The Routledge Handbook of Global Public Policy and Administration

Thomas R. Klassen, Denita Cepiku, T. J. Lah

Decentred Policymaking and Regulatory Finance

Publication details
Ian Roberge, Heather McKeen-Edwards
Published online on: 21 Oct 2016

Accessed on: 27 Sep 2023

Full terms and conditions of use: https://www.routledgehandbooks.com/legal-notices/terms

This Document PDF may be used for research, teaching and private study purposes. Any substantial or systematic reproductions, re-distribution, re-selling, loan or sub-licensing, systematic supply or distribution in any form to anyone is expressly forbidden.

The publisher does not give any warranty express or implied or make any representation that the contents will be complete or accurate or up to date. The publisher shall not be liable for any loss, actions, claims, proceedings, demand or costs or damages whatsoever or howsoever caused arising directly or indirectly in connection with or arising out of the use of this material.
Introduction

Policymakers, private sector and non-governmental actors alike concur that the creation of an effective, efficient, stable and secure financial services sector is essential for a prosperous economy. There remain, however, disagreements on the best way by which to attain this broad policy objective of a thriving yet safe financial system. Policy preferences range from those that prefer pro-active state intervention and regulation to those that favor free market mechanisms, and minimal regulation … and everything in between. The 2007–8 financial crisis highlighted again this substantive division in preferences. The crisis, just as importantly, also showed the major cost of policy failure in this field.

This chapter provides an overview of the key elements of financial services policymaking. How is policy in the financial services sector made? What are the key drivers of reform post the 2007–8 financial crisis? In this chapter, we argue that policymaking in the financial services sector results from the interplay between efforts to create more effective regulation and efforts to liberalize markets. To be more precise, policymaking in finance reflects oscillating processes of regulation and re-regulation, de-regulation, and non-regulation, evidenced in practices of self-regulation. Despite popular and often repeated claims that finance has been deregulated, or is unregulated, the reality is much more nuanced and complex. The trend pre-global financial crisis 2007–8 favored liberalization, yet it was far from universal or linear. Governments, including that of the United-States, continued to impose, even in the heyday of the Washington consensus, various regulatory obligations. Structurally, financial services sector policymaking takes place in a decentred space (Andenas and Chiu 2014; Black 2002) spread across levels of political authority, and between public and private sector actors. However, national governments, operating in a globalized environment, have remained the pillars of finance policymaking; there remain important policy variations across states. In this complex environment recent reform proposals have tended to result in marginal – at least, for now – changes as opposed to a radical restructuring of financial supervision and regulation (Moschella and Tsingou 2012).

This chapter extensively refers to the global financial crisis of 2007–8, which can be seen as a critical juncture. We do not, however, provide a detailed account of the crisis, and its lessons
(for a complete analysis of the crisis, please see Blinder 2013). It is equally important to note that we use finance as a generic term, covering the whole of financial services sector industries. Due to space constraints, however, we largely focus on policies relating to banking and investment, and we only mention in passing insurance and other financial industries.

Why states regulate

There are two main justifications for financial regulation, and for considering this topic in a global public policy handbook. The first reason, as referred to above, is that an effective financial system, including banking, investment, and insurance industries, is central to the health of the overall economy. Finance’s basic role is to facilitate the distribution of limited resources within the economy and it provides the means by which capital through investment can support economic activity. More broadly, Zysman (1983) long ago identified a typology that denotes how countries tend to finance their economic activity through either bank-based lending (e.g. France) or securities markets (e.g. United States). The ‘varieties of capitalism’ approach (Hall and Soskice 2001) also suggests important differences in economic structures across states based largely on institutional legacies, and incremental changes over time. The approach distinguishes between liberal market economies, represented by most English speaking countries, and the more tightly regulated European, Scandinavian, or Asian countries. Put simply, the way finance works, and the way it is supervised and regulated is central to the proper functioning of the economy.

