Citation:
Morgan, JA (2011) Ethos and reform of finance systems, a tentative argument. Real World Economics Review (58). 89 - 94.

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Article (Published Version)

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Ethos and reform of finance systems, a tentative argument

Jamie Morgan [University of Helsinki, Finland]

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The idea of regulation as part of creating a practically operative system of finance opens up the issue of the ethos of the system. Behaviours and practices within a system are conditioned by more than the individual institutional forms within which those behaviours and practices occur: specific habits, laws, rules and so forth. They are conditioned by the more general oxygenation of those institutional forms: the bias of principle within the system i.e. it's ethos. Games have an overall complexity that makes sense of their individual rules. Social forms and specific systems have an ethos that colours what habits, laws and rules exist and how they are followed and iterated. This in part flows from dominant knowledge forms and what they tend to suggest regarding the nature and need for regulation.

A key aspect of a private finance organization is to adapt itself to the control mechanisms placed upon it i.e. in a negative sense to subvert the intention of the regulation that exists and also seek out gaps, lacunae etc in the regulation that exists.[1] A question one might apply here is what ethos does this tendency rely upon? One might state that it relies upon an ethos whose balance is towards *whatever is not formally prevented is allowed*. However, in so far as this ethos is a bias of principle it is not a rigid principle. As a systemic ethos it is multiple in its manifestations and thus blurred in its real meaning if not its substantive definition. The ethos that *whatever is not formally prevented is allowed* has not, for example, always been the absence of the seeking of permissions but rather a way in which inquiry is situated and actions justified.

One of the key underlying causes of the Global Financial Collapse (GFC) was the growth of credit derivatives – the use of credit default swaps and the growth of synthetic CDOs, specifically based on mortgage-backed assets. Credit derivatives were an innovation developed between 1991 and 1995. They were originally focused around collectivised corporate lending (which has very different characteristics than collectivised mortgages). They were intended to do three things for the originating banks. They created a new profit source by extending the possibilities of 'intra-financial' multiplication. They moved risk off a financial organization's balance sheet because any underlying default had been passed on, either to the counter-party in a credit default swap or to the holder of a constructed asset such as a synthetic CDO. And they created the potential for a financial organization's capital reserves to be proportionally reduced based on the reduction in 'risk exposure' because underlying defaults had been passed on (in turn allowing greater volumes of lending). In the context of capital reserve regulation, reducing capital reserves because of a financial innovation required permission from the relevant authority.[2] In the US capital reserves were overseen by

[1] Note that 'subvert' does not always entail an intent that is subversion but rather an outcome that has subverted. The context in which some given focus is considered to be subversive can be various (up to and including the eventual systemic significance of practices or products.

[2] The 1988 Basel 1 accord stipulated an 8% capital reserve (weighted for risk). This 8% essentially represented the expected risk of losses i.e. what would need to be covered if loans went bad. It then followed that if a credit derivative was constructed that removed the risk of 8% of the volume of any given lending to another party then that derivative had effectively offset the risk represented by the capital reserve, removing the need for that capital reserve (since the anticipated losses based on defaults would be absorbed by other parties rather than the originating bank). Banks could thus radically

the Fed and by the Office of the Comptroller of the Currency (OCC). In 1996 the Fed indicated that credit derivatives could be used to reduce capital reserves. What is significant here is that permission was not in the context of whether credit derivatives were allowable but rather what credit derivatives would then allow a financial organization to do. The innovation was in a primary sense uncontested. There was no clear sense in which it first had to be allowed because this was systemically required. There was nothing to prevent it thereafter being extended to mortgage markets based on completely different underlying characteristics.

