WHAT DO FINANCIAL SYSTEMS AND FINANCIAL REGULATORS DO?

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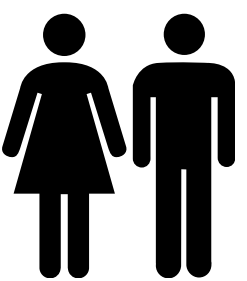
: Summary



: Preface

This is the third volume produced by the initiative *Financial Liberalization and Global Governance: the Role of International Entities*, which began in July 2006. It is coordinated by IBASE and developed in partnership with specialists and activists from 13 countries, with support from the Ford Foundation.

Its objective is to investigate the *democratic deficit* in operations of international financial institutions and to propose alternatives to overcome it. This initiative offers instruments to social organizations and movements, parliamentarians, developing country governments, among others, in the political struggle for a voice and influence in the institutions that make decision on regulations to be followed by financial institutions across the world.

These decisions have a profound and direct impact on the lives and well-being of populations. In addition, they limit the freedom of choice of public policies, especially by developing country governments, which have very little or no participation in decision making processes of those institutions.

The first volume, "*Who rules the financial system*," dealt with the *democratic deficit* in international institutions geared to formulate financial regulation strategies. The nature of those decision making processes was analyzed and the importance and impacts of their decisions was clarified. The analysis was focused on institutions little known by the public at large, but which play a key role in the banking system regulation, such as the Basel Committee.

In the second volume, "*Financial Crisis and Democratic Deficit,*" we addressed the failure of the regulatory system that generated the current crisis. Its magnitude has led developed country governments to drastically intervene in financial markets and institutions – something unimaginable only a few years ago. We presented a brief description of the financial processes that led to the crisis; we analyzed regulatory failures in this process; and, finally, we discussed how civil society organizations could tackle these issues. We also debated alternatives to face the *democratic deficit* in the operation of entities, such as the Basel Committee, a crucial task on the way to more democratic international financial governance.

In this new volume, we initiate a series of publications geared to developing a conceptual and analytical basis to provide civil society organizations with a foundation for their demands and actions in the area of financial regulation. We discuss the functions of the financial system in a capitalist economy; its constructive and destructive potential; and why it is necessary to create a regulatory framework to contain the tendencies to economic crises generated by financial markets.

This latter volume will be followed by others exploring specific aspects of the financial system operation which are relevant for civil society organizations to define demands and action programs, in addition to publications on the formulation of strategies for these entities, and the experiences of some of these organizations with multilateral financial institutions.

This is a privileged moment to promote change that should be grasped by social movements and organizations. One objective of this initiative is to help in developing analytical capacity among activists and leaders of civil society movements and organizations, thus strengthening their critical attitude and political action against neoliberal financial globalization.

The coordinators Fernando Cardim de Carvalho and Jan Kregel wrote the text, hereby published, taking into account the results of dialogues and debates held by participants in this initiative during workshops. However, the coordinators assume final responsibility for the text. Analyses produced by various participants, as well as previous publications are available at the site <www.democracyandfinance.org.br>.

: Introduction
What do financial systems and financial regulators do?

As the first decade of the new millennium comes to a close, a large part of the world's population is not struggling to face the problems of the 21st Century, but is suffering the traditional problems of capitalist economies: unemployment and idle capacity. This is not the result of workers having suddenly forgotten how to produce things, nor have machines become technologically obsolete overnight. Production has come to a halt because of the violent financial crisis in the richest countries of the planet that paralyzed economic activity around the globe.

If proof were needed of the importance of financial systems to the everyday life of the man in the street, and not just a few gamblers in stock exchanges or other speculative markets, the last three years have provided it. Around ten per cent of the workers in the United States are out of a job (with another ten per cent who have simply given up looking for jobs and are therefore not counted as officially unemployed). In Spain unemployment has reached about twenty per cent. One can only guess how many Greek workers will become unemployed as a result of the crisis that has recently broken out in the European Union.

In capitalist economies the ownership of capital is financed by the issue of financial assets. The financial markets that create and trade these assets are thus a central element of the operation of capitalist economies. By supporting investment in new capital assets, financial markets can magnify the growth and employment potential of capitalist economies. If markets are properly regulated and supervised they can thus contribute to accelerated capital accumulation and help create the necessary conditions

for development and a more equitable distribution of income and wealth. But left uncontrolled, the historical experience of capitalist countries shows that they can expose economies to enormous risks and impose enormous reductions in income and employment. The Great Depression of the 1930s and the Great Whatever that has been going on since 2007 (it may be too soon to know) are painful examples of the destructive power of financial crises. The risks of unbridled financial markets can lead even advanced economies to collapse, as has happened now. Developing economies have suffered even more frequent financial crises (and related balance of payments crises[1]). One has only to think of the Tequila crisis in Mexico in 1994, South Korea and other Asian countries in 1997, Russia in 1998, Brazil in 1999, and Argentina in 2001, and on and on.

Warren Buffet has compared some financial instruments to weapons of mass destruction, but one can modify perhaps that analogy to compare financial activity to nuclear power: it can be immensely useful, but the risks it involves are equally immense.

Financial activity, like the use of nuclear power, requires close regulation. For the last thirty years or so, up to the outset of the crisis, the neoliberal counter-revolution has dominated the policy framework of developed and developing country financial markets. One of the central tenets of this approach was the inherent efficiency of free competitive markets because they allow private financial agents to express their preferences directly, rather than through the filter of government bureaucrats. The result was that the entire apparatus of regulation and supervision of financial activities that was erected in response to the damage created by financial markets in the 1930s was dismantled or neutralized.

