A CRITICAL APPROACH TO THE ANALYSIS OF THE EVOLUTION OF FINANCIAL REGULATION BEFORE AND AFTER THE CRISIS

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1. Introduction

This paper examines how financial regulation has been evolving before and after the crisis and considers some interpretations of these events.

Recent mainstream literature tends to examine financial regulation by focusing on the measures that can avoid that the managers of financial firms, 'acting in their own interests, deviate from what a social planner would have them do' (Hanson, Kashyap and Stein, 2010: 1-2). Before the crisis this search for the "right incentives" focussed on "micro-prudential regulation", i.e. on preventing the costly failure of individual financial firms. Many observers now consider this approach deficient and propose that the search for the "right incentives" be instead applied to "macro-prudential regulation", which seeks to limit the extent to which adverse developments hitting one financial firm can lead to greater problems for other firms (See Hanson, Kashyap and Stein, 2010; Goodhart, 2010a: 179; Kashyap, Berner and Goodhart, 2011).

These assessments of the causes of the crisis and of the deficiencies of regulation have been criticised by other authors (See Barth, Li, Lu, Phumiwasana and Yago, 2009; Caprio, 2009; Levine, 2010; Barth, Caprio and Levine, 2011). Levine (2010) claims that this literature fails to identify a major cause of the crisis, the malfunction of the governance of regulation.

> The collapse of the global financial system reflects a systemic failure of the governance of financial regulation - the system associated with designing, enacting, implementing and reforming financial policies. … In contrast to common narrative, my analyses … indicate that … failures in the governance of financial regulation helped cause the global financial crisis. … This conclusion … has material implications for reforming financial regulation' (Levine, 2010, p. 1).

Levine (2010) and Barth, Caprio and Levine (2011) provide several examples that illustrate how the financial authorities and their political overseers did not act in the interest of the public. By using evidence from official documents and archives, these authors argue that the authorities introduced policies that destabilised the financial system. What's more, they preserved them when, before the crisis, they learned that these policies were distorting the flow of credit towards questionable ends and went so far as to provide the Congress with false information in order to keep them in place. These authors conclude that a comprehensive assessment of the causes of the crisis must inquire why policymakers made these choices and propose strengthening the independence of the authorities from the pressures of the financial industry in order to correct the governance of regulation, improve the reforms that have been proposed and adopted, and reduce the probability of future crises.

Without denying the relevance of the identification of the “right incentives”, Levine and his colleagues suggest that it may be misleading to examine the evolution of financial regulation without considering its distributive implications and the power relations affecting the legislation on it. The mainstream literature tends to disregard these issues, which are instead at the centre of the stage in some critical works.

For Palma (2009: 832), for instance, the study of the events leading to the crisis makes theoretical sense if it goes beyond the financial aspects and considers the political settlements and distributional changes in which these phenomena occurred. We took a similar standpoint in a previous paper (Panico, Pinto and Puchet, 2010), moving from Sraffa`s development of the approach proposed by the classical political economists and from his way of dealing with monetary problems. We showed that the expansion of the financial sector affects the level of production and generates changes in the income shares, which can be unfavourable to workers, even if the rates of wage and profits remain constant. These results have the following implications for the study of the crisis and of financial regulation:

- the crisis can be seen as the consequence of the financial industry’s attempts to increase its turnover and earnings regardless of the rise in the systemic risk;
- the financial industry is interested in the introduction of forms of regulation that allow a high expansion of its activities;
- on the contrary, a society that is committed to the stability of the distributive shares should be interested in the introduction of forms of regulations that make the financial industry grow in line with total wages;
- the control of the expansion of the financial industry can be justified *both* in terms of the traditional argument that it brings about a situation in which “speculation predominates over enterprise” *and* for its negative effects on the stability of the income shares, on equality and on social conflicts.

By moving again from Sraffa`s way of dealing with monetary problems, we argue in what follows that, during the decades that preceded the crisis, financial regulation evolved from a “discretionary” to a “rules-based” approach, i.e. from an approach based on the discretionary power of the authorities over the management of financial firms to one based on the respect of compulsory liquidity or capital coefficients. Much literature assumes that this change was introduced to pursue the public interest. We will argue instead that it also reflects the attempts of the different sectors of society to improve their position in the distribution of the social product and that it was favoured by the pressures of the financial industry, which benefited from the modification of the relations of power with the financial authorities and from the expansion of its activities allowed by the new forms of regulation. The conversion to the new approach to regulation was gradual and reflected the strengthening position of the financial industry in the economy and in society. It was attended by a scarce attention of the dominant literature to the questions raised by Levine and his colleagues. This scarce attention also seems to influence the reforms that have been recently proposed and adopted, in spite of the formal acknowledgement by many official documents of the need to reinforce the authorities’ independence and their supervisory powers over the managers of the financial firms.

The paper is so organised. Section 2 describes Sraffa’s approach to money and banking and its implications for the study of financial regulation. Section 3 describes how the literature classifies the instruments of regulation. Section 4 identifies three different periods in the evolution of financial regulation before the crisis. Sections 5, 6 and 7 describe the features of regulation during the three periods and examine the main interpretations of why they emerged. Section 8 deals with some of the reforms that have been proposed and adopted. Section 9 concludes.

2. Sraffa’s approach to money and banking

In a paper recently published in Investigacion Economica, Kurz writes:

> What is needed today is not only a global “lender of last resort”, but also a global “regulator”, i.e., a world financial system that serves “the proper social purpose” of directing new investment into the most profitable channels (Kurz, 2010: 34).

This claim challenges the dominant conception of economic science by stating that its view that prices are scarcity indexes, whose variations leads to an efficient allocation of the available resources, hinders the comprehension of financial phenomena and their influence on the working of the economic system.

In another essay published in Investigacion Economica, Kurz (2007) points out that Sraffa had a different position, akin to that of the classical political economists, which considers that prices are not scarcity indexes, but reflect the distribution of the product between workers, capital owners and landlords in given institutional conditions.

Sraffa conceived income distribution as a historical and “conventional” phenomenon. For him, the material conditions of production and the availability of resources do not fix the level of distributive variables. The material conditions of production only constrain the relation between distributive variables. The level of these variables depends on the way in which the conflictual relations among different groups and institutions find solution over a certain period of time.

Sraffa held this position since his earlier contributions in the 1920s, even if at that time he was not aware of its theoretical contents and implications. His 1922 articles on the Italian banking crisis, the 1923-1927 unpublished writings on the economic policy of the Fascist Government and his Lecture notes on “Continental banking”, presented in Cambridge during the academic years 1928-1929, 1929-1930 and 1930-1931, focus on the formation of monetary interventions and on the benefits they offer to different entities and social groups. In these analyses the evolution of financial markets and monetary policy are the results of the complex historical re-composition of the relations among social groups (workers, owners and managers of industrial, financial and other firms) and among economic, social and political institutions.

