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An Unsafe Financial System

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Caroline Bradley

It Takes a Village to Maintain a Dangerous Financial System, a chapter by Anat Admati in a forthcoming book should be required reading for legislative actors who are thinking about reviewing rules of financial regulation introduced after the onset of the global financial crisis.

Before the global financial crisis, policy-makers believed in risk-free assets and risk mitigation techniques. The Basel Committee on Banking Supervision developed capital adequacy standards to identify and neutralize a range of risks associated with the business of banking. But the crisis revealed weaknesses in the standards, and in their divergent and inadequate implementation, as well as new risks that the standards did not address. At the same time, as Andrew Haldane, Chief Economist at the Bank of England, has acknowledged, “the economic and financial crisis ... spawned a crisis in the economics and finance profession.” In responding to the financial crisis, the G20, the Basel Committee on Banking Supervision, the Financial Stability Board, and the IMF announced a new commitment to focus on improving international standards for bank regulation and to ensure that the standards were implemented effectively. Regular reports by these bodies note concerns relating to financial stability, but suggest that they are making progress in achieving the agreed objectives for financial, and particularly bank, regulation.

The official, rather sanguine, view that financial regulation is becoming more effective faces challenges from two perspectives: that of financial firms and others who argue that regulatory burdens are too onerous and are reducing access to credit, and that of critics who argue that the post-crisis regulatory changes do not go nearly far enough. Jeb Hensarling, the Chairman of the House Financial Services Committee has proposed The Financial Choice Act to undo some of the effects of the Dodd-Frank Act. The EU Commission acknowledged in November 2016 after reviewing responses to a call for evidence on the EU regulatory framework for financial services that “targeted follow-up action is required in ... reducing unnecessary regulatory constraints on financing the economy; enhancing the proportionality of rules without compromising prudential objectives; reducing undue regulatory burdens; making rules more consistent and forward-looking.” These developments imply something of a slide back to pre-crisis thinking.

But we may never really have moved beyond this pre-crisis mindset in any real sense despite the crisis, as Anat Admati’s chapter argues. The chapter builds on previous work, but is shorter than The Bankers New Clothes, her co-authored book with Martin Hellwig, and is an elegantly written and beautifully constructed piece which explains financial regulation as flawed due to the work of a range of “enablers.” The “enablers work within many organizations, including auditors and rating agencies, lobbying and consulting firms, regulatory and government bodies, central banks, academia and the media.” Part of the problem Admati identifies is the familiar issue of revolving doors recently illustrated by the decision of José Manuel Barroso, former President of the EU Commission, to work for Goldman Sachs

. Admati writes that revolving doors “contribute to excessive complexity of regulation, because complexity provides an advantage—and creates job opportunities—to those familiar with the details of the rules and the regulatory process. Complexity also opens more ways to obscure the flaws of the regulations from the public and create the pretense of action even if the regulations are ineffective.”

This issue of regulatory complexity is an important one. But regulatory complexity can be used as an argument in different ways. In the chapter, Admati warns that the problem that expertise is constructed in ways that exclude critical and outsider views is still with us post-crisis, and she discusses the impact of spin and particular narratives on financial regulation (for example, showing how writing about capital is often misleading, and how bankers invoke the specter of “unintended consequences.”) We can see this sort of use of spin and narrative in the Hensarling Financial Choice proposal. The proposal is supported by a “comprehensive outline” which applies a complexity critique to Dodd-Frank, explicitly relying on Andrew Haldane’s Dog and the Frisbee speech (which the comprehensive outline refers to as having “achieved notoriety among financial regulators and scholars). But the proposed unravelling of much of Dodd-Frank would still leave in place much of the complexity of financial regulation in the US.

Admati’s chapter begins with a powerful comparison of safety in banking and aviation. Admati argues that whereas all of the actors in aviation safety have incentives to ensure safety this is not the case with respect to banking where “banks effectively compete to endanger.” The chapter ends with an injunction:

Entrenched and powerful systems resist change, but a just society must not tolerate a situation in which critically important systems like the financial system are run against the interests of the vast majority. More people must become aware of the problem and understand what is wrong. Then they must demand that policymakers do better.

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