Furthermore, the fact that it did not first have to be permitted was one situated to the way in which dominant knowledge affected the shape of finance markets. Derivatives in general had become a subject of regulatory debate in the early 1990s, and there was growing criticism of the problems they might create when in 1994 the Fed unexpectedly shifted the direction of interest rate policy causing losses on interest rate swaps that affected local government funds in the US that had used them as investment tools. Despite these problems derivatives markets remained self-regulated using rules initially devised by the International Swaps and Derivatives Association (ISDA). They were thus formally unregulated by anything other than 'the market'. The ISDA, moreover, was able to resist a series of attempts to impose formal regulation over the next decade. It was aided and abetted in this by the deep ontological role of 'market efficiency' discourse thinking in symbiosis with ethos.

The ethos of *whatever is not formally prevented is allowed* flows from a predominant emphasis on negative liberty. Negative liberty is freedom from constraint or interference in one's decisions and conduct. This predominance prioritises liberty, in an economic sense, as a space energised by entrepreneurial activity. It presupposes that change is beneficial providing innovation with positive connotations. Those positive connotations imbricate with the mechanisms of an idealised market: the process of selection of innovation is competitive and competitive processes are disciplined to produce economic goods that are also social goods. In the case of derivatives prior to the GFC, regulation was considered not to be required because expert counter-party surveillance was held to create discipline at the same time as derivatives themselves create a product for risk dispersion that actually helps to complete the efficiency of all other markets by placing risk where it is most appropriately held (by those who rationally choose it based on good information and sound contracts). One can then readily see how there is a mutuality between specific approaches to regulation, general dominant knowledge forms, and the bias of principle in the system. These combine to continue to shape that system as a real process.

If one considers the effects of ethos on the system then *whatever is not formally prevented is allowed* creates particular problems for the context of reform of the finance system. If there is no primary systemic injunction regarding new practices and products then the need for permissions is piecemeal. As such the scope for scrutiny of products and

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reduce their capital reserves whilst only passing on a small proportion of the original lending in some form through credit derivatives. This potentially enabled great expansions in lending (based on freed capital as well as wholesale sources) whilst keeping 92% of the lending risk on the books. However, since actual volumes of lending could then increase greatly the absolute levels of losses if defaults (or in fact simply writedowns if assets with mark-to-market values are involved) exceeded 8% could be large and could be uncovered by any capital reserve (this was termed 'super-senior risk'). Thus, the existence of credit derivatives opened up a whole new form of real risk exposure in the name of precise risk management. The actual basis of this was slightly modified since the OCC and Fed required the banks to hold 20% of the 8% i.e. instead of $80,000 per $1m, $16,000 per $1m and required the credit derivatives on which the transmission of risk was based to involve AAA ratings. This began the pressure on credit rating agencies to produce high ratings for credit derivatives and was also one reason why the banks began to look for ways of justifying high ratings for these new products.

practices as they emerge is fractured and the scope for those products and practices to become embedded, despite any adverse potential they may have, is actually ingrained in the system. Moreover, if there is no primary systemic injunction then it follows that there is no necessary presumption that private financial organizations must seek a relevant regulatory body to pass judgement on new practices and products or, if none exists, highlight that none exists, *because the ethos of the system makes it necessary that they do so*. They may manufacture their own organization as a legitimating entity but this is not the same. Furthermore, if the prevailing ethos is *whatever is not formally prevented is allowed* then once practices and products are within the system there is no necessary basis for limitations on the extension of those practices and products to new areas of business. In all these cases, injunction relies specifically on the existence of specific organizations with specific remits that are already targeting specific potential problem areas. As such, ethos as an aspect of the design of the system itself is not an aid to organizational form for regulation and supervision but an actual hindrance to it.

This hindrance effect manifests itself in multiple problems for the role of information in the system of regulation. It creates a problem because available information can be disempowered. The ethos of the system leads to a situation where the remit of each organization is likely to have to involve highly specific codifications of powers to impose effects on private financial organizations. This is because the burden or obligation of regulation rests with the stated duties of the regulator rather than is inhered in general obligations or duties imposed on the regulated. They are free to act except where constrained rather than required to constrain themselves except where *freed* to act. As such, regulators are motivated to create highly specified powers of constraint to target specific activities as they occur and those regulated are prompted to respond by viewing regulation as exactly that set of specified powers that can be evaded precisely by relying on what is not in those specifications. They can adhere to the letter but evade the intent because the systemic bias of principle enables this or they can step outside the letter because where the target is not aimed is free space. In either case, the information focus of the regulator can disempower that regulator by the way in which information is systemically operative – it becomes a tool of manipulation.