In these essays, which show a detailed knowledge of the working of the banking system and of the exchange markets (Sraffa Papers, D3/12/68, 2; D3/12/78, 6 and 13; D3/12/111), monetary events, like inflation and deflation, and monetary policies and legislation are part of the processes that emerge when the claims of the different social groups over the distributive shares are incompatible with the constraints set by the material conditions of production. Monetary events, policies and legislation influence social conflicts and contribute to the formation of the distributive rules, i.e.

to the determination of what is considered the *normal* or *equilibrium* level of distributive variables.

At the same time, Sraffa argued that the formation of monetary policies and legislation is affected by the attempts of the most powerful pressure groups to shape the distributive rules according to their material interests.

In his 1922 essay on the Italian banking crisis Sraffa (1922: 191-197) pointed out in which cases the Italian Government acted to protect powerful pressure groups at the expenses of society as a whole. He argued for a general tendency towards the formation of large and diversified financial groups able to influence the exertion of power, to control relevant sections of the economy, of the media and of the political world and to disguise the aims of their initiatives from the majority of the population to such an extent as to represent a danger for democracy.[1] In the subsequent writings he further analysed the questions of liquidity, solvability and exertion of power, relating them to the technical operation of the financial system, and touched on issues that are still relevant in monetary debates. He argued that the ability of the different groups to affect the exertion of power can be the major problem for the smooth working of the financial system and hinted at the necessity that the legal provisions make the financial authorities as independent as possible from the pressures of political and economic groups.[2]

The approach used by Sraffa to deal with monetary problems can be relevant for the current analysis of financial regulation. It leads to a different perspective on this topic from that proposed by the mainstream literature. Within Sraffa's approach, the analysis of regulation should not only consider the adoption of the "incentives" that can best complement the operation of the markets, when these are not perfectly

[1] 'The general tendency seems to be towards the … formation of large "groups" of companies of the most varied kinds concentrated around one or more banks, mutually related by the exchange of shares and by the appointments of Directors common to them. Within these "groups" the various interests are all equally subject to the interests of a few individuals who control the whole group … Very little is known … about these groups … What the public knows and feels … is the enormous financial and political power which they have and the frequent use they make of it to influence both the foreign and home policy of the government in favour of their own interests. Each group keeps several press organs which support its policy, and some of the accusations made against certain Ministries of being actuated by the interests not of a class, but of private concerns, and of favouring one financial group against another, have no doubt a basis of truth' (Sraffa, 1922: 196).

[2] For a detailed analysis of Sraffa's writing on money and banking see Panico (1988; 2001) and Panico, Pinto and Puchet (2010).

competitive. It must also take into account the adoption of rules that can make the working of financial markets compatible with the political agreements reached by the Government and the other sectors of society on distributive rules, development and social welfare.

The instruments of regulation, which propose technical solutions to the problems of liquidity and solvency of financial firms, become available through discretionary decisions of the authorities and approved laws. They introduce rules and controls over the exercise of powers in the formation and the execution of financial contracts and are shaped by the agreements among the different sectors of the economy and the monetary and fiscal authorities over how to meet their material interests and their expectations on social and economic development. According to this approach, then, the forms assumed by financial regulation depend on the ability of the different sectors or groups to impose the distributive rules that are most convenient to them, more than on the need to complement the imperfect operation of the markets.

The approach of the Classical and Sraffian tradition, although close to the institutional and evolutionary approaches proposed on various occasions in the economic literature, does not coincide with them. It does not deny the relevance of individual behaviours, but assumes that they depend on the conventions that historically emerge from social interaction.

Already in the 1940s, Medina Echavarría, a Spanish sociologist who lived in exile in Mexico, noticed that classical economic theories differ from the institutional theories of Commons and Veblen.[3] The former consider that the conventions are an integral part of the construction of the analyses, since they contribute to the formation of legislation and of the existing institutions. The latter consider instead that

[3] Medina Echavarría wrote: "El concepto de institución, por acertado que sea el haberlo destacado en su carácter fundamental, aparece la más de las veces tosco y sin refinamiento teórico.
Si esto vale en general como doctrina sociológica se comprenderá fácilmente la resistencia de los economistas tradicionales a dejarse convencer por los institucionalistas. Pues argumentan que como lo ocurrido en la escuela histórica, no han conseguido ofrecer una teoría económica en estricto sentido. En realidad tienen razón, pues de hecho en el movimiento institucionalista la teoría económica ha tendido a quedar disuelta bien en un empirismo sociológico, ya en una interpretación sociológica de la historia." (2009 [1943]: 79 – 80).

conventions and institutions describe the historical context to which the results of the analyses have to be applied.[4]

Unlike the classical and Sraffian ones, the institutional and evolutionary approaches assume that the legal framework emerges from a process of social selection and has to favour the ability of individuals, groups and organizations to adapt to the environment in which they operate. These approaches tend to overlook that conventions and institutions reflect the relative powers of those participating in the economic processes and their ability to impose to the others distributive rules and agreements over the future of the economy and the society that are functional to their desires and material interests. Finally, the institutional and evolutionary approaches overlook that the maintenance or rejection of the existing conventions depends on value judgements, i.e. on the evaluations of the distributive rules prevailing in the society over a certain historical period, more than on their adequacy to favour social selection.

(To be completed)

3. A classification of the instruments of regulation

The specialized literature describes the instruments of financial regulation in different ways. Traditionally, they were divided into

- structural regulation,
- prudential regulation,
- management and resolution of financial firms' crisis.

Structural regulation designs the financial sector in order to discipline its working. Prudential regulation aims at identifying and controlling the risk exposure of individual firms and of the whole system. The management and resolution of crises aim at reducing the costs and the damage of a distress when it had occurred.

[4] And Medina Echavarría added: "La validez y exactitud del conjunto de principios y leyes de la doctrina clásica no ocurre en méritos de su rigor lógico, sino porque traduce en forma abstracta (teórica) un sistema coherente de sociedad real."(2009 [1943]: 85).

Mishkin (2001) proposes a classification of the tools of regulation, which has been subsequently used to describe the evolution of financial regulation (see White, 2009).

We call *Group* 1 a first set of instruments classified by Mishkin (2001), which can be used to control the degree of competition among financial firms. They belong to structural regulation because they can affect the size of the firms and the structure of the sector, but they can also be used to control the quality of the management and the risk exposure of the individual firms. The four tools classified within this group are:

1. controls of entry,
2. limits on economies of scale,
3. limits on economies of scope and diversification,
4. limits on pricing (e.g. interest ceilings).

