Assets	4	6	7
Soundness of the banking system (ranking from 1 to 134, Global Competitiveness Report 2008)	44	40	1

Source: Summary from the text

The UK column in row 1 is a measure of both the concentration of assets by a few leading banks and the alarming ratio of assets to national GDP. Remembering that bank assets are defined as loans on which a bank *expects* to earn a return (whereas its liabilities are the funds deposited in the bank), the 402% cell shows that the top four UK banks have loaned out a sum of money equivalent to four times the country's GDP. In the contrast, the top five US banking groups have loaned out only half of the equivalent of national GDP. In the middle of this range, the Canadian top banks have loaned out one and a half of their GDP. During the last two decades of financial globalisation, the top UK banks have enlarged their balance sheets far beyond any of their competitors.

The second row shows government funding of banks as a percentage of GDP in 2008. As a result of the extreme stress in the banking market, the UK government had to intervene with an amount of capital equivalent to 3.45% of the GDP whereas the US governmental assistance was 1.60% of the US GDP. Conversely, the Canadian government did not need to intervene. Following the collapse of the inter-bank market, Central Banks had to inject differing amounts of liquidity, which as a percentage of the GDP were just above 12% for both the UK and US.

The fourth row illustrates the reported write-downs of banks in 2008. The Canadian banks had the smallest exposure to 'toxic' structured assets, and thus, were less affected by the fall of equity prices. Also Canada's minimum capital requirements are tougher than the 4% of capital requirements in relation to risk weighted assets called for by Basel II, and the UK and US bank regulators, as shown in the fifth row. Canadian stricter regulation rules played an active role in weathering the crisis or not placing the banks into a highly distressed situation in the first instance.

The last row shows the soundness of the banking system of the three countries with Canada taking up the first position in 2008. The financial competitiveness ranking is based on a

number of indicators such as financial market sophistication, financing through local equity market, ease of access to loans, venture capital availability, restriction on capital flows, strength of investor protection, soundness of banks, regulation of securities exchanges, legal rights index. Since 2005, the World Economic Forum has based its analysis on the Global Competitiveness Index (WEF 2008).

2. The UK banking system

In the Bank of England's 'Financial Stability Report' of June 2009, major UK banks are classified on the provision of customer services in the United Kingdom, regardless of the country of ownership. The following financial groups are included: Banco Santander, Bank of Ireland, Barclays, Britannia, Co-operative Bank, HSBC, Lloyds Banking Group, National Australia Bank, Nationwide, Northern Rock and Royal Bank of Scotland (RBS) (Bank of England 2009). Attention is focused on those with majority UK ownership – RBS, Barclays Group, HSBC, Lloyds Banking Group and HBOS. Lloyds and HBOS have now merged their assets, reducing the top five banks to four. Table 2 shows that the top four UK banks by value of assets had £5,815 billion of assets at the end of 2008.

The banking sector has a major role in Britain's economic growth and it has expanded far more than the national economy as a result of the financial globalisation (see Table 1). Nonetheless, the UK banks entered the financial crisis with a customer funding gap (the difference between customer loans and deposits), which reached £800 billion in 2008 (55% of GDP 2008). Half of this gap – £400 billion – is accounted for by lending to British households and companies that is backed by securitisation; the other half is accounted for by securitisations

Table 2: Balance Sheets 2008

UK Banks	Total assets	Total Liabilities	Total Equity	Loss for 2008
	Million £ or Euros	Million £	Million £	Million £
1. RBS	£2,401,652.00	2,321,154.00	80,498.00	34,373.00
2. Barclays Group	£2,052,980.00	2,016,362.00	36,618.00	n/a
3. HSBC Bank	£924,231.00	903,570.00	20,661.00	n/a
4. Lloyds Banking				
Group (incl. HBOS)	£436,033.00	426,640.00	9,393.00	n/a
Total assets top 4 banks	£5,814,896.00	5,667,726.00		
5. Northern Rock	£104,346.00	103,712.40	633.60	1,309.70
6. Banco Santander UK	€318,790.00			
6.1 Abbey	Banco Santander	–	–	–
6.2 Alliance & Leicester	Banco Santander	–	–	–
6.3 Bradford & Bingley	Banco Santander	–	–	–

Source: Bloomberg, Annual Reports 2008

sold to end-investors (Bank of England 2009). In order to fund, the banks relied heavily on the volatile wholesale markets. Thus the gap placed significant pressure on the UK banks' funding needs from the very beginning of the crisis. The fall in equity markets has contributed to this funding gap with reported writedowns by the UK banks of $110 billion (£66.37 billion at 29 June 2009) in 2008. The IMF estimates the expected write-downs for 2009-2010 to reach $200 billion (£120.66 billion, 29 June 2009), which makes it in total approximately £187 billion (nearly 13% of GDP 2008) (IMF April 2009). In comparison, by the end of May 2009, the Euro-zone large banking groups accumulated portfolio losses of just over €100 billion (£85 billion, 29 June 2009) of which €65 billion was reported in 2008. The ECB loaned banks €442 billion (£375.5 billion in June 2009) for 12 months (ECB 2009).

Table 3: UK Government's measures

Banks	Asset Protection Scheme	Bank Reconstruction Funds	Reconstruction Funds/Equity
	Million £	Million £	*percentage*
1. RBS	325,000.00	20,000	24.85%
2. Barclays Group	0.00	0.00	0.00%
3. HSBC Bank	0.00	0.00	0.00%
4. Lloyds Banking Group	260,000.00	17,000	180.99%
5. Northern Rock		UK State Guarantee Arrangements	nationalised
6. Banco Santander UK			
6.1 Abbey	n/a	n/a	n/a
6.2 Alliance & Leicester	n/a	n/a	n/a
6.3 Bradford & Bingley	n/a	UK State Guarantee Arrangements	n/a

Source: HM Treasury Press Releases 2009

To alleviate strains on the banking sector, the UK government implemented a variety of measures. All schemes have been voluntary (see Table 3). In addition, the Bank of England was prepared to provide up to £200 billion of liquidity (see Table 4) and the UK Government allocated £50 billion under bank reconstruction funds. In total it allocated £250 billion (17.3% of GDP in 2008) to assist the banking system. Furthermore, the government will protect £585 billion value of assets (40% of GDP in 2008) that the RBS and Lloyds Group placed in the asset protection scheme. But to fund future activities, UK banks will need to find alternative sources, which may be affected by uncertainty over the economic outlook and future changes to regulation.

At the time of writing, the figures in Table 4 are probably the only way of estimating what the Government reckons the banks' exposure is to 'toxic' structured assets. The overall figure can be regarded as 'realistic', because on the one hand the Government

will be seeking to minimise its exposure and, on the other, it knows it cannot be seen to underestimate the problem. But as will be seen in the next section, the UK authorities have provided far less information on bank support schemes than the US authorities have.

Table 4: Bank of England's Special Liquidity Scheme

Bank of England's purchase of:	**TOTAL Millions**
Residential mortgage-backed securities; G10 Government Guaranteed agencies debt; USA GSEs; bank and building society debt securities guaranteed under HM Treasury's guaranteed scheme; and others	£185,000

Source: Bank of England 2009

3. The US banking system

The top five banks in the US by value of assets had $8,353 billion of assets in 2008. This accounts for just over half of the US GDP in 2008. Although the US and the UK are the countries with the highest concentration of capital in their banking systems ranked in terms of Tier 1 capital (Held 2009), the top five banks in the US had a less significant role as a driver of economic growth in comparison to the top four UK banks (see Table 1).

In 2008, the reported writedowns by the US banks were $510 billion and the ones estimated by IMF are $550 billion for 2009/10 (IMF April 2009); in total $1,060 billion (7.5% of US GDP 2008). To assist the banks, the US Financial Stability Plan was announced in February 2009 as a joint initiative of the Federal Reserve System, the Treasury and the Federal Deposit Insurance Corporation. The plan targeted only those 19 banks with assets in excess of $100 billion. This decision was based on the outcome of stress-testing and an asset removal scheme, the Public-Private Investment Programme. In contrast to the EU and UK government

schemes, the US scheme TARP (troubled asset relief programme) was compulsory for all those 19 banks (see Table 6).

Table 5: Balance Sheets 2008

US Banks	Total Assets Million US $	Total Liabilities Million US $	Total Equity Million US $	Loss for 2008 Million US $
1. JP Morgan Chase&Co	2,175,052.00	2,008,168.00	166,884.00	n/a
2. Citigroup	1,938,470.00	1,796,840.00	141,630.00	27,684.00
3. Bank of America	1,817,943.00	1,640,891.00	177,052.00	n/a
4. Wells Fargo	1,309,639.00	1,210,571.00	99,068.00	n/a
5. Goldman Sachs	1,112,225.00	1,049,171.00	63,054.00	780.00
Total assets top 5 banks	8,353,329.00	7,705,641.00		
6. Morgan Stanley	658,812.00	607,981.00	50,831.00	n/a
7. Metlife	501,678.00	477,944.00	23,734.00	n/a
8. PNC Financial Services	291,081.00	265,659.00	25,422.00	n/a
9. US Bancorp	265,912.00	239,612.00	26,300.00	n/a
10. Bank of NY Mellon	237,512.00	209,462.00	28,050.00	n/a
11. GMAC	189,476.00	167,622.00	21,854.00	n/a
12. Sun Trust	189,137.96	166,749.85	22,388.11	n/a
13. State Street	173,631.00	160,857.00	12,774.00	n/a
14. Capital One	165,913.45	139,301.02	26,612.43	46.00
15. BB&T	152,015.00	135,978.00	16,037.00	n/a
16. Regions Financial	146,247.81	129,434.97	16,812.84	5,595.77
17. American Express	126,074.00	114,233.00	11,841.00	n/a
18. Fifth Third Bancorp	119,764.00	107,687.00	12,077.00	2,113.00
19. Keycorp	104,531.00	94,051.00	10,480.00	1,468.00
TOTAL	**11,675,114.22**	**10,722,212.84**		

Source: Bloomberg, Annual Reports 2008

Table 6: US Government's measures (Troubled Asset Relief Programme)

US Banks	**TARP funds received**	**TARP funds/Equity**
	Million US $	*percentage*
1. JP Morgan Chase&Co	45,000.00	26.96%
2. Citigroup	45,000.00	31.77%
3. Bank of America	45,000.00	25.41%
4. Wells Fargo	25,000.00	25.24%
5. Goldman Sachs	10,000.00	15.86%
6. Morgan Stanley	10,000.00	19.67%
7. Metlife	0.00	0.00%
8. PNC Financial Services	7,600.00	29.90%
9. US Bancorp	6,600.00	25.10%
10. Bank of NY Mellon	3,000.00	10.70%
11. GMAC	5,000.00	22.88%
12. Sun Trust	4,900.00	21.89%
13. State Street	2,000.00	15.66%
14. Capital One	3,600.00	13.53%
15. BB&T	3,100.00	19.33%
16. Regions Financial	3,500.00	20.82%
17. American Express	3,400.00	28.71%
18. Fifth Third Bancorp	3,400.00	28.15%
19. Keycorp	2,500.00	23.85%
TOTAL	**228,600.00**	

Source: Financial Times 2009

In regard to the Federal Reserve System's programmes, some of them aimed at providing liquidity directly to the banking sector in the US and abroad, while others contributed to the reduction in commercial paper spreads – Commercial Paper Funding Facility and Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility (Federal Reserve 2009). As it is shown in Tables 6

and 7, the liquidity provided by the central bank was $1,750 billion (12.26% of the US GDP2008), while the government assisted the banks with capital of $229 billion (1.6% of the US GDP 2008).

Table 7: Federal Reserve System's operations

FRS' purchase of:	Million US $
Long-term Treasury securities	300,000.00
Government-sponsored enterprise debt	200,000.00
Mortgage-backed securities	1,250,000.00
Total	**1,750,000.00**

Source: Federal Reserve System 2009

4. The Canadian banking system

Comparatively, Canada is also one of the countries with high concentration of capital in its banking system. In 2008, the top five Canadian banks by value of assets had CAD $2,711 billion of assets. As may be seen from Table 1, this accounts for around one and a half times the GDP in 2008, reflecting the banks' major role in the Canadian economy.

The conditions of extreme stress in the banking market that were observed in the US and UK did not happen in Canada, and its Government did not have to urgently assist the banks. It did insure, however, the money banks routinely borrow from other banks (Guarantees of Financial Institutions). Nevertheless, the crisis has impacted on growth and financial conditions as a result of the real and financial linkages between the Canadian and US economies. In 2008, the World Economic Forum ranked Canada's banking system as the soundest in the world (WEF 2008). Banks had smaller exposures to 'toxic' structured assets and relied less on volatile wholesale funding. Bank risk indicators have, however,

Table 8: Balance Sheets 2008

Canadian Banks	Total assets	Total Liabilities	Total Equity	Loss for 2008
	Million CAD $	Million CAD $	Million CAD $	Million CAD $
1. Royal Bank of Canada	723,860.00	693,101.00	30,758.00	n/a
2. Bank of Montreal	563,214.00	531,540.00	31,674.00	n/a
3. Bank of Nova Scotia	507,625.00	485,983.00	21,642.00	n/a
4. Toronto-Dominion Bank	563,214.00	531,540.00	31,674.00	n/a
5. Canadian Imperial Bank of Commerce	353,930.00	340,099.00	13,831.00	2,060.00
Total assets top 5 banks	2,711,843.00	2,582,263.00		
6. Manulife Financial Corporation	211,025.00	183,570.00	27,455.00	815.00
7. National Bank of Canada	129,332.00	123,823.00	5,509.00	n/a
8. Canadian Western Bank	10,600.73	9,921.58	679.15	n/a
9. Pacific&Western Bank of Canada	1,512.47	1,488.34	24.13	20.09
10. First Nations Bank of Canada	253.20	225.75	27.44	n/a
TOTAL	**3,064,566.40**	**2,901,291.67**		

Source: Bloomberg, Annual Reports 2008

risen in 2009 but are below comparable levels abroad (IMF May 2009). In addition, the central bank runs a Liquidity Scheme/ Injections in order to maintain the money market in times of constrained liquidity. It offers up to CAD $10 billion (0.62% of GDP 2008) at each market operation (Bank of Canada 2009).

Table 9: Bank of Canada's Liquidity Scheme

Term PRA for private sector money market instruments	Discontinued March 2009
Term PRA for private sector instruments	Effective from March 2009
Term Loan Facility	Effective from November 2008

Source: Bank of Canada 2009

Also the federal government will purchase up to CAD $125 billion in insured mortgage pools through the Canada Mortgage and Housing Corporation as well as up to CAD $12 billion of securities backed by loans and leases on vehicles and equipment through the Canadian Secured Credit Facility (Bank of Canada, 2009).

5. Conclusions

The substantial support provided by governments to their banking sectors has imposed a heavy burden on taxpayers while threatening major cuts in many critical areas of public expenditure. However, the shocking point in this paper is the range of vulnerability of the states exhibited by the UK, US and Canada as a result of differences in market concentration, funding sources, exposure to 'toxic' assets, regulation rules or total soundness of the system. While much has been said about the banks' problems in this crisis, the evidence here offered shows that the top UK banks had the biggest challenges, and hence that the governmental assistance was the largest in terms of national GDP.

Similarly, the UK and US financial sectors have expanded far beyond their national GDPs. The value of financial assets in the US had reached just before the current crisis were 450% of GDP and the UK assets were 440% of GDP; in the Euro-zone the figure was 356% (Sassen, article in this volume). Of those ratios, the top four UK banks' assets are valued at 402% of GDP and the UK financial assets are highly concentrated in a few banking groups, while the US top five banks' assets are valued at 58% of GDP. In 2008 in the US there is higher competition and dispersion of activities among all organisations that provide financial services, including shadow banking. It is undeniable that there are problems in the US banking system, but the competition itself diversifies the financial markets. The US government had to intervene with capital assistance of

1.60% of GDP, while the UK government allocated 3.45% of UK GDP in 2008. The Canadian government did not have to bail out the banks, so the taxpayers are arguably better-off.

In this crisis, the links between the public and financial sectors have increased radically to a point where sovereign risk is identified as a financial stability concern. Governments cannot continue raising the public financing costs further because of potential fiscal crisis and also of impacts on bank funding costs. Especially in the United Kingdom, the liability of the state is under question. Thus another crisis will be unaffordable from taxpayers' point of view.

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4

Some Inconvenient Truths

Mark Field, MP

As a tumultuous tsunami continues to engulf the financial services and political worlds, I will cautiously anticipate what might lie ahead for the City of London. I shall also examine the prospects of its retaining a continued global role as the UK tries to rebuild its economic fortunes in an environment where correcting the global imbalances of the past decade or so set a template for the future. It should be first understood that the banking crisis that unfolded represented nothing unusual. Indeed, it signalled the end of another in a long line of boom/bust cycles (positively commonplace in the second half of the 19th century) caused by speculative euphoria and an excess of credit.

It has been in the UK Government's narrow interest to present this as being an entirely unprecedented type of downturn caused

by modern financial alchemy gone wrong, failure by regulators or rank unforeseeable misfortune. This is not so. It is true that the global nature of the economic crisis has made things worse. But there are also clear lessons we can learn from the past. One of the grand old names of British banking, Barings, collapsed owing £780 million as recently as 1995; today the Royal Bank of Scotland survives courtesy of a £26 billion bailout. But it is only the extent of the economic downturn, not its cause that is so very different.

The UK economic downturn began when household debt and housing bubbles simultaneously burst. House prices rose 88.5% in the decade to 2007 – even in the sub-prime enhanced US this index rose by only 64.5%. UK average household debt leapt from 105% in 1997 to 177% of disposable income a decade later – in Europe and the US both the overall levels and increases during this period were significantly lower. The toleration and promotion of these debt bubbles alongside the growth in financial services and property industries was an integral part of the Government's narrative of creating an economic miracle. It had long since given up on encouraging old-school manufacturing and needed to find favour amongst middle-income Britons to secure electoral support.

The first decade of the Labour Administration seemed for so long like the best of times. However, in its complacency it planted the seeds of catastrophe. Consumer consumption in the US and Europe was maintained by unsustainable levels of public and private debt. The dotcom revolution was heralded as a 'new paradigm', so whilst almost imperceptibly the wages of middle-income earners stagnated, consumption in a low-inflation, low-interest rate economy remained apparently robust. In truth – as we have seen – Gordon Brown's 'new' economy was sustained by an old-fashioned private and, over time, public debt bubble. Cheap mortgages remained eminently affordable by virtue of the deflationary effects of China and India's emergence on the global economic scene.

The Clinton Administration's deregulatory policies promoted a love affair with home ownership in the US previously seen only in the UK. Millions of families – including latterly many of the sub-prime borrowers – were able to clamber for the first time onto the property ladder. For so long as the housing bubble inflated, this new breed of property owner was able to borrow yet more on the back of rising house prices. Naturally this also happened with a vengeance on these shores, as became startlingly apparent with the demise of Northern Rock.

As the level of private debt reached dizzy heights the financial risk to the general taxpayer of widespread default suddenly got a whole lot more serious. As it is now clear, there was good cause for retaining the distinction between retail and investment banking, which in the US at least existed for over six decades until the repeal of Glass-Steagall in 1999. Little did we know that the inherent risk of investment banking was to be transferred not to retail banking depositors but to global government balance sheets. Instinctively bankers understood this and once their institutions became too big to be allowed to fail, they had precisely zero incentive to minimise danger.

So where does the City go from here? Technically the worst of the economic recession may now be behind us, although it would be premature to conclude that a 'double-dip' recession is not on the cards as the effect of the stimulus dies off in the early months of 2010. There will be several pressing issues that will emerge in the months ahead in our financial heartlands. First, two of the big four domestic banks are all but fully nationalised. One, Lloyds Banking Group (LBG), contains 'assets' from HBOS which engaged in a series of balance sheet boosting debt-for-equity deals during the boom years in the middle of this decade. As a consequence, LBG has large holdings in a swathe of leading UK companies. Doubtless many such household names will require refinancing as the downturn proceeds. Such financial rescue will

come from the taxpayers' coffers – in short, before long large parts of mainstream corporate UK will be effectively nationalised.

Second, there will be a need to use smarter intelligence to nip regulatory problems in the bud. An enhanced role for the Bank of England must be accompanied by the appointment of high-calibre, respected professionals in its top roles. This should be augmented by the emergence of prosecutors with US-style status in place of a Serious Fraud Office, which lacks respect from the public and finance professionals. Nothing less will restore confidence from market professionals and trust from the public at large.

Turning to the banking bailouts, I fear they may have proved an expensive failure. The lesson we must learn is that any institution deemed too big to be allowed to fail will forever be prey to reckless risk-taking. If banks cannot fail, they cannot be effectively regulated, for regulation requires the eradication, not reward, of recklessness. The operation of capitalism requires corporate failure. This is not 'market failure': it is a sign that capitalism is working properly. Instead the message that banks will not be allowed to fail only serves to make their effective regulation all but impossible. Regulation creates barriers to entry and favours large corporations over smaller start-ups. The wisest policy option should be to create smaller, more competitive financial institutions. Manifestly, nationalisation takes us in precisely the wrong policy direction. The best form of regulation must be open competition; public ownership – other than on a strictly temporary basis – is anathema to this policy goal.

Looking back to the autumn 2008, the conventional wisdom has been that the heightened phase of the economic downturn came about as a result of the US Government's decision to allow Lehman Brothers to collapse. But letting a leading bank like Lehman fail will in time, I suspect, not be regarded as a mistake at all. For by nationalising banks, governments have protected not only depositors (unarguably essential in preserving trust in a

market economy) but also bondholders. The latter's interests have been preserved at the expense of taxpayers, present and future.

The current consensus supporting Quantitative Easing will find less favour as time wears on. With little evidence that the velocity of money within the economy is any less sluggish as the real recession takes hold, printing money in vast quantities increasingly seems like a desperate last throw of the governmental dice when nothing else has succeeded. Inflation is clearly not an immediate problem, but mark my words, this unprecedented pumping of money into the system is certain to be inflationary. History suggests that an unsustainable mini-boom will be on the cards by the end of 2010, but stagflation (a toxic mix of inflation, rising unemployment and low growth/diminished competitiveness) will follow. Indeed the commodities and futures markets are already factoring this in when pricing for the early years of the next decade. Moreover, the Government has probably not seen the back of the problems it has recently experienced in trying to sell gilts as Britain's credit rating is hammered in the global capital markets.

How then to deal with the toxic assets that banks still hold and find so difficult to quantify? Curiously enough, the UK has a template close at hand. The near-collapse of Lloyds of London was avoided around twenty years ago by the creation of a government-backed Equitas fund. This experience should be the starting point for consideration of any further large-scale government-backed rescue expenditure. In fairness the government has begun down such a path, although British taxpayers should all be fearful of the ultimate overall cost.

Turning to the wider issues that will affect the City's prospects, the colossal trade imbalance between the West and China will no doubt make its mark on future competitiveness. Since the late 1970s the UK and US have borrowed incrementally more and exported ever less while China, especially since the mid-1990s, has built up a huge current account surplus. Arguably, it is

these imbalances rather than inadequate regulation that have been the cause of the economic calamity that has beset the global monetary system. A new international framework to secure stability in the management of global trade and the flow of money within the world economy is now overdue.

The legitimacy of western capitalism has always been bound up in the idea that it can best deliver prosperity to the masses. But as jobs and money have been sucked eastwards, that mass prosperity – for the West at least – may no longer be guaranteed. The competitive edge the US and Europe have over China and India in financial services, technological development and scientific research may just as easily be taken from the West. China is churning out millions of industrious, well-qualified graduates. As it controls stakes in so many western corporations, it is also able to transfer and copy intellectual wealth with ease. Soon the powerhouses of Asia could be undercutting Western labour not only in manual jobs but also white-collar and the most highly qualified management positions.

To this declining competitiveness the UK's enormous public spending problems have to be added. For every £3 raised in taxes, the Government is spending £4. This cannot remotely be regarded as investment – it is consumption plain and simple. The billions being borrowed now will be repaid by future generations in the form of higher spending and taxation, higher inflation and reduced living standards. To do the right thing in the years to come will not be a politically easy option. Any UK government that is regarded as popular in 2011 and 2012 will probably not be administering the right economic medicine. If public services begin to be cut and taxes rise, the clamour for a less favourable taxation regime for the financial services and those with lucrative jobs in the banking sector will surely intensify. This could make the City of London an increasingly unattractive location for the globally-mobile financial services industry.

Alternatively, should political leaders prove unwilling to face up to the stark facts of the long march back to fiscal balance and economic recovery it may be necessary to bring in the IMF. What better way to encapsulate the power of the quangocracy that has been built up for a political class unwilling to take responsibility or court unpopularity than to bring in a neutral umpire to make the really tough economic decisions? The City's ambitions in this type of scenario would inevitably be clipped.

In cold reality, the UK is a medium-sized economy primarily reliant on a hitherto booming financial services industry, and as a consequence it will remain vulnerable for some time to come. This vulnerability will, of course, significantly affect the City's ability not only to play a global role in financial services but also its chances of operating relatively independently of the state. The price for our collective indebtedness may be for the UK to watch with increasing impotence as it becomes our turn to suffer as the rules of the global trading game are changed to our detriment.

The West's hope that it can assume continued dominance in the 'knowledge economy' may prove optimistic. Within the next twenty years, it is quite likely that the intellectual property (IP) rights that have underpinned the West's competitive advantage (licensing, patents, copyright protection) will seem overdue for a radical, philosophical shake-up. An ever more assertive China will argue that traditional IP structures are no more than the West's attempt to impose its own form of protectionism to suit its particular demographic profile. We should not assume that the dominance of 'our' values in determining global trade will remain unchecked.

In the long term it may prove necessary for the UK Government to make a strategic decision as to the direction of the economy: whether to gamble our future on the possible resurrection of the financial services industry; alternatively, going it alone as a beacon of dynamism, or whether to diversify the economy and – implausible as it may sound today – tie the country's future

more firmly to Europe in the hope that the strength in numbers approach will partially shield us from the stiffest of economic competition from the East.

In looking at both of these options, the City will play a crucial role. But it is likely that in either scenario the strictures of our domestic situation and the colossal changes that have taken place in the UK banking system will make it ever harder for the City to dictate the terms of its place in the British and global economy.

5

Why Financial Regulation Is Essential

Mića Panić

'Those who do not remember the past are condemned to repeat it.'
George Santayana, 1906

Who is responsible for the present crisis?

'Greed and arrogance of the banking sector' seem to be universally regarded as the main cause of the current global financial and economic crisis, the worst since the 1930s.

The problem with this view, as with all oversimplifications, is that it ignores an important fact. There are banks even in the US and the UK that have survived the recent financial 'meltdown' without the need for bailouts from the rest of society. The general

label of greed and social irresponsibility is, therefore, not only unfair to many bankers. It diverts attention from a question that is of critical importance for solving the present crisis and minimising the risk of similar systemic problems in the future: what has made it possible for banks that have blatantly disregarded accepted standards of responsible, prudential banking to engage in activities which have imposed heavy economic and social costs on millions of people around the world?

Unscrupulous, greedy, socially irresponsible individuals are as old as the human race. Yet the world does not exist in a permanent state of crises, systemic breakdowns and conflicts for the simple reason that all stable, successful societies enact and observe the laws, rules and sanctions that prevent and, when it happens, punish anti-social behaviour.

Banking regulations are essential for the same reason: to prevent such behaviour in one of the key economic sectors by protecting prudential banking standards and the society from 'rogue' bankers and financial practices. It was to achieve these objectives that wide-ranging regulations were implemented in all advanced economies in response to the Great Depression in the 1930s.

It should come, therefore, as no surprise, that a concerted, global effort to reverse the institutional changes and policies introduced after the Second World War was bound sooner or later to recreate the kind of conditions that were responsible for the Wall Street Crash in 1929, the Great Depression, social conflicts and political extremism common in the 1930s. Yet this is precisely what those behind the neo-liberal counter-revolution since the end of the 1970s have been doing in their myopic and, ultimately, self-defeating pursuit of narrow personal and corporate interests.

The 2008 financial crash: important warnings that were ignored

Now that one of the worst economic scenarios has materialised, those of strong neo-liberal persuasion – including many financiers, businessmen, economists and political leaders – continue to claim 'complete surprise' and 'bewilderment' at the suddenness and scale of the current global financial crisis. If true, this raises serious doubts about their professional competence, as there have been numerous warnings over the last thirty years that, thanks to a number of serious weaknesses inherent in an unregulated international financial system, the frequency and intensity of banking crises were increasing. What is more, it was also clear from these warnings that, because of unremitting deregulation and globalisation, they would continue to do so.

In the 1990s the International Monetary Fund (IMF), a strong supporter and enforcer of deregulation, reported that between 1980 and 1996 almost three-quarters of its members (133 out of 181 countries) had experienced major banking problems. In 36 of these countries the problems reached crisis proportions. The rest experienced 'significant' problems. At the same time an IMF study comparing financial crises before and after 1950 concluded that banking crises after the second half of the 1970s were without precedent in their frequency and size. (See Panić 2003, chapter 9.)

It was also clear from the experience of individual countries over the period that the economic and social cost of resolving major banking crises would be substantial. For instance, the overall economic cost in developing and transition economies during the 1980s and early 1990s was put at $250 billion. As a proportion of individual countries' GDP, the resolution costs ranged between 10 per cent (Japan, Tanzania and Hungary) and 55 per cent (Argentina).

The social cost is also considerable. The International Labour Office (ILO) estimated in 1998 that in those Asian countries where the banking crisis in 1997 was particularly severe 10–20 per cent of the population would fall into poverty. As the level of absolute poverty was already high in many of these countries, the ILO expressed concern that they would experience major long-term social problems (Panić 2003: 209-10).

More specifically, failures by individual banks (all highly publicised at the time) revealed areas of institutional vulnerability, such as those listed below, that could easily make even large transnational institutions insolvent. And, as the recent experience and unprecedented bailouts have demonstrated, it has not taken long, once these weaknesses were transmitted globally, to produce the worst financial crisis since 1929.

- The Korean crisis in 1997 proved that regulated banks were much less likely to become involved in highly risky, speculative activities than those that were unregulated or 'lightly' regulated.
- Early in the 1982 and 1997 crises central banks of advanced economies were astonished by the extent to which large banks were unaware of the full scale of their exposure in the countries and markets where the risk of default was high.
- The failure of Baring Brothers in the 1990s, avoided ten years later by the American giant AIG only thanks to a massive bailout by US Government, showed clearly the need for close collaboration between regulatory authorities of different countries. The Baring Brothers demise was caused by speculative bets in its Singapore branch that went wrong; and AIG almost met the same fate because of heavy losses by its Financial Products division in London.
- Collapse of the Bank of Credit and Commerce International (BCCI) in 1991 exposed the risks inherent in large financial institutions that are mainly owned by a small country and

based in the same or another small country (Abu Dhabi and Luxembourg, respectively, in this case). The reason, as Iceland has shown recently, is that small countries will lack the resources to supervise global operations of their large banks and, if the banks fail, to protect their depositors.

- The bankruptcy of Swissair, for many years a successful international airline, in 2001 showed clearly the danger of expecting all non-executive directors, or in this case the Supervisory Board, to have the knowledge, time or inclination to supervise effectively actions of senior executives in organisations in which they are not involved full time.
- The collapse of Enron in 2001 revealed the extent to which large organisations are vulnerable to deception, corruption and fraud in the absence of effective control by shareholders – an important aspect of internal control that tends to decline progressively with the size and complexity of such organisations. It also exposed the risks involved in the belief that all accounting firms and credit-rating agencies can be relied on to provide accurate information about the performance and viability of a large financial institution.

All these problems have played prominent roles in the present crisis.

Deregulation, globalisation and 'too large to fail' oligopolies

The case for financial deregulation rests on the belief that it will increase competition and, in this way, stimulate innovation and greater efficiency making everyone better off. The problem is that if the conditions, which those who expect deregulation to produce, either do not exist or change radically the outcome will be very different. This is particularly true of financial systems where, in

the absence of effective regulation, national and international crises have been for centuries both common and costly (Kindleberger 1978; Reinhart and Rogoff 2008).

There are three major reasons for this: diversification into unfamiliar markets and countries; low capital to debt ratios; and the growth of giant financial oligopolies.

Financial deregulation makes it possible for banks and other financial institution to diversify into unfamiliar areas of activity in order to minimise the risk of failure and exploit new opportunities. As the advocates of deregulation and 'free markets' predict, competition intensifies; and, as they also predict, innovation becomes essential for the survival and success in a highly competitive environment. The result is proliferation of new financial instruments like derivatives.

What they either do not realise or deliberately ignore, because it is in their interest to do so, is that many of the new financial instruments created under these conditions are likely to be of a highly speculative nature and to grow to a size that, as the Turner Review (FSA 2009: 49) concluded, cannot be justified 'by the value of [their] service to the real economy'. In other words, far from reducing the risk of banking and systemic failures, many of the innovations increase them by turning banks into what some critics have called 'betting shops'.

The argument used to justify deregulation also ignores the possibility that by making it relatively easy to raise capital, both short and long term, it is likely to encourage some banks, particularly large ones, to hold inadequate capital reserves relative to their debt. As a result, if the financial and economic conditions suddenly deteriorate, as happened in 2008, these banks will be unable (a) to meet their debt obligations and (b) to provide credit that the economy needs to sustain high levels of activity. The ensuing 'credit crunch' will do more than bring economic growth to a halt. In the absence of government intervention the level of economic

activity will contract, as it did in the 1930s, into a deep depression – with the risk of social disorders and political extremism that frequently accompany market failure on such a scale.

Liberalisation of international trade and capital movements, and the subsequent 'globalisation' of economic activity, increase significantly these risks by reducing the regulatory effectiveness of national economic institutions and policies without replacing them with an equivalent system at the global level. Hence, globalisation under these conditions leaves the world without an institutional framework capable of preventing financial crises, economic slump, high unemployment, large and growing inequalities of income and wealth within and between countries that often provoke armed conflicts. (See Panić 1988 and 2008.)

One consequence of the continuous failure by the international community to agree on a common framework of institutions and regulatory policies is that removal of national controls on cross-border capital movements will give banks almost unlimited opportunity to diversify into unfamiliar areas of activity and even less familiar countries. In a world that consists of a large and growing number of independent states, there will always be great differences in their size, level of development, history, culture and institutions. Given this diversity, individual counties are bound to have different needs and priorities, which invariably require also different policies. Moreover, in a dynamic world economy national problems and priorities and, thus, policies are highly unlikely to remain static for very long.

All this is bound to increase macroeconomic instability and shocks, especially as countries often pursue uncoordinated, incompatible policies. The frequency of global financial and economic crises becomes, therefore, unavoidable. Deregulation and globalisation contribute also to greater intensity of such crises by providing a strong incentive for expansion of individual enterprises and, in this way, for the control over large global

resources to be concentrated in a relatively small number of financial and other corporate entities.

The incentive for corporate growth under competitive conditions comes from the instinct of self-preservation as much as a desire for greater wealth, power and influence. A large, highly diversified corporate entity can subsidise losses in one area with profits from another area. The larger the size of an enterprise the lower is the danger of takeover by a more successful competitor. Finally, the more transnational a bank is the easier it becomes to avoid restriction on its freedom of action imposed by the country of origin or any other country.

The American giant AIG provides a good illustration of the power and influence that a large transnational financial institution commands and, equally important, the large social risks and costs that go with it. (See Saporito 2009.) It is one of the largest public companies in the world. In 2006 its sales amounted to $113 billion and it employed 116,000 people in 130 countries, including China. 81 million people around the world had life insurance policies through AIG with an estimated value of almost $2 trillion. The list included tens of thousands of farms, hospitals and various non-profit organisations. It insured 180,000 entities which collectively employed 106 million people in the US alone. AIG also insured every infrastructure project in the US; and it managed seven million retirement savings accounts.

Yet this huge and highly diversified organisation was brought recently to the brink of collapse by actions of a small group of people in its Financial Products division!

As the AIG has survived only thanks to a huge bailout by the state, it is legitimate to ask whether corporate enterprises should be allowed to grow to the size at which, instead of minimising it, they actually increase the cost of failure not just to those directly involved but to the whole society. There are three important reasons for this.

First, they become too large, too diversified and spread over too many countries to manage and control effectively. The President of the New York Federal Reserve warned in a speech in the early 1990s that 'virtually all of the most serious trade-related losses [by banks] have involved internal control breakdowns' (quoted in Kinsella 1995: 3). Nor is the problem confined to banking. Almost 20 years later, in 2009, the Chairman of the US Federal Reserve Bank attributed the AIG failure to the fact that it had 'exploited a huge gap in the regulatory system. There was no oversight of the Financial Products division. This was a large hedge fund, basically, that was attached to a large and stable insurance company' (quoted in Saporito 2009: 18).

This raises two questions of critical importance for corporate governance and optimum size of oligopolies. Did those running the company have all the necessary, up to date information about actions of the hedge fund in their midst? And if they did, did they understand fully the high risks involved in the fund's operations?

Second, they become so large that they can withhold and manipulate to their advantage information on which key decisions at both micro and macroeconomic levels depend. Large oligopolies are an important (in many cases the most important) source of revenue for many professions and organisations on which the whole system relies for its functioning and ultimate sustainability: accounting firms, rating agencies, media, law firms and others. As a result, some of them become too dependent on the large clients to risk exposing their highly risky, speculative, even fraudulent, dealings and managerial incompetence and negligence. A number of well-publicised cases in the US over the past decade show that such systemic failings are by no means confined to a few isolated cases. The danger of collusion driven by self-interest may also influence the relationship between financial institutions and their non-executive directors. Such directors derive substantial material rewards, prestige and influence

through their association with large, internationally known corporate entities.

Finally, they become too large to fail because of the social costs involved. The Chairman of the US Federal Reserve Bank made this clear in his justification of the bailout of $180 billion given to the AIG: 'We have no choice but to stabilise [it] or else risk the enormous impact, not just on the financial sector but on the whole US economy' (quoted in Saporito 2009: 16). The need for this and a number of similar bailouts attracted even more criticism when it became known that hundreds of millions of US dollars from the bailouts were pocketed, in the form of payouts for some and retention bonuses for others, by executives responsible for the failure of these institutions.

This raises a question of fundamental systemic importance. What is the size beyond which a financial institution or any other private corporate entity (a) becomes too large to be owned and controlled privately and, consequently, (b) has either to be broken up into *independent* units that are not, for social reasons, 'too large to fail' or to pass under public ownership and control? No society, especially in a democracy, can be expected to accept responsibility for the cost of a corporate failure unless it also has full control over its activities and all the benefits that arise from them.

Protectionism: its likelihood and consequences

It is clear even from the brief and cursory analysis so far that without radical, far-reaching systemic reforms the cost of major financial crises and the economic, social and political problems that they invariably create is going to be considerably higher in this century than anything experienced since the beginning of the Industrial Revolution.

There are several reasons for this:

First, economic links and, consequently, interdependence between regions and countries are far greater now than ever before. As a result, no country can solve its economic and social problems without active co-operation and support from other countries. In other words, the interdependence reduces the effectiveness of *national* macroeconomic stabilisation policies.

Second, dominant oligopolies in finance and other spheres of economic activity operate globally and control vast resources that give them the power to play a major role in influencing economic and social policies even in the largest economies. At the same time, when it comes to advancing personal interests, those running them increasingly show little or no allegiance to any country or social group. Moreover, in many cases, as recent experience shows, they seem to be unaccountable in practice to anyone – including the shareholders.

Third, national governments in advanced economies are probably in a weaker position now than at any time since the heyday of *laissez-faire* capitalism in the 19th century to compensate for corporate excesses and failure with effective welfare policies. As their ability to tax large corporate oligopolies is very limited, they have inadequate resources to meet basic requirements of a modern welfare state. Yet, as German social conservatives, including Bismarck the country's dominant political figure at the time, realised in the 1880s adequate welfare provisions are essential for survival of the existing socio-economic order in advanced industrial societies. (See Panić 2005.)

