Overcoming Systemic Financial Risks in Europe: Contested Policy Responses

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Abstract:

The monumental crisis of global financial markets since 2007 and the current economic downturn have not only led to significant changes in debates about financial and economic regulation but also brought an enormous amount of regulatory reform proposals on the agenda. While critics of neoliberalism urge fundamental policy change in a situation of an open ‘policy window’ to establish a completely new global financial system based on a ‘New (Green) Deal’, on tight regulation and systems’ diversity, ordoliberals – in their attempt to stop such reforms – demand caution against overregulation and warn of negative or even unintended consequences of responses not awaiting major economic recovery. This paper identifies ‘shadow banks’ and the so-called innovative financial instruments as major sources of systemic financial risk resulting from the underlying trends of financialization and focuses then on the EU’s reactions to these two areas of financial risk regulation, namely the regulatory proposal for Over-the-Counter derivatives (amendment to the Capital Requirements Directive) and the draft Directive on Alternative Investment Fund Managers. Based on classical structural power arguments in relation to the controversies between different models of financial systems in EU member states, the EU’s role in supporting financial integration in the Common Market, regulatory competition (especially between the world’s largest financial centers) and considering contemporary (better) law-making practices, the paper takes a critical view on the likelihood of a fundamental policy change and argues that we should not expect a too radical change but more a moderate reformulation of neoliberalism in terms of its ordoliberal conceptualization. In the final part it outlines and discusses some ideas for a financial system based on an interpretation of the precautionary principle for the financial sector (e.g. financial product safety commission, downsizing financial institutions) and asks about the EU’s capacities to establish such institutional firewalls against future systemic risks.
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Introduction
The great financial crash of 2007 and the following global financial crisis signify the total and disastrous failure of the most sophisticated risk assessment and management systems globalized financial market actors deployed with their ‘originate-to-distribute’ business model of securitization. The overall scope of failure is simply shocking: bad corporate and financial governance, highly perverse and unsustainable incentive structures, financial fraud and crime, opaque and toxic financial products, market failure as well as regulatory and oversight failure to name just a few. This crisis demonstrates the need not just for ‘restoring’ financial stability but for establishing a radically new and alternative financial regime.

Financial markets and in particular international financial transactions gained dominant roles over other markets since their liberalization in the mid-1970s and became driving forces behind phenomena such as neoliberal globalization and financialization (Epstein 2005: 3). Frequent financial crises have been system characteristics and not the exception within this system and alerted critics who have been warning about systemic financial instability and destructive forces and intolerable risks of financialization for quite some time. However, regulators as well as financial market experts, including leading academics, remained convinced that financial institutions have been run by smart ‘masters of the universe’ doing ‘God’s work’ (©Blankenfein still in November 2009) and that liberalized financial markets would be efficient and effective. Within this dominant belief system crises were mainly seen as a result of overregulation or bad governance in developing and transition countries. Only in the aftermaths of the Asian crisis, which significantly increased awareness of the risks of global contagion, more radical reforms came also on the agenda of key institutions and were debated by mainstream academics for a short time. But quickly returning to business-as-usual, the financial sector has remained a light-touch regulated and in many parts self-regulated sector. Yet, with a major structural and ideological crisis affecting the most advanced countries and the world’s financial centers and due to unprecedented public pressure to get regulation right, reform proposals lie on the table that, when adopted, should swing the regulatory pendulum in the other direction and re-embed financial markets. After being ‘slapped by the invisible hand’ (Gorton 2010), ‘time’ seems ripe for the introduction of ‘a visible hand’ (Griffith-Jones, Ocampo & Stiglitz 2010). Keynesian and other interventionist ideas celebrate a revival. Suddenly ‘radical’ changes seem not just necessary but feasible.

However, this unique policy window is also characterized by a situation with increased capital concentration in the sector, a quick return of record profits of big banks and hedge funds and record deficits in many countries, including the US, Japan and most EU member states. Instead of (Green) New Deal policies, that had achieved certain popularity during the last US presidential and EU Parliament elections, austerity programs are now on the agenda and pose radically the question about the relationship between states and markets. Yet it is still highly contested what caused the crisis and how much ‘visible hand’ is necessary and what the right timing for reforms would be.
Those pushing for quick reform argue that ‘a crisis is a terrible thing to waste’: ‘That opportunity would be a terrible – indeed, a tragic – thing to waste’ (Roubini, Mihm 2010: 301). In opposite, neoliberals argue not for more but ‘smarter’ regulation and for awaiting economic recovery and stabilized financial markets to avoid unintended negative consequences. Instead of following populist demands of ‘punishing gangsters’, reforms should better be postponed (Posner 2009). It is within this broad scope of ideas – still marginalising extreme changes of the current system – the regulatory reforms underway have to be understood as highly contested and controversial and as attempts of coping with high uncertainties.

For a number of reasons it remains questionable whether the reforms will achieve what their advocates promise. Massive lobbying activities from financial industry already caused major concerns if not frustration that progress is too slow and far from ambitious enough or that lawmakers remain highly captured by special interests. Not just for these reasons the overall system will remain unsustainable for the foreseeable future. Increasing poverty, high unemployment, social conflicts and trade imbalances are further problems signifying a longer period of instability.

This paper takes a closer look at the reregulation underway in the areas of shadow banking and financial products that contributed in specific ways to the current mess. Starting with a short discussion of core differences in explaining and reacting to financial crises, the paper asks more specifically about the features of neoliberal financialization and how this caused the recent crisis. It proceeds with a discussion of some emergency actions taken to respond to the crisis and then focuses in particular on derivatives and shadow banks in the US and European Union. Although regulatory reforms underway include some fundamental policy changes which can be interpreted as a shift to ordoliberal ideas, core aspects of the reforms do not go far enough, as will be argued. These topics will be linked to the debates about a possible paradigmatic shift from neoliberalism to a new economic paradigm. Based on some lessons from various processes limiting the likelihood of a radical shift – especially structural power of capital, regulatory capture, and regulatory competition, I will finally discuss the possibility of incorporating a more radical precautionary approach into financial regulation.

**Growth, Unsustainability, and Financial Crises in Capitalism**

Capitalist societies are dependent on steady growth; they are even, as Altvater (2004) puts it, driven by a ‘growth obsession’ which is well known to be at least in its past and current form unsustainable in economic, social, environmental and political terms. Demands for a radical shift towards a more sustainable pathway such as qualitative instead of quantitative growth, a steady-state economy, living in terms with nature etc., debated since the 1970s, failed completely to get sufficient support. Since sustainable development emerged in the aftermaths of the Rio earth summit in 1992 as a new global central theme, main institutions and actors propagated successfully the advantages of ‘sustainable growth’ and ‘sustainable budgets’ in a neoliberal version and many big financial institutions, nowadays seen as creators and roots of the biggest financial crisis since the 1930s, were top ranked in sustainability indexes. Reactions to crises were calls to return to ‘sustainable economic growth’, which included a strong focus on fiscal policy discipline. For the financial sector the main critiques within policy demands for a more seriously taken sustainable development have been addressing the increased systemic risks arising from a market-led global financial system and calls for
a coherent international architecture (sometimes called a new Bretton Woods), including the recovery of some of the regulatory controls of the Bretton Woods era or the introduction of a currency transaction tax as proposed by James Tobin since 1978, and for other measures based on ideas of investors and corporate social responsibility to bring investment in line with long-term development goals.