Group 2 refers to other three instruments of regulation, which traditionally belong to prudential regulation. They can be used to strengthen market discipline by reducing the degree of asymmetry in the distribution of information between those who supply and those who demand financial services. The three instruments of this group, which enhance the ability of depositors and other operators to evaluate the behaviour of the managers and the risk exposure assumed by their firms, are:

5. capital requirements,
6. disclosure requirements,
7. bank examination.

In recent years the specialised literature has paid great attention to the instruments of *Group 2*. Disclosure requirements, for instance, have been diversified, re-named as "conduct-of-business" and become the subject of a large set of recent legislation (see de Haan, Oosterloo and Schoenmaker, 2009: 312-317). They now include

- *transparency* in the provision of information to customers and shareholders,
- *quality and objectivity in the provision of advice*, which is considered different from the provision of information,
- *duty of care* towards customers, which aims at enhancing responsible behaviour by requiring financial institutions to adhere to a reasonable standard of care while dealing with their customers.

In some countries conduct-of-business has been separated from the other instruments and entrusted to a different body of regulators (see de Haan, Oosterloo and Schoenmaker, 2009: 317-321).

Group 3 refers to instruments of regulation conceived for the management and resolution of financial crises. In Mishkin's classification it only includes

8. liabilities insurance,

an instrument that also aims at reducing the probability of bank runs by protecting depositors from the loss of their assets.

Finally, *Group 4* refers to instruments of prudential regulation that aim at reducing the probability of systemic distress by assessing beforehand the management's exposure to risk. In Mishkin's classification it is listed as

9. supervision.

It may be "discretionary" or "rules-based" and may be enforced by the imposition of penalties. To make the enforcement effective, legislation may endow the authorities with different degrees of power over the management of financial firms. In some countries it may even allow the authorities to dismiss and replace the managers. The content of legislation on these matters plays a relevant role in defining the relations of power between the different actors of regulation.

4. Alternative regimes of regulation

White (2009) uses Mishkin's classification to analyse the evolution of financial regulation in the US. He proposes to divide the decades following the Great Depression of 1929 in three sub-periods:[5]

- the New Deal or Bretton Woods era (from the early 1930s to the beginning of the 1970s);
- the Post New Deal era (from the beginning of the 1970s to 1990);
- the Contemporary era (from 1991 to the recent financial crisis).

[5]This periodization is similar those proposed by other authors. In his analysis of the changing role of central banks Goodhart (2010b), for instance, distinguishes three periods: the decades of government controls (1933-1970), a transition period (1970-1979) and the triumph of the markets (1980-2007).

During the New Deal or Bretton Woods era, financial regulation was based on a "discretionary" approach, characterised by direct controls over the management of financial firms and a dominant role of the authorities in designing the structure of the markets. After WWII the economies grew at notable rates and showed a high level of stability. At the same time, banks failures disappeared.

The Post New Deal era starts at the beginning of the 1970s with the fall of the Bretton Woods agreements and the slowdown of the economy and the rise of inflation that followed the first oil shock. These events underlined the need to revise the regulation regime of the New Deal or Bretton Wood era. The process of revision was gradual and complex. It gave rise to a transition period, which ended in 1990 and was characterised by a gradual erosion of the powers of the authorities. The first signs of this process were the cuts in the resources attributed to the supervisory authorities, the relaxation of some administrative controls and other occurrences generated by the emergence of a more favourable attitude towards the financial sector. At the beginning of this period the Congress did not pass laws that overtly changed the main features of the discretionary approach. Legislation focussing on specific aspects, like the improvement of coordination and the introduction of compulsory capital coefficients, was approved at a later stage.

The Contemporary era begins in 1991, when the Congress passed the first of a set of laws that abolished what remained of the discretionary approach and ascertained the supremacy of a rules-based one, characterised by the absence of direct controls, the introduction of rules and coefficients trying to induce the managers of the firms to adopt prudent behaviours, and a dominant role of market processes and innovations in designing the structure of financial markets. During this period the financial system grew at very high rates and its operation became extremely complex.

5. Regulation during the New Deal or Bretton Woods era

During the New Deal or Bretton Woods era governments and societies showed limited faith in market discipline and legislation endowed the authorities with substantial powers over the management of financial firms.

The Banking Act of 1933 introduced liabilities insurance through the Federal Deposit Insurance Corporation (*Group 3*) and gave the authorities extensive discretionary powers in the supervision of financial firms (*Group 4*). The Act also separated commercial and investment banking (*Group 1*), assuming that combining these two businesses led to conflicts of interest and increasing risk, and confirmed the role of Regulation Q, which imposed limits on deposit interest rates (*Group 1*). Moreover, the Banking Act of 1935endowed the federal authorities with large discretionary powers over the decisions granting bank charters (*Group 1*), the Bank Merger Act of 1960 entrusted similar powers to the authorities over mergers and acquisitions (*Group 1*), the Bank Holding Acts of 1956 and 1970 limited banks' attempts to expand their business into activities like investment advice, insurance and data processing (*Group 1*), and the Financial Institutions Supervisory Act of 1966 strengthened the supervisory powers of the authorities (*Group 4*).

During the New Deal or Bretton Woods era, legislation thus imposed an approach to regulation that aimed at reinforcing the position of the authorities by fortifying their discretionary powers over the management of financial firms and by avoiding that the financial sector grew more than other sectors. To achieve these results, legislation made an important use of the instruments of regulation listed above in *Groups 1, 3 and 4*. Through the instruments of *Group 1* it enhanced structural regulation, by imposing limits on entries, scale, scope and pricing, in order to reduce competition among financial firms and guarantee a sufficient level of profitability to them.

The tools of regulation listed in *Group 2* had limited relevance in those years. Capital and liquidity ratios, for instance, were used as guidelines and never replaced the evaluations of the competent supervisor, whose discretion had the final word in the identification of the managers' behaviour towards risk exposure.

The strategy followed by this regulatory regime was consistent with that generally pursued by State intervention at the time. It tended to integrate different interests and to secure a consensual participation of as many sectors as possible in the benefits generated by the growth of the economy. Limitations on entries, scale, scope and pricing in a rapidly expanding environment secured the profits and the consensual participation of the banking industry in the national programmes. The regulatory regime thus carried out a complex strategy, which took into account the relevance of the power relations between the authorities and financial firms and the fact that the stability and the growth potentials of the economy can be damaged if the size of the financial sector supersedes that of the other sectors. An increasing weight of the financial sector in the economy and in the society may bring about a situation in which speculation dominates over enterprise and may lead to policies that favour its interests at the expenses of those of the other sectors. It affects income distribution and may consequently exacerbate social conflicts over the distributive shares.

