Comments on Ross Levine's paper "The governance of financial regulation: reform lessons from the recent crisis"

Howard Davies[1]

I enjoyed reading Ross Levine's paper, for reasons of both substance and form. It is very clearly and persuasively written, something which one cannot always say of papers from academic economists!

It also raises some important issues that have become a little submerged in public debate recently. In the United States, in particular, the focus is all on the Senate and House bills yet, as I shall suggest, they do not include remedies for a number of the most important regulatory failings revealed in the crisis. I am particularly conscious of this dislocation, having recently completed a review of the causes of the crisis, which will be published shortly under the title "The financial crisis: who's to blame?" (Davies (2010).

In that book I identify 38 different arguments presented for the crisis, not all of them wholly convincing. (I am pleased to note that the issues covered by Ross Levine in his paper are all included).

We should begin by noting that there were failings other than regulatory lapses that were also highly influential. Levine refers briefly to global imbalances, weak monetary policy and the like as part of the context in which, he argues, regulation failed to do its job. I also attach importance to the influence of monetary policy, and indeed some other government interventions in financial markets that had an impact on financial conditions, often a malign impact. But we cannot deny that regulation did fail in a number of areas, and Levine invites us to concentrate on them. I do so, therefore, against the background of an awareness that this is not the full story.

Levine's argument is that regulators were aware of many of the emerging problems, but did not act on them, in good part for reasons that we often call regulatory capture. In order to avoid a recurrence he wants to see establishment of a new institution "The Sentinel", heavily insulated from political influence and influence from financial firms, which will be charged with keeping the regulatory system under review and identifying the need for change where it emerges.

I am invited to comment as a (lapsed) policymaker, rather than from an academic perspective. It is appropriate to point out, therefore, that I was a practising regulator until 2003 – for part of the period when the roots of the crisis were growing, but perhaps not in the years in which the dangerous trends accelerated. So, for example, when I left the UK's Financial Services Authority in 2003, the total volume of credit default swaps outstanding was roughly $3 trillion, while by the end of 2006 it was more than $60 trillion. I say this not to attempt to join the "I told you so" club. I did not forecast the crisis of 2007, though in my last major speech as FSA Chairman I did draw attention to new instruments of risk transfer and suggested that they should be monitored very closely (Davies (2003)). I argued then that we needed "to know more about how these derivatives are used, and where credit risk has ended up as a result. In particular, we need to know whether regulatory arbitrage is one of

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[1] London School of Economics.

the causes – whether risk is migrating to sectors with inadequate capital requirements for this sort of risk".

I have reflected on why the regulatory system was not more effective in slowing down these, in retrospect, remarkable trends, and how we can attempt to make regulators more responsive, more self-confident and perhaps braver in the future. So I begin with that issue, before commenting on the specific cases which Levine discusses, and then on his Sentinel proposal.

My own analysis of the reasons for the regulatory mindset which Levine describes would give less weight to the "conspiracy" elements in his narrative. I would begin with the observation that there was in the regulatory community a strong element of "groupthink", which was shared by central bankers and indeed by politicians. There was a widespread belief that markets were self-correcting. A heavy burden of proof was placed on regulators who wished to question the rationality of market transactions and market prices. The same philosophy that led central bankers to conclude that it was impossible for them to know that a bubble was inflating induced regulators to believe that even the most exotic price movements must have an underlying rationale. Furthermore, they believed that the managements of financial firms were best placed to judge what made sense for them and that it was not for regulators to second-guess their decisions. Of course, in Congressional testimony in 2008, Alan Greenspan offered a limited "recantation", noting that he had been shocked at the inability of management and shareholders to understand what was in their own interest.

This mindset was built on what seemed like sound intellectual foundations. It is not the place here for an extensive critique of the rational expectations models which underlay much economic analysis. The efficient market hypothesis, albeit amended over time, remained the intellectual underpinning of most financial theory. That also pointed towards a hands-off approach by the regulatory community.

So if new instruments were developed, and credit default swaps are the example set out in Ross Levine's paper, with willing buyers and willing sellers, then why should they not be allowed to develop? If they facilitated trading of claims in a more sophisticated, fine-grained, disaggregated way that made markets more complete, this must generally be a "good thing". Who were regulators to question these developments? It may be argued that the technology of product innovation ran well ahead of the technology of risk management. I certainly take that view today, but regulators did not on the whole regard it as their business to ask whether firms understood the business they were in.