For the financial sector it was up to until recently quite common to assume that the painful lessons from the Great Crash of 1929 had been so much incorporated by financial actors that a repetition would be impossible. However, for the 2007-2009 crisis it was exactly the specter of 1929, quasi the mother of all financial crises, that became the comparison in terms of possible scope and consequences for the real economy. Fears that protectionism could reemerge and put the economic and financial systems under further stress have been widespread since international trade went down for the first time since 1945 (the WTO was expecting a decline of about 9 percent for 2009). Of course, there are many differences between the two crises. However, for the purpose of this paper, these particular qualities of the current crisis expressed in the historical comparison as well as some general aspects of financial crises in capitalism are of key importance in explaining contested issues.

Crises occur frequently and in different forms in capitalist money and market economies. They ‘are hardwired into the capitalist genome’ and as such much more the norm than the exception even in advanced economies, as Roubini and Mihm (2010: 4) emphasize. With Antonio Gramsci (1971: 276) one could say that crisis is the uncertain situation in which ‘the old is dying and the new cannot be born’, and the crisis continues until the new has been established. This is in simple and very general words what is happening in a ‘minor’ crisis, which is part of every short-term business cycle, as well as in ‘major’ or fundamental systemic crisis. Especially the French école de la régulation, from which this differentiation between minor and major crisis is taken, has been focusing on the question what causes systemic capitalist crises and what happens during them allowing capitalism not only to survive but to come out even stronger (cf. Aglietta 2000 [1979], Boyer 1990, Boyer 2004, Boyer, Saillard 2002, Jessop 2001). The very idea that the crisis is a necessary element in a non-steady evolutionary process with even a positive effect is already formulated by Joseph Schumpeter (1992 [1942]) who described the process, in which unprofitable businesses go bankrupt, as ‘creative destruction’. While this is basically a market process driven by competition, not every crisis, however, can be solved by market forces and the ‘hard budget constraints’ in capitalist societies. Certainly, capitalist crises are complex social, political and economic phenomena for which a plurality of explanations exists. Competing theories explaining economic crises in capitalism especially differ in their core assumptions and views of market and policy failures and they for sure come to quite opposite responses on the question about adequate regulatory changes. The same is true for financial crises, which can occur in various forms, be it for example a banking crisis, a speculative bubble and crash or an international financial crisis. Since financial markets became deregulated and liberalized we have seen a good number of such crises, starting with the international debt crisis, and numerous currency crises, banking crises, bubbles and crashes.

The general features of crises as times of openness and uncertainty apply also to the current crisis. As its scope and quality are still uncertain and as it is rooted within the very nature of competition that there is a lack of information there are at best some good arguments supporting one or another expectation. But there is a strong public pressure to implement regulatory changes that will tackle the problems that caused it. There is already quite some indication that those who thought that the
crisis would be over in quite a short period and that growth would come back in a year or so (Greenspan 2009) were too optimistic. Others expect a longer lasting period of recession, a return of ‘depression economics’ (Krugman 2008) or stagnation and a massive ‘debt-deflation’ (Foster, Magdoff 2009). Anyway, if we use Gramsci’s understanding of crisis demanding a new system replacing the old or the French regulation school’s one expecting a new accumulation regime, the crisis necessarily would take much longer than an economic recovery and return to growth. ‘Crisis economics’ (Roubini, Mihm 2010) is definitely back on the agenda for the foreseeable future.

‘Times of crisis’, emphasizes Boyer (1990: xxv), ‘are times of heterodoxy, or, failing that, of the synthesis of orthodoxies in reaction to new problems.’ In political science, Kingdon (2003) introduced the term ‘policy window’ to explain the possibility and likelihood of more fundamental policy changes under specific circumstances. Peter A. Hall’s (Hall 1986, Hall 1989) analysis of changing economic paradigms as well as other theories such as Sabatier’s (Weible, Sabatier & McQueen 2009, Sabatier 1999) advocacy coalition approach emphasize the importance of changing economic parameters (which are in normal situations quite stable) as well as the role of ideas and policy beliefs among further factors for a radical policy change understood as policy learning. In short, in all these theories a deep fundamental economic or financial crisis is a strong but not sufficient factor to bring about a paradigmatic change in ideas on economic policy or finance.

It was Karl Polanyi (1957 [orig. 1944]) who described brilliantly the disembodied, unregulated market as working like a ‘satanic mill’ putting society so much under intolerable stress that countervailing powers would necessarily emerge demanding the (re)regulation of the market. Before him, Marx made his powerful arguments why capitalism enables and demands, although not without frequent crises, permanent revolutionary transformations of the production process – corresponding notions from the Communist Manifesto became popular quotations in the globalization literature, including studies by the World Bank. Yet, the more important aspect in Marx’ analysis received less attention: the very same moment revolutionizing production increases self-destructive forces from within the system. Marx was convinced that money, credit and interest pose such serious threats to civilization that they have to be overcome and abandoned in a communist society. This view was not that astonishing given that financial crises were a common phenomenon during his lifetime. In opposite and despite the huge differences, Keynes as well as Monetarists argued that under specific forms of state intervention and market regulation fundamental crises could be avoided. For Keynesians money necessarily creates instability and does not lead to equilibrium. Based on a theory of instability (Minsky 2008 [orig. 1975], Minsky 2008 [orig. 1986]) they advocate a wide range of institutional precautions against financial instability. The Keynesian ‘revolution’ at the end of the Second World War was therefore broadly interpreted as a re-embedding of markets, while the monetarist program emerging in the 1970s was part of the ‘neoliberal counter-revolution’ against Keynesianism, as Milton Friedman once labeled the process himself. Following von Hayek and Friedman, neoliberals’ standard argument for deregulated financial markets has been that political interference is bad and international regulation should either be self-regulation or via ‘independent’ institutions such as BIS or IMF. The neoliberal belief has been that crisis is always and entirely the result of bad policy and never (pure) market failure. However, the lessons from financial crises since the 1980s showed that economic growth is dependent on financial stability and both need at least a stronger institutional infrastructure.
Neoliberalism, Financialization and the 2007-2009 Crisis

Within the overall globalization discourse neoliberalism became a term especially used by left authors and activists as well as by right-wing cultural nationalists to attack the mainstream economic theory and dominant political approaches such as the Washington Consensus. Neoliberalism is mostly defined as a plural set of ideas framed by beliefs of free market superiority (which is regularly criticized as market fundamentalism or market radicalism), individualism and anti-statism in terms of opposition against social interventions. As such this broad term covers the Austrian and Chicago Schools, ordoliberalism and libertarianism (Plehwe, Walpen & Neunhöffer 2006, Roy, Denzau & Willett 2007, Saad-Filho, Johnston 2005). However, there have never been many calling themselves neoliberals and some scholars explicitly rejected the term as inadequate to describe the overall outcome of deregulation, privatization and liberalization. John Braithwaite (2008, 2005) opposed the idea of neoliberalism becoming dominant since the 1970s as a ‘fairytales’ as the outcome of regulatory reforms was no ‘neoliberal world’. The very same could of course also be said about Keynesianism between 1945 and early 1970s or about Marxism in relation to ‘real socialism’. Neoliberalism, in Braithwaite’s view, did not ‘become an institutional reality’ (Braithwaite 2008: 5) – a paradox that is also recognized by the critics using the term ‘neoliberalism’. Panitch and Konings (2009) emphasize that ‘neoliberalism and financial expansion did not lift the market out of its social context; rather, they embedded financial norms and principles more deeply in the fabric of American society.’ Their focus is therefore more on ‘beneficial’ regulations. In short, for the purposes of this paper the term can and will be used to describe the dominant economic ideology since the 1970s that brought about an investment based growth paradigm (Montegomery 2007) with all its contradictions and especially with regard to deregulated and to a large extent un- or self-regulated areas in the financial sector as well as the regulation supportive for increasing shareholder value over other possible goals. It is exactly the contradictions between theory and practice that might allow neoliberalism to recover from the current situation, as I will argue below.

