Financialisation, Crises and Regulation: A Holistic Examination of Risk

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Submission Date: 27/04/20

Deposit date: 30/06/20

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Acknowledgements

"No struggle can be waged effectively in isolation" – Nelson Mandela

This thesis, is the result of many sacrifices and has been developed from the personal and intellectual generosity and influence of many:

- my husband Rod and my children, Rose and Meenakshi - without whose love, intellectual stimulus (Rod's primarily), hugs and patience, I would not have completed the Phd.
- Alan and Andrew who prompted me to consider doing a Phd, Adrian and John who made me think about it seriously, Evelyn who advised along the way, external examiners Gary and Prem, internal examiner Chris, colleagues at the ICMA Centre including Emese and Alfonso who did internal reviews and friends and colleagues including Andy, Joerg, Urvi, Dhruba, Carlo, Marion, Heike, Mads and Tim who encouraged, commented, cajoled and advised along the way. I am grateful to Adrian for not giving up on me despite the length of the Phd, to Michelle for her chocolate crunch pick-me-ups and to all those unnamed here who stood by me and encouraged me to stay the course when I was diagnosed with serious illnesses along the way and found the Phd and workloads unbearable.
- my family and friends including mum (Sally) and Chitra who fed, watered and babysat the children a lot particularly towards submission date; thanks to appa, Sujatha, Anand mama, Kamala mami, Smita and Prem, and a sad, special loving thanks to those who aren't with us anymore whom I miss very much, particularly my amma, paati and thatha

Abstract

This thesis looks at the relationship between governance, risk and financialisation. It consists of three related, but distinct chapters. The first discusses the 2008 financial crisis. The second introduces the concept of macro-conduct regulation for the financial system, and the third is a case study of the Universities Superannuation Scheme (USS). Through these chapters thesis broadly explores how our understanding of risk is distorted and in some cases manufactured by a prioritisation of financial motives and financialized narratives. Such representations serve the interests of financial actors, elites and institutions while causing detriment to other stakeholders. The thesis then engages with the implications for governance and regulation.

The first chapter, on the financial crisis, shows how financialisation has distorted our conceptualisation of risk, such that some types of risk are magnified while others are de-prioritised or ignored altogether, causing aggregate risk to agglomerate and expand in unexpected and potentially dangerous ways. The second chapter takes recent developments in macro-prudential regulation and examines the need for a similarly holistic approach to conduct regulation. The chapter points out that the current approach to conduct regulation, which looks at each firm individually, is inadequate because it overlooks types of risks that are important. The final chapter, about USS, demonstrates that an overly-narrow conceptualisation of risk, which ignores many aspects of risk relevant to stakeholders, and failures in governance and oversight, by the regulator and by the trustees, have led to stakeholder detriment. Here, a financialized conception of risk results in a situation where a financially sound, healthy pension scheme is wrongly presented as being in distress and this in turn genuinely causes wilful blindness to a range of relevant risks. The case also shows how threats posed to the USS pension scheme are created or exacerbated by those entrusted with its safety – including trustees and regulators. The three papers together show how risk needs to be conceptualised much more broadly, following the trend towards financialisation, in order to allow us to structure our financial system in a way that is more resilient to systemic risk. The papers also reflect on the need to conceptualise regulatory and governance arrangements that appropriately address risks holistically.

Introduction

The Overseas Development Institute (2019) reports that 'Of the world's people, 1 in 12 are living in extreme poverty. One in nine go hungry. Half lack essential healthcare. Half are not covered by social protection. One in five children are (sic) not attending school'.[1]

The burdens of such socio-economic hardship are unequally distributed,[2] structural[3] and self-reinforcing. A well-developed body of literature demonstrates that such inequality and hardship are not just driven by individual choices or circumstances, but are a consequence of policy decisions made by those with socio-economic and political power.[4] It is also well-established in the literature that global finance serves as the arbiter of such power.[5] Financialization, defined by Epstein as 'the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies,'[6] means that finance now has a reach beyond its traditional role harnessing capital and risk for economic purposes. In exercising power beyond the economic realm, finance and financiers are able to influence democratic deliberation and affect power relations therein.[7] How financiers, financial markets and financial regulators define 'risk' and how underlying risks are then evaluated and understood informs the exercise of this power, determines how key risks are created, transmitted and shared, and facilitates accountability for risk-taking. These in turn, affect how hardship is either entrenched or ameliorated through structural and policy decisions. This thesis seeks to engage with these socio-political concerns, through the development of insights regarding risk and financial regulation. Put differently, this thesis examines the tension between the characterisation of risk as used by financiers and financial regulators, and the broader context of risk as it unfolds in society due to the actions of financial institutions. The fact that the latter, broader conception of risk creates consequences and costs for the broader society that are not intended by the core participants in the creation, regulation, and evaluation of risk

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1 Overseas Development Institute, (2019), Financing the end of extreme poverty, [online], at https://www.odi.org/sites/odi.org.uk/files/resource-documents/12907.pdf [accessed on 20th April 2020]

2 Therborn, G., (2013), *The Killing Fields of Inequality*, Polity Press, Malden

3 Mackenbach, J., Kunst, A., Cavelaars, A., Groenhof, F., Geurts, J., (1997), Socioeconomic inequalities in morbidity and mortality in Western Europe, *Lancet*, Vol 349, pp 1655-9 [online] at https://doi.org/10.1016/S0140-6736(96)07226-1 [accessed on 20th April 2020]

4 Young, I.M., (2011), Responsibility for Justice, Oxford University Press, Oxford

5 Moran, M., Payne, A., (2014), Introduction: Neglecting, Rediscovering and Thinking Again about Power in Finance, *Government and Opposition,* Vol 39, Issue 3 (Jul 2014), pp 331-341, [online] at http://dx.doi.org/10.1017/gov.2014.1 [accessed on 20th April 2020]

6 Epstein, (2005), *Financialization and the world economy*, Edward Elgar Publishing

7 Van der Zwan, N., (2015), Making sense of financialization, *Socio- Economic Review*, Vol 12, issue 1, pp 99-129, [online] at https://doi.org/10.1093/ser/mwt020 [accessed on 21st September 2017]

in the system that manages it on behalf of the financial industry, is not a problem that those in the industry have had to concern themselves with.

The thesis is developed as three chapters set around a broad theme of the financialization of risk. A chapter focussed on the reform of conduct regulation in finance forms the core of this thesis. This chapter develops on the substantive political rationales for regulation and advances arguments about the need to address systemic risks. In particular, it showcases, how one of the key aspects of the reform of prudential regulation since the global financial crisis (GFC) has been in recognising and addressing the systemic dimensions of prudential risk. The chapter develops a parallel macro-approach to holistically addressing conduct risk. The chapter therefore seeks to provide the foundation for significant and high-impact reform of the financial sector. The chapter makes a contribution to the literature by substantively expanding the conceptual framework of financial regulation. If implemented the changes proposed by the paper would have a significant impact on post-crisis regulatory reform. This in turn will in turn help prevent the perpetuation of many of the deep socio-political issues and ensure a just and fair response, particularly in the aftermath of crises such as the current Covid-19 pandemic.

The other two chapters in this thesis examine risk across two ends of the spectrum – the macrocosm and the microcosm.

As an investigation into the integrated, complex structure that is the whole of the financial system, chapter one draws lessons about risk by retrospectively surveying the causes of the GFC. The global financial crisis of 2007-09 is of historic significance because its role in increasing poverty has been estimated to be even greater than that of the Great Depression.[8]

[8] Tooze, A., (2018), The Forgotten History of the Financial Crisis, *Foreign Affairs,* Sep/Oct 2018 issue, [online] at https://www.foreignaffairs.com/articles/world/2018-08-13/forgotten-history-financial-crisis [accessed on 14th April 2019] agreeing with the comment made by Ben Bernanke in a submission to The United States Court of Federal Claims on Aug 22, 2014 (not available online) cited as '[T]he country at that time was in the most severe financial crisis since the Great Depression.' also cited in a document of The United States Court of Federal Claims number 11-779C filed June 15, 2015, Section A, pg 11, at https://ecf.cofc.uscourts.gov/cgi-bin/show_public_doc?2011cv0779-443-0 .

This has led scholars not just within the traditional finance and economics discourse, but also those in history,[9] theology,[10] education and pedagogy,[11] law,[12] psychology,[13] sociology[14] and criminology[15] to try to make sense of the causes of this catastrophic systemic meltdown, and their research has offered new and valuable insights. The chapter therefore seeks to integrate these multi-disciplinary insights into the broader discourse of the reform of finance, and financial regulation to enable what is termed a cognitive shift – a step change in the way of thinking. This is achieved by acknowledging, interrogating and integrating the lessons from these discipline-specific investigations, allying these to the theme of regulatory reform within finance, and utilising the benefit of hindsight a decade after the GFC to examine the causes of the crisis more critically. This chapter's new and original contribution to scholarship lies in weaving together the vast literature across various disciplines on the causes of the GFC, and in drawing out the linking thread of financialization that provides the justification to weaken or ignore substantive regulatory reform. This finding is important because recognising this allows for the recognition of the structural flaws embedded in UK regulation today that need urgent correction. This chapter also provides the context and sets the scene for the two subsequent chapters.

Chapter three is a case study of Universities Superannuation Scheme (USS) pension fund. This examination of USS, one of the world's largest defined benefit pension funds provides an ongoing illustration of the microcosm, by reviewing how financialization impacts how risk is conceived and shared. The case reflects on certain key decisions taken by the USS pension

[9] Reinhart, C., Rogoff, K., (2014), 'This Time is Different: A Panoramic View of Eight Centuries of Financial Crises', *Annals of Economics and Finance*, Society for AEF, vol. 15(2), pages 1065-1188, [online] at http://www.un.org/en/mdg/summit2010/pdf/MDG_FS_1_EN.pdf [accessed on 24th November 2016]

[10] ed. Badcock, G., (2016), *God and the Financial Crisis: Essays on Faith, Economics, and Politics in the Wake of the Great Recession*, Cambridge Scholars Publishing, Newcastle-upon-Tyne

[11] Henisz, W., (2011), 'Leveraging the Financial Crisis to Fulfill the Promise of Progressive Management', *Academy of Management Learning & Education*, 2011, Vol. 10, No. 2, pp 298–321, [online] at https://mgmt.wharton.upenn.edu/files/?whdmsaction=public:main.file&fileID=3778 [accessed on 1st September, 2016]

[12] Turk, Matthew. C., 'Reframing international financial regulation after the global financial crisis: rational states and interdependence, not regulatory networks and soft law', *Michigan Journal of International Law*, 09/2014, Volume 36, Issue 1, [online] at http://search.proquest.com.idpproxy.reading.ac.uk/docview/1649626860?accountid=13460 [accessed on 25th November 2016]

[13] Lackner, C., (2009), 'Emotional Causes for the Present Global Financial Crisis', *The Journal of Psychohistory*, Vol 37 Issue 2, pp112-124 [online] at http://search.proquest.com.idpproxy.reading.ac.uk/docview/203963519?accountid=13460 [accessed on 25th November 2016]

[14] Brown, A., Spencer, D., (2014), 'Understanding the Global Financial Crisis: Sociology, Political Economy and Heterodox Economics', *Sociology*, Vol 48, No 5, pp 938-953, [online], at available at http://soc.sagepub.com/content/48/5/938.full.pdf+html [accessed 25th November 2016]

[15] Boddy, C., (2011), The Corporate Psychopaths Theory of the Financial Crisis, *Journal of Business Ethics*, Vol. 102, No. 2, pp. 255-259, [online] at http://www.jstor.org/stable/41475954 [accessed 25th November 2016]

trustee that the paper argues, causes detriment to citizens and pension scheme members, permitting poor conduct and reinforcing the gradual erosion of defined benefit pension schemes on false premises. The analysis within the chapter reaffirms the need for a more holistic approach to risk. The case also examines questions of inequality, justice, power, narrative distortion and harm production, that foreground an investigation into risk-sharing at USS. The case draws out how the gains or losses from risk-taking are apportioned unjustly, and how the protections afforded to citizens by financial regulation are undermined by financialised interpretations of regulatory remit.

The thesis explores the way in which risk has come to be driven by financial motives and financialized narratives, that prioritise the interest of financial actors and institutions in how risk is conceptualised. Together, the three chapters, draw out the dangers posed by this 'financialization of risk', and explore how regulation can be developed such that there is a recognition of the need to tackle risks holistically. Through these discussions the thesis seeks to develop scholarly work in regulation and add a material contribution to more socially conscious approaches to risk and financial regulation.

Chapter 1: Financialization, risk and the global financial crisis

Introduction

The global financial crisis (GFC) of 2007 is noteworthy for its singularly devastating and far-reaching effects.[16] In the poorest of countries, the GFC resulted in singlehandedly wiping out decades of progress towards the Millennium Development Goals[17] that were aimed at combating the most extreme forms and consequences of poverty. Even in developed Western countries such as the UK – and importantly, more than a decade after the crisis - its effects are visible in homelessness[18], child poverty[19], and declines in mental and physical health.[20] For many ordinary citizens, the hardships caused by the crisis have been magnified by public policy responses. In many countries, the State[21] has responded to the crisis in ways that further rebalance power away from civil society and towards powerful individuals and corporations. For example, in the UK this has taken the form of savage cuts to public provision and the societal safety net. The resultant physical and psychological harm[22] inflicted on ordinary citizens has meant that agents of the State, including financial regulators, have been complicit in the violence[23] that the crisis has wreaked on societal stakeholders and the way in which remedial

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[16] International Monetary Fund, (2018), World Economic Outlook, October 2018, Chapter Two [online] at https://www.imf.org/en/Publications/WEO/Issues/2018/09/24/world-economic-outlook-october-2018#Chapter%202 [accessed on 24th February 2019]

[17] United Nations, Millenium Development Goals Achievement Fund website [online], at http://www.mdgfund.org/node/922 [accessed on 24th February 2019]

[18] Faber, W., (2019), On the Street During the Great Recession: Exploring the Relationship Between Foreclosures and Homelessness, *Housing Policy Debate,* Vol 29, Issue 4, [online] at https://doi.org/10.1080/10511482.2018.1554595 [accessed on 24th April 2020]

19 Cantillon, B, Chzen Y., Handa, S., Nolan, B., eds., (2017), *Children of Austerity: Impact of the Great Recession on Child Poverty in Developed Countries*, The United Nations Children's Fund and Oxford University Press, [online] at https://www.unicef-irc.org/publications/pdf/Children_of_austerity.pdf [accessed on 24th April 2020]

[20] Alston, P. (2018), 'Statement on Visit to the United Kingdom, by Professor Philip Alston, United Nations Special Rapporteur on extreme poverty and human rights', 16th November 2018, London, [online], at https://www.ohchr.org/Documents/Issues/Poverty/EOM_GB_16Nov2018.pdf [accessed on 24th February 2019]

[21] Hereafter, the term 'the State' refers to the institutions of government

[22] Oxfam (2013), 'The True Cost of Austerity and Ineqality', UK case study, September 2013, [online], at https://www.oxfam.org/sites/www.oxfam.org/files/cs-true-cost-austerity-inequality-uk-120913-en.pdf [accessed on 1st September 2016]

[23] Huggins, M., Haritos – Fatouros, M., Zimbardo, P., (2002), *Violence Workers: Police Torturers and Murderers Reconstruct Brazilian Atrocities,* University of California Press, Berkeley, California

measures have further inflicted harm.[24] In doing so, the State has served as an agent for harm production and harm redistribution.[25]

Philip Alston, the UN special rapporteur on extreme poverty and human rights, who visited the UK at the tail end of 2018 pointed out[26] that the UK for is noteworthy for successive governments' intentional disengagement with serious societal challenges including homelessness and child hunger, increased insecurity and vulnerability for workers, and the government's intentional underfunding of public services, including education, health and social care. The tolls of these choices will be borne by generations to come.[27] This is not a situation limited to the UK

As the American Financial Crisis Inquiry Commission also notes, 'the collateral damage of this *(Global Financial)* crisis has been real people and real communities'.[28] The crisis has also proven to have extremely adverse consequences for democracy and social cohesion.[29] It has demonstrated quite clearly that the risks posed by, talked about, evaluated by and decided upon by financiers (and those who affect public and influential pockets of discourse about post-crisis reform), have not just affected global finance. It is well-recognised that the scale, complexity and interconnectedness of the financial system with the real economy, have resulted in economic costs[30] to others.

Regulatory changes in the aftermath of the crisis, have been ideationally centred on creating resilience to crises. Their aim was to ensure that the financial system was financially resilient to

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[24] Leszkiewicz, A. (2016), 'The UN declares the UK's austerity policies in breach of international human rights obligations', *New Statesman*, 29th June 2016 [online], at http://www.newstatesman.com/politics/uk/2016/06/un-declares-uk-s-austerity-policies-breach-international-human-rights [accessed on 1st September 2016]

[25] Pemberton, S., (2015), *Harmful Societies: Understanding Social Harm*, Policy Press, Bristol

[26] Alston, P. (2018), 'Statement on Visit to the United Kingdom, by Professor Philip Alston, United Nations Special Rapporteur on extreme poverty and human rights', 16th November 2018, London, [online], at https://www.ohchr.org/Documents/Issues/Poverty/EOM_GB_16Nov2018.pdf [accessed on 24th February 2019]

[27] International Monetary Fund, (2018), World Economic Outlook, October 2018, Chapter Two [online] at https://www.imf.org/en/Publications/WEO/Issues/2018/09/24/world-economic-outlook-october-2018#Chapter%202 [accessed on 24th February 2019]

[28] The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report, [online], available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf [accessed on 24th February 2019]

[29] Hudson, M., Davidson, R., Durante, L., Grieve, J., Kazmi, A., 'Recession and Cohesion in Bradford', report for the Joseph Rowntree Foundation, [online] available at https://www.jrf.org.uk/report/recession-and-cohesion-bradford [accessed on 24th February 2019]

[30] International Monetary Fund, (2018), World Economic Outlook, October 2018, Chapter Two [online] at https://www.imf.org/en/Publications/WEO/Issues/2018/09/24/world-economic-outlook-october-2018#Chapter%202 [accessed on 24th February 2019]

economic costs posed by potential financial crises. But beyond these economic costs, there have been serious socio-political harms that require consideration in a meaningful way, with deliberations over acceptable levels of risk-taking[31] framing how social harms are produced by the financial sector. But post-crisis reform of financial regulation has neglected this, and has predominantly been developed using the idea and language of resilience. Such resilience is vaunted as a mechanism to bear economic costs without sufficient consideration as to what leads to the creation of those costs in the first place.

Discussions of conduct, are framed around individualistic assumptions around vulnerability or personal responsibility. For example, much work has gone into building financial literacy, or dealing with particular vulnerable groups that are assumed to fall outside traditional paradigms of those able to bear the costs of financial collapse. Reform measures have thus followed paradigms premised on markets and driven by incentives and disincentives drawn around narrow presumptions of economic utility.

As society teeters on the edge of another financial crisis, catalysed by the Covid-19 pandemic, this chapter looks back at the GFC. By investigating, interrogating and drawing together the causes of the crisis and adopting a cross-disciplinary approach, the paper seeks to re-frame our understanding of risk around the process of production of harm. It is hoped that this in turn will help with re-examining how risk could be evaluated more holistically and thus facilitate a serious consideration of how the avoidance of social harm is embedded, within both the regulation and the practice of finance. These reflections are prompted by the recognition that many of the causes of the GFC remain in play today, and the consequences of crises such as the GFC have far-reaching, long-term effects for civil society. Much like dormant volcanos, financial crises erupt again and again, wreaking havoc and devastation. But unlike volcanic eruptions, over which we have little control and where societal responses seek primarily to ameliorate consequences, the causes of financial crises shouldn't just be dealt with purely by creating techniques for financial resilience to crises. The focus should not just be on building financial reserves within banks and insurers, so that they can withstand crises. It is also about dealing with the underlying causes that result in crises that eat into financial reserves. The factors that cause serious harm and crises must also be eradicated. To do so, it is essential that we engage more effectively with the process of harm production rather than just with how risks are managed post-crystallisation i.e. harm attenuation or transfer.

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To do so, this chapter pulls together scholarly research specific to a wide range of disciplines and also draws in cross-disciplinary work. Doing so helps to evaluate the GFC more holistically so as to engage with lessons that the cross-disciplinary perspective affords.

In addition to synthesising, critically engaging with, and summarising the different causes of the crisis and marrying together different aspects of the scholarly literature, this chapter makes two key points. First, the paper argues that a number of the causes of the crisis share a single genus - the misperception and/or the misrepresentation of risk. Second, the chapter proposes that this misperception and/or misrepresentation is a consequence of financialization. The chapter makes the point that financialization has resulted in regulators and regulation not fully addressing risk, even after the crisis. Pointing out the unifying thread of financialization, also helps explain why - despite visible changes to financial regulation for over a decade after the crisis - many serious pre-crisis issues remain worryingly prominent and the changes to conduct regulation remain far from credible. In making this point, the chapter prepares the ground for a subsequent chapter explaining how a combination of macro- and micro- approaches to conduct risks, could substantively improve financial regulation.

Methodology

In addition to investigations into financial crises, that one might expect within finance and economics, the lenses of economic history,[32] theology,'[33] pedagogy,[34] law,[35][36] psychology,[37]

[32] Reinhart, C., Rogoff, K., (2014), 'This Time is Different: A Panoramic View of Eight Centuries of Financial Crises', *Annals of Economics and Finance*, Society for AEF, vol. 15(2), pages 1065-1188, [online], available at http://www.un.org/en/mdg/summit2010/pdf/MDG_FS_1_EN.pdf [accessed on 24th November, 2016]

[33] ed. Badcock, G., (2016), *God and the Financial Crisis: Essays on Faith, Economics, and Politics in the Wake of the Great Recession*, Cambridge Scholars Publishing, Newcastle-upon-Tyne

[34] Henisz, W., (2011), 'Leveraging the Financial Crisis to Fulfill the Promise of Progressive Management', *Academy of Management Learning & Education*, 2011, Vol. 10, No. 2, pp 298–321, [online], available at https://mgmt.wharton.upenn.edu/files/?whdmsaction=public:main.file&fileID=3778 [accessed on 1st September, 2016]

[35] Lastra, R., M., (2016), 'The Coming of Age of International Monetary and Financial Law after the Global Financial Crisis', *Journal of International Economic Law,* Vol. 19 Issue 2, pp 371-373 [online] available at https://doi.org/10.1093/jiel/jgw018

[36] Turk, Matthew. C., 'Reframing international financial regulation after the global financial crisis: rational states and interdependence, not regulatory networks and soft law', *Michigan Journal of International Law*, 09/2014, Volume 36, Issue 1, [online], retrieved from http://search.proquest.com.idpproxy.reading.ac.uk/docview/1649626860?accountid=13460 [accessed on 25th November, 2016]

[37] Lackner, C., (2009), 'Emotional Causes for the Present Global Financial Crisis', *The Journal of Psychohistory*, Vol 37 Issue 2, pp112-124 [online], available at http://search.proquest.com.idpproxy.reading.ac.uk/docview/203963519?accountid=13460 [accessed on 25th November, 2016]

sociology[38] and criminology[39] to name a few, have been applied to the study of the global financial crisis. This has contributed to a greater understanding of the crisis across topics as varied as corporate psychopathy,[40] corporate governance,[41] macroeconomics,[42] lobbying[43], human biology (such as financiers' testosterone levels[44]), racist redlining and discrimination in credit extension,[45] financial engineering[46] and the mathematics of financial instruments (CDOs),[47] consumer behaviour, regulation and cognition (willful blindness).

While these investigations provide useful insights for scholars within a particular discipline to delve deeper into issues using discipline-specific tools and paradigms, another way of approaching particularly complex and multi-faceted problems is through recognising the presence of several simultaneous causes requiring the application of different disciplinary perspectives in order to rigorously examine, systematically organise and integrate any analysis. Holistic approaches can allow scholars to abstract and aggregate differently from solo disciplinary approaches by providing unusual perspectives. Osborne (2015) points out that 'Very few of the most important works in the area of 'theory, culture and society', for example,

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[38] Brown, A., Spencer, D., 'Understanding the Global Financial Crisis: Sociology, Political Economy and Heterodox Economics', *Sociology,* Vol 48, No 5, pp 938-953, [online], available at http://soc.sagepub.com/content/48/5/938.full.pdf+html [accessed on 25th November 2016]

[39] Fligstein, N., Roehrcasse, A., (2016), *American Sociological Review*, Vol. 81, No. 4 (August 2016), pp. 617-643

[40] Boddy, C., (2011), The Corporate Psychopaths Theory of the Financial Crisis, *Journal of Business Ethics*, Vol. 102, No. 2, pp. 255-259, [online], available at http://www.jstor.org/stable/41475954 [accessed on 25th November 2016]

[41] Clarke, B., (2010), 'Corporate Governance' an Oxymoron? The Role of Corporate Governance in the Current Banking Crisis, *The Future of Financial Regulation,* Hart, Oregon

[42] Obstfeld, M., Rogoff, K. (2009), 'Global Imbalances and the Financial Crisis: Products of Common Causes', IMF Seminar Paper, November 2009, [online], available at https://www.imf.org/external/np/res/seminars/2010/paris/pdf/obstfeld.pdf [accessed on 1st September, 2016]

[43] Igan, D, Mishra, P., Tressel, H., (2012), A Fistful of Dollars: Lobbying and the Financial Crisis,' *NBER Macroeconomics Annual*, University of Chicago Press, vol. 26(1), pp 195 – 230, [online], available at http://www.nber.org/papers/w17076.pdf [accessed on 1st September 2016]

[44] Newton-Small, J., (2016), *Broad Influence: How Women Are Changing the Way America Works*, Time Books, Washington

[45] Dymski, G., (2012), Racial Exclusion and the Political Economy of the Financial Crisis, in Lapavitsas, C., (ed), (2012), *Financialisation in Crisis*, pp 51-81, Brill, The Netherlands

[46] McBarnet D., (2010), Financial Engineering or Legal Engineering?: Legal Work, Legal Integrity and the Banking Crisis. In MacNeil IG, O'Brien J, eds, *The Future of Financial Regulation*, Hart Publishing, pp. 67-82.

[47] Mendales, R., (2009), 'Collateralized Explosive Devices - Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It', University of Illinois Law Review, Vol 2009, Issue 5, pp. 1359-1415, [online], available at http://heinonline.org.idpproxy.reading.ac.uk/HOL/Page?handle=hein.journals/unilllr2009&collection=journals&id=1369 [accessed on 25th November 2016]

over the last 50 years, are 'disciplinary' in character, or representative of the disciplinary training of their authors.'[48]

Investigations that cross disciplinary protocols help facilitate the equivalent of what psychologists have termed a 'cognitive shift'[49] allowing knowledge to be captured, processed, interpreted and used entirely differently from what one would expect with a single disciplinary lens. This type of exploration is important because it allows for a rounder re-evaluation, and provides a step-change by presenting the problem in an entirely new way, by adding to, or widening the discussion, moving away encumbrances that are specific to single-disciplinary foci and tools, and presenting new perspectives on and solutions to complex problems.[50] Cross-disciplinary and inter-disciplinary approaches have previously been applied very effectively[51] to help analyse complex social phenomena that have more than one disciplinary dimension. They allow scholars to step beyond their own disciplinary protocols to re-envisage both the landscape and the root causes of problems.

This type of interdisciplinary approach is particularly useful in the case of the GFC because it would be grossly insufficient to analyse the entirety of the crisis solely through the use of the tools, discourse and techniques of a single lens such as that of economics or finance, particularly given the wider knowledge gained from and breadth of academic research in different disciplines that have developed in the decade since the crisis. A study of the causes of the crisis, that transcends disciplinary epistemological and narrative specificities, allows for a more holistic understanding of the interconnected spaces that the global financial crisis inhabits. Indeed, the simultaneous / conjoined application of many disciplinary lenses not just matches the needs of the research arising from the plurality of the causes of the crisis, but also the realities of the investigations undertaken by both the public and private sector in the aftermath of the crisis. Key reports on the global financial crisis have been delivered not only by academics

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[48] Osborne (2015), in final submission version of Osborne, P., Sandford, S., Alliez, eds., special issue of *Theory, Culture & Society,* on Transdisciplinary Problematics [online] available at https://core.ac.uk/download/pdf/29471812.pdf [accessed on 26th February 2019]

[49] Latta, R. L., (1998), The basic humor process: A cognitive-shift theory and the case against incongruity, Mouton de Gruyter, Berlin, at https://books.google.co.uk/books?id=bSN5bWSjnHcC&printsec=frontcover&source=gbs_ViewAPI&redir_esc=y#v=onepage&q&f=false [accessed on 26th February 2019]

[50] Institute of Medicine (US) Committee on Building Bridges in the Brain, Behavioral, and Clinical Sciences, (2000), The Potential of Interdisciplinary Research to Solve Problems in the Brain, Behavioral, and Clinical Sciences [online] available at https://www.ncbi.nlm.nih.gov/books/NBK44872/

[51] Callard, F., Fitzgerald, D., (2015), *Rethinking Interdisciplinarity across the Social Sciences and Neurosciences,* Palgrave Macmillan, UK (e-book Online) at https://doi.org/10.1057/9781137407962 [accessed on 23rd April 2019]

but by practitioners and regulators[52] with expertise across a range of disciplines. Given the complexity of the crisis, it has been noted that commentators opining on the crisis particularly those with wider exposure or longer-term experience and understanding of the financial sector, are able to provide a much more meaningful understanding of the crisis.