It is widely acknowledged that the discretionary approach brought about positive results (See Eichengreen and Bordo, 2003; White, 2009: 18; Goodhart, 2010b: 3). The management of financial firms was adequately controlled and bank failures practically disappeared. The few banks that failed were very small and most of them had been involved in frauds that regulators unearthed. Yet, the dominant interpretations of these events tend to underplay the role played by this approach or to consider it irrelevant for the current situation.

White (2009: 25-26 and 31) attributes the positive results of that period to the high and stable growth enjoyed by the economies, rather than to the merits of the discretionary approach. He also refers to the weak state of the financial industry after the crisis of 1929 to argue that it led the banks to assume a conservative attitude and to become more interested in raising reserves and expanding the holding of safe assets than in supporting or stimulating innovative investments.

Goodhart (2010b: 3-4) too attributes the positive results of that period to the conservative attitude of the management of financial system, rather than to the merits of the discretionary approach. For him the dearth of bank failures of those years

> was *not* due to any exertion of effort by central banks to maintain systemic stability; instead the controlled, constrained financial system was just a safe, but dull, place (Goodhart, 2010b: 4).

Goodhart and White overlook that there can be interdependence between the high and stable growth of the economies and the controlled and constrained situation in which the financial system operates. What's more, Goodhart fails to notice that during the Bretton Woods era, i.e. while the controlled and constrained financial system was a "dull place", the economies steadily grew at rates that were on average twice as much that of the subsequent 25 years (see Volker commission on Bretton Woods or Table...). Moreover, unemployment disappeared, income inequality declined, and education, life expectancy, health conditions and security improved. Thus, the dull place provided the productive sectors with sufficient financial resources. It was not as inefficient as Goodhart's words suggest, nor did it prevent the societies from enjoying positive results.

Finally, in an important textbook, de Haan, Oosterloo and Schoenmaker (2009: 299-330) induce the reader to believe that only the rules-based approach to regulation is relevant for the present situation. They state that, as financial institutions became increasingly complex, regulation moved away from the methods of direct control to methods dominated by fixed rules. This claim is not justified by any argument in their textbook. It is simply an assertion that muddles up causes and effects. It disregards that the financial system became increasingly complex after 1990, as a result (not a cause) of the legislation that eliminated what had remained of the discretionary approach (see White, 2009; Bordo, 2008; Eichengreen, 2008). Moreover it plays down the fact that the pressures of the financial industry can affect legislation.

This important textbook ignores the existence of a discretionary approach to regulation and the positive results it achieved. Moreover, it fails to remind the reader of what is considered the basic question of financial regulation: 'Should supervision focus on re-enforcing market discipline or should it rely on regulators discretion and their independent evaluation?' (White, 2009: 15). By doing so, it gives a one-sided account of the matter, preventing the students from knowing some fundamental notions of financial regulation and some relevant parts of its evolution.

6. Regulation during the transition period (1970-1990)

The limits on competition prevailing before the 1970s constrained the ability of financial firms to adjust to the new situation generated by the oil shocks. The slowdown of the economy and the surge of inflation, which raised the nominal interest rates, changed the cost of financial services and affected the preferences of the operators, put at risk the solvency of these firms and forced them to innovate in order to expand their turnover. The regulatory legislation had to be revised because it had become impossible to guarantee the profitability of financial firms by limiting competition. The decision of the authorities to start the "monetarist experiment" of 1979-1982, setting rigid controls on the money supply, further accelerated financial innovation and weakened even more the balance sheets of financial firms. It increased the number of bank crises and made it necessary to bail out many of them.

These events were attended by a change in the political climate, which became more favourable to the pressures of the financial industry and enhanced the ability of these firms to elude the controls of the authorities. The first sign of this change can be found in the reduction of resources assigned to the regulatory authorities by the Nixon administration. A larger reduction was later applied by the Reagan administration (*Group 4*).[6]

A relaxation of the administrative controls foreseen by the limits on competition of the New Deal era also took place (*Group 1*). In the 1970s the authorities weakened the requirements for obtaining bank charters and made rejections infrequent. During the same years the Federal Reserve relaxed its anti-branching rules and several States reached agreements on reciprocal privileges to their banks, weakening the barriers to geographical competition. Moreover, during the Reagan administration, the Department of Justice eased opposition to horizontal mergers. These administrative measures allowed the banks to increase their size.

In the 1980s the Congress abolished other barriers to competition. The Depository Institutions Deregulation and Monetary Control of 1980 eliminated the ceilings on interest rates and the Garn-St Germain Act of 1982 allowed the Saving and Loans (S&Ls), at the time under distress, to deal with activities previously prohibited, like consumer loans, commercial real estate and business loans.

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[6] As White (2009: 36) notices: 'Although bank supervisory agencies were independently funded, they came under increased pressure from several administrations, most notably Nixon and Reagan administrations that sought reductions in regulation. In 1969 the OCC was placed under an employment ceiling, leaving the Comptroller to complain that he had an inadequate staff to conduct examinations. Pressure became more intense under the Reagan administration that sought to reduce the size and scope of the federal government in the early 1980s, just as bank failures were beginning to rise. The OCC saw a decline in its expenditures and its workforce shrank. From 3,282 employees, of whom 2,282 were examiners in 1979, the OCC shrank to 2,702 employees and 1,835 examiners by 1982. Staff at the OCC turnover reached 15 per cent in 1984. The decline in supervision was particularly acute in Texas where the median exam interval in 1986 was 700 days for banks that subsequently failed or needed assistance'.

Supervision underwent a contradictory process (*Group 4*) that testifies to the complex formation of legislation and the need to take into account the interests of the different groups of pressure to interpreter the evolution of financial regulation. On the one hand, the Financial Institutions Regulatory and Interest Rate Control Act of 1978 and the Federal Institutions Reform, Recovery and Enforcement Act of 1989 strengthened the enforcement powers of regulators in order to compel compliance. On the other hand, the emergence of a political climate more favourable to the financial industry led to measures that eroded the powers of the authorities over the management of firms. The reduction in the resources attributed to them changed supervision in quantity and quality. Surprise examinations lost relevance and the authorities had to limit the scope of their reviews and to enhance a regular dialog with banks' managers and board members. The overall result of these changes was a limitation of the ability of the authorities to effectively control a sector that was starting to grow in size and complexity (see White, 2009: 31 and 36).