Let us also be clear about the political climate in which regulators were operating. It was highly unfavourable to tight regulation. In the United States, this is often seen as the result of the lobbying clout of financial firms. I an unsure about that in the United Kingdom. On the whole, banks did not have to lobby politicians, largely because politicians argued the case for them without obvious inducement. The same is true of the media, for the most part. When the Financial Services Authority was established, and its legislation was going though Parliament, there was a vanishingly small constituency for tough powers for the regulator. The FSA was always characterised as an "over-mighty regulator", as "judge and jury" in its own cause. These phrases were on the word processors of every financial journalist in London, and I would not claim that they were venal or corrupt. That was what they honestly thought. One is reminded of the celebrated epigram by Humbert Wolfe (1885–1940):

> You cannot hope to bribe or twist,
> Thank God, the British journalist
> But seeing what the man will do
> Unbribed, there's no occasion to.

There was a casual denigration of regulators in political and media discourse. They were bound to be behind the markets. They were nitpicking, red tape-spinning gnomes, who stood in the way of the animal spirits of the wealth creators in the financial centre. On every occasion that I appeared in Parliament as the Chairman of the FSA I was attacked for overintrusive regulation. In the UK, the City of London was seen as a goose that lays golden eggs, which should on no account be frightened into flapping its wings and flying away.

All this was linked, of course, to a degree of hubris among politicians and financial folk. Gordon Brown talked famously of having put an end to boom and bust. The credit-fuelled boom was creating a feel-good factor which benefited incumbents. Inflation targeting seemed to offer the "end of history" in monetary policy terms.

Everything changed dramatically in 2007, but we should not forget that this was the climate in which regulators operated before then.

These are general problems which apply to some degree all over the world, but the phenomenon was more extreme in the United States and the United Kingdom than elsewhere. The United States also has a particular problem in that regulators there are poorly paid. Levin refers to that himself quite correctly and argues that the Sentinel staff must be very well remunerated. (I have prepared my own job application.) But before addressing the details of the Sentinel, I will offer a few comments on the regulatory cases he describes in support of his proposition.

On credit rating agencies, his analysis is acute. There are conflicts of interest inherent in the business model of the credit rating agencies, though it is fair to say that nobody has found a convenient way of correcting those conflicts of interest, and it may well be that if we abolished the rating agencies as they stand, we would need quite soon to reinvent something rather similar. So my own inclination is to think that one has to accept the existence of credit rating agencies, but one should not be scattering regulatory holy water on them and thereby sanctifying their output. I strongly agree about the unwisdom of the Nationally Recognized Statistical Rating Organization (NRSRO) regime operated by SEC in the past. This, indeed, was a point I made when at the FSA. Other countries did not offer regulatory blessing to the agencies – though the European Union has now passed a directive imposing a new, and quite possibly unwise, regulatory regime in response to the crisis. The NRSRO regime was the worst of all possible worlds. It apparently offered some regulatory comfort about the operation of the agencies, but in fact did not do so. It was responsibility without power, the most dangerous form of regulatory oversight.

In addition, ratings were hard-wired into a number of elements of the regulatory regimes, notably Basel II. Partly for that reason, investors began to use ratings as a substitute for thought. This combination of apparent but not real regulation and excess reliance by the market was a combustible mixture.

His second case, the development of the credit default swap market, is an example of the point I made about financial innovation. This market grew remarkably rapidly, as I have said, without clear understanding of the risks involved. The AIG debacle also demonstrated a poor understanding by the regulatory community overall of just how these risks were being insured.

I believe that Levine's characterisation of the dispute between Brooksley Born of the Commodity Futures Trading Commission (CFTC) and Greenspan, Summers, Rubin and Levitt is broadly correct. In retrospect, Brooksley Born looks to have had by far the better of the argument. Of course, we cannot know what would have happened had derivatives been put under the CFTC when she recommended it. The CFTC itself has changed character several times in the last decades with new political appointees. It has gone from Gramm to Born and back (ideologically). But she was clearly onto something important, and the administration and congress have now recognised that.