Whittle and Mueller (2012) provide a good example of how our understanding of the GFC can be enriched by drawing upon interdisciplinary insights. They use 'discursive psychology, ethnomethodology, dramatism, rhetoric, ante-narrative analysis and conversation analysis'[53] to explore 'discursive devices' used in the stories about the GFC. Their work enriches the scholarly literature about the GFC by offering a new interpretation of the narrative around how scrutiny and reform were shaped. They provide valuable, new insights by exploring what they call the 'stories surrounding the crisis'.[54] Dowell-Jones and Kinley (2011)[55] explore the GFC from the perspectives of both human rights law and the study of finance to trace and link the erosion in human rights to growing financialisation and its deleterious impact. They explain how the global financial crisis has reminded them, as scholars, of the real and present need for, (in their case), a

''macro' or 'systemic' approach to the relationship between global finance and human rights that looks at the interaction between the structures, processes, and dynamics of international finance and the capacity of states to secure broad-based human rights protection'

Since this chapter's methodology and that of the dissertation, echoes D'Agostino's sentiments about the benefits of using multiple disciplinary lenses, it is not just important to understand finance or economics scholars in this instance, or that their contribution 'exhausts what it might be interesting to say' about the crisis.[56] By adopting this cross-disciplinary perspective the chapter posits that the 'red thread' of financialisation links and indeed underpins many of these visibly diverse causes.

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[52] The De la Rosiere Group, (2009), 'Report of the High-Level Group on Financial Supervision in the EU', [online] available at http://ec.europa.eu/economy_finance/publications/pages/publication14527_en.pdf [accessed on 26th February 2019]

[53] Kelsey, D., Mueller, F., Whittle, A., Khosravinik, M., (2016) Financial crisis and austerity: interdisciplinary concerns in critical discourse studies, *Critical Discourse Studies*, Vol 13, Issue 1 at https://www.tandfonline.com/doi/full/10.1080/17405904.2015.1074600 [accessed on 26th February 2019]

[54] Whittle, A., Mueller, F. (2012)., Bankers in the dock: Moral storytelling in action, *Human Relations*, 65(1), 111–139

[55] Dowell-Jones, M., Kinley, D., (2011), 'Minding the Gap – Global Finance and Human Rights', *Ethics & International Affairs*, 25 (2), pp 183-210

[56] D' Agostino, F (2012), Disciplinarity and the Growth of Knowledg*e, Social Epistemology,* 26:3-4, 331-350, [online] at https://doi.org/10.1080/02691728.2012.727192 [accessed on 26th February 2019]

In bringing a more holistic approach to re-examining the causes of the crisis, this chapter draws upon both practitioner and scholarly literature from a range of areas including corporate governance,[57] law,[58] sociology, criminology,[59] finance, politics, economics, psychology and regulation. The chapter extends this literature by developing a nuanced and multi-faceted understanding of the complex phenomena and moving parts that are characteristic of financial crises and linking them to financialization. It seeks to recognise the problems in crafting suitable regulatory and civil society responses when systemic complexity is coupled with dynamism in different elements of the system. Identifying financialisation as a linking cause helps in such circumstances to recognise, relate and address common causes, that in turn has positive network effects, create positive synergies and thereby enhances the impact and viability of regulatory policy changes[60]

The paper is developed in two strands. A discussion of the literature surrounding the causes of the crisis and their interlinkages forms the dominant narrative of the paper. The second strand centres around risk and financialization, and provides an explanation of how financialization animates and exacerbates the causes of the crisis. The analysis that follows sets the scene for further conceptual elaboration of regulatory reform within this thesis as a response to the GFC.

Causes of the Crisis

While there are several well-documented underlying causes for the GFC, what becomes apparent after investigation is that these causes often link to each other in rather multi-dimensional ways. This section provides both the context for and elaboration of these causes.

Ideological and political underpinnings

Since the 1970's, neo-liberal economic doctrin**e**[61] has been influential in determining public policy choices in the US and the UK, and across countries that emulated their legal systems or

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[57] Sun, W, Stewart, J, Pollard, D., (2011), *Corporate Governance and the Global Financial Crisis: International Perspectives*, Cambridge University Press, Cambridge.

[58] McBarnet, D., 'Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis' in MacNeil, I., and O'Brien, J., (eds), *The Future of Financial Regulation,* Hart Publishing, Portland, 2010

[59] Fligstein, N., Roehrcasse, A., (2016), *American Sociological Review*, Vol. 81, No. 4 (August 2016), pp. 617-643

[60] The cross-disciplinary approach also fits particularly well with this chapter because it also reflects the researcher's own prior background, and facilitates the recognition of patterns in the environment that are visible to the author, as a result of drawing upon the author's prior work, discussions with regulators and practitioners, and context, as a former banker, consultant and regulator in the UK and in the EU.

[61] Frankfurter, G., and McGoun, E., (1999), 'Ideology and the theory of financial economics', Journal of Economic Behavior & Organization,

securities markets. Ireland (2010)[62] cites this ideological basis as a predominant causal factor for the GFC noting that

'At the individual level, the vision is one of a world of autonomous, self-reliant, 'responsible', 'financially literate' owners of intangible financial property (property which confers on its holders rights to receive revenues in the future) who achieve personal security not through social insurance but through the ownership of assets ..... and financial property.........'.

Within this paradigm, inherent distrust of regulatory 'interference' and a concomitant emphasis on private economic freedoms provide the impetus for a discourse that accentuates the importance of personal freedoms on the one hand and a minimalist approach to financial regulation on the other. Lynch points out the paradox inherent however in preserving such economic freedoms for which 'the state is a necessary, constitutive actor in the production and reproduction of markets in practice, while discursively painted as the limit to truly 'free' markets'[63]

The central idea is of a rational consumer, who is able to rank preferences and exercise free choice. The market is then seen as the fairest means of allocation of resources based on these rational consumer choices and the decisions of competing suppliers in a competitive market. The exercise of consumer rights is – at a deeper level - equated with greater democracy and indeed seen as interchangeable with citizen rights.[64] Regulatory interventions (within this paradigm) are seen as bureaucratic and are expected to increase inefficiencies and/or hinder productive, mutually agreeable solutions, particularly among larger private market participants.

Coupled with this notion of the rational consumer, is the idea of 'consumer sovereignty', predicated on the premise that the rational consumer can withhold, transfer or transform demand.

From an ethical perspective, the adoption of this neoliberal ideology often ties in to the tacit acceptance of what is known as the 'trickle-down' effect. Economist John Kenneth Galbraith described this concept as 'the less than elegant metaphor that if one feeds the horse enough

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Vol. 39 (1999) 159–177, 1997

[62] Ireland, P., 'The Financial Crisis: Regulatory Failure or Systems Failure' in MacNeil, I., and O'Brien, J., (eds), *The Future of Financial Regulation,* Hart Publishing, Portland, 2010

[63] Lynch, C., R., (2017), 'Vote with your feet': Neoliberalism, the democratic nation-state, and utopian enclave libertarianism, *Political Geography*, Vol 59, pp 82-91 (online) at http://dx.doi.org/10.1016/j.polgeo.2017.03.005 [accessed on 8th May 2019]

[64] Olsen, N., (2017), From Choice to Welfare: The concept of the consumer in the Chicago School Of Economics, *Modern Intellectual Histo*ry, Cambridge at http://dx.doi.org/10.1017/S1479244316000202 [accessed on 2nd May 2019]

oats, some will pass through to the road for the sparrows.'[65] Discussed in the literature under the heading of supply-side economics, the perspective of 'the monetary model was that the economy would grow ... and governmental income such as taxes along with it, if income tax and capital gains cuts were made to the top tier.'[66] This approach to economics also provided the narrative basis for increased globalisation and competition not just between different companies but also importantly between nation states. The objective of competition between nation states was to provide favourable markets through monetary, regulatory and fiscal policies to accompany flexible markets. This approach was supported by greater movement of capital, more international outsourcing to keep labour costs down, and the use of legal and financial techniques to facilitate the extraction of shareholder value. The key assumption within this discourse is that enriching and protecting shareholders, consumers and those at the top, will be good for society as a whole because through the spending by elites, wealth will percolate through to the rest of the economy.

Allied to this broader expectation is the view that in the longer-term society still benefits because of increased entrepreneurship and innovation, wider share ownership and a progressive return of these profits to other sections of society, resulting in job creation, economic freedom and development, entrepreneurial progress and value creation. The ethical emphasis is on societal betterment as a result of economic gains, but the mechanism is through the voluntary spending and benevolence of those whom the wealth will trickle down from.

In practice though, it has been pointed out by scholars that the ideas of trickle-down theory leave too much to the discretion and benevolence of shareholders and the wealthy and therefore are unfoundedly optimistic as to its benefits. Persky et al. (2004) note that important questions such as: 'Who gets new jobs in an area? Wouldn't many of those workers be employed anyway? To what extent do benefits spill over to others in a community? Do gains trickle down to improve the welfare of those most in need?'[67] are left unanswered and at the mercy of the generosity of elites, plutocrats and shareholders who may neither have the motives, nor the

[65] Galbraith, J.K., (1982), 'Recession Economics' , *The New York Review of Books,* February 4 1982 [online] at https://www.nybooks.com/articles/1982/02/04/recession-economics/ [accessed on 2nd May 2019]

[66] Hamilton, G., (2012), 'Horses and Sparrows: The myth of 'trickle down' economics', *The New Maine Times*, analysis section in issue dated 30th July 2012 [online], available at http://www.newmainetimes.org/articles/2012/07/30/horses-and-sparrows-myth-trickle-down-economics/ [accessed on 23rd February 2019]

[67] Persky, J., Felsenstein, D. and Carlson, V., (2004), *Does 'Trickle Down' Work? Economic Development Strategies and Job Chains in Local Labor Markets*, W. E. Upjohn Institute for Employment Research.

means nor the knowledge to be able to help achieve the idealistic outcomes that trickle-down economics predicates its ethical basis upon.

The trickle-down effect is predicated on voluntary redistribution through the spending and efforts of those further up the earnings pyramid. But as Giridharadas (2018)[68] notes, the very class of philanthropists – those who are in a position to finance such voluntary action - tends to disproportionately include those who have profited from serious exploitation of power, people, planet and other resources. To consign society's most serious problems including for example climate change, poverty or serious diseases to be 'solved by the unelected upper crust instead of the public institutions it erodes by lobbying and dodging taxes'[69] can be both highly optimistic and highly detrimental to democracy as wealthy and powerful people are able to manipulate the discourse (and accompanying political process and the law) to change outcomes in ways that ultimately benefit their own interests. The real-world problems that arise despite the so-called efficiency of the markets, are expected to be resolved by the generosity of philanthropists. Emphasising the asymmetries of power and access that this entails, Lynch (2017) shares the example of the Cato institute, a 'Washington DC-based think tank founded by libertarian billionaire Charles Koch' that 'consistently tops international rankings of the most-influential and well-funded 'think tanks in the world'. The billionaire backer in this instance, not only has financial wherewithal that helps to advance his libertarian perspective, but also institutions such as these attract members (Cato Institute Fellows, in this instance) who already have a powerful voice in the mainstream media, including in Forbes, The Washington Post and other large media outlets. This further advances the billionaire's libertarian agenda by adding other voices with clout to their platform. This speaks to the vast prioritisation of both the power and access of those with a neoliberal agenda. As Stiglitz notes, 'It's a land of PowerPoint presentations and cuddly good intentions.'[70] The reality is one of hard-nosed decisions based upon power and access procured through financial might.

The doctrine of market efficiency has importance in this worldview. Fama's seminal work (1970) describes an efficient market as one in which 'prices 'fully reflect' all available information'[71]. The expectation is that where markets are transparent and liquid, securities

[68] Giridharadas, A., (2018), *Winner Takes All,* Afred A Knopf, New York

[69] Penguin Random House website, Quoted text cited from web description of *Winner Takes All*, (online) at https://www.penguinrandomhouse.com/books/539747/winners-take-all-by-anand-giridharadas/9780451493248/

[70] Stiglitz, J., (2018), 'Meet the 'Change Agents' Who Are Enabling Inequality', *The New York Times,* 20th August 2018 [online], at https://www.nytimes.com/2018/08/20/books/review/winners-take-all-anand-giridharadas.html [accessed on 23rd February,2019]

[71] Fama, E., (1970), 'Efficient Capital Markets: A Review of Theory and Empirical Work, *The Journal of Finance*, Vol 25 (2), pp 383-417

traded in these markets will be priced appropriately. Empirical evidence pointing to contrary views was not treated as detrimental to the rule. Instead it was immediately relegated to being an intriguing puzzle or anomaly, that did not detract from the perfection of the efficient markets hypothesis (EMH).

Indeed, scholars such as Jensen (1978) argued that 'There is no other proposition in economics which has more solid empirical evidence supporting it than the EMH.'[72] Estimations of shareholder value were judged by a relentless focus on share price and this underpinning also served to legitimise the neoliberal belief in the use of the market mechanism for pricing and allocating scarce resources.[73] Regulatory or governmental presence in markets was perceived with scepticism, as it was deemed to create distortions. This provides the narrative for a small state apparatus and minimal regulatory 'interference'. An extension of this ideological basis has been found in the extensive application of modern portfolio theory (MPT) in finance, with an emphasis on diversification as a mechanism to reduce risk.[74] In the context of efficient markets, it was expected that above-average returns could not be obtained without above-average exposure to risk. MPT and its underlying models suggested the use of portfolio diversification strategies to alleviate risk. Their conclusion was that the risks of individual holdings could be counterbalanced by those of other holdings in the portfolio through the use of effective diversification strategies, thus increasing rewards without increasing portfolio level risk. Lydenberg (2011),[75] points out that 'MPT defines success in investment in relation to risks taken and measures that success in one of two ways – beating the market or matching its returns at the lowest possible cost.'

This approach fits in well with the broader narrative of supply-side economics and the trickle-down effect because the aim of applying theories of efficient markets and portfolio diversification is to maximise returns to shareholders. This focus on protecting the interests of shareholders and increasing shareholder value has deep synergies with the broader neoliberal assumption that such shareholder wealth would eventually be redistributed to others in the economy. This approach to shareholders assumes the market price of the share is a proxy for

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[72] Jensen, M., (1978), 'Some Anomalous Evidence Regarding the Efficiency of Markets', *Journal of Financial Economics*, Vol. 6, Nos. 2/3, pp 95-111

[73] Lydenberg, S., (2011), 'Beyond Risk: Notes Towards a Responsible Investment Theory', Corporate Governance Failures in eds, Hawley, J., Kamath, S., Williams, A., *The Role of Institutional Investors in the Global Financial Crisis,* University of Pennsylvania Press, Philadelphia

[74] Markowitz, H., (1959), *Portfolio Selection: Efficient Diversification of Investments*, John Wiley and Sons, New York

[75] Lydenberg, S., (2011), 'Beyond Risk: Notes Towards a Responsible Investment Theory', Corporate Governance Failures in eds, Hawley, J., Kamath, S., Williams, A., *The Role of Institutional Investors in the Global Financial Crisis,* University of Pennsylvania Press, Philadelphia

shareholder value. The shareholder value ideology is thus further normalized through the interpretation of corporate purpose and value as perceived by indoctrinated managers of financial and non-financial corporations.[76] Managers are expected to seek to maximise this share price, and espouses short-term share price performance as a key factor in the evaluation of management performance.

The role of enlightened shareholders and the market for corporate control are the key mechanisms of discipline for the protection of stakeholders. Clarke (2011), points out that the empirical evidence suggests the ineffectiveness of this market for corporate control as a disciplining tool.[77] In fact, competition between listed firms encourages aggressive risk-taking and may undermine other stakeholders' interests. Given that the proportions of shareholder capital vis-à-vis stakeholder funds invested in listed firms is typically lower than that provided by other stakeholders, there is a perverse incentive to take greater and greater risks in order to outperform a highly competitive market, because any consequential harm can be socialised. This becomes particularly evident in the context of the financial crisis, because as Chuck Prince, CEO of Citibank noted (2008)., '..but as long as the music is playing you've got to get up and dance'…'[78]The emphasis was clearly on continuing to take untenable risks, as long as others were doing so too, on the grounds that this was both justifiable and acceptable

Trickle-down economics became dominant and its ideological basis took a particularly strong hold amongst both senior practitioners and elite scholars in law and economics, and at business and finance schools in the Anglo-Saxon world. Benjamin (2018) explains that these elite institutions and scholars were (and indeed many today still are) wedded 'to a strict blend of social liberalism and economic conservatism.'[79]

Engelen et al (2011)[80] use the term 'narrative closure' to discuss the proliferation and further entrenchment of this neo-liberal discourse through closing down mainstream discussion of alternative views. They discuss how biased narratives in the run-up to the crisis ideologically

[76] Stout, L., (2012), *The Shareholder Value Myth,* Berrett-Koehler Publications Inc, San Francisco

[77] Lydenberg, S., (2011), 'Beyond Risk: Notes Towards a Responsible Investment Theory', Corporate Governance Failures in eds, Hawley, J., Kamath, S., Williams, A., *The Role of Institutional Investors in the Global Financial Crisis,* University of Pennsylvania Press, Philadelphia

[78] Nakamoto, M., Wighton, G., (2007), Citigroup chief stays bullish on buy-outs, Financial Times issue dated 9th July 2007, [online] at https://www.ft.com/content/80e2987a-2e50-11dc-821c-0000779fd2ac [accessed on 14th April 2020]

[79] Benjamin, J., 'Business Class', *The New Republic,* issue dated 14th May 2018, [online], at https://newrepublic.com/article/148368/ideology-business-school [accessed on 18th February 2019]

[80] Engelen, E., Erturk, I., Froud, J., Johal, S., Leaver, A., Moran, M., Nilsson and Williams, K., (2011), *After the Great Complacence: Financial Crisis and the Politics of Reform*, Oxford University Press, Oxford

contributed to entrenching political positions that were advantageous to specific interests in the financial sector. For example, they point out that the coinage and prolific repetition of the term 'financial innovation' was used to provide credibility to all kinds of financial instruments and techniques. Relying on a Schumpeterian[81] expectation of creative destruction and a Darwinian sense of only the fittest surviving, practitioners, academics and regulators appeared to put forward the view that all financial innovations could be made easily available to rational consumers. The expectation was that because the market mechanism would assert itself, unsavoury products and firms would naturally be weeded out.

Scholars have explored the role of academics in manipulating the narrative as a result of the improper management of conflicts of interest in the manufacture of academic research that further advanced these views. One example that illustrates this point very effectively is Ferguson's (2012)[82] exploration of the conflicts of interest of Glen Hubbard (Dean of Columbia Business School in 2004) – who, in a report co-authored with William C Dudley (then chief-economist at Goldman Sachs) put forward a view – at the very height of the bubble that caused the GFC - that 'The capital markets have helped make the housing market less volatile ... 'Credit crunches' of the sort that periodically shut off the supply of funds to home buyers … are a thing of the past.' Ferguson further notes that 'Hubbard refused to say whether he was paid to write the article. He also refused to provide me with his most recent government financial disclosure form, which we could not obtain otherwise because the White House had destroyed it. Hubbard was *(subsequently)* paid $100,000 (£63,000) to testify for the criminal defence of two Bear Stearns hedge fund managers prosecuted in connection with the bubble, who were acquitted.'

Hubbard has previous undertaken roles as Chairman of the Council of Economic Advisers (within the executive office of the President of the US) and as Deputy Assistant Secretary at the US Department of Treasury. These roles are likely to have increased not just his stature and influence but also his access to official policy development circles. Influential academics such as Hubbard, thus provided the narrative that students who are educated at elite institutions absorbed. Those like Hubbard did not just shape the mainstream discourse by acting as policy advisers. As their students went on to take key positions of influence in public policy or powerful institutions, their views and positions became maginified and entrenched.

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[81] Schubert, Christian., (2013), How to evaluate creative destruction: reconstructing Schumpeter's approach, *Cambridge Journal of Economics*, 37, 227–250

[82] Ferguson (2012), 'Heist of the century: university corruption and the financial crisis', *The Guardian,* 21st May 2012 [online] at https://www.theguardian.com/education/2012/may/21/heist-century-university-corruption [accessed on 18th February,2019]

Parker[83] is particularly critical of business schools where he has documented the effects and entrenchment of this neoliberal ideology. His observations resonate with scholars in economics, finance and the law, when he notes that

'Students at business schools are rewarded for thinking about business as if it were simply a matter of profit and loss. The curriculum teaches how to maximise shareholder value, how to sell products and services that people don't want or need, how to avoid paying taxes and how to externalize costs onto the environment or state. In return for substantial fees, the b-school makes promises about starting salaries of graduates and sells the idea that the manager should be paid more than those that they manage. Given the importance of ethics and politics for politicians, teachers, doctors, journalists or judges, why do we assume that business education should avoid discussion of anything but reward? Why do we accept the teaching of market-based selfishness as if were the only view of human nature?'

Managers of leading commercial enterprises were often drawn from such business and management schools. Their indoctrination meant that their neoliberal mindset caused many to seek to discuss dilemmas of productivity and enterprise solely using a neoliberal lens.
Like Howard Davies, (first chairman and CEO of the UK's FSA and later Director of the London School of Economics) many senior regulators were 'inclined to believe that markets were generally efficient. If willing buyers and willing sellers were trading claims happily, then, ...These people were 'consenting adults in private,' and the state should avert its gaze.'[84] Discussions were framed in terms of market supremacy, freedom of choice, efficiency, competition and shareholder-led governance. This ideological basis has provided the foundation and impetus for much of the finance, law and economics discourse.

Starkman (2015), commenting on the 'capture' of mainstream journalists in respect of the crisis notes that one of the reasons the mainstream media failed to provide suitable warnings in the run-up to the crisis notes that 'Burning a bridge is hard. It is far easier for news bureaucracies to accept ever-narrowing frames of discourse, frames forcefully pushed by industry, even if those

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[83] Parker, M., (no date), *Shut Down the Business School,* (extract of 5 points summarised on the website of Pluto Press), as cited in promotional materials for the book, [online] at https://www.plutobooks.com/blog/why-shut-down-business-schools/ [accessed on 18th February,2019]

[84] Davies, H., (no date), 'Naïve but not corrupt', Slate.com, [online], available at http://www.slate.com/articles/business/project_syndicate/2010/12/naive_but_not_corrupt.html [accessed on 25th November 2016]

frames marginalize and eventually exclude the business press's own great investigative traditions.'[85]

Wade (2009), points out that 'no eyebrows are raised by the prevalence of a vocabulary drenched in value judgements in support of free markets, such that a phenomenon cannot even be described without using words which imply whether it is a good or a bad thing by free market standards.'[86] More generally, insufficient attention was given to the oversight and long-term consequences of some innovations that had the potential to cause great societal harm. One of the challenges with such innovations, was that although they were beneficial to a small section of society, the risks posed by the-called innovations were borne by a large number of stakeholders. This plays to Olsen's discussion of the collective action problem,[87] wherein small groups of relatively well-organised participants (such as industry insiders who will reap a profit) can effectively push through changes in regulation or lobby for wider introduction of new innovations or light touch regulation to accompany these. In the longer term, these so-called innovations (assumed as a result of the term used in the narrative, to be a positive gain for society), may actually cause harm and might be detrimental to large swathes of society. Former chairman of the US Federal Reserve Paul Volcker, pointed out in the aftermath of the financial crisis that 'The only thing useful banks have invented in 20 years is the ATM'.[88] While, this may seem like a throwaway comment, it speaks to questions asked after the GFC regarding the social utility of much of what was propagated by modern finance.

The effects of 'narrative distortion' are also important in understanding how the manipulation of public debate was achieved. Elliott and Atkinson (2008) [89] describe how industry-funded research[90] provided a justification for example for the unprecedented UK investment in Icelandic banks or how hyping-up the broader social democratisation narrative to areas which

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[85] Starkman, D. (2015), 'Wilful blindness: The media's power problem' in Schifferes, S., Roberts, R., eds, (2015), *The media and financial crises: Comparative and historical perspectives* (pp. 3–15), Routledge, London

[86] Izurieta, A., and Wade, R., (2009), 'Robert Wade on the global financial crisis', *Development and Change*, 40 (6). pp. 1153-1190

[87] Olsen, M., (1965), *The Logic of Collective Action: Public Goods and the Theory of Groups,* Harvard University Press, Cambridge, Massachusetts

[88] Volcker, P., (2009), 'The only thing useful banks have invented in 20 years is the ATM', *New York Post,* Dec 13, 2009, [online] at https://nypost.com/2009/12/13/the-only-thing-useful-banks-have-invented-in-20-years-is-the-atm/ [accessed on 13th March 2020]

[89] Elliott, L. and Atkinson, D., *The Gods That Failed: How Blind Faith in Markets Has Cost Us Our Future*, Nation Books, New York, 2009

[90] Portes, R. and Baldursson, F., (2007), 'The Internationalisation of Iceland's Financial Sector', at http://www.vi.is/files/15921776Vid4WEB.pdf [accessed on 14th April 2012]

Also see, Mishkin, F., Herbertsson, T., 2006, 'Financial Stability in Iceland', at http://www.vi.is/files/555877819Financial Stability in Iceland Screen Version.pdf [accessed 14th April 2012] had previously encountered 'red-lining in the US'.[91] They point out that such distorted narratives enabled certain actors 'to present themselves as the virtuous heroes at the heart of social change and progressive problem solving,'[92] when the reality of their contributions was quite to the contrary.

Beyond academic debate (1): the propagation of ideas

But it is not the discourse alone that was affected as there was a wider co-option of those with power in a number of positions of prominence or influence. Mitchell (2006) argues that 'economics takes place, not just as an academic discipline, but in the design and marketing of goods, in the calculation and forecasting of reserve banks and investment houses, in the case studies of business schools and law schools, in the programs of political think-tanks and in the policies of international development organizations.'[93]. His argument is that economic ideology has a particular strength in reshaping other areas because of its ability to use the real world 'as its laboratory'[94] with the consequences therefore visited upon daily societal life. Regulators, the government, mainstream media, academics and practitioners acted to reinforce each other in legitimizing the application of this neoliberal ideological position in the real world by ensuring that the language of the market penetrated a number of arenas. Where the discourse could have been framed in terms of citizen needs and rights, the logic of markets and consumer preference was introduced. Access to one key area, would help create a mechanism for these ideas to get structural support and prominence in others. For example, the notion of the sovereign consumer facilitated the predominance of disclosure and transparency as key regulatory tools to facilitate corrections to poor practice. The belief in this ideological position therefore frames much of current practice in stock markets.

The neoliberal narrative was particularly furthered in areas such as technology, education, the media, the law, politics and regulation. For example, the technology enablers for the communications networks aiding the proliferation of complex instruments and market techniques could be found in newly privatized telecommunications networks. Chakravarty and

[91] Dymski, G., (2012), Racial Exclusion and the Political Economy of the Financial Crisis, in Lapavitsas, C., (ed), (2012), *Financialisation in Crisis*, pp 51-81, Brill, The Netherlands

[92] Engelen, E., Erturk, I., Froud, J., Johal, S., Leaver, A., Moran, M., Nilsson and Williams, K., *After the Great Complacence: Financial Crisis and the Politics of Reform*, Oxford University Press, 2011

[93] Mitchell, T., (2005), The work of economics: How a discipline makes its world, *European Journal of Sociology*, 46(02), pp 297–320 [online] at http://dx.doi.org/10.1017/S000397560500010X [accessed on 2nd May 2019]

[94] Mitchell, T., (2005), The work of economics: How a discipline makes its world, *European Journal of Sociology*, 46(02), pp 297–320 [online] at http://dx.doi.org/10.1017/S000397560500010X [accessed on 2nd May 2019]

Schiller (2010) note that 'Between 1984 and 1999, somewhere between $250 billion and $1 trillion of state-owned telecommunications networks were sold to investors and roughly half of the 189 members of the International Telecommunications Union (ITU) at least partially privatized their national telecommunications sectors….. Greater access and greater profits were seen to legitimize a win-win logic to this chapter of global neoliberal reform, in contrast to other areas where capitalist globalization led to more blatant forms of inequality and violence ….. an army of technocratic experts emerged as influential policy makers trained in MBA programs, economics departments and law schools predominantly based in the Anglo-American world, with an agenda to propagate neoliberal reforms in all areas'.[95] Advances in telecommunication, facilitated further complex developments in financial markets and these in turn fueled a further demand for improvements in specific telecommunications changes. There was little relation to what society needed from either telecommunications or finance, and societal resource was sucked into areas that were profitable to those who already had a prior investment or interest in these sectors. The language of finance therefore penetrated many other walks of life through increased financialization emphasizing Epstein's definition about 'the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies'.'[96.]