The second related reason for financial services sector policy, supervision and regulation is to prevent market breakdown, so as to minimize the impact of policy failure or crisis in the financial system and potential spillover effects into the larger economy. It may be argued that new information technologies and new synthetic financial products – financial products that depend on other investments, instead of directly supporting an economic activity – have, to an extent, decoupled the financial services sector from what is, at times, called the ‘real economy’. However, the economic costs of this most recent financial crisis were still far ranging in geographic and economic scope – the world saw ‘the biggest drop in global trade since the 1930s’ (Warwick Commission 2009: 9). There are many explanations and causes for the 2007–8 crisis; what is fairly clear is that it emanated from a problem in the US sub-prime mortgage market, a smallish subsection of the larger financial sector, demonstrating the impacts that even a relatively small subcategory of financial activities can have on the global economy. The European Commission, for example, has argued that, ‘A safer, sounder, more transparent and more responsible financial system, working for the economy and society as a whole and able to finance the real economy, is a precondition for sustainable growth’ (2010: 2).

To avoid market breakdown, the government intervenes to minimize the risks posed by the financial sector, particularly chances of systemic risk, credit risk, and market risk. Systemic risk refers to the concern that the failure of a ‘too big to fail’ institution, or of many institutions, can have a contagious effect across the whole of the financial services sector, within and across states with serious impact on the ‘real economy’. Credit risk refers to the possibility that a firm becomes insolvent and may not be able to meet its financial implications. Market risk refers to the possibility of actor misconduct. Governments and regulators have put various measures in place to protect investors and consumers, who may not always be market savvy. Credit and market risk can lead to systemic risk, though they do not have to. Traditionally, regulators have sought to address most of these risks through micro-prudential supervision – particularly making sure that firms are solvent – and, to a much lesser extent macro-prudential supervision – the overall state of the sector. After the 2007–8 global financial crisis, governments have become much more interested and concerned with strengthening macro-prudential supervision (Baker
Financial crises are bound to happen; moreover, they are happening with increasing frequency. Governments intervene, therefore, to minimize the likelihood of an occurrence and most importantly to contain a crisis.

How states regulate

The public debate on financial services sector policy has often oversimplified a more complex and multi-faceted process to a government versus liberalization dichotomy. In this framing, liberalization is achieved through processes of de-regulation, i.e. the freeing of financial actors and markets to pursue the most efficient, and generally global, financial system. Regulation, in turn, serves to contain potential negative impacts when markets falter, though pro-market advocates usually see it as stifling market innovation and growth. However, the story is clearly more multi-faceted. As we will show below, processes of regulation and reregulation, deregulation and non-regulation overlap in the policy realm throughout history. While a general trend can be identified at a specific point in time, the actual policy environment is one where there is interplay between coexisting efforts to ensure effective controls and efforts to liberalize segments of the market.

The most useful way by which to think of financial services sector policymaking is as decentred (Andenas and Chiu 2014; Black 2002). Decentred policymaking is characterized by complexity, fragmentation, interdependencies, ungovernability, and the rejection of a clear public/private dichotomy.

Complexity refers to the nature of problems that must be dealt with. Fragmentation refers to the fragmentation of knowledge, resources and capacity for control in the regulatory space. Interdependencies refers to the dynamics between the participants in the regulatory space, co-producing and co-enforcing norms of governance. Ungovernability refers to the autonomy and unpredictability of actor behavior in the regulatory space, which will pose challenges to assumptions made by regulatory authorities. In a decentred landscape, there is, some argue, no public-private distinctions as all participants contribute to and influence governance (Andenas and Chiu 2014: 74).

We detail each component below.

The financial services sector is a complex field characterized by fast-pace change and innovation, particularly with the rise of scientific finance (for a more complete discussion, see De Goede 2001). For instance, the 2007–8 financial crisis helped reveal that senior managers may not have always understood the way their own firms operated, or the products they were peddling. Few, if any individuals at all, have a complete view and understanding of financial markets.

The financial services sector is also said to be globalized, and though to an extent this is true, it is also quite fragmented. For instance, there is no single financial services sector, but rather a collection of industries – banking, investment and insurance – and even within each industry, there are important distinctions between commercial and investment banks, stock markets, over-the-counter activities, clearing and settlements, insurance and re-insurance, etc. Financial firms offer different products and services based on their size and whether they compete within local, national or international markets. The financial services sector does not have a single interest per se. Private sector actors often disagree among themselves when speaking to a specific policy proposal, given that changes are likely to advantage and disadvantage different aspects and actors in finance simultaneously. Governments – finance or treasury departments and regulators – must work to make sense of this disaggregated, but interconnected, whole.