Levine's section on the failings of the SEC's oversight of the investment banks is excellent. The point has been too little made in the public debate. But he does not mention the origins of the consolidated supervisory oversight (CSE) regime. Regulators around the world had long taken the view that these large complex financial institutions must have a consolidated supervisor. That argument was rejected by successive US administrations. This led to considerable frustration in Europe and, eventually, to the passage of the Financial Groups Directive, which required any financial group operating in the European single financial market to have a consolidated supervisor at the parent level, or to sub-consolidate in Europe. The latter would have had some capital disadvantages for the investment banks, which would have had to hold more capital in their consolidated European subsidiaries as a result. They therefore pressed the US regulators to provide some kind of consolidated supervision that would meet the terms of the Financial Groups Directive. Surprisingly, the Office of Thrift Supervision (OTS) put in a bid to carry out this role. The Federal Reserve was unwilling to do so. Eventually, the SEC was prevailed upon to do it. They had no appetite for the job. The culture of the SEC is the culture of a pure markets and investor protection regulator. In the jargon, they are cops not doctors. So, as Levine accurately describes, their regime was half-hearted and ineffective. There were only five firms under their care and three of them effectively failed. To paraphrase Oscar Wilde, to lose one of five might be misfortune, to lose two suggests carelessness, while to lose three does begin to hint at a systemic failure.

How far does the legislation now in prospect in the United States deal with these problems? Only in part, would be my answer. In that context it is instructive to look back at the so-called Paulson Blueprint published in March 2008, following the US Treasury's assessment of the failings of the regulatory regime then in operation. It was a remarkably self-critical document. I will not go into detail here, but it made two particular recommendations relevant to the problems which Levine describes, which have not been carried through in the legislation. Paulson recommended, for example, that the SEC and the CFTC should be merged. Many of the problems of regulatory oversight of derivatives in the United States arise from the split regulation of securities markets. The United States is the only country in the world which seeks to regulate cash securities and derivatives in different ways, through different authorities. Relationships between the SEC and the CFTC have been dysfunctional for decades. The Brooksley Born arguments described by Levine are just one example of the consequences of that dysfunction. It is highly unfortunate that the problem has not been resolved, in spite of the stark lessons of the crisis.

Also, the Paulson Blueprint recommended the introduction of an optional Federal Charter for insurance companies and therefore the creation of a federal insurance regulator. Many large insurers would opt into such a regime and have come out in favour of it. It would undoubtedly have helped greatly in the case of AIG, where a Federal insurance regulator would have taken its consolidated supervision responsibilities seriously and would surely have identified the risks being run by AIG through its financial products subsidiary. It would have communicated more effectively with the Federal Reserve. So, once again, the opportunity presented by the crisis to achieve a more rational regulatory regime in the United States has been missed.

Levine believes that many of these gaps can be plugged by the creation of a new authority charged with keeping the regulatory regime under review and staffed by highly expert, well paid professionals, entirely insulated from short-term political pressures on the one hand, and from persuasive lobbying by the financial community, with the promise of well paid jobs in due course, on the other.

One of the arguments he advances is that "a monopoly on regulatory power and information is dangerous. Such a monopoly is particularly dangerous when it is housed in a central bank or other entity that is designed to be independent of the public or its representatives". This is an important point. Central banks are now generally constructed as highly independent entities, certainly in developed countries, largely because we have reached the view that politicians can't be trusted with the interest rate weapon, particularly when elections are in the offing. Many democratically elected representatives have therefore reached the conclusion that it makes good sense to take this instrument out of their hands and to have it administered by an independent institution. But it is not clear that this argument extends to the exercise of regulatory power, especially where that power – as it often does – effectively influences the distribution of property rights. But this may not be a wholly persuasive general argument for a new body. It may tell us, instead, that we must be careful about the extent to which we put regulatory authority in the hands of central banks. Of course in principle it is possible to devise separate accountability arrangements for regulatory power, from those which apply in the case of the short-term interest rate. Indeed this will have to be done in the United Kingdom under the arrangement now proposed by the new coalition government. But it is complex, and the risk of what we might call accountability contagion from one set of responsibilities to another is high.