Beyond academic debate (2): Reshaping corporate purpose

The study of corporate governance also influenced and was heavily influenced by the propagation of this ideological position. Established scholars such as Fama and Jensen, championed the protection of shareholders. Their argument was that shareholders – were dispersed, non-expert principals, in what is termed within the corporate governance literature as a 'principal-agent' dilemma.[97] These shareholders delegated their powers to expert and powerful executive management as their 'agents'. Using the language of rational utility maximisation, the dilemma was framed as a conflict between principals and agents, where the agents were motivated and able to enrich themselves at the expense of their principals.[98] Shareholders were also termed as 'residual claimants'[99] deserving of protection. It was argued

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[95] Chakravarty, P., Schiller, D., (2010), Neoliberal newspeak and digital capitalism in crisis, *International Journal of Communication* vol 4 pp 670–692.

[96] Epstein, (2005), *Financialization and the world economy,* Edward Elgar Publishing

[97] Clarke, T., (2007), *International Corporate Governance: A Comparative Approach*, Routledge

[98] Fama, E., Jensen, M., (1983), 'Separation of Ownership and Control', *Journal of Law and Economics*, Vol. 26, No. 2, Corporations and Private Property: A Conference Sponsored by the Hoover Institution, pp. 301-325, [online] at http://links.jstor.org/sici?sici=0022-2186%28198306%2926%3A2<301%3ASOOAC>2.0.CO%3B2-A [accessed on 29th May 2019]

[99] Fama. E., Jensen, M., (1983), 'Agency problems and residual claims', Journal of Law and Economics, Vol 26, No 2, pp 327-349, 1983, [online] at http://www.jstor.org/stable/725105 [accessed on 25th November 2016]

that shareholders were only entitled to a share of the residue after other contractual commitments and costs were met by the corporation. It was adduced therefore that shareholders were relatively less protected than others with contractual claims upon the corporation, because shareholders did not have enforceable contracts guaranteeing payment of specific levels of dividends. Scholars including Grossman and Hart (1986) view this lack of pre-agreed returns as evidence of 'incomplete contracting' and this provided their rationale for corporate governance mechanisms to prioritise the protection of shareholders.[100]

Another important argument for enhancing shareholders rights, was the consideration amongst some experts that shareholders are best placed to expect, influence and support value creation by the managers whom they appoint. For many, the implicit assumption here was that of benevolent shareholders who would exercise these rights in an 'enlightened' and responsible manner[101], and thus in turn would effectively safeguard the interests of all societal stakeholders. These arguments therefore cast the challenges of corporate governance into a simple, elegant and easily communicable representation that focused attention only on the conflict between principals and agents while neglecting the need for governance to balance the competing interests of a complex network of stakeholders who contributed to, affected and were affected by the corporation. The simplification also ignored the fact that neither principals nor agents are a homogeneous group; so, neither group's interests or needs are always clear and consistent across the group.[102]

Another failing lay with corporate governance mechanisms that furthered the maximization of shorter term profits and improvements in share price. For example, there was a focus on judging firm performance by looking at quarterly share price performance, in the belief that what was good for shareholders would always be beneficial to society more generally. Such a narrow approach to value creation through short-term profit maximization resulted in unrealistic, conceptual reductionism wherein systemic risks were ignored through the assumption that what was good for (some of) the parts was also good for the whole.[103]

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[100] Grossman, S., Hart, O., (1986), 'The costs and benefits of ownership: A theory of vertical and lateral integration', *Journal of Political Economy* 94(4) pp 691-719, [online], available at http://dash.harvard.edu/bitstream/handle/1/3450060/Hart_CostsBenefits.pdf?sequence=4 [accessed on 11th November 2013]

[101] Ireland, P., (2010) 'The Financial Crisis: Regulatory Failure or Systems Failure' in MacNeil, I., and O'Brien, J., (eds), (2010), *The Future of Financial Regulation,* Hart Publishing, Portland

[102] Clarke, T., (2004), *Theories of Corporate Governance*, Routledge, Oxon

[103] Avgouleas, E., 'What future for disclosure as a regulatory technique? Lessons from behavioural decision theory and the global financial crisis', in MacNeil, I., and O'Brien, J., (eds), *The Future of Financial Regulation,* Hart, Portland, 2010

Inappropriate managerial incentives that engendered conflicts of interest also remained unquestioned as long as they appeared to be aligned to what was deemed to be in shareholders' interest.

Corporate governance framed with the enlightened shareholder at the focus of its protections, essentially militates for the delegation of stakeholder protections to shareholders.[104] This intervention is undertaken through the mechanisms of 'voice' and 'exit'. This means that corporate governance regulations focus on protections for shareholders ability to mitigate against managerial decisions affecting other stakeholders. This is done through mechanisms grounded in the view of the 'rational' shareholder being able to have a voice at general meetings and on key topics such as pay. There is a regulatory preference in this context for ensuring deep and liquid equity markets to enable shareholders to continue to invest in markets (in turn deepening them) and vote with their feet. This however is key to building a regulatory predisposition for the increased deepening and use of financial markets.

Accompanying this are protections around disclosure and transparency and regulatory attempts to prevent activities like insider trading or market manipulation that would detract from price formation in liquid markets. However, in an era of portfolio management, both individual institutional shareholders may not be inclined to engage in battle over some issues, not just because of the relative size of holding of a particular company's stock with respect to their portfolio, but also because the significance of passive investing has grown, and also because a significant proportion of shareholders do not hold stocks for a substantive period with the average stock holding period in the UK being estimated in 2018 at 20 seconds.[105] Although markets may be liquid, in essence, many shareholders who are relied upon to turn the wheel on governance to protect other stakeholders have neither the inclination, nor the knowledge or indeed the foresight, power and ability, to protect the interests of others let alone their own interests. Shareholder-driven corporate governance models therefore perpetuate the neglect of wider stakeholder consequences, despite lip service to stakeholder protection. These points resonate deeply with Epstein's definition of financialisation, as the narrative and logic of the market begin to take precedence in a wide range of areas.[106.]

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[104] Lazonick, W., O'Sullivan, M., Maximising Shareholder Value, *Economy and Society*, 29 (1), pp 13-35 (online) at https://doi.org/10.1080/030851400360541 [accessed on 29th May 2019]

[105] Greene, M (2018), 'Passive investing is storing up trouble', *Financial Times,* August 2, 2018, [online] at https://www.ft.com/content/cdbdd01a-95b4-11e8-95f8-8640db9060a7 [accessed on 26th February 2019]

[106] Epstein, (2005), *Financialization and the world economy,* Edward Elgar Publishing

These arguments have also been used to direct interpretations of corporate law and the determination of corporate purpose. Here the emphasis is on the term interpretation because as Rhee (2017)[107] argues using empirical data (in an American context), 'Shareholder primacy is judge-made law'. This emphasis is important in making the argument that it was an interpretation consistent with neoliberal ideology of those in positions of influence in the judiciary. Rhee points this out when he notes that

'As a general rule applicable to the vast realm of day-to-day managerial decision-making, shareholder primacy is founded on pervasive judicial acceptance. The form of law is a Hartian obligation: it is recognized and institutionalized by courts; it is an important rule imbued with a seriousness of social pressure; it is said to be foundational to corporate law and governance. This social pressure may be inconsistent at times with the manager's own value system, but nevertheless she may feel compelled to obey the rule. Reproach directed at one who deviates from the rule would be considered a legitimate social response. And, occasionally we see in cases like Dodge v. Ford the expressive value of such rebuke. Thus, judicial embrace has legitimized shareholder primacy and given it a cloak of legal authority'.

Corporate law in the UK also enshrined the primacy of shareholders[108] and helped cement the corporate purpose as being one of shareholder value maximisation. Protecting shareholders was achieved through corporate governance mechanisms largely aimed at maximizing returns to shareholders. This argumentation fits in well with the broader narrative of supply-side economics and the trickle-down effect because again, the focus is on protecting the interests of shareholders and increasing shareholder value had synergies with the broader neoliberal assumption that such shareholder wealth would eventually be redistributed to others in the economy.

As Kelsey et al point out 'The moral positions of governments are constructed according to those political agents and institutions who seek to legitimise or delegitimise particular economic strategies.'[109]

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[107] Rhee, R, (2017), A Legal Theory of Shareholder Primacy, Harvard Law School Forum on Corporate Governance and Financial Regulation [online] at https://corpgov.law.harvard.edu/2017/04/11/a-legal-theory-of-shareholder-primacy/ [accessed on 13th February 2019]

[108] Stout, L., (2013), On the Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (in the Closet), *Cornell Law Faculty Publications*, paper 865 (online) at http://scholarship.law.cornell.edu/facpub/865 [accessed on 26th February 2019]

[109] Kelsey, D., Mueller, F., Whittle, A., Khosravinik, M., (2016) Financial crisis and austerity: interdisciplinary concerns in critical discourse studies, *Critical Discourse Studies*, Vol 13, Issue 1 at https://www.tandfonline.com/doi/full/10.1080/17405904.2015.1074600 [accessed on 26th February 2019]

Pay and incentives were structured to encourage short-term share price increases and profit maximization. This caused boards to turn a blind eye to the risks in the market and the liquidity problems that could surface in the longer term. Many executives took risks that were only justifiable due to this short-term focus. There was little consideration of the longer-term consequences of decisions and little incentive to take responsible long-term decisions. In fact, positions that actively posed longer-term risks were considered acceptable due to this short-termist focus[110] Bebchuk (2010)[111] notes that: 'pay packages focused excessively on short-term results....Equity-based awards, coupled with the capital structure of banks, tie executives' compensation to a highly levered bet on the value of banks' assets. Because bank executives expect to share in any gains that might flow to common shareholders, but are insulated from losses that the realization of risks could impose on preferred shareholders, bondholders, depositors, and taxpayers, executives have incentives to give insufficient weight to the downside of risky strategies'.

Many national corporate governance and corporate law arrangements remained rooted in this notion of investor protection. Core legal features in UK Company Law, for example, were therefore primarily aimed at managing the relationship between the Company and its shareholders. The law seeks to protect shareholder interests[112] and reduce the economic self-interest motive of managers. Prior to the crisis (and now), corporate governance requirements for listed UK financial firms were specified within the UK Corporate Governance Code113 (hereafter referred to as the Code), produced by the UK Financial Reporting Council (FRC). This Code is aimed at helping boards discharge their responsibilities in the best interests of the firm. It is rooted in providing investor safeguards. The Code therefore seeks to ensure greater transparency, rigorous accounting and appointment practices and the protection of shareholder rights. It was, and remains, implemented through a 'comply-or-explain'[114] principle that allows

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[110] Prince, C., (2007), 'Citigroup chief stays bullish on buy-outs', *Financial Times*, 9th July, 2007 [online], at http://www.ft.com/cms/s/0/80e2987a-2e50-11dc-821c-000779fd2ac.html#axzz1rph7gtEN [accessed 15th January 2010]

[111] Bebchuk, L., Spamann, H., (2010), Regulating Bankers' Pay, *Georgetown Law Journal,* Vol 98, Issue 2, [online] at https://heinonline-org.idpproxy.reading.ac.uk/HOL/P?h=hein.journals/glj98&i=251
[accessed 15th January 2010]

[112] Clarke, T., (ed), *Theories of Corporate Governance*, Routledge, Oxon, 2007

[113] Financial Reporting Council, (2006), 'U.K. Approach to Corporate Governance', 2006, at http://www.frc.org.uk/images/uploaded/documents/UK%20approach%20to%20corporate%20governance%202006.pdf [accessed 24th April, 2012]

[114] Arcot, S., Bruno, V., and Grimaud, A., (2005), 'Corporate Governance in the UK: Is the Comply-or-Explain Approach Working?', *Corporate Governance at LSE Discussion Paper Series,* [online], at http://www2.lse.ac.uk/fmg/documents/events/seminars/corporateGovernance/496_1st%20Dec%20paper.pdf [accessed 25th March 2012]

companies to comply voluntarily with its requirements, or explain any deviation. Such an approach was intended to encourage firms to comply with the spirit of the law, reduce costs and provide proportionate oversight. In the aftermath of scandals such as those involving Enron, Polly Peck International, Robert Maxwell, this Code has also been revised to better address wider stakeholder concerns. However, by the FRC's own admission and indeed intent, it still remains primarily rooted in shareholder protection. In most jurisdictions, national regulatory requirements for financial firms' corporate governance are developed around such corporate law requirements, and therefore fail to address the particular nuances required from corporate governance in the financial sector. For example, although the UK financial regulator, the Financial Services Authority (FSA), had additional corporate governance requirements for financial firms, the FSA used this Code as the basis for its expectations of corporate governance within the regulated financial sector. Attempts at light touch regulation or self-regulation, such as through voluntary codes of corporate governance, meant that internal conflicts of interest on boards remained outside the active purview of more intrusive regulation.

Shareholder-led governance mechanisms proved to be blunt instruments in effecting responsible behaviour by global, powerful and complex financial firms because dispersed shareholders had limited knowledge. Boards themselves were directed to focus on shareholder protections because the inordinate focus of governance mechanisms was on ensuring that the aim of profit-maximisation was met, as many believed that this alone would ensure value creation. The rights of and costs to other stakeholders were consistently neglected or deemed secondary. Shareholders, boards and regulators ended up in a position where they had restricted opportunities to ensure sufficient oversight and protection of broader stakeholder interests. Some of the key premises of shareholder-led capitalism, such as fundamental social, political and economic freedoms for broader stakeholders and the importance of the prevention of the abuse of power, were forgotten. The ideological, legal, commercial, regulatory and corporate governance context, in turn helped entrench the commercial focus on performance in stock markets.

Beyond academic debate (3): Chasing alpha, short-term price increases and profits

The outcome of this was that managers in both financial and non-financial firms were focused on and incentivised to 'chase alpha'.[115] Particularly in the financial sector, implications for risks

[115] Augar, P., (2011), 'Chasing Alpha' in eds. Hawley, J., Kamath, S., Williams, A., *Corporate Governance Failures: The Role of Institutional Investors in the Global Financial Crisis',* University of Pennsylvania Press, Pennsylvania

arising at a systemic level as a result of these priorities of managers at influential and significant firms - who were chasing alpha - was not given sufficient attention in the regulator's interaction with the firm.

Options pricing models reflecting this understanding were developed in this context and it was believed that future price movements could be accurately hedged using these models. Influential scholars such as Friedman (1970), also suggested that firms should place profits at the centre of their efforts[116] and again, this reiterated the primacy of markets in allocating resources through the price mechanism, and using the price determined by 'efficient markets', alongside key financial ratios such as Tobin's q (a ratio comparing an asset's market value and its replacement value) to price resources and risk, and for hedging risk. This in turn had significant implications for the direction and prioritisation of investment in the real economy. There was a significant refocusing on short term share price performance rather than on investments that deliver growth and longer-term value for all stakeholders.
Varoufakis and Tserkezis (2014) discuss how the reduction in 'real investment through the imposition of a greater distribution of profits to the firms' shareholders... reduces the fraction of profits that are retained in order to be reinvested'. [117] This in turn can reduce investment in research and development, depress real, longer-term employment, affect suppliers and depress production while also affecting the nature of effective demand. The reduced returns arising as a consequence, were in turn compensated for by greater reliance on returns from speculative investments in financial markets rather than in real production. This point demonstrates how wealth is extracted from the real economy and redirected to the financial economy. This also illustrates how increases to returns can mask the 'Ponzi' elements of finance that resulted in the crisis. Like a Ponzi scheme that relies on the presence of a greater fool to perpetuate a continuation of the scheme, investment in finance comes from those who believe the value of their investments will rise. Their belief and continued investment, draws financial resources away from the real economy, and into the financial markets. This in turn fuels the financial markets and the money gets drained even further from the real economy. This results in an increasing inattention and unwillingness to invest in real production, and to contribute to returns achieved from genuine productivity. Like in a Ponzi scheme, this is therefore premised

[116] Friedman, M., (1970), 'The social responsibility of business is to increase profits' , The New York Times magazine, Sep 13, 1970, [online], available at http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html [accessed on 25th November, 2016]

[117] Varoufakis, Y., Tserkezis,L., (2014), Financialization and the Financial and Economic Crises: The Case of Greece, FESSUD studies fstudy25, Financialisation, Economy, Society & Sustainable Development (FESSUD) Project, at http://fessud.eu/wp-content/uploads/2012/08/FESSUD_studies-in-financial-systems_Greece_final_Study25.pdf [accessed on 18th May, 2019]

on being able to find a greater fool, whose investment in the scheme might continue its propagation.

Lobbying, the collective action problem, cognitive regulatory capture and further entrenchment of the neoliberal discourse

Lobbying with the objective of putting forth the regulated industry's point of view became ever-present and lobbyists grew increasingly influential.[118] Olson (1965),[119] in a seminal paper discusses the 'collective action problem'. This term is used to capture situations where fewer numbers of well-resourced organizations, with similar or linked vested interests, find it easier to organise themselves than large numbers of ordinary people with more limited resources. The 'collective action' paradigm, in the case of well-resourced financial institutions, particularly those in an oligarchic or powerful position, explains how a small number of firms can devote considerable time and attention to influencing and achieving policy outcomes that benefit themselves but are at times highly detrimental to citizens and societal stakeholders.

In a UK-specific context, Grant (2000) notes that leading lobbyists had, and continue to have, direct contact with policymakers, and some influential Directors and Chairmen had direct access to the Prime Minister in Britain.[120] It is also clear that many politicians have strong connections to business.[121] Miller and Dinan (2008)[122] note that, 'in 2005 more than 40 MPs (in the UK) had directorships or were paid by corporations as advisors or received donations from them'. There is similar evidence in many other jurisdictions. Whilst theoretically such individuals could recuse themselves from discussions that might create a conflict of interest, in practice, the interests of business are so dependent on so many aspects of legislation that expecting this to be the case in reality would be unrealistic and naïve.

These vested management interests sought to limit management accountability to regulators and avoid any parliamentary or democratic scrutiny. The proponents of such views wanted to encourage the unfettered pursuit of personal benefit or corporate profits using the purported

[118] Arauzo, E. (2013), Banking on the revolving door: Rules full of loopholes for former finance officials, Corporate Europe Observatory website [online] at https://corporateeurope.org/en/news/banking-revolving-door-rules-full-loopholes-former-finance-officials [accessed on 3rd May, 2019]

[119] Olson, M., (1965), *The Logic of Collective Action: Public Goods and the Theory of Groups*, Harvard University Press

[120] Grant, W., (2000) *Pressure Groups and British Politics*, Macmillan Press, London, 2000

[121] Miller, D., and Dinan, W., (2008), *A Century of Spi*n, Pluto Press, London

[122] Miller, D., and Dinan, W., (2008), *A Century of Spi*n, Pluto Press, London

agenda of reducing bureaucratic red tape.[123] Given the significant number of senior regulators who previously worked within the industry and lobbied regulators to reduce red-tape, analysts have highlighted the dangers of the 'revolving-door'[124] phenomenon where key personnel move between roles in government, PR, lobbying, think tanks and industry. For example, former secretary of the US Treasury, Hank Paulson, has held successive positions at investment bankers Goldman Sachs, and in government where he had an influential role in deciding bailouts of firms such as AIG, to the advantage of his former employer Goldman Sachs.[125]

This led not just to conflicts of interest but also 'cognitive regulatory capture'. Regulators were so steeped in the knowledge and mindset of the regulated community that they became overly sensitive to the views of Financial Intermediaries (FIs). This, in turn, leads to skewed decision-making (in favour of financial firms' management), rather than achieving the right public policy outcomes that support the public interest.[126] This influence on public policy was enhanced by the ability of senior players to connect with, and influence politicians, members of parliament and public policy-shaping bureaucrats.

A 2009 report[127] from Alliance for Lobbying Transparency and Ethics Regulation in the European Union, provides examples of how market-based strategies tend to get legitimised in regulatory processes. The De Larosière group, for example, was set up set up by the Council and the European Commission to propose reforms of the financial system to the EU Spring Council of March 2009. Of the eight men in the group, four are closely linked to financial giants like Goldman Sachs and the bankrupt Lehman Brothers; a fifth was responsible for the UK Financial Services Authority, who failed miserably in supervising British bank Northern Rock[128]. The report points out that 'large private banks, insurance giants and a whole range of financial

[123] Portes, R. and Baldursson, F., (2007) The Internationalisation of Iceland's Financial Sector', 2007, at http://www.vi.is/files/15921776Vid4WEB.pdf [accessed 14th April 2012]

[124] Miller, D., and Dinan, W., (2008), *A Century of Spin*, Pluto Press, London

[125] Centre for Responsive Politics, (no date), Employment History – Henry Paulson, [online] at https://www.opensecrets.org/revolving/rev_summary.php?id=70162 [accessed on 22nd May 2019]

[126] Buiter, W., (2008), Lessons from the North Atlantic Financial Crisis, conference paper presented at 'The Role of Money Markets' jointly organised by Columbia Business School and the Federal Reserve Bank of New York on May 29-30, 2008, at https://www.newyorkfed.org/medialibrary/media/research/conference/2008/rmm/buiter.pdf [accessed on 22nd May 2019]

[127] Alliance for Lobbying Transparency and Ethics Regulation in the European Union (2009), A Captive Commission: The Role of the Financial Industry in Shaping EU Regulation, [online] at https://www.alter-eu.org/sites/default/files/documents/a-captive-commission-5-11-09.pdf [accessed on 4th May 2019]

[128] House of Commons Treasury Committee, The Run on the Rock, Fifth Report of Session 2007-08, [online] at https://publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf [accessed on 20th April 2020]

enterprises are hugely over-represented and wield significant power within the EU legislative process – from the drafting of EU strategies and laws to their implementation'.[129] The research warns that not only were 'representatives from the financial sector …actively involved in designing the policies which contributed to the global financial crisis' but, that '..The EU is now consulting the same experts on its plans to tackle the crisis'.[130]

Extensive sub-prime and property lending

Scholars point to the explosion in the provision of sub-prime loans and the rise in complex financial instruments that facilitated the parceling and transfer of risks, as one of the key factors contributing to the GFC. Chomsisengphet and Pennington-Cross (2006) explain how home ownership became prized, particularly by those without a significant stake in corporate equity markets.

There are several factors that contributed to the sudden expansion of this market. Dymski (2009)[131] contextualises the expansion of the market by noting that 'Until the early 1990s, racial minorities were systematically excluded from mortgage-finance due to bank-redlining and discrimination'. Mainstream lenders saw new potential to extend their market by tapping into previously uncharted waters. Research suggests that over fifty percent of sub-prime refinancing originated in African- American census tracts, compared to roughly ten percent of prime refinances[132] in similar settings. At the time, the increased access to sub-prime mortgages was lauded by politicians.[133] Havard Jones (2006) discusses how these changes to the market were presented as the 'democratization'[134] of finance. She notes that 'Subprime lenders argue *(sic)* that they are contributing to the societal goal of greater access to credit by offering innovative mortgage products to traditionally excluded borrowers'.

[129] Alliance for Lobbying Transparency and Ethics Regulation in the European Union (2009), A Captive Commission: The Role of the Financial Industry in Shaping EU Regulation, [online] at https://www.alter-eu.org/sites/default/files/documents/a-captive-commission-5-11-09.pdf [accessed on 4th May 2019]

[130] Alliance for Lobbying Transparency and Ethics Regulation in the European Union (2009), A Captive Commission: The Role of the Financial Industry in Shaping EU Regulation, [online] at https://www.alter-eu.org/sites/default/files/documents/a-captive-commission-5-11-09.pdf [accessed on 4th May 2019]

[131] Dymski, G., (2009), Racial Exclusion and The Political Economy of the Subprime Crisis, *Historical Materialism,* 17 (2), pp 149-179 (online) [online] at https://doi.org/10.1163/156920609X436162 [accessed on 7th May 2019]

[132] Immergluck, D., Wiles, M., (1999), *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development,* The Woodstock Institute, Chicago

[133] Wallison, P., (2011), 'Hey, Barney Frank: The Government Did Cause the Housing Crisis', *The Atlantic,* 13 Dec 2011, (online) at https://www.theatlantic.com/business/archive/2011/12/hey-barney-frank-the-government-did-cause-the-housing-crisis/249903/ [accessed on 2nd May 2019]

[134] Jones Havard, C., (2006), Democratizing Credit: Examining the Structural Inequities of Subprime Lending, *Syracuse Law Review*, Vol 56, Issue 2 online at https://scholarworks.law.ubalt.edu/cgi/viewcontent.cgi?article=1304&context=all_fac [accessed on 8th May 2019]

It is worth noting here that the choice of the term 'democratization of finance' is deceptive. It seems to suggest that the sales of financial products to these new customers is an act of empowerment. However, this framing is characteristic of narratives[135] where actions or situations which are beneficial to financiers are re-cast in the neoliberal language of freedom of consumer choice, the rationality of market participants and the fairness of competitiveness markets. The reality may actually be typical of impaired choice, increased inequality and unfairness. In fact, sub-prime lending was often an excuse for predatory lending and predatory inclusion. Households that had been deprived of credit, and were excluded from the mainstream credit, were suddenly included so wealth could be extracted from them through inclusion. Taylor (2019), discusses the ways in which the private sector motives for wealth extraction helped shape public policy, and how the public-spirited notion of inclusion camouflaged predatory capitalism.[136]

The complexity of sub-prime products such as adjustable rate mortgages, coupled with the lack of experience (in previously redlined minority ethnic communities) with the practices of mainstream lending, resulted in chronic exacerbation of information asymmetry and bounded rationality.

The idea that even those with limited financial resources should be able to buy a home, also contributed to the sub-prime mortgage explosion by allowing firms to provide false justification to the pursuit of home-ownership by those who could not really afford to keep up repayments.

Lenders engaged in various tactics including fraud to increase business. For example, borrowers were offered low teaser rates to attract new customers in what were termed as 'bait and switch'[137] tactics. This essentially meant that lenders were extending credit at rates that did not actually reflect the risks within the underlying transactions. Citing a discussion with litigation attorney Al Hofeld Jr., Gourse (2007) notes that such tactics were used 'to lure in potential borrowers and maximize the amount of money loaned out. At closing, borrowers are often presented with terms that do not match those previously offered by the company, and then pressured into signing documents which they have not had time to review. ..... they routinely

[135] Palley, T., (2013), *Financialization: The Economics of Finance Capital Domination*, Palgrave Macmillan UK

[136] Taylor, K-Y., (2019), *Race for Profit: How banks and the real estate industry undermined black homeownership,* The University of North Carolina Press

[137] Gourse, A., (2007), The Subprime Bait and Switch, In These Times website, article dated July 16 2007, [online] at http://inthesetimes.com/article/3276/the_subprime_bait_and_switch [accessed on 22 May 2019]

baited potential customers by promising fixed interest rates, low or no fees, lower monthly payments, no prepayment penalties, or by representing to borrowers that they qualify for a particular set of terms'.[138] A classic example of this was Ameriquest. They deceived customers by providing terms that were different from the ones the borrower had originally agreed, by using loan documentation in a language the customer did not read, or by unilaterally increasing rates without notification.[139]

Dymski et al (2011)[140] focus on the high levels of mis-selling of sub-prime to those of minority ethnic backgrounds and note that the explanations vary across disciplines. They point out that sociologists, geographers, and urban scholars examining the crisis argue that 'home-loan lending over the years amplified spatial racial disparities, subprime lending exploited them, and consequently the foreclosure crisis has disproportionately affected minority homeowners'[141] while economists 'trace the subprime crisis to human fallibility: over-optimistic assessments of housing-price trajectories; and the inability of financial authorities to either prevent unwise lending or to compel borrowers to repay'.[142] They further argue that 'economists have thus far ignored the links between the foreclosure wave, subprime lending, and racial inequality and segregation'.[143] In their view this disparity arises because while economists choose to ignore 'the structure of social relations that shape risk and return',[144] non-economists do not engage with the market mechanism.