The three remaining components of decentred policymaking are the existence of interdependencies in the regulatory space, the ungovernability of the sector, and the public/
private dichotomy. Networked governance, which includes regulators and representative bodies, industry actors and others, best exemplifies interdependencies. There are a range of public–private governance arrangements from traditional lobbying to regulatory partnerships to the more nefarious regulatory capture and regulatory arbitrage, where firms shop around between and across regulators, taking advantage of gaps in the financial services sector infrastructure within a state; regulatory capture and arbitrage appear to have happened frequently in the lead-up to the 2007–8 financial crisis in the United States. Interdependencies help blur the public/private dichotomy. The rise of private authority in finance, through a sheer belief in the power of markets to self-regulate, is now well documented (Cutler, Haufler, and Porter 1999). The 2007–8 crisis only partially shook this belief system; Helleiner (2014), for instance, shows how the emerging regulatory regime for over-the-counter trading – previously unregulated – directly relies on private sector actors. As for ungovernability, the global and interconnected nature of the sector, among other variables, makes this sector hard to govern. The number of financial crises, as we noted previously, has increased substantially following the end of Bretton Woods, and the lapse time in between crisis appears ever shorter. The crisis cycle is well known, but we remain susceptible to it – this time is rarely, if ever, different (Reinhart and Rogoff 2009). What has emerged is a polycentric regulatory regime that presents interesting challenges for legitimacy and accountability (Black 2008).

Financial services policy is still largely national, though is also influenced by interactions across the national and international levels. National governments are under pressure from various domestic – and, at times international – lobby groups, and policy often results from existing country-specific institutional arrangements. As such, there remain important policy variations across states. Lavelle (2013) points out that financial policy in the United States is generated from the interaction over time between various public and private sector actors. There are circumstances, though, when policy emerges from a two-level game type process between actors at the national and international levels. In her examination of the Volker Rule – which refers to the possibility for an investment bank to play the market with its own money – Lavelle (2013) shows how international actors attempted to influence domestic policy. Singer (2004), among others, also highlights the importance of national governments when it comes to interpreting and implementing voluntary transnational level standards. Policymaking in finance is generally national, but the level of analysis stretches across levels of authority from the local all the way to the international.

Global finance

This section considers the overlapping processes of regulation and re-regulation, deregulation and non-regulation that have taken place in global financial supervision and regulation over time. The analysis also further supports the idea that policymaking in finance is decentred.

The mid-1900s, particularly under the guise of the Bretton Woods System, was a period of capital control and regulation. Bretton Woods, among other characteristics, served to provide stability on financial markets because of its fixed exchange rates practices and its use of the American dollar, still pegged to gold, as the reserve currency. The United States announced in 1971 that it would no longer convert dollars into gold, the definitive end of convertibility, signaling at the same time the end of the Bretton Woods System (for a complete discussion of the Bretton Woods System, see, among many, Best 2005). The pressures for financial liberalization, though, predated the end of Bretton Woods. The creation of the euro-dollar and subsequently euro-currencies markets – trading using a currency outside of its original jurisdiction – in London in 1957 signals the growth of de-territorialized and unregulated
Decentred policymaking and regulatory finance

finance. The euro-currencies markets provided the opportunity for the rise of offshore finance, which has become a major component of the global financial system (for a more complete discussion, see Palan 2006). Offshore finance – constructed on the concept of state sovereignty and supportive of deregulated and unregulated finance – is now generally perceived as the ultimate symbol of globalized, fragmented and ungovernable finance.