[1] A country's balance of payments is a national account that represents the transactions of a given economy's residents with foreign counterparts during a given period of time. These transactions are classified in two groups: current account, which includes exports and imports of goods and services and income payments (interests, profit remittances, salaries paid to expatriate workers, etc.); and capital account, which includes foreign investments, financial applications, derivatives, etc.). In common usage, the expression "balance of payments" came to refer to foreign transactions in general, not only to accounting documents as such. Thus, it became common to refer to a balance of payments crisis when a country's reserves are depleted and there are expenses that still remain to be liquidated.

Measures of financial liberalization and deregulation were introduced to create free, efficient, competitive capital markets. These adjectives evoke freedom and liberty of action, which are considered as positive attributes of free democratic societies. Indeed, many apologists of financial markets argued, successfully, that citizens' ability to dispose of their wealth as they please is almost a basic civil right. Even progressive and leftwing governments refrained from challenging this principle and pursued financial liberalization, both in their national markets and in relation to cross-border capital movements. All the indignation against financial excesses currently professed by political leaders, or the belated discovery that financial markets are moved by greed by the likes of Alan Greenspan (he obviously missed Oliver Stone's film: *Wall Street!*), cannot hide the fact that market fundamentalist neoliberal ideologies of deregulation and liberalization had won the day for more than three decades.

But this recent experience of the failure of financial markets should not hide the fact that under appropriate regulation and supervision they can in fact contribute to improve welfare and speed up development. The text that follows explains why regulation and supervision is crucial, and what strategies have worked best. The goal is not to defend any particular regulatory strategy, but to provide social activists with some of the conceptual tools necessary to assess the current debates taking place in the United States and Western Europe, as well as in international entities such as the G20, the Financial Stability Board, the Basel Committee, etc, and to position themselves to be able to advance the interests of civil society, as opposed to the particular interests of financial agents.

What do financial systems do?

For orthodox economists the main function of markets is the efficient allocation of scarce resources. Thus the main function of a free market financial system is to allocate scarce *capital* to those who can commit it to the most productive and profitable uses. The use of the word *capital* in this statement is not harmless. Most people associate the term with concrete instruments of production, like tools or factories. So when it is said that financial systems work to guarantee that capital is transferred from savers (who do not know how to use it or don't want to use it) to investors, it is implicitly assumed that financial markets are as important to the efficient operation of the productive core of the economic system as, say, supermarkets that make goods available to consumers.

The power of liquidity

In fact, financial systems do not deal with physical capital; they deal with nominal claims on income which also serve as *means of payment*. By making these claims liquid financial markets can provide capitalists with control over real economic resources.

Capitalist economies are *monetary* economies, where access to goods and services, either for consumption or for investment, is granted to those who possess money or the ability to create money. To consume or to invest one has to buy goods; but to buy goods one cannot offer other goods (except in small community markets that are not profit oriented, nor operated by capitalist firms). One has to offer money.

In economic jargon, money, or a means to access or create money, is called *liquidity*. To be liquid means to have means of payment at hand,

either because one owns it or because one has something that can be exchanged easily and quickly for money.

Of course, money is required not only to buy goods and services, but also to pay taxes, to pay off debts, etc. That is why it is called *means of payment*. Thus, in contrast to what is suggested by orthodox economists, financial systems have to do with liquidity, not with capital.

MEANS OF PAYMENT: MONEY OR BANK DEPOSIT

Money can be created, in modern societies, first and foremost by governments. To a large extent, the creation of modern states consisted in the formation of a national army and the creation of a national currency. Indeed, the creation of the national currency was often used to finance the national army. The state imposes the use of the money it creates by requiring that it is the only means of resolving tax liabilities and by legislation designating it as the sole legal tender, that is, the means of payment that cannot be refused in private transactions.

Nonetheless, other institutions can create money substitutes that serve as means of payment even though their acceptance is voluntary. The best known of these parallel means of payment are demand deposits in banks. In most countries, only small purchases are actually liquidated by paying with currency. Much more common is paying for purchases with bank deposits, through the use of checks or credit cards (which postpone and consolidate payments in a given day of the month and are also usually liquidated with bank deposits).

As economist Hyman Minsky used to say, anybody can actually create money, the problem is to have it accepted by others. Well, that is what banks do and that is why they are different from everybody else, including other types of financial institutions. In modern capitalist economies, people are generally indifferent to being paid in currency (like paper currency and metallic coins) or in bank deposits. If anything, there is a preference for bank deposits, in normal times, because they are more convenient, in terms of safety, of transportation, etc. Imagine buying a house and paying it in bank notes! In fact, imagine buying anything of high value with currency.

Confidence loss and bank runs

Why can banks compete with the government monopoly in the creation of money? To a large extent it is because governments have taken measures to support these substitutes in order to ensure financial stability. Of course, for us who use bank deposits, their main quality is that they *are as good as currency*, meaning that accepting bank deposits as means of payment is as good as accepting currency itself, or better.

This is because a bank guarantees that its deposits can be exchanged at any time for cash, and contrary to most other assets, its price is fixed ($1 in bank deposits can always be exchanged for $1 in currency). In other words, if I don't want to keep bank deposits, I can always go to the bank and exchange them for government currency. That is why I am mostly indifferent between them.