This nuanced argument is particularly important and plays to the rationale for the interdisciplinary approach used as the methodology of this paper. It is also worth pointing out the challenges with regulation as it is conceived in a neoliberal, financialized context to deal with visible issues. Even in a welfare economics discourse that is cognisant of the failures and

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[138] Gourse, A., (2007), The Subprime Bait and Switch, In These Times website, article dated July 16 2007, [online] at http://inthesetimes.com/article/3276/the_subprime_bait_and_switch [accessed on 22 May 2019]

[139] Galvin, A., 'Ameriquest settlement wins approval', *Orange County Reporter,* 25th June 2005 [online] at http://tinyurl.com/y29tgn7j [accessed on 22 May 2019]

[140] Dymski, G., Hernandez, J., Mohanty, L., Race, Power, and the Subprime/Foreclosure Crisis: A Mesoanalysis, Levy Economics Institute of Bard College Working Paper Number 669 [online] at http://www.levyinstitute.org/pubs/wp_669.pdf [accessed on 10th May 2019]

[141] Dymski, G., Hernandez, J., Mohanty, L., Race, Power, and the Subprime/Foreclosure Crisis: A Mesoanalysis, Levy Economics Institute of Bard College Working Paper Number 669 [online] at http://www.levyinstitute.org/pubs/wp_669.pdf [accessed on 10th May 2019]

[142] Dymski, G., Hernandez, J., Mohanty, L., Race, Power, and the Subprime/Foreclosure Crisis: A Mesoanalysis, Levy Economics Institute of Bard College Working Paper Number 669 [online] at http://www.levyinstitute.org/pubs/wp_669.pdf[accessed on 10th May 2019]

[143] Dymski, G., Hernandez, J., Mohanty, L., Race, Power, and the Subprime/Foreclosure Crisis: A Mesoanalysis, Levy Economics Institute of Bard College Working Paper Number 669 [online] at http://www.levyinstitute.org/pubs/wp_669.pdf [accessed on 10th May 2019]

[144] Dymski, G., Hernandez, J., Mohanty, L., Race, Power, and the Subprime/Foreclosure Crisis: A Mesoanalysis, Levy Economics Institute of Bard College Working Paper Number 669 [online] at http://www.levyinstitute.org/pubs/wp_669.pdf [accessed on 10th May 2019]

limitations of the market mechanism, the approach is essentially to eschew active intervention by regulators, and to persist in the use disclosure and transparency as tools to achieve greater information symmetry.[145] When these approaches come up against those affected by structural barriers, intentional fraud or those engaged in applying the letter of the law rather than its spirit, the regulatory intervention is reactive and largely predicated on addressing market failure rather than on the substantive issues that should be under consideration.

Securitisation

The mortgaged home did not just provide shelter. It provided an illusory sense of capital growth to homeowners, in the form of an asset whose price, it was expected would continue to rise[146]. It was recast as a speculative asset class These assets were also sources of revenue for those financiers who facilitated their trade using mortgage-based securities. Keys et al (2013)[147] estimate that in 2006 - just before the crisis- the size of the US securities market in mortgages alone was '$1.5 trillion, or 15 percent of the $10 trillion residential mortgage market'.[148] The same securities market was worth only 2% of the market size, just four years prior in 2002.[149]

Lydenberg (2011) explains[150] how investment in real estate such as subprime mortgages had its ideological basis in modern portfolio theory. In order to manage the risks in a diversified portfolio, many institutional (and indeed non-institutional) investors changed the role of property as an asset class that had a primary purpose of providing shelter, into property as an asset class with the purpose of acquiring investment returns. Such an investment in property as a speculative or investment asset was driven by those who were seeking to manage the risks in their portfolio along the lines of the diversification espoused by modern portfolio theory. Not

[145] The detail is discussed further in this thesis within Chapter 2 on macro-conduct regulation

[146] The Financial Crisis Inquiry Commission, (2011), Final report of the national commission on the causes of the financial and economic crisis in the United States [online] at https://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf [accessed on 2nd May 2019]

[147] Keys, B., Piskorski, T., Seru, A., Vig, V., (2013), Mortgage Financing in the Housing Boom and Bust in eds. Glaser, E., Sinai, T., (2013) *Housing and the Financial Crisis*, University of Chicago Press, [online] at http://www.nber.org/chapters/c12624 [accessed on 2nd May 2019]

[148] Keys, B., Piskorski, T., Seru, A., Vig, V., (2013), Mortgage Financing in the Housing Boom and Bust in eds. Glaser, E., Sinai, T., (2013) *Housing and the Financial Crisis*, University of Chicago Press, [online] at http://www.nber.org/chapters/c12624 [accessed on 2nd May 2019]

[149] Keys, B., Piskorski, T., Seru, A., Vig, V., (2013), Mortgage Financing in the Housing Boom and Bust in eds. Glaser, E., Sinai, T., (2013) *Housing and the Financial Crisis*, University of Chicago Press, [online] at http://www.nber.org/chapters/c12624 [accessed on 2nd May 2019]

[150] Lydenberg, S., (2011), 'Beyond Risk: Notes Towards a More Responsible Investment Theory', pp 26-51 in Hawley, J., Kamath, S., Williams, A., eds. (2011) *Corporate Governance Failures,* University of Pennsylvania Press, Philadelphia

only did this change the nature of the asset class, it also affected how risks in relation to investment in property were evaluated, what relationship the person buying property had with the asset class and the term for which property was held. Using the lens of economics, persistently rising house prices[151] and low interest rates also fostered over-optimism in house prices. Investing in real estate as an asset class, appeared to be the rational choice even for those who might need to leverage up significantly in order to afford a home or for those who recognised that property prices were inflated but felt it prudent to invest given the trajectory of house prices. This last point is consistent with our understanding of how debates and choices are recast in ways that hollow out the real economy (in this case the real economic purpose of assets) and frame the broader narrative around societal choices in a narrow way. [152]

The role of financial engineering in slicing and dicing risks

The ability to securitise a range of financial products sold to customers increased the incentives for firms to aggressively push for subprime products to be sold. There was a complex interaction between wholesale and retail markets that contributed to this. Fligstein and Goldstein (2012) approach the literature from a sociological perspective and point to the role of the 'industrial' production of credit products.[153] Large investment banks needed multiple underlying products such as loans and mortgages to aggregate and package into securities that could in turn be spliced into tranches with varying levels of risk and return, that would subsequently be sold on to investors. To facilitate this, a thriving market in the extension of credit products on an 'industrial' scale was needed i.e. securities markets instruments could only be created from the aggregation of large cohorts of retail lending. Conversely this also created a ready market for onward distribution of the risk and revenue streams once the credit products were originated, contributing to increasing sales of these underlying products.[154] Indeed, some of the institutions vertically integrated this process such that 'firms originated mortgages, securitized them, sold them to investors, and were investors themselves in these

[151] Adelino, M., Schoar, A., Severino, F., (2011), Credit Supply and House Prices: Evidence from Mortgage Market Segmentation, National Bureau of Economic Research Working Paper 17832, [online] at http://www.nber.org/papers/w17832 [accessed on 8th May 2019] and Bank of England Statistical Database and Nationwide House Price Survey cited in Positive Money, (no date), Why are House Prices So High, Positive Money website, [online] at https://positivemoney.org/issues/house-prices/ [accessed on 8th May 2019]

[152] Palley, T., (2013), *Financialization: The Economics of Finance Capital Domination*, Palgrave Macmillan UK

[153] Fliegstein, A., Goldstein, A., (2017), The Transformation of Mortgage Finance and the Industrial Roots of the Mortgage Meltdown, Socio-Economic Review, 15 (3) pp 483-510 at https://doi.org/10.1093/ser/mww041 [accessed on 22 May 2019]

[154] Fliegstein, A., Goldstein, A., (2017), The Transformation of Mortgage Finance and the Industrial Roots of the Mortgage Meltdown, Socio-Economic Review, 15 (3) pp 483-510 at https://doi.org/10.1093/ser/mww041 [accessed on 22 May 2019]

products'.[155] At every step along the way, the aim of this vertical integration was to capture a layer of fees and returns. This plays back to the notion of **rentier capital** using their control of existing wealth to expropriate further wealth without engaging in productive activity[156]. It also plays to the narrative of financialisation where there is a deepening of financial markets and bank-based lending is replaced by reliance on securities markets products.

Schuermann and Ashcraft (2008)[157] use the language of market failure in economics to draw upon instances when institutions extending credit were not specifically engaged in vertical integration. They conjecture that in such cases credit products were extended with a view to repackage them once subscribed and to then sell them onto others through securitisation. These institutions may still have invested in tranches but in other firms' securitisation issues. In either case, securitisation provided motives for the weakening of credit scrutiny and it has been suggested that this fostered a lack of adequate diligence around the assessment of risks,[158] dissociating themselves from the risks that might have otherwise blunted their appetite.[159]

Finance begot more finance and the use of financial instruments was perpetuated for rent extraction rather than for purposes that were needed by the real economy.[160] Harvey (2019) discussing the notion of consumer sovereignty picks up on this theme more broadly when he challenges whether there really is any consumer or social autonomy in the context of daily life. He avers that 'more and more consumer choice is controlled' by the business model and this introduces a version of consumerism that 'looks great from a distance' as a result of a false framing of choices. He focusses on the need to increase consumption through increased consumerism. This resonates with the concerns raised earlier in this chapter about an increased demand for home mortgages being stimulated in those who could not afford to pay.

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[155] Fliegstein, A., Goldstein, A., (2017), The Transformation of Mortgage Finance and the Industrial Roots of the Mortgage Meltdown, Socio-Economic Review, 15 (3) pp 483-510 at https://doi.org/10.1093/ser/mww041[accessed on 22 May 2019]

[156] Lapavitsas, C., (2009), Financialised Capitalism: Crisis and Financial Expropriation, *Historical Materialism,* 17 ,pp114–148 [online] at https://doi.org/10.1163/156920609X436153 [accessed on 29 May 2019]

[157] Schuermann, T., Ashcraft, A., (2008), Understanding the Securitization of Subprime Mortgage Credit, Staff Report No 318, Federal Reserve Bank of New York Staff Reports, at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr318.pdf [accessed on 22 May 2019]

[158] Schuermann, T., Ashcraft, A., (2008), Understanding the Securitization of Subprime Mortgage Credit, Staff Report No 318, Federal Reserve Bank of New York Staff Reports, at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr318.pdf [accessed on 22 May 2019]

[159] United States Financial Crisis Inquiry Commission, (2011), *Financial Crisis Inquiry Commission Report*, pg 55 [online] at https://fraser.stlouisfed.org/title/5034 [accessed on 11th May 2019]

[160] Palley, T., (2013), *Financialization: The Economics of Finance Capital Domination*, Palgrave Macmillan UK

He further argues that this results in structuring society around an increasing mass with a need for the products that suppliers want to provide and that controlling the increase of this mass is hard.[161] Transposing this idea into a sub-prime securitisation context for example, there is a direct read-across, because the demand for sub-prime mortgages was in a sense supply-driven. That is, it was driven by a need to build larger, more complex and sophisticated instruments that enabled the financial intermediaries to profit from slicing, dicing and redistributing risks, rather than an inherent demand or need for more sub-prime mortgages. This approach is what Harvey terms the 'mass compensatory consumerism'[162] and a lifestyle that relies on commodification and the presence of what Harvey refers to as the 'spectacle'. Harvey's use of this term neatly captures the reassurances required by the commodification of sub-prime products – Harvey's use of this term describes more and more ostentatious instances of the production of the commodity and the increasing search for even more yield through ostentatious variations of the commodity. For example, in a GFC context, this can be seen in the formulation of complex synthetic securitisations (CDO-squared, CDO-cubed) to provide an answer to the search for increasing returns from the origination and distribution of risks. Securities were based on one or more layers of other securities that were in turn predicated on underlying credit products in a chain. This provided opportunities for further slicing and dicing of the derivatives themselves, and extracted further wealth for financiers constructing these products. The financial institutions engaging in these securitisation markets were essentially making their money from engaging in market transactions with other financial entities and not through real production.

This type of financial engineering took advantage of opportunities for regulatory arbitrage and was accompanied by accounting ingenuity designed to minimise tax and hide wealth. This was further complicated by the use of legal structures that were designed to shield entities from regulatory oversight (i.e. legal engineering), that facilitated regulatory arbitrage and that prevented the scrutiny of beneficial ownership. Here, financialization becomes apparent as the real root cause of crisis.

The layering of complex securities, and the questionable mathematical models that were used to value them, exacerbated opacity and complexity, preventing rigorous scrutiny and analysis by the supposedly sophisticated and rational market participants who were transacting in these

[161] Harvey, D., (2019), Erosion of Consumer Choices, David Harvey's Anti-Capitalist Chronicles podcast, April 25, 2019 (online) at https://www.democracyatwork.info/acc [accessed on 22nd May 2019]

[162] Harvey, D., (2019), Erosion of Consumer Choices, David Harvey's Anti-Capitalist Chronicles podcast, April 25, 2019 (online) at https://www.democracyatwork.info/acc [accessed on 22nd May 2019]

securities. This rationality of the mathematics of risk is typified in the use of the Value-At-Risk models. McCloskey and Ziliak (2008) point out that there was an over-reliance within both firms and their regulators on tests of statistical significance to the detriment of qualitative analytical rigour.[163] The question of whether the numbers were reasonable was considered secondary to the spurious accuracy that the models provided. Financial modeling was based on unrealistic or limited assumptions. Excessive reliance was placed on econometric and mathematical models based on inaccurate data, which in turn underestimated potential capital or liquidity requirements in extreme situations. Taleb et al (2009)[164] discuss the role of reliance on modeling techniques that underestimated or ignored tail-risks and the perils of extreme optimisation. Triana (2012)[165] outlines his criticism of the proliferation of Value at Risk (VaR) based models which, in his opinion, was what 'encouraged banks to take on assets… and that ultimately brought the international financial system to its knees'. Haldane (2009)[166] also criticizes the over-reliance of regulators on the risk-management capabilities of banks purely on the basis that they had developed more sophisticated modeling techniques. Many FIs created an illusion[167] of understanding and predictability by being overconfident about their own ability to predict and manage risks.[168] Their models underestimated potential capital or liquidity requirements in extreme situations. Such models are subject to limitations on account of five key factors:[169]

a) the underlying quantitative and qualitative techniques within the model

b) errors in parameters and issues with data quality

c) the nature and robustness of underlying assumptions

d) issues with the model's application or those flaws based on a misunderstanding of its limitations or results

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[163] McCloskey, D, and Ziliak, S., (2008), *The Cult of Statistical Significance,* University of Michigan

[164] Taleb, N., Goldstein, D., Spitznagel, M., (2009), 'The Six Mistakes Executives Make in Risk Management', *Harvard Business Review,* October, 2009

[165] Triana, P., (2012), *The Number That Killed Us,* Wiley, New Jersey

[166] Haldane, A., (2009), 'Why banks failed the stress test', [online] at https://www.bankofengland.co.uk/publications/Documents/speeches/2009/speech374.pdf , and basis for a speech at the Marcus-Evans conference on stress testing, [accessed 17th March 2012]

[167] Knowledge at Wharton, (2009), Why Economists Failed to Predict the Financial Crisis, article dated May 13 2009, [online] at https://knowledge.wharton.upenn.edu/article/why-economists-failed-to-predict-the-financial-crisis/ [accessed 17th March 2012]

[168] Gerding, E., (2009), Code, Crash, and Open Source: The outsourcing of financial regulation to risk models and the global financial crisis, *Washington Law Review,* Vol 84, Issue 2, pp 127-198 [online] at https://search.proquest.com/docview/213106423?accountid=13460 [accessed 17th March 2012]

[169] Board of Governors of the Federal Reserve System and Office of the Comptroller of Currency, (2011) 'Supervisory Guidance on Model Risk Management', [online], at http://www.occ.treas.gov/news-issuances/bulletins/2011/bulletin-2011-12a.pdf [accessed 24th April, 2012]

e) failures in the governance process surrounding the model's development, implementation or use – which could result in a, b, c or d above.

Unwillingness or inability at board level to challenge these models encouraged larger and larger volumes of trading in the expectation that risk dispersion could reduce impact and enable mitigation. Since boards were keen to ensure ever-increasing profitability,[170] they were willing participants in the underestimation of risks with a view to lessening financing costs through overestimation of performance. A desire for profitability blinded boards to the downside risks within these models and encouraged them to minimise capital and liquidity buffers while pursuing what could otherwise only be understood as highly risky strategies[171]. Some board members lacked the experience and skill to fully understand the implication of business models such as 'originate-to-distribute' for example, or the warehousing risks that such operations might entail[172]. Quantitative explanations have provided 'intellectual justification'[173] for certain choices, but it has been pointed out that a large section of such failure, were a direct result of inadequate senior management oversight.

Thus, issues with capital and liquidity, while apparent during the crisis, were symptomatic of a deeper issue surrounding the misunderstanding of firms' risk profiles. Data-driven modelling and analysis was an area of heavy focus, but in many cases the data was unrepresentative or inadequate[174]. Qualitative considerations and the expertise of experienced staff were not given sufficient attention within corporate oversight mechanisms. Incorrect estimations were made of the limitations and uncertainty associated with economic and econometric knowledge. These models were reliant on the supposed objectivity of algorithms and their assumptions neglecting the fundamental facts that much modelling is fraught with human decisions on assumptions and methods and ignored the reality that 'math is done by people.'[175] This has helped rationalise

[170] Independent Commission on Banking, (2011), 'Final Report', [online], at http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf [accessed 28th January 2012]

[171] The Financial Crisis Inquiry Commission, (2011), Final report of the national commission on the causes of the financial and economic crisis in the United States [online] at https://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf [accessed on 2nd May 2019]

[172] OECD, (2009), Corporate Governance and the Financial Crisis: Key Findings and Main Messages, [online] at https://www.oecd.org/daf/ca/corporategovernanceprinciples/43056196.pdf [accessed on 2nd May 2019]

[173] Eichengreen, B., (2009), 'The Last Temptation of Risk', [online], at http://www-personal.umich.edu/~rudib/lasttemptationofrisk_eichengreen.pdf [accessed on 15th March 2012]

[174] Francis, L., Prevosto, V., (2010), Data and Disaster: The Role of Data in the Financial Crisis, Casualty Actuarial Society E-Forum, Spring 2010, [online] at https://www.casact.org/pubs/forum/10spforum/Francis_Prevosto.pdf [accessed on 15th March 2012]

[175] O'Neill, C., (2017), *Weapons of Math Destruction*, Penguin, UK

deeply discriminatory practices, created complex interactions between risks and compromised individual privacy through the extraction and utilisation of information in ways that were incompatible with their underlying purpose.

This unjustified belief in the fairness and rationality of models was also partly driven by regulation predicated on market-based mechanisms for addressing market failure, where again such models and their results were expected to help with data-driven and expert decision-making. These mechanisms entrusted corrections of issues surfaced by the underlying data through disclosure and transparency to rational actors. Complexity prevented the disclosures from being meaningful exacerbating problems of information asymmetry and bounded rationality, amongst others. Opacity was magnified by spectacular multi-tiered structures that each aggregated several layers of risk undermining any possibility of transparency requirements functioning.

The trend to engineer complex financial products, reflects not just an attempt to extract wealth but also to mask risk, and the concerns arising are regarding the growth of financial engineering techniques because rather than stimulating real and productive investment, they were engineered to generate returns to finance capital. This is visible in the evolution of securitisation and derivative products during the global financial crisis. Such supply-led demand can be hugely detrimental to civil society stakeholder objectives because it requires greater and greater spectacles for validation and continued wealth extraction. It therefore necessitates its own reproduction and therefore ignores considerations of financial and societal sustainability in the ongoing consumption of credit products. This notion of the 'spectacle' one could plausibly argue, essentially fuelled the sub-prime bubble.

Short-term lending to finance long-term purchases

The credit bubble was also affected by the emergence of risks arising from the choice of the sources and application of funds. The procurement of the bulk of these funds from short-term money markets meant that the liquidity risks entailed were greatly exacerbated. This was because funds were procured from the short-term money markets and then used for medium to long-term credit products such as loans & mortgages, thereby increasing what are termed as 'funding liquidity'[176] risks i.e. the ability to refinance borrowings as their repayments fall due.

[176] United States Financial Crisis Inquiry Commission, (2011), *Financial Crisis Inquiry Commission Report*, pg 55 [online] at https://fraser.stlouisfed.org/title/5034 [accessed on 11th May 2019]

It is worth reiterating here that the way credit providers funded themselves also influenced considerations of profitability and pricing, thus encouraging lenders to flog variable rates, offer low teaser rates to attract new customers and essentially to engage in 'bait and switch'[177] tactics (discussed above) to increase profitability.

The role of third party oversight

Credit rating agencies provided ratings for these issuances which was meant to provide an independent assessment of the quality of the securities. This is a typical corporate governance mechanism that follows the financialized narrative of shareholders owning the company and under the principal-agent model needing to achieve returns in the face of the economic self-interest of the management of the company. The principal-agent model offers an explanation of how one might allow the market to function in the context of dispersed, non-expert shareholders and to preserve their best interest in the face of expert senior managers who in turn were expected to preserve their own self-interest. Third party oversight through the use of a credit rating agency to assess securities was expected to allow the market to correct any burdens placed by the attendant information asymmetries by providing expert, third party validation of the quality and financial sustainability of the security. This was particularly necessary in terms of securitisation issuances because of the complexity and opacity of these issuances. The use of credit ratings in this context would restore a level playing field and would therefore allow the market mechanism to correct the market failure caused by information asymmetry by allowing the informed investor to make a rational choice in respect of the investment.

Credit rating agencies though were typically remunerated by the issuer, creating obvious conflicts of interest. As the sub-prime crisis began to unfold, what is revealing is that the credit rating agencies, claimed that their credit ratings were not meant to be objective measures of quality but merely 'opinions'.[178]

In a market-driven economy there is great emphasis on disclosure and transparency, as the tools of corporate governance.[179] The quality of disclosures is reinforced by firms being

[177] Gourse, A., (2007), The Subprime Bait and Switch, In These Times website article dated July 16 2007 at http://inthesetimes.com/article/3276/the_subprime_bait_and_switch [accessed on 22 May 2019]

[178] Ferguson, C., Inside Job, (2010) film transcript provided by Sony Pictures (online) at https://www.sonyclassics.com/awards-information/insidejob_screenplay.pdf [accessed on 11th May 2019]

[179] Clarke, T. (2007), *International Corporate Governance: A Comparative Approach,* Routledge, Oxon

required to seek the opinions of independent, external auditors in relation to reviewing their financial performance. The rigour of professional audit certifications and the use of stringent accounting standards by auditors are both aimed at ensuring that there is robust challenge of the firm's own statement of its financial position. The expectation is that the rational investor, can rely on such audited statements (such as annual reports and interim financial statements), when they express investment preferences in their market transactions. The presence of accounting standards, is also intended to ensure comparability in a competitive market. Again, the emphasis is on rational investors making comparisons between different investment opportunities, with auditors ensuring that the information the investor relies upon is fit for purpose. Yet, examinations of the serious collapses during the Global Financial Crisis of 2007, such as that of Lehman Brothers, make it apparent, that the rigour expected from such accounting reviews did not materialise in practice.[180] In fact, auditors appeared to turn a blind eye to the use of complex special purpose vehicles that undermined transparency and scrutiny of audited firms.[181] Accounting firms' conflicts of interest were intensified because the advisory arms of the Big 4 accountants were often advising banks on the development of securitisation strategies. Not only did these advisory business help create some of the strategies that magnified opacity and complexity through extensive securitisation changes, it is argued[182] that the lucrativeness of this business, compromised the quality of independent challenge by the auditors. Laux and Leuz (2009)[183], Shaffer (2010)[184] and others examine the role of fair-value accounting and the impact of mark-to-market techniques in precipitating the crisis. Some pointed out the conflicts of interest in how accounting standards are set by a small group of powerful accountancy firms, in ways that benefit their own interests and that of powerful clients. Others have taken issue with fair-value accounting on the grounds that the reliance on market prices is closely aligned with the belief in efficient markets pricing risks effectively. It has also been argued[185] that the application of these approaches led to further procyclical

[180] Valukas, A., (2010), Report of Anton R. Valukas, Examiner Lehman Brothers Holdings, Inc. et al. Debtors, Section III.A.1, [online], at https://jenner.com/lehman/VOLUME%201.pdf [accessed on 14th April 2020]

[181] Turner, L., (2008), Plunge: How banks aim to obscure their losses. An interview with Lynn Turner, *Multinational Monitor,* Vol 4, Nov.Dec issue, pp 27-30

[182] Arnold, P., (2009), Global financial crisis: the challenge to accounting research, *Accounting, Organisations and Society*, Vol 34, pp 803-809

[183] Laex, C., Leuz, C.,(2009), The crisis of fair value accounting: Making sense of the recent debate*, Accounting, Organizations and Society,* Volume 34, Issues 6–7, August–October 2009, pp 826–834

[184] Shaffer, S., (2010)'Fair Value Accounting: Villain or Innocent Victim - Exploring the Links Between Fair Value Accounting, Bank Regulatory Capital and the Recent Financial Crisis', FRB of Boston Quantitative Analysis Unit Working Paper No. 10-01 http://dx.doi.org/10.2139/ssrn.1543210 [accessed 15th March 2012]

[185] Turner, L., (2008), Plunge: How banks aim to obscure their losses. An interview with Lynn Turner, *Multinational Monitor,* Vol 4, Nov.Dec issue, pp 27-30

moves to offload assets when market prices of assets began to deteriorate, thus exacerbating the crisis. Accounting firms have also been closely implicated in the legal and financial engineering that served to obscure the true financial position of entities.[186] This included wilful blindness to the misuse of secrecy jurisdictions, techniques such as transfer pricing, and other complex mechanisms to undermine transparency and disclosure and undermine the economy more generally, while facilitating the transactions that capital market participants may wish to pursue[187].

Shadow banking

Lysandrou and Nesvetailova (2015) characterise the literature on how shadow banking contributed to the global financial crisis as being of two key varieties – 'one emphasising factors endogenous to the banking sector (notably regulatory arbitrage and financial innovation); the other emphasising exogenous factors (notably the 'search for yield')'.[188] Some commentators in the area of flash crashes[189] have discussed the sudden liquidity reduction and the magnification of adverse events through increased computerized trading and risk-management techniques of automated stop-loss limits. The pervasiveness of shadow banking entities that were poorly regulated further allowed for the expropriation of wealth through the use of complex structures and mechanisms that circumvented the law and regulation.

Regulation

What is interesting is that one would expect financial services to be a highly regulated market. However, both in the US[190] and in the UK, there was very little regulatory appetite[191] to intervene in these markets allowing the mis-selling to gather momentum. When using a more multi-disciplinary lens, it is obvious that ideological factors and lobbying by coordinated groups who would benefit from increased activity in the housing market, helped influence regulators.