Finally, international organisations, like the IMF, have neither the authority to supervise (even less to regulate!) actions of international oligopolies and national governments nor the resources to deal with the aftermath of major financial crises and their economic consequences. Moreover, as they have contributed to the present crisis through the conditions attached to their membership and financial support that they give to individual

countries, it is highly improbable that the IMF, in particular, would pursue different policies in a more regulated world without substantial changes in its organisation and responsibilities.

Not surprisingly, each of these threats to international prosperity and order features prominently among the fundamental changes that enjoy strong public support globally.

According to the surveys of international public opinion reported regularly by the University of Maryland, people around the world want major reforms in the ways that their national economy and the international economic system are run. The support for such reforms is particularly strong in the US (75 and 64 per cent respectively) and in Western Europe (e.g. 73 and 76 per cent respectively in the UK). (See World Public Opinion 2009.) More specifically, there has existed for some time now (World Public Opinion 2008a) an equally strong global consensus in favour greater government regulation of large companies in order to protect the rights of investors (54 per cent), consumers (73 per cent), workers (74 per cent) and the environment (75 per cent). There is also world-wide support for the view that it is the responsibility of national governments to ensure that the basic needs of their population in healthcare, food and education are met (World Public Opinion 2008c).

What should be of particular concern to governments around the world, including those in major industrial countries, is the fact that although three-quarters or more of the population (83 per cent in the US and 77 per cent in the UK) say that their country 'should be run according to the will of the people', an almost equal number think that it is 'run by a few big interests' for their benefit rather than 'for the benefit of all people' (80 per cent in the US and 60 per cent in the UK). (See World Public Opinion 2008b.)

There is, clearly, a potential threat to the existing social order and political stability in such a high, widely shared, level of public dissatisfaction – especially in those countries where the political

establishment is pursuing policies designed to push back 'frontiers of the state', with the aim of reducing the role of government to little more than that of a 'night watchman'.

Widespread dissatisfaction with the international economic order and the threat of a global retreat into protectionism is equally serious. Yet, judging by past experience, one outcome is virtually certain: if the international community fails to solve in the near future current economic problems collectively – growing social problems and political instability will leave an increasing number of countries with little choice but to try, as in the 1930s, their own solutions behind protective barriers. The risks and subsequent costs may be substantial. Nevertheless, a significant majority of their population is likely to support such a course of action fearing that the long term cost to them personally of trying to protect an unsustainable *status quo* would be far greater.

There is, however, an even more important reason why reforms of national financial systems and the international economic order cannot be delayed for long. The world in 2009 is not only very different from that in the 1930s. It is also, *collectively*, confronted with challenges that are historically unique. The long term consequences of a breakdown in international co-operation would make it virtually impossible to mobilise in time world opinion and resources to deal with the most urgent of these challenges that will affect *everyone* in this century and beyond: rapidly growing world population, resource depletion (including that of water) and global warming.

For all these reasons, the stakes involved in solving current financial and economic problems are exceptionally high – higher than most political leaders, including those in G20 countries, seem to realise.

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6

Can Banking be the Gateway to Social Development?

Jocelyn Pixley

Introduction

Walter Bagehot was fond of accusing Lombard Street banks of losing money from being too gullible and too trusting and, in rejecting all warnings, of acting foolishly. Although such 19th century failings are far more impersonal today, Bagehot was even then talking about banks, *not individuals*. So too, Mark Twain's well-known analogy to the destructive and constructive practices of banks is relevant to today's banking crisis as well. His 'umbrella theory of banking' asked a metaphoric question bitter from his own recurring losses: Why did banks lend out millions of umbrellas on sunny days, and recall them all at the onset of rain? After creating unsustainable amounts of credit-money for so many *incredible*

ventures up to August 2007, banks refused to lend just when money was most needed for socially vital purposes. A full two years into the present crisis, after unprecedented bail-outs for a number of British and American banks, the banking sector is unrepentant.

This chapter looks at the primary aims of banks. Nearly everyone assumes that banks are responsible to the owners and, since banks have behaved so badly, it is up to the owners to hold them to account more rigorously than before. And yet, the idea that shareholders own financial institutions and 'should' control them is not so clear-cut as is often thought. With this latest financial crisis, Bagehot's line (1873) that banks rely on trust, between themselves, their debt-holders, depositors and the public, and need *discretionary state support and firm public control* when that trust collapses, is obvious. Shareholders, it turns out, are not banks' main responsibility but rather, the debt-holders (Pixley 2004: 133-5). The holders of bank shares suffer if banks aim to maximise share value through short-term mechanisms like ill-considered loans.

In teasing out this problem, it is helpful to revisit two abstract arguments that have been all but lost in recent years. The first is that banks are special, because they are not like any other firm. Banks have a primary responsibility to their debt-holders and depositors (that is, *creditors*) even though banks lend/create money from deposits many times over, to such an extent that 'credit operations' of many kinds play an 'essential' role in 'the capitalist engine' of financing new development (Schumpeter 1954: 318; 1934: 70-4). When banks abuse depositors' trust by ignoring the 'limits' to 'pumping credit means of payments' into this engine (Schumpeter 1934: 114), conflict rises; sometimes credit creation is not for future socially-productive purposes. Everyone exits, even in one day. Such banks cannot *remain in business* and one collapse often affects others whether weak or strong. Governments (usually central banks) must step in, to try to

restore public trust in the money created by banks, because markets cannot sustain the creation of credit by private financial institutions when as unconstrained as it was between 2000 and 2007. That was Bagehot's message, not properly heeded to his fury with the 1844 Act (see Pixley 2004: 11).

In these bail-outs, governments borrow from their own creditors. But, as Geoffrey Ingham argues (2004: 49, 79), although a state authority is a necessary condition for money's existence, the major state creditors do not always *believe* that their dividends are secure, except through taxes on populations and fiscal prudence. When a financial crisis becomes a general economic crisis, the authorities face a dilemma. On the one hand, central banks have little option but to 'accommodate' the 'near money' created so foolishly by the private banks, by accepting, that is, buying the banking system's private promises to pay with sovereign state 'high-powered' money – namely the relevant countries' currencies (Ingham 2004: 135; Minsky 1985: 47). On the other hand, in printing money to 'accommodate' this private money, governments run the risk of their own creditors', that is debt-holders', strike (for example, contemporary China and other creditors to the USA). High-powered money is more trustworthy than private credit-money, because of governments' coercive powers of compulsory taxation. Yet if inflation rises, in particular, major creditors also demand public sector cut-backs (fiscal prudence) to maintain control over their loans to governments (as creditors see it). This is the democratic deficit of money with weak governments, because a strong appeal to the general population to sell state bonds and levy specific taxes for popular, productive state ventures could give governments some independence from the controlling inner sanctum of money. Governments would then be ruled by their electorates.

The second argument follows from these socio-political conflicts in maintaining money in a more or less stable form. And

that is, those who *own* shares in banking corporations are less important than governments and their major creditors, major debtors who create productive private ventures, and creditors/depositors and the wider community which support the private banks – under tax-compulsion in these tortured processes.

These related arguments seem self-evident and yet, the chances of decent public debate on arrangements that might help banks meet the needs of citizens and promote economic development are slim. That would be a pity, because the aim for share-owner value that has dominated corporate policy since the 1970s is now correctly facing significant criticism. But, if banking has no aim or defined lines of responsibility beyond competing for market share, it is difficult to see how that would restore money's credibility. Perhaps the banks will get away with their deficit to citizen-taxpayers and continue to enjoy their free lunch in creating unconstrained credit-money until, again, that becomes unsustainable. But another looming problem is the global nature and 'heavy lobbying role' the US banks have taken against the Obama Administration's June 2009 regulation proposals. Not only is it 'conceivable that banks will be able to create other instruments to 'manage their risk' that will escape the attention of regulators' (Hughes 2009: 17). In addition, and despite the mess created by Lehman's products in Amsterdam as its complicated bankruptcy proceedings show, Goldman's has already begun hatching 'new deals' in Ireland, another country with tax benefits for regulatory arbitrage. On 11 February 2009, the 'Goldman Sachs Financial Products Europe' was registered 'to sell notes that seem similar in structure to the ones sold by Lehman' across Europe and Asia. That is not auspicious, because thousands of customers claim that they were misled by Lehman's products, and Hong Kong officials alleged on 28 April 2009, 'that some banks sold minibonds to mentally ill investors'. This 'high finance for the masses' included enticing small investors – in reality 'savings bank

customers … with free digital cameras and flat-screen televisions' (Henry & Goldstein 2009: 62-3).

So, banks still enjoy government bail-outs, guarantees to depositors or at least support (from the state). Yet it seems that we could face a situation of 'government-free' banks, with no clearly-defined responsibilities to any community. With less effective rules even than before, global cross-border banks could require another bail-out some time soon (Plender 2009; Guha 2009). But what entity would or could bail them out next time to restore trust? Which currency would be used, from what countries' taxpayers and bondholders? It is unlikely that fear – 'too global to save' – would discipline footloose managements, especially because the IMF worried in June 2009 that these banks were 'too connected to fail' (Espinosa-Vega 2009). And it is necessary but not sufficient to argue that banks should be cut down in size, to reduce the 'too big to fail' problem, because the lines of responsibility are more important. Hundreds of small banks can also act globally and irresponsibly *in tandem*, as the huge Citigroup and Goldman Sachs do today. But at the time of writing, although Adair Turner, Chair of the FSA did suggest in August (*Prospect* 2009) that the City was perhaps too influential, the pros and cons of bank size is the focus of regulators: 'Just as Barack Obama stood to outline the US Federal Reserve new oversight powers over financial institutions deemed 'too big to fail', Bank of England governor Mervyn King was on his feet calling for a radical scrapping of the 'too big …' concept in the UK' (Mumford 2009: 23, 25).

So, I will explore this vexed issue and in doing so, suggest that this is not a purely economic problem. If banks and their creditors produce destructive recessions that affect social life as a whole and, when times improve, demand that governments (and banks) play little role in satisfying the social wants which are 'consciously asserted by the whole community' (Schumpeter 1908-9) – except to bail out banks the next time, then something is wrong. This is

not simply a situation of 'state capture', because government rules require extreme types of competition between banks. These show that most governments have been captured by neo-classical economic policies whose orthodox nostrums are important for a performative role in smoothing over the social conflicts of money between major creditors and debtors (Ingham 2004: 148-9). Governments are called to task by their major bondholders if they try to act democratically or fairly. Meantime, the banks lobby governments to defend their patch, however counter-productive for the financial industry (let alone for the rest of us, the winners and mostly losers, as revealed in the recent crisis). Competition produces highly aggressive oligopolies and imprudent, often mendacious behaviour. Under competition to sell 'risk', the 'best' do not rise like the cream to the top, rather even some reputable banks are reduced to selling the fiction that obligations and promises are simple commodities (with obscure acronyms, such as CDOs). It is then, difficult to see an open, democratic consensus arising from this likely future mess, but there are important issues worth raising whatever the outcome.

Why are banks 'special'?

The first problem, barely debated since the crisis, is that banks are very different institutions from other kinds of corporations. They have huge liabilities, tiny capital reserves and confidence is imperative for their functioning, especially in societies where the entire public must use banks (although as Viara Bojkova's analysis of bank assets in this volume makes clear, not all banks engaged in reckless practices). This point is made strenuously by Wall Street conservative Henry Kaufman (1986: 51), among others. He challenged the neo-classical policy mantra since the 1970s that all corporations were the same, with a sole purpose of making profits

for their owners. Against this example of policy capture (notable in English-speaking countries), Kaufman insisted that the role of financial institutions should be defined 'properly': *banks are not like any other firm* he said. Unlike a firm that makes tables or offers restaurant services, the extreme view is that 'all bankers are liars' (Tasker 2009). Banking is undoubtedly a confidence game relying on trust that depositors can take their money out at any time they want. It is not *quite* a lie, since banks *usually* lend to each other (for example, consider the role of London Interbank Offered Rate – LIBOR) to keep withdrawals within safe boundaries – and rely on central bank overnight lending to balance their books. The con trick is revealed when everyone demands their money at exactly the same time. In competing for market share, banks copy each others' tactics and each can guess how much everyone is 'over-stretched'. Suddenly LIBOR shows how precarious money is, when this lending ceases or the rate becomes exorbitant, as it did with Bear Stearns in March 2008 and Lehman's bankruptcy in the following September. LIBOR is the enactment of how much trust and distrust is perceived between banks. A run is the enactment of public distrust.

When trust is high, banks lose sight of their depositors. Many depositors are anyway borrowers for, in a counterintuitive sense, banks operate by creating money from loans – in Joseph Schumpeter's words 'loans create deposits' (1954: 1114). Loans are deposited far more than savings, and lent out over and over again, over different timespans, for a fee, among many banks. These loans create more money through layers and layers of deferred promises to pay which stretch into the future. Such inter-connections between banks and their collective role in development (or not) are the key to banking practices, which is not publicised very often and bears no relation to the neo-classical economic story.

In effect, banks must be secretive because they need blind faith from the public, not just trust. On occasion the 'lie' can be

uncovered through no lack of prudence by a bank. At the end of a saccharine movie called *Mary Poppins*, a little boy causes a run on a bank. He is standing with his well-dressed mother at a teller's counter and, in a piping voice, asks why Mummy cannot withdraw her money. Everyone hears and within minutes the bank tries to close its doors. Such a mistaken rumour was not the case with Northern Rock in late 2007. It was 'overstretched'. Worse, the Bank of England foolishly tried to patronise depositors by claiming their panic was irrational: didn't the public anyway know that the Bank would act as 'lender of last resort'? That arcane term became cause of more withdrawals, given that the last run on a bank in Britain was in 1866 and few, beyond the inner sanctum, knew banking practices. 'Last resort', far from reassuring the public, gave the game away that the Bank of England, maybe others, would have to save Northern Rock.

Now the public has seen a bank run, there is enormous anxiety about what to do with savings across the socio-economic spectrum. Trust has evaporated, particularly in private banks, as is evident in behaviour in the UK. As soon as Northern Rock was nationalised, depositors flocked back to it. Suddenly there was a choice beyond the market, namely in a state-owned entity. As if by magic, the state, with its far greater credibility in money-creation and which 'under certain circumstances, can print notes without any assignable limit' (Schumpeter 1934: 115) – in a low- or zero-inflation climate – became more trustworthy than the private sector. Regrettably, most of the old mutuals and friendly societies had also been privatised. But for low-risk bank customers, all the world could see that the private financial sector abused them. In the name of choice, neo-classical economic policy promoted *the abolition of choice* for people to use old safe state-owned or cheap, mutually-owned financial institutions; some in the inner sanctum of banking practices disagreed (Pixley 2004). With the banking crisis, small businesses started collapsing, starved of loans, and a

downward spiral of unemployment, growing indebtedness and collapse of wealth set in (Roche 2009).

Schumpeter (1954: 320-1; 277) thought that many might see this manufacture of money as dangerous. Yet he refused to accept classical economic views that money was 'neutral' or a mere veil over the 'real' economy, a view which also returned in the 1970s. Since the credit crisis, we can see how credit-money has destroyed much of the economic activity in debt-driven consumer spending that it created. Rising house values were not a 'real' phenomenon but grew through the credit-money created by trust and gullibility on a vast, non-'neutral' scale. There was also an unreality in the dot-com bubble, very like the railway bubble of the nineteenth century. Two railway tracks running side by side from New York to Los Angeles speak of excess and gullibility. One track made possible by a bank loan suggests competition is tempered and gives due praise to the role of 'the deposit-creating bank loan in the financing of investment' (Schumpeter 1954: 1114-5). Yet, not only during the property and private equity boom, but also afterwards, it has been depressing to see financial leaders cling to the classical economic view that states the opposite. That view goes back to the hope to find a natural 'value' in the 'real'. The discipline of physics in the 19th century saw itself as 'nature's economics'. But later, while orthodox economics clung to predictive 'science', it was a 'natural' science, physics, that moved on to argue that value is not natural, but 'created by the mind' (Mirowski 1989: 136). Physicists in the 1930s used an analogy to the provisional nature of money so apparent in the Depression. Nuclear particles were then said to 'borrow energy' metaphorically, with these implications:

> if we live with a banking system wherein money is created out of near-zero fractional reserves, then this process of borrowing energy could cascade, building upon itself until the entire universe is conceptualised as a 'free

> lunch'. The nineteenth century would have recoiled in horror from this idea, they who believed that banks merely ratified the underlying real transactions with their loans. (Mirowski 1989: 137)

Unlike this thoughtfulness in physics (and most social sciences) which included the influence of the observer, in orthodox economics – once the banking disasters of the 1920s and 1930s became less immediate – comforting fictions about the 'real' economy and hopes for forecasting returned. Schumpeter's devastating criticism of seeing money as a 'veil' over the 'real' was banished. There would be no more talk about the provisional nature of money, because it must be seen as a commodity, with banks simply the corporations that traded this commodity. Banks were not the special 'engines' of capitalism (Schumpeter 1954: 318). Unfortunately this performative role of orthodox economics and its policy results have permitted banks to play con tricks on the public and on governments, who have paid fantastically for this free lunch.

The current crisis may not dislodge such a powerful, cosy view among the free lunch set, who castigate governments for the debt (a dubious proposition with low inflation) which pays for their free lunch. Money when traded as a product (an alienated promise), ignores that 'the community' has to vouchsafe the believability of money. Another aspect of the free lunch, provided by 'Big Bang' – that quaint attempt to ape physics in 1980s British policy – was to pretend that money ratified the 'real'. But what was 'real' about private equity leverage, 80 Telco lines or, with some hindsight, Dutch tulips? Anyone could compete in the City of London after Big Bang and, *in practice*, faceless, impersonal corporations rose, to charge commissions, fees for privatisations, advisory costs *ad nauseam*. The failure of various financial corporations (such as BCCI and Barings) did not follow text books of the pro-marketeers, and made them a laughing stock.

Corporate practices could hardly be ignored, so orthodox economics redefined corporations into 'artificial persons' (the metaphorical atom of nineteenth century physics) which acted with 'guile' (Williamson 1991), and were said to be capable of outwitting the future. Oliver Williamson's work on 'markets and hierarchies' – in particular – lent justification for bank lies and opportunism, taking care, as he did, not to mention banking itself. It is an incoherent story because it defines firms by their success. More worrying, in citing firms' success in reducing transaction costs and using 'crafted safeguards' for contracts and commitments, he implies that firms can break promises (Pixley 2004: 133-5). True, the former personal trust relations among the postwar City elite, always with the threat of afternoon tea with the Governor of the Bank of England should boundaries be crossed, never worked that well. The elite stood aloof from working class and emergent female desires for decent wages, safe savings and cautious borrowing. But no firm after Big Bang knew how to operate among all the other impersonal firms and distant, underfunded regulators. Cut-throat competition, with its requisite arrogance, secret safeguards and hidden charges against the rising numbers of modest savers and borrowers, rose with each new pro-market rule for 'transparency' or 'financial literacy'.

These competitive practices, structured by such policies, remain a global problem. One cannot personalise the irrevocable problem of how *impersonal* firms and bureaucracies can or should act outside their glorious free lunch. Perhaps bankers were comforted by the neo-classical economic idea that banks were like any other firm, and should be studied according to strict 'micro foundations'. Clearly the corporate financial institutions basked in the fact that few people knew much about banking practices – not even among their own Chief Executive Officer ranks (as the 2009 Treasury Select Committee hearings chaired by John McFall showed, among others). The culture of banking is an increasingly

closed shop of closed minds – with very honourable exceptions, who some years ago pointed, ineffectually, to the unsustainability of the 'free lunch' (Pixley 2004).

The contradictions are plain to see. The banking culture demands that banks are not so special that they need regulations: in fact they want fewer rules than firms that make tables or provide food. Yet this culture assumes that banks are so special that they need support (far more than ordinary firms) and, should they become 'too big to fail' or rather 'too irresponsible to fail', they will not be permitted to fail. A mark of the financial industry's special nature is that it is capable of trying to hold governments to ransom (on the adage if I owe $100 it's my problem, but if I owe $100 billion, it is 'their' problem). Allied with the power of a lending strike implied in Twain's 'umbrella theory' of banking, that is why some commentators call for bank nationalisation, as with Northern Rock.

The political power of the financial industry and state creditors pertains particularly to the culture of Anglo-American finance. For example, *who* should make sacrifices to defend 'sound money' is a political question which affects social development. The state, econocrats and, above all, CEOs have done terrible jobs, under the systematic promotion of shareholder value and democratising credit. But if a neo-liberal European Union Commissioner, Charlie McCreevey (2009: 63), can justifiably say 'privatising bank profits and socialising their losses is not acceptable in democratic societies', what is happening in mid-2009 is hardly cause for optimism. Plender (2009: 20) argues that a 'victory for the bankers' in the United States was gained in mid-May, against the Obama Administration's efforts to control over-the-counter markets in derivatives, and over the 'remarkably unstressful stress tests'. That leniency might flow through to the City of London where far more derivatives are sold, particularly when the City and the Turner Review want national rather than European regulations (Bishop 2009).

It is not, however, a 'conspiracy' or a 'capture' of the state. This view only shows the similarity of otherwise opposing positions which agree with Friedrich Engels's reduction of social life to economic life, that the state is the executive committee of the 'whole' bourgeoisie. Rather, in democracies, once protection creates *confidence* in economic activity and trust in money (however conflict-ridden), governments walk a tightrope if they try to remove this support. For example, Lord Turner's *Prospect* interview (2009) may open a somewhat populist debate about socially 'useful' banks, but not if the City's equally populist lobbying is effective (Stephens 2009: 7). All governments resort to 'bread and circuses' as in stimulus packages, to assuage popular anger and attempt to avoid electoral damage. A major democratic deficit for governments is the unpredictable outcomes of conflict between creditors and debtors with deep pockets. Creditors won against debtor industrialists and full employment thirty years ago and now whole economies are geared to consumerism – that cannot be stopped overnight. In Australia, let alone the United States, the rural lobby has remained one huge protection racket for 200 years: its mouthpiece, the Country Party, as it used to be called in Australia, has always capitalised gains and socialised losses (and in Coalition with Liberals!). Why would the banking industry be any different in special pleading? The problem is that banks are 'special' and no one wants to admit the huge uncertainties of promises, not governments even when stemming the mess, and not banks unless it suits them. 'The question of the degree of accommodation of privately created credit is, arguably, the fundamental dilemma faced by monetary authorities.' (Ingham 2004: 141)

Is there another path between markets and state? Markets are not creative – buying cheap and selling dear is the sole aim – however they provide the freedom of exit. Loyalty and 'voice', to use Albert Hirschman's well-known terminology, reside in equally

important, but very different *creative domains*, namely in corporations and states. Exit is difficult, unlike from markets, but loyalty and above all 'voice', which raises critical views and ideas, give the creativity and powers of recuperation to government and corporate organisations. And yet, do banks need any more ideas from the usual suspects? More than most productive activities, money is a public good riven by conflicts: the whole world suffers when money is debased by creating 'too much' credit-money, too much asset inflation (or too many printing presses for fiat money). With credit-money as with state-money, we *equally* need caution, dull and prudent approaches – or creatively modest – such as the old mutuals and friendly societies: they also undercut the fee structure of the private for-profit banks.

All in all, the banking industry's double standards about competition and innovation during its conflict to regain badly lost ground during 2009 are obvious. The sector may get away with it. Maybe everyone will forget that the CEO of Wells Fargo, only in 2008, remarked: 'It's interesting that the [banking] industry has invented new ways to lose money, when the old ways seemed to work just fine' (cited John & Saulwick 2008: 45). Whether this is a joke or a bad taste of innovations to come remains in the lap of the gods.

Bank competition over risk *forced* the current bail-outs by taxpayers, and these furthermore, show how money/bank credit is a 'public good' let alone 'the headquarters of the capitalist system' from 'trading in credit for the purpose of financing development' (Schumpeter 1934: 126-7). Like lighthouses, a simpler example, everyone benefits from trustworthy money from financial institutions that lend for democratically-expressed wants for social innovation but, because private beneficiaries cannot collect fees from everyone who freely shares the safe light, the state has to create and safeguard the light and promises of money. Hence government unpopularity arising from the imposition of VAT and other regressive taxes.

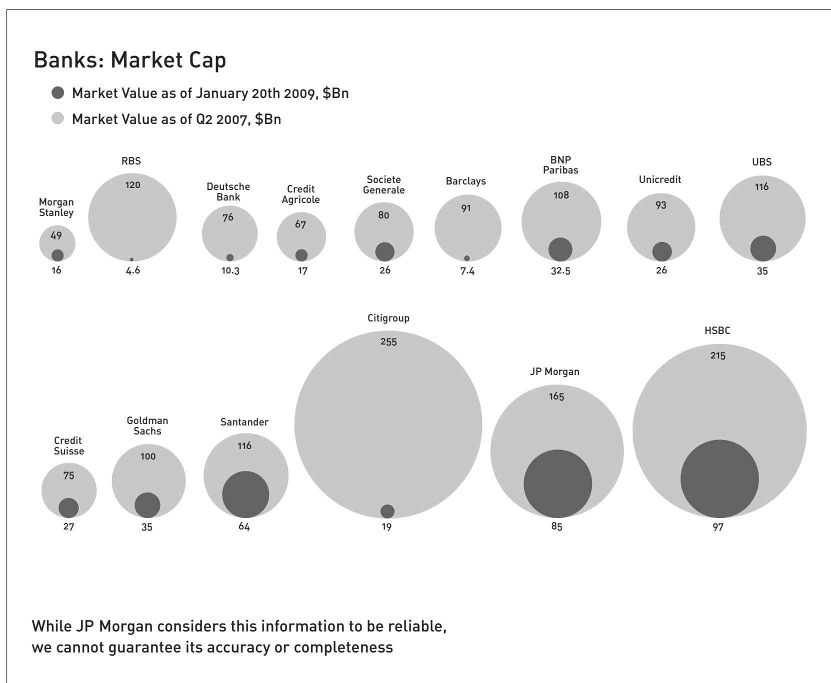
Governments find it hard to dislodge the mendacity of banking practices, notably regulatory arbitrage which plays off nations' rules, simply for socially useless gambles, because governments risk further downward economic spirals. Furthermore, contradictory competitive policies deny the possibility for corporate honesty even when extolling transparency. The bank that gives away its secrets to competitors will collapse in minutes for owning up to heavy debts. Who would suffer? Competition and innovation is still promoted heavily (and misguidedly) by the strong banking lobby. Banks want to avoid regulation of activities – like remuneration, scope of operations, treatment of customers, bad loans and above all, the reckless innovations that got us into this mess.

The old norms between banks and central banks – which offered insider trading by another name of telling each other things – were also dubious. But as Kaufman (2008) points out, it is only government entities that are actually transparent these days: treasuries and central banks must provide *public* signals only comprehensible or useful to the financial sector. These include a predictable environment for that sector to operate: low interest rates, low inflation via unemployment, early announcements of potential profitable ventures, privatisations and their lucrative, certain fees, *or* quantitative easing and open market operations. Above all, there should be no messy (unpredictable) compromises by governments with other major social groups such as pensioners, unions, churches, consumers, environmentalists, public servants or households anxious about their futures: modest debtors and creditors. The problem for the world's economic livelihood is for what purpose. Are banks' purposes (for example, during a depression) to create a 'credit policy' by individual banks and by central banks, or is the banking sector's actual 'credit restriction' in such times aiming to 'destroy without function' (Schumpeter 1934: 254)? The banks do not *aim* to demolish

other organised social institutions or groups, for they seem to have no purpose except winning market share. If they are not constructive, they do not *mean* to destroy, it happens as night follows competitive day. Schumpeter stressed that banks are the 'engine of capitalism' (1954: 318; 278) because 'the creation of new purchasing power out of nothing' by banks is the source of most development (1934: 73). The banker 'authorises people, in the name of society as it were' to innovate, and is 'the ephor' (supervisor/magistrate) of 'the exchange economy' (1934: 74). However his student, Hyman Minsky (1992: 6) worried more about the opposite: banks can be 'merchants of debt'.

Does anyone own the banks?

There is much confusion among regulators about what might make banks more responsible, or who would guard the guardians of lowly, but lucrative, constituencies like modest depositors and borrowers. The problem of *quis custodiet, ipsos custodes* is daunting. Even those like Jack Welch (former CEO of General Electric), who popularised the idea that firms should have one aim, to maximise the value of shares, are now rejecting it (Skapinker 2009). Banks have not maximised share value during 2008-09, but the reverse, as the market capitalisation statistics from Bloomberg shows. By June 2009, market values had improved for HSBC and JPMorgan Chase, but not for Citigroup (Wolf 2009: 11). But what could be an alternative to alleged shareholder 'control'? Many regulators (and banks, now) cannot see beyond making share-holders more active on boards, through accepting (by habit) Milton Friedman's dictum (cited Bell 1976: 292) that share-owners are 'principals' who hire 'agents' (CEOs). Managers (agents) are allegedly employees of share-owners, and the 'only purpose' of *any* firm is to make profits for the owners (principals): these days few know anything else.



Source: Bloomberg, Jan 20th 2009

In mid-May 2009, for example, the SEC proposed a rule to 'allow large shareholders such as pension funds to nominate up to a quarter of a company's board members' (Brewster 2009). The problem is pension funds are *agents* as well: be they CALPERS, the largest industrial fund in the USA which runs the Californian public employees (teachers notably) retirement system, or private Wall Street money managers. Their duty is to maximise their pension-holders' income. Yet, CALPERS, like the Regents of the University of California, invested heavily in Enron. Private fund managers have regularly voted for large remunerations for CEOs. As the debacle of 2007 unfolded, it was clear the whole financial sector is enmeshed in a system of special pleading about remuneration and 'a collective whistling in the dark' (Jackson 2007: 17). And anyone on a board can be hood-winked by management.

This incoherency in the *shareholder value model* is most obvious in the case of banks, given share value collapsed and governments had to guarantee deposits and nationalise some of the banks. Problems with the agent-principal model were explored in the 1930s with Berle and Means, *The Modern Corporation and Private Property* (1933). Debate continued into the 1970s, when Daniel Bell and Robin Marris criticised Milton Friedman's retrieval of this 18th century agent-principal conception. What was carefully argued back then is that shareholders are not owners. They own securities, which gives the right to buy/sell shares and the right to some income stream, namely dividends. But dividends *per se* are not a right – management can delay and reduce them by fiat; start-up firms do not offer them. The point is that *publicly-listed firms are not owned*. Money/fund managers are *also* 'agents' on benchmarks, fees or worse, sometimes violating savers/investors, Bernard Madoff being only a spectacular transgressor. The impersonal models are more worrying than Madoff *individuals*. Fund managers already control corporations to a significant degree in their option for market-moving exits: this practice has structured the financial industry for years, not to very good effect.

Berle and Means explored the problem of defining the lines of accountability and responsibility in the absence of 18th century-type individual owners of firms (a notable absence in banks). In the 1930s, A. A. Berle asked: If a corporation was 'legally' in trust for shareholders, but also 'deeply affected by a public purpose', then management has inordinate power. This was because if the corporation really is *an institution*, there is no 'clear and reasonably enforceable scheme of responsibilities to someone else' (Berle cited in Bell 1976: 293).

Daniel Bell suggested that the logical corollary is that 'the constituencies which make up the corporation themselves have to be represented within the board of corporate power' – and this would be an effective 'countervailing power to that of corporate

management' (Bell 1976: 296). Although European firms (such as Deutsche Bank) incorporated some of this, not so satisfactory 'stakeholder' thinking, English-speaking firms moved in the opposite direction to exclude any gesture to a moral economy of community, or a new democratic consensus. Robin Marris (1998: 25-6) shows control over managers also occurs via takeovers (not via masses of disparate, lone shareholders), but not for a public purpose nor share-owner benefit even. The debt from the private equity movement – formerly called asset-strippers and barbarians – is another story waiting to unfold. Meantime, executives are trying to be more friendly to individual shareholders in 2009. But why would individual shareholders be interested in an active role at Annual General Meetings, even if they had more say? A diversified portfolio, more so a hedged portfolio (which shorts stock) and options to exit, gives little lasting interest in any particular firm.

A further problem with the agent-principal model is that it is founded on 'distrust' (Pixley 2004). The agents – managers – were not hired or *trusted* to be professional, creative and responsible officers to the corporation. Instead CEOs are indirectly controlled through aligning their 'interests' with shareholders on the grounds that *they could not be trusted* unless they had a similar stake in the enterprise as shareholders. Many CEOs lived down to that distrust and narrow definition of rank short-term interest. One would have thought the final straw in the idea was when the Enron directors sold their shares the day before the firm collapsed. Following the inquiries into Enron, however, the same old agent-principal model remained in place, but revamped. Non-executive directors (NEDs) were to have enhanced power to defend share-owners, for example in the UK's Higgs review and the Sarbanes-Oxley Bill in the United States. But who would want to be a NED and why would major institutional money managers (agents-cum-share owners) promote *suitable* directors any more than management? Boards find it difficult to question manage-

ment. Resignation or whistle-blowing are among the few pitiful exit and voice options for NEDs.

What could be a trustworthy model to replace or modify the failed, archaic agent-principal approach? This is where debate is sorely needed. In the case of banking the problem is most acute, because of the misuse by banks of depositors, low-risk borrowers and other modest bank customers. Shareholders in fact *had* to be left out in the cold during the height of the crisis, because the really catastrophic risk was that depositors would withdraw from every bank. A new model needs to acknowledge this, and modify the notion that firms are owned, because shareholders are not 'principals'. Depositors, bank survival and the crucial public developmental purposes of banking should be banks' main aims, which could also help make shares somewhat more secure. What this means is that the money markets, like the labour markets, cannot be permitted to treat money as a pure commodity. The crisis shows, as do past crises, that banks cannot sell promises and obligations indefinitely. Interesting policies, which may address some of the problems, start with trying to redefine the purposes of firms.

One sophisticated proposal – as relevant to banks as to pension fund managers – stresses long-term requirements and fiduciary duties, not the power *per se* of share holders, stakeholders or agents. Trustees of funds in many jurisdictions – since the 1985 English (Cowan) court case – have been narrowly required to seek to maximise profits for their beneficiaries. Even the judge in this case later described the fiduciary duties of a trustee more broadly. US court cases and cases under Australia's Superannuation Industry (Supervision) Act 1993, have since moved towards the 'prudent investor rule'. It provides that 'there is no absolute duty on trustees to maximise the return on individual investments; instead the duty is to implement an overall investment strategy that is ... appropriate', which includes a variety of risk levels, yielding 'a positive, overall financial result for

beneficiaries' (cited in Denisenko 2009: 60-61). Such considerations, global warming and the financial crisis, prompted the Commonwealth of Australia in 2008 to press for trustees to use the financial consequences of one or more Environmental, Social and Governance considerations (ESG) in their 'traditional' investment decision-making. Australian regulators are to require trustees, for example, to take a *financially-motivated view* of poor governance practices, climate change concerns and poor labour standards – such as a building materials firm called James Hardie, where workers claimed against asbestos-related fatal illnesses. The Hardie case was not an ethical issue alone (as Socially Responsible Investment supports). The firm tried to shift its responsibilities and, in the costs of moving to register the firm from Australia to the Netherlands (and in 2009 in trying to relocate to Ireland!), in the law-cases and final payouts, lost share-value and reputation over the long term.

Conclusion

These prudent investor rules are equally a means for defining bank responsibilities, in their lending practices as well. Is it prudent for banks to indulge in regulatory arbitrage (pitting country against country) or to lend to coal-fired power utilities if these are destroying the planet, *and* investors and depositors will lose? In other words, we have a capitalist economy (profits) that cannot achieve sustainable long-term profits if daily profit motives are the sole consideration. In particular, banks have public responsibilities they should no longer be able to evade. To restore trust, banks 'should' pursue a social development that is relevant to the urgent needs and social wants of the 21st century. Some already do. The *type* of competition – such as selling high-risk products and obligations, the secrets entailed and weekly

performance benchmarks could be minimised. Competition over honesty, probity, private/public/mutual, and *impersonal reputation* could be maximised, governments leaving the imprudent to fail. Beneficial competition might restore professionalism against *markets in talent*; and (at least) re-enforce the 'public goods' aspect of money at national and multi-polar levels.

A new model involves long-term statutory fiduciary duties, public deliberation and professional judgement over *inevitably uncertain development proposals*, between bank managers, technical/regulatory experts and lay-citizens. Prudent rules inspired by social, environmental and governance considerations would act between market and state. Such measures of democratic control to promote social development and pension fund security, would slow the often reckless pace of decision-making of the City into the bargain. Banking has a profound public importance which has foundered on destructive competition and a short-term, counter-productive view of owner interests. Maybe orthodox economics has outlived its performative role because the double standards of the banking industry and the interesting changes in the major state creditors are clear to all. For global banking, it could be China that next bails it out. Any new creditor control is probably no more alarming than the previous elite creditor power but, even so, it would be preferable for banks' purposes to be defined according to citizens' long-term hopes and the social and global nature of money in the first place.

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7

The Dangers of the Cult of Shareholder Value

Jacques Reland

Crises can be a blessing in disguise or, as Emmanuel Rahm put it so succinctly, 'We must not waste a good crisis'. It is a time to learn and reflect on the factors which brought the world economy to its knees. Indeed, billions of words have been written on the causes of this systemic shock, which led to the wipe-out of trillions of dollars worth of assets, and on what should be done to avoid a repeat.

Many reforms of the global financial system have been mooted, culminating in the April 2009 G20 summit. Financial and banking regulation and supervision, ratings agencies, control of hedge funds, curbs on tax havens, and reform of the IMF were on the menu of the London summit. But the key issue of shareholder value maximisation, which some economists consider as one of the main causes of the world economic collapse, was not discussed by world leaders. Is it

because it does not fit in with the global regulation remit, as it is a problem mostly affecting Western capitalism? Or is it because the shareholder value cult is at the core of the neo-liberal economic culture, based on blind faith in the power and intelligence of the market, which has spread from Wall Street and the City of London to dominate Western economic policy-making for nigh-on thirty years?

But the times they are changing. And we are beginning to witness some Damascene conversions, the most notable being that of Jack Welch, widely considered as the godfather of the trend, who in an interview, which made the front page of the *Financial Times*, declared: 'On the face of it Shareholder Value is the dumbest idea in the world. Shareholder Value is a result, not a strategy. Your main constituencies are your employees, your customers and your products (*FT*, 13 March 2009).' Welch did not elaborate on the reasons why he came to that conclusion, but his spectacular turnaround was undoubtedly a tacit admission that the single-minded pursuit of shareholder value undertaken by institutional investors and Chief Executive Officers (CEOs) had played its part in the meltdown. This in itself was not a shock revelation, as some, especially in France, where Keynesian economists never were an endangered species, had laid the blame for the rise in household debt on wage curbs and job destructions resulting from the profit maximisation drive.

What made it interesting is that it emanated from the man, whose speech titled 'Growing fast in a slow moving economy', which Welch delivered on 8 December 1981 to financial analysts at the Pierre Hotel in New York, soon after he was appointed CEO of General Electric, is considered as the foundation stone of the trend. Although he claims not to have set shareholder value maximisation as the sole objective of governance but to have merely expressed his beliefs in selling underperforming businesses and aggressively cutting costs in order to deliver consistent profit rises that would outstrip global economic growth, he was,

however, widely seen as the trailblazer of a corporate governance trend. Alfred Rappaport spelt this out in his 1986 book, *Creating Shareholder Value*: 'The ultimate test of corporate strategy, the only reliable measure, is whether it creates economic value for shareholders.' (Quoted in *FT* 13 March 2009)

It is now clear that the headlong rush for profit maximisation and the mollycoddling of shareholders at the expense of other stakeholders, namely the employees and, accessorily, the consumers played its part in the meltdown. It would also eventually help to depress household purchasing power (of the working classes initially, before hitting the middle-classes) and therefore growth. In addition, the short-termist approach it entailed was going to be detrimental to the long-term interest of companies and their shareholders, as current share prices and company bankruptcies indicate. Shareholder value maximisation is not only bad for demand, it is bad for supply. It has caused as much damage to companies and shareholders as it had already done to industrial employment and the macro-economic balance of western economies.