Of course, there is a catch, and an important one. Banks are usually private firms. How can they guarantee that I will always be able to cash my deposits if they themselves can fail? This is the question of financial stability. Banks will take measures such as holding reserves of government currency or assets that can be quickly converted into currency. But sometimes these measures are not sufficient and the failure to exchange deposits for cash leads to the failure of the bank which frequently spreads to other banks and creates a classic bank run as everyone tries to convert their deposits into cash. To prevent this result, governments have created regulations to ensure safe banking practices. In many countries they have instituted insurance schemes in which the government guarantees that, even in the case where the bank goes bankrupt, I will still be able to cash my deposits. So I trust the banks, in fact, because I trust the government which serves as a backstop to their liabilities in the form of bank deposits.

If for some reason, this trust does not exist or is not strong enough, bank runs can take place. Bank runs are those situations where depositors suspect that banks will not be able to honor their deposit liabilities and that the government may not support them, or, as it is the case of the UK, will take too long to come up with the support, so it may be better to cash deposits now while it is possible instead of waiting until it may be too late. Of course, if enough people are taken by these suspicions, the bank will actually fail when they try to cash their deposits.

Deposits and loans: bank privilege

Deposit taking is a *privilege* that is granted by the government through a bank charter that creates a financial institution. Since this privilege includes not only the safekeeping of deposits, but also the creation of deposits that provide loans to its customers, it is an important source of bank earnings generated by the difference between the interest rate charged on loans and the rate paid to depositors.

Let us see an example of how it works. A firm comes to a bank in search of a loan, for instance, to hire workers and buy raw materials and the bank decides to make the loan. It will not lend the currency that has been received in deposit from its other customers. The bank will instead create a deposit account in the name of the borrower and will record the value lent to his "credit". The borrower, on the other hand, is unlikely to cash that deposit. He will probably make his payments transferring those credits to third parties using checks. Whoever else is downstream in the payments chain will probably do the same, so the bank that created the deposit may never need to actually give currency to honor deposit withdrawals. It bought things (in this case, the debt of the borrowing firm, which will pay interest) in exchange for nothing!

Banks, therefore, do not intermediate credit. They create it. They create liquidity by creating deposits and making them available to borrowers. They don't have to borrow first from depositors. Banks actually create deposits and loans at the same time. Modern banking is the alchemist's dream!

Non-banking financial institutions

By regulation or control of bank charters, this privilege is not extended to other financial institutions or to capital markets. Other non-bank financial institutions only serve to redistribute liquidity from those who have, but will not use it in the foreseeable future, to those who have planned expenditures but don't have the money to do it. They only lend or buy if they could attract funds first.

However, these institutions do provide a different type of liquidity. By acting as underwriters and dealers or market makers, they provide

their clients with the ability to sell their assets for currency quickly. Thus company shares are considered liquid if they can be sold quickly to a financial institution acting as a market maker in the equity market. Just as banks, these market makers can provide liquidity only if they have sufficient reserves of currency to be able to buy and sell without large changes in prices. When they are unable to do so prices will vary widely and market liquidity will decline.

In both cases, both banks and non-banking financial institutions are providing clients with access to means of payment; that is, liquidity not capital. Whether these funds will actually be used to finance capital investments depends on which borrowers are more attractive to financial institutions. They may be firms willing to make investments, but they can also be consumers or even other financial institutions. In fact, to a large extent, the growth in lending activity in countries like the U.S. in the last twenty years has been mostly done between different financial institutions.

PRESERVING CONFIDENCE

Because banks create the most widely used means of payment in modern economies, dire consequences may ensue if they fail. There have been recent examples such as the Argentine "corralito" crisis of 2001 and 2002, which made it all but impossible to access bank deposits. In such cases payments cannot be made other than those small ones that are done with paper money and coins. Payrolls cannot be paid, debts cannot be liquidated, and the economy just stops working. This is not a common or frequent situation, but when it happens its impact can be devastating.

Thus the operation of the banking system depends on the public's shared belief that bank deposits are as good as currency because everyone believes that one can be traded for the other if necessary. As long as confidence is maintained, the system can function. To ensure that measures are taken to preserve this confidence is a central task of regulators.

Why do you need regulators?

Why not just trust private markets to provide stability as happens in so many other sectors? Because the financial sector is not like other sectors. Means of payment are an essential input for all transactions. Since bank deposits are the main means of payment, it falls to banks to run the payments made in an economy. If they fail, debts and obligations are not settled and the economy comes to a standstill.

Besides their function of running the payments system, banks are also the main providers of credit, another essential input to productive activities and to support markets such as those for consumer durables.

The problem, of course, is that banks are not public institutions operating in the interests of society. Banks do not clear checks because this is a more efficient system of payments than that based in the use of currency; they do so because clearing checks is a subsidiary service to maintaining deposits which are key to bank profits. These services are a class of externalities that economists call public goods because they accrue to the entire economy and their benefits cannot be restricted by or to those who provide them.

As any private firm, banks have strong incentives to maximize their profits. Since their profits increase with the amount of liquidity they create, they have an incentive to lend without limit, since any new loan that is made yields more profit. The worst that could happen is that the loan may default. But the bank will not be concerned since it is not their capital that is being used to make loans, not is it even the money they had to borrow. They are lending currency they don't have; indeed the bank deposit that is created to make the loan is simply a promise to deliver currency on demand. What is the consequence of a loan that does not pay the expected return?

This is precisely the point where *prudential regulation* enters the picture. As the label indicates, it serves to impose prudent behavior on banks since there is no private profit incentive for them to do so. Stability is a public good and the provision of public goods is never efficient if left to private agents. *Prudential regulation* imposes actions on banks to ensure that they can always make good their promise to repay deposits at one to one with government currency. These are primarily limits on

the amounts that they can lend relative to the deposits they receive or in proportion to their paid-in capital.