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[186] Fraser, I., (2007), Creative accounting, December 4th 2007, [online] at ww.ianfraser.org/creative-accounting, [accessed on 20th April 2020]

[187] Sikka, P., (2009), The auditing industry should serve society…. not themselves, *Herald Scotland,* 23rd November 2009

[188] Lysandrou, P., Nesvetailova, A., (2015), The role of shadow banking entities in the financial crisis: a disaggregated view, *Review of International Political Economy*, Vol. 22, No. 2, pp 257–279, [online] at http://dx.doi.org/10.1080/09692290.2014.896269 [accessed on 22nd May 2019]

[189] Australian School of Business (2012), 'Can Regulators Stop the Next Crash?', February 20th, 2012, at http://asb-stage.wharton.upenn.edu/article.cfm?articleid=1545 [accessed 20th April, 2012]

[190] Gnaizda, R., (no date), cited in Ferguson, C., Inside Job, (2010) transcript provided by Sony Pictures, pg 26 [online] at https://www.sonyclassics.com/awards-information/insidejob_screenplay.pdf [accessed on 11th May 2019]

[191] United States Financial Crisis Inquiry Commission, (2011), *Financial Crisis Inquiry Commission Report*, pg 55 [online] at https://fraser.stlouisfed.org/title/5034 [accessed on 11th May 2019]

This is typical of economist Mancur Olson's collective action problem[192] where smaller, well-organised groups of industry practitioners are able to act to the detriment of larger groups of consumers, on account of their ability to marshal efforts more effectively to further their interests. These lobbying efforts, in turn, encouraged regulators to dilute or only loosely implement consumer protection regulation, and to adopt fiscal policy measures providing implicit or explicit subsidies[193] for home purchase, again strengthening the more economic arguments for why consumers chose to take on a range sub-prime products. Lax regulation essentially acted as a catalyst for financial institutions to aggressively extend sub-prime credit

Disclosure and transparency as regulatory techniques

The marketised ideology predicated on markets and using disclosure[194] and transparency[195] as antidotes to the problems caused by information asymmetry and bounded rationality. Experts including Federal Reserve Chairman Alan Greenspan have acknowledged that even with a doctoral qualification, the technicalities of adjustable rate mortgages would have been difficult to understand.[196] That these mortgages were then sold to retail consumers, who were not conversant with the way such products operated provides an insight into how predatory the market was intentionally set up to be. To make matters of social justice worse '...racial minorities were increasingly given access to housing-credit under terms far more adverse than were offered to non-minority borrowers'.[197]

Sub-prime loans were also sold to customers who would have been eligible for prime loans with associated typically low, longer-term rates. This was because in a market predicated on rising house prices, and with the transformation of housing from providing a home to an investment class,[198] the prevalence of teaser rates, encouraged both prime customers and their advisors to rely on attaining value through the 'churning' of mortgages. Indeed, it was rational to choose a

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[192] Olson, M., (1965), *The Logic of Collective Action*, Harvard University Press, Cambridge, Massachusetts

[193] Woellert, L., (2016), Powerful lobbyists swoop in to save sacred tax break, Politico.com article dated 31st December 2016, [online] at https://www.politico.com/story/2016/12/lobbyists-mortgage-interest-deduction-tax-233081 [accessed on 8th May 2019]

[194] Avgouleas, E., (2010), What future for disclosure as a regulatory technique in MacNeill, I, O'Brien, J., eds (2010), *The Future of Financial Regulation*, Hart Publishing, Portland Oregon

[195] Clarke, T., (2007), *International Corporate Governance: A Comparative Approach*, Routledge, Oxon

[196] Greenspan, A., (no date), in a quote reported by Robert Gnaizda in Ferguson, C., Inside Job, (2010) transcript provided by Sony Pictures, pg 26 [online] at https://www.sonyclassics.com/awards-information/insidejob_screenplay.pdf [accessed on 11th May 2019]

[197] Dymski, G., (2009), Racial Exclusion and The Political Economy of the Subprime Crisis, *Historical Materialism,* 17 (2), pp 149-179 [online] at https://doi.org/10.1163/156920609X436162 [accessed on 7th May 2019]

[198] Lydenberg, S., (2011), 'Beyond Risk: Notes Towards a More Responsible Investment Theory', pp 26-51 in Hawley, J., Kamath, S., Williams, A., eds. (2011) *Corporate Governance Failures,* University of Pennsylvania Press, Philadelphia

sub-prime mortgage with a teaser-rate, and either flip to another low rate after the offer period, or to sell the property itself to benefit from rising house prices in order to benefit from the low teaser-rates.

Returning to the notion of the sovereign consumer, the reliance on sovereign consumers to address these issues through voting with their feet affords a false sense of fairness and protection, and compounds the imbalance caused by information asymmetries because it 'attaches responsibility'.....for corrective intervention,, 'to those with less prevalent or powerful voices than the institutional elites who have greater opportunities to shape financial discourse'.[199]

The focus on securitization of these mortgages, so as to ensure that the originator of the mortgage did not necessarily hold the risk, was another phenomenon that affected the quality of the mortgages being offered.[200] Assuming that securitization meant they would offload the risks onto others, many lenders did not scrutinize the loans as carefully as they would have done were they to have to hold the loans on their books until maturity. While complexity undermined transparency, in parallel, disclosure was also undermined because disclosures were being made to those who had no real interest in addressing risks. Thus financialization undermines the use of the techniques that would be typically strengthened to prevent

Systemic and structural issues (including global capital flows)

Bookstabber et al (2007)[201] have discussed the role of structural issues in causing the financial crisis. These include the imbalances in global financial flows between various countries including at a macro-level between the USA and China. The UK House of Commons' Treasury Committee cites Mervyn King,[202] Governor of the Bank of England, who commented that the 'failures in the international monetary system led to imbalances in capital flows between

[199] Kelsey, D., Mueller, F., Whittle, A., Khosravinik, M., (2016) Financial crisis and austerity: interdisciplinary concerns in critical discourse studies, *Critical Discourse Studies*, Vol 13, Issue 1 [online], at https://www.tandfonline.com/doi/full/10.1080/17405904.2015.1074600 [accessed on 26th February 2019]

[200] Segoviano, M., Jones, B., Lindner, B., Blankenheim, J., (2013), Securitization: Lessons Learned and the Road Ahead, IMF Working Paper Series, [online] at https://www.imf.org/external/pubs/ft/wp/2013/wp13255.pdf [accessed on 14th April 2010]

[201] Bookstabber, R., (2007*), A demon of our own design: Markets, hedge funds and the Perils of Financial Innovation*, Wiley, 2007 cited in Crotty, J., (2009), Structural causes of the global financial crisis: a critical assessment of the new financial architecture', *Cambridge Journal of Economics*, Volume 33, Issue 4, July 2009, Pages 563–580, [online] at https://doi.org/10.1093/cje/bep023 [accessed on 26th February 2019]

[202] King, M., (2009), Testimony to UK House of Commons, cited by House of Commons Treasury Select Committee in 'Banking Crisis: dealing with the failure of the UK banks', 2009 at http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/416/416.pdf [accessed 17th April 2012]

countries that created the conditions of remarkably low interest rates and encouraged risk-taking.' Although these failures in the international monetary system, were often thought to be distinct from other causes of the crisis, there were driven by the very same ideological positions that contributed to the other causes. Walter and Wansleben (2019) explain 'how an alignment between techniques of monetary governance and 'unfettered' financial markets can explain central banks' endorsement of increasingly fragile structures of liquidity and their strategic ignorance towards growing amounts of debt'.[203] A financialized perspective on the role of the central bank, faith in financial markets' ability to slice and dice risk, and a belief in the moral superiority of market-led solutions underscored a commitment to enabling choices of financial institutions. While there was some consideration at a micro-level of the institution concerned being able to withstand the financial losses or be unwound in a reliable manner, there was little recognition of the system-wide problems such increases in debt and leverage could cause.

Central banks focused on mechanisms for inflation targetting and adopted artificially suppressed interest rates which in turn fostered market participants' increased risk taking and became known as the 'search for yield.' Due to incentives related to profitability and remuneration, coupled with a low interest rate environment, senior executives began to take more risks with greater and greater leverage. Institutions used debt to finance transactions in ways that vastly increased risk and reduced personal liability. Leverage magnified the impact of risks, at individual, institutional and national levels by magnifying the effects of falls in asset prices. They also set the scene for drastic needs for deleveraging in the cases of significant reductions in asset prices. Crotty (2009) points to the leverage ratios of banks stating that 'Many European banks had leverage ratios of 50 or more before the crisis (Goodhart, 2009), while Citibank's and Bank of America's ratios were even higher (Ferguson, 2008). By the end of 2008 many large banks had seen their equity position evaporate to the brink of insolvency and beyond. Only massive government bailouts kept these 'zombie banks' alive. Rising leverage was facilitated in part by the easy money policies of the Fed'.[204]

The dependence of the US and the UK on flows of capital from abroad so as to maintain their economic models, and the recycling of those inflows into secondary exports of capital which created large rewards for those who brokered these flows also exacerbated some of the risks.

[203] Walter, T., Wansleben, L., (2019), How central bankers learned to love financialization: The Fed, the Bank, and the enlisting of unfettered markets in the conduct of monetary policy, *Socio-Economic Review*, Vol. 0, No. 0, pp 1–29 [online] at 10.1093/ser/mwz011 [accessed 27th April 2020]

[204] Crotty, J., (2009), Structural causes of the global financial crisis: a critical assessment of the 'new financial architecture', *Cambridge Journal of Economics,* Vol 33, pp 563-580, [online] at 10.1093/cje/bep023 [accessed 27th April 2020]

The transfer of financial activity from regulated firms to unregulated firms, and the increasing use of technology that allowed financial firms to 'follow the sun' to keep trading positions active globally across different jurisdictions and follow a round-the-clock, inter-linked model of trading, also contributed to greater systemic risk. Financial firms' boards in turn encouraged their contacts in government to promote greater financial liberalization[205] and therefore increased interconnectedness with unregulated cross border entities. But, here there is some element of needing to operate with caution in relation to counterfactuals i.e. what would have happened if banks did not have such subsidiaries, or indeed deal extensively with shadow banks. Even when corporate governance and regulatory failures do not exist, bubbles can still be created and then burst causing crises. Modern market economies have a tendency to be cyclical, with boom followed by slowdown / recession. But the reality is that these can be excessively magnified in a globalised electronically-interwoven marketplace where governments intentionally create complex chains of risk. The absence of knowledge re: risks in one area can have immediate and severe impacts in relation to cautiousness in other jurisdictions. For example, the lack of recourse in certain securitisation arrangements during the crisis, caused a sudden drying up of liquidity for other transactions even when they had clauses for recourse in case of poor underwriting. One of the symptoms of distrust of this nature is seen in the reluctance of lenders to lend for viable new projects even in relatively stable markets. Tett (2010) has blamed other structural issues such as the silo mentality of supervising only specific aspects of the financial system, and the lack of integrated transnational oversight by regulators.

Of the structural issues listed above, the key area that merits introspection is the role of financial firms in encouraging the growth of their own shadow banking subsidiaries in order to facilitate the legal and financial engineering they needed to gain tax and other advantages, as discussed earlier. Financial Institutions thus often held low-quality loans on their own books or 'passed the buck' by securitizing such loans. Senior bankers, academics and regulators strongly espoused the risk-transfer properties of new financial instruments. Through influential trade bodies, such as the BBA and ISDA[206] they advocated new techniques such as securitisation, stating that these would enhance liquidity and facilitate risk-sharing[207] and should therefore be

[205] Clarke, T., (2017), *International Corporate Governance: A Comparative Approach*, Routledge, Abingdon, Oxon

[206] See for example, Additional Key Concerns paragraph 2 on page 3 of the detailed response letter dated February 2006, written by the BBA, ISDA, LIBA and ESF to the Committee of European Banking Supervisors (CEBS) 'Second round of consultation on the validation and assessment of credit and operational risk approaches', 2006, at http://www.bba.org.uk/media/article/cebs-second-round-of-consultation-on-the-validation-and-assessment [accessed 9th April 2012]

[207] Jobst, A., (2006), 'Asset securitisation as a risk management and funding tool: What small firms need to know', *Managerial Finance*, Vol. 32 Issue 9, pp.731 - 760

subject only to light-touch regulation (see comments re: lobbying listed above). They did not however pay enough attention to the possibility that techniques such as securitisation lowered the incentives for banks to monitor borrowers effectively. This led to systemic repercussions, as defaults could be contagious[208] and risks were transmitted from retail lenders to wholesale institutions and vice versa, and these were then further magnified because of the global linkages within the financial sector. The structural nature of these problems was entrenched by the issues surrounding governmental and regulatory policy.

The crisis as a confluence of unintended consequences

Some senior financiers, such as HBOS CEO Andrew Hornby,[209] who led highly aggressive sales and customer services practices, extended a hypothesis that the crisis was the result of unexpected and unplanned circumstances, thereby refusing to find themselves culpable for the ways in which the crisis unfolded. However, looking at this range of causes, what becomes obvious is that the causes of the crisis do not exist in isolation, and while the timing of the collision of various factors was in some ways left to chance, it was not difficult to expect that a crisis of significant magnitude would result from certain policy options and management choices. McCluskey (2012) notes that 'the 'unintended consequences' framework steers analysis away from the interests and values of those who gain from harmful policies, so that the harm appears to arise from an inevitably challenging and uncertain technical puzzle or a tragic accident of nature, rather than from the wrongful or careless exercise of power'.[210] By harking to unintended consequences, the legitimacy of a course of action is not considered in sufficient depth because there is a redirection to the ownership of these consequences by those who were unfortunately exposed to its outcomes. From an accountability and policy development perspective the use of the 'unintended consequences' rhetoric suggests 'uncertainty and complexity, rather than to the foreseeable power of particular policy choices to lead to harm', absolving policymakers and lawmakers of their responsibilities for the outcomes entailed. [211]

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[208] Mccoy, P.A., Pavlov, A.D., and Wachter, S., (2009) 'Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure', *Connecticut Law Review*, Vol 41, Number 4, May 2009

[209] The Telegraph (2010), 'Bank bosses refused to say sorry during financial crisis, academics find', *The Telegraph* newspaper, 21 September 2010, [online] at https://www.telegraph.co.uk/finance/financialcrisis/8013998/Bank-bosses-refused-to-say-sorry-during-financial-crisis-academics-find.html [accessed on 21st August 2017]

[210] McCluskey, M., (2012), How the 'unintended consequences' story promotes unjust intent and impact, Berkeley La Raza Law Journal, Volume 22, [online] at https://heinonlineorg.idpproxy.reading.ac.uk/HOL/P?h=hein.journals/berklarlj22&i=29 [accessed on 14th April 2020]

[211] McCluskey, M., (2012), How the 'unintended consequences' story promotes unjust intent and impact, Berkeley La Raza Law Journal, Volume 22, [online] at https://heinonlineorg.idpproxy.reading.ac.uk/HOL/P?h=hein.journals/berklarlj22&i=29 [accessed on 14th April 2020]

Risk and harm production

In reviewing the preceding causes of the crisis, the sustained theme that remains is the need for a more holistic consideration of risks, who makes decisions about risk, and what accountability there was and should be for such decision-making. Risks affects both wealth and well-being. The evaluation of risk can help to promote equality or entrench inequality as discussed as the start of this paper. A discussion of the causes of the crisis would therefore be incomplete without a recognition of the big picture issues in relation to how risk is conceived, measured, addressed and apportioned.

Underlying many of the problems that have manifested in the crisis is the fact that the conceptualization of risk has been narrow, limited, incoherent and incomplete[212]. There have been serious problems in the measurement of risks, as a result, with only certain types of risks to certain types of stakeholders receiving attention. One egregious example of the impact of such narrow conceptualization of risks is made visible by the bankruptcy examiner's investigation into the collapse of Lehman Brothers[213]. Although managers at Lehmans observed their firm's risk management policies, the very scope of these policies limited what they chose to consider as risks that required their management efforts. This misconception of risks was exacerbated by distortion and closure of the public & expert narrative[214]. The misleadingly framed 'democratisation of finance' resulted in citizenship and rights being recast in terms of 'universal access to 'safe' and affordable financial products.' [215]. Citizens have been invited to 'organize their daily lives around 'investor logic', active individual risk management, and involvement in global financial markets.'[216] However, because these stakeholders and risks were not given sufficient attention at any stage of the Lehmans' flawed risk management process or the sale of subprime products for example, accountability for these risks and

[212] Rajan, R., (2005), Has Financial Development Made the World Riskier?, Paper presented at Federal Reserve Bank of Kansas City Symposium at Jackson Hole, [online] at https://www.kansascityfed.org/publicat/sympos/2005/pdf/rajan2005.pdf [accessed on 14th April 2020]

[213] Valukas, A., Report of Anton R. Valukas, Examiner Lehman Brothers Holdings, Inc. et al. Debtors, Section III.A.1, [online], at https://jenner.com/lehman/VOLUME%201.pdf [accessed on 14th April 2020]

[214] Engelen, E., Erturk, I., Froud, J., Johal, S., Leaver, A., Moran, M., Nilsson and Williams, K., (2011), *After the Great Complacence: Financial Crisis and the Politics of Reform*, Oxford University Press, Oxford

[215] Storm, S., (2018), Financialization and Economic Development: A Debate on the Social Efficiency of Modern Finance, *Development and Change*, 49(2) pp 302–329 [online] at https://onlinelibrary.wiley.com/doi/epdf/10.1111/dech.12385 [accessed on 14th April 2020]

[216] Storm, S., (2018), Financialization and Economic Development: A Debate on the Social Efficiency of Modern Finance, *Development and Change*, 49(2) pp 302–329 [online] at https://onlinelibrary.wiley.com/doi/epdf/10.1111/dech.12385 [accessed on 14th April 2020]

ownership for their management was willfully ignored. Similarly, efforts to slice, dice and apportion risks through complex securitisations, failed because there was little recognition of the broader effects of increased complexity on obscuring risks, the systemic impacts of risks and the distortion of asset classes and increase of risk that the very slicing and dicing aimed at risk management sought to address. [217]

This in turn led to serious and material failures that had significant and foreseeable impacts on a range of stakeholders. Simpson (2019) discussing the evidence of legitimation and moral disengagement, suggests that focusing on social harm, allows a better insight into how to address immoral, injurious and wrongful acts.[218] However, an examination of the causes of the crisis and standard risk management practices at firms such as Lehmans[219], suggests that a discussion of the wide impact and probability of social harm was excluded from conceptions and definitions of standard risk types used in academic discourse, in firm's own risk management practices, and regulatory assessment of risks. This led to these common-sense issues and risks being sidelined, ignored in measurement, mitigation or distribution. Social harm was consigned to being collateral damage.

Risk management efforts within institutions (including regulated institutions) were therefore at odds with what one might consider is necessary for managing risk if a civil society protection motive were employed. The use of technology tools, for example, rather than helping to measure and mitigate risk led to 'profiling, policing and punishment' of those with less power and less access to finance capital, while entrenching profitability for those with greater power and access to finance capital.[220] Rights of vulnerable stakeholder groups have been undermined because of an inordinate focus on certain types of risks to certain types of stakeholders. The rights of consumers for example, were completely invisible in much organisational decision-making within financial firms and regulators, prior to the crisis, and as the next chapter suggests certain types of conduct risk remain invisible in the reform efforts post crisis. How risk is conceived, measured, monitored, mitigated, distributed or redistributed, has therefore caused, affected and amplified the crisis and undermined meaningful reform in its aftermath. Tombs (2016) explains how many of the risks that citizens are subject to, are 'routine,

[217] Lydenberg, S., (2011), 'Beyond Risk: Notes Towards a Responsible Investment Theory', Corporate Governance Failures in eds, Hawley, J., Kamath, S., Williams, A., *The Role of Institutional Investors in the Global Financial Crisis,* University of Pennsylvania Press, Philadelphia

[218] Simpson, A., (2019), The culture of moral disengagement and harm production in the City of London's financial services industry, *Justice, Power and Resistance,* Volume 3, Issue 1

[219] Valukas, A., Report of Anton R. Valukas, Examiner Lehman Brothers Holdings, Inc. et al. Debtors, Section III.A.1, [online], at https://jenner.com/lehman/VOLUME%201.pdf [accessed on 14th April 2020]

[220] Eubanks, V., (2017), *Automating Inequality*, St Martins Press, New York

systematic and crucially avoidable.'[221] Harms increase while a continued democratic deficit in terms of scrutiny and redress also continues apace. So how did routine, systematic and avoidable risks fail to achieve any scrutiny or redress prior to their crystallisation during the crisis? The logic underpinning the issues with conceptualisation, measurement and allocation of risk, is explained by financialization.

Financialization:

Dore (2008) points out that there can be a variety of interpretations of the term financialization, and that 'Financialization' is a bit like 'globalization'—a convenient word for a bundle of more or less discrete structural changes in the economies of the industrialized world'.[222] Van der Zwan, describing the various interpretations points to 3 key conceptions: financialization as a description of the shift from industrial to finance capitalism; financialization as a conception of the corporation where shareholder value primarily motivates corporate behaviour and shareholder value ideology is predominant; and financialization of the 'everyday' where finance draws its power from individuals taking on 'new norms of risk-taking and develop(*ing*) new subjectivities as investors or owners of financial assets'.[223] She adds that all three approaches ''share a common concern for financialization as a structural transformation of contemporary capitalism'.[224]

Although there is no single definition of financialisation, influential scholars including Palley, Krippner and Epstein do share a similar, nuanced understanding of what financialization entails.

Epstein (2005) defines financialization broadly as 'the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies'.[225]

[221] Tombs, S., (2016), 'Better Regulation': Better for whom?, Centre for Crime and Justice Studies: Briefing 14, [online] at https://www.crimeandjustice.org.uk/sites/crimeandjustice.org.uk/files/Better%20regulation%20briefing%2C%20April%202016_0.pdf [accessed on 14th April 2020]

[222] Dore, R., (2008), Financialization of the Global Economy, *Industrial and Corporate Change*, Vol 17, pp 1097–1112

[223] Van der Zwan, N., (2014), 'Making sense of financialization', *Socio-Economic Review,* Vol 12, Issue 1 pp 99–129, [online] at https://doi.org/10.1093/ser/mwt020 [accessed on 21st August 2017]

[224] Van der Zwan, N., (2014), 'Making sense of financialization', *Socio-Economic Review,* Vol 12, Issue 1 pp 99–129, [online] at https://doi.org/10.1093/ser/mwt020 [accessed on 21st August 2017]

[225] Epstein, G., (2005), *Financialization and the world economy,* Edward Elgar Publishing

Krippner (2004) characterises financialization as a 'pattern or accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production'.[226]
Palley (2007) elaborates noting that the 'changes in the structure and operation of financial markets, changes in the behavior of non-financial corporations, and changes in economic policy'. [227]

Through extensive research, Epstein and Jayadev (2005) demonstrate how 'rentiers – financial institutions and owners of financial assets – have been able to greatly increase their shares of national income in a variety of OECD countries since the early 1980s'. Sawyer (2013), referring to FESSUD's description of work notes that financialization serves to

'(i) Reduce overall levels and efficacy of real investment as financial instruments and activities expand at its expense.
(ii) Prioritise shareholder value, or financial worth, over other economic, social, and environmental values and goals.
(iii) Push policies towards acceptance of the operation of market forces and commercialisation in all areas of economic and social life.
(iv) Extend influence more broadly, both directly and indirectly, over economic *and* social policy.
(v) Place more aspects of economic and social life at the risk of volatility from financial instability and, conversely, places the economy and social life at risk of crisis from triggers within particular markets (as with the food and energy crises that preceded the financial crisis, for example).
(vi) Encourage particular forms of culture and corresponding governance that shapes what policies can be formulated and implemented'. [228]

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[226] Krippner, G., (2004), What is Financialization, cited in ed. Epstein, G., (2005), *Financialization and the World Economy*, Edward Elgar Publishing

[227] Palley, T., (2007), 'Financialization: What it is and why it matters', Working Paper Number 153, University of Massachusetts Amherst Political Economy Research Institute Working Paper Series, presented at a conference on 'Finance-led Capitalism? Macroeconomic Effects of Changes in the Financial Sector,' sponsored by the Hans Boeckler Foundation, Berlin, Germany, October 26 – 27, 2007 (online) available at http://scholarworks.umass.edu/cgi/viewcontent.cgi?article=1124&context=peri_workingpapers [accessed on 21st August 2017]

[228] Sawyer, M., (2013), What Is Financialization?, *International Journal of Political Economy*, Vol 42, Issue 4, pp 5-18 [online] at 10.2753/IJP0891-1916420401 [accessed on 26th February 2019]

Through the six factors listed above financialization thus causes, nurtures, incentivises and embeds a narrowing of understanding. It fosters wilful blindness in the examination of the causes and consequences of risk, as well as in the use of measures such as austerity economics to address the effect of the crystallisation of risks. Whether it is in the extension of credit, without suitable security, in the hope of offloading the risks from institutional books through securitization, or the financial and legal engineering that increases opacity and complexity thus increasing risk, or in the way that regulators engage with and respond to crisis, financialisation[229] acts as a catalyst for poor practices in conceiving and addressing risk. By serving as the engine that powers risk to coalesce in opaque and complicated patterns that are difficult to unpick, financialization has caused risk to manifest as a range of adverse outcomes including increased incentives to disproportionately reward a small number of wealthy individuals while obscuring visibility of burdens borne by a large majority.[230] In doing so, financialization also prevents substantive and meaningful reform even after a severe crisis[231] because those in positions of power[232] also determine risk management strategies and drive the agenda for reform.

Financialization and its effects therefore need to be acknowledged if we are to frame solutions to crises in a way that does not embed the financialized logics that caused a crisis, into its resolution.

Conclusion

This chapter draws together scholarly work across different disciplines to explain the causes of the global financial crisis. It begins by setting out why the crisis of 2007- is important and why its causes are significant. The examination of these causes using both mono-disciplinary and multi-disciplinary lenses, unveils much that otherwise would remain hidden from view by drawing on a range of perspectives and subject specialisms.

Each of the causes is examined critically and there is an effort to examine any features that link causes. Through the narrative, financialization then slowly comes to the fore, as the linking factor that energises and motivates the development of these causes, and prevents regulatory

[229] Epstein, (2005), *Financialization and the world economy,* Edward Elgar Publishing

[230] Bivens, J., Shierhoz, H., (2018), What labor market changes have generated inequality and wage suppression?, Economic Policy Institute Report, [online] at https://www.epi.org/files/pdf/148880.pdf [accessed on 14th April 2020]

[231] Sawyer, S., (2012), The corporation, oil, and the financialization of risk, *American Ethnologist*, Vol. 39, No. 4, pp. 710 -715

[232] Appel, H., (2012), Offshore work: Oil, modularity, and the how of capitalism in Equatorial Guinea, *American Ethnologist*, Vol. 39, No. 4, pp. 692–709

reform from effectively addressing the causes. The causes of the global financial crisis of 2007 cited in this chapter are driven by one or more of the three ways of conceiving financialization as elaborated by Van der Zwan – the reshaping of capital accumulation from industrial activity to financial activity, the conception of the corporation as a tool to deliver shareholders' interests and the change in the everyday discourse and how productivity is conceived. In thus affecting risk, financialization contributes to crises being exacerbated, because agendas for governance and regulation are heavily compromised by regulators and politicians who are willfully blind to the problems of finance. As Kelsey et al (2015) point out 'The moral positions of governments are constructed according to those political agents and institutions who seek to legitimise or delegitimise particular economic strategies'.[233] Financialization thus explains how social harms emanating from the poor conceptualisation, measurement and apportionment of risk are then explained away or legitimised whilst the harm production continues.[234]

These points are also very important in understanding how reform, in the aftermath of the global financial crisis, was in several instances delivered by those who manufactured, established and helped embed a false narrative. Many key issues including the need for holistically engaging with and assessing risk, were either missed in conceptualizing reform, or narrowly conceived in the policy and institutional changes required or in implementing appropriate reform measures.

In the chapters that follow, lessons from the crisis of 2007 are used to animate a discussion of the interplay between financialization, risk and regulation post-crisis. The first paper discusses how risk is perceived in the conduct regulation space as a result of financialization and the consequent gap in conduct regulation visible from the reform of regulation post-crisis. The second paper is a case study of the University Superannuation Scheme (USS) that is used to explore and demonstrate how even a decade after the crisis, financialization continues to distort both perceptions of risk and mechanisms to address it.

[233] Kelsey, D., Mueller, F., Whittle, A., Khosravinik, M., (2016) Financial crisis and austerity: interdisciplinary concerns in critical discourse studies, *Critical Discourse Studies*, Vol 13, Issue 1, [online] at https://www.tandfonline.com/doi/full/10.1080/17405904.2015.1074600 [accessed on 26th February 2019]

[234] Simpson, A., (2019), The culture of moral disengagement and harm production in the City of London's financial services industry, in eds Mitchell, D., Pantazis, C., Pemberton, D., (2019), *Justice, Power and Resistance,* Volume 3, Issue 1, EG Press

Chapter 2: Rethinking financial regulation: making the case for macro-conduct regulation

Section 1: Introduction

The previous chapter of this thesis examined the causes of the global financial crisis (GFC) of 2007 and explained how these causes linked back to financialization and the need for a fuller conceptualisation of risk. An approach that takes into account not just risks to firms and capital providers, but also to the risks that failures pose to a wide range of societal stakeholders, is essential to avoid repeating the GFC. This chapter responds to this need by setting out a new, holistic approach to the regulation of conduct risks that takes into account the systemic dimension of conduct. Such an approach would enable a more meaningful approach to conduct regulation by taking into account the range of stakeholders who are affected adversely by misconduct.

The chapter begins by setting out the regulatory context and then explains why a holistic approach to prudential risk gained credence after the GFC. As a result, macro-prudential regulation (as a complement to micro-prudential regulation) was developed to replace the pre-crisis emphasis on solely micro-prudential regulation with occasional thematic reviews. The chapter explains why a similar holistic approach to conduct regulation that makes better use of the combination of micro- and macro- tools, is needed.