Over the last decades neoliberal globalization has increased global trade and transnational financial transactions as well as vulnerability of national economies significantly. The French regulation theory described the evolution as an ongoing transition toward a finance-dominated regime of accumulation, in which ‘barriers between banking and non-banking activities are removed’ and the system of market finance with its predominance of institutional investors becomes crucial and responsible for a shift towards short term maximization of their equity ‘under the constant threat of hostile mergers and leveraged buy-outs’ (Aglietta 1998: 69). Liberalization, deregulation and globalization of financial markets and financial innovation especially since the 1980s can be interpreted as ‘a very successful market fundamentalist project’ (Soros 2008: 95) which – despite enormous innovation in risk management – brought back financial crises as a systemic risk. The increased returns on equity demanded by that system have been defended with the superiority of the shareholder value concept to alternative corporate governance concepts culminating in the idea that greed would be good. Financial crises, fraud and other negative effects that occurred could certainly not even be ignored by the neoliberal mainstream. The neoliberal responses to crises were a combination of bank regulations (e.g. Basel II), voluntary agreements but also regulatory reforms leaving a number of loopholes especially in terms of capital requirements of banks and investment funds. Critical scholars pointed for a long time at the ‘madness’ of investment banking and labeled

1 For a more systematic look at how neoliberalism changed institutions and how institutional analysis contributes to our understanding of these changes see (Campbell, Pedersen 2001).
the new situation as ‘casino capitalism’, which had driven financial markets ‘erratically manic at one moment, unreasonably depressive at others’ while seriously damaging third parties (Strange 1998: 1). In particular, critics pointed continuously at the negative effects of a finance-dominated growth regime such as unemployment, increasing inequality and moderate overall growth rates. The risk of systemic crisis became more and more a research topic for regulators as well as for academics. Even the likelihood of a deep financial crisis with comparable economic consequences to the 1929 Great Crash that would not only hit a country, a region or a continent but the whole world economy was now seen as increasing (Altvater, Mahnkopf 1996, Assassi, Nesvetailova & Wigan 2007, Glyn 2006). Above all, the East Asian financial crisis of 1997-1998 raised serious concerns about possible negative impacts on global markets. ‘The presumption, widely held before 1997, that financial liberalization is invariably beneficial has now been abandoned by almost all serious commentators. But there is as yet no consensus either about the appropriate analysis of the impact of financial liberalization or about what should be done’, stated Eatwell and Taylor (2000: ix). As a result there were numerous demands for a more or less radical reform, formally only discussed by critical scholars but yet becoming part of the dominant discourse, including elements such as a new Bretton Woods, a Tobin tax and other ideas for a new international financial order. However, the reform of the international financial architecture did not go far in the neoliberal climate and radical reform proposals remained marginalized. Many policy responses to stabilize the global or at least regional financial markets such as the creation of the European Monetary Union got and remained oriented towards a neoliberal paradigm.\(^2\) The US as well as the EU strongly supported the idea of self-regulation and soft law. They too refused to fill regulatory gaps for competition reasons. While neoliberals argued against overregulation or against regulation affecting other jurisdictions, mainstream modern finance made even the illogical claim ‘that it could control risk’ and was enthusiastic about the fact that risk management and insurance became fast growing and highly profitable businesses (Dembinski 2009: 62). Moreover, regulatory reforms of the past few years before the crisis were strongly influenced by neoliberal ideas of ‘better regulation’ (EBF 2007). However, the recent crisis radically changed the situation and opened a policy window for far-reaching reforms. Given the yet broadly shared view that deregulation was at least a crucial source of this particular crisis, re-regulation became more or less automatically the postulate of the time. Evans (2008) already proclaimed that the crisis has ended the era of financial deregulation.

**Haunted by the Satanic Mill, but already in the Blame Game to Avoid ‘Over-Regulation’**

Macroeconomic imbalances, decoupled financial markets from the ‘real economy’, the global diffusion of the shareholder value paradigm, tax havens and other forms of aggressive international economic competition as well as speculation on raw material markets with devastating effects for poor countries are some of the many sources and features of the current crisis. Additionally, financial and economic crime, fraud, corruption and greed supported by a problematic structure of benefits and incentives for managers, shareholders and auditors are part of the overall story. Alone the number and complexity of underlying problems clearly shows the difficulty to identify, not to speak of agreeing on necessary regulatory responses. Without doubt this is a major crisis which

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\(^2\) The Maastricht criteria and the Stability Pact within the European Union are such neoliberal policies. For a discussion of neoliberal aspects in European banking regulation see Bieling and Jäger (2009).
Gramsci would call an organic and hegemonic crisis, including not only unsustainable structures but also the neoliberal beliefs in markets, their self-control and self-regulation.

Since 2007 politicians, regulators, central and other bankers and experts frequently addressed the public to secure people that in their area the system would have been sound enough before they were proven wrong only a little while later. Many actors in politics and economy – formerly apologists of the idea of the free market and advocates of neoliberalism – all of a sudden turned towards regulation and demanded state action to bail out banks. Some even proclaimed a clear trend in the overall economic paradigm on the horizon characterized by all turning into Keynesians. Keynes (2008 [orig. 1936]: 236) himself had expected that in certain situations banking policy would be unable to induce sufficient investment for full employment and ‘a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment.’ Yet, the socialization of banks during the past years did not come gradually – as Keynes proposed – but as an emergency ad hoc action based on a shared belief that some banks would just have become ‘too big to fail’. Moreover, the order of the day was to assure markets and investors that socialization nowadays definitely would not mean a return to past ideologies and the socialized banks would be privatized again as soon as possible. Prominent figures within the neoliberal mainstream argued for the necessity of a radical shift by highlighting the events more or less as natural disasters. Alan Greenspan, formerly Chairman of the Federal Reserve of the US until 2006, defended his errors and wrong forecasts by referring to a ‘once in a century credit tsunami’ that had destroyed his paradigmatic views.\(^3\) Gordon Brown, whom many accuse of failing to regulate the financial sector during his time as Chancellor of the Exchequer, blamed the financial sector for excessive and irresponsible behavior (Financial Times 12 October 2008). German politicians, bankers and businessmen as well as those from other continental European countries especially blamed the Anglo-American model of capitalism, ignoring that their own systems played to the same music until the ‘satanic mill’ showed its work also here. Across all countries and driven by huge public pressure demanding that those responsible for the crisis have also to pay, regulation was now on the agenda.

In the stage of continued uncertainty about the overall scope, costs and damages emerging from the 2007-2009 financial crisis blame shifting is an important game, be it for setting the agenda for regulation or for distraction from an actor’s own responsibility in creating the mess or for avoiding ‘over-regulation’.\(^4\)

Since crisis management turned more and more from emergency action to questions about who will have to pay the costs and what regulation is needed to avoid such crises in future, severe concerns have been raised whether we could expect the creators of the crash to contribute seriously to a (more) sustainable future system. Given this very nature of the crisis and the existence of powerful economic interests (an aspect to which I will return below to explain policy outcomes), we have already seen a number of rather disappointing new policies adopted. The OECD approach on tax havens, for example, remains a quite poor policy, simply because the laws of regulatory competition on a global market without global government force countries with tax havens to protect them as long as others exist. The poor re-regulation of rating agencies recently brought them back on the

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4 Recently, TIME Magazine published a list of 25 people who could be blamed for the crisis, ranging from the Clinton to the Bush administrations and from various managers to Greenspan to the American consumer. See: http://www.time.com/time/specials/packages/completelist/0,29569,1877351,00.html.
agenda for tougher regulation. However, I will now turn towards two very specific areas for regulation: derivatives and shadow banks.

