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"Underpinning systemic stability – the case for standards"

an article by

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Underpinning systemic stability - the case for standards

Measures designed to make the financial system safer may not achieve their aim as they lack the necessary engagement with the industry. There is a better way, Sir Andrew Large and Sir David Walker argue.

The response to the crisis has been inevitable, multifaceted and massive. We are now seeing a tsunami of official planned interventions designed to change the behaviour of bankers and other market participants. They can be grouped into three policy areas: first, innovations in macroprudential or systemic policy designed to limit leverage and reduce credit bubbles; second microprudential measures such as new capital and liquidity rules (commonly known as Basel III), guidelines on remuneration, improved governance, and controls on credit rating agencies, hedge funds and other institutions as the perimeter of regulation is extended; and third, new approaches to resolution whether in relation to orderly run down, like living wills, or clearing up the mess with improved insolvency rules, listing requirements and the like.

However, little serious thought been given to the most effective means to ensure desirable changes actually happen. Here there is a major gap in thinking. In this article, we argue that there is too much focus on rules as the only way of delivering results. Other methods might in some cases be better able to deliver the intended changes in behaviour.

Coercion misses the need to secure both the willingness of those on whom the rules bear, and the extent to which individual responsibility could and should be relied upon to provide a better outcome. So how can we secure buy-in for the behaviour needed, and can we find a broader set of incentives to get market participants to comply or at least to give a clear explanation of their reasons not to conform? Will behaviour be improved more effectively if restraints are self imposed? Or is coercion indeed the only way? The matter is made more complex

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in the area of systemic risk where required behaviour may have to be constrained beyond what is normally legitimate, given the danger of rational and acceptable behaviour at the level of the individual beyond a certain level becoming negative for society as a whole. All the more reason to engage the industry.

Rules vs standards

At one level this is often looked at as an argument about rules versus standards. It need not be so. There is a place for both. But hard thinking is needed to first of all, determine where standards are more likely to deliver the desired outcome and, second, to introduce a plan to do something about it. Standards need not, and should not, be some sort of voluntary cop out. On the contrary, whilst they may be market based, and indeed require industry input, standards can be tough and capable of statutory backing. They can complement statute, and be part of the overall process of public policy to satisfy societal demands. Indeed, governments themselves implicitly recognise that there is a place for market-based solutions. In Britain, we see this in terms of reliance on conformity with or enforcement of governance codes which whilst based on market best practice, are in practice statutory in the sense that for example companies quoted on the London Stock Exchange must comply with the listing rules which are enforced by the listing authority, the Financial Services Authority, and one aspect of the listing rules is that you must conform with the Combined Code on Corporate Governance. And globally we see it in terms of actions in, for example, the remuneration space, where the Financial Stability Board (FSB) and G20 are grappling with how best to ensure a dependably better alignment of incentives: knowing that trying to achieve this by rules alone will simply not make it happen. There has to be a mixture of incentives ranging from moral suasion, shame and shareholder pressures to get the effects you need. No chief executive who has recently forgone a bonus has done so in response to a rule!

Rules of course have a place in any system of regulation requiring specific behaviours or prohibiting others. For example, they are needed in areas where requirements are clear, actions binary, and sanctions easy to apply. Equally an example from the crisis arises in the area of data availability for systemic supervisors: clearly they need to have full access to relevant and timely data in order to enable them to make assessments as to how to mitigate threats to financial instability. Rules requiring certain types of institution, such as hedge funds, to supply such information on request are also clearly of value. And more generally rules are needed when you need to ensure that specific kinds of disclosure are comparable among institutions, say on levels of remuneration to higher-paid staff. Equally rules are needed in areas of sales practice like the full disclosure of costs and commissions in sales of life policies, or in areas of market integrity.

Shortcomings of rules

But equally rules impose a cost and people sometimes overlook that it is the fiduciary duty of trustees and fund managers acting as agents for their shareholder clients to avoid or minimise such costs. So in areas where there are ambiguities and definitional gaps, these may well be exploited and the rules circumvented. Clearly this compromises the intent behind the rules. To ensure legal certainty and close loopholes the rules need to become ever longer and more detailed. In other words there is a ratchet effect at work: rule books tend to become ever more complex and costly, but often have diminishing effectiveness.

So if rules are foisted onto unwilling parties who may at best try to find ways round them and at worst question their legitimacy, people will seek to redefine activities or engage in regulatory arbitrage so as to avoid the impact of the rules. You cannot simply assume people will conform to the spirit of rules. Indeed reliance by public authorities on rules in areas where rules don't easily work frequently results in failure to get any change. In the run-up to the crisis rules encouraged people to find ways round them. Why were special purpose vehicles created to get around the capital adequacy constraints imposed by Basel II? All too clearly it was because this was a legitimate way of avoiding otherwise costly capital constraints. But that it happened led to a less secure situation ex-post than existed before. Rules were not merely ineffective but counter-productive. Lehman Brothers' use of loopholes in accounting rules and its disastrous consequences was another case in point.