Currently, in the U.K., conduct risks are typically addressed through systematic supervisory responses to individual firms / groups of firms as well as thematic work on an ad-hoc basis. Against the backdrop of the rationales for financial regulation, the chapter explains how a call for a more holistic approach is rooted in the substantive political rationales for regulation. It then makes the case for why the existing approach does not work. The chapter then specifically sets out a new macro level for regulating conduct regulation in order to address the systemic risks generated by misconduct, so as to complement micro-conduct work in a systematic macro- way. The chapter concludes by pointing out that both prudential and conduct regulation should also be developed so as to mesh effectively with monetary and fiscal policy objectives and tools, in order to deliver appropriate societal outcomes and prevent avoidable crises, and proposes this as a direction for further research.

Context

Financial regulation is typically conceptualised[235] across two key areas of oversight - prudential regulation and conduct regulation.

Prudential regulation is premised around achieving 'safety and soundness', and for practical purposes is bifurcated into micro- and macro- prudential regulation.[236] Micro-prudential regulation is carried out at the level of the individual regulated financial entity. Micro-prudential regulatory efforts seek to ensure that regulated entities and their officers manage the entity's finances such that they can honour financial claims made upon the entity, or be prepared for an orderly wind-down. The focus is at an institutional level and the regulatory tools applied are enacted in the context of the individual firm or group of firms. Macro-prudential regulation has a more high-level approach as it is aimed at the level of the system as a whole, rather than the individual institution. Macroprudential regulation also focuses on safety and soundness but here matters are viewed from a system-wide perspective and regulatory tools are deployed to address systemic concerns.

Conduct regulation is preoccupied with addressing risks arising from the interactions with, and behaviours of, financial institutions. Regulatory safeguards are aimed at protecting consumers, investors and market participants and are typically applied at the level of the individual firm. In the UK, conduct regulation has historically been categorised into 'market conduct' oversight and 'consumer protection' oversight. Both categories have broadly similar aims - preventing consumer/ investor detriment, and regulatory discourse is usually driven by the language of welfare economics and the addressing of 'market failures'[237]

Pre-crisis v post-crisis approaches

Prior to the GFC, prudential regulation in the U.K. was framed by the expectation that effective micro-prudential regulation (in conjunction with central bank moral

[235] Barth, J., Caprio., G., Levine, R., (2013), Bank Regulation and Supervision in 180 countries from 1999 to 2011, *Journal of Financial Economic Policy,* Vol 5, Issue 2, pp 111-219 [online] at http://tinyurl.com/y28cdp6f accessed on

[236] The European Systemic Risk Board (2014), The ESRB handbook on operationalising macroprudential policy in the banking sector, [online] at https://www.esrb.europa.eu/pub/pdf/reports/esrb.report180115_handbook~c9160ed5b1.en.pdf [accessed on 7th April 2020]

[237] MacNeil, I., (2015), Rethinking conduct regulation, *Butterworths Journal of International Banking and Financial Law,* 30(7), pp 413-420

suasion) i.e. ensuring that individual regulated entities were safe and sound, facilitated the safety and soundness of the financial system.[238] A tripartite mechanism[239] between the central bank (Bank of England), government (Her Majesty's Treasury) and the financial regulator (Financial Services Authority), was used to address and respond to systemic stability issues, but the primary regulatory focus on the prudential front was on designing, deploying and enforcing prudential regulatory tools at the level of the individual regulated entity. Such micro-prudential regulation was accompanied (in a relatively small measure) by thematic supervision[240] which was aimed - in a relatively idiosyncratic manner - at issues that spanned more than one entity.

This emphasis on micro-prudential regulation was called into question by the global financial crisis of 2007. Experts recognised that focussing solely on micro-prudential regulatory techniques causes a 'fallacy of composition'[241] problem. The crisis had demonstrated that it was wrong to assume that the regulatory oversight of individual entities' safety and soundness, would in turn address broader system-wide risks. Actions intended to benefit the financial soundness of individual financial entities, do not necessarily aggregate into appropriately sound systemic choices. Schoenmaker and Wierts explain that 'the system as a whole behaves differently from its individual components'.[242]

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[238] International Monetary Fund, (2009), *Global Financial Stability Report,* April 2009,

[239] Her Majesty's Treasury U.K., (2010), A new approach to financial regulation: judgement, focus and stability, [online] at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/81389/consult_financial_regulation_condoc.pdf [accessed on 28th May, 2018]

[240] Her Majesty's Treasury U.K., (2010), A new approach to financial regulation: judgement, focus and stability, [online] at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/81389/consult_financial_regulation_condoc.pdf [accessed on 28th May, 2018]

[241] "The fallacy of composition is the informal fallacy that occurs when the reasoner illicitly moves from a premise asserting that the parts of an object individually have a certain property to the conclusion that the object as a whole has that same property" (Source: Cook, R.T., (2009), *A dictionary of philosophical logic*., Edinburgh, UK: Edinburgh University Press [online] at https://search-credoreference-com.idpproxy.reading.ac.uk/content/entry/euppl/fallacy_of_composition/0?institutionId=158) [accessed on 28th May, 2018]

[242] Schoenmaker, D., Wierts, P., (2016), Macroprudential Supervision : from theory to policy, European Systemic Risk Board Working Chapter Series No 2, February 2016 at https://www.esrb.europa.eu/pub/pdf/wp/esrbwp2.en.pdf?93878091124f5619b34ea09131a08407 [accessed on 28th May 2018]

Post-crisis, this led to renewed consideration of the role of more comprehensive mechanisms for oversight of system-wide prudential risks. Clement (2010)[243] and Galati and Moessner (2012)[244] explain how the concept of macroprudential regulation (a more system-wide perspective on prudential matters) and the development of associated institutional arrangements and policy tools to enable regulatory oversight to take place in a more holistic manner, gained traction in regulatory policy circles.

<u>Contributions of this chapter</u>

This chapter argues that the lessons arising from the 'fallacy of composition' problem apply not just to prudential regulation but also to conduct regulation where regulatory intervention is largely undertaken at an individual regulated entity level. The chapter therefore develops relevant learning from the discourse of macroprudential approaches to regulation, and repurposes them to engage with the challenges of conduct regulation. A new conceptual approach to conduct regulation – macro-conduct regulation – is proposed. Macro-conduct regulation is a holistic, structured and systematic approach to system-wide issues of conduct. The aim is to ensure better protection of the real[245][246] economy due to the increasing susceptibility of the real economy to system-wide conduct risks. This chapter also documents the importance of such a macro-conduct approach in the context of financialization and links these back to the substantive political rationales for regulation.

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[243] Clement, P., (2010), The term "macroprudential": origins and evolution in Bank for International Settlements, *BIS Quarterly Review,* 1st March 2010 [online] at https://www.bis.org/publ/qtrpdf/r_qt1003h.pdf [accessed on 11th February 2018]

[244] Galati, G., Moessner, R., (2012), Macroprudential policy: A literature review, *Journal of Economic Surveys*, Vol. 27, No. 5, pp. 846–878 [online] at http://onlinelibrary.wiley.com/store/10.1111/j.1467-6419.2012.00729.x/asset/joes729.pdf?v=1&t=jdlfogbw&s=33882d7e1893b49f48713b701fd307f4f944e218 [accessed on 11th February 2018]

[245] Neiburg, F., Guyer, J., (2017), The real in the real economy, *HAU Journal of Ethnographic Theory*, Vol 7, Issue 3, pp 261-279 at http://dx.doi.org/10.14318/hau7.3.015 [accessed on 15th April, 2018]

[246] Neiburg (2017) explains that the "real economy, as an official concept of economic governance, was initially created to track the relationship between money and commodities over time. It is still a key concept in the organization of the contemporary world, circulating among experts and ordinary people, through scientific and vernacular spaces, in multiple contexts, with shifting meanings. It is something that "real persons" can feel in their pockets, like the value of money, economic growth, or recession". According to him, it "also evokes a set of opposites: virtual, fictitious, black, or false economies". He adds that "Discussions of slogans such as "Wall Street versus Main Street," widely deployed in the popular press, also enact these oppositions. Some social movements denounce the dominance of a spurious financial economy, arguing that people are losing the real value of their wages and their currencies."

The key advances to the scholarly literature on regulation, made through the development of macro-conduct regulation as a concept are, a recognition:

1. of the systemic implications of risks arising from regulated entities' misconduct
2. that the narrative for regulatory engagement with such conduct risks is currently phrased in a financialised way. The 'costs' of misconduct are judged in terms of financial implications for the providers of finance (investors, customers, bondholders and in some enlightened arguments, taxpayers). To focus solely on monetary costs however neglects the wider implications of poor conduct across the financial system
3. within the narrative arguing for conduct regulation, of the injustice that systemic misconduct can cause to, and structurally entrench against, civil society stakeholders.
4. that conduct regulation can and should be more inclusive in its approach towards its responsibilities to the real economy. Conduct regulation currently does not recognise effectively or engage with the detriment that system-wide misbehaviour imposes on civil society stakeholders. Currently there is an overwhelming focus on monetary costs for consumers, investors and regulated entities themselves, rather than a broader understanding of what a responsible financial sector owes to society and the real economy. The current approach can and does have consequences for the privatisation of profits and socialisation of risk and costs. Structural and institutional problems arise from consigning these to circumstances beyond regulators' and regulated firms' control, when clearly there is need for greater regulatory scrutiny and accountability.

Structure

This chapter has six key sections.

This section (section 1) introduces the chapter and explains how it will be developed so as to address the research question. Section 2a provides contextual theory broadly introducing the topic of regulation and briefly sets out the scope of the chapter. Section 2b outlines the methodology employed. Building on the definition of regulation outlined in section 2a, Section 3 provides a review of the relevant scholarly literature alongside setting out a more detailed theoretical context for this chapter.

Section 4 explains how post-GFC, the regulatory discussion of how to address systemic issues has largely centred around prudential (macroprudential) regulation. Using a range of arguments, it then makes the call for a more substantive re-thinking of conduct regulation. The case for a macro-conduct approach to conduct regulation to partner current micro-approaches to conduct regulation is made in Section 5. Section 6 concludes and provides a discussion of potential directions for further scholarly research.

Section 2a: Contextual definitions and scope

Regulation

The term regulation, although ubiquitous to modern commercial activity and widely used in the literature, does not have a generally well-accepted definition.

Selznick (1985), in his seminal definition, explains regulation as the 'sustained and focused control exercised by a public agency over activities that are valued by the community'.[247] Selznick is parsimonious in his choice of words for this definition, and so this may, at first glance, seem very broad, but his careful wording then intentionally narrows the focus to a particular type of regulatory authority i.e. one that is state-designated, thereby intentionally excluding others who may perform similar regulatory functions outside the state's remit. Selznick then highlights the role of ongoing and purposeful oversight in the act of regulation. Regulation is therefore seen as directive. In this definition, the aim of such authoritative and ongoing engagement is to address matters that are of societal concern. Black (2002) defines regulation as 'the sustained and focused attempt to alter the behaviour of others according to defined standards and purposes with the intention of producing a broadly identified outcome or outcomes, which may involve mechanisms of standard-setting, information-gathering and behaviour modification'.[248] Black's definition is quite obviously more descriptive than Selznick's, and adds a layer of detail and specificity. Black emphasises the focus of regulation to be pre-defined regulatory outcomes (again indicating purpose) and requires regulation to modify behaviours (indicating the specific orientation she expects, of that purpose) within an agreed framework of

[247] Selznick, P (1985), Focusing Organizational Research on Regulation in Noll, R., (ed), 1992, *Regulatory Policy and the Social Sciences*, pp. 363–367, University of California Press, Berkeley

[248] Black, J., (2002), Critical Reflections on Regulation, *Australian Journal of Legal Philosophy*, 27, pp 1–35

minimum requirements (standards). She then highlights how such regulatory activity might be undertaken i.e. through the use of policy, investigative and behaviour-altering tools. Noll (1992) describes regulation as the 'rules constraining certain kinds of private economic decisions, using a quasi - judicial administrative process to develop these rules'.[249] Noll introduces a different legal and economic hue to the definition of regulation through his emphasis on the use of rules in the pursuit of addressing activities that would traditionally lie in the domain of private law but are now proposed through a different designated channel – one of quasi-judicial bureaucratic intervention. Noll's definition does not make a direct reference to any specific types of societal activities that may merit regulation. Instead the focus is on who (i.e. a quasi-judicial body) might be permitted to intervene in a domain (that is seen as the preserve of private economic transaction and associated private law) and in what form (i.e. the imposition of a definite set of rules).

Baldwin et al (see Koop and Lodge, 2017) point out that there are a range of such 'definitions in usage which are not reducible to some Platonic essence or single concept'.[250] Further explaining the variations in the definitions used across the scholarly literature, Koop and Lodge (2017)[251] note that 'Baldwin et al. argue that there are three main conceptions of regulation: (i) regulation as 'the promulgation of an authoritative set of rules, accompanied by some mechanism [. . .] for monitoring and promoting compliance with these rules,' (ii) regulation as 'all the efforts of state agencies to steer the economy,' and (iii) regulation as 'all mechanisms of social control – including unintentional and non-state processes'

[249] Noll, (1992), *Regulatory Policy and the Social Sciences*, University of California Press, Berkeley

[250] Koop, C., Lodge, M., (2017), What is regulation? An interdisciplinary concept analysis, *Regulation and Governance,* 11, pp 95-108 [online] at http://onlinelibrary.wiley.com/store/10.1111/rego.12094/asset/rego12094.pdf;jsessionid=9F9D0438C60B4CF2EEED3934D21E8700.f02t01?v=1&t=j5wk28qp&s=fc4d7ef19127ab3a5560f86c223a758c06cab851[accessed on 1st July, 2017]

[251] Koop, C., Lodge, M., (2017), What is regulation? An interdisciplinary concept analysis, *Regulation and Governance,* 11, pp 95-108 at http://onlinelibrary.wiley.com/store/10.1111/rego.12094/asset/rego12094.pdf;jsessionid=9F9D0438C60B4CF2EEED3934D21E8700.f02t01?v=1&t=j5wk28qp&s=fc4d7ef19127ab3a5560f86c223a758c06cab851

Such diversity in primary definitions goes some way to explaining why the scholarly discourse on regulation is vast and multi-disciplinary. Koop and Lodge (2017)[252] explain this diversity in academic discourse, showcased in the above conceptual breadth, by ascribing the variations to 'differences in disciplinary concerns, with lawyers, political scientists, and economists building mainly on the first two conceptions, while socio-legal scholars emphasize the third'.[253] But, importantly, they point out that regulation is not a field that lacks 'shared understanding' despite this diversity; instead 'there is a broad but shared conception of regulation ....with different but largely interdisciplinary research agendas, ranging from those on state authority - based bureaucratic activities to those on non - state - based transnational ones'. [254]

<u>Use of the terms 'regulation' and 'regulators' specifically for the purpose of this chapter</u>

Given the plurality and co-existence of definitions within the field, and the cross-disciplinary nature of sources and arguments used in this chapter, the following section sets out how the terms 'regulation' and 'regulator' are used within this chapter, and why.

Selznick's seminal definition above, includes two interesting nuances that are particularly important for this chapter. The first is the persistence and concentration of interest - regulation is not seen as an ad-hoc or one-off activity. Developing this theme, this chapter will argue that misconduct has systemic dimensions. Regulation must engage with such risks in a consistent and organised manner through macro-conduct regulation, rather than just through ad-hoc thematic pieces of work or specific interventions directed at firm-level misconduct. The second is the recognition

[252] Koop, C., Lodge, M., (2017), What is regulation? An interdisciplinary concept analysis, *Regulation and Governance,* 11, pp 95-108 at http://onlinelibrary.wiley.com/store/10.1111/rego.12094/asset/rego12094.pdf;jsessionid=9F9D0438C60B4CF2EEED3934D21E8700.f02t01?v=1&t=j5wk28qp&s=fc4d7ef19127ab3a5560f86c223a758c06cab851

[253] Koop, C., Lodge, M., (2017), What is regulation? An interdisciplinary concept analysis, *Regulation and Governance,* 11, pp 95-108 at http://onlinelibrary.wiley.com/store/10.1111/rego.12094/asset/rego12094.pdf;jsessionid=9F9D0438C60B4CF2EEED3934D21E8700.f02t01?v=1&t=j5wk28qp&s=fc4d7ef19127ab3a5560f86c223a758c06cab851

[254] Koop, C., Lodge, M., (2017), What is regulation? An interdisciplinary concept analysis, *Regulation and Governance,* 11, pp 95-108 at http://onlinelibrary.wiley.com/store/10.1111/rego.12094/asset/rego12094.pdf;jsessionid=9F9D0438C60B4CF2EEED3934D21E8700.f02t01?v=1&t=j5wk28qp&s=fc4d7ef19127ab3a5560f86c223a758c06cab851

that the boundary for regulation i.e. the regulatory perimeter, is defined by the community, based on assessments of whether the resource or activity carry societal importance. This chapter will accordingly argue that there is need for financial regulators to serve and protect the public interest. The chapter will also posit that, given financialization and globalisation, macro-conduct regulation is of particular importance from a societal standpoint. For the purposes of this chapter, Selznick's definition is therefore used as the basis and specific elements from other definitions above are added to it.

In this revised definition of regulation, the aim has been to capture the relevant definitional basis of regulation with a view to elaborating concepts in the specialised and narrower study of financial regulation, whilst retaining the breadth of more general definitions of regulation. Despite financial regulation being a specialist area, emphasising this duality is key because of the interdisciplinary nature of regulation itself, and the consequent interdisciplinary influences on financial regulation.

The revised composite definition adopted within this chapter is therefore: Regulation is the sustained and focused control exercised by a public agency over services, activities and resources that are valued by the community. It encompasses directions, rules, requirements and principles that are intended to deliver safeguards, deterrents and corrections so as to achieve societal protection in the employment, conservation or distribution of resources, activities and services that have societal significance. The reader should note that this definition of regulation and the preceding commentary refer to regulation more generally rather than financial regulation more specifically.

Types of regulators under consideration in this chapter

Regulatory authorities are set up with a view to expertly formulating and implementing regulation, and providing oversight and intervention in accordance with agreed objectives. Given the definition of regulation above and the different types of regulators one encounters in society, the following paragraphs seek to clarify what is meant by the term 'regulator' in the context of this chapter. The broad types of regulators and regulatory activities that are of relevance to this chapter, are then outlined.

Contrary to the use of the term 'public agency' in the definition for regulation that we have adopted above – in reality, there is a section of non-state actors who may be perceived as regulators (or quasi-regulators) and may also exert regulatory influence. Regulators therefore range from state-nominated authorities to quasi-governmental bodies and independent regulatory authorities or other public agencies accountable to the government of the nation state (or groups of nation states), through to non-state actors (or private legislatures) who may only be accountable to their members or funders.[255] Within these, the nuancing of their objectives and powers may vary, creating underlying subtypes and variations.

<u>The type of regulator that is of primary interest in this chapter</u>

For the purposes of this chapter we are focussed on the first type of regulator i.e. institutions designated by the state to carry out regulation. Such regulators - by virtue of the public responsibilities set out in their statutory mandate – are usually expected to carry out their duties in a manner that protects the public interest. Their powers are prescribed by or through national or international legal frameworks that help ensure some degree of accountability for the exercise of the powers that are bestowed upon them. Assuming they function within a representative democracy, they are expected to be held accountable to the governments of nation states and consequently to a range of societal stakeholders. Some of these regulatory authorities may be government departments or other appendages of government while others may be constituted as an independent regulatory authority.[256] In the application of regulation such bodies are expected to rely extensively upon formal regulatory policy tools and mechanisms.

Another powerful set of regulators includes transnational[257] bodies (such as the Basel Committee on Banking Supervision and the European Statutory Authorities ESAs) who may straddle the two categories described above. Such regulators typically have a mandate driven by international political arrangements. Their regulatory requirements are often achieved through delegated application by national authorities and although their remit is international and they may not have statutory powers in national law, they may achieve their objectives through mandating,

[255] Sikka, P., Wilmott, H., et al, (2019), Regulatory architecture to enhance democracy and business accountability, [online] at http://visar.csustan.edu/aaba/LabourPolicymaking-RegulatoryArchitectureReportJan2019.pdf [accessed on 15th February 2020]

[256] Coen, D., Thatcher, M., (2008), Network governance and multi-level delegation: European networks of regulatory agencies, *Journal of Public Policy*, 28 (1). pp. 49-7

[257] For ease of reference, I will hereafter refer to all such bodies as transnational bodies, although not all are necessarily transnational.

encouraging or coercing nation states to apply their requirements by codifying these into specific national law and regulation. Such transnational bodies may not directly enforce regulation in the way a national supervisor could, but they can still drive compliance through engaging in processes such as moral suasion; 'naming and shaming'; developing networks, knowledge banks and associated competency and confidence-building amongst regulators; and activities resulting in the promotion of shared values among a range of national agencies. This type of regulator is not the central focus of this chapter, but the chapter will develop some ideas that might of relevance to the European Supervisory Authorities (ESAs)

Other types of regulators

Regulatory bodies may take the form of self-regulatory organisations, guilds and community-based entities. Such organisations may focus their attentions more narrowly on serving the interests of their members or constituents although they may have or may disseminate the opinion that they are serving the wider public interest as a consequence of protecting / regulating their interest group. These bodies may or may not be rule-making bodies. They may use different regulatory tools from those used by state designated regulators to ensure that their objectives are met. For example, self-regulatory bodies such as industry bodies, trade associations etc. typically do not always have state-granted formal authority or legal sanctioning powers to take punitive action against their constituents. They are often dependent upon generating mutually agreed standards and ensuring voluntary compliance with their requirements. For this they may use consensus, peer pressure, minimum standards for inclusion in their membership base, non-statutory methods of censuring transgressors of mutual norms, influence or persuasion including moral suasion, education or other efforts to promote shared values and cultural norms. They may also set, develop and police standards or provide good practice guidance to their constituents. This, in turn, enables the achievement of their (quasi-) regulatory objectives. These regulators are not the primary focus of this chapter although some of the findings might also be relevant to them. There may of course be a role for self-regulatory bodies, trade associations and others in supporting or helping enforce macro-conduct regulation, but those remain intentionally outside the scope of this chapter although they might form an interesting area for further research.

To summarise - since the primary rationale behind the policy suggestions described within this chapter is to protect societal stakeholders from the consequences arising from financial intermediaries' behavioural (and financial) failures, and to invoke enforcement through statutory regulation or the law to address this, the focus within this chapter is therefore primarily on regulators (and regulations) that are congruent to the notion of the term 'public agency' i.e. on statutory regulators and regulations as well as on transnational bodies who are expected to have a specific mandate for societal stakeholder protection. Specific attention is paid within this chapter to the first category of regulators, but many of the findings apply to transnational bodies mentioned above that have a public interest mandate such as systemic risk oversight bodies in the EU.

Rationales for regulation

Scholars have discussed how regulation can arise from a range of socio-political, historical, institutional and economic motives.[258] To set macro-conduct regulation in its scholarly context, it therefore is worth understanding the rationales for regulation.

Regulations are typically conceived, developed, deployed, dismissed and/or eroded by a variety of internal and external factors including the emergence of new ideas, socio-cultural factors, changes in living conditions, the pressures applied by those with a specific interest, or the behaviours and predispositions of those responsible for developing or deploying regulations.[259] The complexity of the financial system, institutional pressures, changing political motives, and internal political choices can radically shape financial regulation. Moloney et al (2015), point out that 'the purpose and related reach of financial regulation remains highly contested'.[260]

Even when it may not seem overtly apparent, more often than not, many elements of regulatory discourse hinge on these rationales (which may be applied concurrently or individually). These rationales become particularly important in the consideration of how regulatory tools and techniques are devised, applied or rescinded or when

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[258] Koop, C., Lodge, M., (2017), What is regulation? An interdisciplinary concept analysis, *Regulation and Governance,* 11, pp 95-108 [online]at http://onlinelibrary.wiley.com/store/10.1111/rego.12094/asset/rego12094.pdf;jsessionid=9F9D0438C60B4CF2EEED3934D21E8700.f02t01?v=1&t=j5wk28qp&s=fc4d7ef19127ab3a5560f86c223a758c06cab851 [accessed on 1st July, 2017]

[259] Sunstein, C.R., (1990), *After the rights revolution: reconceiving the regulatory state*, Harvard University Press, Cambridge, MA

[260] Moloney, N., Ferran, E., Payne, J., (2015), *The Oxford Handbook of Financial Regulation,* Oxford University Press

regulatory resources are maintained, increased or withdrawn in pursuit of what might be seen as the societal good or public interest.[261]

Given the breadth of rationales that are covered by the regulatory literature[262] and the specific focus of this chapter, the following segment seeks to explore in detail one dominant category of rationales that have had a significant bearing on regulation and financial regulation more generally, and on conduct regulation more specifically. These come under the heading of 'public interest grounds for regulation'.[263] This plays to the notion of the public service motive inherent in the definition of regulation selected at the start of this chapter, although it is recognised that private interests may corrupt the operation of such regulation and so on, as discussed below. The theoretical context of this chapter is rooted in the substantive political rationales[264] that are a subset of these public interest approaches.

Brief descriptions of the three other key overarching categories of rationales are also provided at this point for the purposes of completeness and to clarify the reasons this chapter focuses on the public interest rationales.

<u>Key categories - rationales for regulation</u>

Public interest theorists view the emergence of regulation as the outcome of efforts by the state to address matters of public policy so as to achieve the collective aspirations of society.[265] Private interest and interest group theorists are sceptical of such altruistic motives. Instead they surmise that regulation evolves as a consequence of measures taken by 'individuals or groups who seek to maximise their self-interest'.[266] Institutional theorists' perspectives are more diverse in range, and can best be described as an eclectic, miscellaneous selection of theories with no particular emphasis on whether actors are public or private.[267] For example institutional

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[261] Feintuck, M., (2010), Regulatory rationales beyond the economic: In search of the public interest, *The Oxford Handbook of Regulation,* Oxford University Press

[262] Ogus, A., (2004), *Regulation: Legal Form and Economic Theory,* Hart Publishing

[263] Ogus, A., (2004), *Regulation: Legal Form and Economic Theory,* Hart Publishing

[264] Feintuck, M., (2010), Regulatory rationales beyond the economic: In search of the public interest, *The Oxford Handbook of Regulation,* Oxford University Press

[265] Morgan, B., Yeung, K., (2007), *An introduction to law and regulation*, Cambridge University Press

[266] Morgan, B., Yeung, K., (2007), *An introduction to law and regulation*, Cambridge University Press

[267] Morgan, B., Yeung, K., (2007), *An introduction to law and regulation*, Cambridge University Press

theories include scholarly insights into important topics such as tripartism[268] and 'regulatory space'[269] that influence the development or reduction of regulation. Morgan and Yeung (2007), note that the primary common factor of institutional theories is the view that institutional arrangements and dynamics can provide the impetus for regulation.[270] Forces of ideas theorists, believe that regulatory developments (or reductions) are shaped by changes in ideological beliefs. For example, some scholars have explained trends in deregulation by showing how ideological developments have led to the expansion or contraction of financial regulation in certain jurisdictions in the run-up to the global financial crisis of 2007.[271]

It is worth remembering that the origin of regulatory efforts can be highly complex and can often be attributed simultaneously to more than one (and perhaps even all) of these theories. To rephrase this, more than one of the theoretical categories discussed above may actually explain the true reasons for the emergence or erosion of a particular type or aspect of regulation or the seriousness with which it is applied.

Focus on public interest approaches

Yeung and Morgan (2007), identify three key categories within the public interest approaches.[272] These are:

- welfare economic approaches,
- substantive political approaches, and
- procedural political approaches.

Our interest – within this chapter – is primarily in the substantive political rationales for regulation, which fall within the public interest theories of regulation. This focus on public interest theories is important in the context of financial regulation, because as the previous chapter - analysing the financial crisis of 2007- suggests, the financial sector has serious and multifarious connections to the real economy. Systemic failure

[268] Ayres, I., and Braithwaite, J., (1992), *Responsive Regulation,* Oxford University Press, [online], available at http://johnbraithwaite.com/wp-content/uploads/2016/06/Responsive-Regulation-Transce.pdf [accessed on 24th November, 2016]

[269] Vibert, F., (2014), *The New Regulatory Space,* Edward Elgar Publishing, Cheltenham

[270] Morgan, B., Yeung, K., (2007), *An introduction to law and regulation*, Cambridge University Press, Cambridge

[271] Ireland, P., (2010), The Financial Crisis: Regulatory Failure or Systems Failure, *The Future of Financial Regulation*, Oregon

[272] Morgan, B., Yeung, K., (2007), *An introduction to law and regulation*, Cambridge University Press, Cambridge

has a very dramatic real economic impact.[273] Ongoing misconduct has an impact on crucial democratic objectives including equality of opportunity, access to human rights and the importance of fairness and social justice.[274] The literature on financialization[275] and globalisation discussed below also explains why financial markets today have a particular impact on the above. The soundness and ongoing health of the financial sector underpins the functioning of many essential socio-economic aspects of modern society.