Liquidity for development

But stability is not the only concern when one evaluates the function of financial systems in modern capitalist economies. It is also very important to consider the destination of the liquidity created or reallocated by financial institutions and markets.

The system may privilege investment and capital accumulation, accelerating growth, and supporting economic development, but it can also finance speculative activities or lead to over-indebtedness of families. To a large extent the path chosen will depend on regulation, which defines both obstacles and incentives to operational strategies of financial institutions. One can use financial regulation to provide the incentives for the system to channel liquidity to the activities society favors most.

Regulation can, in fact, not only favor some activities over others, but it can also contribute to the attainment of other social goals. Left to themselves, financial markets tend to favor more profitable activities which are usually linked to providing services to wealthier constituencies, like firms (particularly large firms) and rich families (to provide private banking, investment services, portfolio management, etc). Lower income families, small and medium firms, have limited access to the financial system and when they have it, they usually pay much higher prices for the services they get.

THE COMMUNITY REINVESTMENT ACT

In fact, the primary problem for lower income or disadvantaged groups is access to financial services at a reasonable cost. The perception that this may be a serious problem led to the passage of the Community Reinvestment Act (CRA) in the United States in the 1970s. It aimed at creating the incentives for financial institutions to avoid such discriminatory practices such as redlining (selecting clients by race). It

also tried to prevent banks from taking deposits in lower income areas (like inner cities) and using them to provide financing to privileged groups elsewhere.

The use of financial regulation to promote income and wealth redistribution is still in its infancy; but it is a promising possibility that should be explored more carefully by progressive political parties and civil society organizations.

In fact, such a concern should not be confined to the provision of credit. It should also focus on the providing lower income groups with access to modalities of wealth accumulation that could allow them to share the fruits of economic prosperity such as participation in investment funds.

What do Financial Regulators do?

Financial systems are regulated both for reasons that are similar to other sectors' regulation and for purposes that are specific to financial activity. Specific regulations are required because as noted in the preceding section, the financial system, or, in fact, the banking system, is special because it runs the main payments system of the economy. Therefore its smooth operation is a condition for the regular operation of every other market in that economy.

As private firms, banks try to maximize profits given the constraints under which they work. The problem is that there actually are few intrinsic constraints on the activity of banks. Hence, there is a persistent temptation for banks to overextend their activities. One can assume that there is no natural limit to the expansion of bank loans. In particular, the availability of deposits is not an effective obstacle since deposits are created when loans are made.

The guarantee of central banks

The root of the privilege enjoyed by banks is the confidence the public maintains that, in modern economies, deposits can always be honored if and when depositors decide to cash their deposits. Since people trust banks they don't actually usually try to cash deposits en masse so that confidence is actually held up by its bootstraps.

But there is something more involved. If depositors did try to cash their deposits in large amounts the central bank will normally step in to lend the banks the money they need to satisfy depositors. Central banks

are called lenders of last resort for the banking system precisely because they are there to guarantee that deposits can be turned into cash so that the confidence of the public will not be shattered (as it happened at the outset of the 2007/8 crisis).

So the public trusts banks, not necessarily because people are naïve, but because institutions were evolved to give support to this trust. To guarantee the stability of the financial system has always been a central mission of central banks, even those whose directors seem to believe that fighting inflation is their only obligation.

The fact that society actually subsidizes banking activities, through the creation and maintenance of lenders of last resort, deposit insurance schemes, etc, is crucial to understand not only why regulation must exist but also why society can place some demands on these firms.

To a large extent, regulation, or at least prudential regulation, is the other side of the coin of the facilities created to support deposits. If currency and demand deposits are very close substitutes, banks could, and certainly would, abuse their privilege of sharing the power to create means of payment. In fact, every time regulation is relaxed, banks overextend their lending until a crisis comes to stop it.

Prudential regulation, thus, is created to control banks, to limit their risk exposure because if the public loses its confidence in the banking system there can be a run on deposits which would paralyze the payments system. Moreover, if there is a bank run, many will probably fail, and credit supply will be curtailed, reducing production and employment. Regulated prudential behavior aims at avoiding all these damaging effects of overextension.

There are, of course, other good reasons to regulate the financial system, and not only the banking system. These other reasons, however, are not specific to financial institutions and markets, although some of the problems the sector shares with others may manifest themselves in a more perverse way in financial activities.

BANKING OLIGOPOLY

Thus, monopoly power may be a problem in financial markets just as much, if not more, than in other sectors. Banking is a notoriously concentrated activity, where a few very large institutions lead a possibly large number of much smaller banks. As any monopolist, banks can easily overcharge for their services, for instance, while clients cannot expect much help from the competition. In fact, banking is a good example of an oligopoly, a sector dominated by a few large players, practically everywhere, rather than of classical monopolies.

Regulatory objectives

Transparence and asymmetry of information is another common problem that characterizes financial activities. Even simple products, like participation in investment funds, may be more complicated than people generally think. In particular, the spectrum of risks to which each product is exposed is usually hidden or presented in incomprehensible ways to clients. The 2007/8 financial crises showed that even financial executives didn't always know exactly what the institutions they run were doing.

Many financial innovations of the last two to three decades seem to have been motivated by the goal of making things more opaque to other market participants, regulators, and the general public. Financial contracts are seldom simple products, but they can be made inaccessible if enough effort is put into it, and sometimes this is exactly the easiest way to make money – that is, to market financial products that no buyer actually understands. Of course, if one is betting one's own fortune on these markets, it may be their problem. On the other hand, if you have, say, pension funds doing it, or if you are misleading people into risking their savings in investments they don't understand, then that is a public policy problem.