Standards: an alternative approach

If multiplication of rules often leads to sclerosis for the business, or an increased determination to find ways round the rules altogether, is there an alternative?

Standards, if properly interpreted, do provide such an alternative. But our use of the term should be distinguished from others.

The word "standards" is often used by regulators at present, but often in practice as little more than a stepping stone to a set of rules. In this area the words get in the way. But we are driving at more than some dry terminology. We need to create sets of normative statements that lay down best practice, relevant to the nature of the business being performed, which are likely to produce the changes in behaviour that society wants. And which articulate for the business covered well accepted principles of fairness, integrity and other ethical criteria. If these principles can be set down as a matter of law so that the behavioural determinants are hardwired, as they are with the principles of the Financial Services Authority, then so much the better. For want of a better word we will refer to these statements as standards. You can think of them as being principles of behaviour but at a more granular level, being based on the practices and business realities relevant to the area of activity in which an organisation operates. Rules are often much too dry and legalistic to be of any use at all in that sense: but best practice standards can actually work.

Good examples exist of standards of this sort which are working already in practice. The standards for managers of hedge funds under the Hedge Fund Standards Board; and standards for private equity houses under the British Private Equity & Venture Capital Association, are cases in point.

Overcoming a sense of suspicion

What is important is that these standards should be set at a level where conformity with them is observable, whether to supervisors or customers. Otherwise, standards indeed have to stand scrutiny and be accorded credibility. And particularly at a time of post crisis trauma and lack of engagement between industry and the public authorities, we have to overcome a sense of suspicion among officials, and perhaps also the public, that industry-created standards are the creature of commercial interests. Standards may not be politically correct at a time when the industry, and those working within it, are perceived by the public to have caused the mess. But their role must not be neglected.

The blame game that ensues is unhealthy just as it demonstrates a lamentable failure of proper engagement between the industry and those engaged in creating public policy as to how behavioural norms should be shaped. To parody a little, rulemaking can be thought of as the State saying what it wants, with little serious consideration of the realities of the industry: standard setting on the other hand cannot be handled without engagement of both sides. And the proposition is that if they are engaged you have more likelihood of getting the changes of behaviours, or outputs that you want. It is clear that improvements and changes in behaviour are badly needed to create a safer environment, but that you need buy in from those on whom they bear.

When are standards better?

You cannot rely on rules where what constitutes required behaviour is a matter of judgement. Issues such as governance, transparency and risk management or how to align incentives not just of employees and shareholders, but also of the interests of society generally, require often difficult judgements for which standards are needed. Both sides, industry and the authorities, have to be involved in drawing them up and endorsing them; both sides crucially must have an interest in seeing that they are conformed to.

As far as the process of creating standards is concerned, the best outcome arises when standards are drawn up as a deliberate exercise by groups inspired by industry best practice, with the encouragement and backing of statutory authorities. They need to include the inputs of both sides. And once drawn up, to retain legitimacy, standards have to be kept up to date. Mechanisms to achieve this require the continuous interplay between industry stakeholders and the public sector. Certainly, at a time when business generally is probably the most powerful unelected force in society it behoves business to adhere to clearly understood norms of behaviour - this is obvious in areas such as health and safety, emissions, planning, and payment of taxes, as well as financial services. But alongside these obligations business also needs to acquire and maintain a wider implicit social legitimacy. This cannot be achieved merely through anodyne conformity with rules themselves.

Dynamics of interplay: the systemic issue

In terms of dynamics the initiative may start on the private side: "How should we behave to conform to public policy behavioural needs? What is the likely supervisory response in terms of devising detailed prescriptive rules if we don't?"

But the likelihood is that in the face of systemic concerns, the state itself will need to assert the changes felt necessary. The industry will after all need to alter behaviour beyond what it may perceive to be in its best, or its shareholders best, interests to avoid over-leverage, a collapse in confidence and adverse behaviours in a crisis. The state arguably has a responsibility to define just how safe it wants the system to be, and what systemic risks - and costs - society should be prepared to bear. Clearly there needs to be a debate about that. In other words where there are systemic concerns the state has a duty to require organisations to act in ways which they might not choose to. This is a fact of life in any system of leveraged finance. It helps if the official sector openly expresses what behaviour it wants as the standards are drawn up. In effect this is what is happening in the area of remuneration right now. And progress is urgently needed in relation to accounting standards. Such progress would be best achieved through a process such as we have described.

Conformity and enforcement

Conformity, or enforcement, is clearly vital. So are the drivers which encourage people to do so. For many in the industry the thought that your customers might desert you or that your peers will ostracise you if you fail to conform to an agreed standard is every bit as powerful as the thought that you might get sanctioned for breaking some rule. And if in addition you would face the wrath of the supervisory community for not conforming to the standard, the collective pressure is such that you have a good chance that the behavioural change will in fact take place. The general principle needs to be that to achieve buy in and conformity you need standards to be accorded legitimacy with both a big and a small 'l'.