Consistent with Feintuck's (2010)[276] and Sunstein's (1990)[277] broader observations, this chapter argues that many challenges arising from systemic misconduct in the financial sector, such as those that will be identified by this chapter are currently being neglected or distorted because they do not fit the paradigms of the mainstream discourse arising from the wider application of welfare economics approaches to regulation.[278] The chapter also suggests that a purely market-based approach to addressing these challenges, neglects broader and important considerations such as the role of values or the importance of equality and justice in society. This problem is specifically discussed further in the financialization segment of this chapter. A brief introduction to the welfare economics approaches is also included below so as to clarify this point. It is noted at this stage that the chapter does not peremptorily discount the potential use of market mechanisms while elevating the role of substantive political rationales, in underpinning the reasons for macro-conduct regulation. The aim is not to avoid the market per se, but to encourage the use of appropriate regulatory tools and the market mechanism in a manner that more

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[273] Bullard, J., Neely, C., Wheelock, D., (2009), Systemic risk and the global financial crisis: a primer, *Federal Reserve Bank of St. Louis Review*, September/October 2009, 91, 5, Part 1, pp. 403-17, [online] at https://files.stlouisfed.org/files/htdocs/publications/review/09/09/part1/Bullard.pdf [accessed on 14th February 2018]

[274] United Nations, (2010), Report of the Office of the United Nations High Commissioner for Human Rights on the impact of the global economic and financial crises on the realization of all human rights and on possible actions to alleviate it, Document A/HRC/13/38 Human Rights Council, Thirteenth Session, Agenda Item Three, [online] at http://www2.ohchr.org/english/bodies/hrcouncil/docs/13session/A-HRC-13-38.pdf [accessed on 14th February 2018]

[275] Epstein, G., (2006), Introduction: Financialization and the world economy, Financialization and the world economy, Edward Elgar Publishing

[276] Feintuck, M., (2010), Regulatory rationales beyond the economic: In search of the public interest, *The Oxford Handbook of Regulation,* Oxford University Press

[277] Sunstein, C.R., (1990), *After the rights revolution: reconceiving the regulatory state*, Harvard University Press, Cambridge, MA

[278] Feintuck, M., (2010), Regulatory rationales beyond the economic: In search of the public interest, *The Oxford Handbook of Regulation,* Oxford University Press

critically recognises the underlying fallacies of the market or other paradigms, and the relevant applicability or limitations of economic tools.

Jurisdictional scope

Although there is no specific jurisdictional limitation to the adoption of the macro-conduct financial regulatory approach, this chapter is specifically aimed as an aid for financial regulatory reform of conduct regulation in the U.K and the EU (at a community level).

Methodology

This chapter applies relevant learning from the development of macroprudential approaches to regulation, to the theory of conduct regulation – and makes a case for the adoption of macro-conduct approaches to regulation.

Although the chapter, much like the subject area of regulation, is approached in a multi-disciplinary way, its methodological basis also has an alignment to critical theory and critical social science research. Critical theory is described as 'an evaluative approach to social science research, associated with Germany's neo-Marxist 'Frankfurt School,' that aims to criticize as well as analyse society', ……… 'Its goal is to promote human emancipatory forces and to expose ideas and systems that impede them'.[279]

The aim of this chapter – consistent with this approach, although not specifically derived from it - is to reveal conceptual weaknesses (and ideological biases where applicable) that underpin the application of systemic considerations of regulation post-GFC to a prudential regulatory context alone and not to a conduct context. This misapplication is particularly worth notice, as it serves to conceal the true systemic impact of misconduct, and at times ascribe it to circumstances beyond the control of regulation and regulated firms. As Villiers (2010)[280], Feintuck (2010)[281] and Ireland (2010)[282] suggest, the presence of such excusing factors can undermine efforts at sectoral reform and stakeholder protection.

The debate within this chapter also plays to the notion of the exertion of power described by Lukes (1974)[283]. Eakin et al (1996) explain how Lukes (1974), when describing power, suggests three key dimensions or faces of power. The first face is when different issues and perspectives though surfaced, are actively inhibited through mechanisms such as intimidation. The second face of power is more subtle, because although dissenting views are aired, they are side-lined through negotiation, efforts at meeting-in-the-middle, or through co-option. The third

[279] University of South Carolina, (website version last updated Feb 7, 2018), Organizing Your Social Sciences Research Chapter: Glossary of Research Terms, *USC Library Research Guide* [online] at http://libguides.usc.edu/writingguide/researchglossary [accessed on 14th, February 2018]

[280] Villiers, C., (2010)., 'Has the financial crisis revealed the concept of the responsible owner to be a myth' in MacNeil, I., and O'Brien, J., (eds.), *The Future of Financial Regulation,* Hart Publishing, Portland

[281] Feintuck, M., (2010), Regulatory rationales beyond the economic: In search of the public interest, *The Oxford Handbook of Regulation,* Oxford University Press

[282] Ireland, P., (2010) 'The Financial Crisis: Regulatory Failure or Systems Failure' in MacNeil, I., and O'Brien, J., (eds.), *The Future of Financial Regulation,* Hart Publishing, Portland

[283] Lukes, S. (1974), Power: A Radical View. Macmillan, London

hidden dimension of power is when dissenting views are excluded because dominant views are so entrenched and embedded that discussion does not extend beyond those views that fit in naturally with the existing paradigms – dissenting views remain outside the very realm of discussion.[284] Gramsci, in the 1920s in his prison notebooks,[285] explains cultural hegemony as exerting a different type of influence from the power of domination. This domination is created through the manipulation of the public discourse, which in this case has been in relation to the beliefs, conceptions, values and attitudes towards finance and the lack of regulation of systemic misconduct in finance. It is this cultural hegemony that is highlighted by scholars such as Engelen et al (2011) [286] in their explanation of how narratives prior to the GFC were closed off or distorted; by Epstein(2005)[287] and Krippner (2004)[288] in their study of financialization; and by D'Andreta (2018)[289] who notes the lack of breadth of the discourse at the World Economic Forum in Davos . Although the underlying power dynamics relevant to this cultural hegemony are intentionally not the focus of this chapter, the very emergence of macro-conduct regulation as a completely new conceptual paradigm a decade after the GFC, indicates a structural gap in the mainstream discourse and regulatory conceptualisation of conduct regulation post-GFC. This gap is even more noteworthy because there have been numerous investigations by regulators (and analysts of regulation) of serious and wide-ranging behavioural issues that contributed to the crisis. However, there have been no adoptions of a macro-conduct approach in the UK or the EU that would engage with the system as a whole from a behavioural standpoint. The absence of such a regulatory initiative, in the regulatory reforms since the GFC, speaks to Luke's third face of power discussed above, where 'the possibility that things could be otherwise simply does not arise', in the space of conduct regulation. The chapter therefore seeks to recalibrate this imbalance of power through developing the discourse around the rationale for a holistic consideration of prudential regulation.

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[284] Eakin, J, Robertson, A., Poland, B., Coburn, D., Edwards, R., (1996), Towards a critical social science perspective on health promotion research, *Health Promotion International,* Vol 11, 2 [online] at https://academic.oup.com/heapro/article-pdf/11/2/157/1775899/11-2-157.pdf [accessed on 14th February, 2018]

[285] Gramsci, A., (circa 1920), in eds Hoare, Q, and Nowell Smith, G., (1999), *Selections from the Prison Notebooks of Antonio Gramsci, transcribed from edition published by Lawrence and Wishart 1979,* The Electric Book Company Limited at http://abahlali.org/files/gramsci.pdf [accessed on 29th May 2018]

[286] Engelen, E., Ektuerk, I., Froud, J., Johal, S., Leaver, A., Moran. M., Nilsson, A., Williams, K., (2011), *After the Great Complacence,* Oxford University Press, Oxford

[287] Epstein, (2005), *Financialization and the world economy,* Edward Elgar Publishing, Cheltenham

[288] Krippner, G., (2004), What is Financialization, cited in ed. Epstein, G., (2005), *Financialization and the World Economy*, Edward Elgar Publishing , Cheltenham

[289] D'Andreta, M., 'Davos discourse drives cultural hegemony', article dated 22nd January 2018 via Transnational Institute website at https://www.tni.org/en/article/davos-discourse-drives-cultural-hegemony [accessed on 29th May 2018]

The chapter also seeks to encourage the use of a reflexive[290] posture esteemed by critical social science research and to apply this reflection to the study and practice of financial regulation by recognising that the contemporary discourse on the practice of regulation at key financial regulators including the Pensions Regulator and the Financial Conduct Authority is subject to some of the same failings that deprioritise social justice imperatives. (See chapter 1 for commentary on lack of recognition of the negative impacts of financialization on the landscape of financial regulation).

This chapter seeks to articulate regulatory arguments by addressing philosophical debates in the development of regulation and integrating these with practical considerations in the tradition of critical social science research. The purpose of reviewing theory and practice, is to bring to light the neglect – particularly within post-crisis revisions to regulation - of the systemic impact of misconduct after the crisis of 2007.

Although this analysis is developed within the limited microcosm of conduct regulation, this chapter in common with critical theory seeks to illuminate the oppressions of social and economic life. The expectation is that this understanding in itself creates a degree of freedom that was not previously conceived possible. [291]Through this, the chapter seeks to re-invigorate the consideration of fairness and justice in conduct regulation, playing to the substantive political rationales cited within public interest approaches to regulation, and to provide the analytical arguments underpinning changes to conduct regulation. Such changes seek to remedy and prevent the injustice experienced by civil society as a result of wide-ranging[292] and significant[293] instances of misconduct by influential regulated financial firms, and by the lack of regulatory attention to the systemic patterns and consequences of their behaviour.

[290] Eakin, J, Robertson, A., Poland, B., Coburn, D., Edwards, R., (1996), Towards a critical social science perspective on health promotion research, *Health Promotion International,* Vol 11, 2 [online] at https://academic.oup.com/heapro/article-pdf/11/2/157/1775899/11-2-157.pdf
[accessed on 14th February, 2018]

[291] Thompson, M., (2017), Introduction: What Is Critical Theory? in ed Thompson, M., (2017), *The Palgrave Handbook of Critical Theory*, Palgrave Macmillan, New York

[292] Ireland, P., (2010) 'The Financial Crisis: Regulatory Failure or Systems Failure' in MacNeil, I., and O'Brien, J., (eds.), *The Future of Financial Regulation,* Hart Publishing, Portland

[293] Sikka, P., Wilmott, H., (2010),The dark side of transfer pricing: its role in tax avoidance and wealth retentiveness, *Critical Perspectives on Accounting,* 21 (4), pp 342-356 [online] at https://doi.org/10.1016/j.cpa.2010.02.004 [accessed on 14th February, 2018]

Theoretical rationales for regulation and key elements of literature

This section begins by outlining the scholarly literature on welfare economics approaches and substantive political approaches, as subsets of the public interest approaches to regulation. The specific relevance of these approaches to a financial regulation context, is the focus of this discussion, as the rationales to regulate financial services are explored alongside a discussion of the scholarly views on why financial entities should be treated with particular caution by regulators. This is supported by a discussion of the scholarly views on financialization with a few contextual comments about globalisation, that are relevant given the global reach and remit of many significant EU and UK regulated financial entities.

Public interest approaches to regulation

Hatzopoulos (2012) tautologically explains that public interest approaches to regulation 'are based on the presumption that regulation is necessary for, and justified by, public interest'.[294]. So, what is meant by the term 'public interest' and how is it explained by regulatory scholars? The term public interest has roots in traditional political philosophy with Aquinas who perceived 'common good' *(bonum commune*) to be the prime objective of government and law, Aristotle referred to the concept of the 'common interest' (*to koinei sympheron*) drawing the difference between those constitutions that were interest of those who were governed visavis others that were shaped to favour rulers those governments. Locke regarded such public interest to mean 'the peace, safety, and the public good of the people' such that 'the well-being of the people shall be the supreme law'. Jean-Jacques Rousseau discussed the 'common good' (*le bien commun*) as the purpose of the 'general will and purpose of government'.[295]

Hatzopoulos (2012) also notes that there are some rather fundamental differences between the two key theoretical positions within the umbrella of public interest approaches to regulation. He characterises these into two groups - those aiming to correct the market consistent with a welfare economics paradigm, and those who envision public interest more broadly such that they incorporate broader policy objectives that go beyond making the market function.

[294] Hatzopoulos, V., (2012), *Regulating Services in the European Union*, Oxford University Press, Oxford

[295] Anon., (undated), *Public Interest, Political Philosophy and the Study of Public Administration* on the Defining Public Interest webpage on the website of ESRC-funded research project on Public Interest in UK courts based at the Law school at Queen's University Belfast at http://publicinterest.info/?q=public-interest-political-philosophy-and-study-public-administration [accessed on 10th March 2018]

In this chapter, given the emphasis within this thesis on developing regulatory solutions that prioritise broader socio-economic motives, the emphasis is on the latter interpretation of the term public interest. To explore this assertion further, these two subsets of the public interest approaches to regulation, subtitled the welfare economics rationales and the substantive political rationales, are discussed in more detail in the following segment of the chapter.

Welfare economic approaches

Primary economic rationale

Before delving into the detail of the welfare economics rationales, this segment sets out the primary arguments underpinning the use of the market mechanism for resource allocation and the use of market price as the dominant/only estimator of value. Although welfare economics approaches go beyond these presumptions, their foundation is largely predicated on an appreciation of these economic arguments.

Conventional economic theory suggests that price formation in competitive markets takes place through the interaction of supply and demand functions in the market. (Salvatore, 2008). [296] Although there is no single accepted definition of the term 'competition', a competitive market is typically understood in the economics literature to refer to a market with an infinite number of market participants (buyers and sellers), none of whom can have significant influence over the market. In this idealised scenario, goods are perfectly substitutable, and factors of production adjust without frictions when required. Market participation by sellers is defined by the profit motive. Market participation by buyers is aimed at utility maximisation. When prices are free to fluctuate, a competitive market drives the actual price (and quantity) to an equilibrium value in the interaction of demand and supply, and the market clears (Salvatore, 2008)[297] at a market-clearing price. When this clearing price is achieved, economic theory then suggests that the market has valued and allocated resources in the most economically efficient manner paying attention to utility maximisation and Pareto optimality.[298] Profitable markets attract sellers (competitors), who help with achieving price equilibrium (in the absence of barriers to entry and exit). Although innovation may allow for sellers to achieve temporary 'super-normal' profits, these are eroded over time by competitive forces and prices return to an equilibrium value that includes only 'normal' profits. Markets that are free are expected to allow

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[296] Salvatore, D., (2008), *Microeconomics: Theory and Applications*, Oxford University Press, Oxford

[297] Salvatore, D., (2008), *Microeconomics: Theory and Applications*, Oxford University Press, Oxford

[298] Friedman, M., (1962), Capitalism and Freedom, 1982 edition, University of Chicago Press (online) at http://circuloliberal.org/livros/capitalismo-e-liberdade.pdf [accessed on 14th February 2018]

for best allocations as they do not have any meddling by regulators that may result in unintended outcomes. The price mechanism is therefore considered the most optimal mechanism for the allocation of resources for a variety of overt and covert reasons.

Arguments for competitive markets explain that competition allows for better consumer outcomes than monopoly or oligopoly and address concerns about predatory behaviour, cartels, fair treatment and abuse of power. They also lend credence to arguments that competitive markets actually help consumers in various ways.[299] Competition is seen as serving to: reduce prices for consumers; increase efficiency and productivity thus achieving higher quality outputs, encourage innovation and enhance variety. Competitive markets are therefore promoted because they facilitate the optimal allocation of scarce societal resources and enhance material welfare. There is also a more philosophical case that notes that in doing the above, competition supports economic liberty, disperses economic power, helps create wealth equality, promotes choice and increases well-being by allowing individual initiative and supporting economic liberty and free association.[300]

In this context, the scope of regulation (if any) is envisaged as advocating, ensuring and fostering competition so as to allow the market mechanism to work[301] and for prices to allocate resources optimally, as this is seen to be conducive to democracy and material progress. Post-crisis reform of anti-trust law and accompanying regulatory changes for example, assumes the existence of markets consisting of rational firms that maximise profit and consumers with competence and strength such that their will-power is never compromised.[302]

Such faith in the power and value of competitive markets, has underpinned and informed the shaping of the role of the conduct regulation in the UK, even as it stands today.[303] For example, the FCA's website explaining the importance of competition, notes that 'When competition works well, consumers are empowered as well as informed. They can make sense of the information they receive and can take their business elsewhere if they are not happy. In turn, firms strive to win custom on the basis of service, quality, price and innovation. This helps

[299] Arrow, K. (1951), Social Choice and Individual Values, (2nd Edition, 1963), John Wiley, New York

[300] Young, I.M., (2011), *Responsibility for Justice,* Oxford University Press, Oxford

[301] Davies, H., (1997), Speech by Howard Davies, Chairman, The Securities and Investment Board at the London Metal Exchange Annual Dinner on 7th October 1997 paragraph 5 [Online] at http://www.fsa.gov.uk/library/communication/speeches/1997/sp01.shtml [accessed on 18th March 2018]

[302] Stuecke, M., (2011), Reconsidering Competition, *Mississippi Law Journal*, Vol 81, Issue 2 [online] at http://heinonline-org.idpproxy.reading.ac.uk/HOL/P?h=hein.journals/mislj81&i=111 [accessed on 14th March 2018]

[303] The UK Financial Conduct Authority (FCA) is now tasked with a competition objective in addition to conduct regulatory objectives.

generate better outcomes for consumers. Markets are open to entry and innovation, and successful, innovative firms thrive, while unsuccessful firms change or exit'.[304] This quotation provides a prime example of how the market mentality is embedded within the regulatory approach of the FCA. It explains how the market ideology fundamentally underpins conduct regulation developed by those at the FCA.

<u>Finance theory</u>

Although some of the points that follow are covered in some depth in the previous chapter, these points are reiterated here briefly so as to contextualise the influence of finance theory in this area. Within finance scholarship, arguments that have dominated the mainstream finance narrative in the run-up to the GFC, are built upon how to resolve the most fundamental of economic problems i.e. how to optimally allocate scarce resources.

The finance scholarship that is of particular relevance in the context of these economic arguments, broadly fall into two major categories - literature on efficient markets and scholarship on modern portfolio theory. Lydenberg (2011)[305] summarises the content of these arguments as:

- 'Diversification reduces risk. Diversification offsets the risks of individual holdings and, properly managed, can increase rewards without increasing portfolio-level risks.
- Rewards and risks are related. The greater the risk taken by investors, the greater the rewards they should expect. Money managers can be deemed successful only if the returns they achieve are adjusted for the risks they take.
- Markets are efficient. Liquid and transparent markets reflect all information available at any given time and hence price securities traded in these markets appropriately.
- Options can be priced. Future rises and falls in the price of securities or markets can be hedged against by using options and other derivatives, for which accurate pricing models are available'.

How does this affect financial regulation?

Of these, the first and third points (i.e. that markets are efficient, and that diversification is beneficial) are particularly relevant to this chapter. The reason these arguments are of particular interest is because, in financial markets – although we might now be accustomed to a

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[304] Financial Conduct Authority website, About us – Promoting Competition section, [online] at https://www.fca.org.uk/about/promoting-competition [accessed on 14th March 2018]

[305] Lyndenberg, S., (2011), Beyond Risk: Notes towards a more responsible investment theory in eds. Hawley, J, Kamath, S., Williams, T., (2011), *Corporate Governance Failures*, University of Pennsylvania Press

world of regulated finance - the views above and the associated work of scholars such as Fama[306] are often drawn upon to suggest that regulation can interfere with the operation of markets and create inefficiencies in price formation. Avgouleas (2009) notes[307] that this is then translated into the financial regulation discourse as the well-acknowledged mainstream narrative that regulation is only warranted for the correction of irregularities and failures that interfere with the functioning of markets. This explains the regulatory emphasis - in the UK particularly, but also more globally – on mechanisms that promote disclosure, transparency and competition in turn allowing rational choice and competition and thereby ensuring market self-correction in rational markets. Regulators are perceived to be a pesky but necessary nuisance; their presence is only tolerated in circumstances where they allow market pre-eminence to regain its vaunted position.

A narrative of 'risk-based' regulation[308] – particularly in the UK[309] – occupies the discourse around the regulatory perimeter (which entities fall under the scope of regulation), the allocation of regulatory resource to various activities and the evaluation of efficiency and effectiveness of regulators.[310] Risk-based regulation aims to hold regulators to account for the scope of their regulatory activity and the prioritisation of their regulatory interventions in accordance with the riskiness of different circumstances.[311] The aim of risk-based regulation is to encourage regulators to focus their regulatory resources on those interventions that deal with matters of highest risk and to reduce the use of resources on matters that hold a lower risk grading. Risk-based regulatory prioritisation has been employed as the rationale to eliminate regulatory topics that go beyond minimal utilisation of resources so as to be consistent with this market supremacist narrative. Nicholls (2015) [312] explains this as 'A risk-based approach to

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[306] Fama, E., (1970), Efficient Capital Markets: A Review of Theory and Empirical Work, *Journal of Finance*, 25 (2) pp 383–417

[307] Avgouleas, E., (2009), The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case of Reform, *European Company and Financial Law Review*, Vol. 6, Issue 4 at http://heinonline-org.idpproxy.reading.ac.uk/HOL/P?h=hein.journals/ecomflr6&i=466 [accessed on 18th February 2018]

[308] Nicholls, A., (2015), 'The Challenges and Benefits of Risk-Based Regulation in Achieving Scheme Outcomes', Presentation to Actuaries Institute Insurance Schemes Seminar, 8-19 Nov 2015, Adelaide at https://www.actuaries.asn.au/Library/Events/ACS/2015/NichollsRegulation.pdf [accessed on 8th April 2018]

[309] Financial Services Authority, 2002, *Building the New Regulator: Progress Report 2* pp 5–6.

[310] Black, J., (2005), 'The emergence of risk-based regulation and the new public risk management in the United Kingdom', *Public Law*, 2005 Autumn , pp 512-549

[311] Baldwin, R., Black, J., (2016), Driving Priorities in Risk-based Regulation: What's the Problem, *Journal of Law and Society,* Vol 43 Issue 4 at https://doi.org/10.1111/jols.12003 [accessed on 8th April 2018]

[312] Nicolls, A., (2015), The Challenges and Benefits of Risk-Based Regulation in Achieving Scheme Outcomes, Presentation to the Actuaries Institute Injury Schemes Seminar, 8-10 November 2015, Adelaide at https://www.actuaries.asn.au/Library/Events/ACS/2015/NichollsRegulation.pdf [accessed on 15th August, 2017]

regulation will focus on those risks that hamper the delivery of public value rather than expending resources on ensuring compliance to laws where no real harm is being done….'. The assessment of 'no real harm is being done' is an inherently subjective and political question.

Why is the 'risk to whom' question important?

Given the scale and scope of the financial sector and the question of 'risk to whom', this question of recognition of the impact of risk beyond contributors of funds, becomes particularly important. In this context, it is also worth pointing out at this stage that the mainstream narrative of choice for, and rationality of, consumers has played an important role in the discourse

Much of this framing of the rationality of consumers and the reframing of deregulation as furthering democracy and personal choice, has in turn been drawn from the powerful narratives in the wider economics and finance discourse. Olsen[313] highlights the importance of what is known as the Chicago school (the term is used for an approach spearheaded by prominent economists moulded in an approach to economics instigated at the University of Chicago). Olsen argues that the:

'Chicago school's turn towards deregulation in the post-war period was made possible by a new figure of the 'efficient consumer,' a figure that is positioned at the centre of ideational structures …. Emerging as early as the 1950s, the figure of the efficient consumer was central to and allowed for a new understanding of the marketplace, one that uncoupled ideals of economic efficiency, utility and growth from the promotion of democracy and moral behaviour. As Chicago school scholars launched this new ideal of the consumer, they also elevated the figure into the key actor in the marketplace, and mobilized it in discussions of efficiency in other societal contexts such as the public sector. Altogether, these moves served to energize and expand the deregulation discourse. As such, the efficient consumer came to function as a key dimension in--as well as a driver of--a large, complex and multidimensional shift in thinking about political economy. This shift derived from the Chicago school'. [314]

[313] Olsen, N., (2017), From Choice to Welfare: The Concept of the Consumer in the Chicago School of Economics, *Modern Intellectual History*, 08/2017, Volume 14, Issue 2 pp 507-535 at https://doi.org/10.1017/S1479244316000202 [accessed on 8th April, 2019]

[314] Olsen, N., (2017), From Choice to Welfare: The Concept of the Consumer in the Chicago School of Economics, *Modern Intellectual History*, 08/2017, Volume 14, Issue 2 pp 507-535 at https://doi.org/10.1017/S1479244316000202 [accessed on 8th April, 2019]

Other reasons for the importance of the 'risk to whom' question, lie in a conduct regulatory context for a financial sector that dominates the economy and is able to re-shape the mainstream narrative through lobbying, regulatory capture and access to vast funding sources. When examined in conjunction with the literature on financialization, this also translates into a philosophical pre-disposition within risk-based regulation, on risks to those owning or managing finance capital rather than on a broader range of risks to citizens that should be evaluated in a holistic way. This, in turn, can cause severe stakeholder detriment because the impact of conduct risks on wider stakeholders is not captured effectively in regulatory evaluations. This results in poor regulatory oversight and lopsided decision-making. Ireland (2011) and others point out how market ideologies in this area impact the kinds of products, services and behaviours that are considered permissible.[315] Sandel (2012) points out how activities and value-based judgements that should be outside of the purview of financial markets and market-based incentives are ignorantly brought into their scope.[316] The broader point to be made here is that this has meant that regulation is viewed with much scepticism in influential quarters, and market-based solutions are prioritised. The relevance of this to our consideration of the recalibration of conduct regulation, is discussed later within this chapter

And returning to welfare economics…..

Welfare economics approaches build on the understanding of the markets as discussed above, but engage with the reality of circumstances when the market equilibrium between supply and demand functions does not result in optimising the economically efficient allocation of resources. The resultant failure in the allocation process – arising from a breakdown in the market mechanism - is discussed using the term 'market failure'.[317] Ogus (2004),[318] Yeung and Morgan (2007)[319] explain how welfare economics then offers rationales for regulation in the correction of such market failures. Note that regulatory intervention in markets is only considered acceptable within the welfare economics paradigm, as a somewhat 'last-resort'[320]

[315] Ireland, P., (2010) 'The Financial Crisis: Regulatory Failure or Systems Failure' in MacNeil, I., and O'Brien, J., (eds.), *The Future of Financial Regulation,* Hart Publishing, Portland, 2010

[316] Sandel, M.,, (2012), *What Money Can't Buy: The Moral Limits of Markets*.,

[317] Zimmerman, E., (2011), Market Failures, in eds. Badie, B., Berg-Schlosser, D., and Morlino, L., *International Encyclopedia of Political Science* (2011), Vol. 5. pp 1487-1492, SAGE Reference.