**Taming the ‘financial weapons of mass destruction’ or sustaining the unsustainability of financial markets?**

Decoupling finance from the real economy caused quite fundamental changes including significant transformations in risk perception, risk taking, risk management and regulation. The increased attractiveness of investments on financial markets led to more actors involved, an enormous concentration process of capital and a huge number of financial innovations. But financialization also increased systemic risk. Neoliberal globalization and financialization, blamed by critics for increasing economic pressures on states and firms, destabilizing economies and increasing inequality globally, eventually brought about the 2007 ‘heart attack’ (Goodhart 2009: 1) of the international financial system and are to be seen as the origins of the greatest post-war financial and economic crisis. The short and costly lesson from the 2007-2009 financial crisis is that global, liberalized and in core parts unregulated markets create a too high financial instability and unacceptable social costs. Financial risk management demands preventive and precautionary action to a much larger extend than politics was willing and able to achieve until recently. Given the very nature of the current situation characterized by a lack of (tough) regulation in several core areas and of now considered new regulation there is an ongoing debate about ‘firewalls’, regulatory policy reforms to avoid future financial systemic crises and adequate risk management as well as about whether a ‘better safe than sorry’-approach would rather harm economic growth, world trade and overall wealth. How much and what kind of risk is tolerable and necessary for modern capitalism not only to work properly and to allow optimum resource allocation and innovation but to become part of a path towards sustainable development? In terms of risk regulation, especially derivatives and shadow banks such as investment and hedge funds have to be seen as highly contested issues in the current crisis given their roles for investment and growth as well as their complexity and threat potential. Both definitely did not work the way they were designed – or at least, the way their advocates advertised them as excellent growth markets and clever ways to hedge risks – and while derivatives proved to be ‘financial weapons of mass destruction’ (Buffet 2003, Das 2006), shadow banks were and still are among those making high profits with derivatives speculation and increasing systemic risk by playing the leverage game.

Over the past decades the structure of the financial market as well as the products changed fundamentally. Deregulation and liberalization supported concentration processes in the financial sector that led to the emergence of powerful gigantic financial institutions. Yet, a highly sophisticated but also problematic practice of risk management within the financial sector is to be seen as the core problem behind the current crisis. Commercial banks set up associated conduits, structured investment vehicles (SIVs) and hedge funds to increase their leverage and make high profits with new complex financial products that can be combined, unbundled and repackage in many ways. Goodhart (2009: 101) explains this in a very common way as an escape strategy resulting from regulation of the banks traditional business areas. ‘If regulation is effective’, he states, ‘it will constrain the regulated from achieving their preferred, unrestricted, position, often by lowering their profitability and their return on capital. So the returns achievable within the regulated sector are likely to fall relative to those available on substitutes outside. There will be a switch of business from the regulated to the non-regulated sector. In order to protect their own businesses,
those in the regulated sector will seek to open up connected operations in the non-regulated sector, in order to catch the better opportunities there.’ However, it also has to be emphasized that this process was heavily supported by neoliberal policies as new financial institutions and financial innovations need in first instance permission or toleration of regulatory bodies and neoliberal policies played an active role in market creation. Moreover, it was a deep core neoliberal belief that actors in the financial sector would be clever enough to know what they do. In the European Union, the Financial Services Action Plan (FSAP) for example supported the creation and expansion of the securities and derivatives market by reducing national barriers and establishing a European framework which was presented as crucial part of the overall Lisbon strategy trying to increase competitiveness against the US market. Other explanations for the fast growth of shadow banks and financial innovations were an increasing demand from firms to respond to risks from international trade such as unpredictable changes in exchange or interest rates and last but not least the opportunity for high profit they offered (Strange 1998: 30f).

The problems that some of the fastest growing financial innovations of the past decades and the increasing number of so-called shadow banks pose in terms of financial stability have been well known for many years. It was rational behavior in a highly competitive market that drove financial institutions and investors into this dangerous game. Banks had to get involved in these businesses to increase their profits and to satisfy shareholders, even – as we know today – many of them often did not understand these ‘games’. Those who understood the system logic argued that there would be no escape if you want to survive on highly competitive markets. ‘You can’t stop dancing as long as the music still plays’ became the slogan for the herd when it was already time for a parachute for a soft landing. If at all, ‘clever exit strategies’ can only be seen in the greedy behavior to bet against one’s own products. Nowadays, we have testimonials of insiders demonstrating that they were well aware of their Ponzi games and that they just hoped that they would already have retired when everything goes down. Others described the practices earlier as just too electrifying and ‘better than sex’ (Das 2006: 102).

Derivatives such as futures, forwards, options and swaps belong to the up to recently highly celebrated innovative tools of a modern finance system. Their values are derived from an ‘underlying’ value be it an asset such as residential mortgages or commodities for credit derivatives or an index as in the case of inflation or energy derivatives or weather conditions for agricultural products or all kind of open air events. Derivatives can be defined as ‘financial contracts that are designed to create market price exposure to changes in an underlying commodity, asset or event’ (Dodd 2005: 149). They are traded on specialized derivatives exchanges (with EUREX being the most important) or over-the-counter (OTC derivatives), usually by a few dealers. According to their designers, their main function is hedging, which is a risk insurance activity, or speculation and arbitrage. Dodd (ib.: 155) lists a number of public interest concerns, including the lower risk taking and risk shifting expenses, their potential use to outflank prudent regulations and taxation, fraud, market manipulation, and increasing credit, liquidity and systemic risk. The impact of derivatives on speculative bubbles and crashes has been known for some time and they have been condemned by many as tools of gambling (Strange 1998, Altvater, Mahnkopf 1996, Bryan, Rafferty 2007, Bryan, Rafferty 2006, LiPuma, Lee 2004).

Although derivatives have a long history in commerce and trade, their overall trading volume – especially of OTC derivatives – has more or less exploded over the last decades. OTC derivatives
were exempted from regulation. Because these markets completely lack transparency, Roubini and Mihm (2010: 199) polemized that ‘under the table’ would also be a legitimate definition. Before the crisis, ‘the size of derivatives markets’ became ‘enormous and by some measures it exceeds that for bank lending, securities and insurance’ (Dodd 2005: 150). This growth was not only in the overall size of derivatives but even more with regard to product diversity. The huge variety and high complexity of these products made them opaque even for experts (Das 2006, Dodd 2005, Bryan, Rafferty 2007, Acharya 2009, Acharya et al. 2009).

The overall growth of derivatives is an indicator for the decoupling of financial and real accumulation (Altvater 1996: 250) and for the trend of ‘profits without production’ in ‘casino capitalism’ (Strange 1998, Binswanger 1994, Strange 1986). The casino image has always been neglected by mainstream scholars, although it fits quite well for the overall system as well as for actions by greedy traders that were driven by high incentives to speculate for maximum returns and did not have to bear costs of any losses compared to their employers. Traders love all kind of exotic derivatives because of the high fees they can charge thanks to the complete absence of price transparency. Rating agencies also had fantastic incomes from these products.

Various forms of collateralized debt instruments (CDOs) allowed banks to get risky assets off their balance sheets by creating conduits or getting involved with structured investment vehicles (SIVs). These practices seemed to be clever tricks of risk management and ‘creative compliance’ with capital requirements (in Europe with Basel I) and to increase profits with every round of new ‘securitization’. However, ‘the originate-to-distribute’ business model of securitization was only a cover up of lower-quality loans backed by the image of the large banks and the embarrassing support from rating agencies. ‘The increased scale and complexity of the securitised credit market was obvious to individual participants, to regulators and to academic observers. But the predominant assumption was that increased complexity had been matched by the evolution of mathematically sophisticated and effective techniques for measuring and managing the resulting risk’ (FSA 2009: 40). Since 2007 the creators of these innovations found themselves in the situation of Goethe’s sorcerer’s apprentice. Like he needed his master to get delivered of the spirits he called, the financial institutions now needed the state to bail them out. The overall problem now was that banks only thought that they would no longer hold the risk or that they had made the underlying risk disappear successfully. However, you cannot make gold from crap forever. It only worked like a Ponzi game as long as the market grew (the endgame started when the US housing market turned in the first quarter of 2006 signaling the end of the bubble). In this situation a crucial problem became obvious: ‘At the heart of the present approach are estimates of risk and value that use current and past market prices’ (Goodhart 2009: 95). As soon as market prices change dramatically and quickly, the most sophisticated computer tools turned out to be inadequate. The overall result was not just erosion of investor confidence caused by toxic derivatives, but also increased counterparty risk. The latter ‘created a financial system that was not only too big to fail, but too interconnected to fail’ (Roubini, Mihm 2010: 200) and maybe even a system ‘too big to be saved’ (Pozen 2010).