The tools of regulation of *Group 2* also underwent important changes. The Financial Institutions Regulatory and Interest Rate Control Act of 1978 obliged banks to disclose more information and introduced a new Uniform Interagency Bank Rating System, named CAMEL, to harmonise the criteria used by the different regulatory agencies. In 1981, in the face of the difficulties of the banks' balance sheets caused by the consequences of the monetarist experiment, the compliance of capital ratios, previously used by supervisors as first indicators of the risk exposure of a firm, became compulsory at 5%. The resistance of the financial industry, which complained about the advantages that this measure gave to foreign banks, led to the Basel I agreements of 1988, which phased in a set of compulsory ratios, going up to 8%, until 1993.

Thus, during the Post New Deal era, the difficulty of the financial industry to cope with the unstable economic situation and the high number of banks' crises imposed important changes in financial regulation and led to a financial system radically different from that of the New Deal or Bretton Woods era The discretionary approach introduced in the previous years had to be revised. It could be reformed in different ways, maintaining or reducing the powers of the authorities over the management of financial firms. Interest ceilings and other limits on competition, for instance, were lifted in those years in the US and in Europe. In the US, where the process of financial innovation was autonomously accomplished by the private sector as a reaction to the difficulties generated by the new economic situation, the process of liberalisation was accompanied by a set of measures, like those recalled above, which enhanced the ability of firms to elude the controls of the authorities. In continental Europe, instead, the process of liberalisation and financial innovation was guided by the authorities and did not deprive them of the ability to control the management of financial firms.

The measures introduced to reform regulation led to a financial sector, which, unlike the dull place of the previous years, was becoming increasingly adept at assuming risks. During the 1980s the turnover and the assets of financial firms grew at higher rates than GDP (see Table ...). Moreover, the introduction of fixed rules, like the compulsory capital coefficients, stimulated a large diversification of activities by inducing financial firms to device new contracts in order to circumvent them.[7]

While the financial system was changing from a “dull” to a “dynamic” place, the performance of the economy deteriorated. During the Post New Deal era the average rate of growth became half as much that of the Bretton Woods era and unemployment rose (see Table ...). Moreover, after the introduction of the monetarist experiment in 1979, inequality returned to worsen after five decades of constant improvement. These negative results make it difficult to argue that the change of the financial system during those years improved its ability to provide resources for the productive sectors and to promote the achievement of desirable social objectives.

Another negative result of the Post New Deal era was the high number of banks' crises. Some of them occurred in the 1970s, partly as a result of the unstable economic environment. In the 1980s the number of banks' distress increased as a result of the monetarist experiment and of the elimination of some barriers to competition. The crisis of the S&Ls was the most relevant case. The monetarist experiment made the sector insolvent, raising the percentage of unprofitable insured S&Ls from 7 per cent in 1979 to 85 per cent by 1981 (see White, 2009: 32). To help these firms to cope with the difficult situation, the Garn-St Germain Act of 1982

[7] As White (2009: 32-33) noticed: ‘Off-balance sheet business grew considerably, and it included standby letters of credit, loan commitments, loan sales, securisation and provision of derivates. By 1990, the credit equivalents of these off-balance sheet positions stood at 50 per cent of the value of commercial and industrial loans’.

allowed the S&Ls to deal with activities previously disallowed and these firms took advantage of the new rules to raise their risk exposure hoping to increase their earnings and come out of the problems of insolvency. The gamble failed and the authorities had to intervene to bail them out and to avoid a dangerous contagion to the rest of the financial system.

White attributes the crisis of the S&Ls to the authorities' misuse of their discretionary powers. He claims that the S&Ls gambled, after the introduction of the Garn-St Germain Act, because they knew that the authorities were adopting the "too big to fail" doctrine and would have exercised forbearance towards them.

> The New Deal had given the bank agencies considerable discretion to treat troubled or failing institutions. During the crisis of the 1980s, this discretion led to forbearance towards failing banks that allow them to take more risks and towards bailouts of large banks with the adoption of the "too big to fail" doctrine at vast cost. (White, 2009: 33).

White's interpretation of these events reflects his opposition to the authorities' intervention and to their role of lender of last resort. He underlines the costs of bailing out the S&Ls and plays down those that the economic system would have paid if these institutions had not been rescued and contagion would have spread to other firms.

7. Regulation during the Contemporary era

In the 1990s legislation further accomplished the process of reforms and liberalisation. It formalised the conversion to a rules-based approach to regulation, the abolition of the limits on competition, the emergence of universal banking and the upsurge of the OTC derivatives operations. The financial markets enjoyed an "explosive" expansion (see Table …) and the economy underwent a period of growth (see Table …) punctuated by the distress of some financial firms and disrupted by the recession produced by the recent financial crisis.

Some important laws approved during those years were

- the Federal Deposit Insurance Corporation Improvement Act of 1991, which abolished what remained of the discretionary approach to regulation;

- the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which definitely eliminated all barriers to nation-wide branching;
- the Gramm-Leach-Bliley Financial Services Modernization Act of 1999, which permitted universal banking within the structure of a financial holding company;
- the Commodities Futures Modernisation Act of 2000, which exempted OTC derivatives market from Government oversight.

Another important measure was the Federal Reserve's decision of 1996 to allow banks to use Credit Default Swaps (CDS) to reduce capital reserves (see Levine, 2010: 5).

The Federal Deposit Insurance Corporation Improvement Act occupies a central role in the process of reform. It formalised the change from a discretionary to a rules-based approach to supervision and introduced the "prompt corrective actions" with the intention to hold back the possibility that the authorities' forbearance could lead to wide financial distresses. Banks were classified according to five categories of risk exposure, defined by financial ratios calculated by dividing the value of risk-weighted assets to that of capital. The thresholds of risk exposure were automatically calculated and when banks crossed them, mandatory actions, which increased monitoring and restrictions, inevitably applied.

To evaluate their risk exposure the Federal Deposit Insurance Corporation Improvement Act obliged financial firms to provide for regulators an amount of information larger than before. These new obligations and the obstacle set to forbearance gave the impression that firms were more strictly constrained. Yet, the removal of discretionary powers from the authorities enhanced the ability of financial firms to evade controls:

> By ruling out discretion, banks were able to develop new complex financial instruments that are not subject to statutory standards and allow them to assume more risk with existing capital. The most notorious of these were of course, the mortgage-backed securities that were held off-balance sheet in Structured Investment Vehicles (SIVs) that skirted the rules-based control system that was sufficiently rigid that it was difficult to quickly adjust to innovations. Banks were able to increase their risk and hence their return, while regulators appeared to be faithfully executing their mandates (White, 2009: 36).