So the point of regulation is to curb incentives that lead banks, other financial institutions, and financial markets in general to overextend themselves, or to expose themselves to risk they don't understand. It

is not a question of individual freedom, because the effects of wrong decisions can hit third parties that are unable to counteract these effects, creating what economists call *negative externalities*. Drunk driving is illegal not because drinking and driving is possibly morally wrong (independently of whether or not it really is) or because drunk drivers may kill themselves, but because drunk drivers can hurt other people, independently of what the latter do. Financial activities can gravely hurt society, as the present crisis has dramatically illustrated. That is why financial activities have to be controlled.

THE ORIGIN OF FINANCIAL REGULATION

Financial regulation has a long history. It is usually revised in response to a major financial crisis. This is the case with the most recent body of internally-consistent rules for the operation of financial markets formulated in the 1930s in reaction to the succession of financial collapses that ended up in the Great Depression. The Stock Exchange crash of 1929 was followed, in the United States, by at least three waves of bank runs that paralyzed the American banking system and, as a consequence, the whole economy.

The idea that financial systems could not be trusted to operate entirely according to their whims led to the adoption, in a remarkably short period, of many initiatives, creating regulatory entities or modifying the *modus operandi* of existing ones (like the Fed). In the decades that followed, other countries copied and adapted that initiative.

Systemic crises: banking regulation

Most commonly, financial regulation evolved along two axes. The first, prudential regulation, has focused on banks. The reasons for that were discussed above. The idea was that if the banking system stopped working, the whole economy would grind to a halt. This is called *systemic risk*: the risk that a localized shock, hitting even a few banks (and not

necessarily big banks), could first spread throughout the banking system and then to the whole economy. The first part would result from the loss of confidence on the part of depositors about the health of banks, leading them to question the health of the banking system as a whole, and generating bank runs against both good and bad banks. The contagion to the economy as a whole would result from a paralysis of the payment system and the reduction in the credit supply.

Systemic intervention consisted in attacking along two lines: creating rules of prudent behavior that banks had to follow, to minimize the chance they would get in trouble that could erode the confidence of the general public; and building a safety net through deposit insurance schemes and improving the operation of the lender of last resort in order to contain the negative effects of shocks that broke through the barriers created by prudential regulation. The general idea was, therefore, that by guaranteeing that no individual bank would get into serious problems, the risk of a crisis would be diminished. To the extent that something would go wrong in any case, the safety net would help to contain the damage before it contaminated the whole system.

Integrity of markets: regulation of non-banking institutions

For decades, it was not expected that systemic risks could be generated by other segments of financial systems, mostly because they didn't operate the payments system, as banks did. Therefore, regulation for non-banking institutions focused mainly the so-called *integrity of markets*. The goal was not really to protect investors as much as protecting the markets themselves. If speculation, market manipulation, the use of inside information, etc, were left unrestrained, bubbles would become normal and crashes too.

When investors realized the degree of market manipulation, speculation, etc, to which they were subjected, they could panic, and financial crises could follow. These crises, again, were not believed to be capable, by themselves, of generating significant damage to the real economy, but they could help create an environment of distrust, fertile ground for bank runs and thus, systemic crises. Integrity of

market regulation focused mostly on securities markets, defining rules of conduct that could minimize the problems listed above.

The difference of diagnoses as to the effects of adverse shocks in banking and in securities markets was reflected not only in the definition of different bodies of regulation for each segment, but also in the creation of different entities in charge of supervising them. In the case of the United States, this division of labor was strengthened by the mandatory separation of banking and securities markets through the Glass-Steagal Act of 1933.

Regulating stability

The importance of regulation about the integrity of markets notwithstanding, let us focus on stability regulation, that is, regulation to control systemic risks, directed mainly at banks. The evolution of banking regulation in the past century can be divided into two stages.

BANKING REGULATION

In the first stage, beginning with the reforms of the 1930s and lasting until about the 1980s, banking regulation was almost a police action against deviant behavior on the part of banks. The relation between banks and supervisors was hierarchical: supervisors exercised a supervisory authority over banks' operational decisions, limiting their scope of operations and controlling their exposure to risks. Stability regulation focused mainly on the liquidity position of banks – that is, their ability to honor their deposit liabilities so that the risk of bank runs could be minimized. Banks, of course, managed their risks, but this activity was confined to the lines of business that regulation allowed them to pursue. Risky activities like participating in securities markets were restricted or downright outlawed. Balance sheet mismatches between assets and liabilities were also controlled.[2]

[2] Borrowing through short term instruments to lend in longer maturities, to earn the spread between short and long term rates of interest, was limited by the authorities. Thus, the risk of being unable to rollover debts while assets were still maturing was contained within intervals considered safe by regulators.

Financial supervision, in this approach, is really exercised as a police authority. Anti-social behavior on the part of banks (subjecting society to unacceptable risks) was targeted for repression and supervisors had the power to enforce the rules. As in other sectors of activity where the power of police is seen as necessary, resistance and attempts at circumventing the rules on the part of banks were to be expected. Many so-called "financial innovations" were born as attempts to escape controls. But this only meant that rules had to be frequently updated, not that the function itself was hopeless.

FINANCIAL LIBERALIZATION

In the second stage, the neoliberal revolution of the late 1970s and early 1980s changed this picture, as happened with practically all areas where private liberties were curbed by state powers. Many arguments were raised to dismantle the regulation created in the 1930s and change supervisory strategies.