From today’s point of view, the dominant paradigm on derivatives and regulation seems somewhat naïve: ‘The past philosophy of the FSA, shared with market and bank regulators across most of the developed world, has been to assume that wholesale market customers are by definition sophisticated and do not need protection, and that financial markets innovation delivers benefits to customers and the economy. There was moreover until the crisis an overt and authoritatively stated
theory that financial innovation had resulted in a significant reduction in financial stability risks’ (Turner Review 2009: 108). Moreover, it signifies the ignorance against critical voices warning about ‘a frightening scenario’ (e.g. Bryan, Rafferty 2006: 177). Anyway, derivatives came into the focus of regulators, although the precise impact of derivatives as a cause for the crisis remains controversial, the possibility of regulating them uncertain5 and despite strong opposition from industry defending them as essential and highly beneficial for risk management.

So what are the policy responses to the problems associated with derivatives? Challenges for regulation are obviously the huge complexity of these products and their lack of transparency resulting in high counterparty risk, which all together constitute a too high systemic risk. Greenspan (2008: 4) expected that ‘(t)he financial landscape that will greet the end of the crisis will be far different from the one that entered it … Investors, chastened, will be exceptionally cautious. Structured investment vehicles, Alt-A mortgages, and a myriad of other exotic financial instruments are not now, and are unlikely to find willing investors.’ A good part of toxic assets were written off or destroyed with bankruptcies. Analysts estimated in early 2009 that ‘almost half of all the complex credit products ever built out of slices of other securitized bonds have now defaulted […] and the proportion rises to more than two-thirds among deals created at the peak of the cycle’ (Financial Times 10 February 2009). But obviously market mechanisms do not solve the problems and not all problematic and exotic contracts have disappeared; an uncertain degree of derivatives can still default in several years, given the variety of life-times of specific products. During the recent crisis speculation with derivatives linked with high speed trading moreover contributed significantly to the fast return to high profits of big financial institutions. So the core question for regulators remains how – if at all – these financial products can be regulated in a smart way.

Dodd (2005) argued already earlier for ‘three pillars’ for ‘carefully designed prudential regulatory measures’: reporting and registration requirements for OTC derivatives dealers and the use of derivatives to improve the transparency; capital and collateral requirements; and orderly market rules. The most radical view is a complete ban of OTC derivatives, demanded for several years for example by Attac Germany. Now based on the G20 summit declaration from 15 November 2008, the US as well as the EU reacted quickly to fill the regulatory gaps on derivatives, both jurisdictions with a strong focus on overcoming problems in the area of transparency and on credit derivatives (which were behind the collapse and subsequent nationalization of insurer AIG) and introducing a system that will require clearing of OTC derivatives through regulated central counterparties. The core features of future regulation are agreed on the international level, but details in regulatory proposals might cause regulatory competition and significant unintended negative consequences.

In the US it had become clear in autumn 2008 that regulation of derivatives already proposed in states such as New York would only lead to a ‘race to the bottom’ because only a minority of states was seen to be powerful enough to regulate these products. It has eventually been the Obama administration that pushed the idea on the federal level after G20 countries had agreed on harmonization. The US House Agriculture Committee, which also holds responsibilities for securities, passed in February 2009 the Derivatives Markets Transparency and Accountability Act of 2009 (H.R.

5 ‘You can no longer control or regulate this sort of thing. It's taken on a life of its own. You can't put the genie back into the bottle’ (Buffet 2008). Bryan and Rafferty (2006: 177) discuss a number of reasons why regulating derivatives ‘cannot be successful’ and why they are so crucial for modern capitalism. Roubini and Mihm (2010: 203) also conclude: ‘Derivatives are among the trickiest thing to regulate and monitor’.
977) to increase the transparency and strengthen oversight of futures, options and OTC markets.\textsuperscript{6} Treasury Secretary Geithner announced further regulation on 13 May 2009, including amendments to the Commodity Exchange Act and the securities laws.\textsuperscript{7} On 2 December 2009, the House of Representatives passed the Financial Reform Bill, short titled The Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173). This bill includes an ‘Over-the-Counter Derivatives Act’ (Title III), amending the Commodity Exchange Act. Wall Street successfully lobbied against more ambitious reforms by pushing for the ‘end-user exemption from transparency’, which might result in 60 percent of standard contracts being left ‘in the opaque, bilateral over-the-counter markets’ (Bloomberg.com 13 January 2010). The Senate bill would be stronger. Some argue it would be ‘too strong’ (The New York Times 25 May 2010). Most derivative contracts would be traded on a public exchange and cleared through a third party. Especially the provision to force the biggest Wall Street banks to spin off their lucrative derivatives business into a separate subsidiary is controversial and opposed by banks as well as the Obama administration. An amendment to the Senate bill, put forward by Senator Dodd to achieve a compromise, would delay a final decision on this matter for two years and await a study by a council of federal regulators.

Critics have argued that the US approach would ‘allow a set of highly specialized derivatives to trade largely outside government view’ and that ‘this exception might lead traders to create increasingly complex derivatives to avoid regulation’ (Cho, Goldfarb 2009). The bill ‘is still not tough enough to avoid another catastrophe’ and ‘has too many loopholes’, summarized the New York Times (22 April 2010) recently the debates. Big banks currently focus their lobby strategies on the specific design for venues where swaps are traded that would allow them to limit information about pricing to keep prices high for such products. Another focus is to keep them in the business to own swap facilities (the House bill has a 20 percent limit, the Senate bill has none). Uncertain are also whether deals over the telephone will be banned and the possibility of derivatives trading facilities bailouts (Morgenson 2010).

Within the European Union the de Larosière Group under the chairman Jacques de Larosière was established as a group of 8 ‘wise men’ in October 2008. The European Commission’s immediate reaction to the need for addressing problems arising from derivatives was the demand for a voluntary agreement. However, as the European industry failed to come up with one and the G20 summit and Ecofin pushed for regulation, the Commission prepared an amendment to the Capital Requirements Directive (CRD, adopted in 2006). ‘Indeed, the main actors in the credit derivatives market failed to agree on a common position during a series of discussions organized by the Commission in December’ (euractiv.com 5 February 2009). The EU reacted with a new policy, presented in early February 2009, of establishing a central clearing house to monitor credit derivatives and credit-default swaps (CDS) in particular.\textsuperscript{8} There was also the plan that OTC exchange should be replaced by exchange through a third intermediary.\textsuperscript{9} However, the industry remained

\textsuperscript{6} http://agriculture.house.gov/inside/Legislation/111/HR977.pdf.
\textsuperscript{8} CDS ‘first emerged in the mid 1990s and had grown to over $60 trillion of gross nominal value by end 2007’ (Turner Report: 81). CDS then came under sharper attack in 2010 with the Greek crisis.
\textsuperscript{9} The de Larosière report published later in February 2009 included identical proposals on derivatives recommending changes such as the simplification and standardization of OTC derivatives, ‘at least one well-capitalized central clearing house’ for CDS and a ‘guarantee that issuers of securitized products retain on their books a meaningful amount of the issuance’ (The de Larosière Group 2009: 25).
concerned ‘that introducing a model similar to that for exchanges might wipe out the added value of derivatives undermining their very existence’ (euractiv.com 5 February 2009). Moreover, the approach is not unproblematic as the CRD got ‘under attack from many member states on different issues, and its final approval is far from certain. Moreover, the amendment does not imply direct regulation, but puts the ball back in the Commission’s court by asking it to “put forward legislative proposals to regulate credit-default swaps”’ (ib.).