Shareholder value and neo-liberalism

The shareholder value cult did reach its apex in the early 21st century, but its roots go back to the neo-liberal revolution, which Reagan and Thatcher promoted so vigorously. The financial situation of many Western firms had become so bad in the 1970s that these governments rightly thought it was crucial to restore companies' profitability in order for them to survive and create future jobs, because, as West Germany's Chancellor Helmut Schmidt had famously articulated: 'the profits of today are tomorrow's investments and the jobs of the day after tomorrow'.

As the neo-liberals thought that business had been hampered by high taxation and over-regulation, which they saw as the primary

cause of weak profits and therefore under-investment and absence of growth, they successfully argued that markets work better than the state in coordinating economic activity and in allocating resources. They therefore sought to reduce the presence of the State in the economy by privatising, deregulating and reducing taxes and welfare benefits. Moreover, in a departure from the postwar Fordist compromise, wages ceased to be seen as an element of demand for national output and more as a cost to firms. As the labour market should become a market like any other, i.e. ruled by the laws of supply and demand, it was therefore deemed unnecessary to try to control unemployment and imperative to curb trade unions and to repel legislation protecting workers. To complete the picture, privatisations and the UK's 1986 'Big Bang' of financial deregulation were meant to promote the ideal of a property and share-owning democracy. The EU's removal of exchange controls in 1990 was going to boost the process further by kicking off the relentless march of financial globalisation and give Western economies growing access to the massive savings from other parts of the world, oil-producing countries and China especially.

These factors would help to transform corporate governance. CEOs were given a mandate and all the powers to manage the company with the overriding aim of creating profit and capital gains for the shareholders. Initially, there was nothing wrong about wanting to restore corporate profitability, as it is obviously the best measure of a company's competitiveness, of its ability to provide the right product to its customers. It is also quite legitimate for the management to be accountable to shareholders, whom they must enrich. Having a vested interest, a share-performance related compensation for managers is therefore not scandalous in itself. But the problem comes when, under pressure from investors, companies set unrealistic profit targets and when rapid share value maximisation becomes the CEOs' overriding objective. The problem is made even worse when managers are

rewarded beyond the most reasonable expectations through extravagant compensation schemes for meeting short-term goals.

An unholy alliance was struck between CEOs and institutional investors and it was sealed by bonuses and stock options, which were going to amount to around half of US CEOs' pay packages for 90% of them by Y2000, against 11% in the 1960s. Corporate managers, who got most of their pay from the rising value of shares, became the zealous servants of 'professional investors motivated by their own incentives in the form of quarterly performance reviews and there developed a cosy relationship between the two groups which encouraged the adoption of certain mutually satisfactory corporate financial operations' (Butler 2009). If they failed in their duties, the only risk was the sack with a golden parachute and a cast-iron pension. The life expectancy of their jobs shortened, but rewards were such that they could be set for life after a few years at the helm, whatever their performance. By 2004, the average mandate of a CEO was 6.6 years, against 9 in 1995.

This new breed of managers, whose goal was to maximise profits and to create shareholder value rather than increase the activity or the employment in the firm, were no longer answerable to their employees and unions, but to financial investors looking to maximise their returns. The postwar managerial capitalism had given way to financial capitalism, which helped to bring unprecedented wealth-creation before it was wiped out in the space of a few weeks.

Shareholder value, demand, debt and social cohesion

Industrial workers were obviously the first to feel the drawbacks of the drive for rising corporate profitability. Cost-cutting so as to produce more cheaply became the route to corporate prosperity and it led to factory closures, job destruction, wage curbs,

increased flexibility, outsourcing and eventually offshoring. Industrial employment collapsed in the West, while more jobs were created in other sectors, but flexibility, job insecurity and low pay for the lower-skilled became the norm.

Employment and work participation rates rose, but salaried incomes stagnated or decreased for the majority of the working population. In the US, Japan and Europe, productivity always rose faster than the hourly paid rate from 1996 to 2009. Consequently, in the OECD15, the share of wages in corporate added value duly fell from 67.3% in 1981 down to 62% in 1993, 59% in 2001 before dropping to 57.3% in 2006. This was bad for demand, and sluggish consumer spending was one of the reasons for the mediocre growth of the last 15 years in Continental Europe. In countries like France, where unemployment remained steadily over 10% throughout the 1990s, wages remained low (by 2007 50% of the French workforce was earning less than €1,500 net a month), but welfare benefits and correlated public deficits helped to compensate for their stagnant purchasing power.

US and British growth was much more dynamic as a result of buoyant household consumption, but it was not due to the famed trickledown effect. It is now safe at last to say that the hubristic claims of the superiority of the Anglo-Saxon model rested on excessive private borrowing and corporate leverage. In the UK and the USA, strong job-creation in the services sector, cheap and easy money coupled with spectacular rises in the value of financial and housing assets helped to boost the borrowing capacity of households which fuelled their spending spree. Encouraged to borrow by low interest rates, artificially so after 2001, and the rising value of financial and especially housing assets, US and British households mortgaged and leveraged themselves to the hilt so as to maintain or improve their standard of living. By 2008, Britain's personal debts amounted to 173% of UK households' disposable income and in the US they had risen to 140%. Even in the more

cautious Euro-zone, that ratio had gone from 65% in 1998 to 90% by 2008, according to Eurostat.

Ironically, Anglo-Saxon credit-fuelled conspicuous consumption was one of the by-products of growing inequalities. The very rich became the trendsetters for the rest of society, with everyone encouraged to match their spending habits. Designer clothes, exotic holidays, SUVs and Mercs became the standard fare and modes of transport for those aspiring to keep up with the Beckhams and the traders. Encouraged by the soaring value of their homes, which had turned many into virtual millionaires, they started to behave like ones. The losers, who were in the majority, wanted to spend like the minority of winners, even though their salaried incomes were not keeping up with the rising cost of living. Overall wage growth had been fairly steady but it was very unevenly spread. A recent Société Générale survey, reported by Phillip Blond in the *The Guardian*, says that in the US the income of highest-paid fifth of the population rose by 20% since 1970, while for the rest it fell by 10%. The piece concludes, 'rather than trickling downward, the wealth has leveraged upwards' (*The Guardian* 3 July 2009). This phenomenon was not however limited to the United States.

In October 2008 the International Labour Office reported that wage differentials had increased massively since the early 90s, notably as a result of aforementioned generous compensation packages for managers and directors (ILO 2008). They noted that in 2007, the CEOs of the 15 top US companies were earning 521 times more than their employees, as against 370 times in 2003. For the same year, the OECD came to same conclusion and showed that it was particularly marked in Anglo-Saxon and other countries (OECD 2008), which had embraced financial capitalism most enthusiastically, as Andrew Leigh shows in his analysis of inequality (2007). It confirmed what many had suspected: the extra growth generated by financial capitalism had gone into few pockets, leading to a 'winner takes all' society.

We had moved a long way from the principles laid down earlier by Rockefeller and JP Morgan who thought that a company boss should never earn more than 40 times the employees' wage. Paul Krugman came up with an interesting figure, when he compared the wages of the managing directors of the biggest American corporation in 1969, when General Motors ruled the roost, and 2005 when Wal-Mart was the undisputed leader. The GM chairman was earning 88 times the average company wage, which stood at $40,000 in current dollars, while that of Wal-Mart was earning 1,278 times his employees' miserly $18,000 average annual salary. As Andrew Leigh found, the before-tax income of the richest 0.1% of the US population, which had stood at around 2% from the 1950s to the late 1970s, had risen to 5% by 1987 and was close to 7% in 2003 (Leigh 2007: F595-6). Such an accumulation of wealth in so few hands had not been seen since the late 1920s, when their share hit 8.19% in 1929. Even though the world is different, it is tempting to conclude that the same causes have the same effects.

In his memoirs published in 1951, Mariner S. Eccles, Chairman of the Federal Reserve Board from 1934 to 1948 wrote:

> A mass production has to be accompanied by mass consumption. Mass consumption in turn, implies a distribution of wealth to provide men with buying power. Instead of achieving that kind of distribution, a giant suction pump had by 1929-30 drawn into a few hands an increasing portion of currently produced wealth. This served them as capital accumulations. But by taking purchasing power out of the hands of mass consumers, the savers denied to themselves the kind of effective demand for their products that would justify a reinvestment of their capital accumulations in new plants. In consequence, as in a poker game where the chips were concentrated in fewer and fewer hands, the other fellows could stay in the game only by borrowing. When their credit ran out, the game stopped. (Eccles 1951)

Plus ça change! Thirty years on, it is now clear that virtuous growth and industrial job-creation were not the aims behind the abandonment of the Keynesian consensus. The real objective was to redress the balance between labour and capital, which was deemed to have swayed too much towards the former as a result of the postwar Keynesian consensus. This tectonic change was meant to restore the economic competitiveness of the West and strengthen its companies, but did it?

Shareholder value and corporate performance

Growing inequalities and reduced social cohesion might have been acceptable, if they had helped to preserve our industrial infrastructure and our economic might, but, as Dominique Plihon, the author of *le Nouveau Capitalisme* (2001), pointed out in 2002, in the wake of the Enron, Worldcom and Vivendi collapses: 'There is a fundamental contradiction: on one hand stock markets dominate capitalism, on the other, they are unable to guide firms towards choices likely to guarantee their long-term development' (Plihon 2002).

It is now widely accepted that, partly as a result of the managers' remuneration system, industrial strategies often gave way to short-termist financial strategies aimed at maximising short-term profits and share value. This in turn undermined their growth and wealth creation potential. Mainstream economic editors, such as Anthony Hilton of the London Evening Standard can now rightly claim that:

> The flaw in this was the belief that this strategy gave management a stake in the system – their growing prosperity being aligned to the prosperity of the company – without realising that they operate to different time horizons. Thus the manager can maximise his wealth in three years and live

> happily ever after even if he has destroyed the company in the process… That is one reason why the cult of shareholder value and the alignment of executive and shareholder interest have resulted in the worst decade of share-price performance in memory, with stock markets lower today than they were 10 years ago. (Hilton 1999)

The same point is made by Jeffrey Sonnenfeld of the Yale School of Management who is quoted in the *Financial Times* (13 March 2009), as saying: 'Immediate shareholder value maximisation, by itself, was always too short-term in nature, it created a fleeting illusion of value creation by emphasising immediate goals over long-term strategies.' It is now clear that 'performance' related pay for managers did not help to improve their companies' long-term prospects. If shareholders were initially pleased with their returns, they have now become painfully aware of the drawbacks of the shareholder value drive.

Until the late 1990s, the profitability drive brought many benefits. Companies restored their balance sheets and invested, in ICT especially, to increase their productivity, size (for some) or profitability, notably in Continental Europe, so as to take advantage of the Single Market and globalisation. After the 2000 internet bubble crash and 9/11, the situation changed for the worse under the influence of new factors, such as cheap money, a favourable regulatory environment, new accounting standards ('price to market'), quarterly results postings, and the 'herd mentality' inherent to the financial industry.

The low interest rates policy initiated by the Federal Reserve to kick-start the economy encouraged the overleveraging of institutional investors, who, thanks to financial globalisation, began to spread their financial investments further and to manage them more actively. The quick return culture spread from the Anglo-Saxon world to Continental Europe, where Anglo-Saxon Pension Funds and institutional investors are becoming increasingly

present. By the end of 2002, foreign shareholders, mostly from the US and the UK, controlled 43% of the capital of French Bourse CAC40 groups, against 36.3% at the end of 2000, according to a Banque de France study. But these shareholders are not there for the long-term. They move their money around very quickly and they accounted for 73% of trade on the Paris Bourse in the last quarter of 2002. Private equity funds were meant to nurture companies over the long-term, but in 2004, 85% of their investments were financed by short-term leverage, requiring money to move fast. Pensions were being financed by shares held for seven months on average.

European managers readily abandoned the comfort of Rhine Capitalism for the heady delights of financial capitalism. Even though inflation was now much lower and growth sluggish, investors still expected the same or better nominal rates of return than in the 1990s. A 15% to 20% return on equity becomes the norm. Josef Ackermann aimed at 25% for Deutsche Bank and achieved it in the second quarter of 2005, as had 32 of top 100 European banks in 2004, according to Fitch Rating. Non financial companies were also shooting for the stars and succeeding, as shown by the average 15.4% return on equity achieved by French CAC40 groups in the same year.

These high returns on capital mirrored their growing operating profitability: CAC40 companies' cumulative profits went from €37 billion in 2003, to 50 billion the following year and soared to 84.5 billion in 2005, 97.7 billions the following year before breaking the 100 billion threshold in 2007. Many were alarmed not only by the size of the profits made by CAC40 companies, which did not bear any relation to growth trends, in the 2004-06 period, but mainly by how they were used and allocated: a smaller share of these profits was being used productively, as an ever-growing proportion was devoted to rewarding and attracting shareholders.

Stock markets versus the firms

The free-market revolution was meant to promote countries' economic interests and to spread growth through efficient allocation of financial resources, to the right places at the right time. Financial markets were meant to be at the service of ambitious far-sighted companies, which would help to boost growth and supply. But, since the turn of the century, the tables have been turned. Institutional investors began to see non-financial companies as 'milch cows', which helped to boost their soaring profits. In a country like Britain, the financial sector accounted for 13% of the economy, but had a 30% share of domestic profits, while in the United States, the share of financial profits as a percentage of total domestic profits soared from 28% in 2000 to 40% in 2004 (Economic Report to the President 2008). A large proportion of these astronomical gains were made on the back of non-financial companies and against their long-term interest and sustainability. The kind of returns they expected had become unrealistic, and they could not be achieved with a sustainable, organic long-term strategy aimed at raising turnover and profitability through good product development, effective management of human resources and high customer satisfaction. Managers were now ready to do anything to artificially swell the value of their shares. A few were even ready to cheat and cook the books: Enron in 2001, Worldcom and Parmalat in 2003. As a response, the 2002 Sarbanes-Oxley Act changed the rules but not the core values of the system. Its aim was not to protect the common good, just the perceived interest of the shareholders.

In their quest for high return on equity, many companies chose to forego investment, especially capacity investment. The corporate fixed capital formation rate fell from 13% of GDP in the USA, 12.5% in Germany and 11.5% in France in 2000 to below 10% in 2004. While in 1990 75% of French companies' profits were devoted to investment, by 2007, that share had gone down to 57%. Companies

were beginning to look more concerned about nurturing their share price than their future. To do so, they devoted a rising share of their profits to rewards for shareholders in the form of dividends, which rose to 36% of their profits in 2007 from 22% in 1992.

A 2005 survey ('Quand la Bourse ne finance plus les entreprises') by Société Générale reported in *Le Monde* (1 February 2005) showed that in 2004, European companies had paid €199bn in dividends to their shareholders, 10% more than the previous year. This trend gained strength in the following years, as shown by the French CAC40 figures. Dividends doubled from €18.5 billion in 2004 to €37.9 billion in 2007, before reaching €43 billion in 2008, according to another Société Générale study reported in *Les Echos* (2008). In the same article, Fabrice Théveneau, who oversaw the survey, noted that 'in the last few years, companies have tended to raise their dividends faster than their profits to maintain high stock market yields'.

The mollycoddling of shareholders also took the form of share buybacks, an operation which helps to raise the value of a company's shares. The same Société Générale surveys show that in 2004, European companies devoted €30 billion to those operations and that in France the sums involved followed the same trend as dividends, with CAC40 share buybacks nearly doubling from €10.4 billion in 2004 to 19.2 billion in 2007. In 2004, European companies gave back €120 billion more to financial markets than they raised from them. They paid out €229 billion in the form of dividends and share buybacks, whereas they only raised €110 billion in new share issues and new listings. It looked as if stock markets were no longer financing economic development; they were feeding off it, sucking companies' wealth-creation and growth potential for their own short-term gains.

The problem for companies was made worse when these companies borrowed to finance such operations. As Dennis C. Butler recently pointed out:

> Egged on by institutional investors, companies often used buybacks and balance sheet leverage (debt) together in a potentially lethal combination which saw companies borrow money to buy in their own stock, more often than not at times when share prices were at or near highs. The long-term consequences have in some cases been catastrophic. It is not uncommon to find companies in financial distress due to debt taken on during good times, often to buy in shares when prices were high. (Butler 2009: 4)

Patrick Artus and Marie-Paule Virard were warning in 2005 that 'financial capitalism (was) a capitalism without project, which does not do anything useful with its billions, which does not invest much, which does not prepare for the future. Money is flowing through the world economy, but is rarely used wisely, especially in Continental Europe.... (where) it feeds the voracity of investors, in a race for short-term financial yields.' (Artus and Virard 2005: 6)

After helping to destroy Western industrial employment and infrastructure in the 1980s and 1990s, from 2001 the financialisation of the economy started sucking companies dry of their capital and future, thus undermining the West's long-term economic prospects. As the Western economy reached the edge of the abyss, bringing most of the rest of the world down with it, it is time to stop and think.

What next?

We obviously must reform corporate governance if we want to avoid repeating errors of the past, but we must not content ourselves with overhauling 'long held tenets of corporate faith', as Francesco Guerrera recommends (*FT* 13 March 2009). Many technical reforms have been mooted, ranging from tighter regulation, reforms of remuneration linking it to long-term performance, end

of quarterly postings and pricing to market, more control of directors and company accounts by shareholders, changes in the composition and role of boards of directors to make them less internecine, leaner and more professional, to the inclusion of employees' representatives as in Germany. But these measures are purely technical. They would help to improve the economic sustainability of firms, but they would not address the deeper related social, economic and therefore political issues linked to the neo-liberal orthodoxy which underpins financial capitalism.

Lionel Jospin had warned us in 1999 that financial capitalism is a force that moves, but it does not know where it is going (Jospin 1999). A few years later, Jean Peyrevelade was wondering whether capitalism had gone mad and asserting that 'financial capitalism is neither ecologically nor economically sustainable' (Peyrevelade 2005). In 2009 Denis Clerc, founder of the French magazine *Alternatives Economiques* put it, 'the financialisation of the economy is not only morally unjust, it is also economically suicidal' (Clerc 2009).

We therefore must question our economic orthodoxy and change our mindset. We now have a window of opportunity, or, as President Sarkozy put it: 'The crisis gives us back our freedom, because we had previously stopped thinking; it gives us the opportunity to renew our ideological corpus' (*Le Figaro* 26 March 2009). We must begin to address the following questions: Have big firms got a social responsibility beyond their commitment to shareholders, who are no longer the owners or entrepreneurs of yesteryear? Have they got a national or regional economic responsibility? Are they global entities or do ownership and nationality matter? Which role can the state or the European Union play to help reindustrialise our economy and boost its long-term prospects? And, in short, what is the role of finance: master or servant?

Many are calling for the emergence of moral capitalism. One can always dream, but I, for one, would be satisfied with a more

socially responsible, economically and ecologically sustainable form of capitalism in the West. Judging by the current noises from the City of London and the return of obscene bonuses, this can be easily dismissed as typically French 'dirigiste' wishful thinking. But if we go back to business as usual, we shall come up against the same problems, and next time the damage might be beyond repair.

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8

The Past is Another Country? The Long View of the Market Meltdown

Helen Parry

Today there are very few people in the marketplace who have been through a previous crisis. Banks have been de-layering middle management and removing the 'corporate experience' – the people who would mentor others and talk about the past. So there is a knowledge gap. (Bris et al 2008)

The dot-com bubble and the South Sea Bubble; the credit crunch and the savings and loans crisis; Jerome Kerviel and John Rusnak; UK local authorities' adventures with Icelandic banks and BCCI; Northern Rock and NHLC/Paragon; interlocking collateral debt obligations (CDOs) markets and split capital trust crossholdings; AIG and BCCI and slipping though the regulatory net – these are just some of the many striking parallels that can

be drawn between historical and contemporary events in the financial marketplace which could furnish any scholar anxious for corroboration of the old cliché, *plus ça change plus c'est la même chose*, with an embarrassment of riches. Cynics, meanwhile, will yawn wearily at this apparently endless vindication of the proposition that fear, greed and the threat of the regulatory dive to the bottom have held sway and will, despite the positive plethora of post-crash policy proposals, continue to do so in the decision making fora, not only of banks, but also of governments, regulators and the many and various gatekeepers whose spectacular failure to create and enforce an effective system of law and regulation of financial markets has helped create the current devastating global recession.

One event, however, which has recently erupted into the public domain with the news of the arrest of Ross Mandell and fellow executives on charges of running a boiler room through the Sky Capital Group of companies has, by a side wind, highlighted one of the most startling and illuminating parallels of all – between Raymond Dirks, who blew the whistle on the Equity Funding Corporation of America (EFCA) the Enron of its day – in 1973, and Harry Markopolos who blew the whistle on Bernard Madoff. On 19 August 2002 Mandell vehicle Sky Capital Holdings Ltd named Raymond Dirks as Managing Director of Institutional Sales.

The Equity Funding Scandal

According to shareholder litigants (in re Equity Funding Corp. of America Securities Litigation 416 F.Supp. 161D.C.Cal. 1976.January 23, 1976) who had lost money buying EFCA stock, the fraud had been carried out by certain officers and directors of EFCA, which had caused the records and financial statements of EFCA to show continued false and inflated rates of growth in the

stated assets, incomes, and earnings of the company and its subsidiaries. This was done to influence the price of EFCA securities traded on the national securities exchanges, to induce the purchase of those securities by others, and to influence stockholders in other companies acquired by EFCA to exchange their stock in those companies for EFCA securities. From 1964 through 2 April 1973, the price of EFCA securities was inflated on account of the fraudulent activities at EFCA. It was also done to inflate the pay of the Chief Executive Officer (CEO) and other executives who had a huge financial interest in the price of EFCA stock as a result of their executive compensation packages which consisted of a significant tranche of EFCA stock options.

The misstatements were achieved through a number of fraudulent devices including false entries in the books, records, and financial reports of EFCA and its subsidiaries, the use of foreign corporations to create fictitious and inflated assets for EFCA, and a method by which bogus life insurance policies were created for the files of Equity Funding Life Insurance (EFLIC) a subsidiary of EFCA, then reinsured by unknowing companies or carried as assets by EFLIC. According to the complaint of the shareholder litigants the fraud was continued for eight years with the aid, complicity, and neglect of accountants, underwriters, actuaries, brokers, exchanges, the states of Illinois and California, and a number of other defendants.

The Billion Dollar Bubble

The scandal was excruciatingly and fabulously chronicled in the movie *The Billion Dollar Bubble* starring a very young James Woods. Anyone fortunate enough to have viewed this classic could not have failed to have been struck by the astonishing resonance it has in terms of reflecting not only more recent equally

notorious accounting fraud cases, such as Enron, but also the deliberate blowing up and bursting of the dot-com and credit bubbles, driven as they were by, *inter alia*, the inappropriate prioritising of excessive levels of executive compensation – now the focus of much regulatory soul-searching. The Walker Review cites the de Larosière report on the point:

'Remuneration and incentive schemes within financial institutions contributed to excessive risk taking by rewarding short term expansion of the volume of risky trades rather than the long term profitability of investments (de Larosière 2009: §24)'.

The EFCA whistleblower and the SEC

In 1973 ex-Equity Funding staffer, Ron Secrist, tipped off stock analyst Raymond Dirks to the fraud and Dirks brought Secrist's then-unproven allegations to the Securities and Exchange Commission(SEC). But far from being hailed as a courageous whistleblower who had tirelessly and fearlessly worked to uncover a massive fraud, Dirks was charged and found liable for insider trading by the SEC. They took this action against him on the basis that he had informed some of his EFCA stockholding institutional clients before contacting the authorities. These clients had, predictably, proceeded quickly to offload $18 million of stock in the market before the information became public. When the scandal broke the stock price collapsed. The SEC found Dirks liable as a tipper and this was affirmed by the Court of Appeals for the District of Columbia (Dirks v. SEC 1982). However, in a very famous securities law landmark judgement, Dirks took his case to the Supreme Court and won. The Supreme Court held that it was not against the law to trade on insider information as long as the insider supplying the information did not benefit or breach a duty to disclose it to stockholders (Dirks v SEC 1983).

While from a legal point of view this is a highly significant case, some of the facts that emerged in the course of the appeal case are also of great interest. Secrist had made a number of allegations referring to the fraud and had warned Dirks that its top officers had Mafia connections which they had used to threaten the lives of employees who had objected to the fabrications. He had also warned Dirks that merely presenting the information to the SEC would be abortive and that employees who had attempted to do so in the past had been brushed aside with a comment that it was a ridiculous story. Those employees had also found that the information was sometimes relayed back to Equity EFCA and they were placed in personal jeopardy as a result. Despite these warnings, Dirks decided to investigate the allegations. He also informed a journalist at the *Wall Street Journal* who was initially reluctant to run the story for fear of possible libel action.

Some of the following remarks made in Dirk's appeal brief could have been made by Harry Markopolos in relation to his ten-year-long campaign to persuade the SEC to properly investigate his suspicions about Madoff's Ponzi scheme:

> Both the state and the public at large have an interest in exposing corporate misconduct. Ordinarily, we would expect that official law enforcement agencies would be sufficient for that task, but this case shows that the organs of government are not always able to accomplish swift investigation of possible crimes. The press also has an historic role in discovering and exposing wrongdoing, but here, too, the press failed to move as quickly as Dirks. (Lee *et al* 1982)

After the scandal broke a federal grand jury in Los Angeles returned a 105 count indictment against 22 persons. Guilty pleas or convictions were obtained on all 22. Chairman Stanley Goldblum received an 8-year prison sentence and a substantial fine.

Markopolos and Madoff – the SEC and regulatory capture

Markopolos is reported as having informed a gathering of investment professionals on 4 June 2009 at Boston College that the SEC in the past had employed too many lawyers and had suffered from regulatory capture in that it had been reluctant to take on anyone who was too big or powerful. He further indicated that when he failed to persuade regulators to investigate Madoff he increasingly came to fear for his life.

This view of the SEC as suffering, to some extent at least, to the condition referred to by some as 'regulatory capture' has been confirmed by one SEC insider, Gary Aguirre, who recently remarked:

> if you try to pursue a big player as I did, it can be career-shortening experience. At the SEC, it is a culture of deference. That culture is intolerant of investigations into the Wall Street elite. All the agencies have to some extent or another revolving door. SEC managers may make $200,000. That same person may make $2 million as a starting salary outside. He takes his Rolodex with him and that Rolodex is gold. Then, the departed employee calls back to his former colleagues and says, 'You know I really don't think there is much of a case against so-and-so, I'd like for you to take a look at it.' And the case goes away; the system goes on in perpetuity. (Renner 2008)

The FSA whistleblower – wholesale funding and the credit bubble

A whistleblower at the FSA has recently added his voice to the debate about the effectiveness of regulation in preventing the endless cycle of bursting bubbles in the financial marketplace. An anonymous former FSA employee has indicated in a letter to Vince Cable, since forwarded to Lord Turner, that in the early and

middle part of this decade, FSA had allowed building societies to depart from their traditional core business model and move into specialised lending like commercial real estate and sub prime self certified and buy-to-let mortgages. 'They were unsophisticated and inexperienced and when they bought commercial loans or acquired mortgages from lenders it was obvious they were fools in the market being exploited by Wall Street and the City of London' (wikileaks 2009). He accused FSA of permitting this lowering of asset quality. The FSA has since acknowledged that they must move more towards assessing business models than they have in the past. Lord Turner proposed that the FSA should, as part of the enhanced supervision programme, be focusing on the business models and strategies of firms, as well as the systems, as it had in the past placed too much weight on ensuring that systems and processes were correctly defined rather than on challenging business models and strategies (HM Treasury 2009: 4.58). The FSA had alluded to this issue in its internal review of its supervision of Northern Rock, identifying four key failings including a lack of sufficient supervisory engagement with the firm, in particular the failure of the supervisory team to follow up rigorously with the management of the firm on the business model vulnerability arising from changing market conditions and processes they put in place to support them (HM Treasury 2009: 4.55).

Another whistleblower, Paul Moore, head of group regulatory risk at HBOS in 2002-05, informed the Treasury Select Committee that he had been repeatedly threatened after claiming internally that the bank was going too fast and that there was a cultural indisposition to challenge. This, in his view, was a serious risk to financial stability and consumer protection. He stated further that he had, in the end, been sacked for raising such concerns (Treaner and Bowers 2009). After he left the bank, HBOS settled a claim for damages brought by Moore. The settlement was subject to a gagging order, but he chose to break his

silence. According to reports, HBOS rejected Moore's allegations after it hired KPMG to conduct a review. The report, which was shared by HBOS with the FSA, found the allegations had no merit. KPMG was auditor to HBOS. It is worth noting that Sir James Crosby, chief executive at HBOS at the time of Moore's complaint had been a non- executive director of FSA since 2004 and went on to become Deputy Chairman of FSA in 2007 and a favourite for the chairman's post. Crosby's successor at HBOS, Andy Hornby, told the Treasury Select Committee that from HBOS's incarnation in 2001 it had been too reliant on wholesale funding.

Wholesale funding and mortgage marketing – echoes of the secondary banking crisis – the NHLC/Paragon affair

The credit crunch has ended in tears for many institutions, as well as for those unfortunate individuals whose homes have been repossessed. One of the institutions that has been affected is Paragon, a specialist buy-to-let lender, which has been forced to raise £280m in a rights issue. When its £280m revolving facility for working capital such as wages came up for renewal on 27 February 2008, the banks were asking for five per cent above the London Interbank Offered Rate (LIBOR). Paragon was unable to do any securitisations as a result of the credit crunch and without the rights issue the likely scenario was that it would have to appoint an administrative receiver.

The credit crunch is reminiscent of an earlier crisis which hit a previous incarnation of Paragon, National Home Loan Corporation (NHLC), a second mortgage specialist, which first entered the mortgage market in the mid-1970s as part of the so-called secondary banking market (famously rescued by a Bank of England lifeboat during the secondary banking crisis of 1974 – 79). NHLC was willing to make self-certification loans,

i.e., loans to borrowers who vouched for their own income, and it had also been among the first to securitise mortgages. By 2008, the securitisation of mortgages was over 50 per cent of the UK mortgage market, although at the time of the NHLC crisis it had been only 15 %.

The company was badly affected by rising interest rates in the late 1980s and got into serious financial difficulties. It was forced to withdraw from further lending in 1991. It was re-financed by a consortium of banks in 1992, and re-entered the market in 1994 via a new subsidiary company, Home Loans Direct Ltd, which in 1997 changed its name to Paragon Mortgages Ltd. Like Northern Rock, Paragon Mortgages unusually relied on 100 per cent funding from the money market. NHLC and its innovative business plan had begun to feel the heat in the dog days of recession-driven early 1990s negative equity. One banker has noted that as a result of the NHLC case: 'It was drummed into every senior banker that they must be careful about the over-reliance on money-market funding'. He cited the adage of those times: 'Don't be solely reliant on money market funding: there is a high risk (Spowart 2007).' It was clear from this case that excessive use of the money markets and securitisation could render a bank very vulnerable in a market downturn, but such insights seem to have been largely forgotten by the time the credit bubble was being so enthusiastically inflated.

Paragon's fortunes are linked to those of HBOS. Paragon has been engaged in litigation over its right to repossess properties when lenders had fallen behind with their payment obligations. In Paragon Finance Plc v Pender (EWHC 2003), the court was called upon to consider, *inter alia*, the issue of which party in a securitisation chain had the right to claim repossession of a property for non-payment of arrears. The property at the heart of this dispute was formerly a council house, of which Mr and Mrs Pender had been the tenants. Under the new right-to-buy regime that

Margaret Thatcher's Government introduced, they bought the property in 1985 for the princely sum of £29,000 with a loan from the Halifax Building Society of £17,000, secured by a first charge on the property.

Interest-only loans also featured in the mortgage landscape of Thatcher's eighties. In May 1989, the Penders applied to Paragon (under its then name NHLC) for a loan of £75,000 to enable them to carry out works of repair and renovation to the property. Paragon offered the Penders a loan of £75,000 repayable over 25 years on an interest-only basis, to be secured by a legal charge. The offer was based on a valuation of the property at £100,000, and was expressed to be subject to the special conditions set out in the offer and to Paragon's standard general conditions. The standard general conditions then current were Paragon's Mortgage Conditions 1988.

Since early 1987, Paragon had been involved in the mortgage-backed securities market, which involved the transfer by way of sale of a portfolio of mortgages to a 'special purpose vehicle' (SPV) in return for a sum which was funded by the issue of the SPV of listed bonds carrying an entitlement to interest at a floating rate. To attract investors, the bonds had to carry a credit rating which was acceptable to the market, for example, by a rating from a well-known credit agency such as Standard & Poor's. Interest payable on the bonds, in turn, was funded from the income generated by the mortgages transferred. The sale was non-recourse, in that the transferor was not liable for losses incurred by holders of the bonds. The transfer of the mortgages may or may not have been completed by the vesting of the legal title in the SPV. In the case of a mortgage of registered land, vesting of the legal title would occur on the registration of the SPV as proprietor of the mortgage. In the case of a mortgage of unregistered land, vesting of the legal title would occur on the execution of an appropriate deed of transfer.

By 1994, the Penders had fallen into arrears with monthly payments under the legal charge. On 10 February 1994, Paragon made a formal demand for payment of all sums due. The demand was not met. On 22 April 1994, Paragon commenced the action, and claimed possession of the property and payment of the sums due. Following a number of interlocutory hearings and adjournments, a possession order was eventually made on 5 January 1995, subject to the proviso that it was not to be enforced without the leave of the court. Following the making of the possession order, the Penders made regular monthly payments under the legal charge, but in consistently lesser sums than the amounts due. The arrears continued to rise. Since May 2000, however, no further payments had been made. By the time this case was heard, the Penders owed the staggering sum of £280,000, including costs.

On 22 July 2000, Paragon issued a warrant for possession and the Penders appealed. One of the grounds of appeal was that Paragon had no right to possession because it had transferred the legal charge on the securitisation. The court found, however, that on the specific facts of the case, the full legal title had not been transferred because an uncompleted agreement to transfer the legal charge conferred on the SPV no more than an equitable interest in the mortgage and, as such, could not operate in law to divest the claimant of an essential incident of its legal ownership. As the SPV only had an equitable title, Paragon did, therefore, have the right to repossess the property. There have been many similar cases in the US in the recent crunch conditions where several notable judges have been taking lenders to task and refusing to play ball if they have failed to complete the securitisation process and documentation appropriately.

Securitisation in the United States – the early days – Fannie Mae and the New Deal The solution – not the problem

> In order to curry congressional support after their accounting scandals in 2003 and 2004, Fannie Mae and Freddie Mac committed to increased financing of 'affordable housing.' They became the largest buyers of subprime and Alt-A mortgages between 2004 and 2007, with total GSE exposure eventually exceeding $1 trillion. In doing so, they stimulated the growth of the subpar mortgage market and substantially magnified the costs of its collapse. (Calomiris and Wallison 2008)

This journalistic comment suggests that it may be illuminating to revisit the origins of US property market securitisation and the subsequent fraud scandals that overtook some major players – Fannie Mae and Freddie Mac. These scandals played a significant role in helping to create the climate of easy money that contributed to the blowing up of the credit bubble. This is in stark contrast to the philosophy that lay behind the creation of Fannie Mae in 1938. In those days mortgage guarantees and securitisation were seen as part of the solution to the problem of great depression of the 1930s. The Federal National Mortgage Association (Fannie Mae) was founded in 1938 to provide stability in the secondary market for residential mortgages by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing and guaranteeing residential mortgage loans and mortgage-related securities, which it financed by issuing mortgage-related securities, debt securities, and equity to ensure that funds were consistently available to the institutions that lend money to home buyers. It is now a shareholder-owned government-sponsored enterprise chartered by Congress to expand the flow of mortgage bonds by creating a secondary market.

Freddie Mac is also a shareholder-owned government-sponsored organisation dating from 1970 to provide a continuous flow of funds for residential mortgages by buying and guaranteeing residential mortgage loans and mortgage-related securities.

The Savings and Loans crisis – the era of Liars's Poker

The factors causing the housing bubble in the US were many and various. One significant factor was the inflow of funds into the mortgage market in the aftermath of the savings and loans crisis. In September 1981 the Federal Housing Loan Board introduced rule and accounting changes which allowed savings and loans to defer the losses from the sale of impaired assets over a ten-year period and the issuance of capital certificates that artificially boosted apparent capitalisation. This made Savings and Loans (S&Ls) eager to sell their loans. The buyers – major Wall Street firms – were quick to take advantage of the S&Ls' lack of expertise, buying at 60%-90% of value and then transforming the loans by bundling them as, effectively, government-backed bonds (by virtue of Ginnie Mae, Freddie Mac, or Fannie Mae guarantees). S&Ls were one group buying these bonds, holding $150 billion by 1986, and being charged substantial fees for the transactions.

As Michael Lewis noted:

> From the moment the Federal Reserve lifted interest rates in October 1979 thrifts haemorrhaged money. The entire structure of home lending was on the verge of collapse. So on September 30, 1981, Congress passed a tax break which allowed thrifts to sell all their mortgage loans and put their cash to work for higher returns – often by purchasing the cheap loans disgorged by other thrifts. It led to hundreds of billions of dollars of turnover at Wall Street ... and there were a thousand sellers and no buyers – correction – one buyer: Lewis Ranier of Salomon Brothers and his traders. (Lewis 1989: 93)

The original S&L crisis stemmed from several factors including the fact that interest rate volatility caught many institutions borrowing money at high rates and lending at relatively low ones which wreaked havoc on bank earnings and net worth. Banks had also overextended themselves in the commercial real estate sector making risky loans to high-risk borrowers. When the economy slowed, losses surged. The oil price bust of the mid-1980s made a bad problem worse, helping wipe out scores of S&Ls in Texas. Weak regulation and low capital levels made S&Ls vulnerable to failure. The use of brokered deposits – where S&Ls chased 'hot money' depositors by offering high interest rates also caused problems when rates turned against them. Ultimately, more than 1,000 S&Ls failed, and the U.S. government was forced to step in with a bailout totalling an estimated $150 billion. It took years for the agency established to help resolve bad loans, the Resolution Trust Corporation, to finally work through the morass of impaired assets.

Meanwhile in 2004, Fannie Mae was, however, found to have engaged in egregious bonus culture driven accounting fraud. Regulators at the SEC and the Office of Federal Housing Enterprise Oversight (OFHEO) reached a settlement with Fannie Mae that included $400 million in penalties. The report of the affair (SEC 2006) portrays Fannie Mae as governed by a weak board of directors, which failed to install basic internal controls and instead let itself be dominated and left uninformed by chief executive Franklin Raines and Chief Financial Officer J. Timothy Howard, who were both later removed. Fannie Mae's managers were found to have engaged in manoeuvres designed to make it appear that the company had reached earnings targets, thus triggering the maximum possible payout for executives – echoes of EFCA.

The report, like the Equity Funding movie, portrays an arrogant and unethical corporate culture. From 1998 to mid-2004, the smooth growth in profits and precisely-hit earnings targets each

quarter reported by Fannie Mae were 'illusions' deliberately created by senior management using faulty accounting. The report went on to point out that Fannie Mae's faults were not limited to violating accounting and corporate governance standards but included excessive risk-taking and poor risk management. The bonus-driven accounting fraud ran from 1998 to 2004. The SEC ordered Fannie Mae to restate its earnings back to 2001.

The SEC alleged that Freddie Mac also deceived investors about its true performance, profitability, and growth trends, and that in 2000, 2001 and 2002 the Company misreported its net income in each of those years by 30.5%, 23.9% and 42.9%, respectively (USDC D.D.C. 2007). Senior management exerted consistent pressure to have the Company report smooth and dependable earnings growth and to present investors with the image of a company that would continue to generate predictable and growing earnings. The Company's violations were the direct result of a corporate culture that placed great emphasis on steady earnings, and a senior management that fostered a corporate image that was touted as 'Steady Freddie' to the marketplace.