The most important was the change of climate as to the state in general. The idea that state intervention in economic affairs could be positive for society was severely criticized. Some argued that the state was inherently corrupt and that state bureaucracies pursued only their own interests and not those of the society at large.[3] Others argued that bureaucrats could mean well but the state was inefficient beyond salvation. This view was illustrated by then-presidential candidate Ronald Reagan when he stated that the most dangerous words in the English language were "May I help?" when uttered by a state official.

At the same time, old conservative ideas were taking new shape, mostly under the label "efficient market hypothesis" and things like Lawson's law, named after Margaret Thatcher's Chancellor of the Exchequer. It affirms that only imbalances created by the state were dangerous to society because the ones created by private agents were an expression of private interests that would be resolved by efficient markets.

[3] Some economists were even awarded Nobel prizes to make that argument, like James Buchanan, leader of the group known as Public Choice economics.

Financial markets seemed to approximate the idealized concept of market for rightwing thinkers and economists. Therefore, financial regulation was made a special target of political initiatives to reduce the powers of the state, including its regulatory authority. Even the Great Depression itself was the object of reexamination, through new studies leading to the conclusion that it was caused by mistakes made by the monetary authorities rather than by private agents and financial institutions. If this were true, of course, it would mean that the whole regulation apparatus, built on the assumption that unregulated financial systems were inherently unstable, was a mistake.

All these elements, and some more, led to what became known as the *deregulation* process (or financial liberalization) that shaped financial regulation and supervision for the next decades, until the unleashing of the current crisis. In this second stage, regulation still sought to ensure stability, but the approach to how to do it was dramatically changed.

Efficient markets?

First, the concept of stability itself was redefined. The hypothesis that financial systems were inherently unstable was replaced by the notion that markets were largely efficient, but could be improved if the right stimuli were provided. The state should stimulate these changes, not stand in their way.

In particular, the creation of new instruments and the opening of new markets should be unreservedly supported because, so the theory goes, the more markets there are, the more opportunities to trade emerge, the more efficient the system is, and the highest the resulting satisfaction. This is what happened to derivatives[4], for example, or with securitization[5]. These innovations were welcomed and the few attempts

[4] Derivatives are financial contracts whose value is derived from other contracts (for example, the futures markets of exchange rates and loans). They are used to protect investors from adverse events, what is called hedge, or to speculate on future developments of the markets (such as variations in asset prices).

to control them were aggressively rejected by the likes of Robert Rubin, Alan Greenspan, and Larry Summers in the Clinton years, the heyday of financial "innovation."

Prudential regulation had to change too, both in terms of instruments and in terms of procedures. The emphasis on liquidity was judged to be obsolete, since deposit insurance (which neoliberals most frequently proposed to shut down) had eliminated the risk of bank runs. Now the problem was to make banks conscious of the risks to which they were exposing themselves and to push them to improve their risk administration strategies.

As to procedure, supervision should abandon the police approach, and replace it with market-friendly tactics. In fact, the whole idea was to mimic private practices to nudge financial institutions in the direction of more stability. Indeed, it was presumed that government supervisors were not capable of understanding the sophisticated risk management practices of banks so that the most efficient method of supervision was to leave it to the banks themselves.

The apex of the new approach was Basel II.

THE BASEL COMMITTEE

The Basel Committee of Banking Regulation is hosted by the Bank for International Settlements (BIS), an international organization created in 1930 to promote international monetary and financial cooperation and to serve as a bank for central banks.

[5] The term securitization derives from securities and refers to the substitution of loan practices by the issuance of securities in the market. Companies used to borrow working capital from banks. Now, many prefer to raise funds by selling short-term securities in the market, i.e., selling directly to investment funds, individuals, etc. They are called commercial papers. Another example is the market to finance the purchase of housing (mortgages). In the past, the most common practice was to request this type of loan from a savings bank. Later, it became usual to obtain these funds through a much more complex process by selling securities to pension funds, insurance companies, and other financing institutions.

The Basel Committee was created in 1974 to enable informal dialogue among banking supervisors from the member countries: Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, Holland, Spain, Sweden, Switzerland, United Kingdom, and the U.S. Amid the international crisis initiated in 2007, other countries, including some emerging countries, were invited to participate in the Committee: Argentina, Australia, Brazil, China, Hong Kong SAR, India, Indonesia, South Korea, Mexico, Holland, Russia, Saudi Arabia, Singapore, South Africa, and Turkey.

The Committee is an informal group, with no formal power to make decisions or enforce them. The group makes *recommendations* to banking regulators from participant countries and to the community of regulators. At least since the 1980s, the Basel Committee has been the main formulator of banking regulation for the entire world. For this reason, it is a strategic actor in the international financial system governance and an exemplary case of the democratic deficit in this governance.

REGULATORY AND SUPERVISORY METHODS

The Basel Committee's approach to risk represented a break with traditional methods of regulation and supervision. The First Basel Accord (1988) sought a standard that could create a single measurement and a situation of equality for global banks at the international level. This measurement was a common coefficient between the bank's capital and its assets weighted by the risk – established at the minimum level of 8%. Weights assigned to banking assets were common to all banks and reflected the relative risks of different types of assets.

Thus, the short-term sovereign debt of a developing country received weight zero – which means that the bank does not have to reserve capital for funds invested in those assets – while commercial loans and mortgages had weight of 100% – meaning that the bank had to reserve eight cents of capital for each dollar loaned. As banking capital cost is determined by the return on alternative investments bank owners could gain, the idea was to stimulate banks to keep less risky assets on their balance sheets.