In the European Monetary Union, where national central banks do not set interest rates, the problem is not so severe, and there it may well make sense to use the national central bank in a regulatory role.

Levine is also rather dismissive of internal audit arrangements in regulators. He notes that some do have internal assessment functions but that they have not been effective in holding them to account. This is, I think, rather an American perspective. Clearly it was highly unfortunate that the SEC Inspector General's report on the Madoff affair came out on the same day as the accusations of fraud against Goldman Sachs, which significantly reduced its public impact. In the case of the FSA in the UK there have been two occasions, in relation to Equitable Life Assurance Society and to Northern Rock, where the publication of an internal audit report has been embarrassing for the FSA and has certainly brought about changes in regulatory practice. Typically, central banks do not have such an internal audit function with the right to "publish and be damned". So there has been no internal audit report about the Bank of England's role in the Northern Rock collapse. It will be interesting to see whether, when prudential regulation is in a Bank of England subsidiary, the power to issue internal audit reports remains and, if so, whether it is effectively used.

These arguments suggest to me that there might be other ways of strengthening the accountability of the regulatory authorities without necessarily setting up a new institution on the lines Ross Levine recommends.

So, finally, how do I assess his proposal?

There are some good things about it which need to be said. First, there is certainly value to be had from published objective assessments of the state of the regulatory regime, and indeed of potential imbalances in the financial system. It is hard for regulators and central banks to do this, without the temptation to pull their punches. There is a serious risk of generating a self-fulfilling prophecy if they forecast trouble ahead. And it is rather difficult for an agency to say publicly "we are doing a bad job". If we look back at the build-up to the crisis we can see very rapid growth in the number of financial stability reviews published by central banks, and indeed in some cases by non-central bank regulators. Yet they were often rather partial in coverage, did not draw attention to some of the most dangerous trends, and do not seem to have had much influence on market behaviour. Whether through the Sentinel route, or some other means, we certainly need to find a way of improving our early warning systems.

Another point in Levine's favour is that we cannot necessarily rely on politicians to remain focused on financial regulation. Over the last three years it has been a topic of great interest in many jurisdictions, but that is unusual. From one decade to the next, Congress and the British parliament hope not to have to engage in the complex process of regulatory reform. So some kind of agency keeping the system under review has that to commend it.

But I see some considerable difficulties in the way of the proposal that is formulated in Ross Levine's paper. Perhaps the most fundamental is that he assumes it will be possible for a group of well intentioned people, supported by information and analysis, to determine "the degree to which financial regulations reflect the public interest". This presupposes that there is a particular definition of what the public interest might be, which the Sentinel's staff can determine. That strikes me as being a heroic assumption. After all, there were many who believed that the subprime mortgage market was very much in the public interest, given that it provided poor families normally excluded from the credit markets with access to owner occupied housing. In this view, the subprime market broadened owner occupation, with positive implications for the stability of society and the American economy.

It is misleading to suggest that these judgements do not have a strong political dimension to them. They cannot be put on autopilot, or entrusted to a group of disinterested “wise men”.

The second potentially fatal flaw is that the Sentinel would be a public sector body, yet deliberately constructed so as to have minimal political accountability and be outside the normal controls on pay in the public service. It is a nice idea, but I wonder whether it is practically possible to create such an institution. Politicians are highly unlikely to be prepared to spend money on a body which does not have the normal accountability mechanisms in place.

Which leads me to my final point. Could we not envisage a Sentinel in the private sector? There are some models around. There are shadow monetary policy committees in the UK and in Europe, staffed by economists who monitor and mimic the actions of the real monetary authority. There is now a committee on global financial regulation, of which I am a member, which is attempting to do something similar in relation to regulation at the global level. The latter is philanthropically funded (to a very modest degree).

Could we not imagine a public interest foundation establishing a Sentinel-like body to monitor the behavior of financial regulators in the light of evolving market conditions? It could not be set up directly by the financial industry itself, but one could imagine donors who would not seem to put its independence at risk. Perhaps the “Buffet Sentinel” could be envisaged, for example? Though, if it were established in Omaha, Nebraska, I would withdraw my job application.

References

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