In February 2009, nine of the leading dealer firms in the CDS industry as well as the European Banking Federation (EBF) confirmed in letters to Internal Market Commissioner Charlie McCreevy their support for the central clearing for eligible EU CDS contracts (ISDA Press release 19 February 2009; euractiv.com 20 February 2009). In the meantime, a draft on Recommendations for Central Counterparties (CCPs) clearing OTC derivatives prepared by the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR) went into a consultation process. Further legislation is expected in June-July 2010 emerging from two Commission Communications. The first of these, entitled ‘Ensuring efficient, safe and sound derivatives markets’, was published a year earlier. At the same time, the Commission had launched a consultation on the regulation of derivatives. The second Communication, ‘Ensuring safe and sound derivatives markets: Future policy actions’ was published in October 2009. Further proposals include the creation of a European Systemic Risk board, stricter regulation of credit ratings agencies and regulation of the shadow banking system. The Commission proposals will also be subject to regulatory impact assessments.

Early in the debate a conflict started about the risk of divergence between the EU and US with the US being stricter but putting pressure on others to follow. Officials from both sides frequently emphasized the enormous coordination taking place across jurisdictions. Dealers would have preferred ‘a global one-stop shop solution’ but ‘regulators in both jurisdictions insist on local set ups that can be directly controlled’.10 With regard to CDS the US and parts of the financial sector including the hedge fund industry criticized that the European Commission would plan that market participants would have to use a European-based central counterparty and that this would create unfair competition and discrimination against US firms. Financial industry prefers a system that creates competition among central counterparties and has supported the US approach which allows registration of non-US market participants. The European Commission reacted to this critique with emphasizing a ‘European passport’ that would guarantee similarity to the US approach. More importantly, details of the US bill and the European proposals such as the type of contracts covered by different and wider derivatives’ definitions or the overall scope of clearing are under attack.

Another conflict is between EU member states, with Germany and France taking the lead for stricter regulation. The UK, defending the City of London as one of the world’s three most important financial centers, remains critical against a number of proposals. The UK’s House of Lords European Union Committee recently produced a report on ‘The future regulation of derivatives markets: is the EU on the right track?’ to prepare domestic actors for the decision-making processes on the European level. The outcome of these processes has to be awaited.

However, it is already possible to draw a first conclusion. What we observe is not an entirely radical change compared to the demand for a complete ban of speculative derivatives. As the Turner

Review stated: ‘securitization is here to stay, and can be made safer by appropriate regulation’. The centralized clearinghouse has just to assure that both parties trading credit derivatives internalize to a high extend the risk they impose on others and to increase overall transparency. The FSA estimated that clearing and central counterparty systems would ‘only be feasible for the roughly 50-75% of the CDS’ and ‘a large volume of bespoke contracts will continue to be traded in an OTC fashion’ (Turner Review 2009). The envisaged policy change is nevertheless a fundamental policy change in standard political science terms as it replaces a process formerly left to markets’ self-regulation with regulation for market (re)creation. But it is not necessarily a shift away from neoliberalism. Of course, in a dogmatic interpretation one could argue that neoliberals would prefer the pure market at work; however in more practical terms of the applied real-world neoliberalism increased transparency and ‘safer’ markets make regulation tolerable as long as it does not drive firms out of the whole business, which is assured by benefit cost analysis and regulatory impact assessments, and this is exactly what is provided with regulation underway.

But let us turn to the next problem: those who were strongly involved in trading derivatives. Over the past 20 years and in reaction to deregulation, liberalization and stricter banking regulation a shadow system has emerged that includes broker-dealers, hedge funds, private equity groups, structured investment vehicles and conduits, money market funds and non-bank mortgage lenders. Their overall importance is by far not in line with their overall regulation as this industry defended itself quite successfully against all kinds of demands for regulatory action. Hedge funds and private equity, including offshore financial centers, have been criticized for a number of years. In 1992 speculative attacks by global hedge funds were seen as source for turbulences within the European Monetary System. With their impact on the Asian financial crisis and the demise of the at that time largest hedge fund LTCM in 1998 following the Russian financial crisis or their impact on the world bond markets in 2004 the critique and demands for regulation intensified. In most jurisdictions hedge funds were excluded from regulations governing short selling, derivatives and the like and a huge number of hedge funds are registered under regulations of offshore centers. In the mainstream view they were important financial institutions contributing to growth and wealth. It was not until recently that securities and banking regulators recognized the need for stricter regulation (Athanassiou 2008, Moloney 2006). In Europe countries with a large number of hedge funds, foremost the UK, adopted light regulation over the past years while the European Commission did see ‘no need for a heavy-handed legislative intervention’ at the Union’s level (Commissioner McCreevy, quoted in Moloney 2006: 38). In the US the SEC reacted to several fraud cases with a regulation in 2004 that was then abolished by the federal court. In Germany hedge funds and private equity became popular under the derogative terms grasshoppers or vulture funds which have been used to criticize their excessive expectations of rates of return. As such the involved topics became part of a moderate capitalism critique within the Social Democratic Party and trade unions since about 2004. The core critique within that argument is that anonymous investors destroy firms for short-term profit maximizing interests while neglecting long-term social consequences. As a result, Germany became part of a coalition of EU member states pressing for a European regulation, although with moderate results until the recent crisis. Former Commissioner McCreevy’s view of hedge funds and private equity remained very pronounced and positive: ‘They are a powerful force for greater market efficiency. They are driving innovation and performance improvements right across the asset management business. This success should be cherished. The practices and business models which have underpinned this success should not fall victim to unfounded fears or theoretical
risks.’ … ‘In Europe, we are also continually reviewing the situation. We have a well-developed set of checks and balances in place to address the possible impacts of hedge fund/private equity businesses on the overall financial system. I don’t see any case for complementing them by a set of EU legislation specific to hedge funds’ (Speech EU/NR 16/07, EU Internal Market and Services Commissioner Charlie McCreevy welcomes President’s Working Group Report on Hedge Funds, 23 February 2007).

The shadow banking system contributed to the 2007-09 crisis in a very particular way. As these private institutions ‘moved as a herd, they helped inflate the bubble and worsened the bust’ and as soon as the run on the first shadow banks had started they ‘knocked holes in the balance sheets of the ordinary banks that lend to them’ (New York Times 24 February 2009). The IMF analyzed their impact on the crises in its 2008 and 2009 Global Financial Stability Reports. Paul Krugman also blamed the shadow banking system for a good part of the crisis: ‘Yet the crisis, for the most part, hasn’t involved problems with deregulated institutions that took new risks. Instead, it has involved risks taken by institutions that were never regulated in the first place. And that [...] is the core of what happened. As the shadow banking system expanded to rival or even surpass conventional banking in importance, politicians and government officials should have realized that we were re-creating the kind of financial vulnerability that made the Great Depression possible – and they should have responded by extending regulation and the financial safety net to cover these new institutions. Influential figures should have proclaimed a simple rule: anything that does what a bank does, anything that has to be rescued in crisis the way banks are, should be regulated like a bank’ (Krugman 2008, 163). Other reform proposals are the ECB’s idea of a credit register, demands for increasing the capital requirements or introducing a ceiling on leverage, capital controls etc.