However, because risk categories covered a broad spectrum of assets (a loan to the local bar had the same risk weight as the church mortgage), banks sought to increase their returns by providing loans to riskier borrowers in each class. In addition, the mere existence of different classes of risk created distortions in bank capital allocation, which began to be driven by risk classification rather than economic considerations.

Thus, the Basel II revision was made to provide more precise risk specifications and to include other factors such as operational risks. This gave banks more room for self-regulation through their own models of risk assessment.

The Basel II method of prudential regulation, based on the assumption that stability can be ensured if relevant risks are adequately measured by the banks themselves, is grounded in a false idea: that positive statistics on past events can supply reliable quantitative indicators for safe operational strategies. This has proven to be an error, as all banks had satisfactory capital coefficients when they entered a period in which almost all of them were close to insolvency. This suggests that this might be the time to return to a more traditional assessment of acceptable limits for bank strategies[6].

Basel II

In 2004 the new Basel Accord, destined to replace the original 1988 Accord and its 1996 Amendment, was finally announced, after some delays with respect to its expected completion. It was supposed to herald a new era in prudential regulation. It put to rest all those rough strategies designed after the Depression, which treated financial institutions as enemies, or at least as potentially dangerous players that had to be forcefully contained.

[6] For further details on the Basel Committee, see "Who rules the financial system?" Ibase, Rio de Janeiro, 2009.

Basel II is an exceedingly complicated financial regulation instrument based, however, on a few simple principles. The core of Basel II, as it was with Basel I, is the definition of required capital coefficients. That is, the demand that banks (and, depending on the country, other financial institutions) maintain net worth as a proportion of total assets, *weighted by their risk*. In other words, banks cannot operate only with third party funds; they have to rely at least in part on their own capital.

It is easy to confuse capital requirements with other variables. In fact, even experienced analysts in the *Financial Times* and *The New York Times* have made such a mistake in books written about the current crisis. Basel is not about money reserves or whether banks are allowed to use all the cash they have or not. Capital coefficients are about sources of resources: a bank (or any firm, for that matter) can commit their own resources (that is, their net worth or the equity capital provided by the bank's owners) or third party resources they may borrow. A financial intermediary, in principle, does not need any capital. It may borrow from resource-holders and lend what they borrowed. Basel II says they have to, by command of regulators, maintain some resources of their own.

So, if banks want to borrow funds to buy earning assets, they have to chip in first in the form of their own capital. The bank's shareholders have to put their "skin" in the business. Capital coefficients are simply the proportion of the shareholders' net worth and risk-weighted total assets regulators think appropriate. In this way, the first loss of inappropriate banking practice is borne by the owners of the bank.

BASEL II GENERAL FEATURES

While the first Basel Accord, signed in 1988, was very simple, stating that national supervisors should direct internationally active banks to maintain net worth (own capital) in the proportion of 8% of their risk-weighted assets (the weights being determined by the Committee itself, as appended to the Accord). Basel II is very complex. Besides setting differential capital requirements for different classes of banks, it also directs supervisors' actions and defines information disclosure requirements.

Basel II relies on three "pillars": risk-based capital coefficients, supervisory review, and market discipline. By far, the most important section of the new text refers to capital requirements. Banks are to be divided into two broad categories: less sophisticated banks will have to calculate their capital requirements according to evaluations of their assets provided by "external" agencies, such as ratings agencies. Banks that already possess more sophisticated risk measurement systems will be able to rely on information generated by the bank itself as inputs to the calculation of capital requirements. The more advanced banks are allowed to use more of their own data than the less advanced.

Supervisors are supposed to perform many more functions in the new system than in the past. They are supposed to evaluate the risk measurement and management systems, to assess the adequacy of banks' administrative structures in implementing their stated risk strategies, and to develop specific ways to deal with risks not explicitly treated in the new Accord, such as liquidity risks. Finally, the third pillar market discipline, lists the kinds of information banks are required to disclose in order to allow markets to make their own evaluation of their risks.

Capital coefficients are supposed to be effective as a regulatory instrument for various reasons. First, because if shareholders have to commit their own net worth in the operation of banks (concessions of loans, investments in securities, etc), it is expected that they will be more careful when choosing which assets to buy than if they were only using resources coming from other people. Shareholders have something to lose from wrong decisions, so they would be expected to pay more attention to risks, instead of only being attracted by the upside in terms of expected returns.[7]

[7] Without capital requirements, it is argued that banks would be irresistibly drawn to risk investments because riskier investments pay higher interest rates. So, if the investment was successful, banks would earn a lot. If it went wrong, the depositor would lose his deposit. With capital requirements, if investments go wrong, bank shareholders have something to lose too.

The second virtue of capital requirements is that, in the case of a bank failure, the owners' equity can be used to meet at least part of the losses that have been the result of imprudent practices. Some of banks' liabilities are guaranteed by the authorities, notably demand deposits, but, frequently, other liabilities as well. If the bank fails, these liabilities have to be honored anyway. If a bank has capital, which means that a share of the assets it controls is owned by this bank, these assets can be sold to help pay for the uncovered liabilities.

Finally, establishing a required capital coefficient is equivalent to establishing a limit to leverage[8], since banks cannot appeal to third party financing indefinitely. How far a bank can get indebted depends on how much capital of its own it has to begin with. However, the fact that Basel calculates how much capital owned by the bank is required in proportion to assets weighted by risk seems to have made capital coefficients less effective in controlling leverage than could be the case. Proof of this insufficiency is that in the current review of Basel II the Basel Committee is performing, a new leverage limit may be defined directly between total assets and a bank's own capital, to be respected along with the risk-weighted capital coefficient.