Shadow banking and other manoeuvres: adding fuel to the fire – Enron and SPVs

Bankers and corporates like Enron were taking advantage of an accounting rule that made it relatively easy legally to take a special purpose vehicle off balance sheet. This requirement was that those outside the company who were setting up the SPV had to provide a minimum of three per cent of the capital of the SPV. Furthermore, earlier restrictions on executive pay had encouraged the use of payment through share options. This had the effect of concentrating the minds of chief executives and others on the share price to an unconscionable degree.

Fraud and insider-dealing in the junk bond market which led to Levine/Milken and Boesky scandals created such bad press for Milken's junk bond market that bankers were motivated to create new products such as collateralised bond obligations. The junk bond market had originally been developed for the same reason that the CDO and later related markets had been developed – the legal rules that were applicable to credit-ratings and credit-ratings agencies provided a market opportunity. Michael Milken had noted that low-rated bonds outperformed less risky bonds because the legal rules which artificially restricted demand made them artificially cheap. This was the investment banker's Holy Grail – a market inefficiency that a legal rule had created that no-one else had really spotted.

Early examples of structured finance deals featured securitised and repackaged junk bonds. In this way, junk-rated bonds became magically transformed into a range of tranches or categories, some of which were triple A. This was a denial of the old saying that is beloved of geeks – rubbish in, rubbish out. This was spinning gold from straw. This was the trick. It allowed institutional investors such as insurance companies which were restricted to buying investment grade bonds into the market. This increased demand and, therefore, the price rose, which meant that higher yields than government debt or standard corporate bonds could provide were on offer. This also meant that investment banks could charge higher commissions and everybody was happy.

Get if off the balance sheet

By securitising bank loans and credit receivables, financial institutions were able to remove bank assets from the balance sheet if certain conditions were met, thereby boosting their capital ratios and enabling them to make new loans from the proceeds of the

securities sold to investors. The process effectively merged the credit markets (for example, the mortgage market in which lenders make new mortgages) and the capital markets, as bank receivables were repackaged as bonds that were collateralised by pools of mortgages, auto loans, credit card receivables, leases, and other types of credit obligations. As banks looked to investors as the ultimate holders of the obligations that bank lending created, banks as an industry began to act more as sellers of assets rather than portfolio lenders that would keep all the loans they originated in their own portfolio.

Securitisation also redefined the bank definition of asset quality, and loan underwriting standards, because lenders were looking at loan quality more in terms of their marketability in the capital markets than the probability of repayment by the borrowers. For regulatory reporting purposes, a loan that was converted into a security and sold as an asset-backed security qualified as a sale of assets. The seller retained no risk of loss from the assets that were transferred and had no obligation to the buyer for borrower defaults or changes in market value of securities that were sold.

CDOs cubed and other excesses: the endgame

> Chairman: We have heard of CDOs-squared and CDOs-cubed. Lord Aldington, can you explain to me what a CDO-squared or CDO-cubed is?
> Lord Aldington: I have not come before this committee as an expert on CDOs.
> Chairman: But your organisation is involved in collateralised debt obligations?
> Lord Aldington: That is true. My organisation is involved in a very broad range of products and I would not claim to be an expert on all of them. (Select Committee on Treasury 2007)

The case of Nick Leeson and his role in the downfall in 1993 of Barings Bank notoriously thrust senior managers' professed ignorance of complex financial products to the forefront of public discourse. The 1995 report into the Board of Banking Supervision's inquiry into the collapse of Barings noted that at the bank neither the top managers nor the relevant members of the management at the Financial Products Group had a satisfactory understanding of the business that was purported to be transacted in Barings Futures Singapore, despite the significant profits that were reported and the funding that it required. The Senior Management Arrangements, Systems and Controls provisions of the FSA Handbook are generally agreed to have sprung forth from the smoking ruins of Barings Bank; however, sadly, as is clear from the recent colloquy cited above, it appears that the endless stream of regulatory change and rulemaking on the subject of the level of product knowledge of senior managers at banks may have been less than entirely effective.

When the Northern Rock crisis hit, the Bank of England's Board of Banking Supervision was but a distant memory. The (relatively) new kids on the banking regulation block, however, have been stepping up to the plate post-Northern Rock with a comparable raft of regulatory remedies. The FSA notably has been at pains to put in place a system of enhanced supervision and, in his speech delivered on 12 March 2009 on delivering intensive supervision and credible deterrence, its chief executive Hector Sants produced a basic check list for senior managers:

- Do not take risks that you do not understand.
- Ensure the focus is on the long-term franchise and profitability of the institution, not the short term.
- Ensure a healthy and ethical culture in your organisation.
- Recognise the future is not predictable and ensure that at all times you understand the circumstances under which your firm will fail and that you are happy with the degree of risk mitigation you have.

- Ensure a healthy and thoughtful culture of challenge from the independent directors.

A similar list could easily have been extrapolated from the Barings report.

The vexed and rather mystifying subject of CDOs squared and cubed was discussed in some detail in relation to a live class action in the United States (in re Merrill Lynch & Co. Inc., Securities Derivative and ERISA litigation). According to the complaint, Merrill Lynch would earn underwriting fees from securitising sub-prime mortgages into mortgage-backed securities. It would then proceed to earn additional fees by repackaging mortgage-backed securities into CDO securities. The CDO securities were then transmuted into CDO-squared securities, which are securities that CDOs issue which contain other CDO securities. These were then repackaged into CDO-cubed securities, which are securities that CDOs issue which contain CDO-squared securities. It argued that this practice of re-securitising sub-prime related assets that had already been securitised once, twice or even three times generated fees for the handful of big banks which were heavily involved in sub-prime underwriting, without actually adding value in the repackaging process. This was because the purchasers of the CDO securities were a rather small pool of investors – mostly other banks that needed CDO securities to repackage into new CDOs.

An interlocking tangled web of risks

The original ostensible purpose of a CDO was to spread the risks of uncorrelated assets among pool investors who were willing to take on different amounts of risk through new CDO securities separated into tranches, although the reality has

turned out to be somewhat at odds with this aim. This has been described as a tangled hairball of risk – passing of the risk parcel between fewer and fewer players so that the resulting crossholdings concentrated the risk to an extreme degree – a situation reminiscent of the split capital trust scandal in the UK where similar extreme levels of crossholdings took place. Split-caps are a type of investment trust.

Investment trusts are listed companies which buy shares in other companies. Their success – and the return they provide to investors – largely hinges on the performance of the companies they invest in. Investors in investment trusts get both income – from a dividend paid by the trust – and capital growth – through the rise in the price of the shares. With share prices rising, and interest rates low, some borrowed additional funds to invest in the stock market. This left them facing much greater losses as the market fell. Some of the trusts invested in each other. This led to a tangled web of cross-holdings which amplified the damage caused by the fall in value of some trusts in 2000. In fact, many shares in split-cap funds became worthless when they reached their wind-up date. The collapse of split-capital trusts left many small investors facing financial ruin. In total, about 50,000 are believed to have lost an estimated £700m.

Untangling the mess

Since the collapse of Lehman Brothers in August 2008, regulators at national, regional and international levels have been toiling to draft proposals for reform in the fervent hope and belief that, despite all common sense and evidence to the contrary, lessons can be learned as the world cannot afford a reoccurrence of such a catastrophic event. But as Professor Hamilton noted, people have short memories (Bris 2008).

Did those local authorities who were so seduced by the offer of a few extra basic points by those rather odd Icelandic banks know what had happened before the collapse of BCCI when local authorities who had been similarly seduced found too late that there is no such thing as a free lunch? Had the managers at Société Générale completely forgotten about Nick Leeson and John Rusnak and all the rogue traders that were so frequently in the news in 1990s? Did the Amaranth scandal and the focussing of attention on the Enron and London loopholes and the lamentable lack of regulation in over the counter (OTC) markets not cause any doubts to be raised when the OTC market for naked credit default swaps mushroomed out of control in the years before the crunch only to be burst so spectacularly by the case of AIG?

While the Turner Review, the Treasury White Paper and the Walker Review make scant reference to the subject of financial crime, it is the case that time and time again the dangerous combination of an encouraging macroeconomic climate, executive greed for success and fear of failure combined with light-touch regulation by partially captured regulators is of course a criminogenically-compelling concoction which many individuals find themselves quite incapable of resisting. Such criminal behaviour can at times, such as that evidenced by the Spitzer Settlement, for example, be egregious and implicate a very large number of major players. The famous psychological phenomenon of the tendency of members of a group to 'follow the herd' can mean that where one deviant bank may go others will follow. At the retail level the sheer volume of mortgage fraud and predatory lending that was taking place in the years before the crash indicates that such conduct was widespread. Such high levels of criminal behaviour in the market can be the final straw that brings down the whole edifice down.

Can anything be done to prevent another catastrophic market failure? Until the authorities are willing to grasp the nettle, call a spade a spade and admit that there is a financial crime elephant in

the room it seems unlikely. The Walker Review is proposing more voluntary codes. How can one reasonably expect full compliance with such codes when even the threat of a lengthy prison sentence has failed to deter so many market players when tempted by the dreams of avarice prompted by the delicious prospect of an inflating price bubble or while staring transfixed in horror at the dreadful prospect of failure? The George Osborne analysis of the causes of the credit crunch as a complex interaction of underlying macroeconomic imbalances, poor understanding of the risks created by financial innovations and weak regulation of financial institutions is staggeringly inadequate. With a Conservative general election victory imminent I am not holding my breath (Osborne 2009).

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9

Hedge Funds and Tax Havens. Two Key Components of the Current Financial Crisis

Nick Kochan

Introduction

Hedge funds and tax havens were key and integrally-related components in the recent economic disruption. They are also only part of a much larger picture of financial negligence that thrived under the laisser-faire regime of the Thatcherite era, which in its financial aspect has continued to the present time. The mechanics and principles of that regime are now, at last, being revisited. The outcome of such a review of investment, saving, and foot-loose capital and its attendant risks is far from clear. Whether either hedge funds or havens will have their wings clipped in the wake of the crisis is a moot point.

The commonality between hedge funds and the offshore regime is a reliance on secrecy and opaqueness, rather than

transparency and disclosure. The development of secrecy regimes, both for the purpose of avoiding tax and of hiding criminal proceeds, has been an important factor of the last three decades.

The so-called 'shadow economy' has expanded with 'globalisation'. The wider the net expands for countries to look outwards to trade value across borders, the greater the opportunity for the creation of so-called 'secrecy services' to bypass national taxation and disclosure rules. Such secrecy services are legal structures for 'sheltering tax' and for the non-disclosure of critical identifiers of capital ownership, such as beneficial owners. Legal fictions like trusts (the British structure) and foundations or *Stiftungen* (the German structure) are created by lawyers to create a barrier between their wealth and any prying external authority such as a tax or law enforcement agency. The identifiers of capital control and of economic control have been steadily undermined by the expansion of channels for money movement.

The onset of globalisation has set in train economic forces without parallel in recent economic history. They are also forces without countervailing national or even supranational controls. Value has been transferred from territories where measures of value and risk have been identified to territories in the so-called offshore world, without clear definitions of the risks involved or standards of compliance.

Offshore risk has become a universal concern with changing investment patterns. The agglomeration of pension and insurance capital within large institutions – in the search for above-average reward – has increased the measure of risk exposure for low-level investors incapable of asserting their governance rights. Modest pensioners are now exposed to the lowly-regulated offshore economies as never before. Previously offshore funds and tax havens were the preserve of investment structures for privately wealthy professionals who could assert

their own financial governance, whereas now there is a democratic interest in the governance of offshore financial protectorates.

Hence the shadow economy was born out of the hunt for fiscally-driven niches, crucially defined by the shading of the definitions between avoidance and evasion. This definitional failure has limited the scope for the operations of tax-recovery agencies such as national fiscal and specialist criminal authorities. A shortfall in the exercise of regulatory vigilance, on a scale to match and evaluate the change in shape and size of global capital flows, has set in train a paradoxical outcome to the advance of global trade flows. While world trade opened up one set of newly emerging industrial markets, like China and India, another set of newly emerging markets was opened up to exploit the benefits of fiscal and legal competition. The proliferation of low-tax centres, like Nairu and the British Virgin Islands, each outbidding the next for the claim on a taxable dollar, has given a new and broader definition to the global economic movement of money. Offshore havens typically have no capital gains tax and a minimal (perhaps 10%) income tax. This compares with 18% capital gains tax (CGT) in the UK and 40% top rate of income tax.

Opportunities to use tax havens for tax evasion and avoidance have played a major part in shaping the globalised financial markets more widely, according to John Christensen of the Tax Justice Network: 'The UK and USA have provided tax concessions which create distortions in the global capital markets in their desperate efforts to attract much needed capital to balance their chronic current account deficits.' The Tax Justice Network, a group campaigning for greater transparency in tax matters, argues convincingly that tax authorities have treated hedge funds with enormous leniency, allowing them to operate in London and New York, but treating them for tax purposes as though they were resident in the Channel Islands and Cayman Islands and therefore not taxable on profits or capital gains. Their distributions to

investors are not subject to withholding tax, says Christensen, and their location in secretive tax havens provides investors a tailor-made opportunity for tax avoidance.

Such competitive tax regimes have not only provided ripe territory for the attraction of capital outside more heavily-regulated jurisdictions, but have also added steam to the pressure for capital to flow more quickly between jurisdictions. The greater the speed at which the money moves, the less easily it is regulated and the less facility there is for measuring and understanding the strategy of its managers and owners. Hedge funds have been key drivers for this enhanced volume and velocity of the movement of money which, as will be seen below, has been integral to the enormous rise of funds channelled into the shortselling of securities.

This pursuit of fiscal benefit has enjoyed the concomitant benefit of 'regulatory-bypass'. Regulation was not so much 'light touch' as 'no-touch' for money that spent so little time in any sector or any jurisdiction. This was not merely the case of investments being repackaged many times, as we saw with the burgeoning of credit default swaps and other derivatives, but was rather the simple but shrewd arbitrage between havens in order to move under the radar of regulatory oversight. The control of fund managers was lost in this roundabout of hot money.

The best analogy for understanding the movement of heated-up money triggered by the hedge fund community between offshore centres is that of the money laundering process. Criminals arbitrage between the differing levels of scrutiny in place in offshore havens. Black money will enter the offshore whirligig at a point of least regulatory resistance (say a local bank in Nairu). Launderers will move the money up the offshore food chain (by moving it, say, to a bank in Cayman, in a bid to win a regulatory stamp of approval). Regulators are least likely to investigate the source of black money once it has earned the imprimatur of a mainstream bank in a mainstream financial centre.

The presence of hedge funds in offshore centres, notably the Cayman Islands, puts them at risk of participating in this financial whirligig. Hedge fund abuse has proliferated in the wake of the credit crunch, as will be demonstrated in the following section. Another and related catalyst for the creation of offshore centres has been the expansion in 'grey money' – money obtained by government officials from bribery or crime – where owners seek cover from the surveillance of domestic political or law enforcement agencies. Chinese government officials have routinely used Hong Kong for this purpose.

Offshore facilities for secrecy, loose governance and opaqueness have facilitated such frauds as Madoff, Stanford and Bayou. Bernard Madoff operated a Ponzi scheme over a 25 year period in New York. Early investors were paid off with the money deposited by later investors until the music stopped in 2008 and many investors were left out of pocket. It is understood some $60 billion in total was staked on Madoff. Sir Allen Stanford's Stanford International Bank, based in the offshore centre of Antigua, lied to buyers of his certificates of deposit about the investments he was making. Civil proceedings were begun against him in 2008, when it was alleged he had run a $9.2b fraud and he faced criminal charges in 2009. The Bayou Hedge Fund Group was a group of companies and hedge funds founded by Samuel Israel III in 1996. Israel raised some $450m from investors, whom he subsequently milked. He was tried and imprisoned in 2005 These are some of the more egregious cases of hedge fund fraud, a form of crime believed to be proliferating in recession-hit British and American economies.

The involvement of offshore money in Madoff's scam was extensive. Investors in Swiss banks are among the losers. One Cayman fund administrator has said that one of its regulated funds had significant investment in the Madoff funds. One unnamed Cayman bank, which doesn't conduct domestic business, has also confirmed that it had significant exposure to the

Madoff funds. Funds based in offshore tax havens allegedly used Madoff to evade American taxes. Foreign banks are also believed to have withheld American taxes in Madoff accounts, as required by the US Internal Revenue Services. Charities, which invested in Madoff, are also believed to have improperly allowed donors to shift money offshore. Offshore havens helped fund managers to defer or avoid American taxes on their personal profits by channelling the earnings through offshore affiliates.

At least a dozen offshore entities were involved with Madoff's firm, according to several regulatory filings. They include funds linked to the Fairfield Greenwich Group, a fund of funds that lost $7.4 billion of its investors' money invested in Madoff. Other offshore entities involved are affiliated with one hedge fund, which had $3.3 billion invested, and several Swiss banks, including Union Bancaire Privée and Banc Benedict Hentsch & Cie.

It has further been reported that an offshore company in the Cayman Islands, called M-Invest, lost hundreds of millions in the Madoff scheme. M-Invest was set up several years ago in the Cayman Islands by Union Bancaire Privée (UBP), a 39-year-old elite private Swiss bank which has US$125 billion in assets. Many of the world's richest families, individuals and institutions are UBP clients. M-Invest was set up in the Caribbean, according to reports, to make it easier to channel money into the United States, while at the same time keeping the transactions secret and out of the reaches of United States federal tax officials.

Irving Picard, the court-appointed trustee to the Madoff bankruptcy, has said he has located assets and businesses 'of interest' in offshore centres such as Ireland, Luxembourg, Switzerland, Gibraltar, Bermuda, the British Virgin Islands, the Cayman Islands, the Bahamas. Picard has hired lawyers in Gibraltar, the Cayman Islands and elsewhere to help trace the money from Bernard L. Madoff Investment Securities LLC in New York and Madoff Securities International Ltd in London. Picard is also

seeking the retrieval of funds from London, arguably the world's largest offshore centre.

This is understandable. London-based funds use offshore branches of UK banks, based in British dependent territories – notably Jersey, Guernsey, the Isle of Man and the British Virgin Islands –to set up tax arbitrage schemes. These funds take management fees which are earned and repatriated to London. Offshore centres were extensively used in the Madoff fraud, so Irving Picard, the court appointed trustee, has recovered $75m from institutions based in Gibraltar. Fraudsters involved in Enron allegedly used nearly 900 offshore entities, mostly in the Cayman Islands, to conceal bogus trades and accounting fraud.

The culpability of the Antiguan regulatory and monetary authorities in the surveillance of Sir Allen Stanford's financial vehicles is only now starting to emerge. As it does so, it will not be an edifying sight. The SEC's amended complaint indicates in lurid terms the alleged role of offshore regulators in culpability for the Stamford scam. It alleges that 'Leroy King, the administrator and chief executive officer of Antigua's Financial Services Regulatory Commission (the "FSRC"), facilitated the Ponzi scheme by ensuring that the FSRC "looked the other way" and conducted sham audits and examinations of SIB's books and records. In exchange for bribes paid to him over a period of several years, King made sure that the FSRC did not examine SIB's investment portfolio. King also provided Stanford with access to the FSRC's confidential regulatory files, including requests by the Commission for assistance in investigating SIB as a possible Ponzi scheme.'

Offshore entities played key roles at Bayou Management, a Connecticut hedge fund that collapsed in scandal in 2005. Federal prosecutors alleged that Bayou had lied about its operations since the beginning, by 'overstated gains, understated losses, and reported gains where there were losses'. Court docu-

ments show that Bayou never made any money. In mid-2004, Bayou sent a letter to investors claiming that its assets were valued in excess of US$450 million. Bayou Offshore Fund was a defendant in this case.

Background to hedge fund fraud

The incidence of hedge fund fraud is believed to be expanding at a rate of two cases per month, according to Protean Investment Risks. Hedge fund fraud totals $11 billion, if one excludes Madoff (where $60 billion of fraud has been alleged, but where the amount has yet to be established). That is likely to be an underestimate, for much securities fraud lies buried, waiting to be discovered as the recession persists.

The extent of hedge fund abuse and fraud needs to be put into some proportion. Some $1.3 trillion is managed by almost 9,000 hedge funds globally, according to figures produced by the Federal Bureau of Investigation. Managers who control the investments are at the pivot of hedge fund fraud. As they are rewarded on the performance of their funds, a number have been persuaded to inflate this crucial indicator of success. The manager must provide false information to the investor to retain investor loyalty. While the investor believes his money is steadily earning interest, the manager is removing large amounts for his own benefit. This depletes the total pot so that the longer investors remain in a fund, the less likely they are to receive the full value of their investments. For example, it is understood that hedge fund managers use their offshore status to manipulate their own tax exposures. So, Inland Revenue investigators are pursuing fund managers who cannot justify the way they have split their income and expenses between UK and offshore companies. The challenges could have serious knock-on effects on some hedge funds

since it could jeopardise their tax-free status in the UK. The Inland Revenue is concerned that a large proportion of management fees is sometimes allocated to an offshore company that does little to justify it. Even if an offshore operation provides marketing or other services, fund managers might struggle to supply the detailed paperwork required to justify the breakdown of fees, which are supposed to reflect 'arm's length' prices. Political pressures may curb some Inland Revenue efforts, when party or other private interests risk being affected.

Offshore structures are fundamental to the complex investing patterns used by hedge fund managers. Helen Parry, editor of *Hedge Funds Law and Regulation* noted:

> The sector has seen more than its fair share of fraud and abusive practices. In many instances the strategies and products that hedge funds select are far from plain vanilla. The combination of the propensity of some hedge fund managers to select such esoteric investment vehicles, coupled with the propensity of a considerable number of funds to defraud their clients has hurt many investors. The courts in the US in particular have seen many disputes featuring highly sophisticated individual, corporate, institutional and even investment banking clients who have sought to claim damages for fraud against hedge funds and their managers and advisers. Financial sophistication is not a complete prophylactic against fraud. (Parry 2008a)

One might demonstrate this by citing the case of an experienced investor like Nicola Horlick whose Bramdean Asset Management fund invested in the Madoff vehicle and lost heavily as a result.

Hedge funds have been the target of many law enforcement agencies over recent years. From 1999 to 2004, the US Securities and Exchange Commission instituted 51 enforcement actions alleging that hedge fund advisers defrauded either their own investors or other market participants in amounts estimated to exceed $1.1 billion on a global basis (SEC 2004).

Regulators are responsible for some aspects of the surge in hedge fund fraud. Penny Cagan, managing director for operational risk and credit content at Algorithmics, a consultancy company, claims that government bodies had lost touch with changes in the investor base for hedge funds: 'The investor base was once wealthy individuals. But it was becoming more institutional like pension funds. So all of a sudden it's a different complexion of investors. The regulatory regime probably didn't keep up with that.' (Interview with the author, May 2009)

The regulatory system assumed that that the wider system had little to lose if some wealthy people lost their shirts on a hedge fund failure. Cagan cites a 'light touch' approach. But the superior returns of the canny hedge fund managers had tempted in with their investment pitch large numbers of pension fund managers who wanted the high returns to pay for black holes in pension funds and the growing cost of providing for an aging population. These funds were less able, than the wealthy individuals, of coping with the losses arising from a failure.

While government took little interest in the workings of hedge funds, the governance of hedge funds themselves was weak. Due diligence in hedge funds had reached dangerous levels says John Cassey, a partner at Protiviti, the consultancy. 'Some hedge fund directors held positions on the boards of more than one hundred funds. If you are a director of hundred funds, how could you carry out your duties that are required? There has been generally a cloak of secrecy. The fact that you might be doing something that's a bit secret wouldn't have raised any red flags'. There was a general lack of transparency in the hedge fund world which exacerbated the problems. When the markets were going up that didn't seem to be an issue to anyone. But when the music stopped, investors found they had been abused. According to Cassey: 'Hedge funds are not going to be the ones who want to make a virtue over the transparency. They weren't going to want to have a board who meets

together regularly with a strong non-executive directors that ask the tough questions. There was no particular diligence'. (Interview with the author, May 2009)

Thorough investor diligence is the key outcome of the Madoff disaster, says a source. Nathan Sewell, managing director of Protean Investment Risks, advises investors to probe managers' backgrounds, education and professional records. A number of red flags will also send out warnings of fraud in the management office. These include lack of access to the manager, too-good-to-be-true returns, an inadequate or fictitious auditor, lack of independent price verification, lack of internal controls and procedures, lack of qualified staff and inadequate segregation of duties.

Investors should also beware investing in smaller firms, as these have greater proclivity for fraud, says Jean-Renée Giraud, director of development at EDHEC Risk and Asset Management Research Centre. 'Investors in small and medium sized organisations are more likely to be victims of deliberate initial or secondary fraud. Fund size is of significant importance when it comes to assessing the likelihood of fraud' (Giraud 2009: 28-9).

While most fraud involving hedge funds is perpetrated by their managers, some has also been perpetrated by their investors on the funds themselves. Greater due diligence is again essential. Hedge fund managers need to probe people selling them the esoteric instruments in which they routinely invest and trade. So a group of New York managers thought that Marc Dreier was merely a rich investor and broker of financial instruments, until they found he was also a fraudster. Dreier showed how he had turned the tables on the fund managers in May of this year when he told a court and as reported in *New York Law Journal* 14 July 2009: 'I engineered a scheme to issue and sell fictitious promissory notes purportedly issued by companies in the United States and Canada, and subsequently pleaded guilty of swindling $380m

from various hedge funds by selling worthless financial instruments without any plea agreement with the government.'

Investors' insistence on quality governance is invariably compromised by their expectation of high returns. One hedge fund insider, interviewed by the author, who did not want to be named pointed to investor greed as a component in hedge fund fraud: 'Investors do not care what the manager invests in so long as they make money and retrieve their investment. Even if the manager says he will invest in one thing and completely changes the mandate, no-one is bothered until the show goes belly-up. They are as greedy as the managers. But at the point that their money is at risk, the investors will run to their lawyers. That is when they find that the manager was exploiting their greed, and taking them for an expensive ride.'

That may all be changing. The surge of hedge fund fraud has proved a catalyst for greater investor wariness, says Cassey. 'If you're an investor who was deciding between a hedge fund that had a 15% performance but was totally secret and one that offered you 10% but was very transparent, in the past you might have gone for the one with higher returns. But now I think you'd be happier with 10% and know that you'd done all you could to know that it was independent and well run.' But Cassey also warns that costs will rise. 'The more you use independent administrators, valuers and trustees the greater will be the cost. There will be a greater focus on value at risk (VAR) and this methodology will be seen as a minimum requirement.' Tougher controls on manager practices need not impact on performance, he claims: 'Just because you have more controls, more transparency and more regulations than in the past doesn't equal bad returns. The cost will go up. But a talented investment manager should be able to get returns even if it is more regulated.' (Interview with author, May 2009)

Regulation may not, however, come in exactly the form that the hedge funds are prepared to accept. A recent EU draft

Directive (The Alternative Investment Fund Managers (AIFM) directive, released 29 April 2009) contained a requirement on hedge fund managers to hold capital, in a manner not so dissimilar to that required of banks. A minimum level of capital of Euro 125,000 plus a further 0.02 per cent of the value of assets under management over Euro 250 million will be imposed on EU hedge fund managers with assets under management of more than Euro 100 million. Reporting to both national regulators and investors will also become more onerous. Hedge fund managers will have to supply detailed reports to the home state regulator and to investors. The former will need to receive information on governance structures, internal risk management systems, valuation procedures and risk management systems. Investors will need to receive descriptions about valuation procedures, liquidity risk management, redemption rights, the identity of the fund managers' depository and third party independent 'valuators'.

At the time of the launch of the AIFM, which has subsequently been heavily criticised by London managers, the European Commission wrote:

> The proposed Directive is an important part of the European Commission's response to the financial crisis, as set out in the Communication on Driving European Recovery. It aims to create a comprehensive and effective regulatory and supervisory framework for AIFM in the European Union. AIFM, which include the managers of hedge funds and private equity funds, managed around €2 trillion in assets at the end of 2008. This is the first attempt in any jurisdiction to create a comprehensive framework for the direct regulation and supervision in the alternative fund industry. (EU Commission 2009)

According to PriceWaterhouseCoopers, the accountants, in a commentary on the directive:

> the draft Directive seeks to change some of the existing relationships and infrastructure within the industry. Under the proposals, it will be necessary for each alternative investment fund to appoint an independent valuer to value the assets and then the units/shares of the fund each dealing or subscription/redemption day and at least annually. It is unclear whether there is sufficient supply of expertise in the EU marketplace for such an independent valuation process, especially when it comes to hard–to-value assets. (PriceWaterhouseCoopers 2009)

Hedge fund frauds in the market

Fraud committed by hedge fund managers are usually based on a series of misrepresentations or omissions in the fund literature, according to Helen Parry. She cites three key areas of hedge fund crime, including fraud, market manipulation and insider dealing. Hedge funds are typically in the forefront shorting and distorting in the secondary market for equities Parry asserts: 'This is often to fulfil the short sale commitment with cheaper securities which they know will be cheaper because they have driven down the price by spreading bad news or colluding with other funds'.

Parry also cites figures that show that hedge funds account for 32 % of credit default swap sellers and 28 % of buyers, second to banks in each category.

> Some more outlandish conspiracy theorists posit schemes predicated on an hors d'oeuvre of short selling of an issuer's debt and/or equity securities, followed by an entrée of disseminated false rumors, finishing with a dessert of strategic positioning in the CDS market. As the short sellers and rumor-mongers work their malevolent magic, the credit ratings agencies are compelled to downgrade the securities. Under the terms of the CDS, such a downgrade can trigger payment obligations on the swap. This happy event will then complete the menu of multiple profit-taking opportunities

> for the conspirators to be found in short sales and the swaps. Hedge funds, of course, typically feature in such scenarios as the villains of the piece (Parry 2008a)

Parry writes that the CDS market is often active 'just before the announcement of credit quality affecting news. The credit derivatives market may be especially vulnerable to asymmetric information and insider trading risks since firms tend to have a much closer relationship with their private financiers, than with investors in their public securities.'

The potential for conflicts of interest is obvious. In the absence of perfect 'Chinese walls' within banks, the CDS market provides the trading desks of relationship banks with a mechanism through which the information that the loans side possesses can be exploited in the markets. Hedge funds can buy into a small portion of loan syndication to access information about various borrowers. Parry writes, 'This may provide the fund managers with a veritable cornucopia of inside information. Hedge fund managers' fees are performance driven, therefore, this may act as a very powerful incentive to either omit to erect an internal or external Chinese wall or to be unable to resist the temptation to nip over it if it is there (2008b).'

Hedge fund operations have been granted privileged investment status. They have been allowed to arbitrage jurisdictions to obtain maximum privacy and tax advantage for managers and investors. They have also enjoyed substantial investment autonomy, a grant from regulators who have been under governmental pressure to place least curbs on a national industry and substantial contributor to UK GDP. This autonomy has enabled hedge fund managers to explore complex and technical territories such as short-selling, derivatives and unusual commodities trades. The issue for regulators is the extent to which the privileging of a financial sector has incurred hidden costs which are now being

paid by the onshore governments in the throes of credit crunch and recession. This would appear to be the view of the European Commission, whose directive aims to increase hedge fund transparency and accountability. The ironic conclusion to the hedge fund story is that so long as governments kept their regulators on the leash, hedge funds were able to have above-average returns.

As far as the City of London is concerned, there is a clear mismatch between regulatory and investing structures. The need for democratic principles to be injected by onshore administrations into the surveillance and regulatory structures governing hedge funds is now paramount.

The last chapter may not yet have been written in the hedge fund story. But those who believed the claims of hubristic hedge fund managers to be invincible must surely think again. Governments that were once in thrall to the City's highfliers need to learn a lesson about the cost of the risk-takers in their midst, and decide to rein in their wilder excesses.

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10

How to Regulate Banks Effectively

John Kay

I have spent quite a lot of my life looking at the regulation of industries other than financial services, so it is appropriate to start by spelling out some lessons of regulatory history. A central lesson is that regulation works well when it is focussed on a limited number of well defined objectives. Regulation works badly when it seeks to engage in the general supervision of activities to ensure the adoption of what are considered industry-wide good business practices. The latter kind of generalised supervisory regulation tends to be extensive, intrusive, and prone to regulatory capture, discussed elsewhere in this volume. Capture means that despite its intrusiveness it is, taken as a whole, ineffective. Today, financial services is the paradigm case of regulation that has the character of generalised supervision. Financial services

regulation achieves all these outcomes: intrusive, extensive, ineffective and prone to capture.

The textbook example in all books on the history of regulation is the US airline industry. It is obvious that we need to regulate airlines because we cannot have unsafe planes flying over the City of London. So we need to regulate airline safety. Such regulation has been in place since the beginning of the industry. But if we were going to have safe aircraft these safe aircraft needed to be maintained by well-run and well-financed companies. So regulators started looking at the capital structure and finances of airline businesses. Then they started looking at their business plans. Eventually regulation in the airline industry extended to the regulation of routes and fares. By the 1970s the scope of regulation embraced not just these matters: regulators reviewed the distance between seats and even in one notorious instance what was and what was not appropriate for an airline sandwich.

In the 1970s all that regulation in the United States was dismantled. It was dismantled by a US Congressional coalition of Left and Right. On the Left many thought that this regulatory structure had become a racket for large corporations – and they were correct. On the Right, many thought that market forces were almost always to be preferred to regulatory structure. They were correct too.

The result of deregulation, as is well-known, is that today we have regulation that focuses on safety. We do have safe planes and we have a competitive market for airline services. The kind of services that have been offered to consumers have been transformed, mostly for the better, in the last thirty years.

The approach of focussing on specific public policy objectives and confining regulation to these areas was – belatedly – adopted in aviation. Such focussed regulation was also introduced in other industries like telecommunications. More recently, more structures for electricity and gas were created in this style. That is the regulatory model that is needed in financial services.

We do not, contrary to much opinion, need more regulation. We do need better regulation. The better regulation we need is narrowly focussed on important public policy objectives. The rest of the supervisory apparatus should be dismantled as quickly as possible.

Let me spell out some specific lessons. What are our public policy objectives? The principal one is to protect the integrity of the payment system. The financial services industry provides the mechanism by which we all receive our salaries and pay our bills. The integrity of the payment system requires that we protect the deposits of retail customers, both personal customers and small businesses. Protecting payments is the primary purpose of banking regulation.

More generally, there is a need for regulation to ensure better outcomes for retail customers. I do not know anyone who thinks that the retail financial services industry today is delivering a good deal to its customers. We need regulation which is focused on these objectives of consumer protection and of protecting the integrity of the payment system.

Most other financial services regulation should be left to the market. Businesses may choose to construct appropriate self-governing regulatory institutions without state involvement. But the Government should regulate wholesale financial markets as little as possible. We should under no circumstances accept that the Government should act as unpaid insurer of counterparty risk for off-exchange transactions.

That role which is now being cast for government when a wide variety of wholesale markets transactions are described as involving systemic risk. Either people transact through exchanges and the exchange polices them; or they make transactions with counterparties knowing they must do their own due diligence in relation to the counterparty.

When we are told that institutions are too big and too complex to fail – the only acceptable public policy response is to say that if

institutions really are too big and complex to fail they must be restructured as institutions that are simple enough and small enough to be allowed to fail. Anything else contradicts fundamental principles of a market economy.

I have used the metaphor of the utility and the casino and it has become quite a successful metaphor. What we have had over the last two decades in financial services is a casino attached to a utility. There are two things we can do to resolve that problem. We can regulate the casino to such a degree that no one will ever lose enough money in the casino to do any damage to the utility. But those who believe that is a feasible outcome do not know anything at all about casinos or the kind of people who go into them. Alternatively, we can separate the utility from the casino. And that is what we should do.

So we should restore boring banking – the sort of banking described by John McFall as 'Captain Mainwaring type banking'. But he and a lot of other people have said that such a restoration is not possible because financial innovation means that global financial markets are now too complex to permit that kind of structure. That is, in my view, just the opposite of the truth. Actually financial innovation makes narrow banking a lot easier to introduce. The case for this was made twenty years ago: it is a book by Lowell Bryan called *Breaking Up the Bank* (1988). Now Head of Global Banking Strategy Practice at McKinsey, he explained in his book that the likely outcome of financial innovation was that we would have specialist providers of all the individual services which were traditionally encompassed by the traditional bank.

In saying that Bryan was half right and half wrong. He was right in that almost all the individual services that were historically provided by banks are now provided by what in the retail area are called monoliners – that is firms that specialise in one particular business. There are many more specialist product providers

than there were. But Bryan was also wrong: the same period has seen the growth of a limited number of very large financial conglomerates. If one asks why he was half wrong the reason is simple. The scale of the retail deposit base is so large that getting control of it is irresistible to traders and investment bankers and that is what they have done and that process – the financing of the casino from the utility – is the fundamental source of the problem we have today.

In a recent article in *The Atlantic* by Simon Johnson in which he likens the power of investment bankers in Britain and the United States to the power of the Russian oligarchs and to similar corrupt groups in developing countries (Johnson 2009). While Johnson may be overstating to make his point, he correctly identifies a central issue. In a society when individuals become too rich and too powerful, they establish a symbiotic relationship with the political class. That symbiosis leads to reinforcement of the original power and influence and enhances their wealth.

That is exactly what has happened in Britain and the United States over the last twenty years. That is the nexus that needs to be broken. It is only by the existence of that nexus that we can explain the extraordinary fact that the Governments of Britain and the US have provided unimaginably large amounts of money to the financial services sector without imposing any substantive conditions on how that money is used and without demanding any meaningful reform of the way in which these institutions operate.

What we need, then, is structural reform – to separate the utility from the casino. In short, we need 'narrow banking'. What I mean by a narrow bank is an institution that takes deposits and invests them exclusively in a limited and previously defined group of safe assets. Basically these are government securities and equivalents. Narrow banks would have a legal monopoly of deposit taking. They would also have a monopoly of access to the money transmission system. They would be the only institutions allowed

to call themselves banks and the only institutions qualified for deposit protection or any other kind of scheme of government support. Narrow banks would be allowed to engage in consumer and small business lending and would be encouraged to do so. But they need not do so and institutions other than narrow banks might engage in consumer and small business lending.

Narrow banks could be owned by larger or more diversified financial institutions and in the short term they probably would be. Barclays Bank – a narrow bank – might be a subsidiary of the Barclays Group. But a subsidiary that was a narrow bank would be required to operate from physically separate premises and would be subject to the kind of restrictions that I describe. These restrictions would include reserving requirements that would effectively insulate the activities of that organisation from the rest of the Barclays Group or other business activities.

Here space restraints permit only the outlining of the main elements of this solution. But there is no doubt that with modern financial innovation one can restructure the financial system in this way to restore narrow banking. These banks are not quite the same as the 'Captain Mainwaring banks' but are recognisable to the British public as being the kind of banks with which they used to deal and in which they are justified in having confidence. Most of wholesale financial services regulation ought to be returned to market forces to deal with.

The final criticism that will be made of this kind of proposal is that now is not the moment for this kind of radical restructuring: we should get through the wider economic crisis first and we can think about these longer term issues after that. But in my view the truth is exactly the opposite. I have already described the degree to which the financial services industry has become in two decades by far the most powerful industry lobby in the country. We have today a British Government that is almost entirely beholden to it – otherwise it would not have behaved as it has done.

We thus have a moment when the future of financial conglomerates is wholly dependent on direct and indirect measures of government support. If we are not in the position to insist on and implement reforms now, we will never be able to insist on and implement reforms. What we need to do in Britain today is to build a consensus both on the need for that reform and on the specific measures that need to be implemented to start that process of reform.

