‘Lead Us Not into Temptation’: the Formulation of the Present Orthodoxy and the Deficiencies of Regulation

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Title
‘Lead Us Not into Temptation’: the Formulation of the Present Orthodoxy and the Deficiencies of Regulation

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ABSTRACT
This note sets out some tentative thoughts concerning regulation, based on my own experience and that of a few others who worked in the City of London during the transition from the ‘Old City’ to the ‘New City’.² It was originally written as a background paper to discussions in the Harvard/LSE Workshop 2009 on ‘Risk Management: Islamic Economic and Islamic-Ethico Legal Perspectives on the Current Financial Crisis’.

¹ The rights of Nicholas Foster to be identified as the author of this work have been asserted in accordance with s 77 and s 78 of the Copyright, Designs and Patents Act 1988. This paper is a slightly modified version of the paper prepared for, but eventually not submitted to, the Harvard/LSE Workshop 2009.
# Table of Contents

<table>
<thead>
<tr>
<th>I.</th>
<th>THE (WRONG?) PATH OUT OF CHAOS</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>II.</td>
<td>THE OLD ORDER, MARGARET THATCHER AND RONALD REAGAN</td>
<td>3</td>
</tr>
<tr>
<td>III.</td>
<td>REGULATION</td>
<td>3</td>
</tr>
<tr>
<td>REFERENCES</td>
<td></td>
<td>7</td>
</tr>
</tbody>
</table>
I. THE (WRONG?) PATH OUT OF CHAOS

In the initial stages of a new crisis, chaos reigns. Out of that chaos comes consensus, on the main issues of the crisis, its origins, and its solution. The consensus becomes an orthodoxy, the orthodoxy becomes history. All too often, though, that consensus is defective. The result is that the solution is also defective.

There is some evidence that a consensus is already forming on the present crisis. In the media and beyond, we hear little but blame of ‘greedy’ bankers and, surprisingly late in the development of the consensus, some criticism of governments and other authoritative state institutions, such as the central banks. (The relative paucity of criticism of state institutions is curious, particularly in the UK, the Prime Minister of which, as Chancellor of the Exchequer, presided over the system for ten years.) The occasional plea, such as that made by the Archbishop of Canterbury in December last year, for a consideration of more general and more fundamental causes, such as the state of our moral values, is rare. And, of course, his comments were immediately brushed aside by the Prime Minister.3

Some commentators go back further in time (perhaps to avoid criticising a Labour government?) and attribute responsibility to Margaret Thatcher for ‘deregulating’.

To someone who lived through the changes of the early Thatcher years and their effects in the City of London, this distribution of blame, even if corrected to ensure that the politicians and other policy makers take their fair share, is curious. Moreover, it may be harmful if, taken in combination with a lack of appreciation of some fundamentals of regulation, it leads us into the false conclusion that we need more behavioural regulation. For blame results in all too often to the desire to control behaviour via rules. But such control does not work.

Before considering this issue in more detail, consider some historical background.

II THE OLD ORDER, MARGARET THATCHER AND RONALD REAGAN

As is well-known, back in the 1970s United Kingdom the old order still dominated. Based on conservativism in both its political and more general sense, socially the system was founded on privilege and tradition.

This old order was very much in evidence in finance and in the professions generally. They were characterised by caution, separation of functions and small players. Institutional and transactional systems were quite simple and, given the small size of the players, fairly easily controlled by management, such as it was. The dominant group was the ‘Old Boy Network’, a small closed community of people from the British ruling classes. These men (women were entirely unknown until the very end of the period, and even then were very few in number and had almost no influence) had shared attitudes, knew each other, had often been to school together. The behaviour of the Old Boys was based on trust, and when the need arose largely controlled by social norms, with hardly any formal regulation. ‘Verbum pactum meum’ (my word is my bond) may well have been to some extent an old-fashioned marketing tool, but it contained a significant element of truth. Clients were, usually, also Old Boys. Business was based on relationships; when I first joined a city firm in 1983, that firm

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had a very stable client base, which changed extremely slowly, and the idea of a law firm bidding for work was unheard of. Problems such as difficulties of risk management were either dealt with by means of simple prudential principles, such as ‘Never lend against security’ (in other words, when you enter into a financial transaction, do so for good commercial reasons, do not do so because you consider you can get your money back), lending to those able to repay, and so forth. The opportunities for profits were relatively modest and, although there were crises and mistakes, the risks were relatively modest as well. Generally safe, if rather dull.

For many decades, the only alternative model seemed to be that of socialism, relying on cooperative and egalitarian ideas, but with a high degree of control and totalitarian, oppressive regimes.

Margaret Thatcher and Ronald Reagan, of course, changed all that. Inspired largely by the thoughts of authors such as Friedrich Hayek, they rejected both models.‘Freedom’ in a right-wing sense, freedom of opportunity, meritocracy, admiration for innovation, a ‘practical’, technocratic approach to education, a reliance on property rights and their popularisation (a property-owning democracy) and reliance on market forces. And for Thatcher, the US model (in a ‘grass is always greener on the other side’ version distorted by a failure to understand fully all the facets of that system and its locally situated causes and dynamics) was the road to this new heaven. The goal, and what came to be for many, was material advancement, which was to be available for anyone prepared to work hard enough to achieve it. (It must be stressed here that the ‘greed is good’ idea would probably have horrified Thatcher.)

In this view of the world, it seemed that competition was the natural order of things, the impetus for all progress, and the universal panacea, the answer to all our woes. The old order was aristocratic, exclusionary, static and fuddy-duddy. Cooperation and control were socialist and therefore anathema. Also implicit was the idea that principles of professionalism and service were, at least partially, excuses for restrictive practices, and had to be modified in the name of a more ‘commercial’ attitude. Hence the present system of free competition in free markets, in which it was envisaged that everyone would have the chance of becoming rich by hard work and ingenuity, which was at a premium, because it could solve any problem. The job of legal and accounting professionals was to provide a commercially oriented service to their clients.

