Lessons from the past can clarify banking crisis

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Stricter regulation of the financial services sector is likely to result from the latest upheaval in national and global markets. It is being demanded by politicians of all parties while the Financial Services Authority, which polices the sector in the UK, has announced that it is recruiting additional staff as part of a more stringent regulatory approach.

"The history of regulation is largely one of regulators trying to catch up after a crisis has arisen," says Professor Catherine Schenk, from the World Economy and Finance Research Programme at the University of Glasgow. She emphasises that while, regulatory changes are a familiar response to financial upheavals that does not guarantee their future effectiveness. "The experience of global crises shows that new guidelines tend to be aimed at the problems that caused the last crisis rather than anticipating the next source of weakness."

During the current crisis, many commentators have called for more robust cross-border regulation of a banking system which has become ever more global in recent decades. But Professor Schenk, whose research has included examining attempts at regulating international financial markets in the decades since the Second World War, points to long-standing and continuing obstacles which face drives for greater multilateral regulation of international financial markets. These include:

-- The difficulties of tracking international financial flows and complex transactions;
-- fears of pushing markets to off-shore centres which would be more

poorly regulated than the existing major national ones;
-- lack of agreement between nations on the costs and benefits of greater global regulation;
-- perceived threats to national sovereignty.

"In the past, attempts at collaborative supervision have most commonly come after a crisis when an international event has threatened national financial systems," says Professor Schenk. "When a crisis recedes, however, so does the impetus for regulatory reform. Meanwhile financial institutions innovate in ways to evade the new rules aimed at controlling their activities and this can cause new dangers."

"One obvious question is, will the sheer dramatic scale of this crisis strengthen the prospects for greater multilateral regulation succeeding this time?" Professor Schenk explains, "A lot will depend on the effects on the stock market and the wider economy. The extent to which far more people are now exposed to the stock market through pensions, ISA savings and in other ways is one of the main differences between what is happening today and the 1929 crash or the 1982 Latin American debt crisis.

"The financial sector is undoubtedly a very difficult and complex one to regulate. The current initiative, known as Basle II took 9 years to develop and has now been over-run by current events. I think much will now come down to how the regulators police the new regulations which will be developed, and to what extent different national regulatory regimes can succeed in creating and implementing common approaches and features."

Source: Economic & Social Research Council