The limited availability of resources made it difficult for the authorities to analyse the large amount of information coming from the banks and to monitor the quality of these new instruments. It forced the authorities to rely on the advice of the Ratings Agencies. Yet, the intervention of these entities raised conflicts of interest, due to their position of advisors of controllers and customers of the controlled firms, and drove the system further away from a suitable solution of the problems of regulation.

Dealing with the origin of the recent financial crisis, White (2009: 36) claims that 'the genesis of the most recent collapse has part of its root' in the shift to the rules-based regime. It generated a financial industry that grew in scale, scope and complexity and further weakened the ability of the authorities, already limited by the availability of resources, to control financial firms and the rise of systemic risk:

> The fast changing character of the financial system increased the challenge to federal bank supervisors, who had a relatively rigid rules-based statutory supervisory regime, who faced an increasingly complex and evolving banking system, adept at increasing risk (White, 2009: 37).

The introduction in the 1990s of rules-based forms of regulation has been presented as a consequence of the problems caused by the discretionary forbearance of the authorities during the banks' crisis of the 1980s. The role attributed to the "prompt corrective actions" in the Federal Deposit Insurance Corporation Improvement Act corroborates this view (see White, 2009: 34; and de Haan, Oosterloo and Schoenmaker, 2009: 306, Box 10.2).

There are elements however suggesting that other factors, including the lobbying activities of the financial industry, can have played a role in the formation of this piece legislation. For some literature, the 1991 Act was introduced at a time when politicians criticised supervisors for being too though, not too relaxed. Dealing with the relation between regulators and politicians, Mishkin (2001) refers to a paper by Berger, Kyle and Scalise (2001) that, in order to argue that bank supervisors are not completely independent of political pressures, provides evidence that from 1989 to 1992 supervisors were tough and were blamed by politicians for creating the credit crunch of those years.

Moreover, the theoretical debate on monetary policy and the actions taken in this field since the late 1980s moved in a direction opposite to that of the Federal Deposit Insurance Corporation Improvement Act. The failure of the monetarist experiment and the development of the "institutional design" literature[8] promoted the view that in monetary policy competent and independent judgement works better than any conceivable rule:

> Competent and dedicated policymakers are better able than quantitative rules to exercise good judgement and deliver the adequate mix of restraint and flexibility. To do so, however, they must be shielded from temptation and pressures that are part of political life (Wyplosz, 2005: 82)

The central banks' reforms implemented since the late 1980s moved from the view that monetary rules do not work and endowed these institutions with discretionary powers, checked by transparency and a high degree of technical independence. The Federal Deposit Insurance Corporation Improvement Act contradicts this tendency: it replaces a rules-based for a discretionary approach to regulation. This contradiction raises further doubts over the claim that this piece of legislation was a consequence of the problems caused by the relaxed standard applied by the authorities in the 1980s and suggests that its introduction may have been favoured instead by the pressures of the financial industry to reduce the power of the authorities in order to increase its turnover and revenues regardless of what happens to systemic risk.

The role of lobbying activities in the formation of monetary legislation is testified by the information provided by the US Senate. According to these data, organised by the Centre for Responsive Policy (see www.opensecrets.org), the financial sector spent nearly 477 million dollars for "campaign contributions", i.e. 1.1 million dollars for House representative, during the election cycle 2007-2008 and 455 million dollars for specific "lobbying activities", i.e. 0.85 million dollars for each member of the Congress, in 2009 and 1.04 million dollars for each House representative. Moreover, the financial sector has the highest quota of expenditure in "campaign contributions" (on average 19.4% during the period 1990-2010) and in "lobbying activities" (on average 14.7% during the period 1998-2009) of all other sectors of the economy.

Lobbying activities are paid limited attention by mainstream literature[9] and, when they are considered, they are mainly seen as a means to resist changes that favour

[8]This literature was inspired by Rogoff (1985) trying to find a satisfactory solution to the dynamic inconsistency problem raised by Kydland and Prescott (1977). For an account of this literature, see Panico and Rizza (2004).

[9] For a review of the literature on this topic, see Igan, Mishra and Tressel (2011: 7-8). They argue that, in spite of its relevance, the literature on this subject is scarce and consider their contribution 'the first study documenting how lobbying may have contributed to the accumulation of risks leading the way

efficiency[10], rather than as a means to affect the power relations with the authorities in order to increase the revenues of the sector regardless of what happens to systemic risk. The data presented above suggest instead that they may play an important role in the formation of monetary legislation, as argued by some critical literature.

With the finalisation of the process of conversion to a rules-based approach to regulation in the 1990s legislation, the financial sector was able to enjoy an unprecedented expansion of its activities. The share of this sector in total profits has been rising while the wage share in GDP has been declining. For many economists this process has produced a rise in the systemic risk and the recent crisis.

8. The evolution of financial regulation after the crisis

Sraffa's approach and Mishkin's classification can be used to evaluate how the reactions to the recent financial crisis are affecting the evolution of financial regulation. We shall mainly refer to the content of the Interim Report of the 18th June 2010 written by the Financial Stability Board (FSB) in response to a mandate of the G20 Pittsburgh meeting to elaborate on the development of a policy framework for reducing the moral hazard risks posed by "Systemically Important Financial Institutions" (SIFIs), until recently known as "Too Big To Fail" (TBTF) financial institutions. Some reference will also be made to the package of reforms, named Basel III (July-September 2010), agreed upon by the Group of Governors and Heads of Supervision of the Basel Committee on Banking Supervision, to the Dodd-Frank Wall Street Reform and Consumer Protection Act approved by the US Congress in 2010, and to the institution by the European Union in 2010 of the European Systemic Risk Board (ESRB) and of the European System of Financial Supervisors (ESFS).

These initiatives move from the standpoint that before the crisis regulation was not working effectively because the balance between market discipline and official supervisory oversight was wrong.

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to the current financial crisis' (Igan, Mishra and Tressel, 2011: 40).

[10] Mishkin's (2001: 29), for instance, refers to Kroszner and Strahan (2001), who argue that private interests play a role in determining votes on banking regulation, to point out that small banks, the traditional beneficiaries of branching restrictions, tried to block interstate branching reform.

> It was tilted heavily toward ex ante market discipline, which proved to be elusive until it was too late … It also relied too little on official oversight, which failed to foresee the buildup of systematically significant imbalances and weaknesses' (Schinasi and Truman, 2010: 9).

The need to make supervision more effective is not considered contentious as a principle. There is no extended discussion however on what is required for its implementation. Moreover it is seen as an issue likely to meet opposition from the financial industry (see Cornford, 2010: 3 and Schinasi and Truman, 2010: 18-19).