The outcome was a new environment. The Old Boy Network disappeared or had its importance greatly reduced in many areas. In the 1986 ‘Big Bang’, the London Stock Exchange saw the old small firms replaced by large institutions, which quickly came to dominate the market. Most such institutions were foreign and staffed by a disparate group of people who did not know or trust each other. Relationships were replaced by transactions. Trust and social control of behaviour were replaced by formal regulation of transactions – lots and lots of it, such as the Financial Services Act 1986 and the numerous volumes it spawned.

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4 Notably *The Road to Serfdom*, *The Constitution of Liberty* and *Law, Legislation and Liberty*.

5 Stone, O (director), *Wall Street*, 1987. The full quotation is: ‘greed, for want of a better word, is good’. The phrase was inspired by a speech by Ivan Boesky’s commencement address at the UC Berkeley's School of Business Administration on 18 May 1986.
Structural divides, such as the division between brokers and jobbers in the Stock Exchange, were abolished. The new players traded on their own account as principal as well as agent for others. Other financial roles, formerly clearly separated, were blurred as a result with, for example, brokers and corporate financiers in the same firm, leading to clear conflicts of interest, with corporate financiers, who wished to see their issuing client’s stock placed for the sake of the financiers’ commission, putting illegitimate pressure on brokers to place that stock regardless of its value to the investor clients of the broking arm. The ‘Chinese Walls’ which were supposed to stop such practices, relying on the respect of the rules by those involved, often did not work. In the US, we saw the repeal of the Glass-Steagall Act.

Complexity increased vastly, because problems could be solved by ingenuity: for example, the emergence of swaps and other such instruments, the extension of commodity futures to financial futures and the invention of a new term, ‘derivatives’ to cover a plethora of new contractual financial instruments, exploded.

People came into areas they knew little or nothing about, and tried to substitute decades, sometimes generations of institutional expertise by formal training. Commodity futures, for example, was for centuries the preserve of small groups of people with self-perpetuating dynamics and institutional knowledge and experience of the field. The new derivates were traded by personnel of the large institutions with no such knowledge or experience.

It has been rightly pointed out that one of the problems is that financial institutions do not just hedge for themselves and their clients, in other words use derivatives to transfer risk, but trade on their own account, in other words take that risk on. Just as germane, perhaps, are the differences between the present environment and that of the Old City. In the old system, ‘Commodity Futures’ related to commodities which had a practical use and therefore in nearly all circumstances would have some value. The futures contracts were largely traded on exchanges with a clearing house system by, on the one hand, users of the commodities who wished to divest themselves of the risk of price fluctuation and, on the other, speculators who were prepared to take on that risk. And nearly everyone involved was well aware of the way in which the system worked and its dangers. In the new system, the underlying asset had only a metaphysical existence and the risk of its being worth nothing was more significant.

The transformation from Old City to New City, from Old Boy Network to International Anonymity, can be compared to giving alcohol away for free, while at the same time passing laws to control its abuse. The problem is that such attempts to control behaviour in an environment in which temptation is rife are doomed to failure.

III. REGULATION

Regulation, or the lack of it, is always mentioned, whether in the context of the problems of proposed solution. This concept is used by many people, particularly journalists and politicians, without adequate consideration of its definition, underlying principles or difficulties.

Pointless if it is not enforced; problems of capture by the regulated (Enron); groupthink; and political pressure/lobbying (often via related parties, duality of function).
A broad distinction might be made between *systemic* regulation and *behavioural* regulation. The distinction and the terminology are both crude, but may be of some use. Put baldly and, once again, crudely, systemic regulation can be effective; behavioural regulation, particularly if it is enacted in a poorly conceived systemic environment, has severe limitations. Indeed, it may create more problems than it solves.

Contrary to much of what has been written recently about the lack of regulation, we have, in the past few decades, created a plethora of regulation, a veritable paradise for regulators, and groups of people, such as regulators themselves, specialist lawyers and academics, with vested interests in regulation. There is no evidence that any of it works. The more ‘sophisticated’, ie complicated, you make the regulatory regime, the more difficult it is to understand for the regulated and the regulators, so the more difficult it is to make workable and enforce. It creates more and more expense for the operations of the honest and principled participants, with the cost being transmitted to their clients. It does not induce more honest or more principled behaviour.

We need to distinguish here between two types of regulation. The first, the type just described, is behavioural regulation. The second is systemic regulation, of which more in a moment. The fundamental problem with behavioural regulation is that it assigns far too much effectiveness to the law, relying on what one might call the ‘magic wand’ effect. Pass a law and it will be effective. We know, though, that this is not how the law actually works. Behavioural regulation has a role, but it is mainly one of backing up social norms, serving as a line of last resort. For example, most of us do not refrain from killing each other because murder is a crime, but because our upbringing and other social controls prevent us. Attempts to solve the problem by more regulation in fact exacerbate it, as the legal regime becomes ever more unwieldy, remote and incomprehensible to regulated and regulators alike, and presents more opportunities for deception and manipulation by the truly fraudulent. The main effect of a highly complex regulatory system is to increase expense to the end-user.

Essentially, behavioural regulation is premised on the assumption that humans can be reprogrammed by law. This is not true.

Nor will an appeal to morality work either; an alcohol abuser will not be prevented from drinking by telling her that it is wrong.

Systemic regulation, on the other hand, has more chance of success. Systemic regulation could be designed to remove the alcohol, or at any rate make it available only to those who are less likely to abuse it. Examples include conservative asset ratios and the separation of functions.
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