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11

From the Religion of Regulation to Long Finance

Michael Mainelli

How does the Credit Crunch affect London? Bob Giffords and I call this the Credit Scrunch in the firm conviction that much more is at stake than just recovery from current economic confusion (Mainelli and Giffords, 2009). Scrunch means to crush, crumple or squeeze. We believe that reacting to current events with current mindsets could lead to the scrunching of the world economy, but likewise that we may need to crush, crumple and throw away traditional responses to financial markets. An important discontinuity requires a holistic rethink and response.

I am pleased to hear John Kay push real change with narrow banking (see 'How to regulate banks effectively' in this volume), because my points are largely to move some of these uncomfortable changes further along. Regulation cannot solve our problems,

in fact it is a big part of the causes; we need more competition, not less. London has to decide whether it supports a quick return to dysfunctional normality, or whether it wants to line up to support radical changes to financial markets in a quest for improvement, to make finance sustainable, and to think about the long-term.

Treating all comers fairly

Z/Yen Group compiles the Global Financial Centres Index every six months on behalf of the City of London. The Index has shown over the past two years that London and New York City are neck-and-neck as the only two truly global centres. People focus on two frontrunners, but survey-by-survey Hong Kong, Dubai and Shanghai are making significant inroads. Whilst all financial centres are taking a hit, things are especially precarious for London.

The heritage of London and the UK is treating all comers fairly – the so-called Wimbledon effect – the local champion may have little chance, but the judging will be fair. London thrives when it is open to foreigners, from French Huguenots to Hong Kong Chinese. London suffers when it is unfair to foreigners – the expulsion of the Jews in 1290 or the closed shops of brokers and jobbers until 1986.

London has been built on others' mistakes. Eurodollar markets grew swiftly in the 1960s when US tax rule changes meant multinationals found it attractive to leave dollars outside the control of US authorities. Sarbanes-Oxley requirements after 2000 increased the attractiveness of London as a 'light touch' regulatory environment. AIM listings increased listings at the expense of New York Stock Exchange. But when the UK makes mistakes, for example with the shipping industry last year, retribution is non-existent, but exodus is swift.

True, in the past 18 months or so pessimism has become the new black, but blackest for me are overseas clients claiming that

the UK is a big political risk. Why? The answer is tax since 2007 – changes in six months to non-doms, capital gains tax, foreign dividends and trusts. First a proposed 45%, now a 50% tax rate. On access, they complain about visitors' visas, work visas and ID cards for non-EU nationals. Then they mention terrorist legislation used against Iceland. Then they point out that it is difficult to get fair treatment in a country where the government controls the banks; whether it is a banana republic or the UK, the courts will not operate fairly. When I defend fairness in UK courts, overseas clients point to the 1992 case, Hammersmith and Fulham Council versus Hazell.

Extreme Connectivity

The Scrunch is about connectivity and feed-through and this section is adapted from Mainelli and Giffords (2009: 34-37). In the late 1990s many business gurus made a fortune with breathless panegyrics to the internet. Marshall McLuhan had been right back in 1964: the medium is the message; we are living in a global village. The dot-com boom and bust did not really change anything. We would just arrive at the global village a little later. If liquidity provides the flow, connectivity provides the plumbing to pump it round the system. Extreme connectivity accelerated the systemic feed-through mechanisms on all levels, creating more leptokurtic exposures and increasing volatility. Walt Lukken, of the Commodity Futures Trading Commission (CFTC), concludes that derivatives may be one of the 'flattest' of global industries. His 'aha' moment came when he realised that electronic traders in Gibraltar could now compete directly with the Chicago traders in the pits. 'Clearly a flat world gives the advantage to the Rock over the Windy City,' he concluded, given their off-shore tax and regulatory concessions.

Gertrude Tumpel-Gugerell, executive board member at the European Central Bank, noted the effect of extreme connectivity on equity volatility in 2003. Historical and implied volatilities on stock options had doubled from about 15% to 30% in a matter of six years on European and American stocks. She attributed this to, among other things, technology and questioned whether such pricing volatility might have an adverse impact on capital allocation decisions. More recently she pointed to the huge spike in implied volatilities on stock options on the DJ Eurostoxx index from 15% in 2006 to more than 75% in late 2008. In Chicago the CBOE VIX volatility index hit nearly 90 in October 2008 before falling back to 60 in December. It is hard to imagine such volatilities without the speed and connectivity of electronic trading and straight-through-processing. The Financial Times attributed the American volatility to the use of 'aggressive algorithms' based on intraday pricing feeds. The linkage between equity and derivatives markets is also increasing, with some market participants suggesting that 20% or more of US equity trades probably involve a derivative play. In London anything up to 40% of equity trades are now said to be driven by contracts for differences (CFDs).

Together, these innovations translate into faster systemic feed-through and complex chains of systemic causality. People using similar models add to homogenisation and leptokurtosis. Much of this risk was concentrated in fewer than 20 global sell-side brokerages at the investment banks – in their roles as brokers for the buy-side, issuing dealers for derivatives and proprietary traders. Failure became almost inevitable.

Credit Scrunch

The Credit Scrunch is a systemic failure with multiple causes and multiple effects. One key failure point is lack of competition. The

wholesale financial system has systemically failed among an oligopolistic core of investment banks, auditing firms and credit rating agencies. It is important to stress that many zones of financial services thrive, such as foreign exchange, commodities, and clearing houses. But the core systems around the investment banks have failed. In the UK, Ireland and Iceland, an oligopolistic core of retail banks failed too. And the regulators of these systems failed. Note that Fannie Mae and Freddie Mac had their own regulator.

The strategic question facing everyone is whether the crisis is a short-term bump on an endlessly rising road to prosperity, or an apocalyptic warning that severe design faults imperil political and economic activity. If you believe the crisis is a blip, then you 'hunker down' and want to know when things will get back to normal. If you believe it foreshadows apocalyptic changes, then the question becomes: 'how would you know when the financial system is working again?'

Religion of Regulation versus Open Competition

Market failure comes in three broad categories: lack of competition, information asymmetry/agency problems, and externalities. Wholesale finance certainly exhibits classic signs of lack of competition: self-evidently excessive salaries, a banking industry with 2006 profits per employee a magical 26 times higher than the average of all other industries worldwide (according to McKinsey), an industry that went from 5% of USA market capitalisation in 1990 to 23.5% in 2007, and a cast list of the top 10 that would be largely recognisable back in 1929, Goldman Sachs, Merrill Lynch, Lehman Brothers, Bear Stearns, Morgan Stanley, JP Morgan Chase, Citi ... In summary, by 2007 there were less than twenty global investment banks, four auditing firms, three credit rating agencies. Perverse incentives of bonuses and regulatory disso-

nance expose the information asymmetry/agency problems. And, whether it is third world debt, savings & loan defaults, dot-com bubbles, or Credit Scrunch problems, the burden borne by taxpayers around the world shows too clearly the externalities.

But lack of competition is key. More regulation is a knee-jerk, and senseless response. 'Never mind the quality, feel the width'. When we see market failure we should first try and fix it through trust-busting or anti-monopoly laws – the 1890s in Britain, the 1900s in the USA. Only *Private Eye* (2 October 2008: 3) had the guts to call a spade a spade: 'Gordon Brown promised to increase regulation to deal with collapsing financial institutions, but his biggest move so far is a massive decrease in regulation' suspending normal competition and takeover rules for Lloyds and Santander. Later we should add 'supervision', i.e. knowing what is going on. Later still we should add direct regulation, i.e. saying what should go on. We should start with the Competition Commission, not start with the Financial Services Authority.

People discuss the recent failure of free markets. Actually, the problem is that the financial markets that failed were hardly free; they were heavily regulated. Regulation failed to stop concentration in overly-large, dangerous banks. Regulation creates barriers to entry, thus promoting large banks over the small. Regulation homogenises and embalms, reducing diversity. But financial services regulation is a religion: 'regulation failed because you really really didn't believe in regulation. So pray harder.' The religious faithful of regulation want to go much further the other way and now seek powers to follow mega-banks, rather than question whether size itself might be a sign of regulatory failure. We do not need special rules for system or large complex financial institutions if we don't let them get too large. London failed to push for open markets among global investment banks, audit and credit rating, resulting in over-concentration and loss of diversity, and a Scrunch.

If we were talking about the great internet crash of 2007 and looked at 2 billion internet users focused through less than twenty nodes, at least two of which crashed, several of which wobbled and all of which are dodgy, our analysis would simply conclude: do not concentrate on just twenty nodes. Break it up. Wholesale investment banking is no different. Even regulators need a nuclear option, the ability to look a bank in the eye and threaten to pull the license to operate. Without that ability, too big to fail is too big to regulate. The USA got through the savings & loans debacle by letting 1,700 of 3,400 banks go down over ten years from 1986 to 1995. It cost $125billion. We spend $1.25 trillion a month trying to keep two score too-large organisations together when they should be broken up.

I would add that we need to look at three elements of open markets – competition (having participants keep each other in check); knowing what's going on (supervision); and telling people what to do (regulation). These are three different, complementary and important roles, and they are not necessarily unitary or global. Competition among regulators itself promotes diversity and the information provided by supervision is a key part of keeping regulators on their toes. In fact, if current suggestions for regulatory homogenisation had been implemented earlier we could not look to Sweden, Spain and Denmark for lessons on other ways of regulating which seem to have worked. While supervisors should share data, who needs a global regulator if investment banks are not allowed to get too big? Regulation favours the big getting bigger, creating firms too big to fail, and thus too big to regulate.

The Credit Scrunch is not amenable to quick fixes but, in today's world of 'keep-it-simple-stupid' bullet points, some high-level conclusions include:

- the Scrunch was not a failure of open markets but a failure of highly regulated markets that were closed;

- too big to fail is too big to regulate – financial services is a bit special (so are pharmaceuticals, defence, electricity, air travel, shipping, water, ...), but the fundamental control tool in all markets is competition and we need to increase competition in financial services, not reduce it, or, in a nutshell, size matters;
- increases in regulation reduce diversity – a healthy financial services ecosystem should exhibit diversity, yet society appears to over-value presumed economies of scale in financial services when it should encourage heterogeneity and the broadest possible range of market participants.

Long Finance

Everyone has their favourite fixes, but the question we should be asking far more stridently is 'how would we know when the financial system is working?' More permanent solutions need permanent questions, such as 'can a 20-year-old responsibly enter into a financial structure for his or her retirement?' Such a question raises a host of related issues. The question draws in actuaries, accountants, life insurance, savings, investments, security, fraud, risk, returns and firm defaults. An average 20-year-old today should, under reasonable actuarial expectations, live to 95. Most 20-year-olds with whom I talk assume they'll live to 120. So the question implies a financial structure that should last 75 to 100 years. Yet *The Economist* ('Where Have All Your Savings Gone?', 6 December 2008: 11) observes: 'Any American who has diligently put $100 a month into a domestic equity mutual fund for the past ten years will find his pot worth less than he put into it; a European who did the same has lost a quarter of his money'. So 20-year-olds, and others, vote with their savings.

I do not know how 20-year-olds can responsibly enter into a financial structure for their retirement, but I do believe that the

question matters. Another permanent question might be, 'how do we fund a forest?' These questions remind me of a question posed by the computer scientist Danny Hillis in 1995: 'how could one build a clock to last 10,000 years?' Dr Hillis' question led to the 01996 (sic) Long Now Foundation, providing a counterpoint to today's 'faster/cheaper' mindset by promoting 'slower/better' thinking. From the Long Now Foundation emerge projects such as a timeline tool (Long Viewer), a library for the deep future (Long Server), and tracking bets on long-term events (Long Bet). Another venture with long-term aims is Carlo Petrini's Slow Food movement. Perhaps we need a Slow Finance movement or, my favourite, a Long Finance Foundation.

London seems a tragic hero – it lost its own principles of open markets in pursuit of a decade of quick bucks. Once you look at the problems involved in Long Finance, you realise that many of today's sustainable finance issues arise because society's core, global risk/reward transfer system, finance, does not have enough diversity to deal with the long-term. In conclusion, I do believe in the power of competitive markets to make the world a better place. I equally believe that markets are social tools requiring design and oversight to meet their objectives. I would argue that the focus must be on increasing competition – keeping London open as a market for all to be treated fairly, over the long term. London should lead the debate on Long Finance.

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12

Sovereign Wealth Funds in the Light of the Global Financial Crisis

Xuecheng Jing

Since the outbreak of the sub-prime mortgage crisis in the United States, Sovereign Wealth Funds (SWFs) have attracted great attention worldwide and have become a central issue in academic research. This paper begins with China's SWF, China Investment Corporation (CIC) and elaborates on the stabilising role of SWFs in the light of the global financial crisis. It also puts forward some suggestions for the development of SWFs and in its last part addresses the orientation and development strategies for the City of London.

The status quo of SWFs

It is well known that Sovereign Wealth Funds are set up by govern-

ments and operated independently from the nation's monetary and fiscal authorities. They are managed by specialised and market-oriented investment institutions and are funded by public money. The United States Treasury defined Sovereign Wealth Funds as investment vehicles set up by the Government for the management of foreign currency assets. The OECD (2008) believes that Sovereign Wealth Funds are mediums of investment owned by governments and mainly funded by foreign exchange reserves. In a speech on SWFs in June 2007 Mr Clay Lowery, who was then the US Acting Under Secretary for International Affairs, defined SWFs as 'a government investment vehicle which is funded by foreign exchange assets, and which manages these assets separately from official reserves'. In addition, according to Morgan Stanley's Stephen Jen, a typical SWF has five features: sovereignty, high foreign currency exposure, no explicit liabilities, high risk tolerance, and a commitment to long-term investment (Jens 2007). The IMF in its publication 'Sovereign Wealth Funds—A Work Agenda' held that 'SWFs are special purpose public investment funds, or arrangements. These funds are owned or controlled by the government and hold, manage, or administer assets primarily for medium- to long-term macroeconomic and financial objectives. The funds are commonly established out of official foreign currency operations, the proceeds of privatisations, fiscal surpluses, and/or receipts resulting from commodity exports. These funds employ a set of investment strategies which include investments in foreign financial assets' (IMF 2008).

Since the establishment of the world's first Sovereign Wealth Funds – the Kuwait Investment Authority – in 1953, SWFs have developed rapidly, in terms of the numbers as well as the total assets they manage. It is estimated that by the end of 2008 some 41 SWFs had been established in over 34 countries around the world. It is important, however, not to exaggerate the importance of SWFs; according to the International Financial Services London

they accounted for around $3.9 trillion, only half the world's total foreign exchange reserves (IFSL 2009). In addition, according to a Morgan Stanley forecast report of 11 November 2008, due to the global financial crisis, SWFs' assets are only expected to reach $10 trillion by 2015, instead of $12 trillion estimated before today's crisis. Overall, as Figure 1 clearly shows, SWFs' position remains low in the global asset management industry, and they are only a little bigger than private equity funds or hedge funds. Having said that, major adjustments have taken place in the landscape of the global financial industry and this will result in a huge growth of SWFs in emerging markets, with countries like China and Saudi Arabia leading the way.

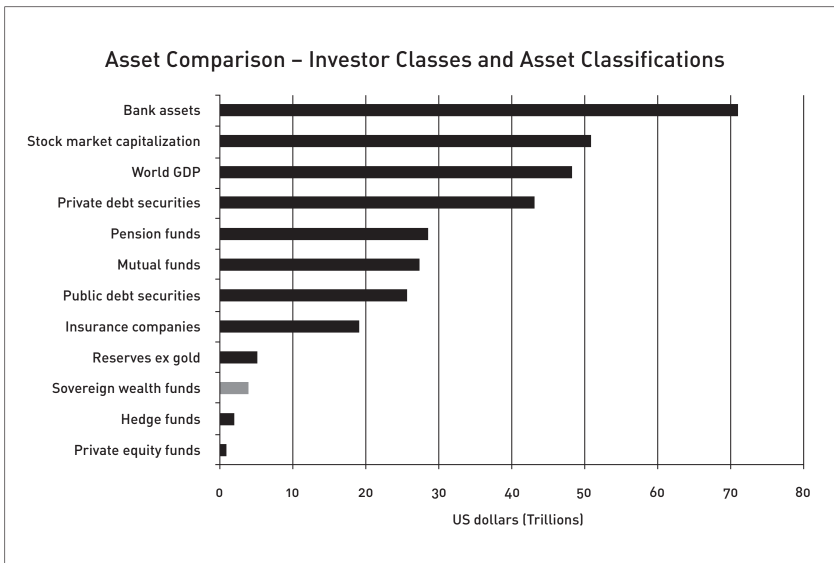

Figure 1

Source: IFSL Maslakovic (2008), various IMF publications – Global Finance Stability Report, Sovereign Wealth Fund Institute. Last updated August 2008

Compared to the investment principles of safety, liquidity and profitability of foreign exchange reserves, Sovereign Wealth Funds pursue higher yields and strategic purposes. According to

Cambridge Associates, of the world's top 50 to 60 big investors with total assets of over $1 billion, more than a dozen have long-term (five to ten years) investment returns of between 5 and 6 per cent. But since the outbreak of the sub-prime mortgage crisis in the US, major SWFs suffered an unprecedented hit in 2008. The value of SWFs' investments have plunged substantially. A Morgan Stanley report of 11 November 2008 showed that global SWFs had losses of about 18-25% in 2008. For example, South Korea's SWF invested $60 billion and lost $40 billion. Singapore's Temasek Holdings' investment portfolio shrank to $83 billion as of the end of November 2008, from $120 billion at the end of March 2008. Abu Dhabi Investment Authority lost $183 billion in book value. The investment returns of Qatar Investment Authority and UAE-Abu Dhabi Investment Authority declined by minus 20% and minus 40.4% respectively during the same period. As a result, SWFs have become more prudent with their decisions and they have all been waiting on the sidelines for better investment opportunities.

Even under normal trading conditions they faced enormous risks and challenges. Firstly, high investment costs. The biggest difference between SWFs and other investment funds lies in their huge size, which means that their every move will be particularly eye-catching and secrecy is difficult to achieve in the market. Once the market is informed that a SWF intends to invest in a property or a security, the relevant assets' prices will rise, and then the investment costs of the SWF will increase as well. Secondly, the political obstacles. Most SWF investments are in foreign countries, which often gives rise to suspicion by the host country as well as hidden, and even openly hostile, resistance due to the sensitive political background. There are restrictions on the proportion and direction of investment in some areas, while nationalist sentiment and protectionism will also stymie their investments. Thirdly, it is difficult for them to balance trans-

parency and commercial secrets. Increasing transparency by SWFs could partly alleviate suspicions about their political and national motives and can facilitate their investment activities in developed countries. However, with large-scale investment, SWFs are often reluctant to fully disclose information, some of which may have a significant impact on the market and may involve state secrets. Therefore, it becomes a challenge how to balance commercial interests and transparency and how to design an appropriate information-disclosure system. Fourthly, the continuing resurgence of financial protectionism. When SWFs undertake direct

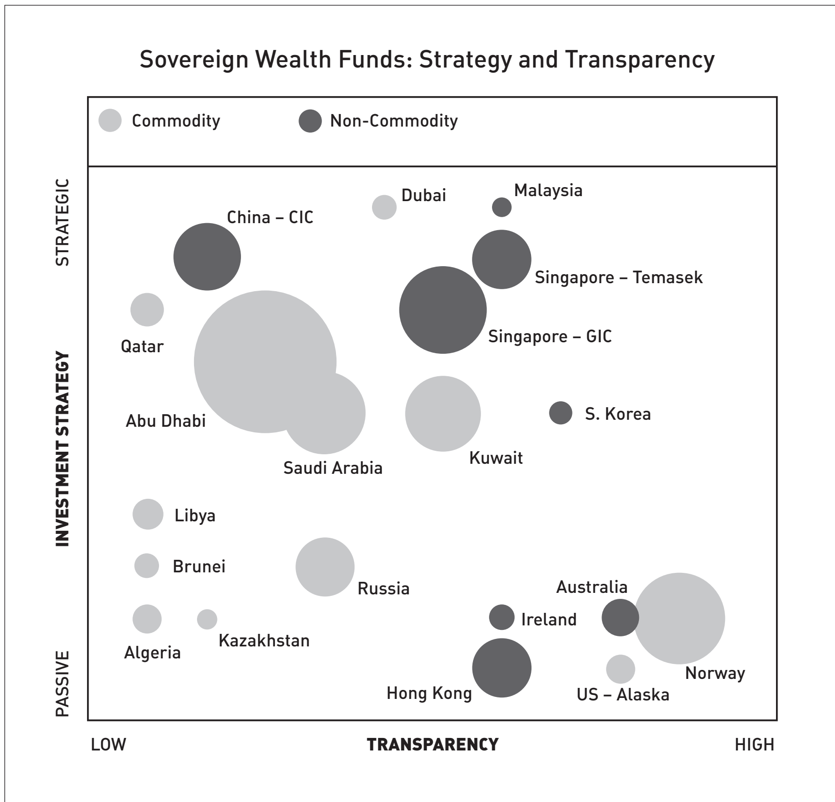

Figure 2
Source: Sovereign Wealth Fund Institute. Updated 18 March 2008

investment or concentrate ownership and private equity investment, these investment strategies may lead to resistance from financial protectionists. For example, early in 2006, Singapore Temasek planned to acquire the Thai telecommunications company Shin Corp from the then Thai Prime Minister, Thaksin Shinawatra. The project was criticised by the public as endangering Thailand's economic security and helped trigger a coup against Thaksin's government.

China's Sovereign Wealth Fund, China Investment Corporation (CIC) was established on 29 September 2007. The Ministry of Finance issued 1.55 trillion yuan worth of special treasury bonds to buy $200 billion foreign exchange reserves from the central bank and injected the money into CIC. The fund's business objectives are to carry out an active and steady operation aimed at maximising the shareholder's value within an acceptable range of risks, and to continuously improve the corporate governance in the major state-owned financial institutions it controls. In addition, the establishment of China's fund has a great significance – the beginning of a shift in China's economic growth model – from an exporter of commodities to an exporter of capital. And it also helps optimise China's industrial structure on a global basis.

Features of China Investment Corporation

1. CIC has two kinds of funding sources. One is the $200 billion provided by the Ministry of Finance, serving as CIC's registered capital which is the principal funding available. The other is the dividend income of the large commercial banks (which are state-owned) paid to CIC as their major shareholder. This is used to cover most of interest payments on the special treasury bonds. At present, half of the funds are used to purchase shares in financial institutions in China and half in overseas investment.

CIC mainly invests in equity, fixed income and alternative assets, in both developed and emerging markets. The alternative investments include hedge funds, private equity, commodities and real estates, etc.

2. The investment strategy and trading conditions. The principles behind CIC investments are that CIC selects investments based on economic and financial objectives and an assessment of the commercial return. CIC allocates capital and assets within a given risk tolerance, which can fluctuate according to pressures from the Sate Council and the media, in order to maximise shareholder value. CIC seeks long-term, stable, sustainable, and risk-adjusted returns and it usually neither seeks an active participation in the management of the companies in which it invests, nor attempts to influence those companies' operations. Its investment portfolio covers a combination of international financial products, with a majority in publicly traded products and a small part in alternative assets. Moreover, the company will not give up the opportunity to undertake direct investments, such as real estate and private equity. Investments are mainly entrusted to outside fund managers, and gradually CIC will increase the proportion of proprietary trading.

Until now, four items of its investments have been disclosed. CIC agreed in May 2007 to buy a non-voting stake of just less than 10 percent in Blackstone Group for $3 billion. It invested $100 million in China Railway Group when the latter went public in Hong Kong on the 20 November 2007. A month later, it bought $5.58 billion stake in Morgan Stanley, representing approximately no more than 9.9% of equity ownership in the US investment bank. The price was more than $50 per share. So far, the overseas investments have all incurred huge book losses. In December 2008 Lou Jiwei, Chairman of the Board of CIC, announced that CIC would adopt a more 'cautious' investment strategy because of unresolved economic problems facing many countries and uncert-

inty with regard to their future economic policy. On 4 June 2009, CIC invested in Morgan Stanley again, with 1.2 billion US dollars at a price of $27.44 per share, which boosted its stake in Morgan Stanley back to 9.9%. The price per share was much lower than the investment in December 2007. Thus it probably diluted the average purchase price of the shares of Morgan Stanley CIC holds, bringing it closer to reversing the paper losses.

3. The Organisational Structure. On 29 April 2009 CIC established four new departments: Public Market Investment, Tactical Investment, Private Market Investment and Special Investments to replace Fixed Income Investment, Equity Investment and Alternative Investment departments. Based on decisions made by the Investment Committee, investments and mandates are managed by four investment departments. Each performs research on its relevant markets, formulates its investment strategies within the context of the overall portfolio and risk management framework, builds and manages its portfolios and recruits, manages and evaluates external fund managers as required. The four departments are:

- The *Public Market Investment Department*, which implements traditional beta strategies in public-market equities, fixed-income products, commodities, currencies, as well as cash management. Because CIC is a new organisation, virtually all public market investments are managed by external managers. It expects that over time CIC managers will assume increasing responsibilities for portfolios within this department.
- The *Tactical Investment Department*, which manages internally managed proprietary portfolios and liquid absolute-return investments utilising external managers.
- The *Private Market Investment Department*, which invests in private markets through third-party managers, co-investment vehicles, partnerships and separate accounts. The department also invests in real estate and infrastructure markets.

- The *Special Investment Department*, which directs and manages, on an in-house basis, large-scale investments with positions concentrated towards the longer term horizon. CIC's investments in Morgan Stanley and Blackstone are managed within this department.

Currently the company has established a sound corporate governance structure, including the Board of Directors, the Board of Supervisory and Executive Committee. Its organisational structure is in the form of 'the Board of Directors – Executive Committee – Chief Executive Officer' under the Executive Committee. There is an International Advisory Board. Under the Chief Executive Office, there are Chief Investment Officer, Chief Risk Officer and Chief Operating Officer and a subset of 11 departments.

Risk Management

Based on the policies set by the Board of Directors and the Executive Committee, CIC's risk management strategy and approach is overseen by the Risk Management Committee, which is responsible for setting company-wide risk strategy, defining risk management policies, determining exposure thresholds, reviewing and finalising reports concerning risk management and establishing risk control evaluation criteria. The Committee proactively assesses and measures the company's portfolio risks and reviews the portfolio's composition to ensure corporate risk exposure is managed appropriately. The Committee meets quarterly or more frequently when needed.

The Risk Management Committee is comprised of senior executives and department heads to facilitate comprehensive and integrated oversight of strategic, financial and operational risk. Investment risk is managed by the Risk Management

Department. The department has formulated a formal Risk Management Policy that provides policy guidance for managing risk throughout CIC. Within the Legal and Compliance Department, the legal team focuses on development and review of contracts and management of legal risk. The compliance team is charged with the responsibility of assuring that CIC complies with investment and related laws and regulations of the markets in which it invests and with internal policies. Reputation risk, policy risk and other non-commercial risks are addressed by the Public Relations Department.

CIC has developed a comprehensive risk control and limit system to manage market, credit, sector, country and currency exposure. The Risk Management Department meets monthly with each investment department to discuss investment strategy, risk developments and other investment risk management issues. The Department reviews and comments on every investment and external manager mandate proposal. In addition it participates in the calculation of risk adjusted performance, assists in the evaluation of internal and external investment managers and monitors risk performance. Finally, it should be noted that the half of the staff in the Risk Management and Legal and Compliance Department have international experience.

The Stabilising Role of the SWFs in the financial crisis

Sovereign wealth funds are an important force for the steady growth of world economy and orderly adjustment of global economic imbalances. During the current financial crisis, SWFs have been playing a significant stabilising role.

Firstly, SWFs play an active role in stabilising national macroeconomic situation and exchange rates. On the one hand, SWFs can be more professional and reasonable in managing and util-

ising budget surplus and public assets, and this is conducive to balancing fiscal revenue and expenditure and guaranteeing national standards of living. On the other hand, the establishment of SWFs is good for exchange rate stability. It will reduce the total foreign exchange reserves when a particular country uses foreign exchange reserves to set up sovereign wealth funds. At the same time SWF 's investments in overseas assets or securities may also help slow that country's exchange reserves growth. Therefore, the establishment of SWFs actually helps stabilise the exchange rates of currencies and is conducive to macroeconomic stability. In an event organised by the American Foreign Relations Committee in Washington on 7 May, 2008, billionaire financier George Soros said, as far as America was concerned, the sovereign wealth funds are a 'positive factor' in the stability of the US financial industry.

Secondly, SWFs diversify and limit risk in financial markets. Poor management of SWFs may increase potential risks to an economy, but the negative impact on the global financial markets is quite small. At a global level risk levels are stabilised because of the nature of SWFs' funding sources and diversification in their asset allocation in appropriate ways. In addition, those features could prompt SWFs to take modern risk measurement technology in order to avoid unaffordable risks.

Thirdly, SWFs promote the development of the global financial markets and enhance market efficiency. SWFs have an enormous influence on the development of global financial markets. The rapid rise in the global capital market of state-owned investors is bound to change the framework for global investors and their behaviour. SWFs have a long-term investment perspective and higher risk tolerance, and their support for companies enhances the credit rating and financial tolerance of those companies. They undertake 'counter-cyclical' investments. This behaviour could improve the efficiency of market resources allocation and reduce

the volatility in financial markets. Therefore, SWFs become the 'stabilising factor' of financial markets. In addition, the activities of SWFs introduce a substantial increase of funds' inter-regional arbitrage, which is beneficial to market efficiency of the global financial markets, especially emerging markets. But it does also introduce some element of Western financial protectionism.

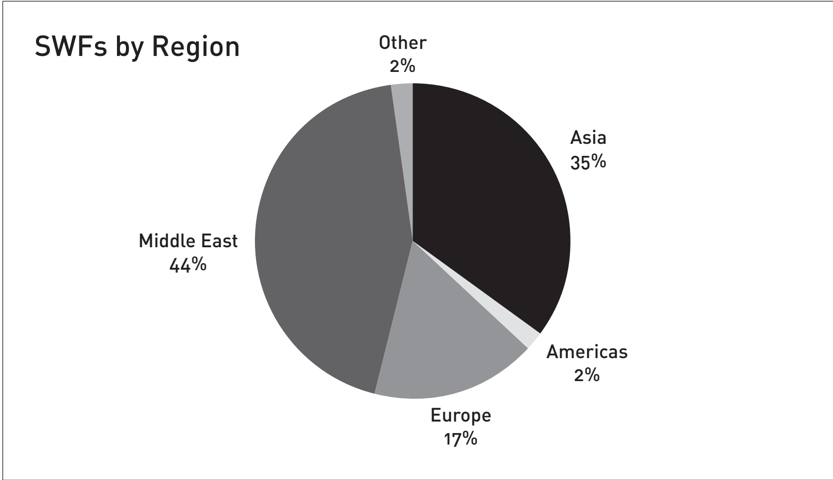

Figure 3
Source: http://www.swfinstitute.org

Fourthly, SWFs have a positive effect on corrections of global financial imbalances. SWFs have an influence on the status of global reserve currencies, including of course the US dollar. SWFs emerged and developed in the context of economic globalisation, and their investment activities can help adjust the relationship between investment and savings globally. Because the investment activities of SWFs span the Euro-zone, Japan, and emerging market for other non-dollar reserves areas, and because SWFs are so large, they are important in the process of 'making-markets' and currency trading, so helping markets to clear and prices to stabilise. For example, SWFs can increase national demand for currency

reserves, so affecting the position of international reserve currencies and the US dollar. SWFs are able to counter international and US criticism of currency imbalances, which would be otherwise worse by some margin. Moreover, SWFs transform their investments from short-term investments in low-risk bonds to long-term bonds and equity, and so they are able to alleviate the global imbalance between revenue and expenditure. The majority of SWFs have played an important role in the present crisis, acting as firemen in rescuing many financial companies and providing significant cash flows to smooth the market.

Some suggestions for the development of SWFs

First they should invest at a strategic level and adjust their investment portfolios in order to prevent the losses of SWFs and the global inflation brought about by the depreciation of the US dollar. SWFs should consider investments from a strategic perspective, in line with national interests and global economic stability, and then participate in and promote the process of the domestic and world economic recovery. Specifically, SWFs should avoid politicising investment and reduce the political risks of investments, implement effective corporate governance and conduct professional management, diversify their investment and standardise their own investment behaviour.

Secondly, there should be an increase in the transparency of SWFs. Their lack of transparency gives rise to suspicion by the outside world of their investment behaviour and strategic intentions and this leads some countries to resist investments by SWFs. The situation is not unconnected with the comparatively recent establishment of the majority of SWFs. With the maturing of these funds, however, SWFs should try as hard as possible to improve their transparency. Provided that no transaction secrets

are involved, there should be a timely disclosure of information such as investment goals, organisational structure, financial information, asset allocation and so on. This should bring about more understanding by the international community as well as improving the environment of international investment.

Thirdly, oppose investment protectionism. Following the outbreak of the financial crisis, world economic growth has slowed down and this has increased the risk of protectionism. Protectionism, in its turn, would lead to a further deterioration of the current economic situation. At the same time, protectionism is not conducive to the development of SWFs. Host countries should not interfere with investment activities of SWFs and should provide a relatively accommodative environment for their investments. Only in this way, can SWFs play a better role in stabilising financial markets and helping countries to better cope with the financial crisis.

Fourthly, the development direction of SWFs may attract more private funds into SWFs, leading to a diversification of their sources of funding. The boundary between the national and private capital will become much more blurred. The equation of SWFs plus private funds resulting in the creation of sovereign and private wealth funds enjoys the twin features of both public policy and commercialism. More native funds are able to enjoy profits from overseas investment in this way, while SWFs are able to absorb more capital into their investment pool. It can not only enhance the SWFs' ability to avoid risks but also encourage them to pursue profits.

The orientation of development strategy for the City of London

The geographical size of London is small in relation to its functioning as a global financial centre. Daily foreign exchange turnover

in London is about $1.36 trillion, 34 per cent of the world's total. OTC trading of financial derivatives exceeds $1 trillion, accounting for 42 per cent of the global amount. According to figures provided by the Bank of International Settlements, three quarters of the Fortune 500 firms as well as 254 foreign banks operate there. In short, the long history of London's culture, advanced technology, mature markets and law created its unique status as a world financial centre. To some extent, it is the 'global powerhouse'.

There are three key areas that the City of London should focus on. Firstly, establishing links with emerging economies could be its main orientation after the crisis and against the background of global economic recession. Business strategies are shifting gradually from the developed countries to emerging economies. The City of London needs to keep a close eye on developing countries and the emerging economies, particularly in view of the competition from its chief rival, Wall Street. For the City of London the opportunities lie in investing in emerging markets. This could become a growth point, allowing the City to become a truly 'global' financial services centre. The global financial market has changed a great deal during the crisis and future global growth will come mainly from the emerging economies, both financial markets as well as industries. In 2008, the BRIC nations contributed more than half of the world's growth. The IMF forecast that Asian economies will grow at an annual rate of 5.56 % in 2009. Goldman Sachs projected that the BRIC nations will see their stock markets quadruple in 10 years with an emerging middle class of some 800 million people, thus becoming the world's most important consumer market in terms of energy, national resources as well as capital. That will provide a rare restructuring opportunity for global financial centres like the City of London. At the operating level, the City of London can create financial products linked to the developing countries to attract investors from there; for example, a stock futures index linked to China's A-share market. It

can also provide third-party services for the economic and trade activities of the developing nations. The City of London can also take equity stakes in stock exchanges of developing nations and share profits. In these ways, it can increase its voice and participate more in the developing world while deepening its influence in emerging markets. That is not only the way to make a breakthrough for the City of London during the global financial crisis, but also it would provide growth potential for the City when the 'tsunami' ends.

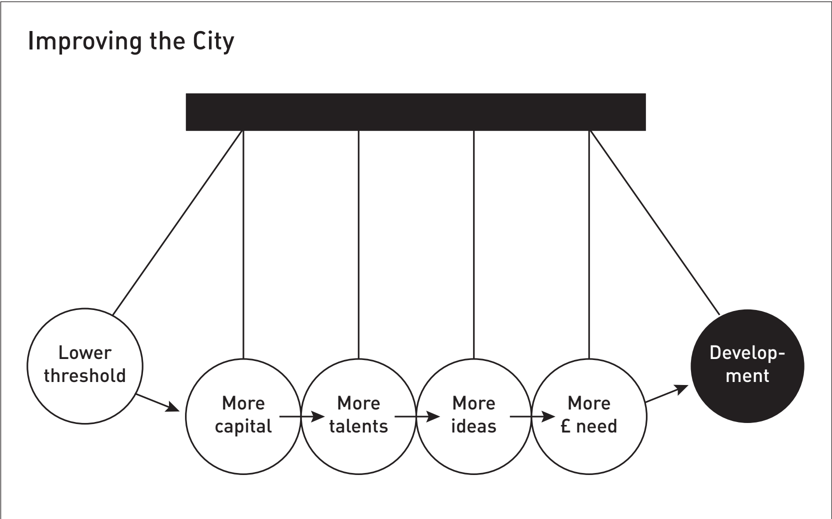

Figure 4

Secondly, the City of London should increase the export of talents, products and technologies. This would establish a long-term strategy, enabling it to maintain its time-honoured status as a financial centre. In China, the textbooks of finance are mostly written by US economists, using US cases, and many professors got their degrees or did research in the United States. Therefore, Chinese students are more familiar with the US market than that in London. And this is also the case in many other developing

countries. So, the City of London should speed up efforts to spread ideas about its unique funding strategies and financial services among these countries. It will surely take time, but such efforts ought to start as soon as possible.

Thirdly, the City of London, and Britain, should lower the threshold to allow in more foreign investors. We hope that the development strategy of London will change from the 'starfish' to 'octopus' in its mode of business services. Instead of funds flowing into the City of London from a fixed number of (national) geographical points, London needs to reach out to more regions with more customised services. For example, it may allow foreign firms to issue depository receipts in London (LDR), and enable SWFs, including CIC, to expand their equity and direct investment. Huge capital from SWFs will inject much vitality into London. More foreign investors will also boost employment, add to the demand for financial services and help to expand the financial markets in London, so creating the prosperity for the City's future.

Of course, London has expressed its sincerity in these regards. The Lord Mayor of London, Ian Luder, said during the April 2009 G20 meeting that the City welcomes long-term investors, no matter whether they are state controlled or not. London also welcomes China's sovereign wealth fund to invest in its banking sector. The worst time is over for the banking industry and the current price is very good for long-term investment. If China's sovereign wealth funds show an interest in investing in British banks, it is an indication of confidence in the country's financial system. The second Sino-British economic financial and economic dialogue with the theme of 'Strengthen the Sino-British Cooperation, Support Sustainable Development,' was held in London on 11 May 2009. Chinese Vice-Premier Wang Qishan and British Chancellor of the Exchequer, Alistair Darling, co-chaired the dialogue. Through their joint effort, the two sides have reached a consensus in many areas, such as exchanges and coop-

eration in bilateral financial supervision and financial services, pragmatic cooperation and technology transfer in the field of new energy sources, and trade cooperation in services and technologies. A new era is dawning and the future is bright. Such an open attitude from the City of London towards global investors including SWFs will inject more life into its future development.

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13

Global Power Shifts: Challenges and Opportunities for the City of London

Chris Dixon

While we are perhaps too close to a global crisis that may well have further shocks in store to assess its long-term impact, there are indications that it may prove a watershed in the position of the City of London within the global system. The crisis has highlighted changes in the global distribution of power that have been evident since at least the mid-1990s, but which have only attracted major interest with the start of the present century. On the one hand this has been marked by renewed debates over the decline of the USA, on the other hand, by a major focus on the rise of the BRICs – Brazil, Russia, India and China – particularly the latter. But while the extent and implications of these changes remain highly contested, the evidence does point to the current crisis having a significant impact on the global distribution of economic and polit-

ical power, and a related movement away from neo-liberalism. Such global shifts will pose major challenges to such global nodes as the City of London which have done so well out of the increasing liberalisation of markets. In particular, the City has taken a lead in the penetration of new or 'emergent markets'. This has involved exporting services, managing assets, establishing local operations and the provision of advisory facilities for investors in such markets as a whole. City business strategies have been based on assumptions of progressive opening of markets, and the adoption of international standards of financial and commercial practice for which the City has been regarded as the 'gold standard'. However, this situation rests on the continued domination of the neo-liberal paradigm, the global leadership of the USA, and the related implementing and managerial functions of the IMF, WTO and the World Bank. Such a combination facilitated the elimination of opposition to liberalisation and alternative developmental and business forms. It is argued here that the USA-centred system is now facing serious challenges which will in turn impact on the whole basis for the success that the City has enjoyed since the late-1980s.