After Bretton Woods, market pressure favoring liberalized capital flows, deregulation in the banking sectors and other neo-liberal policies began in earnest. The reducing or removing of government controls, particularly in the securities markets, became a dominant trend in financial regulation until the turn of the century, and arguably up to the global financial crisis. These efforts toward deregulation of financial services and markets have also been combined with a tendency to avoid creating regulation in areas that were unregulated. There may be a tendency to present these trends as driven by market actors outside of the power and influence of states. The financial system that emerged, however, was not necessarily beyond the power of states; rather, the relaxation of capital controls and efforts to relax regulations that limited financial actors from particular activities or areas, including ensuring separation between banking and securities markets, could be argued to have reflected distinct political preferences (Helleiner 1994).

Moreover, a new international financial infrastructure and new regulation did emerge during this period, alongside the trends of deregulation and non-regulation. The creation of a voluntary standard to harmonize capital adequacy for banks – capital adequacy is the amount of capital a bank, or another financial institution must hold in their reserves at any point in time – Basel I (1988) and Basel II (2004), is a good example. Most studies of Basel I tend to agree that it is an outcome of the interaction between different states seeking to achieve international financial stability while at the same time considering issues of international competition in banking and the need to minimize the competitive implications of the capital requirement (Wood 2005; Simmons 2001). There are other examples including the construction of a full-blown regime to address money laundering and terrorist financing from the 1980s onward, whereas prior nothing of the kind existed (Sica 2000). The interplay between regulation, re-regulation, deregulation and non-regulation on the whole created during this period a less restrictive regulatory environment.

The 2007–8 global financial crisis led to a short-lived crisis of legitimacy for the neo-liberal paradigm (Helleiner 2010; Nesvetailova and Palan 2010). The policy window for substantive policy change, however, closed quickly. Instead, ‘across the system, as they had done after every other crisis since the 1970s, leading states acknowledged their preference for not abandoning the policy trade-offs and global architecture permissive of large-scale capital movements’ (Pauly 2009). What emerged was a mixed range of reforms, some with the potential to become important and others quite minimal (Pomerleano 2010). There has been, however, an apparent shift in the relative weight of the long-running push and pull between increased governmental regulation and decentralized regulation of markets toward the former. This is evidenced by the quick adoption and implementation of Basel III, various Financial Stability Board initiatives, and attempts to regulate previously unregulated activities. Most states and jurisdictions, including the United States and Europe, with a few exceptions, also undertook important reforms of their national financial services sector. The exact nature of this shift and its impact is yet to be fully determined or felt; the crisis left scars and remains fresh enough in people’s mind to incite, at the very least, the appearance of action.
The United States remains at the center of the global financial system and New York is still the world’s largest financial center. We focus on the United States both because of its central role in global finance, but also because it is the starting point for the 2007–8 global financial crisis.

American financial regulation before the global crisis of the early twenty-first century can be split into two eras. The first appeared after the stock market crash of 1929 and the resulting Great Depression. During this period, the United States’ regulatory infrastructure and its principal regulations were put into place. Financial services policymaking aimed on creating regulatory structures that would limit the overlap of banking and securities markets. The Glass–Steagall Act of 1933 is the signature legislation of this period. The Act forced banks to choose between the more traditional roles of a deposit-taking commercial bank or becoming an investment bank, creating a division that attempted to keep the commercial banking sector used by average citizens safe from the more speculative, and less stable, activities of securities markets and investment.

The second period started in the 1970s and 1980s when pressure from banks was mounting on the federal government to remove regulatory barriers to bank activities. The passing of the Financial Services Modernization Act (also known as the Gramm–Leach–Billey Act) in 1999 repealed the Glass-Steagall imposed barriers between commercial banking services and investment operations for banks. It also ‘repealed the parts of the Bank Holding Company Act of 1956 that separated commercial banking from the insurance business’ (Barth, Brumbaugh, and Wilcox 2000: 190). The Gramm–Leach–Billey Act amplified and exacerbated the general trend toward financial deregulation discussed earlier by facilitating the expansion of large financial firms into multiple areas of activity, creating in turn the tangled web of overlapping liabilities that would become prominent during the 2007–8 sub-prime crisis.