First, in the small 'l' area there should be a combination of peer and stakeholder group pressures. Sadly it is unfashionable to suppose that peer group pressure can play any credible role today. It is a bit like self regulation which suffers from the suggestion of rabbits tending the lettuces. We can only cite our own experience that, whilst clearly you need more than peer group pressure to obtain conformity, it can in practice be quite powerful. Why did the chief executives of the UK banks give up their bonuses one after the other when there was no law to say that they had to? Those who make great efforts to conform to standards which may in practice be quite demanding - indeed painful - will put pressure either directly or through forms of whistle blowing on competitors who may try to cheat.

Still in the small 'l' area, there are the customers and other stakeholders such as suppliers, shareholders and the media, all of which have their own methods of applying influence. They can refuse to buy. They can refuse to supply. They can remonstrate with authority. They can sell the company's shares or go short. This aspect of discipline is central to the adoption of required behaviours. Well devised standards should have these stakeholders in mind.

Second, there is the threat of official sanction. This is where the big 'L' comes in. In terms of behaviours which are required for systemic reasons this is a necessary condition. The state after all is asserting the need for behaviours which go beyond those felt to be necessary by other stakeholders including shareholders. But there are other areas such as corporate governance, customer protection and market integrity where public interest demands higher quality behaviour. The techniques to encourage conformity with standards include "cold shoulder techniques" and in the UK the concept of 'confirming' the status of standards. This means that conformity with them is taken into account by supervisors when making supervisory judgements. And even in Napoleonic law jurisdictions ways can be found to give more weight to standards. Examples where this combination of pressures is at work with encouraging results include both the hedge fund and private equity areas as well as that of corporate governance referred to above. But there are an increasing number of other initiatives, both based in Britain and internationally. For example, shareholder engagement standards are now in place to encourage asset managers to exercise their fiduciary duties vis-a-vis shareholders.

And, globally, standards exist which eventually have statutory backing in many areas. These have been devised by the Financial Stability Board, the International Monetary Fund, the Basel Committee and others under the encouragement of the G20, with inputs from the private sector. They include, as a good example, standards for remuneration. The pressure to conform in most cases comes from a similar source: namely - given the absence of global government - through peer group pressures among national supervisory authorities themselves, who in turn place pressures on the industry itself to conform, exercising statutory clout where necessary.

Combining standards and rules

There are three reasons why standards, in addition to rules, should be included as having a legitimate and useful place in securing behavioural change consistent with public policy objectives.

First, they minimise the dangers of people trying to circumvent them which arise with prescriptive rules and can reduce the pressure to indulge in arbitrage.

Second, they help to secure buy in and positive impulse to conform from those on whom they bear, encouraging a better level of mutual understanding between the private and public sectors. Present events throw into perspective the need for such an improvement and have highlighted the mutual suspicion which has all too often characterised the relations between the industry, who regard officials as short sighted and blinkered bureaucrats, and officials who regard those in the industry as little more than pigs with their snouts in the trough. Industry must not view the public authorities as people to lobby but rather as a party to cooperate with in the interests of both long term shareholder value, and society.

Finally they can help to secure legitimacy not only in the eyes of the industry and its users, but also of society more widely.

Securing a stronger system

Many legislators, supervisors and others in the official community can see the merit of standards: but they lack confidence as to how to engage with the industry. Yet a large part of the FSB/G20 agenda is reliant on standards being adhered to. Authorities in a number of member jurisdictions have acknowledged that in some of the areas where rules are suggested they can simply not be written, and if written will not be enforceable, and will invite arbitrage. The only feasible alternative is to fall back onto standards.

So with the pain of the crisis and the deep recession still fresh in our minds, it is time for both sides to get together. Sending papers out for consultation is not enough. We believe that the official community whether in individual jurisdictions, or globally at the G20/FSB level, should develop a plan to create and then enforce standards across the whole industry area by area. We should start with creating standards in specific areas: such as, long-only asset management; corporate finance; and the many areas in banking where rules are presently deployed but would be better handled through standards.

Of course the public side certainly needs to articulate what it wants to achieve. And this will need the state taking a view on just how safe society demands that our leveraged system of finance should be. And as for the private side firms in the industry need to ask some tough questions, encouraged by their boards.

Where did we go wrong or how did we let society down by our behaviours leading up to this disaster? What must we do to prevent another collapse in confidence? Have we implicitly been expecting the state to bail us out? If so, what can we do to prevent a recurrence? For what aspects of our operations should best practice standards be drawn up? What are indeed the required behaviours, and how can we best achieve them through standards? How best should they be articulated? How can we keep them up to date? How can we get discipline ourselves so that we wish to, and do, conform to them?

Such a list may look naïve, but people in banking and finance are asking themselves such questions. There is plenty of soul searching going on.

And absent proper and responsible answers to the above, our fear is that the public authorities will remain under extreme populist and political pressure to write rules that will not work but could damage the finance sector and the wider economy. If the industry does not volunteer standards, and display a willingness to engage on their production with the public authorities in areas where it knows that they could be effective, public officials have little alternative then but to try to write rules as the only alternative. The reality is clear. Just as you cannot write rules to abolish sin so you will never be able to rely on rules to stop crises. ❑