In the European Union member states such as Germany or France pushing already for a couple of years for a strict regulation of hedge funds and private equity now got a vital momentum. At the EU level, the Party of European Socialists (PES) was eventually the driving force behind the idea of addressing the perceived risk posed by private equity and hedge funds. Based on a report by Poul Nyrop Rasmussen, PES president, and a supportive vote by the European Parliament11, the European Commission started to prepare a draft Directive on Alternative Investment Fund Managers (AIFM) which is designed to apply to anybody with a head office or registered office in the EU who manages all sort of funds defined as collective investment undertakings that are not regulated under the current EU legislation for investment funds (Undertakings for Collective Investment in Transferable Securities, UCITS Directive adopted in 1985). Private equity funds, hedge funds, real estate funds, commodity funds, infrastructure funds and other types of institutional fund would become regulated by this directive. According to the Commission’s DG Internal Market, this Directive should come into force in 2011 and the provisions regarding the treatment of third countries in 2014.

The preparation of the draft directive included a structured consultation process on hedge funds between December 2008 and January 2009, a first impact assessment on retail-oriented non-harmonized investment funds, a stakeholder conference on hedge funds and private equity in February and a further impact assessment on alternative investment fund managers in March 2009.

11 European Parliament resolution of 23 September 2008 with recommendations to the Commission on hedge funds and private equity (2007/2238(INI)). Liberal and conservative MEPs also argued against old-fashioned top down regulation and demanded that best practice approaches just adopted recently should get longer time to show positive results.
Now, with the French Michel Barnier becoming Commissioner for Internal Market in November 2009 concerns in industry and especially among politicians and bankers in London grew. The draft directive was approved by the European Parliament’s Economic and Monetary Affairs Committee and in a quite different version by the European Finance Ministers in May 2010. A compromise from the Commission on this controversial topic is expected by June and a first plenary vote in the EP in July 2010.

In 2009 Rasmussen had criticized that the draft Directive would be ‘full of loopholes’. Instead of covering the funds themselves, the draft only covers the managers (following the UK regulation) and would therefore allow ‘off-shore funds to market their products without effective registration or regulation’. Moreover, registration would not be more than a ‘formality and does not include effective transparency on leverage, fees or investors’. By regulating only funds larger than € 250 million, the threshold would be ‘much too high, and allowing many funds to remain outside the directive’. In total, the Commission had prepared ‘a weak draft directive covering only fund managers’ which would only be ‘inadequate regulation’.12

The problem of only regulating the larger shadow banks might moreover result in another problem: ‘focusing on only the biggest shadow banks — on the theory that they are the systemically important ones — won’t necessarily work, either. To circumvent regulation, giant hedge funds could just split themselves into smaller units. Given the herding mentality, lots of little shadow banks can cause havoc as easily as a few big ones’ (Dixon, Beales 2009). Already in the past, hedge funds showed enormous creativity and flexibility in adjusting to new circumstances. Moreover, as The Economist (December 19th 2009, p. 127) concluded: ‘Hedge funds, always the most mobile of firms, are likely to be in the vanguard of any exodus.’ This simple fact is a powerful argument against a too ambitious approach. However, for representatives and lobbyists of the financial sector the draft is already too ambitious and should be rewritten. The Alternative Investment Management Association (AIMA), representing 1,200 hedge fund firms worldwide, fears that the draft directive would be ‘open to ambiguous interpretation’ and implementation would ‘be unworkable’ (euractiv.com 25 May 2009; AIMA press releases 29 April and 26 May 2009). Dick Saunders, CEO of the Investment Management Association (IMA), blamed in an article in the Financial Times (31 May 2009) ‘some continental European politicians’ for the bad draft. ‘The Commission drafted the directive under political duress’, he complained, ‘that is no way to approach financial regulation. There has been no consultation, no due process and no cost-benefit assessment. But that is not the Commission’s fault.’ If the draft directive would have remained like a draft some weeks earlier, which was ‘no more than current practice in the UK’, the ‘directive would have been unequivocal good news for the industry.’ The UK had tried to pioneer the reforms in order to create new realities. In total these were quite typical industry argument in EU law-making processes, raising concerns about bureaucratic consequences, too high costs, loss of jobs during economic crisis and the like. Commissioner McCreevy, who had been criticized repeatedly throughout the process for business-friendly behavior and for delaying regulation, had earlier welcomed the new policy as ‘right balance’ indicated by the fact that ‘both sides of the argument are unhappy’ (Speech/09/242; 13/05/2009). Yet hedge funds and private equity funds increased pressure, counting especially on the UK government in the Council. In the UK some of the biggest hedge funds polemicized against the ‘French plot against

London’ and have, concerned about rules limiting borrowing, warned the Treasury that they would leave the country if the EU directive will not be changed radically. FSA and Treasury representatives assured industry their support in the ‘fight for changes’. In their view ‘the definition of borrowing was so “obviously ridiculous” it has to be rewritten’ (Financial Times 3 June 2009).

The versions of the directive discussed in May 2010 in the EP Economic Affairs Committee and ECOFIN remained controversial with regard to several aspects. While the EP supported the idea of an EU passport, making market access for non-European managers easy, several member states, especially France, remained concerned about a simple EU-wide access. In the EP the Liberals and Tories criticized the legislative proposal as extremely protectionist, making it too difficult for EU investors to invest in non-EU funds. The US remained concerned about third country access to the European market. Now the industry reported first cases considering or already planning to leave the UK and settle in Switzerland. Over the past decades such serious threats from industry would have without any doubt succeeded at the EU level. But now, the UK has lost its strong Commissioner support and is much more isolated within the EU, especially since the Tories gave up their influence on the European Conservatives (EPP). However, there are also pressures from other countries and even in Germany and France financial industry has an interest in keeping their hedge funds and derivatives businesses flourishing.

Although there are still uncertainties about the final frameworks for derivatives and shadow banks, it is already clear that the policy change underway is of limited scope. I will now turn to theoretical explanations and then to question how a more radical approach would look and become feasible.

**Explaining the Poor Outputs: Structural Power, Regulatory Capture, Regulatory Competition and Policy-making**

Research on business power over politics as well as on the superiority of financial capital over productive capital has a long tradition (cf. Hilferding 1968 [1910]). Lindblom (1977) argued that industry has a dominant position in market economies deriving from structural power, the dependency of governmental actors on knowledge from business actors for effective policy-making and implementation and superior resource mobilization capability. Especially, materialist state theory has been focusing on limitations of state interventions caused by the necessity to assure capital accumulation and on different interests among industry, specific sectors and branches based on various structural contradictions and strategic dilemmas inherent in the capital relation and what Jessop (2002) calls their changing structural articulation and forms of appearance in different accumulation regimes and their modes of regulation. Distinctive modes of regulation, governance and accumulation regimes are necessarily results of competition. They are possible because the state must retain some autonomy from the various fractions of capital to serve its function. As a result, there is generally always a space for strategic choices.