Though there was a trend toward less government regulation of the market between the 1970s and the 2000s, it is important to highlight that there were also some moves to expand the regulatory reach prior to the global financial crisis. Three initiatives in the early years of the new millennium are worth highlighting. First, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act – more commonly referred to as the USA Patriot Act – was quickly adopted in the weeks that followed the terrorist attacks of September 11, 2001. The Act imposed many obligations on financial firms to help deter money laundering and terrorist financing. In this regard, the Act built on earlier international and domestic efforts to address the, more or less, recently created threats associated with illicit finance. Second, the government adopted the Sarbanes–Oxley Act in 2002 to respond to problems of fraudulent accounting, which came to light during the Enron scandal. Both the Patriot Act and the Sarbanes–Oxley Act imposed significant costs on the industry. Third, credit rating agencies like Standard and Poors and Moodys received extensive coverage because of the facilitation role they played during the global financial crisis. The unregulated nature of the industry has often been noted (Sinclair 2005). While it is true that these bodies were poorly regulated, it is also worthwhile noting that limited regulations were first introduced in the US as early as 2006.

The 2007–8 financial crisis highlighted a range of problems with financial services sector policy, supervision and regulation in the US. The failure to properly regulate, coupled with the political choices in some cases not to regulate, is a central component in the build-up of the sub-prime mortgage bubble. The neo-liberal preferences for self-correcting markets and minimalist regulation, shared by regulators and private sector actors alike, helps to explain the policy failure, why it was difficult to act and intervene, and the breadth and depth of the crisis.
Unsurprisingly, after the crisis the United States moved to reform its financial regulatory system. The Dodd–Frank Wall Street Reform and Consumer Protection Act adopted in 2010 represents a comprehensive financial reform effort. The Act aimed ‘to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes’ (United States 2010: 2).

Yet even in this new era of financial regulation, American policymaking in this sector is undoubtedly still decentred. The policy field is complex; many of the synthetic products at the heart of the 2007–8 crisis were invented and popularized by American financial institutions. The policy field is fragmented. It is important to remember that much finance in the United States is regulated at the sub-national level by State governments. There are five major banks in the United States – JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, and Goldman Sachs – but there are thousands of state-regulated banks across the country. The financial services sector remains ungovernable despite the rather imposing supervisory and regulatory infrastructure. It is also highly networked. At the federal level alone, the infrastructure is centered around the Federal Reserve System, the Treasury Department, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (the Office of Thrift Supervision was amalgamated with the Comptroller of the Currency in 2011) and, the Securities and Exchange Commission; regulators have, in fact, often appeared in competition with each other. The governance arrangements and the relationships between governments, regulators and private firms – interdependencies and the blurred public/private dichotomy – have also drawn a lot of attention coming out of the crisis. Johnson and Kwak (2010) have described the close connection between public sector and private sector individuals.

Whether the American financial system, at the time of writing, is safer than it was prior to the 2007–8 financial crisis is still difficult to say. There came a very short policy window following the crisis that allowed for the adoption of the Dodd–Frank Act. The real issue is not whether the Dodd-Frank Act goes too far or does not go far enough, but whether the right measures were adopted and implemented to minimize the risk, and contain the effects, of a future crisis.

**Conclusion**

Throughout this chapter, we have endeavored to provide an overview of policymaking in the financial services sector. We have argued that financial services policymaking is the result of the interplay between regulation and efforts to liberalize markets. This has resulted in a mix of regulation and reregulation, deregulation, and non-regulation (often under the guise of self-regulation). We have suggested, as well, that policymaking in finance takes place in a decentred space.

During the 2007–8 financial crisis, policymakers, the press and observers often suggested that a fundamental change in financial policy was needed, that the time was right for a paradigm shift in the relationship between the state and the market. Barely a few years after the crisis, it is clear that such a paradigm shift has not occurred. The trend favors greater government intervention, but it is not definitive and is reversible, especially the further we move away from the 2007–8 crisis. How ready are governments around the world for the next crisis? How safe are financial markets and are they safer now than they were pre-2007? Without government intervention, the global financial crisis of 2007–8 likely would have been much worse. Governments, however, often prepare for the last crisis and lack the necessary foresight to organize for the one that is forthcoming. Maybe it is time, before it is too late, to consider anew the state–market relationship.
References