The origins of the power shift

The roots of the changes that are taking place in the global order, like the current financial crisis, can be traced back to the neo-liberal counter-revolution of c.1980 and the end of the Cold War in c.1989 (Haseler in this volume; Haseler 2008). The latter left the West in general, and the USA in particular, in a position to exercise a perhaps unprecedented level of influence over the operation of the global system (Ravenhill 1990: 732). While the geo-political and ideological shifts combined to herald what might be termed the 'neo-liberal era', characterised by an almost mystical belief in the power of free markets, open economies, and Western

forms of business, regulation, state-market relations and democracy. Other forms would either stagnate or be swept away by irresistible forces that would produce a truly global market place, characterised by uniformity of practice. The opening of such economies as China, India, Vietnam and Eastern Europe as a whole was seen as confirming both the inevitability and the wisdom of neo-liberalism and marketisation, as witnessed by the use of the term 'emerging markets'. This concept reflects both post-Cold War geo-politics and the dominance of neo-liberalism, and was constructed by a range of financial interests and agents – including specialist brokers, and asset managers – out of what might previously been considered the global 'periphery' or the Second and Third worlds (Sidaway and Pryke, 2000).

The 1990s were dominated by 'hyper-liberalisation' driven globalisation, to which (it was repeatedly said) there was no viable alternative. As Bill Clinton put it:

> Globalisation is not a policy choice – it is a fact. But all of us face a choice. We can work to shape these powerful forces of change to the benefit of our people. Or we can retreat behind walls of protection – and get left behind in the global economy. (Bill Clinton, speech to the WTO, 18 May 1998)

But the wave of liberalisation that swept the global system during the 1990s combined with the end of the Cold War to promote much that may prove inimical to both globalisation and the power of the West. This included resistance and popular protest centred on the view of Fidel Castro that:

> The Third World countries have been losing everything: custom tariffs that protected their emergent industries; agreements on basic commodities; producers associations; price indexation; preferential treatment; any instrument protecting their export value and contributing to their development. (Fidel Castro, comments on the WTO, cited *Guardian*, 20 May 1998)

On the national level resistance took a variety of forms. These included elements of economic nationalism and reversal of liberalisation (as in Argentina in 2001 and Malaysia in 1998). The subsequent economic success of such economies encouraged other reactions against the globalisation project. In some cases countries sought to increase their power to resist and their voice in the international system through a variety of formal and informal groupings. The latter is most clearly illustrated by the Group of 21 within the WTO and the former by regional agreements.

The neo-liberal era has been one of regionalisation (Hurrell 2007: 130). There has been an extraordinary proliferation of regional agreements, and expansion, intensification and relaunching of established ones. While the forms, origins and effectiveness of these bodies vary enormously, all have been motivated by the desire to increase their power and scope for independent action within the global system. While regional groupings, led by the EU, are becoming significant actors in the global system, the USA has long regarded regionalism with suspicion and has actively discouraged initiatives in Asia and South America, unless they remain largely powerless and / or closely tied to US interest, as with Asia-Pacific Economic Cupertino (APEC) and the proposed Free Trade Area of the Americas (FTAA) (Aggarwal and Fogarty 2005: 333-34; Beeson 2007: 217; Higgott 2007: 94; Vasconcelos 2007: 179). But formal regionalisation has been accompanied and reinforced by significant regionalising tendencies within the global economy. Indeed, it can be argued that much of what was termed 'globalisation' was 'regionalisation'. This is most clearly the case with so-called 'global companies' that in practice operate regionally (Dicken 2007: 124), either accommodating to and, in turn, furthering, the integration of existing regionalisations (as in the EU), or promoting informal regionalisation (as in East and South East Asia). Overall, the global system is dominated by the regional 'triad' of the EU, North America, and

Asia-Pacific (East and South East Asia). These account for 75% of world trade, 90% of foreign direct investment (FDI) and 75% of global product; that is, three interacting (and very contrasting) regional systems, with close linkages to some critical outlying individual counties and groups, such as the major oil exporters. But the proliferation of interconnections at all levels together with the dominance of neo-liberalism and attendant regulatory, cultural, informational and organisational forms gave credence to the 'hyper-globalisation' view of the world.

With the exception of the EU, the increased regionalisation of the global system tends to be overshadowed by the rise of new national economic powers that in different ways may come to challenge the US position. During the 1980s much was made of the increasing economic power of Japan and the four Asian tigers – Hong Kong, Singapore, South Korea and Taiwan. From the early 1990s the focus moved to China, and more recently the rest of the BRICs and various secondary powers such as Argentina and South Africa. While extremely varied and starting from very different national bases and positions within the global system, these economies have development forms that have been significantly removed from neo-liberalism. In general, they have tended to attempt to reap the benefits of an increasingly liberalised global system while heavily protecting their domestic economies, business practices and regulatory systems. Instead of these situations being isolated and temporary pockets of resistance to globalisation, they are coming to provide significant challenges to neo-liberalism. This is something, which is being furthered by the involvement of such powers as China and Brazil in regionalisation projects, and their increasingly close economic links.

The rising national and regional powers are already engendering competition for access to markets, investment, raw materials and strategic locations. This has attracted most attention with respect to Chinese activities in Africa where there is

increasing rivalry with India, the EU and the USA over access to oil and raw materials (Shaxson 2007; Speigal and Le Billion 2009; Zeig and Jianhai (2005). In a wider context, Khanna (2008) has termed this the 'New Imperialism', but one under which the possessors of key materials or locations can play one power against another. That is, for some countries there is an alternative to Washington and its Consensus. There is also the prospect of 'borrowing' from the old and new powers to produce blended forms and roots to modernity. In this respect a 'Turkish way' or 'Libyan way', for example, may engender significant counters to the levelling tendencies of the neo-liberal era (Khanna 2008).

By the early 21st century the rise of the BRICS and a series of secondary economies, such as Argentina and South Africa, together with the proliferation of regional and other groupings, had produced a significantly more diffused pattern of economic and political power than was present at the end of the Cold War. These changes were accompanied by the maintenance, emergence, and increasing influence of developmental forms that provided direct challenges to neo-liberalism. This was most apparent in Asia and, to a lesser extent, South America (on the latter see Grugel and Riggirozzi 2007; Grugel *et al* 2008).

The Asian challenge

There is general agreement that the major Asian economies (with, perhaps, the exception of Japan) are better placed to face the present crisis than the West, or perhaps any other part of the global system (Dixon 2009; World Bank 2008). Headed by China, much of Asia is likely to emerge first from the present crisis, a reflection of not having to rescue and stabilise financial systems, very large foreign reserves and the application of very major stimulation packages. The predictions made late in 2008 of sharp

contractions of Chinese growth to 5% for 2009 (from 9% in 2008) were by July 2009 replaced by expectations of 8.5% for the year and a rapid return to the 10% level (though official Chinese sources have also urged caution about the reliability of the return to growth); there are similar expectations for India (IMF 2009; Wolf 2009). A return to high rates of growth for these major economies and other smaller, but highly dynamic ones, such as Singapore (*Financial Times*, 14 July 2009) adds weight to the argument that it is Asia that will lead the global system out of recession.[1] Whether this proves to be the case or not, rapid recovery in Asia with the OECD group still mired in efforts to rescue their financial sectors, may well significantly accelerate shifts in global economic power. This involves much more than shares of output, trade and investment. For just as US business models, regulatory systems and general emphasis on liberal markets have been widely discredited, so attention has focused on the basis of Asia economic success and resilience in the face of the present crisis (Dixon 2009; Seneviratne 2008).

The successful economies of East and South East Asia have long posed a serious problem for the neo-liberal perspective (Dixon 2002: 93-101). While these countries developmental forms are extremely varied, they generally involve close links between the state banks and business in general, far from fully liberalised markets, and distinctive business forms – often with limited separation of management and ownership. Despite the extensive literature that emphasises the generally state-led nature of these economies (see in particular Wade 1990), this has been generally ignored or refuted by neo-liberals (Amsden 1994; Wade, 1996, 1998). Indeed, Asian development has been variously misrepresented as the product of free markets and open economies, most strikingly so in World Bank's study *The East Asian Miracle* (1993).

In 1997-8 the neo-liberal view of the Asian economies underwent a remarkable reversal in the wake of the financial crisis. This

was almost universally seen in the West as rooted in a heady mixture of financial liberalisation, unsound bank lending, and lax national regulations. It was asserted that banking systems were out of control and governments and regulatory authorities had not taken action to deal with asset bubbles and curtail the excesses of the financial systems. The Asian governments had presided over the rise of 'casino capitalism'. In Thailand, we were told in an editorial (in terms that resonate with recent events in the UK):

> The scandal at the Bangkok Bank of Commerce involved billions of dollars in questionable loans. The bank managers disguised their malfeasance using shell games, such as backing loans with vastly overvalued property. The mess at the Bangkok Bank exposed the weakness of Thailand's banks and the lack of government oversight in a deregulated financial system run amok. (*International Herald Tribune*, 5 January 1998)

The causes of the crisis were depicted as lying at the heart of Asian developmental forms, with the Director of the IMF, Michael Camdessus, stressing the need to 'dismantle an economic system based on collusion between state, banks and business, and the restrictive markets' (cited *Far Eastern Economic Review*, 12 February 1998: 46-7). Thus, the Asian regimes had been found wanting and the solution was to make them operate as much like those of the West as possible. In essence, these views were enshrined in the conditionalities attached to the IMF loans negotiated by Indonesia, Thailand and South Korea.

For many Asian policy-makers pinning the blame for the crisis on domestic shortcomings diverted attention from the operation of the global financial system. Since the late-1980s this increasingly liberalised system had shown marked tendencies to volatility and national crisis. In Asia the experience of 1997 brought home to policy-makers the vulnerability of their region and the ineffec-

tiveness of the IMF in preventing or addressing crises. This engendered some serious debate over policy options which led to a focus on self-insurance against further national, regional or global crises, and the need to appeal to the IMF for emergency funding. While there has been considerable variation in the sequencing, intensity and effectiveness of policies, there have been some important common features. Most significantly, there has been emphasis on domestic consumption and investment, trade promotion, management of currencies to maintain stability and competitiveness, the accumulation of central bank reserves, the development of regional financial structures, and restructuring and regulatory reform, particularly in banking (for an overview see Dixon 2009). Particular attention should be drawn to: the establishment of regional financial monitoring and a multilateral fund as an alternative to the IMF and its neo-liberal conditionalities;[2] and the changes made to the banking and financial sectors. These have been extensively reformed, restructured re-capitalised, and subject to much tighter and more effective regulation; and there have been significant developments in ATMs, consumer credit and commercial loan facilities. Surprisingly little attention outside of the Asian media has focused on these changes. But it is of significance that none of the Asia-Pacific countries have had to launch major rescue packages for their banking and financial sectors. This reflects the general improvement in regulation and practice since 1997, and the dominance of 'narrow', domestically oriented banking with long-term inter-corporate linkages (Xiao Gang 2009).

Asian banks have become significantly 'risk adverse' with capital adequacy ratios generally well above Western levels and the 8% minimum proposed under Basel II (Yao 2009; Freshfields Bruckhaus Deringer 2008).[3] Overall, the close links between state, bank and business have been retained and reformed, not 'dismantled' as called for by the Director of the IMF in 1998. It is these linkages and the 'narrow' form of Asia-Pacific banking that is its

real strength, both in the current crisis and, perhaps in the much longer term.

The comparatively strong position of the Asia-Pacific economies and the Western financial and regulatory disasters is doing much to restore the credibility of distinctive Asia-Pacific forms of capitalism. Perhaps more importantly, the current situation is giving new confidence to the region's policy makers to build on their own national and regional systems, rather than, as they have been repeatedly urged to borrow directly from the West. Some observers have suggested that this may constitute the final decolonisation of the Asian mind and a major watershed in the rise of Asia (Seneviratne 2008). It may be that the Asia-Pacific economies are in the process of providing some important lessons for the West as it wrestles with its own credit-driven, asset bubble form of 'casino capitalism'. However, most importantly, the rise of Asia is likely to prove a critical factor in the move away from neo-liberal-dominated globalisation, which has been so instrumental in the success of the City of London. In addition, rather than representing a series of rapidly expanding markets for the City, some Asian financial sectors may become significant competitors.

London and the emergent markets

Well before the crisis London was transacting increasingly large amounts of business that related directly to emergent markets, particular in Asia and Latin America. In addition, the City was both exporting increasingly large amounts of financial and other knowledge-intensive business services to such markets, and benefiting from cost saving through the off-shoring of a wide range of activities, particular to South Asia, the Philippines and Caribbean. The growing importance of emergent markets is reflected in the growing number of databases, specialist units and consultancy

firms dedicated to spotting and evaluating such markets (Sidaway & Pryce 2000). Such activity reflected the need to be constantly ahead of the game, identifying what are variously termed 'pre-emergent' or 'frontier' markets and establishing an initial presence; that is, not just following established or perspective clients into new markets, but anticipating their moves and even encouraging them. In this way some of the City of London's financial and other business services have become a critical 'lead sector' in the opening of new markets, with other forms of investment following. Thus, Taylor *et al* (2004) have depicted the international networks of business service firms, particularly those based in London, as the 'cutting edge of globalisation'.

In 2008 London financial institution were the largest financiers of emergent markets (16%) and the London Stock Exchange accounted for 30% of Sukuk listings, the second largest market after the Dubai Nasdaq. It is also the case that London appears to have held particular attractions for emergent market Sovereign Wealth Funds (SWFs), notably the Chinese Investment Corporation (see Jing Xuecheng in this volume). In addition, Chinese business has reportedly seen London as a prime centre for activity, with 74 companies listed on the LSE, 68 on the AIM and 6 on the main board (Zhou Jiangong 2008); for example, the Chinese Merchant Bank in July 2009 selected London as its base for international expansion (Think London 2009). This undoubtedly reflects the attractions of the City's financial expertise, with major Chinese companies using London as a base for a wide range of international activities, including those in Africa. It is also the case, however, that the UK continues to have 'light touch regulation' and has not been part of the 'protectionist drift' in FDI amongst the OECD and G7 groupings, which appears to have been largely directed at SWFs (Cohen 2009: 721-22; Marchick and Slaughter: 2008: 3). Indeed, London is 'showing the welcome mat' to foreign Mergers

and Acquisitions attempts (Zhou Jiangong 2008).[4] However, the critical question is whether London can maintain its position with respect to emergent markets in the wake of the current crisis and shifts in global financial markets.

Emergent markets are set to significantly increase their share of global output (from 25% in 2008 to 35% in 2020, measured in market value), with growth rates well above those of the advanced countries for the foreseeable future (HM Treasury 2009: 20). In 2008 the BRICs alone accounted for 50% of global growth and are projected to substantially increase this during 2009. These facts are well recognised in the City and reflected in the promotional activities of the City Corporation, the London Chamber of Commerce, major City-based firms, and a variety of professional and business groupings. In addition, a number of studies have underlined the opportunities offered to the City by emergent markets (Research Republic 2008; Trusted Sources 2009; HM Treasury, 2009). However, a major problem is that there appear to be major shortcomings at many levels in the City's knowledge of emergent markets, their likely trajectories and what types of services they may come to require from London.

There is here a broader question of the international business strategies of City-based firms. These appear to be still locked into approaches rooted in concepts of comparative advantage, increasing liberalisation, and the domination of Western business practice. The assumption is that the emerging economies will become not merely more open, but in terms of the markets for financial and other services, increasingly like that of the UK. This is a reflection of the extent to which the neo-liberal paradigm has come to inform the international strategies of individual firms and such institutions as the City of London. This is also revealed in the attitudes towards the transfer of skills and knowledge into the domestic sectors of emergent economies. Many firms which allocate significant effort to this process, see it as an important

element in their long-term strategy of establishing good relations with firms and state institutions, and promoting operation to London standards (see Dixon 2008 on Vietnam). The view is that this approach will pay dividends as the markets gradually open. However, under changed circumstances, particularly in Asia and South America, this type of 'staged penetration' (Roberts 1998) may become increasingly limited as countries become more reluctant fully to open their service sectors or internationalise their business and regulatory practice, whatever may be prescribed by WTO rules and bilateral trade agreements. Nor does it seem to be appreciated that London has lost credibility in the wake of the current crisis and the evident failure of its much vaunted regulatory system (see Research Republic 2008: 7). This may translate into emergent markets becoming less keen on such centres as London and New York, as sources of funding, asset management and professional services. They may look more to their own developing financial sectors over which they have control. Resentment over contagion from the USA and UK financial disasters and some significant losses by SWFs (see Jing Xuecheng in this volume) may add impetus to such moves.

A new global financial map was emerging before the current crisis, with the rapid expansion of centres in Asia and the Middle East. Particular attention focused on such established sectors as those of Hong Kong, Singapore and Tokyo, and such aspiring centres as Beijing, Dubai, Mumbai and Shanghai (Research Republic 2008). While London was maintaining its leading position (see City of London Corporation, 'The global financial index') other centres were catching up and there was concern over loss of young and talented professionals to Dubai, Shanghai and Singapore. This is a reflection of taxation, other costs, facilities, and a questioning of the utility of the London location beyond the *cachet* of a London address. These processes may well be greatly accelerated by the present crisis:

> this has been the first major international crisis where Asian markets have been relatively stable and losses have been concentrated in the West. As such, this may be a 'tipping point' in the emergence of Asia as a dominant force in the global economy. (Research Republic 2008: 7)

Such views have led to much speculation over which Asian centres are likely to be central to such a shift. For many commentators, Singapore and Hong Kong are by far the best placed in terms of infrastructure, supporting services and culture. Indeed, Hong Kong is becoming the runner-up behind Wall Street and the City of London, rather than Tokyo (Aalbers 2009: 41). But it may be that Shanghai will overtake Hong Kong, with Singapore fulfilling a major offshore role for China. Certainly, the promotion of Shanghai as the Pacific Asia financial centre remains high on Beijing's agenda. It is possible to dismiss this because of tight regulation, the underdevelopment of the financial sector, and the willingness of the state to intervene to limit volatility and asset bubbles (on the latter see 'Asian equities', *Guardian*, 30 July 2009). However, one should not underestimate the capacity of the Chinese state to carry through such projects. Moreover, Shanghai is well located with its trading hours overlapping with London and San Francisco. In addition, business and financial services from China are beginning to compete with City-based firms, not just in China and other presently emerging markets, but in the advanced economies as well. In this respect the recent entry of the Bank of China into the UK mortgage market should be watched with interest.

Conclusion

It important not to exaggerate the present extent of the global power shift or of the undermining of neo-liberalism. In addition to any doubts that remain over American decline or the rise of China

(see respectively Germain 2009: 684; Shirk 2007), any transition in the global power structure is likely to be a gradual, far from unidirectional, complex and contested process.[5] This will remain so even if the current crisis spills over into a protracted 1930s style global recession.[6] The international system and related dominant paradigms have very considerable inertia, and new players tend to become socialised into existing structures and forms of interaction (Johnston 2008). However, the current crisis does raise major questions over the United States' global role. The economy has been seriously damaged and, much more significantly, its business models, regulatory system and developmental consensus discredited, especially in the eyes of emergent markets. Most importantly, it has (along with the rest of the G7 group) 'lost the capacity to act as directorate of world affairs', and to lead the stabilisation of the global system and return it to private sector-led growth (Germain 2009: 683). If this loss is permanent, then the USA will no longer *own* globalisation (Gardels, 2007: 2-5). It will no longer be the rule-maker and the rest of the system rule-takers (Grugel, et al. 2008: 499-517). However, it is too simplistic to suggest that the global role of the US will be rapidly replaced by some combination of the BRICs and other emergent markets. A much more likely scenario is an acceleration of the relative rise of the new powers and a diffusion of economic and political power as they catch up with the USA (Fukuyama, 2008: 42; Zakaria, 2008: 7). This is also the view of the National Intelligence Council (2008), which predicted that the USA's role as the sole superpower will *be* challenged and that it will become more of a 'first among equals'. Such a situation will be accompanied by both greater diversity in such key areas as state-market relations, regulation, and business forms.

For the City of London any move away from neo-liberal-dominated globalisation will pose serious problems and necessitate significant adjustments to business strategies and general outlook. But can the City do this and maintain its global position?

A wide variety of commentators continue to believe so, drawing attention to 'London's enduring ability for re-invention in the face of changing demand and worldwide wealth patterns' (HM Treasury 2009: 19). Yet while we should not underplay the City's past achievements or continuing capacity, we are moving into a radically different period of world development, under which London may find its global position eroded by the rise of more regional-oriented and regulated financial centres, with more limited (and perhaps niche market) global reaches. Under such conditions the City might, like the USA, become 'a first amongst equals' as other centres catch up. This would also involve a loss of the City's key role in 'rule-giving', though it could rehabilitate itself as a provider of 'gold standard' services by building on probity, professionalism and security. It is here that the global financial system in general, and the emergent markets, in particular, might be persuaded to look to London. This cannot be said for such activities as complex debt instruments, hedge funds and private equity, and the 'casino rules' that underpin them. These have become increasingly unpalatable and unprofitable for emerging markets, which are likely to dominate the next phase in the financialisation of the world. Thus, the City of London will have to adjust to the specific needs (and rules) of these markets, rather than assuming the continued expansion of a liberal global financial system within which its established rules, products and expertise give it overwhelming comparative advantage.

Notes

1 See Elliott (2009) for a counter view based on the relative size of the Chinese economy, preoccupation with internal issues and potential problems. Even if China and the other major Asian economies do continue to successfully weather the crisis, their policies of internalising growth and

reducing reliance on exports and FDI, may well significantly limit the benefits to the rest of the global system.

2 At time of writing the fund stands at US$120bn, which is the same as the total IMF assistance to the region provided in 1997-8. There is also an agreement in principle to increase the fund to the equivalent of 10% of the region's central bank reserves. This would make some US$383bn available.

3 Though some have only very recently raised their ratios to this level. See for example the announcement by the China Merchants Bank (Reuters 14 August 2009).

4 M&A activity, while one of the most lucrative activities for auditors and commercial lawyers, cannot provide a sustainable source of business for the City, if the only targets are UK-based firms. Under prevailing conditions there can be no immediate return to the cross-border M&A driven waves of FDI that have characterised the global system since the late 1980s (UNCTAD 2009) and out of which London has done so well. This is a reflection of a general disenchantment with M&A as a business expansion strategy and, perhaps even more, as a speculative financial activity. This sentiment has been reinforced by increased protectionism and slower and less effective liberalisation of foreign ownership regulations. Indeed, all the signs are that the long-awaited M&A bonanza, which would attend the full opening of such economies as China and India, are unlikely to occur in the near future, if at all.

5 It should be stressed that prediction of American decline has a long history and has been, and continues to be, hotly disputed (see Germain 2009: 684; Taylor 1996: 171-188; Strange 1987). Indeed, Germain (2009: 684) has suggested the decline of the USA is not as yet inevitable or irreversible, although it does, at present, seem the most likely projection.

6 On this see Germain's (2009: 673-675) comments on the comparison with the 1930s – the last time that a shift in the global power structures has coincided with a major financial crisis. Then it took some 20 years from the start of the crisis for the new global pattern to emerge – and this with the added impetus of a global war of unprecedented disruptive and destructive power. Ultimately, though, there was a radical realignment not only of global power structures but also of international finance and state-market relations.

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14

The Specialised Differences of Cities Matter in Today's Global Economy

Saskia Sassen

There is no such entity as 'the' global economy in the sense of a seamless economy with clear hierarchies. The reality is a vast number of highly particular global circuits. Some of these are specialised and others are not. Some are worldwide circuits, others are regional. Different circuits contain different groups of countries and cities. For instance, a city like Mumbai is today on a global circuit for real estate development investment that includes firms from cities as diverse as London and Bogota. Global commodity trading in coffee includes as major hubs New York and Sao Paulo. London, along with a dozen other cities, is on an unusually large number of these inter-city global circuits.

Viewed this way, the global economy is not seamless. It is lumpy. It becomes concrete and specific. Cities located on many or

a few global circuits become part of distinct, often highly specialised inter-city geographies. Not only global economic forces feed this proliferation of inter-city geographies. Global migration, cultural work, international art and design annual fairs, civil society struggles around global issues; these and others also feed the formation and development of these geographies. These emergent inter-city geographies begin to function as an infrastructure for multiple forms of globalisation. The other side of these trends is an increasing urbanising of global networks.

Detailed research from the perspective of a given city makes legible the diversity and specificity of a city's location on some or many of these circuits, and makes legible what are the other cities on each of these circuits. The mix of cities and circuits for a given city partly depends and at the same time feeds the particular strengths of a city. And so will the groups of cities on each circuit. This often brings out particular specialised differences of cities. We now know that these specialised differences matter. This also means that there is less competition among cities and more of a global/regional division of functions than is commonly recognised.

In what follows the focus is on the economic urban dimensions.[1] I focus particularly on the strengths and weaknesses of London as a global city. It is worth noting that there is no perfect global city: in a globally networked economy, no city today can function like the imperial capitals of older periods. While London is in a group of cities that do extremely well, it also has some notable weaknesses.

The deep economic history of a city matters

There is an interesting discovery that comes out of recognising the value of the specialised differences of cities and urban regions in today's global economy. It is that the deep economic history of a

place matters for the type of knowledge economy a city or a city-region winds up developing. This goes against the common view that globalisation homogenises urban economies. How much this deep economic history matters varies, partly depending on the particulars of a city's or a region's economy. But it matters more than is commonly assumed, and it matters in ways that are not generally recognised. What globalisation homogenises is standards: among these standards are the much noticed financial reporting and accounting standards. To this I add standards for building state of the art office districts, spaces of consumption and high-end residential districts. It is these standards for the built environment that often create the impression that urban economies are being homogenised by globalisation. But globalisation also rests and depends on diverse specialised economic capabilities. In that regard I argue that the state of the office district is today more akin to an infrastructure – necessary but indeterminate. In this indeterminacy, then, lies the possibility that similarly built state of the art office districts, or financial centres, are producing rather diverse specialised components of the global knowledge economy, including different types of financial activities. London, with its long history of developing capabilities to manage vast imperial geographies has, not surprisingly, become the leading global city in the world today. It has long known how to handle complex cross-border transactions and tensions.

The capabilities needed to trade, finance, service, and invest globally need to be produced. Such capabilities are not simply a function of the power of multinational firms and telecommunications advances. The global city is a platform for producing these types of global capabilities, even when it requires large numbers of foreign firms, as is the case in cities as diverse as Beijing and Buenos Aires. Each of the 70 plus major and minor global cities in the world contributes to produce that capability in its home country and thereby to function as a bridge between its national

economy and the global economy. In this networked, multi-city geography, most of the 250,000 plus multinational corporations in the world have kept their headquarters in their home countries, no matter the thousands of affiliates, subsidiaries and offshore sourcing sites that they may have around the globe.

Within a vast and diverse region such as Europe it has now become clear that several cities function as key hubs, each representing a distinctive mix of strengths. In a top tier we find London, Paris, and Frankfurt. In the top ten we have besides these three: Amsterdam, Madrid, Copenhagen, Stockholm, Zurich, Milan, and Berlin. This points to the fact of an increasingly multi-sited platform for the global operations of firms and exchanges. As some of the data discussed next shows, a city like Copenhagen has become a sort of Dubai for Europe: a platform from which to do European-level operations. Firms do not locate there only to invest in the country.

The other side of this dynamic is that for a firm to go global it has to put down its feet in multiple cities that function as entry points into national and/or regional economies. This bridging capacity is critical: the multiple circuits connecting major and minor global cities are the live infrastructure of the global economy. It indicates that cities do not simply compete with each other, as is so often asserted. A global firm does not want one global city, even if it is the best in the world. Depending what a firm makes or sells, different groups of cities will be desirable, and they will go to these cities even if they have some serious negatives.

This contributes to explaining why the number of global cities has kept growing since the 1980s when this phase began, and why none of them is dying, not even with the financial crisis. What the crisis has done is to destroy a number of firms and to reduce the overall capital of firms and markets –besides the larger macroeconomic effects and a sharp rise in unemployment. Particular specialised sectors have clearly been hurt (or disci-

plined!) more than others. I return to this in the last section of the chapter.

There is no perfect global city

A large study of 75 cities, using over 60 measures provides two critical sets of measures. One is the growing strength of European cities. The second is that not even the most powerful global cities, such as London and New York, rank at the top in all measures.

On the first point, very briefly, the rise of European cities points to the larger story of the rise of a multipolar world. The loss of position of US cities is part of this shift: Los Angeles fell from the 10th to the 17th rank, and Boston from the 12th to the 23rd, while European and Asian cities moved in the top ranks, notably Madrid going from 17th to 11th.[2] It is not that the US is suddenly poorer, it is that other regions of the world are rising and that there are multiple forces feeding the multi-sited character of economic, political, and cultural globalisation.

On the second point, it is important to emphasise that no one city ranks at the top in all of these.[3] London and New York, the two leading global cities, rank low in several aspects – neither is in the top ten when it comes to starting a business, or closing a business, for example. If we consider some of the sub-indicators in the Ease of Doing Business indicator in the study, such as 'Ease of Entry and Exit,' London ranks 43rd and New York ranks 56th. Perhaps even more surprising, London ranks 37th on contract enforcement and 21st on investor protection. It is Singapore that ranks number one in all three variables. Perhaps less surprising, New York ranks 34th on one of the sub-indicators for Livability: 'Health and Safety'. In the Global South, cities like Mumbai and Sao Paulo are in the top twenty when it comes to sub-indicators such as financial and economic services, but are brought down in

their overall score by their low rankings in factors related to the ease of doing business and livability, especially low levels of well-being for vast sectors of the population.

Table 1. WCOC Overall Index Top 20 global cities, 2008

1	London	79.17
2	New York	72.77
3	Tokyo	66.60
4	Singapore	66.16
5	Chicago	65.24
6	Hong Kong	63.94
7	Paris	63.87
8	Frankfurt	62.34
9	Seoul	61.83
10	Amsterdam	60.06
11	Madrid	58.34
12	Sydney	58.33
13	Toronto	58.16
14	Copenhagen	57.99
15	Zurich	56.86
16	Stockholm	56.67
17	Los Angeles	55.73
18	Philadelphia	55.55
19	Osaka	54.94
20	Milan	54.73

Source for all tables: Tables prepared by Saskia Sassen
Based on MasterCard Study of World Centers of Commerce (WCOC) 2008.
The top score is 100. See Endnote 2 for more details on the study.

Table 2: Indicator 1: Political and Legal Frameworks

	City	Dimension 1 Score
1	Stockholm	90.82
2	Singapore	90.32
3	Copenhagen	89.53
4 – 14	Various US Cities[4]	88.28
15	Zurich	86.68
16	Geneva	86.68
17	Toronto	85.85
18	Montreal	85.85
19	Vancouver	85.85
20	Frankfurt	85.75
...	...	...
26	London	85.17

Table 3. Indicator 2: Economic Volatility

	City	Dimension 2 Score
1	Vienna	92.42
2	Madrid	92.07
3	Barcelona	92.07
4	Lisbon	91.67
5	Brussels	91.65
6	Paris	91.58
7	Milan	91.20
8	Rome	91.20
9	Copenhagen	90.72
10	Zurich	90.47
11	Geneva	90.47
12	Amsterdam	90.47
13	Athens	89.90

14	Frankfurt	89.88
15	Berlin	89.88
16	Munich	89.88
17	Hamburg	89.88
18	Düsseldorf	89.88
19	Singapore	89.74
20	London	89.66

Table 4. Indicator 3: Ease of Doing Business

	City	Dimension 3 Score
1	Singapore	82.82
2	Hong Kong	80.37
3	London	79.42
4	Toronto	76.24
5	New York	75.91
6	Dublin	75.71
7	Edinburgh	75.29
8	Vancouver	74.89
9	Montreal	74.60
10	Chicago	73.81
11	San Francisco	73.68
12	Sydney	72.39
13	Los Angeles	72.34
14	Boston	71.89
15	Washington D.C.	71.78
16	Copenhagen	71.72
17	Atlanta	71.69
18	Miami	71.51
19	Melbourne	71.34
20	Dallas	71.32

Table 5. Indicator 4: Financial Dimension

	City	Dimension 4 Score
1	London	84.70
2	New York	67.85
3	Frankfurt	52.88
4	Seoul	52.76
5	Chicago	52.51
6	Tokyo	48.95
7	Mumbai	47.32
8	Moscow	47.27
9	Shanghai	46.54
10	Madrid	44.60
11	Singapore	42.15
12	Paris	41.85
13	Hong Kong	39.61
14	Sydney	39.47
15	Milan	38.45
16	Sao Paulo	34.92
17	Amsterdam	34.44
18	Copenhagen	33.24
19	Taipei	33.04
20	Zurich	31.93

Table 6. Indicator 5: Business Centre Dimension

	City	Dimension 5 Score
1	Hong Kong	72.25
2	London	67.44
3	Singapore	62.58
4	Shanghai	60.30
5	Dubai	59.34

6	Tokyo	58.15
7	Paris	57.73
8	New York	54.60
9	Amsterdam	48.00
10	Seoul	47.33
11	Frankfurt	46.73
12	Los Angeles	44.47
13	Bangkok	44.21
14	Chicago	40.52
15	Miami	39.23
16	Taipei	37.78
17	Madrid	37.71
18	Milan	36.46
19	Beijing	35.07
20	Atlanta	33.69

Table 7. Indicator 6: Knowledge Creation and Information Flows

	City	**Dimension 6 Score**
1	London	62.35
2	New York	59.02
3	Tokyo	52.06
4	Paris	51.65
5	Seoul	51.31
6	Zurich	47.84
7	Chicago	46.31
8	Geneva	45.28
9	Stockholm	44.15
10	Los Angeles	43.08
11	Osaka	40.87
12	Boston	40.58

13	Copenhagen	39.57
14	Singapore	39.45
15	Berlin	39.41
16	Amsterdam	39.11
17	Atlanta	38.21
18	Philadelphia	37.80
19	Washington D.C.	37.46
20	Taipei	37.00

Table 8. Indicator 7: Livability

	City	Dimension 7 Score
1	Vancouver	94.38
2	Düsseldorf	93.88
3	San Francisco	93.44
4	Frankfurt	93.38
5	Vienna	93.38
6	Munich	93.13
7	Zurich	92.81
8	Tokyo	92.69
9	Paris	92.63
10	Copenhagen	92.63
11	Sydney	92.56
12	Berlin	92.56
13	Toronto	92.38
14	Boston	92.19
15	Geneva	92.06
16	Stockholm	92.00
17	Los Angeles	92.00
18	Amsterdam	91.63
19	Montreal	91.63

20	Melbourne	91.63
...	...	...
24	London	79.17

Below are a set of tables that show some of the lowest or most surprising rankings for London on the sub-indicators. They are here to illustrate the larger notion that there is no perfect global city. They reflect rankings based on sub-indicators. And there are two tables where London ranks high; the interest here is the mix of cities, which is somewhat different from the mix of cities on many of the other indicators and sub indicators in this set of tables. The list of tables below does not include 40 or so sub indicators where London ranks high, since her high rankings are to be expected as it is the leading global city, even if at 79 she is far from the perfect score of 100.

Table 9. Dealing with Licenses

	City	Dimension Score
1	Copenhagen	92.49
2	Seoul	88.87
3	Stockholm	88.63
4	Singapore	88.18
5	Frankfurt	87.30
6	Berlin	87.30
7	Munich	87.30
8	Hamburg	87.30
9	Düsseldorf	87.30
10	Toronto	86.70
11	Montreal	86.70
12	Vancouver	86.70
13	New York	86.26
14	Chicago	86.26

15	Philadelphia	86.26
16	Los Angeles	86.26
17	Boston	86.26
18	Atlanta	86.26
19	Miami	86.26
20	San Francisco	86.26
...	...	...
40	London	80.89

Table 10. Registering Property

	City	Dimension Score
1	Riyadh	89.80
2	Stockholm	89.41
3	New York	87.13
4	Chicago	87.13
5	Philadelphia	87.13
6	Los Angeles	87.13
7	Boston	87.13
8	Atlanta	87.13
9	Miami	87.13
10	San Francisco	87.13
11	Houston	87.13
12	Dallas	87.13
13	Washington D.C.	87.13
14	Zurich	86.72
15	Geneva	86.72
16	Dubai	86.59
17	Singapore	83.99
18	London	80.92
19	Edinburgh	80.92
20	Bangkok	78.36

Table 11. Starting a Business

	City	Dimension Score
1	Sydney	96.68
2	Melbourne	96.68
3	Toronto	96.49
4	Montreal	96.49
5	Vancouver	96.49
6	Dublin	92.23
7	Brussels	92.16
8	Singapore	92.02
9	Paris	91.61
10	Stockholm	90.72
11	New York	90.49
12	Chicago	90.49
13	Philadelphia	90.49
14	Los Angeles	90.49
15	Boston	90.49
16	Atlanta	90.49
17	Miami	90.49
18	San Francisco	90.49
19	Houston	90.49
20	Dallas	90.49
...	...	...
24	London	89.32

Table 12. Getting Credit

	City	Dimension Score
1	Kuala Lumpur	79.15
2	London	71.15
3	Edinburgh	71.15

4	Frankfurt	69.79
5	Berlin	69.79
6	Munich	69.79
7	Hamburg	69.79
8	Düsseldorf	69.79
9	Sydney	68.33
10	Melbourne	68.33
11	New York	67.50
12	Chicago	67.50
13	Toronto	67.50
14	Philadelphia	67.50
15	Los Angeles	67.50
16	Boston	67.50
17	Atlanta	67.50
18	Miami	67.50
19	San Francisco	67.50
20	Montreal	67.50

Table 13. Researchers in R&D (per million of people)

	City	Dimension Score
1	Stockholm	100.00
2	Copenhagen	93.57
3	Tel Aviv	84.62
4	Tokyo	83.96
5	Osaka	83.96
6	Zurich	82.03
7	Geneva	82.03
8	Singapore	76.66
9	Taipei	76.27
10	Moscow	74.63

11	St. Petersburg	74.63
12	Toronto	73.99
13	Montreal	73.99
14	Vancouver	73.99
15	Sydney	70.66
16	Melbourne	70.66
17	Paris	68.44
18	Amsterdam	67.60
19	Frankfurt	66.65
20	Berlin	66.65
...	...	...
46	London	32.75

Table 14. Number of MBA programs

	City	Dimension Score
1	New Delhi	100.00
2	London	92.31
3	Bangalore	73.08
4	Madrid	65.38
5	Mumbai	65.38
6	Paris	53.85
7	Singapore	50.00
8	Hong Kong	46.15
9	Barcelona	46.15
10	New York	38.46
11	Chicago	34.62
12	Bangkok	34.62
13	Beijing	34.62
14	Philadelphia	26.92

15	Boston	26.92
16	Vienna	26.92
17	Dublin	26.92
18	Washington D.C.	26.92
19	Buenos Aires	26.92
20	Tokyo	23.08

The consequences of the current financial crisis

To what extent can the current financial crisis alter the basic features of this globally networked inter-city urban geography? Here I want to examine briefly the particularity of the financial crisis that erupted in September 2008 from the perspective of this question. This is a lens that brings to the fore a few distinctive trends and potentials because a city is much more than a financial centre.

