Warwick Commission Highlights the Local and Political Dimensions of Global Financial Reform

by Leonard Seabrooke

Introduction

Leonard Seabrooke is a professor at the International Center for Business and Politics of the Copenhagen Business School and also professor of international political economy and director of the Centre for the Study of Globalisation and Regionalisation at the University of Warwick. His publications include *The Social Sources of Financial Power* and *US Power in International Finance*, and he has coedited *Everyday Politics of the World Economy* (with John M. Hobson), *Global Standards of Market Civilization* (with Brett Bowden), and *The Politics of Housing Booms and Busts* (with Herman M. Schwartz). Professor Seabrooke is coeditor of the international journal the *Review of International Political Economy*. He was also the director of studies of the Warwick Commission on International Financial Reform.

As director of the Warwick University Centre for the Study of Globalisation and Regionalisation (CSGR), you were closely involved with the Warwick Commission on International Financial Reform. Can you tell us what effect that report has had since it was published in November 2009, and then summarize the main findings of the Commission?

The Commission and its report reflect the University of Warwick's commitment to being involved in important international policy debates. We have a particular interest in highlighting the impact that rigorous scholarly analysis can have on policy thinking. The Commission's chair was Avinash Persaud, who brought a bag of ideas and a bundle of energy to the project. The Commission comprised world-class political scientists and economists, who met at Warwick, Berlin, and Ottawa over nine months to discuss the political economy of international financial reform. I certainly feel that the argument we ended up with was very different from our opening positions—which was a sign that there was some real learning going on. Avi, I, and the commissioners are all proud of the findings published in the report and think that they highlight not only how some key problems should be addressed, but also that we have to recognize that financial systems are political—they are linked to the welfare system and the economy as a whole and are, therefore, of great political interest.

There is plenty of anecdotal evidence that the main findings of the report have found their way into mainstream thinking by regulators, politicians, and financial market practitioners. Given the nature of the report and its far-reaching conclusions, I hope that it will inform thinking long after the most acute effects of the crisis have passed. It bears fundamentally on the key question: What is a financial system for? In other words, who does it serve, and what is its purpose?

Financial markets are highly complex, and it is all too easy for well-intentioned initiatives aimed at implementing macro-prudential regulation to have unintended consequences. To quote from Lord Adair Turner's introduction to the Commission's report:

"[The Report's] focus on the credit cycle as the key driver of financial and macro-economic instability is correct and crucial, and the Report rightly identifies the danger that apparently sophisticated risk management and regulatory techniques, seeking to draw inference from observed market prices for assets and risks, can themselves generate instability of asset prices, of maturity transformation, and of credit extension."

Lord Turner (chair of the UK Financial Services Authority) goes on to praise the way that the report draws a strong distinction between macro-prudential and micro-prudential regulation. Armed with this distinction, the Commission argues that if the regulatory focus is all at the macro level it will miss the point, and that micro-prudential regulation is an equally essential part of the mix. We also argue strongly that the current focus on global regulation—understandably inspired by the desire to avoid regulatory arbitrage by financial service

players (where they simply move their operations to the regulatory environment with the lightest touch)—misses the importance of local regulatory responsibilities and initiatives at the national level. The subtitle of our report is “In praise of unlevel playing fields,” and this side of the argument has yet to be fully taken on board in present regulatory discussions in the European Union and the United States.

One of the big questions for regulators to decide is whether to focus on instruments or on behaviors. My view, and that of the Commission, is that the right target is behaviors.

The ratings agencies clearly had a role in the crisis. What is your opinion of how they should be treated going forward?

The power of the major ratings agencies, such as Standard & Poor’s and Moody’s, has not gone away since the crisis, despite the outcry against them from politicians or their conspicuous errors in classifying subprime-backed securitized products as triple A. The knee-jerk reaction from both European politicians and the European Commission was initially to threaten to extend regulatory control over the ratings agencies. Many people have discussed various solutions to how they should be regulated, including very innovative proposals from Jacques Delpla, the French economist, and others that would require strong political backing. But perhaps the moment for such change has already passed. The sovereign debt crisis has moved us in a direction that has taken the debate on a different course from talking serious regulation of the ratings agencies. European politicians and regulators are now all too aware that when it comes to eurozone economies that are not doing so well, they have no real mechanism as yet that bears on this problem other than to urge prudence on national governments.

This leads to massive inefficiencies. The case of Greece gives us a very clear example. When that country’s crisis was winding up, it struck me that the sums it was originally asking for to keep the vultures at bay were not vast. They were directly comparable to the US$15 billion that the three EU countries involved had put up to bail out Fortis. So on the one hand we had prompt action to rescue a failing private institution by just three members of the eurozone, while on the other we had inaction on the part of the whole European Union to bail out Greece at a time when all that the markets needed was a sign that the European Union would stand behind Greek debt.