The Interim Report of the FSB to the G20 leaders proposes a policy framework based on five points covering several national and international aspects of financial regulation. The main focus is on the first two points, which deal with the management and resolution of financial firms' crises and with the control of their risk exposure in order to reduce the probability of a crisis. The Report (FSB, 2010: 3) describes these two points as follows:

(A) actions that seek to ensure that firms can be resolved safely, quickly and without destabilising the financial system and exposing the taxpayer to the risk of loss;

(B) the capacity for national authorities to impose, when necessary, supplementary prudential requirements on institutions and/or structural constraints that reflect the greater risks they pose to the financial system.

Under point (A) the Report proposes actions designed to avoid 'exposing the taxpayer to the risk of loss' (FSB, 2010: 3) in the case of firms' crises. It considers national and cross-border measures for the resolution of firms' crises (*Group 3*). Among the former there are measures regarding capital and liability restructuring, the provision of temporary funds, the establishment of a temporary bridge bank to take over and continue the operation of certain essential functions, mechanisms to convert debt into equity. Among the latter the Report considers in the first place measures regarding the identification of the cross-border features of a financial instrument, of the connections among financial firms, and of the risks posed by certain trades to the stability of the financial system. Secondly, the Report considers measures regarding the adequacy of the system of information provided by financial firms. Finally, there are measures regarding the establishment of cross-border crisis management groups able to assess the possibility of resolvability without taxpayer losses and to formulate firm-specific "recovery and resolution plans" (RRPs), which include indications of the changes a financial firm must undergo to facilitate resolution.

Under point (B), which is introduced to deal with the control of the risk exposure and of the probability of a crisis, the Report (FSB, 2010: 4) proposes actions that

(i) significantly reduce the probability of SIFIs' failure by strengthening their resilience and loss absorbing capacity;

(ii) reduce the negative externalities that could arise from their failure;

(iii) improve their resolvability and ensure that essential functions for the financial system and broader economy can continue to be performed should the firm fail.

The Financial Stability Board, like the Basel Committee on Banking Supervision, is aware that the introduction of these measures may stimulate competition among jurisdictions and considers it necessary to set floors or minimums to be applied in all member countries. Moreover, its Interim Report considers it necessary to introduce supplementary prudential requirements for SIFIs. The Dodd-Frank Act of the US Congress moves from a similar standpoint and establishes the Financial Stability Oversight Council, which evaluates the existence of systemic risks and, in case of necessity, authorises the Federal Reserve to introduce supplementary prudential requirements for those financial firms that have been identified as large and interconnected. The institution in the European Union of the European Systemic Risk Board, which has to assess the existence of systemic risks, and of the European System of Financial Supervisors, which has to supervise the SIFIs, responds to similar purposes.

Unlike those designed to reduce the negative effects and improve the resolvability of a crisis – i.e. unlike those listed under (ii) and (iii) above - the measures proposed by the Report to reduce the probability of SIFIs' failure fit in the classification outlined by Mishkin. They belong to two different groups of instruments classified by Mishkin, one designed to improve "market discipline" (*Group 2*) and the other designed to regulate the degree of competitiveness and inter-connectedness of the financial system (*Group 1*).

To improve "market discipline" the Report suggests the introduction of capital, liquidity and leverage surcharges for the SIFIs. This subject is under the responsibility of the Basel Committee on Banking Supervision that in December 2009 sent out for comments a proposal on an upward revision of these requirements. The Group of Governors and Heads of Supervision of the Basel Committee on Banking Supervision met in July 2010 to review the proposal and in September 2010 agreed upon a set of measures that raised the minimum capital, liquidity and leverage requirements and scheduled their phasing in for all member countries (*Group 2*). The agreement represents a progress with respect to the previous situation, but the size and timing of the increased requirements are considered inadequate to reduce the probability of future crises (see Schinasi and Truman, 2010: 11).

Compared with what the Group of Governors and Heads of Supervision of the Basel Committee on Banking Supervision had envisaged in December 2009, the final agreement provides several concessions for the banking industry:

> Unfortunately, compared to the revisions to Basel II put forward in the December 2009 proposals, the agreement reached in July 2010 provided many concessions favorable to the banking industry, including a less demanding definition of Tier 1 capital, less stringent liquidity requirements, and a lower leverage limit (only 3 percent) phased in over a longer period ending in 2017. (Schinasi and Truman, 2010: 10)

These concessions are interpreted as a sign of the ability of the banking industry to resist the introduction of measures that increase their costs. They show that the Basel Committee failed to obtain the consensus of this pressure-group on its original proposals and was bound to recede towards an agreement, which is a source of preoccupations for the evolution of regulation and the future stability of the financial system:

> That a consensus could not be reached is disappointing: excessive leverage and poor liquidity-risk management by the major global banks played an important role in creating the conditions for the global crisis. They also contributed importantly to the virulent market dynamics and market dysfunctioning that prevailed throughout 2008–09. This mixed record to date by the regulators and supervisors is not reassuring for the prospects to agree on the difficult reform trade-offs and decisions that are yet to be taken and implemented on both sides of the Atlantic, including those pertaining to SIFIs, over-the-counter derivatives markets, and resolution mechanisms for cross-border banking problems. (Schinasi and Truman, 2010: 11)

The measures envisaged to regulate the degree of competitiveness and inter-connectedness of the financial system can fit in *Group 1* of Mishkin's classification. They are designed to control the size and complexity of SIFIs' operation and organizational structure. The Interim Report (FSB, 2010: 5) envisages for SIFIs the following additional measures:

(i) reducing intra-group connectivity through for instance intra-group exposure limits;

(ii) a structural separation of various financial activities within a group's legal and organisational structure, including requirements relating to separate incorporation and stand-alone capacity of operations that are systemically important in a financial system;

(iii) simplifying structures in a manner that aligns them more closely with the applicable regulatory and resolution frameworks.

As Cornford (2010: 6) points out, these measures are likely to be strongly resisted by the banking industry and to enhance competition among jurisdictions:

> Changes designed to simplify the structure of financial conglomerates (which SIFIs are) or to limit the range of activities in which they can engage are likely to be strongly resisted by the banks. In London suggestions that reform might include such measures have produced rumblings from this quarter about possible moves to other jurisdictions. Such threats underline the importance of coordinated action on measures for the structural reform of large, complex financial institutions on the part of FSB member countries. (Cornford, 2010: 6)

Measures consistent with this policy framework have been included in the Dodd-Frank Act. They are referred to as the "Volcker Rule" and the "Lincoln Provision" and are envisaged to constrain the organizational structure and the operations of SIFIs:

> Subject to certain exceptions the Volcker Rule prohibits banks from proprietary trading (i.e. trading for one's own account in securities or derivatives) and from investing in or sponsoring a hedge or private equity fund. Exceptions to the prohibition on proprietary trading can be authorised subject to supplementary capital requirements and quantitative limits. The Lincoln Provision, also referred to as the "spin out" or "push out" provision, limits the ability of banks to act as OTC derivatives dealers. The limit takes the form of a prohibition of Federal assistance (in the form of access to Federal Reserve lending facilities and reliance on deposit insurance from the Federal Deposit Insurance Corporation). (Cornford, 2010: 2)

Although significant for the lack of similar measures in previous legislation, these instruments appear of limited use with respect to the large and complex design of structural regulation existing during the New Deal and the Bretton Woods eras.