Not only can available information be disempowered, information itself can be made unavailable since it is effectively privatised by the presumption of the bias of principle in the system. One aspect of organizational reform of regulators is to extend their coverage to more kinds of financial organization: hedge funds, private equity etc. Another is to require greater transparency from these, including information on trading positions. The problem remains that effectiveness inheres in the effectiveness of the regulatory organization rather than in the system. That effectiveness is subject to the possibility of blind spots – particularly if the basis is a new kind of financial organization not currently specified (in the way say SIVs were new a decade ago). Moreover, even though specific organizational reforms are moves towards more available information this need not be the reversal of the privatisation of information because what the reforms ultimately involve is a requirement to produce data for the regulator from which strategies can be inferred and from which ideas about practices and the effects and flows of products can be constructed. The presumption is not that a practice or product is not allowed until such time as it has been fully justified and then permitted. At best, the inquiry concerns how the products and practices are already being used.

The net effect is that ethos has been a contributor to the widely recognized phenomena that regulation has tended to find itself fighting the last war. Regulation has been

oriented on the specific problems of the previous period of recognized instability and its manifestations of crisis. This has led to the view that regulators are trapped in an arms race with the regulated, constantly responding to what has been done rather than what is being done. This has created scope for critique of pervasive regulation on the basis that it is often ineffectual because it is backwards looking and it is potentially dangerous because in intervening to meet old problems that markets have or would have rectified themselves it has simply created a new distortion from which further subversions flow to create new adverse outcomes (regulators are responsible for the next phase of instability).

So, ethos is an important issue to explore because it is a prime source of analysis for how a system creates a context for regulation, information, and the discursive critique of the imposition of regulation. A focus on ethos allows one to look at these in a different way. In each case a primary problem is the systemic presumption that change is allowed unless formally prevented.

One way forward is to explore the implications of reversing the dominant ethos to create a systemic bias of principle based on *whatever is not formally allowed is prevented*. Doing so would create a quite different framework in which private finance organization activity tended to pursue subversive adaptations to control mechanisms placed upon them. The ethos of the system would constitute a counter-balance to this tendency in various ways. The need for permissions would no longer be piecemeal but rather ingrained in the system. In this framework permissions would come before implementations rather than as a corollary to some aspect of implementation. This would also hold for extensions of practices and products to new areas of business. Not only would the privatisation of information be reversed but the tendency for information to be disempowered would also be balanced.

If the ethos were *what is not formally allowed is prevented* then injunction would not rely on the existence of specific organizations and there would be an obligation on private financial organizations to seek out an organization or highlight its lack. Moreover, since the nature of obligation was general to the system and, the burden or weight of obligation or duty rested with the regulated rather than the regulator, then regulation could more easily become general in its form without losing effectiveness in its expression. The regulated would be required to constrain themselves except where free to act. The regulated would, therefore, be the one now pushing for clarification and would be the one offering more information and argument. In so far as this shift is possible then the regulator would not be trapped in an arms race with the regulated in quite the way that has been the case over the period of liberalised finance. Their relationship would be repositioned, giving the issue of the specific design of regulation for finance new inflections. As such the meaning frame within which actual real stability-instability processes occurred in a market system would be changed. It would then follow that the basis of any process of interventional stabilisation would be altered. Furthermore the possibility that problems could be foreseen would become a quite different issue because the shape of the system within which forecasting occurred would be qualitatively affected.

