BANK OF ENGLAND

Regulators, financial industry and the problem of regulatory capture

Foreword by

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Driven by hubris, greed and stupidity bankers led the charge off the cliff. But where were the regulators? Why did they not see it coming? Why did they not prevent it? Why did they trust bankers to know what was best for banking? In short, how could regulators have been so dumb as to believe that bankers were so smart? This book supplies answers to these questions. It explores the ways in which regulators can sometimes be captivated, co-opted and conned by those they regulate. Best of all, it suggests a number of actionable policies to mitigate the problem.

Industry influence operates at all levels of the rule making ranks – from the peak of politics to the substrata of supervision. It need not be unhealthy. Indeed, interaction between regulators and the regulated is natural and normal. Yes, industry seeks to shape the rules under which it will operate. But rule-makers need industry input in order to craft sensible policy. Some degree of influence is therefore inevitable. Unfortunately, there are times and industries where special interest groups are able to bring disproportionate influence to bear – a condition called “regulatory capture.” The financial sector is one such industry and the run-up to the crisis one such time. The obvious question which arises: is such influence still excessive and thus unduly shaping the needed regulatory response?

My first encounter with “capture” came at a moment of meltdown in 2008. At the time I chaired both a London-based investment firm and the trade association representing the UK investment industry. As financial panic spread I watched in disbelief as bankers trooped through the doors of Downing Street to advise Government on how best to address a problem which bankers themselves had largely created. Far from being discredited, the guidance of these “experts” was eagerly sought – and with virtually no counterbalancing input from other stakeholder groups. Over the succeeding months officials went on to tap a more appropriate range of expertise. But at that key moment in time - capture was complete.

“Political capture” can be fueled by campaign contributions but in the case above, it resulted from the pervasive beliefs of the day. The theology of the time maintained that: markets were efficient and would provide the necessary discipline to participants; the financial sector could be left largely to police itself; global banking and their host centers were engaged in fierce global competition; regulation should facilitate that competition and not get in its way; and therefore, when it came to regulation, less was more. This set of beliefs permeated the body politic, shaped the regulatory approach of “light touch” and, believe it or not, established a mindset amongst some supervisors that the regulated banks were to be seen as “clients.” The technical term here is “cognitive or intellectual” capture. The non-technical term is brainwashed.

Four years on, one might imagine that bankers’ ability to bewitch and bamboozle would have ebbed. Alas not. Their formidable lobby has led and continues to lead an effective campaign to persuade pundits, public and politicians that calls for higher capital requirements are impeding the economic recovery. It is an argument framed so as to force the gullible and well intentioned to choose between public safety and economic growth. It is a false argument and a false choice. It ignores the facts - not the least of which is an entire half century of post-war expansion during which bankers operated profitably at lower levels of leverage. That such myths find favour with otherwise intelligent commentators shows that intellectual capture is alive and well. Other stakeholders in financial stability - such as the investment industry, should speak up to help counter the sway of the spurious but seductive. Indeed, a proposal to mobilize better the competing interests in the regulatory debate is one of the author's principal recommendations.

This book is not a polemic. It did not begin with a particular point of view followed by a search for supporting facts. Its conclusions flow from a dispassionate review of the question. The objective of the author, as indeed that of its sponsoring publisher, is the making of better regulation. What therefore, could be more timely than an analysis of a key impediment to effective rule making and supervision?

The work contains a series of thoughtful reflections on the topic of capture in the regulation of the financial sector. It examines the issue through the eyes of both the regulator and regulated. It taps perspectives of both the practitioner and the academic. And it takes a useful look at other highly regulated but non-financial industries in a quest for relevant lessons and solutions. Finally, the book proposes a series of specific policy responses designed to combat the worst aspects of capture. The recommendations in this volume are presented as actionable "low hanging fruit" – which they are, provided excessive industry influence does not prevent their adoption.

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