Always under point (B), the Report (FSB, 2010: 5) finally proposes the use of systemic levies 'to build up a resolution fund and hence facilitate resolution when such firms fail'. Various authorities (the G-20, the UK and US authorities), in response to the crisis, have been considering different kinds of levies: as an insurance for future problems, as an incentive to reduce the size of financial firms and specific operations, and as a means to pay back the cost of recapitalization. They raise the questions of competition among jurisdictions and international coordination and it is not clear whether they will end up by being introduced (see Schinasi and Truman, 2010: 11-12). The US Congress, for instance, discussed at length the need to introduce these measures and in draft legislation even brought them in. None the less, the final version of the Dodd-Frank Act does not foresee any such levy.

Under point (C) the Report explicitly refers to the need to reinforce the powers and the resources of the supervisory authorities:

> We will call for a strengthening of the mandate, powers and resources of supervisory authorities where appropriate and recommend a range of actions to render supervisory tools and practices more effective. (FSB, 2010: 6)

Yet, the recommendations of the Report refer vaguely to measures that can strengthen the discretionary powers of supervisory authorities over the management of financial firms. They can be summarised by the following four items:

1. production of knowledge on corporate governance, on the working of the financial system, and on measures and quantitative models to evaluate the risk exposure of financial firms;[11]
2. improvement of collection and treatment of data and information (*Group 2*);[12]

[11] The Report recommends: 'an increased focus on corporate governance and measures to better ensure the effectiveness of boards in overseeing the risks being taken by firms; methodological guidance to strengthen horizontal or benchmarking supervisory review processes; deeper investigation and understanding of the risks inherent within the business models of firms and the risks embedded in new innovations as well as ongoing activities (such as highly structured or complex products); better investigation into the appropriate use of quantitative models within a firm including their risks and limitations' (FSB, 2010: 6). Notice that only the first recommendation can be interpreted as vaguely referring to the relations of power between supervisory authorities and the management of financial firms.

[12] The Report recommends: 'the early identification of risks through better data collection, processing and monitoring leading to stronger on-site and off-site review work' (FSB, 2010: 6).

3. improvement of coordination among supervisory authorities at home and abroad;[13]
4. ‘an appropriate number of sufficiently skilled supervisors overseeing systemic firms’ (FSB, 2010: 6) (*Group 4*)

As can be noticed, only item 4 refers to measures that, as argued in the previous section, directly affect the discretionary powers of the supervisory authorities over the management of financial firms. For this reason, the call of the Report ends up by sounding as a mere acknowledgement (without practical consequences) of the role that this instrument can play in the overall organisation of financial regulation.

Under point (D) the Report (2010: 6) deals with the introduction of robust core financial infrastructures (such as exchanges and networks capable of making trades orderly, supportable and transparent) designed to reduce the probability of contagion due to counterparties exposures. These actions do not fit in Mishkin’s classification. They were already discussed and introduced before the recent crisis, in the form of systemically important payment systems, securities settlements systems and central counterparties (CCPs).

The Report (FSB, 2010: 6) recommends the support of the consistency of clearing and exchange or electronic trading requirements across jurisdictions and the organisation of infrastructures ‘that make derivatives standardised and increase the share of the market that is clearable’.

In the face of the significant role played by derivatives contracts during the recent crisis, the reference to the latter measure appears important. As a matter of fact, current discussions show that the authorities are now moving from the standpoint that the derivatives markets must be seen as an extension of the international inter-bank markets and that the most useful action in this respect is to try to ensure, as much as possible, its orderly working.

[13] The Report recommends: ‘enhanced consolidated supervision including through improved coordination among (sectoral) supervisors as well as home and host authorities; … effective cooperation and close coordination of supervisory activities among key home and host authorities, including through core supervisory colleges’ (FSB, 2010: 6).

The organisation of central counterparties (CCPs) capable to attract a large share of the transactions on derivatives contracts can represent a significant progress towards an improved management of systemic risk. CCPs can guarantee

- an increased transparency through the records of transaction and the definition of standard contracts,
- a reduction in the likelihood of a contagion due to the failure of a single counterparty owing to the introduction of arrangements for the sharing of costs of these failures among clearing members and for the use of this infrastructure as a clearing house for exchanges whose degree of liquidity can also be supported by coordinated interventions of the monetary authorities (see Cornford, 2010: 3).

Finally, **under point (E)**, the Report deals with the need to achieve consistency and coordination across home and host authorities. These actions too do not fit in Mishkin's classification. Their main objective is to avoid regulatory arbitrage.

The Report proposes the establishment of peer review processes to examine and compare national policies and the introduction of supervisory colleges and crisis management groups ensuring transparency among national policies in order to enhance trust during coordination and to reinforce the credibility of resolution policies.

To sum up, the current reactions of the national and international authorities to the financial crisis are producing some progress in micro-prudential regulation and in the resolution of firms' crises. Interesting proposals are also emerging in the organisation of core financial infrastructure, particularly in relation to the treatment of derivatives contracts.

None the less, the literature shows preoccupation for the evolution of financial regulation and the future stability of the financial system. The source of this preoccupation is the ability of the financial industry to affect national legislation and international agreements in ways that are not considered reassuring in the face of the recent experience. This preoccupation is mainly related to the content of the agreement reached in July-September 2010 by the Group of Governors and Heads of Supervision of the Basel Committee on Banking Supervision, an agreement known as Basel III. In the previous pages we have argued that there is another reason to be preoccupied on the evolution of financial regulation and the future stability of the financial system. We have noticed that although there is a widespread consensus on the fact that before the crisis regulation was not working effectively because the balance between market discipline and official supervisory oversight was wrong, the current reactions to the crisis by the national and international authorities seem to be essentially focussed on actions related to market discipline (*Group 2*). The need to restore the discretionary powers of the authorities over the management of financial firms is broadly overlooked.

Sraffa's approach suggests that this outcome is due to the ability of the financial industry to affect national legislation and international agreements, an interpretation that, as shown above, is acknowledged here and there, but not in a systematic way, in the literature examining and proposing reforms of financial regulation.

9. Conclusions

[To be written]

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