What the incident showed very clearly was that, although the European Union is a political entity centered on Belgium, it is also an economic entity centered on Germany. When the economic and political centers of the European Union come into conflict, the economic center wins hands down. A colleague of mine on the Commission, Eleni Tsingou, who is also a research fellow at the CSGR, points out that what this highlights is a profound difference in Europe between countries that make things and those that do not. The European Union is a political project, and when things get tough the level of industry inside a country becomes extremely important. This in turn leads on to the question of what one does when it becomes clear that some of the countries within the European Union are to all intents and purposes emerging markets. In a crisis, an emerging market country would normally devalue its currency and look to export its way out of its difficulties. With the weaker EU countries that option is not available. The euro actually favors the heavily industrialized countries in general and Germany in particular, since it helps them to export. But that is achieved at the expense of countries like Greece and Spain. As a regulator trying to make sense of systemic risk, you cannot ignore macro factors like this.

You have written and spoken on Europe and Asia’s involvement in the US subprime debt saga. Can you summarize your views on this?

I will start with the prime mortgage market rather than the subprime mortgage market. If you trace the money from overseas that went directly to Fannie Mae, Freddie Mac, and Ginnie Mae, the three state-sponsored entities responsible for securitizing debt in the US mortgage market, the main flows came from China and Japan. The amount of money coming from Asia into the prime securitization market in the United States can be read directly from the US Treasury funds data. These show that by June 2008 Ginnie Mae got US $369 billion from China and US$121 billion from Japan. The next biggest inflow, US$38 billion, came from Switzerland. Although we are talking about public–private hybrids here, this was in essence a state-to-state system. At the turn of the century nine-tenths of all the securitization was done by Fannie Mae and Freddie

Mac, so it is not surprising that when they really starting investing in mortgage-backed securities, China and Japan thought Fannie and Freddie would be bailed out.

Another point to bear in mind is that, despite the subprime fiasco, the United States is primarily a prime mortgage market, whereas the United Kingdom and Scandinavia—if we use the same basic classifications—are really subprime mortgage markets. This is because the usual definition of subprime is that you are spending more than 34% of your post-tax income servicing your mortgage. In the United States this is high, whereas in the United Kingdom and Scandinavia it is common practice. In fact most Anglophone countries, including Ireland, are subprime in that sense.

In the United States the prime mortgage market grew very strongly through the 1990s. However, as more liquidity poured into the country and access to credit became increasingly easy, the market extended down into the subprime arena and many players began to compete aggressively for market share in what was a new space in the US mortgage market. What should have happened to counteract this is that Fannie and Freddie should have moved to properly redefine the criteria for prime lending. They did not do so. Another factor was that there was no real wage increase through this credit boom period, so the boom pushed household credit levels across the United States toward a level comparable to the norm in Anglophone countries.

In 2002 you got a real change of behavior in Fannie Mae and Freddie Mac, with a much greater willingness to concentrate on what we would consider the monied middle classes. The US Home Mortgage Disclosure Act of 1975 makes it very easy to see who is applying for loans and not getting them. This is all tied up with race politics, which is a hot topic in the United States when it comes to housing finance and legislation to address racial discrimination. It quickly became clear around 2004 that working-class African Americans and Latinos were increasingly not able to secure prime loans and had to accept subprime deals, with much heavier interest. This alone did not lead to the bust, but the structuring of securitized debts led to the panic and freeze that we saw in the financial markets in 2008.

All this does not mean that Fannie Mae and Freddie Mac should not play a role. By the end of 2008 Freddie Mac had delinquent loans (where the householder is three months or more behind with their payments) amounting to 1.8% in the prime market. Fannie Mae's equivalent delinquency level was 2.1%. However, in the subprime category delinquency rates were well above 19% for both institutions.

The interesting point here is that a regulator should conclude from this that it is impossible to get rid of Fannie and Freddie from the US housing system. Their founding charter is to bring a balance of opportunity across the races, and they are there to assist the housing sector to provide housing for ordinary Americans. Despite the crash and the huge debts of both companies, it remains a system that works. If these two institutions had recalibrated the meaning of prime debt and the growth of nonbank financial intermediaries had been curbed, the number of people forced to accept subprime loans at high interest rates would have been sharply reduced. Nor would we have seen such a wide difference in delinquency rates between prime and subprime. That in turn would have had a very beneficial knock-on effect in the financial service sector's innovations around residential mortgage-backed securities, collateralized debt obligations (CDOs), CDO squared, and so on.