A comparison of the major crises since the current phase began in the 1980s shows the extent to which financial leveraging has caused the greater acuteness of the current crisis compared with the other three major crises since the 1980s. Figure 1 shows that financial leveraging added another 20% to the underlying banking crisis, thereby bringing the current financial crisis up to an equivalent of 40% of global GDP, compared to earlier crises, which rarely went beyond 20%.

The data in Figure 2 also show the extent to which Asia (in 2008) is in a very different position than the US and Europe. Its emergent crisis is economic rather than financial. But also continental Europe evinces differences from the US. In that regard, as has been well established, the UK is in a different situation from the rest of the EU.

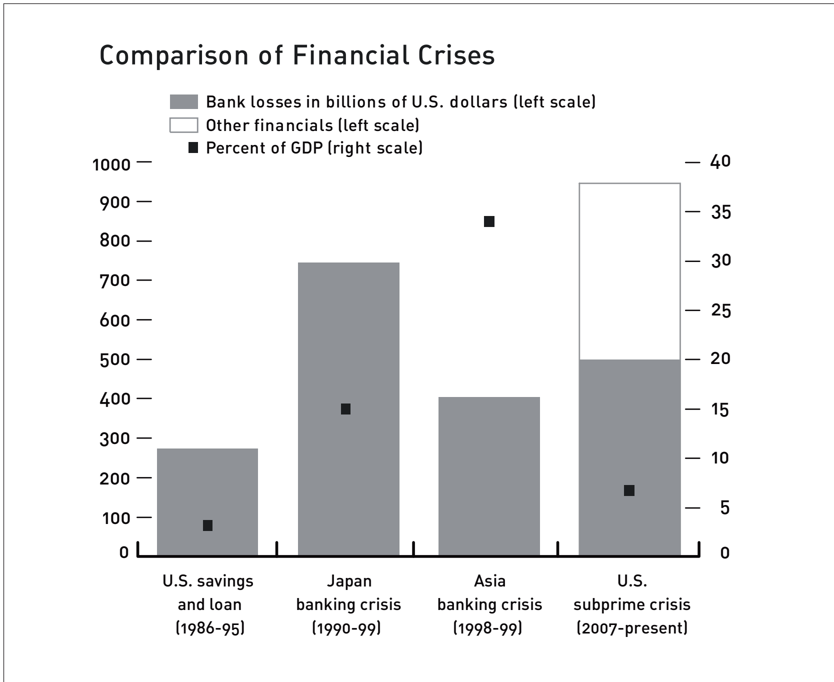

Figure 1
Sources: Goldman Sachs; UBS; and IMF staff estimates.
Note: ABS = asset-backed security; CDO = collateralised debt obligation; SIV = structured investment vehicle.

The critical component that brought the financial system to a momentary standstill was a complex, highly speculative financial innovation – the 'Made in America' innovation that came to be called credit-default swap. The US$ 62 trillion dollar credit-default swap crisis exploded on the scene in September 2008, a full year after the sub-prime mortgage crisis of August 2007 which is often erroneously thought to be the cause of the crisis. The value of credit-default swaps was more than the US$ 54 trillion in global GDP. The graph below (Figure 3) shows the extremely sharp growth over an extremely short period of time, from 2001 to 2007. While much attention has gone to subprime mortgages as causes of the financial crisis, the 60 trillion in swaps in mid-2008

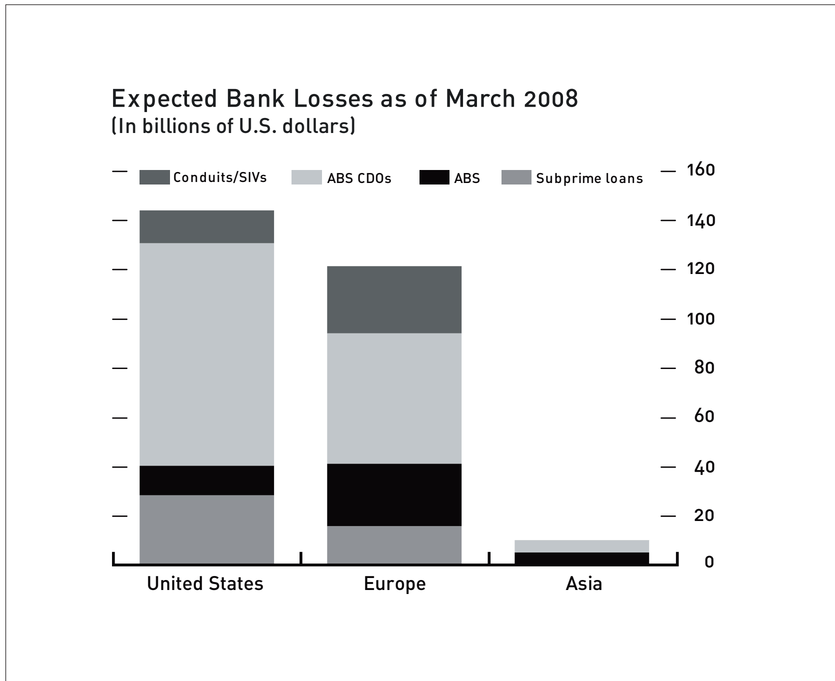

Figure 2
Sources: World Bank; and IMF staff estimates, Global Financial Stability Report, Oct 2008. Note: U.S. subprime costs represent staff estimates of losses on banks and other financial institutions. All costs are in real 2007 dollars. Asia includes Indonesia, Korea, the Philippines, and Thailand.

is what really got the financial crisis going. The decline in house prices, the high rate of mortgage foreclosures, the declines in global trade, the growth of unemployment, all alerted investors that something was not right. This in turn led those who had bought credit-default swaps as a sort of 'insurance' to want to cash in on their swaps. But the sellers of these swaps had not expected this downturn or the demand to cash in from those to whom they had sold these credit-swaps. They were not ready, and this catapulted much of the financial sector into crisis. Not everybody lost: investors such as George Soros, made large profits by going against the trend.

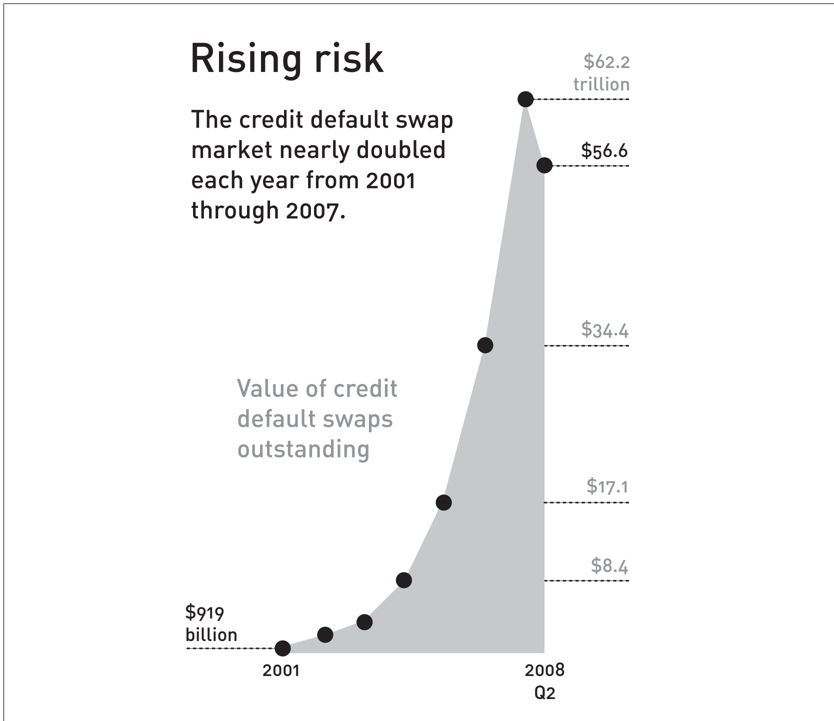

Figure 3
Source: ISDA

These credit-default swaps are part of what has come to be referred to as the shadow banking system. According to some analysts, most notably Tett (2009), this shadow banking system accounted for 70% of banking at the time that the crisis exploded. The shadow banking system is not informal, illegal, or clandestine. Not at all: it is in the open, but it has pushed the boundaries of what is 'legal' and thrived on the opaqueness of the investment instruments. The complexity of many financial instruments is such that nobody can actually trace what all is bundled up in some of these financial instruments. Eventually this meant that nobody knew exactly or could understand the composition of their investments, not even those who sold the instruments.

This shadow banking system has thrived on the recoding of instruments, which, at the limit, allowed illegal practices to thrive. For instance, it is now clear that credit-default swaps were sold as a type of insurance. But they were actually derivatives. If they would have been sold as insurance the law requires they be backed by capital reserves and be subject to considerable regulation. Making them into derivatives was a *de facto* deregulation and eliminated the capital reserves requirement. Credit-default swaps could not have grown so fast and reached such extreme values if they had been formally sold as insurance, which would have been the lawful way. None of the financial firms had the capital reserves they would have needed to back 60 trillion in insurance. Because they were actually derivatives, they could have an almost vertical growth curve beginning at a low 1 trillion as recently as 2001 and jumping to over 60 trillion in a few years.

This is a moment for radical departures from the old ways. We need to de-financialise the economy: for instance, before the current 'crisis' the value of financial assets in the US had reached 450% to GDP (McKinley Report 2008). In the European Union it stood at 356% to GDP, with the UK at 440%, well above the EU average. More generally, the number of countries where financial assets exceed the value of their gross national product more than doubled from thirty-three in 1990 to seventy-two in 2006. The global value of financial assets (de facto a kind of debt) by September 2008, as the crisis was exploding, was three and half times larger (160 trillion dollars) than the value of global GDP.

In what follows, I will link these overarching trends to an urban microcosm. This is an American microcosm, partly because so much of the logic that produced the current financial crisis was 'Made in America.' This becomes an urban lens, a way of connecting the macro level financial circuits to the specifics of urban space.

When the financial crisis hits urban land

Much has been made, especially in the US media, of the subprime mortgage crisis as a source of the larger crisis. Modest-income families unable to pay their mortgage were often represented as irresponsible for having taken on these mortgages and thereby leading to the crisis. But the facts show another pattern. The overall value of the subprime mortgage losses was too small to bring this powerful financial system down. But the interlinking of financial markets means that even a ‘small market’ crisis, such as the subprime market, can produce ripples. In this case the ripple was a crisis of confidence among large investors. The key was the growing demand for asset-backed securities by investors in a market where the outstanding value of derivatives was US$ 600 trillion, more than ten times the value of global GDP. To address this demand, even sub-prime mortgage debt could be used as an asset. But the low quality of this debt meant slicing it into multiple tiny tranches and mixing these up with high-grade debt. The result was an enormously complex instrument that was also enormously opaque: nobody could trace what was contained within it. When the total number of foreclosures moved into the millions in 2007, investors had a crisis of confidence: it was impossible to tell what was the toxic component in their investments and which of their investments might be 'contaminated'.

Sub-prime mortgages can be valuable instruments to enable modest-income households to buy a house. But what happened in the US over the last few years was an abuse of the concept. The small savings, future earnings, or already fully paid houses of modest-income households were used to develop a financial instrument that could make profits for investors even if those households in the end could not pay for the primary or secondary mortgages they were often pushed to take. The result was the loss

of both their home and whatever savings and future earnings they had put into it – a catastrophic and life-changing event for many of these households. This becomes clear in the microcosm that is New York City. Table 15 below shows how whites, who have a far higher average income than all the other groups in New York City, had a far lower share of subprime mortgages than all other groups, reaching just 9.1 % of all mortgages taken on by whites in 2006 in NYC compared with 13.6 % for Asians, 28.6 % for Hispanics, and 40.7 % for blacks. The Table also shows that all groups, regardless of incidence, had high growth rates in subprime borrowing from 2002 to 2006. If we consider the most acute period, 2003 to 2005, the share of subprime mortgages in all mortgages more than doubled for whites, basically tripled for Asians and Hispanics, and quadrupled for blacks. The result is that a far higher share in each of the latter groups lost their homes to foreclosure than in the white group.

Table 15. Rate of Conventional Subprime Lending by Race in New York City, 2002 to 2006

	2002	2003	2004	2005	2006
White	4.6%	6.2%	7.2%	11.2%	9.1%
Black	13.4%	20.5%	35.2%	47.1%	40.7%
Hispanic	11.9%	18.1%	27.6%	39.3%	28.6%
Asian	4.2%	6.2%	9.4%	18.3%	13.6%

Source: Furman Center for Real Estate & Urban Policy, 2007

There were, then, two very separate crises: the crisis of the people who had gotten these mortgages and the crisis of confidence experienced by the investor community. The millions of home foreclosures were a signal that something was wrong, but, in itself, it could not have brought down the financial system. There is a profound irony in this crisis of confidence: the brilliance of those who make these financial instruments became the undoing of a large number of investors (besides the undoing

of the modest-income families who had been sold these mortgages). The toxic link for modest-income households was that for these mortgages to work as assets for investors, the aim was to sell as many mortgages as possible (at least 500 were necessary to work into an asset-backed security), regardless of whether the home-buyers could pay their monthly fee. The faster these mortgages could be sold, the faster they could be bundled into investment instruments and sold off to investors. This secured the fees for the sub-prime mortgage sellers and reduced the effects of mortgage default on the profits of the sub-prime sellers. In fact, those sub-prime sellers that did not sell off these mortgages as part of investment instruments went bankrupt eventually, but not before having secured considerable profits in fees.

In brief, the financial sector invented some of its most complicated financial instruments to extract whatever were the meagre savings or assets of modest households by offering sub-prime mortgages and promising the possibility of owning a house or getting a second mortgage on a fully paid for house. The complexity of the financial innovation was a series of products that de-linked subprime sellers and investors' profits from the creditworthiness of consumer home mortgage-buyers. Whether the mortgage is paid matters less than securing a certain number of loans that can be bundled up into 'investment products'. The crisis of homebuyers was not a crisis for financial investors, even though millions of middle- and working-class families in the US have lost everything, and many now live in tents. For finance it was a crisis of confidence. But it showed the importance of the systems of trust that make possible the speed and orders of magnitude of this financial system. The crisis of home-owners (valued at a few hundred billion dollars) was the little tail that dented the enormous dog of trust in the financial system. In other words, this type of financial system has more of the social

in it than is suggested by the technical complexity of its instruments and electronic platforms.

The costs of the current financial crisis, especially its subprime mortgage component, extend to whole metropolitan areas. The loss of property tax income for municipal governments varies across different types of cities and metro areas. Table 16 shows the ten metro areas with the largest estimated losses of real GMP (Gross Municipal Product) for 2008 due to the mortgage crisis, as measured by Global Insight 2007.[5] The total economic loss of these ten metro areas is estimated at over US $45 billion for the year 2008. New York loses over US $10 billion in 2008 GMP, Los Angeles loses US $8.3 billion, and Dallas, Washington, and Chicago each lose about US $4 billion.

Table 16. US Metro Areas with Largest Losses of GMP, estimates for 2008

Rank	2008	Revised Real GMP Growth, %	Loss in Real GMP Growth, %	Loss of GMP, Millions
1	New York-Northern New Jersey-Long Island, NY-NY-PA	2.13	-0.65	-$10,372
2	Los Ángeles-Long Beach-Santa Ana, CA	1.67	-0.95	-$8,302
3	Dallas-Forth Worth-Arlington, TX	3.26	-0.83	-$4,022
4	Washington-Arlington-Alexandria, DC-VA-MD-WV	2.79	-0.60	-$3,957
5	Chicago-Naperville-Joliet, IL-IN-WI	2.23	-0.56	-$3,906
6	San Francisco-Oakland-Fremont, CA	1.88	-1.07	-$3,607
7	Detroit-Warren-Livonia, MI	1.30	-0.97	-$3,203
8	Boston-Cambridge-Quincy, MA-NH	2.16	-0.99	-$3,022
9	Philadelphia-Camden-Wilmington, PA-NJ-DE-MD	1.85	-0.63	-$2,597
10	Riverside-San Bernardino-Ontario, CA	3.51	-1.05	-$2,372

Source: Global Insight, Inc. 'The Mortgage Crisis: Economic and Fiscal Implications for Metro Areas,' 5. Prepared for the United States Conference of Mayors and the Council for the New American City, 2007.

Conclusion

While much has been said about the global economy homogenising national economies, the urban trends discussed here actually point in the opposite direction: different cities have different strengths. Global firms and markets, but also cultural enterprises, want many global cities because each of these cities expands the global platform for operations and because each is a bridge between the global and the particularities of national economies and societies. This also brings to the fore that global cities are built, developed, made.

The rebuilding of central areas that began to take place in the 1980s and accelerated in the 1990s and onwards is part of this new economic role. It amounts to rebuilding key parts of these cities as platforms for a rapidly growing range of globalised activities and flows, from economic to cultural and political. This also explains why architecture, urban design and urban planning have all become more important and visible in the last two decades. And it explains the emergence of strong competition for space and the development of a new type of politics claiming the right to the city.

The costs to cities of this mode of economic growth have been high. Massive displacements of low-income households and low-profit firms have been evident in all these cities. And the financial crisis has brought its own specific costs, increasingly naked and direct. This has been an economic urban dynamism charged with social costs. It needs to be said that the fact that global firms need cities, and, indeed groups of cities, should enable the political, corporate and civic leadership in cities to negotiate for a better share of the benefits. This could lead to overall positive outcomes if the governing classes can see that these global economic functions will grow better in a context of a strong and prosperous middle class rather than sharp inequality and inmiseration of a

growing share of households. European global cities have done better than US global cities precisely for this reason.

It is to the advantage of cities to have more distributed growth. The types of differences that characterise even the most powerful global cities suggest that there is less competition in the global system and more specialised differences. In this context the financial crisis and the ensuing economic crisis should be an occasion to resist the extreme competition that leads towards massive concentration of advantages. The leadership of a city like London, whether civic, corporate or political, should resist the notion that the City will go under if these extreme trends towards concentration of economic advantage are not enabled. The City of London is part of a globally networked financial system. No city can be the best in everything in a complex economic system. And no financial centre can thrive if it allows the rest of the city within which it is embedded to have growing inequality, unemployment and social decay. That is clear from the fact that cities such as Sao Paolo and Mumbai which have some of the most powerful financial centres are brought down sharply by the larger social devastation within which they exist.

Notes

1 For an examination of the political and cultural dimensions see the author's *Territory, Authority, Rights*: Part 3 (Princeton University Press, 2008).

2 These earlier numbers come from the first version of the MasterCard study (2006) using 2005 data.

3 It is the recently released 2008 MasterCard Study of Centers of Global Commerce, for which the author was one of eight experts. The 63 variables cover a very wide range of conditions – from macro level factors such as political/legal frameworks to the particulars of cities, such as how easy it is

to execute an import/export operation, how many days it takes to open and to close a firm, and on to livability factors and global recognition.

4 New York, Chicago, Philadelphia, Los Angeles, Boston, Atlanta, Miami, San Francisco, Houston, Dallas and Washington D.C. all score 88.28 on Dimension 1 because it is a macro-level variable.

5 The report contains a full list of GMP estimated losses for all 361 metros in the US (Appendix, Table A2, pages 8-16.). The report states that 128 metros will see slow real GMP growth of less than 2% in 2008, and that growth is cut by more than a third in 65 metros, and by more than a quarter in 143 metros.

15

New Geo-Political Alignments

Thomas Harris

Stephen Haseler, in his chapter to this volume, stresses that one of the fundamental geo-political trends of recent years is the way in which the global economic centre of gravity is shifting from West to East. In part, this reflected the consequences of the entry into the global economy of major Asian economies such as India and China and their ability, thanks to globalisation, to pull hundreds of millions of their people out of poverty and to emerge as major new service and manufacturing hubs deeply involved in global flows of trade and investment. This, as Haseler suggests, was astonishing but it was also, to my mind, wholly welcome.

But part of this shift in the economic balance of power reflected a much less welcome phenomenon and that was the tendency of the new Asian economies (and the Gulf States) to run

massive current account surpluses which they then used to finance the equal and opposite deficits accumulating in the USA, and to a lesser extent the UK. This part of the new geo-political alignment was based on structural imbalances which we now know to have been risky and unsustainable and one of the causal factors behind the eventual financial crisis. It is now a commonplace observation to say that in future the deficit economies of the West will need to save more and consume less, while the surplus countries of the East will need to consume more and save less. But achieving that happy state of equilibrium will be neither easy nor painless.

For the moment, the transfer of economic power from the West to East continues apace. While global economic output is due to fall in 2009, most of the major Asian economies are still experiencing significant GDP growth, albeit at rates which they find uncomfortably low by recent experience. Our economists at Standard Chartered Bank forecast reasonable GDP growth in 2009 of 6.8% in China, 5% in India, and 4% in Indonesia. It is absolutely certain that by the end of next year, Asian economic output will have emerged at higher levels than those in the West. This crisis represents a fundamental tipping point in global economic history.

There are some optimists who believe that this will be a short-run phenomenon and that, once the current fiscal and monetary stimulus measures work their way through the system, we will see first the USA, and then the Euro-zone and Japan, resuming economic growth in 2010. I wish this were true but as anyone who read Martin Wolf's recent piece in the *Financial Times* (29 April, 2009) will know, this is not a financial crisis from which there is any easy way out. He pointed out that the latest IMF Global Financial Stability Report includes revised and higher estimates of the writedowns which will be required to fix the financial system. writedowns on assets originating in the US have increased to $2,712bn from $1,405bn last October; writedowns on European

assets have now reached $1,193bn and on Japanese assets $149bn. This represents about 13% of aggregate GDP.

The IMF calculates that a further $391bn of capital will be required by the US banking system and $243bn in the Euro-zone as the process of massive deleveraging continues. Government bail-outs have so far provided less than a third of the refinancing needed by this huge shrinkage in balance sheets.

So the idea that the West is likely to reemerge rapidly from this financial and economic crisis looks positively rose-tinted. Our own estimates in Standard Chartered Bank suggest that the first significant recovery from the global crisis will not be in the USA or Europe but in East Asia where the scale of the fiscal stimulus packages being undertaken, in particular, by China, Japan, and South Korea , and the strength of the economic fundamentals, such as lower levels of leverage, high savings rates and foreign exchange reserves, mean that recovery will be easier and swifter. In addition, Japan, China, S. Korea and the major South East Asian economies have agreed to a $120bn pool of foreign exchange reserves to defend their currencies. If these measures succeed, the geo-economic global alignment will look even more favourable to Asia over the next few years.

To some extent this is now a statement of the obvious and the most encouraging feature of government responses to the financial crisis has been the recognition that the days of a G8 of Western economic powers lording it over everyone else are now over. The emergence of the G20 as the focal point for global economic decision-making is a belated, but highly welcome recognition of the new reality.

Even more welcome was the decision of the G20 to open up membership of the Financial Stability Board and the Basel Committee to the major Asian economies. At last there are signs that some in the West are recognising the fundamental shift. It will take time, however, before all Western governments realise

that the Asians mean it when they say that they will only give full-hearted support to enhanced IMF facilities once the current quota system is reformed. At the moment S. Korea, which has twice the economic output of say Belgium, has half Belgium's voting rights on the IMF. This is where the developed countries, particularly in Europe, will have to give up more ground.

Against this background of a fundamental shift of economic and political power to Asia, it could be argued that this means that the ascendancy of London and New York as global financial centres will also wane. One only has to look at long-term historical trends to see the way in which financial centres have shifted, over the centuries, from Italy, to Amsterdam, to London and then New York to recognise that no financial centre can take its place in the pecking order for granted.

But before we get too gloomy about what all this means for the future of the City of London, it is worth pointing out that global financial centres do not emerge solely because the domestic economy in which they are located is big or because they have a large hinterland. I disagree with Stephen Haseler fundamentally on his suggestion, in his paper in this volume, that a large economic hinterland is a pre-requisite for a global financial centre. There are a multitude of factors which contribute to the success of an international financial centre. Some are intangible such as quality of life and cosmopolitanism.

Indeed, before we rush to the assumption that, because India and China will continue to grow more rapidly than North America and Europe over the next few decades, that necessarily means that Shanghai or Mumbai will replace London or New York, we need first to consider the experience of Frankfurt and Tokyo, both of which totally failed to make the cut as international financial centres despite the extraordinary success of their respective economies for long periods after the Second World War. It would take too long to list the reasons why they failed and why London

succeeded but the fact that both had very deep domestic pools of savings and significant current account surpluses was not sufficient to project them through to the front rank of financial centres. And this remains a fundamental problem for both Shanghai and Mumbai. Thanks to prudent, but very conservative, financial regulation, neither is anywhere near being able to take the place of a London or New York. Both still have balance of payments restrictions in place; both lack significant capital markets able to offer their savers access to a significant range of fixed-income instruments such as corporate bonds; and both continue to restrict the ability of foreign investors to operate on an equal basis in their respective markets. It is inconceivable that Mumbai, for example, can emerge as a major regional, let alone global financial centre, so long as local political pressures restrict the ability of foreign firms of lawyers, accountants, insurance companies and banks from operating freely.

So, we should not rush to the conclusion that because the global economic map is being rapidly redrawn, that necessarily means Asia will inexorably replace London or New York in the foreseeable future. Indeed, I would argue that the biggest threat to London's status as a global financial centre comes not from any significant increase in competition from other markets but from the real risk that the regulatory response to the current crisis will lead, unconsciously, to new forms of financial protectionism which will make it impossible for London to continue to be the free and open market it has been in the past. The examples of potential regulatory over-kill are too numerous to list. New capital requirements on foreign bank branches operating in London; pressure on UK banks to increase domestic lending at the expense of their overseas operations; FSA anxieties about the need to reinforce the UK capital of large British international banks; pressure on the over-the-counter (OTC) derivatives industry to put all their business through regulated exchanges; the EU's proposal in April 2009

which would make it almost impossible to sell products or Government securities which have been rated by non-EU Credit Rating Agencies such as those in S. Korea and India; and proposals to regulate hedge funds and private equity firms which could well lead to a rapid diminution in the alternative investment sector.

Nobody can for a moment deny that the scale of the current financial crisis is such that new regulation, particularly for the banking sector, is going to be essential. The Turner Review represents a sensible and measured first step towards a tougher set of controls. But, what I liked about the report is that it recognised that much of the improvement needed can only be undertaken on the basis of international agreement and harmonisation. There is a real danger that retrenchment and repatriation of financial capital to the national level will result in a balkanisation of global financial markets. There is growing evidence that the regulatory response to date is damaging international trade, now falling at a faster rate than any time since the 1930s. We need measures which will facilitate global flows of credit and capital.

Unilateral measures rushed out in a panic from Washington or Brussels which take insufficient account of such international repercussions mean that, unless we are very careful, London and New York will fall behind over the next few years not because of enhanced competition in Asia but as the result of self-inflicted wounds which take insufficient account of the need to maintain the whole process of globalisation which has served us so well in recent decades. My bank (SCB) operates in 72 different countries; I suppose HSBC must operate in about 85 different countries and Barclays must also have an extensive network. We are all used to having to deal with different regulatory requirements in different markets, but it would help if those responsible for financial services regulation in Brussels recognised that the EU does not represent the relevant market for European banks, particularly those based in London. We need harmonisation at international,

not regional, level and proposals by European regulators which ignore this global dimension can be very dangerous.

In short, I am much more concerned that we will find this recession prolonged and painful not because, as in the 1930s, the major economies have engaged in tit-for-tat trade protectionism (where the scope for really damaging action is restricted by WTO obligations) but because their response to the undoubted severity of the financial crisis has been to introduce a series of measures intended to improve prudential supervision and domestic lending but which also unintentionally happen to have the effect of rolling back the progress we had seen in the emergence of global and open capital markets. That is the real threat to London.

Finally, while anger and frustration with banks is entirely understandable, we must remember that, if well-managed, they play an essential role in securing savings and providing credit. The failures of the banking industry in London were neither wholesale, nor uniform. There are still plenty of well-managed, profitable and responsible institutions operating in the City which did not need to participate in government rescue schemes. We must strive to ensure that in dealing with the failures, we do not inadvertently drive out or damage those who are still successfully operating from the City of London. Banking is fundamentally about confidence and, while apologising for the industry on what went wrong, we do need to point out that much continues to go well which is crucial to global prosperity.

16

Can 'the City' Adapt to the Coming Era of Big Government?

Stephen Haseler

The collapse of the banking sector in the City of London amounts to, by any standards, a major financial and economic crisis. But it is also a major political (and geo-political) crisis. As I have argued in my book, *Meltdown*, the origins, and causes, of our present financial discontents will not be discovered through purely *economic* analysis; rather, they can be traced to two profound, and allied, *political* (and geo-political) changes (Haseler 2008). The first, in the 1980s, was the victory of the Reagan/Thatcher neo-conservative political revolution which ushered in the age of market fundamentalism and de-regulation. The second – caused by the sudden collapse of communism in the early 1990s and the subsequent entry of China and Eastern Europe into the global economy and world labour market – was

the great push by western capital to take advantage of this new, and lower, cost base.

They called this new era of mobile capital 'globalisation', but, of course, it was no such thing. For, in reality, although capital became foot-loose, global capital was in no way to be matched by 'global' politics or 'global' governance. Western investors, banks and financial companies could all of a sudden take great advantage of what became a new 'wild west' – a whole global economy increasingly beyond the reach of national governments and regulators, a nirvana of de-regulation and untold profitability, all created by exploding credit and run through a new 'shadow banking' system.

By the late 1990s this new 'free market' world – led from Wall Street and the City of London – was becoming both triumphalist and aggressive. Footloose global capital had the world as its playground and went in search of lower and lower costs, primarily in Asia. This seriously weakened the position of western labour, as jobs in the West were outsourced and the numbers in temporary and part-time work (with lower or no benefits) grew. It was a process, certainly in the US and the UK, that saw wages and incomes lag seriously behind profits. And at the same time, as incomes were relatively depressed, some investors were securing untold riches (and achieving mind-blowing fortunes, often through tax havens, by both avoiding and evading taxes). It was all leading, under the radar, to seriously deepening social divisions. I discuss the declining incomes and increasing inequalities in a chapter of *Meltdown* entitled 'Disaster for the Middle Class' (Haseler 2008: Ch. 7).

Yet at the same time as average incomes were stagnant (and in some western countries actually falling) the western economies, particularly the 'Anglo-Saxons', were, paradoxically, witnessing a boom based upon consumer-led growth. This 'growth' was, in the absence of increasing incomes, fuelled by an irresponsible explo-

sion of credit in the US housing/mortgage market and more widely, in the American-influenced global economy (built around more and more exotic financial derivatives). However, much of the rest of the world was also complicit in this essentially phoney US 'growth economy' – as exporters from Germany to China acted as cheerleaders for the high American consumption machine. Americans, with the full support of foreign policy-makers, became the global consumers of last resort. Americans were living beyond their means, but this huge debtor nation could continue to do so because, being a reserve currency and a 'safe haven', they could continue to attract foreign money and could always pay off their debts through issuing US Treasury bonds. Yet, this great global credit explosion – the specific cause of the present global crisis – was only made possible because of the more general global environment of low inflation (and low interest rates) enabled by low-cost Asia.

During the 1990s, and then more intensely in the first years of the new millennium, the world saw a huge Wall Street and City of London-led global leveraging up with some estimates, by prize-winning economist Hernando de Soto, putting this credit explosion in the quadrillions of dollars (de Soto 2009). It broke world economic history records. It was a bubble that was bound to burst. Yet, it is important to place this phase of economic history in its more general geo-political context. For the global financial boom was more than just an economic matter. It was part of a major geo-political surge. Following the collapse of communism Francis Fukuyama's hugely influential *End of History* laid out a future for Americans in which liberal democratic (essentially American) values and institutions would increasingly dominate the world. It was a worldview which President Bill Clinton and Prime Minister Tony Blair would, in essence, come to share, and attempt to implement – Bill Clinton through his belief in Wall Street-led 'economic globalisation' and Tony Blair through his

support for military 'liberal interventionism'. During the Presidency of George W. Bush these, by historical standards at least, extremist views were to be developed further by those who came to be called the 'neo-conservatives'. And 9/11 presented the opportunity for implementing them. Built around the 'global war on terror' (in which countries were required to be 'with us or against us') an extraordinarily ambitious attempt was made to 're-make the world' through the power of the Pentagon which ended up in 2003 with the invasion of a country that did not threaten the USA. The West – both through the soft power of 'globalisation' and the hard power of the American military – was seemingly on the march.

This extraordinary phase in world history, of course, did not last. The strategy was simply unsustainable. And it all came crashing down. Early in 2005 it was clear that the Iraq invasion was not going to be the catalyst for 're-making the Middle East' (indeed, it was setting back US interests). And in the summer of 2007 the over-extended Wall Street/City of London-led global banking system started to implode as banks simply stopped lending to each other. The tipping point was the sub-prime mortgage crisis in the US, but this served only as the trigger of a broader and deeper global credit collapse.

Now that the bubble has burst, the world is witnessing a great 'de-leveraging'. This 'de-leveraging' is essentially a private sector event – a 'great unwinding' of a global *private* debt mountain much higher than that of the 1930s. It is an 'un-winding' that will have grave repercussions in terms of growing unemployment and will trigger a social dislocation, and a coming social crisis that may well threaten the very fabric of our western civilisation.

These extraordinary times demand extraordinary thinking and extraordinary solutions. Yet, as the present group of world leaders try to grapple with how to staunch this *private* debt deflation, we are facing a very real intellectual problem: the continuing hold on

the minds of our present governing elites of the failed economic thinking – the market fundamentalism that got us into the crisis in the first place. In a sense this intellectual sclerosis is not surprising, for the neo-liberal consensus of the past era was very tight, and almost hegemonic. For instance, in neo-liberal Britain the past two decades have seen all three political parties, virtually the whole of the economics profession, most of 'Fleet Street' and all of the business community succumb to the thought-processes, values and strictures of an extreme market fundamentalism, led by the finance sector. The Gods were Friedrich von Hayek and Milton Friedman, the devils were John Maynard Keynes and Karl Marx. But this neo-liberal British consensus was only an extreme form of a broader 'free market' western consensus that spread out from Wall Street around the world and included many European elites, not least in the EU Commission, and 'third world' leaders.

Of course, to admit failure and to change one's mind takes considerable courage. And the Thatcherised – and marketised – British political and financial elites are still finding it very difficult to re-invent themselves to meet the new challenges. The US primarily because of its more open society (and more competitive elites) has, with President Barack Obama, at least started to think out of the box. Obama, unlike most western leaders (including Gordon Brown, David Cameron, Angela Merkel, even Nicolas Sarkozy), was not implicated in the past 'free-market' system and is free to think afresh – though such fresh thinking in Washington is still somewhat constrained by some of his advisors. One such, Larry Summers, an architect no less of the failed global market system, is, albeit following a public *mea culpa*, still in post. But, what of new thinking in Britain? And can the City of London – so important to Britain – adapt to the new world, or will it be stuck in the ways of the old, failed global market system?

There seems little doubt that London's financial district will need to re-invent itself so that it can prosper, even survive, in the

new world that is coming. First, it will need to stop acting like a pressure group (the most important pressure group) for the minimal-de-regulated state and a front for Britain as an offshore hedge fund dominated island. It is in the City's interest to argue for a more sustainable and balanced British economy (located in a wider European economy) in which it can operate. The City's leading lights need to fully understand that the age of the minimal state (and minimal regulation) is well and truly over. It was the minimal state that caused this crisis, and the memory of this failure, a memory that will be fuelled by the high unemployment of the coming years, will stop in its tracks any government that will try to revive the ideology.

In fact, the key characteristic of the coming era will be 'the return of the state'. Of course, so far in 2009 the state has acted as little more than a temporary Accident and Emergency room set up to patch up the bleeding neo-liberal economy. We have certainly seen a huge increase in public spending by governments and in 'quantitative easing' by central banks, but this huge public sector programme has been constructed as, and seen as, little more than a bail-out of the private sector – that is, a temporary socialising of the private sector's losses until the patient revives and can return, on the back of the taxpayers bail-out, to his old ways of profit-making. This use of the state for private sector interests may be breathtaking in its audacity, but it is nothing new. It is in the long tradition of the corporate business-led economy in which the state's role is crucial – not, of course, as a constraint on the private sector, but rather is used as a 'handmaiden' – providing infrastructure, providing outsourcing opportunities and tax breaks.

I think, however, the image of the neo-liberal economy being on a life support system in A&E is in essence a wrong one. Rather, I see the neo-liberal economy, and its minimal state, as having, in fact, already died on the operating table. Indeed, with the collapse of global private credit (and with much more private de-leveraging

to come), with government interventions replacing private with public credit and effectively nationalising the banking system, with increasing state regulation, and with the various stimulus packages (and further stimulus packages on the way), the balance between public and private has already shifted dramatically in the public sector's favour. And as the financial and economic crisis becomes a social crisis (with lower average living standards and higher real unemployment colliding with rising expectations) the state's role, both in terms of the automatic stabilisers of welfare spending and the budget for policing, will grow.

With private sector credit still contracting (and by all accounts it has much further to go) what can be called 'the destruction of wealth' – more accurately, the destruction of private wealth and capital – continues apace. Furthermore, public support (legitimacy) for the private sector has taken a terrible battering. All in all, the factors which secured the legitimacy of the neo-liberal minimal state – globalisation, economic growth and confident intellectual backing – will not be returning for decades to come, if at all. Even so, the western political and financial elites are as yet still unable to accept this fact, and consequently continue to delay the funeral. Nevertheless, and irrespective of the laggardliness of our elites, we can dimly see the outlines of the new economy that has already been born.

A strong state will, inevitably, be at the heart of this new economy. Such a renewed state need not necessarily mean a radical change in ownership patterns from private to public. It will, though, need to be strong enough to ensure that the new economy, unlike its old neo-liberal predecessor, is sustainable – that is, that it is no longer susceptible to wild economic and financial swings and to extreme social inequalities and dislocations. And in order to secure the goal of economic sustainability it will need to regulate the private sector. In the City of London this, among other things, will mean a new form of 'Glass-Steagall' whereby 'narrow banking'

is encouraged and 'universal banks' (which put domestic clients and electorates at risk through wild and speculative global activities) are controlled. And in the wider economy, in order to secure *social* sustainability, which in turn can only be achieved by a political culture of social fairness, we will need to be able to redistribute both income and wealth in order to secure that minimum fairness needed to limit extremism and violence and maintain social peace during the coming sharp downturn.

The financial sector in the City of London of the future will need to come to terms with the new popular legitimacy of the state. The near-worship of financialised corporate business and the disdain for government, so much a feature of the old ways, is already coming to an end as the state (or 'government') is increasingly seen, and rightly so, as the only thing standing between us all and the collapse of organised society. In today's frighteningly fragile economy it is the state that is protecting citizens from the collapse of their banking system; it is the state that is keeping unemployment from going through the roof; and it is the state that is the only institution capable of maintaining minimum welfare for the most vulnerable (many of these new vulnerable coming from the private sector).

Almost every government in the West is now 'protecting' its citizens even whilst they all attack 'protectionism'. Yet, no one should be surprised if governments continue to develop protectionist policies if no one else – in the absence of global government or, in Europe's case, the EU – will do so.

The British government, for instance, though regularly denouncing 'protectionism', has recently engaged in two major protectionist measures. First, what else than a major act of protectionism is the recent policy decision to devalue sterling against the euro? And secondly, what else than yet another act of protectionism is the decision to bail-out the bulk of British banking and the City of London? Over the last year or so the City of London's

banking sector has become the country's biggest and most expensive welfare case – one that is now costing British taxpayers dearly, so much so that the country now has a real problem with funding its budget. Britain's current budget deficit (now, in July 2009, topping 13%) is, in percentage terms, the worst of all the major industrialised nations, including that of the high-spending USA.

How is Britain's deficit to be funded? There is a strong case for increasing taxes, but such a course would also weaken demand and future tax receipts. There is also a case for cutting services, but that too would severely lower demand, and would start the country on a self-flagellating negative downward spiral: of lower demand, lower revenues, more public sector cuts, and so on. For the foreseeable future, if Britain does not default on its debts, it will need to fund this deficit through borrowing. But the big question remains: will it be able to do so?