It is interesting to note that capital coefficients are only indirectly relevant to prevent bank crises. In the case of a bank run, or of liquidity drying out for these banks (that is, of lenders refusing to lend to banks), capital coefficients are not very effective to prevent the crisis itself. It may help to build confidence on the part of lenders that the bank will *ultimately* be able to honor its liabilities, but "ultimately" is not enough to deal with an ongoing crisis. Liquidity ratios can work more effectively than capital ratios in this case, because if banks have liquid assets they can honor their liabilities right away rather than "ultimately."

Market participants and regulators alike seemed to think that this concern was obsolete, that nobody would worry about liquidity nowadays.

[8] In general, leverage is a term that refers to any process that increases the impact of an individual agent's action based on his/her own resources. The simplest way of leveraging an activity is to use one's own capital as a means (i.e., collateral) to obtain loans, thus increasing the volume of assets one can buy.

They were wrong. The Basel Committee itself has belatedly discovered it. It is now trying to correct the situation by proposing that liquidity ratios should be defined along with risk-based capital coefficients and leverage ratios.[9]

Basel II relied heavily on the setting of appropriate risk-based capital coefficients, along with two other "pillars" – supervisory review and market discipline.

Supervisory review meant that supervisors would have to constantly examine the adequacy of these coefficients given a set of additional conditions, such as the efficacy of risk management techniques utilized by the bank, the strength of its data base to support appropriate risk measurement, the efficiency of bank management in dealing with risks in the determination of their operational strategies, etc.

Market discipline was the residual result of the assumption that markets are efficient, so that clients and customers of banks should "control" bank exposure to risk through the spreads over risk-free securities that they would demand when buying bank securities or lending to the bank. One result from the crisis is the dramatic reevaluation of the effectiveness one can expect from these mechanisms.

Basel II was not just a plan to require capital coefficients from banks, though. This requirement was after all already the core of Basel I, signed in the late 1980s. What singles out Basel II is less the instruments but the ways to calculate capital coefficients.

In Basel I, required risk-based capital coefficients were calculated according to a table of risk groups *set by the regulator*. In Basel II, risk weights were to be based on private assessments. Less sophisticated banks would rely on assessments made by rating agencies, while banks with more advanced risk measurement systems could use their own assessments of risk (in the so-called IRB option).

The idea was to induce all banks to become not only more cautious, as argued above, but also more efficient in risk measurement and management, since this would give them the possibility of reducing their capital requirements.

[9] The new proposals, still under study, are generally referred to as Basel III, to indicate that it would constitute a third wave of regulation reforms, incorporating now the lessons of the current crisis.

This was a market-friendly method of regulation: acting through the interests of banks themselves, making them want to improve their behavior thereby making, one hoped, the banking system more stable.

The risk measurement systems banks could use had to be approved by regulators and supervisors, but this was not really a problem, since the standards of efficient measurement were set by reference to the models actually in use by banks (in the jargon of regulators, to rely on banks' "best practices"). The idea, naturally, was that bank risk management should be sufficient to maintain stability and avoid crises.

The Crisis and its Aftermath

It is certainly too soon to say that the economic crisis is over; it is more likely that the end is still far in the future. The financial crash, on other hand, may perhaps be a turned page, after the spectacular debacle of 2008 and the massive intervention by monetary authorities and Treasuries all over the more developed world. The situation is not safe, but the sense of urgency typical of 2008 and 2009 seems to have been lost.

The current Greek crisis has primarily to do with monetary arrangements, public finance, and balance of payments, rather than financial fragility in the sense described in this note. Governments everywhere are no longer as zealous as they were about the need to reform the financial system and the industry's lobbies are back in force.

Despite the initial rhetorical insistence on the need for global action to reform (to be effective in a context of financial globalization), most of the actual initiatives in this field have been national in character (or regional, in the case of Euroland).

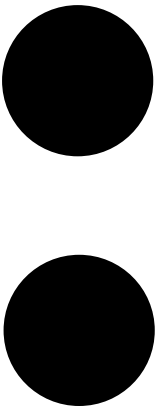
Meetings of the G20 notwithstanding, the only international activity focused on reforming regulation seems to be the revision of Basel II, currently being done by the Basel Committee. It has been called Basel III, but the new label may overstate the extent to which new thinking is actually being applied. The Committee has already made public, for comment, drafts of the new proposals. They seem to consist basically of some tightening of existing provisions, but without any new dramatic change in their approach.

"Basel III"

Capital coefficients are expected to be increased (a foregone conclusion, since most banks that failed or had to be bailed out in the crisis were in compliance with the required coefficients stipulated by Basel II). New operations are supposed to be brought into the radar of supervisors. New, finer definitions are being sought to close some regulatory loopholes present in Basel II. One would also expect that supervisory review would toughen up somewhat, but this would be due to the memory of the crisis and could not last.

The principles, and more importantly, the market-friendly approach characteristic of Basel II are maintained in Basel III. There is no criticism of the strategic view, oriented by efficient market theories, that has been behind regulatory developments of the last three decades, even though the efficient market hypothesis has been widely discredited by the crisis.

This means that progressives in general and militants of civil society organizations have an important task of pushing the envelope on more effective regulatory reforms. A set of alternative regulatory strategies is available. They range from going back to regulatory methods that worked well in the past, reversing the trend to try to mimic private markets that has been dominant, to more radical ideas of radically restricting the latitude of securities markets and the scope of securitization, outlawing the use of derivatives, or at least those that are not justifiable for hedge purposes, or even of nationalizing the banking system. Some of these alternatives are explored in papers produced within this project, and are available at www.democracyandfinance.org.br/index.php/en.



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