Again, this speaks of micro-prudential regulatory steps that were never taken. Had they been, they would have had profound implications for the way the financial crash might have played out.

A standard part of the consensus analysis today of the financial crash is that the overready availability of cheap liquidity from abroad contributed hugely to the inflation of the US housing bubble. To what extent was this avoidable in your view?

It is very interesting to see the extent of what looks like hedge fund money coming into the subprime asset-backed securities (ABS) market from June 2008, which was very late in the development of the crisis. For example, some US$164 billion was invested in US ABS products from the Cayman Islands, one of the world's leading offshore domiciles for hedge funds. The United Kingdom was next at US$44.6 billion, though much of that was institutional investments. The Germans, Irish, and French were next at US$31 billion, US$28 billion, and US$24 billion, respectively. All this money was clearly chasing the high yields associated

with subprime ABS. As we now know, those yields were illusory, but it is clear that the hot money coming into the subprime market was from Europe.

The safe money coming into the prime ABS market came from East Asia. So Europe was right in there inflating the US subprime ABS bubble, and that money was being driven, quite simply, by greed. The East Asian money was betting on the state-sponsored entities, with the assurance of a US government bailout if things went wrong. There is nothing wrong with East Asian money going into Fannie Mae and Freddie Mac. That money increases home ownership, and from the standpoint of Japan and China that is a logical long-term play. Not only do they find a home for their export-driven balance of payment surpluses, but new homeowners can be expected to go to Walmart to purchase a wide range of goods for their homes, from consumer electronics to fabrics, and that plays well for the export markets in these two countries.

Clearly, lending on housing is a very political issue in the United States. One of the groups I have studied is the National Community Reinvestment Coalition (NCRC). In January 2009 the NCRC made an official complaint against Standard and Poor's for its involvement in restructuring subprime debt on the basis of race. Their argument was that these products have had an adverse effect on African Americans and Latinos, and that the regulator had enough data available to see the damage coming. This is going to be a very interesting judgment. At the time of writing no judgment had been given, but it has the potential to be very far-reaching.

What essentially happened to regulation in the United States from the 1980s until the crash was that regulation was becoming more and more permissive, and most of the regulatory effort was focused on the banking sector via Basel I. The thrust there was the self-modeling of risk and the need to ensure that banks had enough capital to buffer them against a downturn. From the late 1990s the regulatory effort moved out to securities and, again, became much more permissive. The amount of innovation that went on was viewed as beneficial, but the innovation was clearly on a scale so large that the regulatory authorities simply lost track of what was happening.

The Warwick Commission Report laid great stress on the idea of capture, that is to say, the capture of the regulatory authorities by the sector they were supposed to be regulating. We looked in some detail at how the regulators lost their autonomy and authority, and how the market, rather than the regulator, was in the driving seat.

This phenomenon of capture carries through into the Warwick Commission's emphasis on the importance of host regulation over home regulation when it comes to regulating cross-border entities ("home" here refers to the country where the institution concerned has its headquarters). The key here is that the regulator is not distant from the market. Host regulators have a much better grasp of what is going on in their economy than a home regulator based, in some cases, on a different continent.

Going down this road also takes us into the area of considering the right size of a financial services entity. As we are now seeing from the way the banking crisis is transforming into a sovereign debt crisis, a financial system can become a threat to the sovereign entity. The Irish government, in particular, was guaranteeing a far larger volume of bank deposits than the country's GDP could cover.

Another interesting and rather neglected area which regulators are going to have to think about is the relationship between welfare systems and financial systems. I have done quite a bit of work in this area. Of course the "financialization" of the economies has extended credit to groups that previously did not have access to credit. The ring-wing reaction is to blame crises on groups that have been newly included in this way, claiming that they are riskier and therefore have added more volatility to the financial system. In fact most of the volatility comes from the top end, where the instruments are made, not from the bottom end, where people are aspiring to own their home or buy a car, etc. As we have become more financialized the sensible thing to do is to have clear guidelines and regulations on access to credit. Of course those who are high risk should not be given soft loans. But it is also hard to chirp on about austerity and cut welfare during a period in which more people need it (readers really should really see Mark Blyth's view on austerity given in the references below). One of the things that the Warwick Commission Report does is to be quite blunt about the impact politics can have on financial systems, and regulators need to take cognizance of this. People with high expectations of what can be achieved through regulation also need to keep in mind the political context that shapes what the regulators can do. The next few years are going to be a very interesting demonstration of precisely these points.

More Info

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- Posner, Joe (dir). *Austerity*. Watson Institute for International Studies, Brown University, September 2010. Presented by faculty fellow Mark Blyth. Online at: www.watsoninstitute.org/news_detail.cfm?id=1388

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