Key here is whether ethos as an aspect of the design of the system itself is now an aid rather than a hindrance to the organizational form of regulation and supervision. There are two challenges here, a negative and a positive one. The negative one is the counter-argument that an ethos of *whatever is not formally allowed is prevented* creates an overly bureaucratic system that is sclerotic, expensive to administer, overly conservative, subject to capture by the needs and interests of administrators, and replaces the good self-interested decisions of

market participants with the poor uninterested decisions of state (or other political entity's) employees. These are all potential problems but not necessarily actual problems. Whether they are depends upon the way the ethos can be and is inhered in the system. This is the positive challenge. It rests on a combination of changes to law and changes to organizations based on a clear overall attempt to cohere change in terms of the reversal of ethos.

For example, one might think about the use of principles of jurisdiction to provide concrete expressions of ethos. If a particular form of practice or product has not been allowed in a jurisdiction then the construction of a contract that then tries to enact it within that jurisdiction or based on original assets within that jurisdiction can be deemed unenforceable. This would create sufficient ambiguity such that counterparties or clients would be extremely disinclined to enter into contracts under these conditions. The jurisdiction need do no more than this. Clients and counterparties *may* undertake and fulfil contracts but will do so in a void that is quite different than liberalised finance where the absence of the state from the market is still a tacit guarantee of the market (a simulation of trust because of the legal infrastructure). Here the legal infrastructure removes that simulation and thus by *actively* doing nothing the law fails to tacitly guarantee the market.

A more fundamental reply to the negative challenge is to question the basis on which the ethos of *whatever is not formally prevented is allowed* provides a means to question the need for a practical expression of the alternative ethos. *Whatever is not formally prevented is allowed* is an ethos that relies upon markets simulating processes that they don't actually engage in. Efficiency assumes that markets demand and receive information and use it on an individual basis for individual purposes in a way that produces a collective outcome that is in some sense the best that could be attained (where best means optimal or if not optimal then better than what would be achieved through some non-market process). In essence the presumption is that market actions simulate what a collective discussion would agree to be the ideal economic and social outcome and this obviates the need for such discussion. This is conceptually problematic and manifestly empirically questionable.

What a reversal in ethos does is actually create conditions for such a collective discussion where that information can be genuinely put to collective debate and scrutiny. It replaces blind calculative rationality (putting aside the realism of such an assumption) with reason in which ideas of what is an economic good and a social good must be defined and defended rather than simply assumed to spontaneously emerge in a way that need not be defined or debated because it is self-evident. What this reversal in ethos does not demand by virtue of its form, however, is that once a product or practice has been subject to such scrutiny it will then be administered rather than marketised. This does not necessarily follow from the reversal of ethos. Whether it does is an additional argument regarding the role of regulation and monitoring in specific approaches to sets of reforms. As such, if a product or practice is genuinely an economic and social good in the context of the finance system then its originators need not fear its scrutiny on the basis that it will be prevented.

This does, however, raise further practical issues regarding the nature of finance based on such an ethos since the real basis of profitability for many products and practices is not their role as innovations creating market efficiencies per se but rather the restricted market in them based on the control of the innovation. Put another way it is precisely the nature of privatising information that creates the profitability of practice and product construction. There is a clear contradiction here between the idea of efficiency and the reality of practice and that, in turn, may be one reason why a product or practice is prevented (or

may be a reason for its public dissemination if its good is more than its current profit margin potential). In either case a variety of further issues are raised, for example, whether a financial patent system might be an appropriate way to match public needs and private motives. This, in turn raises new issues of the reification of power in regulatory reform. What it does not do, however, is close down the potential of thinking in terms of issues of ethos.

Author contact: zen34405@zen.co.uk

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SUGGESTED CITATION:
Jamie Morgan, "Ethos and reform of finance systems, a tentative argument", *real-world economics review*, issue no. 58, 12 December 2011, pp. 89-94, http://www.paecon.net/PAEReview/issue58/Morgan58.pdf

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