Financial Stability: Regulation and Politics

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In the post global financial crisis world , governments of the G20 countries made public collective statements in which they committed to focusing on maintaining financial stability in new ways. Financial regulation would in future focus on macroprudential risk (systemic risk) as well as on microprudential risk, and monetary policy would take account of financial stability concerns. Some have argued that this new approach represents a paradigm shift in financial regulation, although others maintain that there has merely been an evolution of pre-crisis financial regulation.

Systemic risk was a concern of regulators before the crisis: contagion and panics have been a feature of financial systems for generations. The European Central Bank has published a Financial Stability Review since December 2004 nearly two decades after the Bank of England published its first financial stability review in 1996 after the failure of BCCI and Barings. The Financial Stability Board, which is responsible for ensuring implementation of the transnational financial stability agenda is the Financial Stability Forum, established in 1999 in response to the Asian financial crisis, but with a new name. But whether or not the financial stability turn represents a paradigm shift or an evolution, financial stability is an ongoing focus of financial regulators and the transnational standard-setters and international financial institutions.

Assuming that the financial stability rhetoric, and the measures proposed to ensure it, were intended by the G20 and others to be real policy initiatives rather than merely rhetorical devices to calm the markets, it makes sense to take seriously the idea of financial stability as an objective of financial regulation, to evaluate what progress has been made towards achieving any sort of stable financial stability since the failure of Lehman Brothers and to consider to what extent regulation can likely ensure financial stability.

One part of the paper will address the measures that have been proposed and that are being implemented to improve financial stability, including living wills for financial institutions, and new rules for systemically significant financial institutions. Progress towards implementing these new rules is slow and uncertain and it is not clear that, even if implemented, new rules will achieve their objectives. It is a perennial characteristic of regulation that it tends to address issues which are historic, and policy-makers' ability to predict the future is limited. And regulation introduced to control risks which developed in the past may create their own new risks as market participants manoeuvre around the rules.

Another part of the paper will consider whether financial stability really makes sense as an objective of financial regulation. Financial stability discourse tends to assume that if policy-makers can only identify the significant risks to financial stability they can deal with them. Thus focusing on financial stability may invite ever more complex models of financial system behavior. But this idea of being able to identify and control for risk is one of the ideas the financial crisis challenged. If financial firms' modelling of financial risks was flawed how can we be sure that financial regulators' modelling of risks to financial stability is not similarly flawed? Moreover, if some of the real risks to financial stability are about changes in perceptions

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of reality the financial stability models may not effectively capture the real risks. To the extent that value in financial markets is a matter of perception, and if it is impossible to ensure the stability of perception, then regulation cannot ensure financial stability. In the post-crisis period regulators have focused on securitization (changes in perception of the value of the securities was a cause of the crisis), but new examples of problems of perception have emerged, from accounting issues to manipulations of indices and benchmarks. The value of many financial "assets" depends on others' assessments of value rather than on any true value. Whether or not securities and derivatives have this characteristic, gold, diamonds, oil, and art clearly do. Moreover, some market participants purposely see the world differently from the crowd to identify opportunities for profit, hoping that events, perhaps even their own investing behavior, will alter perception. If value is malleable, stability is unreliable. During 2015 China supported prices in its securities markets for a while when unjustified speculation threatened investors with losses. By September restrictions on borrowing to invest in securities reduced the need for state support of the markets.

A third part of the paper will consider the relationship between politics, particularly transnational politics, and financial stability. As regulators claimed to be thinking in new ways about how to address systemic risk in financial regulation a European sovereign debt crisis posed challenges to financial stability in addition to the loss of confidence which prompted the original crisis. Some of the European sovereign debt challenges related to endemic vulnerabilities in the Euro area and Europe's particular mutual dependence between banks and governments: issues which the new language of financial stability was framed to address. But other aspects of the European sovereign debt crisis related to its political context rather than merely technocratic issues of economics and financial regulation. Austerity measures encouraged a new populist politics: in Greece elections brought Syriza to power twice in 2015. When the eurozone considered how to deal with the renegotiation of Greek sovereign debt in the summer of 2015 in the face of a Government which had been elected to oppose austerity it is not clear that concerns about financial stability, rather than concerns about maintaining an elite, technocratic and anti-populist conception of the European project, predominated

Enforcement actions arising out of pre and post-crisis events suggest that there has been and remains a systemic problem in the culture of finance. Therefore, a fourth and final part of the paper will consider non-compliance with existing rules of financial regulation as an issue of financial stability, and discuss the extent to which current approaches to enforcement of financial regulation do or do not take account of and promote financial stability concerns.