David Vogel (1989) showed that business power fluctuates over time. Business does not always get what it demands as already Lindblom argued. In total, the structural power arguments help understanding the rise of the finance-led accumulation regime as well as shedding more light on possible outcomes of current regulatory reforms. Within the globalisation debate one of the core arguments is that business power has increased maybe even dramatically and as a consequence the (nation) state got under threat. Studies showing the decreasing power of the nation state have been present for quite a long time. Charles P. Kindleberger (1969: 297) made an early claim that the
'nation state’ was ‘just about through as an economic unit’ because the transnational corporations that had emerged knew no loyalty to any country. Transnational corporations have also been a driving force behind liberalization and deregulation of financial markets. The observation that business power – and foremost the financial sector’s – has significantly increased became a broad issue within the ‘Globalization debate’ since the 1990s and lies within the centre of the financialization concept. ‘The globalization of financial markets’, so George Soros (2008: 95), ‘puts financial capital into a privileged position. Governments often have to pay more heed to the requirements of international capital than to the aspirations of their own people. That is why the globalization of financial markets served the objectives of the market fundamentalists so well.’ Financialization is therefore seen as a key driver in the ‘erosion of democracy’, or more specifically, ‘it is the structural dominance of international finance that undermines social democracy’ (Perret 2007: 70)

Many ‘left’ critics of this development have called for regaining the ‘primacy of politics over markets’, assuming that politics would have ever had such a primacy. However, what is criticised mostly is the domination of financial capital, of shareholder value, the effects of decoupled growth processes between new financial instruments such as derivates and production caused by increased speculation. Business power, the impact of business men and women and especially (but not only) big firms became again seen much more controversial. With recent cases of firms and banks ‘too big to fail’ and capital concentration as one of the results of the current crisis the question about structural power and business influence becomes even more important.

Another explanation for regulatory gaps and failures is regulatory capture. ‘Capture is’, as Makkai and Braithwaite (1998 [1995]: 173) state, ‘an influential concept in debates about why regulatory agencies persistently fail to enforce the law against business offenders.’ They list ‘three empirically distinct forms of capture: identification with the industry, sympathy with the particular problems that regulated firms confront in meeting standards, and absence of toughness’ (ib.). In short, regulatory capture means that regulators act not just once but systematically in the interest of the regulated industry and not in the public interest. If this was the case for the financial sector remains, of course, controversial. For critics of financialization the answer has been clear. In opposite, mainstream scholars and regulators argued until the recent crisis that any losses were outweighed by much higher gains from modern deregulated financial markets. Yet, we see a significant shift to a certain extent, especially in the US where the financial sector is sharply attacked in public hearings and threatened by demands like splitting up the too big to fail institutions. But several policies, such as the bailouts, are well interpreted by capture theory. Moreover, Wall Street firms are still the most important donors for the political parties.

A third theoretical approach, relevant for explanations and evaluations of the overall scope of reforms, is regulatory competition. Many solutions would require international harmonization. This is also frequently emphasized for derivatives and shadow banks and explains the slow and moderate progress. Even if the underlying business practices are not in the public interest and the long-term costs are intolerable, lawmakers fear that firms just move to another jurisdiction and the overall problems remain unsolved while they lose competitive advantages. They also fear that they could lose out significant tax incomes if they ban these highly lucrative businesses.
As a result, the outputs and outcome of recent regulatory reforms are quite mixed. While states had to bail out banks to assure system stability, the very same banks have their offshore accounts still untouched and unquestioned and redevelop a highly risky market in attempts to sustain the unsustainability of finance. Moreover, states are forced to adopt austerity measures to reduce the huge debts created from the bailouts and unsustainable fiscal policies. Mergers and acquisitions have happened which would in a normal situation cause serious concerns about competition law and policy implications. While profits continue to be privatized, losses get socialized and this is exactly what makes people angry and might give support to a more radical approach.

‘Better Safe than Sorry’? – How much Precaution and Prevention and What would it need to shift away from finance-dominated growth

Given the overall scope of the frustration with existing regulatory frameworks and the economic consequences of the crisis many hope that there might be a unique chance for more radical demands and to push through policies that would definitely be a clear shift from neoliberalism and towards sustainability. Here we come back to demands for overcoming finance-led growth and for a Green New Deal.

In the UK the Green New Deal Group calls for ‘Breaking up the discredited financial institutions that have needed so much public money to prop them up in the latest credit crunch. We are calling for the forced demerger of large banking and finance groups. Retail banking should be split from both corporate finance (merchant banking) and from securities dealing. The demerged units should then be split into smaller banks. Mega banks make mega mistakes that affect us all. Instead of institutions that are ‘too big to fail’, we need institutions that are small enough to fail without creating problems for depositors and the wider public.’ Capital controls should be re-introduced and only derivatives approved by official inspection ‘should be permitted to be traded. [...] Ultimately our aim is an orderly downsizing of the financial sector in relation to the rest of the economy’ (The Green New Deal Group 2008: 4).

The idea that derivatives need a stricter approach is also supported by George Soros who recently demanded that regulators will have to refuse the allowance to create derivatives and synthetic securities for which ‘they cannot fully evaluate the systemic risks’. More precisely: ‘Tailor-made derivatives would have to be registered individually, with regulators obliged to understand the risks involved. Registration is laborious and time-consuming, and would discourage the use of over-the-counter derivatives.’

Roubini and Mihm (2010: 203) called rather optimistically for a ‘new generation of derivatives’, which ‘should be the subject of fare more systematic and ruthless scrutiny by regulators. Put differently, this is not a situation where regulators need to fear that cracking down on these instruments will somehow imperil economic growth. Far from it: their continued existence poses a far greater danger to global economic stability, and the sooner legislators, policy makers, and regulators understand that, the better.’

All these proposals are very much a precautionary approach in financial risk regulation. For highly uncertain and potentially catastrophic risks the precautionary principle has become a powerful, also highly controversial idea. The principle demands that in areas where there are threats of serious or

13 [http://www.project-syndicate.org/commentary/soros58/English](http://www.project-syndicate.org/commentary/soros58/English)
irreversible damage, precautionary action should be taken even if there is scientific uncertainty. In some more radical interpretations the principle moreover demands the proponents of an activity to provide sufficient information that their activities pose no intolerable risk. In current debates there is a focus on systemic risks, which rarely ever tackles questions such as how to shift away from pure and excessive speculation, why should we need any exotic derivatives for pure speculative purposes or hedge funds and how the underlying investment needs can be met differently. If, for example, financial innovations would be seen simply as products that have to get market access via registration and authorization an approach such as in the new European regulatory framework for chemicals could be used which is based on the idea ‘no data – no market’. However, the fine-tuning would need to be much more radical. The result would then be a less complicated and simpler system that reduces possibilities for pure speculative purposes with negative impacts more and more to a minimum. Growth has to become sustainable otherwise it has no future. Of course such a radical policy change has currently still much weaker supporters. New Deal ideas supported by governments in the US or in Europe are yet not used to transform the economic system systematically away from a finance-led accumulation regime but only an add-on to increasing energy security. Moreover, risk ‘averse’, precautionary strategies are discredited as being anti-modern. A ‘Better safe than sorry’ approach as emerged in the environment discourse and pushed foremost by green NGOs is a big threat to capital interests in many ways. However, the core question is not about specific technical details, for example about shadow banks or derivatives, but about what kind and what dynamic of innovations are possible and desirable in the light of the necessity to shift away from unsustainable growth and a finance-led accumulation regime is obviously not of that kind.

A core idea for such a change was expressed by Aglietta and Rebérioux (2005: 247) who argued in favor of a model of economic democracies and of policies supporting shareholders ‘whose interest lies in promoting performance criteria that hold to democratic principles of governance. These shareholders should become preponderant in the allocation of capital.’ Strengthening long-term interests in investments has also been a main issue for some time in concepts of sustainable investment, again with limited results and only creating niche markets. Yet, this might be the crucial point for a real change towards a New Green Deal that has been propagated in reaction to the recent crisis and which found in parts support by political leaders, including US president Obama. The tricky element would somehow be how to get systematically rid of all the speculative, risky and at the end of the day only costly financial innovations and aggressive profit-maximizing funds. Given the size and complexity of the market, strong regulatory bodies would definitely be required.

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14 A similar demand calling for ‘dematerialization’ to reduce the overall system risk has been raised unsuccessfully in chemicals regulation and in resource policy since the 1990s.


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