In fact Britain has a special problem when it comes to funding its deficit – and it is essentially a question of size. The fact is that Britain is too small for its over-extended financial services and banking sector. It is a question of the size of the 'hinterland', or, more precisely, the relationship of the hinterland to the financial sector. Put starkly, as it is the British taxpayer, and not the global economy, that is called upon to bail-out the banks in the City of London, then the size of the British tax-base becomes all-important. Again, put starkly, the UK has simply too small a tax-base – just as the Iceland economy had too small a tax-base for the over-extended Icelandic banks. In this sense the City of London compares unfavourably both with Wall Street (where the US economy is big enough to sustain and bail out its financial district) and with the Euro-zone (which is ultimately big enough to support European banks, for example those in Ireland). The figures prove the point about Britain's over-extension and vulnerability: for as Viara Bojkova sets out in her article ('The crisis and the taxpayers') in this volume, in 2008 the assets of

Britain's top five banks as a percentage of national GDP was 402%, whereas in the US the 'top five' amounted to 58% of US GDP. In the US government bail-out funds amounted to 1.60% of GDP, whereas in Britain they amounted to 3.45%. It is sobering to read the views of Martin Wolf, the eminent *Financial Times* columnist: 'The worst of the financial crisis may be behind us, but the financial system remains undercapitalised and weighed down with an as yet unknown burden of doubtful assets. It is also far from a truly "private" financial system. On the contrary, it is underpinned by massive explicit and implicit taxpayer support. The probability of mischief down the road is close to 100 percent' (Wolf 2009).

As Britain's over-extended financial institutions go onto state life-support systems it is being asked of Britain's comparatively small number of taxpayers to carry the burden on their own. Without international help it simply cannot be done. And such international help is not likely to be forthcoming. The likelihood is that China will be focusing on its own regional Asian economy; the USA, with almost as big a deficit as Britain's, will ultimately look after itself; and Europe is unlikely to help out as long as Britain refuses to accept Europe's rules (for instance as set out in the new EU proposals for financial regulation) and stands aside from the Euro-zone.

This problem illustrates the present strategic impasse of the City. There are only two options. One is to engineer a traumatic restructuring of our banks and financial services system. The economist John Kay has been a consistent advocate of what he has called 'narrow banking' (see his chapter in this volume); and there is a good argument for separating domestic lending from more exotic foreign risk-taking. But ending the system of 'universal' banks in London, and letting their global investment arms rise or fall in the market, would, as happened in the case of Lehman Bros., amount to condoning a national default.

Defaulting, though, may yet become necessary, but it will be catastrophic. Larry Elliott has argued (*The Guardian* 14 July 2009) that it will take another two years or so before we know whether the United Kingdom Financial Investments Ltd. will return their banks to solvency. So, if Britain is not to default then it will need to fall back on the only option available – namely enlarging the government and currency that stands behind the City of London. And this in turn means the further integration of the UK into the only going concern around – the European economic and financial system. In the short term the European Central Bank is already playing an important stabilising role – it has already loaned £375 billion in 2009 to the European banks, and it has the resources and ability (through the bond market), should a policy decision be taken to deploy them, to play a pan-European recovery role. Yet, even whilst the ECB continues with its more limited present role, this crisis has forced back onto the British policy agenda the country's relationship with the Euro-zone. The fact is that Britain needs to borrow large amounts of money to finance the spending made necessary by the collapse of the banks – so an urgent question needs to be addressed: would foreigners be more likely to lend to London if they were to be repaid in euros – that is, in a strong currency with a continental size economy behind it – or in pounds?

During the 1990s, following the 'Big Bang' and the fall of communism, the City of London, with the Westminster government in full agreement, took a strategic decision to go global. But it is still has a large amount of European business, and with the global economy now severely contracting (and likely to remain in an anaemic way for some decades), Europe remains London's natural home – and its only real hinterland. There is an urgent need for government, and the City of London, to reconcile the new economic realities with this great continental economy on its doorstep. But it is here that the Westminster

political elite's twin and contradictory obsessions – with both 'sovereignty' (in essence the 'sovereign' ability to devalue) and with a 'global role' (with its imperial overtones) becomes self-defeating, indeed self-damaging. Whether these twin obsessions can be overcome will be the great test of British economic and political statecraft in the coming era.

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17

Sociality and Pathology in Financial Institutions

Sam Whimster

There is a view, though one hears less of it as the crisis unfolds, that with judicious injection of public money the banking system can be put back on its feet, governments can sell off their unwanted bank shares at a profit, and a re-regulated system takes us back to business as usual. One can but hope that things do bounce back to some kind of normality, but in this chapter I will tend to the opposite view – not out of pessimism but in order to grasp the combination of causal factors at work. What became manifest in 2008, but had in fact been incubating for years within the financial and banking system, was a deep-seated pathology. September 2008 must be reckoned as a near-death experience, not an episode of high blood pressure. The banking system has come out of emergency resuscitation and is now in intensive care.

One way forward, in a very intractable situation, is to inquire what kind of banking and finance is required for the challenges of the twenty-first century and to proceed with those aims in mind.

Banking and finance presented itself as the leading edge of the new knowledge and service economy, an image that greatly attracted politicians and eased the pleasure of consumers, whereas what was occurring was a large-scale appropriation of the resources placed at the disposal of bankers and financiers and this was made possible by digitised financial engineering. This enabled a widespread misallocation of resources. The sector's former legally prescribed powers of disposal – what bankers and financiers could and could not do in the era of paper – were displaced by new policies, such as the repeal of the Glass-Steagall Act in 1999, that allowed an expanded radius of action coupled to technologically enabled powers of disposal. Legislators, regulators, and citizens had almost no inkling of the wholesale shift in the power of disposal, and within the financial services industry there was little appreciation as to just how powerful these informational technologies were – other than their ability to realise profitable opportunities. In the twenty-first century the new technologies of information will be a social good whose cost approaches zero for the average user. Reform should recognise this as a principle when returning banking and finance to its proper social functions.

Doctor, how bad is it?

This question can be answered: 'The good news is you [the bankers] will pull through, the bad is that many others will die.' The pathology so manifest in the awful statistics of financial institutions and government support schemes during 2008 and 2009 needs to be seen over the period from 2002, as the finance and the general economy came out of the dot-com crash, to around 2015

when some kind of normalisation of the situation may have occurred. Bank lending and profitability grew like a fever until 2007 based on an unsustainable business model, cheap money, unreliable auditing and profits inflated by their accounting practices. This had knock-on effects in the real economy as consumers availed themselves of cheap credit bringing savings levels to zero, unviable projects were financed and asset price inflation took hold. The emergency phase lasted from September 2008 to the early summer of 2009, and thereafter financial institutions went into intensive care dependent on continuing government support and other measures. Recovery, taking until 2014 and beyond, will be the mirror image of the 'noughties'. Banks, if they have not gone bankrupt, will be burdened with massive writedowns on their loans: US$ 1.025 trillion in the US, $ .604 trillion in the UK and $ .814 trillion in the Euro area (IMF 2009: 10). It is the expectation of governments and international financial institutions that banks will address their toxic assets (mostly derivatives and commercial property loans). Banks will also be forced to re-capitalise their capital base (worldwide just under $2 trillion by the end of 2010), and regulators will demand higher capital adequacy ratios. Banks, to some huge but yet to be determined amount, will repay sovereign governments for their capital injections and asset guarantee schemes (see Viara Bojkova in this volume). Bank revenues are not expected to reach normal levels until the end of 2014 (IMF 2009: 16). As a result of these negatives banks 'lost the capacity during the crisis to manage their maturity profiles.' They have rolled over debt obligations, thanks to central bank and government treasury support, but face 'an unprecedented $1.5 trillion of bank debt due to mature in the euro area, the United Kingdom, and the United States by 2011' (IMF 2009: 16).

The unfolding of this dynamic will have a negative feedback interaction with the general economy as consumers are faced with more expensive credit and a deflationary environment. Significant

negative GDP growth through 2009 will depress profits, wages, and increase unemployment. A weakened and convalescing banking sector will be therefore operating in a less prosperous economic environment. The other dynamic, just to note, is the fiscal expansion of the state both prior to meltdown and its massive increase afterwards; then from 2011 to beyond 2015 a period of fiscal rectitude as governments reduce their expenditure and increase taxes. The full miserabilism of this scenario is set out in the dismal 'economese' of the IMF's Global Financial Stability Report of October 2009.

In short, any deeper analysis of the crisis should recognise that what is referred to as the crisis has a trajectory of boom, bust and slow recovery of some fifteen years or more. There clearly was, however, a crisis moment. On the morning of 18 September 2008 in the United States an electronic run on the money markets was occurring with $550 billion being withdrawn in less than two hours. The US Treasury pumped in $105 billion to no effect. It then decided to close down money accounts and announce a $250,000 guarantee for all accounts. A similar moment occurred in the United Kingdom with the Governor of the Bank of England admitting on 8 October 2008 that 'Not since the beginning of the First World War has the banking system been so close to collapse.' In the view of Congressman Paul Kanjorski, had the US Treasury not intervened 'the entire economy of the US, and within 24 hours the world economy would have collapsed. It would have been the end of our economic system and our political system as we know it' (quoted in Skidelsky 2009: 9).

The enormity of this moment – the near-death experience – requires more attention than it has been given (in the rush to restore confidence and 'normality'). Had the US Treasury not thrown itself between bank deposits and account holders what would have happened next? Psychologically, it would be like a person going to a cashpoint in a foreign city, introducing their card

and being told their account had been closed. In that situation the person goes to Thomas Cooke to utilise their card insurance, but the insurer has no money to pay out. The person then has to beg or borrow from some other person, but everyone else is in the exactly same situation. Payrolls are frozen, credit cards will not work at petrol stations and supermarkets. Queuing outside a bank, as in the Northern Rock case, is futile since banks cannot draw down electronic funds and they have little physical money in their vaults to pay out. And when the engine runs out of oil, so to speak, can the motor be restarted? The ability to impose a command economy with rationing would have been vestigial, since that is a feature of wartime economies. What the Comintern had spent over a century trying to engineer was almost achieved on that one day in September 2008.

The other unexplored side of this event was the digitalisation of banking, finance, and fund transfer. The whole international financial system could be crashed within a matter of hours. For this to be possible, the system had to be networked sufficiently so that hardly any country or region, or class of business or customer remained outside the system. Secondly, the speed at which catastrophic events is transmitted is extremely short – hours. The digital system of finance allows prodigious sums of money to be moved around at will and with almost no time delay – a feature that has made short-selling so profitable. Had Ben Bernanke and Henry Paulson dithered on the morning of 18 September, the counterfactual sketched above would have become real. The rationalisation of finance on a digital basis – making it an efficient, rapid, uniform and ubiquitous system with transaction performance superbly enhanced and transaction costs gratifyingly low – has created capabilities, both good and bad, that urgently require impartial social science inquiry. Rationalisation drives out redundancy – there are no time or flow buffers, everything is interconnected on a uniform digital platform with no alternative

way of operating. In the next section I give a reminder of the virtuous world of banking, its reliance on paper and files, and the professionalisation of banking as an occupation.

Rational and social characteristics of banking and finance

As Jocelyn Pixley in this volume so rightly points out, banking performs important social functions. Indeed to understand its social functions is to appreciate properly the nature of modern banking. In contrast to many economists, Joseph Schumpeter argued that banking should not be reduced to the extension of trust beyond material value (of gold or silver), or that it was a mere vehicle of macro-economic spending and saving decisions that were the 'real' factors in economic theory. The craft of banking involves taking in deposits and lending them out as loans on some multiple of the original deposits, thereby creating credit – and further deposits – and spending on a much wider scale than say a personal bilateral arrangement between two people (Schumpeter 1954: 1114). In the early history of credit, loans were an obligation of one neighbour to another in cases of emergency, like fire or famine. This passed into canon law where it was a sin to charge interest (usury) because a person would be benefiting from another's need. In the absence of modern banking practice, able to generate multiples of lending from a certain amount of deposits, to borrow from usurers was expensive, and unpopular. The price of credit was high because it was based on repayments from high risk customers, not on deposits – and the modern loan shark has the same 'business model'. (This is why it is still important to include low income groups into some sort of banking scheme.) When central banks finally arrived at their crucial social role as bankers of *dernier ressort* in the late nineteenth century, the modern reliable banking system was born.

Liquidity, as Willem Buiter has recently pointed out, is a public good, and private banks benefit from it and the central bank's guarantee of its continued availability (quoted in Mainelli and Giffords 2009: 32). Banks are enabled to develop a socialising function through a mechanism in which savers and borrowers' economic needs and decisions become fortuitously coincident. The availability and relative cheapness of credit is fundamental to the expansion of capitalism, and in the 21st century it will be absolutely vital as current infrastructures of societies have to be renewed, or, in developing societies, put in place. The task of regulators now is to restore the social functions of banking, ensuring that the multiples of loans to deposits is stabilised and efficient – and free from the depredations of investment banking (see John Kay in this volume and Kay 2009).

This same line of argument can be applied to derivatives and swaps. It is a train of thought worth pursuing, because at some point derivatives turned from being useful financial instruments that introduced more liquidity into the financial system into the now notorious 'weapons of mass financial destruction'. The international economic system could not have developed without some form of financial engineering and derivatives and swaps were part of that story. From the 1970s there was a huge increase in capital flows and currency imbalances (for reasons well-rehearsed elsewhere). Firms, governments and economic agents had to manage their profitability and finances in the face of major uncertainties – price of currencies, price of commodities, interest rate volatility. They had to manage their presumed future economic chances and – for a government or pension fund – their known liabilities in a world where known and unknown contingencies could occur. Contemporary capitalism is not a managed process and over the 1980s and 90s very many countries went capitalist as socialist and communist countries renounced the stasis of the socialisation of the means of production and ex-colo-

nial countries boot-strapped themselves into dynamic economies. The economic environment was punctuated by what seemed at the time major shocks – the collapse of the Argentine economy, the cardiac arrest of the Mexican peso and Russian rouble, the Asian crisis of 1997 – but subsequently should be seen as just part of the noise of a rude and flourishing capitalism.

The original rationale of a swap was to hedge risk. Going back to the halcyon days of financial innovation, the economist Nick Robinson wrote: 'Hedging involves reducing the company's exposure by adding something to its portfolio with the opposite "exposure" or "payoff" of the entity's own exposure' (1992: 78). If a company is exporting to the United States a decline in the dollar would affect its profitability, therefore a hedge could be purchased which would offset that decline (for example by futures in the price of gold). Futures and options, themselves, were developed, as any first year economics text notes, to iron out price volatility in agricultural markets where good or adverse weather would affect crop volumes and so price. In a world where national economies had become less managed by the state, and the international economic system less managed by inter-governmental agreements and international institutions, something like the changeability of weather was being imposed on all tradable products and services. A future or an option is a derivative and is bought and sold on exchanges, or used to be. Markets in commodities futures like the Chicago Mercantile Exchange do business because there are two classes of buyers and sellers, those who are speculators, the risk takers, and those who are risk averse – mainly because their longer time horizon is anchored in the real world. Obtaining a risk *neutral* position was the objective of the farmer, the firm or a pension fund. Speculators are necessary to take bets on price movements, but the economic function of derivatives was to remove volatility and downside risk. The other 'rational' feature of trading derivatives – forward rate agreements,

swaps and options – is that buyers and sellers have different time horizons. A multinational company, for instance, knows it has a payment to make in a particular currency at a fixed point in the future. It can choose a variety of instruments for fulfilling this known obligation, and will choose it according to the particular conditions, or portfolio, of its treasury. The company can not only remove the risk of currency or interest rate fluctuation, it can also choose the best instrument according to the liquidity and types of assets already in its treasury.

Everyone now knows that derivatives are at the heart of the firestorm that is today's global financial system. But it is worth recalling that back in the late 1980s they were a rational innovation operating in an open market that gave users considerable flexibility in the use of their funds in an increasingly unpredictable world. That they were 'derivative' of some other substance, like currency, real estate, or pork bellies, was not in itself a besetting sin. In fact a forward rate agreement operates *after* the basic buying and selling of some substance has been concluded. So one party taking receipt of ten million yen may choose to iron out subsequent currency movements and the forward rate agreement allows these marginal differences to be negotiated. For a company this is a cheaper way of proceeding than holding large amounts of liquidity in its treasury in the event of some unexpected contingency.

The same progressive argument can be extended to mortgages, their bundling together and sale as bonds in wholesale markets. At the time in the mid-1980s this new procedure had merit. Thrifts and building societies had a massive need for more finance and their only assets were the income from existing mortgages. Mortgages could not be securitised and sold as bonds, because mortgages all have different redemption dates and are open to early redemption. A bond has to have a fixed maturity date, enabling its valuation at maturity and the all-important

calculation of yield. Mortgages could, however, be grouped into tranches where on average the redemption dates would be say, five, ten, and twenty years for each tranche, and buyers, like pension funds, knew whether they would be receiving an income for a fixed period, or if they chose principal repayments at a date. The collateralised (the bogusly Latinate term for aligning tranches of mortgages) mortgage obligation could claim to be a rational innovation (Lewis 1989: 122). The solvency of banking and finance in general is very dependent on meeting and covering the maturation dates of myriad types of savings while at the same time not quite knowing the temporal flow inwards of deposits. The collateralised mortgage obligation fulfilled this requirement and thereby an important social function was achieved – making available home finance to a wider range of income groups. Whatever happened from the late 1990s onwards should not obscure the social function of housing finance. This has now been withdrawn from whole income classes leaving them exposed to the vagaries of the private rental market and homelessness.

In retrospect there is still a fundamental question to be decided: was it wise to break down the barrier between home finance and international capital markets, remembering that laws had to be changed – at the behest of lobbyists – for this to happen? This is also a massive current issue, since the majority of toxic assets (we are told) are constructed from actual people's mortgages. People's lifeworlds are now inextricably bound up with financial malpractice. In reforming the international financial system regulators might choose to reverse the history of financial innovation and decide which instruments and practice were, for instance, pernicious, rent-seeking, and system-destabilising. For example insurance swaps for collateralised debt would seem illogical, since swaps should be a market driven trade between the risk averse party and the speculator; insuring bonds side-steps pricing in the market. Likewise abolishing hedge funds may be considered

because they no longer perform the original function of the hedge component of any swap; they have become highly leveraged private capital pools of the super-rich creating instability to make short term gain. But the question for the regulator should remain: what is the social function of any practice?

The economist, Leonard Stafford, wrote in the early days of innovation: 'An irony is that markets and instruments designed to limit risk for investors have sometimes led to a greater fragility in the market as a whole' (1992: 43). If irony comes in bucket-loads then Stafford's misgivings have been amply confirmed. What has yet to be fully explained is how these innovations were so bent out of shape and removed from rational market based transactions. One set of arguments concern straightforward market abuse and the loss of professionalism.

De-professionalisation and the flight from rationality

There is a beguiling line in Leonard Stafford's account of the feel of the City way back in 1986. 'A senior manager in a most respected British merchant bank told the writer that it was traders, barrow boys, that were needed, but he hired graduates' (1992: 31). Perhaps that 'respected' merchant bank might still be in business if it had kept to this policy (and not sold out its ownership to foreign buyers). But it is more than a stereotype to say that investment banks had a habit of taking the most uneducated, unqualified and myopic person and put them in charge, on the basis of their trading prowess, of whatever bond or instrument was in vogue. Traders have to settle their books at the end of each day while just about every other economic actor has to keep in mind a longer timescale. Altering the power structure of banks in favour of the trader introduces a drastically foreshortened time horizon. The trading mentality prevailed first in the

investment banks and then in the brave new world of financial conglomerates as they took over the 'high-street' banks. The culmination of this trend occurred when the top British bankers sat before the Treasury Select Committee in early 2009 and declared they did not have a banking qualification between them. The wonder is that the banking system did not collapse before, or to be more methodological, there is a very large 'explanandum' still to be explained. There is also a need for a sociological research charting the generational move from professionalism to the new knowledge worker in the financial services industry. The Centre for the Study of Financial Innovation has articulated the degradation of professionalism in one of their publications. It is entitled *Grumpy Old Bankers* though perhaps 'enraged bankers' is nearer the mark (CSFI 2009). Sociologically, this would involve examining the emergence of a new service middle class (see Whimster 1992).

The evolution of the modern banking system in the last century and before involved the institutionalisation of rational calculative behaviour. Strict adherence to double-entry book-keeping, accountancy and auditing protocols, an ongoing awareness of present and future likelihoods of deposits and loans, capital adequacy rules, corporate and banking law and so on. A banker possessed a degree or professional diploma that qualified him for the job and its procedures. In addition, bankers were a profession in the sense that they abided by a code of conduct that included some notion of ethics and certainly included trust as the social cement in any business dealing. While banks might be very large they had an organisational structure that allowed the attributes of expertise and trust to be exercised at each level in what were often face to face business relationships.

As these attributes, which most commentators regarded as essential prerequisites for modern capitalism in general, were dispensed with progressively from the 1980s onwards, on what

new principles did the banking and financial system operate? One problem for observers and social scientists is that it is very hard to obtain reliable empirical evidence of what exactly was occurring inside the new financial behemoths. One of the first forensic accounts to come out of the present crisis is the complaint lodged, in March 2009, by the Investment Division of the Treasury Department of the State of New Jersey against the CEO and directors of Lehman Brothers Holdings Inc. Specifically, the action arises 'from its purchases of over $180 million of securities from Lehman as part of two offerings issued by the Company on April 1 2008 and June 9, 2008' (New Jersey v. Fuld et al: 1).

New Jersey's Investment Division had a longstanding relationship with Lehman Bros (and other investment banks) by virtue of it being one of the largest public money managers in the United States. The Investment Division manages 'pension and retirement plan funds for over 700,000 active and retired New Jersey employees. In addition the Division manages over 185 other separate funds.' These funds include Public Employees' Retirement System, Teachers' Pension and Annuity Fund, the Police and Firemen's Retirement System, the State Police Retirement System and the Judicial Retirement System (New Jersey v. Fuld et al: 7).

The Investment Division's complaint is able on the basis of its own records, and public statements made by Lehman, to put together what it takes to be the lapses from sound business practice and law-breaking by the bank. The court has not judged on the case and the truth of the claims against Lehman remains to be confirmed. But the main headings and types of laws alleged to have been broken give a very clear indication of what would seem to be a marked departure from 'normal' rational banking practice.

The plaintiff's complaint divides into two parts. One is the infringement of the federal Securities Act of 1933 and the other part include 'violations of New Jersey's securities state, negligent misrepresentation, breach of fiduciary duty, fraud and aiding and

abetting by E&Y [Ernst and Young], among others'(New Jersey v. Fuld et al: 2). The substance of the complaint is that Lehman engaged in highly risky business, claimed its financial position was much better than it actually was and in the process broke a series of laws.

Lehman had become a market leader in the mortgage business but was heavily exposed in the sub-prime and 'Alt-A' (borrowers who had no documentable income). The overall US sub-prime mortgage market had grown from $40 billion in 1994 to $600 billion in 2005 and the Alt-A from less than $20 billion in 2000 to more than $300 billion in 2005. In the early 1980s, by way of comparison, the whole US mortgage market was $1.2 trillion at a time when thrifts originated, checked and owned their mortgage assets and securitisation of mortgages had not yet been invented (Lewis 1989: 76). At a system level what was happening in major investment banks in the 'noughties' was akin to a money machine. Existing mortgages were bundled and securitised and sold as bonds at a price and with a yield higher than the underlying value of the assets. The money released by these sales went out again to generate more new mortgages, of increasingly doubtful quality. Tranches were arranged not according to the original rationale of aligning maturation dates but to adulterate the reliable with unreliable mortgages and then to obtain a quality stamp from the ratings agencies. In the world of financial assets no Gresham's Law seemed to apply, for the good and the bad are indistinguishable and unlike specie money there is no limit to the amount of paper (bonds) that can be issued by investment houses so long as the market is prepared to buy, although, as Gillian Tett has pointed out, many of the mortgage bonds were being held on the books of investment banks without being sold on and with fatal consequences for those banks (Tett 2009: 109).

The complaint against Lehman is that this was fraudulently disguised, and in general, due to the closed world of investment

banks, few were able to figure out how the money machine scam operated. That said, regulators must have realised since this business was generating massive turnover and entering the bloodstream of wholesale money markets. In addition, the dynamics of the process had already been described and explained in Michael Lewis' exposé of mortgage bond markets in *Liar's Poker* (1989), and the enormous mess it created in the early 1990s has been graphically described by Alan Greenspan himself (2007: 114-8).

In order to build their own money machine Lehman acquired two large companies whose business was selling non-prime mortgages. One of these companies, Aurora – acquired in 2000, bought mortgages from about 10,000 brokers and originators around the country and had an $80 billion mortgage portfolio. On the back of this business the Investment Division complaint notes:

> In 2007, according to its 2007 Form 10-K, Lehman securitised more than $100 billion in residential mortgages and $20 billion in commercial mortgages, making it the MBS [Mortgage Backed Securities] leader in the world. Fuelled by its dominance in the MBS area, Lehman purportedly achieved record profits earning net income of $3.260 billion in 2005, $4.007 billion in 2006, and $4.192 billion in 2007. However, Lehman achieved these record profits by substantially increasing its risk exposure for real estate-related securities it held. The aggregate value of Lehman's mortgage and asset-backed securities totalled $57.7 billion at the end of 2006, and increased by a whopping 54 percent to over $89.1 billion by year-end 2007, almost four times its $22.5 billion in shareholder equity. (New Jersey v. Fuld et al: 22)

As the property market began to collapse in 2007, the profitability of Lehman's business model declined, and its assets were – by normal practice – subject to writedowns, and Lehman faced an increasingly dangerous liquidity problem. The complaint alleges that Lehman misrepresented its true situation and in doing so violated a series of State and Federal laws in its actions.

Lehman, while a self-confessed 'junkie' in the property and mortgage business, was by no means alone in its reckless pursuit of profit and growth. Leading British and European banks were exposed to this business, but as yet no class action, or other lawsuit, or Government investigation has revealed the extent and scale of delinquency. It is, however, necessary to establish the main categories of these adult delinquencies. From a City of London perspective the Lehman collapse was a bitter experience, since the company was profitable in its London, European and South East Asian operations. The Lehman business model was in the short-term extremely successful in creating profitability and shareholder value. For an individual company what they buy and sell is irrelevant, in a *laissez aller* system, so long as the firm maintains its profitability. As a medium-term business model it was flawed, because a rising house market would not endure indefinitely, especially since so much was being invested in low-value properties. Underlying price signals were never actuated and no ongoing and gradual correction of market value took place. Markets could not operate effectively because information was withheld, disguised and, it would appear, fraudulently misrepresented by business professionals.

More specifically, it is alleged by the Investment Division that:

- Lehman and its auditors fraudulently misrepresented the financial health of the company. (In the first quarter of 2008 Lehman reported net revenues [turnover] of $3.507 billion, net income of $489 million, total assets of $786.035 billion and financial instruments and inventory positions owned of $326.658 billion.) On 15 September 2008 the company filed for bankruptcy;
- Lehman's accounting and auditing procedures did not conform to the rules of the relevant accounting bodies and the SEC;
- Lehman did not operate an effective risk management oversight;
- Lehman maintained its liquidity and capital base were strong throughout and Lehman did not disclose to investors that it

was obtaining liquidity from the Federal Reserve and the European Central Bank;
- Lehman did not write down its real estate and mortgage related assets to reflect their true fair value. (New Jersey v. Fuld et al: 115).

Lehman may be taken as the 'ideal-typical' bank of the period leading into and up to the crisis. Many commentators have noted that this bank represented something of a negation of known market rules, accountancy standards, regulatory and securities law, and corporate governance. A very few other investment banks, notably JPMorgan, did not get into the terminal state of Lehman, because they observed the above mentioned disciplines, laws and regulations (Tett 2009: 138-167; Harris in this volume). Hence a strong case can be mounted that the rationality criteria embedded in markets and their proper functioning would have stopped this investment giant – and others – from auto-destruction. From the regulatory aspect, as Helen Parry points out in this volume, regulation has a part to play but is by no means a panacea. There has been a less than enthusiastic attitude of some in the markets towards compliance, and the Financial Services Authority cannot be said to strike fear in the hearts of market participants. Current laws define legal powers of disposal by market actors, for example by demanding compliance of proper reporting of company accounts. Therefore it is a 'simple' matter of upholding and enforcing those laws, which of course did sometimes happen; back in the late 80s in the case of Milken and junk bonds, and Boesky with insider dealing – though curiously Long Term Capital Management in 1998 was bailed out at stupendous cost with no legal redress. Or, why now are failed CEOs of British banks put out to pasture with stupendous pensions, when in the late 1980s the British Government went to considerable lengths

to prosecute in the cases of Blue Arrow and the Guinness affair and where those proven guilty were given prison sentences? (Levi 1992: 136; Kochan and Pym 1988).

There is an argument to be made that the level of misdemeanour has reached a new dimension and that financial giants have gone beyond the discipline of the market and its supporting legal prohibitions. Lehman was not alone in its behaviour, merely taking new trends to the extreme. The general thrust of these trends is that financial institutions no longer inhabit a competitive market environment. In the terms of economic theory, financial institutions are oligopolies able to extract rent in addition to the normal rate of profit expected of their activities. In part this relates to their huge size and the reduction in the number of banks and independent financial companies. 'As institutions merged, financial activity broke through long-standing barriers. The art of trading corporate bonds had always been siloed off from the business of extending loans and underwriting equities. Now investors began hopping across asset classes, not to mention national borders, with abandon. Aggressive and high-risk hedge funds exploded on to the scene, some growing so large that they were competing in earnest with the new banking behemoths'. Gillian Tett goes on to note that the financial world was 'morphing into one seething, interlinked arena for increasingly free and fierce competition' (Tett 2009: 83-6). There is more to be explored here. Only for certain financial instruments was there intense competition with margins being cut. Business, on the other hand, was being conducted within the financial conglomerates where transactions were deemed, and engineered, to be far more profitable than operating in an open market. Where markets operated business was priced unrealistically and where they did not super profits were made.

Cognitive finance

To these significant trends, which demand far more attention than afforded here, should be added the move to cognitive finance and closely related to it, de-professionalisation. When de-regulation and Big Bang was sprung upon the British people and latterly the world (through a race to be bottom in terms of de-regulation) Leonard Stafford noted a leading characteristic of this new world:

> Behind the global financial markets was the *technology* [author's emphasis] of globalisation: the technology of financial innovation and the technology of information and communication. When there were defects of information or delays in transacting, opportunities for profit tended to induce new practices and innovation. Technological developments made increased financial innovation possible but they also made it more necessary, so that a strong element of positive feedback was introduced into the process with the number of financial innovations increasing year by year. One respected observer recorded thirty-seven major innovations in 1985 alone (Kaufmann 1986). (Stafford 1992)

Thirty-seven innovations a year is as nothing compared to the recent practice of banks hiring mathematics PhDs and contracting them to produce a new financial product every fortnight. Had the sphere of financial transactions remained at the level of recording everything on paper and the telephone, the financial world would still have operated with options, futures, derivatives, bonds and the long-established methods of recording financial assets and liabilities. Information technology undeniably offers huge opportunities in functionality and efficiency. But it is worth pausing to consider Marshall McCluhan's famous line: 'The medium is the message' (1964: Chapter 1). A real-estate lender commented about Lehman's real estate lenders that 'they were totally spreadsheet-oriented, analysis-oriented, with no understanding of the

industry....They were buying buildings they never even visited.' (quoted in New Jersey v. Fuld et al: 57). They were also forecasting returns on the basis of a perpetually rising real estate market. The world is seen through a screen, and behind that screen is embedded powerful calculating devices like the spreadsheet and pricing algorithms. Marking prices and values to model, which accountancy and auditing rules allow for certain classes of assets, removes the calculation of future expected opportunities and risks away from the real world to a virtual world.

How, it may be asked, does a firm go from being worth almost $1 trillion to the fire sale valuation of the odd billion or so, as Lehman's did within six months – and on the way precipitate global meltdown? One explanation (undoubtedly of many) is that financial assets were being moved from Level One to Two, and from Level Two to Three. Under US Generally Accepted Accountancy Principles (GAAP), Fair Value Measurements (FAS 157), Level 1 assets are valued according to quoted prices in active market, Level 2 are assets not priced by an active market but are still ascertainable through observable inputs. Level 3 assets are valued according to unobservable inputs, that is, they are valued at the discretion of the management's internal modelling. FAS 157 does, however, state of Level 3 valuation that 'the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort.' When an investment bank buys up billion dollars worth slabs of real estate sight unseen, and is also able to classify those assets as Level 3 and make them subject to their own in-house valuations, this suggests a view of the world as particular business leaders would like it to be, not as it is on the ground.

This is one example and similar points could be made across the whole front of digital-based financial innovation. Hedging (in the sense of short-selling), tax havens and the new gigantism of fraud are made possible by the speed of transactions, as Nick

Kochan argues in his chapter in this volume. There is no longer a paper trail laid down and lodged in filing cabinets that allows the auditor and the revenue services to understand where assets are located. The massive trade in complex derivatives was only made possible firstly by computer origination of the financial instrument and secondly the communication technology of trading in both open and over-the-counter markets. Equally, the massive expansion of banks like the Royal Bank of Scotland and HBOS owe much to marketing techniques and purchases that were enabled by modern information and computer technology and that expansion was justified by in-house projections of the value of future growth.

McLuhan's argument is cognitive in the sense that the medium through which the world is viewed is not just a lens, with known biases, but is constitutive of people's reality. The virtual is the real. There is another sense of the cognitive, which has recently been developed by Moulier Boutang (2007). Finance and banking are no longer a profession based on a standard curriculum of specialist knowledge. Instead it invests heavily in information technology (recalling another of McLuhan's apothegms: 'War now consists not of the moving of hardware but of information'). Information is networked, it is always expanding, it sweeps away fixed boundaries of knowledge, and its price for the user approaches zero, i.e. it is a free good. Google books can swallow up the whole of written literature, destabilise existing copyright law and the publishing industry, and offer a product on demand for a relatively small amount of money. When top British bankers were asked by the Treasury Select Committee if they could explain a CDO cubed – see Helen Parry in this volume for the answer! – none could. Even if they had been bankers by profession, given their age they would not have been able to answer. The informational front of change constantly re-writes expert knowledge, and the world of financial institutions

has failed to work out how to tether this expansion to professional standards. By contrast, I do not think one would say this of the engineering profession and its professional standards and associations, even though it has made extensive use of computer aided design. Financial institutions hoover up the best scientific brains from the universities, but this puts brain-workers in charge who by training and urges have little appetite for such a socially grounded and static entity like a profession. We are faced with a *nouvelle trahison des clercs*.

Moulier Boutang also argues that this new information based economy, what he calls 'cognitive capitalism' is no longer susceptible to market mechanisms. The mode of production has moved on from market capitalism (1780 – 1975) to cognitive capitalism. Information does not conform to market pricing since it is a common good or resource in contrast to the scarcity, and hence value, of goods in the industrial economy (Moulier Boutang 2007: 73-128). In a socialist or cooperative movement, it would follow therefore that financial services could be offered as a free good, or at least approaching that depending on the number of people in any one financial or banking cooperative. This most obviously is not the case today and indeed its very opposite has precipitated the present crisis. The social good and cooperative nature of software and computing was appropriated by financial institutions as a vehicle for growing companies at an unsustainable rate and the extraction of personal gain. In the period 2004 to 2007 Lehman paid out to its employees $16 billion in bonuses, which was 50% of net revenues (New Jersey v Fuld et al: 109). More exactly, once the 'money machine' had been put in place, the executives of Lehman and other leading investment banks were able to shield their activities from outside scrutiny in the form of corporate governance, proper auditing – and competition from new entrants, which could have been expected to offer cheaper financial services so reducing the profitability of existing providers. Instead the business model

of new entrants appears to have been to construct their own money machines – creating new sorts of derivatives which could be traded or used to inflate a company's assets.

By such procedures large complex financial institutions (LCFIs) were able to double their total assets from US $9 trillion in 2000 to over $22 trillion in 2007, as the Bank of England warned in its Financial Stability Report of April 2007 (Bank of England 2007: 9, 30). A bank like Lehman was not untypical of investment banks in its apportioning of net revenue to staff compensation. Over the period 2001 to 2006 Lehman was compensating its staff at an average rate of .67% of its total annual assets. If this ratio was extrapolated to the $22 trillion figure for 2007 for large complex financial institutes, just under $350 billion would have been disbursed to their staff. This is an indicative figure and it only applies to the sixteen largest financial institutes, which is how the Bank of England identifies LCFIs. 2007 must be reckoned to be the most egregious year, but it would seem that over the 'noughties' the biggest redistribution of wealth in the modern world was occurring. Also over the 'noughties', there was no equally proportional increase in capital reserves and shareholder equity of large financial institutions, leading inevitably to collapse and one of the biggest destructions of wealth by market value in modern history.

Some conclusions

The insistence on terming the financial and banking crisis a pathology, rather than a set of outrageous delinquencies, focuses attention on underlying causes. The cultural anthropologist Mary Douglas has argued that societies tolerate a level of risk that is socially determined. Close knit and inward looking societies have a very low tolerance to actions that endanger or move the boundaries of societies; so typically certain activities are proscribed as taboo

which when infringed lead to severe punishment of the perpetrators. Modern contemporary societies have weaker notions of identity and far more fluid boundaries and to the extent that an internationally trading capitalism is perceived as core to developed nations, forms of risk-taking are encouraged. That said, system-endangering activities as a sociological rule are normally punished, not least as a warning to others in the social group and, as Durkheim argued, as a way of reinforcing the collective sense of a society. At the moment, *pace* New Jersey v. Fuld et al, there seems to be a society-endangering event and little or no punishment, which aside from issues of morality, crime and social justice, is sociologically strange.

One answer is to say that cognitive finance has dodged under the radar of collective disapprobation. Cognitive finance has a number of attributes that has enabled it to escape attention: it operates with an esoteric language, its transactions now are completely computerised and can move enormous sums of money around very quickly. The legal company entities, to which this virtual digital world is attached, are themselves set up in highly complex ways. The financial instruments in which it deals are removed once, twice even fourfold from material substances like houses, wheat and oil. Hence not only was the visible connection to real economic parties broken but it was disguised by the process of financial innovation, where origins and fundamentals became irrelevant to increasing the flow of turnover, profit and compensation. Particularly striking was the inability of white-collar professionals to discriminate between legitimate businesses and fraudulent ones. Rating agencies, regulatory authorities, beholden politicians, accountancy and auditing firms all became part of the neoplasm of cognitive finance (or what Gillian Tett calls cyberfinance).

If Moulier Boutang's taxonomy is followed, returning to an industrial mode of production with finance as subaltern to the dominant business of producing things and operating under market conditions and its legal constraints is most unlikely. This

was an era when the use and abuse of markets was visible, measures to uphold market rationality were enforceable, and collective sense of morality and social justice had some leverage. In many ways this is the mindset of the reaction that has now kicked in post-crisis, but it has to be asked how much traction this will exert when grappling with the slipperiness of cyberfinance. This does not exclude new political initiatives but they would have in themselves to be innovative. What has to be grasped, and further investigated, is the distribution and concentration of economic power available to economic actors through the way in which 'markets' are enabled, legally regulated and invested in information technology (Weber 1972: 33-4).

What is lacking are ideas and principles and here it may be useful to consider the present ills as the entry costs (or wake-up call) of new era of an informational society whose goods are social and whose costs tend to zero. Investment capital and credit, however economic theory may choose to price these, will always remain expensive. But new ways of offering financial services as an informational good, priced according to professionalism and long-term integrity rather than appropriation, should be considered. And the social functions of credit and banking needs to remain as a primary goal whatever new ways are devised for their more effective delivery.

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