[318] Ogus, A., (2004), *Regulation: Legal Form and Economic Theory,* Hart Publishing

[319] Morgan, B., Yeung, K., (2007), *An introduction to law and regulation*, Cambridge University Press

[320] Scott, B., (2006), The Political Economy of Capitalism, Harvard Business School Faculty Working Chapter (online) at http://www.hbs.edu/faculty/Publication%20Files/07-037.pdf [accessed on 15th August, 2017]

measure powered by the need to prevent economic losses and ensure allocative efficiency so that 'Pareto-efficient'[321] economic growth can be achieved.[322]

This welfare economics discourse is cast within broader philosophical perspectives in law, sociology and politics, on the nature of the welfare state and the role of state intervention through regulation. Scholars such as Murray (1984)[323] and Mead (2006)[324] derided the welfare state and offered the view that the attributes and behaviours of individuals accounted for advantages and disadvantages in position. The pre-eminence of such views can be noted in the emphasis on 'personal responsibility' which came to be cast as the predominant factor in affecting inequality, poverty and position and is also reflected in what Young (2011) terms as an 'ownership' society.[325] There was a stark de-recognition of the importance and nature of structural factors in such circumstances. Scholars such as Dworkin (2000),[326] were more committed to a welfare state. But again, Young (2011) points out that they ignored structural factors. Instead they cast the realm of welfare intervention as remedying the problems caused by misfortune or luck.[327]

A parallel to this can be seen in the pre-crisis regulatory narrative in the U.K. where discussion around regulatory protections against vulnerability are built around who is suffering misfortune (disability, ill-health) or is on the fringes of society. In a financial regulatory context, Crotty (2009),[328] Ireland (2010)[329] have pointed out that in the run-up to the GFC, the narrative around financial regulation acquired a distinctly neoliberal flavour.[330] This market-oriented

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[321] eds Black, J, Hashimzade, N., Myles, (2017), A dictionary of economics, 5th edition, Oxford University Press (online) at http://www.oxfordreference.com.idpproxy.reading.ac.uk/view/10.1093/acref/9780198759430.001.0001/acref-9780198759430-e-3814 [accessed on 17th August, 2017]

[322] Morgan, B., Yeung, K., (2007), *An introduction to law and regulation*, Cambridge University Press

[323] Murray, C., (1984), *Losing Ground: American Social Policy, 1950-1980,* Basic Books, New York cited in Young, I. M., (2011), *Responsibility for justice,* Oxford University Press, Oxford

[324] Mead, L., (2006), *Beyond Entitlement: The Social Obligations of Citizenship,* Harvard University Press, Cambridge MA, cited in Young, I. M., (2011), *Responsibility for justice,* Oxford University Press, Oxford

[325] Young, I. M., (2011), *Responsibility for justice,* Oxford University Press, Oxford

[326] Dworkin, R., (2000), *Sovereign Virtue: The Theory and Practice of Equality,* Free Press, New York cited in Young, I. M., (2011), *Responsibility for justice,* Oxford University Press, Oxford

[327] Young, I. M., (2011), *Responsibility for justice,* Oxford University Press, Oxford

[328] Crotty, J., (2009), 'Structural causes of the global financial crisis: a critical assessment of the new financial architecture', *Cambridge Journal of Economics*, 33, pp 563-580, [online], available at http://cje.oxfordjournals.org/content/33/4/563.full.pdf+html [accessed on 24th November 2016]

[329] Ireland, P., (2010), 'The Financial Crisis: Regulatory Failure or Systems Failure', *The Future of Financial Regulation,* Hart, Portland, Oregon

[330] Ireland, P., (2010), 'The Financial Crisis: Regulatory Failure or Systems Failure', *The Future of Financial Regulation,* Hart, Portland, Oregon

economic narrative – as distinct from other narratives by critical political economy scholars or those from other subject areas such as sociology - has been used as the dominant and visible description of the rationales for regulatory intervention in financial markets in many Western economies, and particularly in the UK.[331] In the UK, views from influential regulatory practitioners and scholars such as Davies meant that certain aspects of finance and certain players, were deemed to be legitimately outside of the purview of regulation.[332]

As discussed in the previous chapter of this thesis, it has become obvious that insufficient regulatory attention was directed to these issues, despite the damage that could be caused to other stakeholders and to the markets.[333] Ferguson (2012) explains how - in the US - in influential regulatory circles and discussions, such as the Jackson Hole Symposium of 2005, alternative views that suggested that innovative financial products and services may bring disproportionate risks to the real economy, and that there could be a reasonable alternative to the unfettered operation of financial markets, were ignored or de-emphasised.[334] This is a characteristic problem in the mainstream narrative .[335]

Encouragingly, there has been some recognition post-crisis that financial vulnerability is not reserved for those on the fringes of society given the complexity of financial products and markets. For many citizens, it is likely that there elapses a long period of time from when the product is sold to us and when the product is found to be improperly sold or unviable for a range of reasons including the inability of the financial firm to meet its liability.[336] It is however worth noting, that despite this recognition, the wider discussion of regulatory reform is mainly structured around welfare economics rationales.[337] The emphasis therefore still remains on

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[331] Harnay, S., (2016), The influence of the economic approaches to regulation on banking regulations: a short history of banking regulations, *Cambridge Journal of Economics*, Vol 40, Issue 2, pp 401-426

[332] Davies, H., (2010), "Consenting adults in private, that's their problem really" quoted from Davies, H., 'Naive, but Not Corrupt', Slate.com article dated 26th December 2010 [online] at http://www.slate.com/articles/business/project_syndicate/2010/12/naive_but_not_corrupt.html [accessed on 17th November 2017]

[333] Ireland, P., (2010), 'The Financial Crisis: Regulatory Failure or Systems Failure', *The Future of Financial Regulation,* Hart, Portland, Oregon

[334] Ferguson, C., (2012), *Inside Job: The Financiers Who Pulled Off The Heist Of The Century,* Oneworld Publications

[335] Rajan, R. (2005), Has Financial Development Made the World Riskier, Speech at Jackson Hole Symposium (online) at https://www.kansascityfed.org/publicat/sympos/2005/pdf/rajan2005.pdf [accessed on 17th November 2017]

[336] Financial Conduct Authority (2015), Consumer Vulnerability, Occasional Chapter No. 8 [Online] at https://www.fca.org.uk/publication/occasional-chapters/occasional-chapter-8-exec-summary.pdf [accessed on 16th March 2018]

[337] Harnay, S., (2016), The influence of the economic approaches to regulation on banking regulations: a short history of banking regulations, *Cambridge Journal of Economics*, Vol 40, Issue 2, pp 401-426

individuals taking personal responsibility for financial decisions that are then made in such markets that operate in an environment that has implemented regulatory remedies for market failure. This harks back to points previously made about the approaches to economics being influenced by the Chicago school, emphasising rationality of consumers and the need to allow consumers to make choices.[338] Welfare economics rationales have not just dominated regulatory policy-making and rationales for regulation before the GFC[339] but have also formed the overt or covert basis particularly in the UK, US and much of Western Europe for regulatory reforms and discourse post-GFC.[340] Regulatory rationales were, and continue to be shaped by a 'marketised', financialised language that engages with terms such as cost-benefit analyses, competition, incentives, disincentives and efficiency gains in the assessment of the rationale or value of regulation. This again plays to the ideas of democracy, personal freedom, choice and rationality drawn from influence of the neoliberal perspectives on economics of the Chicago school. Scholars such as Young (2011),[341] Feintuck (2010),[342] Harnay (2011),[343] Palley(2007)[344] and Ireland (2011)[345] explain how values, quality, justice, fairness or equality have been abrogated from the regulatory discourse as a result.[346] Engelen et al (2011) explain how the role of innovation in finance is overemphasised in this discourse, without an appropriate estimation of the consequences of such innovation.[347]

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[338] Olsen, N., (2017), From Choice to Welfare: The Concept of the Consumer in the Chicago School of Economics, *Modern Intellectual History*, 08/2017, Volume 14, Issue 2 pp 507-535 at https://doi.org/10.1017/S1479244316000202 [accessed on 8th April, 2019]

[339] Harnay, S., (2016), The influence of the economic approaches to regulation on banking regulations: a short history of banking regulations, *Cambridge Journal of Economics*, Vol 40, Issue 2, pp 401-426

[340] Ireland, P., (2010), 'The Financial Crisis: Regulatory Failure or Systems Failure', *The Future of Financial Regulation,* Hart, Portland, Oregon

[341] Young, I. M., (2011), *Responsibility for justice,* Oxford University Press, Oxford

[342] Feintuck, M., (2010), Regulatory rationales beyond the economic: In search of the public interest, *The Oxford Handbook of Regulation,* Oxford University Press

[343] Harnay, S., (2016), The influence of the economic approaches to regulation on banking regulations: a short history of banking regulations, *Cambridge Journal of Economics*, Vol 40, Issue 2, pp 401-426

[344] Palley (2007), 'Finanzialization: What it is and why it matters', Working Chapter Number 153, University of Massachusetts Amherst Political Economy Research Institute Working Chapter Series, presented at a conference on "Finance-led Capitalism? Macroeconomic Effects of Changes in the Financial Sector," sponsored by the Hans Boeckler Foundation, Berlin, Germany, October 26 – 27, 2007 (online) available at http://scholarworks.umass.edu/cgi/viewcontent.cgi?article=1124&context=peri_workingchapters [accessed on 21st August, 2017]

[345] Ireland, P., (2010), 'The Financial Crisis: Regulatory Failure or Systems Failure', *The Future of Financial Regulation,* Hart, Portland, Oregon

[346] Engelen, E., Ektuerk, I., Froud, J., Johal, S., Leaver, A., Moran. M., Nilsson, A., Williams, K., (2011), *After the Great Complacence,* Oxford University Press, Oxford

[347] Engelen, E., Ektuerk, I., Froud, J., Johal, S., Leaver, A., Moran. M., Nilsson, A., Williams, K., (2011), *After the Great Complacence,* Oxford University Press, Oxford

Within this narrative there is little room for a credible discussion of regulation calibrated around social norms and ethics. Instead where there is an acceptance of societal objectives such as justice and equity as goals within regulation, the solutions that are considered are allied to the 'trickle-down' effect. There has therefore been significant scholarly scepticism of these arguments, outside of the 'neo-liberal'[348] finance and economics discourse. Ireland (2010), points to fallacies in the 'neoliberal' approach to economics that simultaneously justify and constrain regulatory activities, and seem to have an idealistic focus on the primacy of individual choice and an unhealthy reliance on a trickle-down approach to societal betterment when the evidence in relation to important areas such as inequality and unfair treatment is clearly to the contrary, as particularly evidenced by the GFC.[349] Avgouleas (2009)[350] and Young (2011)[351] explain how regulatory priorities, in finance, predicated on tenets of personal responsibility and market hegemony, protect societal stakeholders in a very circumscribed manner[352] and fail to engage with core democratic values (such as justice and equality) and real economic implications of misconduct in finance. This emerging scepticism has helped develop regulatory practice and provide a platform for critical regulatory discourse, particularly in the aftermath of the GFC. The arguments above are of importance to this chapter because regulatory scope and accountability have currently largely been calibrated in accordance with many aspects of this marketised philosophical outlook. This chapter suggests a revision to the approach to conduct regulation to engage better with such fundamental objectives.

<u>Substantive political approaches</u>

Substantive political motives for regulation focus on a range of 'non-economic substantive goals that justify regulatory intervention'.[353] Regulation justified by substantive political rationales engages with the needs for fairness, equity, justice, socially motivated redistribution,

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[348] Smith, N., (2017), *Britannica Academic,* (online), at http://academic.eb.com.idpproxy.reading.ac.uk/levels/collegiate/article/neoliberalism/600983 accessed on 18 August, 2017

[349] Ireland, P., (2010), 'The Financial Crisis: Regulatory Failure or Systems Failure', *The Future of Financial Regulation,* Hart, Portland, Oregon

[350] Avgouleas, E., (2009), The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case of Reform, *European Company and Financial Law Review*, Vol. 6, Issue 4 at https://heinonline-org.idpproxy.reading.ac.uk/HOL/P?h=hein.journals/ecomflr6&i=466 [accessed on 18th February 2018]

[351] Young, I. M., (2011), *Responsibility for justice,* Oxford University Press, Oxford

[352] Avgouleas, E., (2009), The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case of Reform, *European Company and Financial Law Review*, Vol. 6, Issue 4 at https://heinonline-org.idpproxy.reading.ac.uk/HOL/P?h=hein.journals/ecomflr6&i=466 [accessed on 18th February 2018]

[353] Morgan, B., Yeung, K., (2007), *An introduction to law and regulation*, Cambridge University Press

paternalism or the formation of diverse preferences and shared social values.[354] It takes account of factors such as irreversibility, or fairness to future generations whose views are not reflected in current economic demand and supply interactions. It may also reflect consideration of those who are unable to participate in the market i.e. those who – although they may have a valid view or concern - lack power or representation at the right time in the right currency and in the right forum to express concerns or alternative demand functions.

Examples of the use of substantive political approaches include regulations for the prevention of usury, speculation or gambling in certain jurisdictions which may arise from shared social values that reflect the relevant society's abhorrence of such practices on ethical or moral grounds. Conly (2013) describing another practical example of such a substantive political rationale (the importance of coercive paternalism)[355] shows how patients may rigorously check the internet or other sources to find out the causes of their symptoms, and may be self-confident in their diagnosis but are prevented - by regulation - from getting certain drugs unless it is prescribed by a registered medical practitioner. These regulatory safeguards supplant the market mechanism with price at its core. Safeguards instead may stem from concerns about new or more appropriate medication being available, side effects, contraindications arising from family history or other factors. Conly explains that in such cases, society agrees that 'expert knowledge is necessary and available, and we are thus, on the whole, better off having the decision taken out of our hands'.[356]

Substantive political approaches (although they do not arise simply to correct failings of economic theory) may also help to provide a different way to address failures by the market to address issues such as adverse selection, collective action problems or free rider concerns.

Why is the focus on substantive political approaches important to this chapter?

Substantive political approaches engage with concerns about societal priorities that are consistent with notions of freedom, equality and justice. Such approaches are central to democratic ideals that have largely been ignored - or as in the case of arguments drawn from the Chicago school, have been misappropriated[357] to pursue outcomes inconsistent with

[354] Morgan, B., Yeung, K., (2007), *An introduction to law and regulation*, Cambridge University Press

[355] Conly, S., (2013), *Against Autonomy,* pg 18, Cambridge University Press

[356] Conly, S., (2013), *Against Autonomy,* pg 18, Cambridge University Press

[357] Olsen, N., (2017), From Choice to Welfare: The Concept of the Consumer in the Chicago School of Economics, *Modern Intellectual History*, 08/2017, Volume 14, Issue 2 pp 507-535 at https://doi.org/10.1017/S1479244316000202
[accessed on 8th April, 2019]

democracy - in the regulatory discourse.[358] The inordinate emphasis on market-driven outcomes within the Chicago characterisation has meant that political citizenship is derived from and associated with economic power and citizenship, rather than from the fundamental rights afforded within a democracy.

In modern economies, financial markets are the fulcrum for the agglomeration and allocation of capital. Particularly given the retreat of state provision, citizens in developed economies find that the use of financial products and financial intermediaries are woven into the very fabric of their day-to-day lives ranging from the mundaneness of booking of a train or bus ticket through to more complex health or personal care provision.[359] The extent of the financial sector's powers to provide or to withhold access to other non-financial goods and services, to allocate capital and to redistribute associated income[360] evoke the need for fairness and social justice considerations in any economy.

However, for many financial products, such as pensions, insurance and investment products there is a layer of complexity in assessment and a material time lag between the purchase of the product and any real attempt by the consumer to test its efficacy through use. With products such as life insurance, the ability to check whether the product pays out may not actually be in one's own lifetime. Indeed, the construction of the corporation and the engineering around many financial products add a layer of complexity in judging anyone outside the firm selling the product knowing whether it might be worth purchasing. This complexity is thus further exacerbated by the challenges posed by information asymmetry. Many financial consumers know comparatively little about financial products relative to the manufacturers of complex financial products and services.

In the tradition of positivism,[361] the narrative of financial regulation, (particularly prior to the global financial crisis) has been dominated by arguments that suggested that the use of financial market mechanisms and techniques to underpin various financial and non-financial decisions was a value-neutral proposition. That these are underpinned by socio-political and economic assumptions and choices, was and continues to be largely ignored. The neoliberal state

[358] Young, I. M., (2011), *Responsibility for justice,* Oxford University Press, Oxford

[359] Baker, A., Epstein, J., Leaver, A., Montecino, J., Fields, D. Atkinson, R., (forthcoming), 'The UK's Finance Curse? Costs, Processes and Future Research Agendas', Sheffield Political Economy Research Institute Working Chapter, 2018 cited in Shaxson, N., (2018), *The Finance Curse,* Vintage Publishing, United Kingdom

[360] Pickett, K., Wilkinson, R., (2009), *The Spirit Level,* Allen Lane, United Kingdom

[361] Bryman, A., (2004), *Social Research Methods,* Oxford University Press

encourages regulators to engage with the notion of a financial 'consumer' by using the language of personal freedom and choice in such a framing, and this helps provide a basis for regulators to see themselves as mainly being in the position of preventing individuals from benefitting from moral hazard. When considering financial capability, this focus on the notion of citizen as consumer results in many regulators using their financial capability budgets to focus on formulating regulation enabling citizens to engage as responsible consumers.[362] Regulators are inclined to emphasise the need for such a consumer to take responsibility for various aspects of financial provision as one would expect such consumers to make rational choices in a competitive market.[363] Vulnerable consumers are broadly conceived as only comprising the weakest who live on the fringes of society. The assumption – that is unstated but broadly prevalent – is that the vast majority of citizens are portrayed as consumers who are rational and able to engage with such complex products and to make rational choices. Standard regulatory tools deployed in this context are those predicated on disclosure and transparency,[364] which have been proven (as in the previous chapter about the Global Financial Crisis) to fail to address the information asymmetry problems or other behavioural biases that plague financial decision-making across a broad swathe of the population in a sufficiently effective manner. Due to the ubiquity of financial products in everyday use, their complexity and the lag-time to problem discovery amongst other factors, this problem is multiplied manifold and the impact is not limited to the so-called vulnerable.

The resurgence of the study of behavioural finance post-crisis, has made some dent in the assumptions of rationality present in the wider financial discourse, but has largely been diverted[365] to engage with issues at the fringe of regulation such as the use of 'nudge'-economics in the development of certain policy tools which allow consumers to make better choices, with incentives or engagement, with modifying consumer consumption behaviour and also on the market conduct side with whether engaging with ESG factors improves financial returns to portfolios for investors, again casting citizens who deserve financial regulatory protections as only those who have sufficient access to financial capital. Regulatory intervention

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[362] Hutten, M., Maman, D., et al, (2018), Critical Financial Literacy – An Agenda, *International Journal of Pluralism and Economics Education,* 9(3) , [online] at https://www.researchgate.net/profile/Matthias_Thiemann/publication/326640683_Critical_financial_literacy_an_agenda/links/5c9f32c745851506d7343c04/Critical-financial-literacy-an-agenda.pdf [accessed on 20th April 2019)

[363] Olsen, N., (2017), From Choice to Welfare: The Concept of the Consumer in the Chicago School of Economics, *Modern Intellectual History*, 08/2017, Volume 14, Issue 2 pp 507-535 at https://doi.org/10.1017/S1479244316000202
[accessed on 8th April, 2019]

[364] Avgouleas, E., (2010), 'What future for disclosure as a regulatory tehnique', *The Future of Financial Regulation,* Oregon

[365] Ireland, P., (2010), 'The Financial Crisis: Regulatory Failure or Systems Failure', *The Future of Financial Regulation,* Oregon

is largely predicated on restoring market supremacy within the existing paradigm of welfare economics by adjusting levers in moderate ways to promote competition and root out cases of serious abuse. There is little engagement with the core subtext of the substantive political discussions of financial regulation i.e. that there might be motives other than market primacy such as fairness and justice, that might drive financial regulatory activities in relation to the conduct of financial intermediaries and in the design, manufacture, marketing, sales, after-sales and retirement of financial products and services.

Another key area affecting the role and remit of financial regulation more generally and conduct regulation more specifically is financialization. Epstein (2005) defines financialization broadly as 'the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies'.[366] Krippner explains that financialization refers to a 'pattern or accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production'.[367] Palley (2007) notes that 'financialization operates through three different conduits: changes in the structure and operation of financial markets; changes in the behavior of non-financial corporations, and changes in economic policy'.[368]

Instruments to encourage corporate and consumer indebtedness are engineered through 'steady financial innovation that ensures a flow of new financial products allowing increased leverage and widening the range of assets that can be collateralized'.[369] Non-financial corporations are increasingly affected by these financial machinations as they are increasingly dependent upon and judged by ever more impatient and complex financial markets. Managers in financial and non-financial firms are judged by the yardstick of their visible performance in financial markets – there is an ideological dominance of investor primacy resulting in an

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[366] Epstein, (2005), *Financialization and the world economy,* Edward Elgar, Cheltenham, UK

[367] Krippner, G., (2004), What is Financialization, cited in ed. Epstein, G., (2005), *Financialization and the World Economy*, Edward Elgar Publishing, Cheltenham, UK

[368] Palley (2007), 'Finanzialization: What it is and why it matters', Working Chapter Number 153, University of Massachusetts Amherst Political Economy Research Institute Working Chapter Series, presented at a conference on "Finance-led Capitalism? Macroeconomic Effects of Changes in the Financial Sector," sponsored by the Hans Boeckler Foundation, Berlin, Germany, October 26 – 27, 2007 (online) available at http://scholarworks.umass.edu/cgi/viewcontent.cgi?article=1124&context=peri_workingchapters [accessed on21st August 2017]

[369] Palley (2007), 'Finanzialization: What it is and why it matters', Working Chapter Number 153, University of Massachusetts Amherst Political Economy Research Institute Working Chapter Series, presented at a conference on "Finance-led Capitalism? Macroeconomic Effects of Changes in the Financial Sector," sponsored by the Hans Boeckler Foundation, Berlin, Germany, October 26 – 27, 2007 (online) available at http://scholarworks.umass.edu/cgi/viewcontent.cgi?article=1124&context=peri_workingchapters [accessed on21st August 2017]

inordinate focus on the interest of capital providers and financial performance. Competition – even in the non-financial sector – is therefore eased away from productive innovation. Instead managers are forced to compete by adopting innovative approaches to showcasing financial performance (not all of which are legitimate – a prime example of this is Enron[370]) or through financial wizardry using the proliferation of derivatives and other instruments. While these products at times have a real economic purpose, at many others, they are used for creating or showcasing returns to capital providers, needlessly embroiling non-financial firms in financial activities that would be secondary to any assessment of productive performance in satisfying real economic needs. Studies such as Ceccheti and Kharroubi[371] (2014) show that rapid financial sector growth can 'crowd out real economic growth', financial development affects aggregate productivity growth and concluded that the level of financial development is good only up to a point, after which it becomes a drag on growth, and that a fast-growing financial sector is detrimental to aggregate productivity growth.

Complexity and opacity in financial products magnifies risk within the financial system and the interconnectedness with the real economy results in highly adverse societal impact. Crotty (2007) also avers that financialization results in a transfer of power to the financial sector.

Van der Zwan (2015), describing the scholarly studies of financialization across subject areas including anthropology, economics, political science, sociology and geography explains how these diverse perspectives are brought together by the recognition that finance is not just a capital provider for economic purposes. 'Instead, studies of financialization interrogate how an increasingly autonomous realm of global finance has altered the underlying logics of the industrial economy and the inner workings of democratic society'.[372]

Epstein (2005)[373] has evidenced how financialization (often intertwined with neoliberalism) can account for a persistent enrichment of financiers, typically at the expense of other stakeholders in the real economy. The financial sector shapes politics through lobbying and campaign contributions, business through fostering debt-driven business cycles and the sector

[370] Clarke, T., International Corporate Governance: A comparative Approach, Routledge, Oxon
[371] Cecchetti, G. and Kharroubi, E. (2014) 'Why does financial sector growth crowd out real economic growth', Bank for International Settlements, Basle, at http://www.bis.org/publ/work490.pdf [accessed 11 Feb 2018]

[372] Van der Zwan, N., (2015), Making sense of financialization, *Socio- Economic Review,* vol 12, issue 1, pp 99-129 [online] at https://doi.org/10.1093/ser/mwt020 [accessed on 21st September, 2017]
[373] Epstein, (2005), *Financialization and the world economy,* Edward Elgar, Cheltenham, UK

also artificially inflates aggregate demand by supporting consumer spending through easily-obtained credit facilities of dubious value. Palley (2007) explains how financial markets, institutions and elites exert control over economic policy and economic outcomes. Within the economy, the financial sector gains precedence and importance over the real sector. Wealth is extracted from the real economic production and fuels the financial sector instead. Increasing proportions of income leading to increasing inequality between financial elites and those producing real goods and services, thus contributing to wage stagnation or erosion within the productive part of the economy. Palley notes that '… there are reasons to believe that financialization may render the economy prone to risk of debt- deflation and prolonged recession'.

Financialization is directly related to greater moral hazard and increases in financiers' propensity to take risk without being accountable for their actions. It causes an artificial distortion in asset prices that prevents the appropriate interaction of aggregate demand and supply functions to determine price in the market mechanism. Lydenberg (2011) points out that such an emphasis on financial performance to the exclusion of the consideration of the role of assets in addressing real economic needs has also resulted in a change in the fundamental nature of asset classes and undermined the reliability of the price mechanism in valuing those assets effectively. He notes that while successful investing is really about the focus on 'maximizing the societal benefits that each asset class is intended to create, while achieving competitive financial returns,'[374] in economies overshadowed by financialization, investors and managers are encouraged to maximize financial performance with little reference to the societal benefits generated from the assets. For example, property in many big, international cities such as London, is no longer valued by markets in relation to the demand and supply functions of serving the real economic need of providing housing. Instead its value is heavily influenced by speculative investment activities of those who neither intend nor are expected to ever use it for providing shelter, or a home. The price mechanism is therefore no longer able to efficiently allocate scarce economic resources efficiently in a manner that is consistent with societal needs.

Incentives and requirements for directors and managers of corporations are restructured to suit this new paradigm. Less attention is paid to product or service quality, or fair wages to labour. Instead the focus is on reportable financial performance with an inordinate focus on short-term returns. This naturally results in a decrease in real investment, because the financial markets offer more lucrative returns. Leverage is used by managers to maintain returns to

[374] Lydenberg, S., Beyond Risk in eds, Kamath, S., Hawley, J., Williams, A., *Corproate Governance Failures*, University of Pennsylvania Press

equity. In parallel, the aggregate demand function is artificially inflated by greater financialization as a result of the lax approach to easy consumer credit. This inflationary spiral in turn engenders greater and greater indebtedness. Society and the real economy are thus recalibrated to serve finance, rather than finance serving purposefully in enabling the real economy to serve societal needs. Egregious behaviours have resulted in significant direct and indirect hardships to civil society as has been evidenced both in the past and more recently by the relevations within the Panama Papers scandal.[375]

Specifically, in respect of reforming conduct regulation, these substantive political rationales therefore become important because there may be structural solutions that need to be put in place or instances when regulators should intervene to address systemic weaknesses in conduct which are susceptible to contagion. Essentially many of the implications of misconduct bring into question the structures that perpetuate disadvantage in the guise of choice and personal responsibility. Examples include co-location and payday loans. To these issues, competition and the market mechanism do not provide a suitable answer. Instead, a clearer understanding of the systemic dynamics that entrench weakness and reward misconduct are required. As Anderson (1999) points out in her seminal essay: 'One's capabilities are a function not just of one's fixed personal traits and divisible resources, but of one's mutable traits, social relations and norms, and the structure of opportunities, public goods and public spaces'.[376] This is particularly important in the context of financial regulation because regulatory structures, interventions and the structure of financial markets – particularly in the context of financialization – can have a significant impact on addressing or exacerbating structural advantages and disadvantages thereby increasing inequality and reducing the effectiveness of competition and rational choice as tools for remedy.

Section 4

Prudential and Conduct Regulation: Scope and application

This segment of the chapter explains how one of the key corrections to the regulatory discourse and practice around prudential regulation post-GFC, should also be extended to conduct regulation.

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[375] Obermaier, F., Obermayer, B., et al, (no date), Panama Papers: The secrets of dirty money, *Sueddeutsche Zeitung*, [online] at https://panamapapers.sueddeutsche.de/articles/56febff0a1bb8d3c3495adf4/ [accessed on 20th April 2020]

[376] Anderson, E., (1999), What is the point of equality, *Ethics,* Vol 109, No 2, pp 287-337 at http://www.jstor.org/stable/10.1086/233897[accessed on 17th March 2018]

Prudential regulation is intended to ensure safety and soundness of regulated entities and markets, whilst conduct regulation attends to the conduct exhibited by regulated entities when engaging with consumers and markets. In practice, financial regulators may also be mandated with allied responsibilities such as the oversight of payment systems and competition, the prevention of financial crime, enhancement of international cooperation and specific mandates such as the promotion of the domestic financial markets. Current approaches to prudential regulation can be classified into micro-prudential regulation and macro-prudential regulation.

The dominant discourse and structural arrangements of prominent regulators including the UK FSA, prior to the GFC were largely within the micro-prudential regulatory space. The term 'micro-prudential' regulation refers to regulatory activities that oversee the financial viability of individual regulated entities or groups, thus seeking to ensure the soundness of these entities at a 'micro' i.e. individual regulated entity level. The object is to ensure that micro-prudentially regulated entities are able to honour financial claims, as they fall due; or that recovery plans can be initiated or the entity can be unwound in an orderly manner in case of distress. A key focus of these efforts is to minimise the reliance on the public purse from the failure of a regulated entity, or the creation of financial instability arising from the unwinding of a failed entity / group. Within the literature, influential justifications for micro-prudential regulation, such as that provided by Llewelyn (1999), are primarily drawn from the economic rationales for regulation.[377]

Macro-prudential regulation – although discussed formally since at least the 1980s - only achieved significant policy prominence in the UK in the aftermath of the GFC. The glaring absence of structures to support and enable macro-prudential regulatory activities, although macro-prudential regulation as a concept was clearly discussed by influential regulatory practitioners[378] is noteworthy at this stage. The following segment explains the nature and rationales for the adoption of macro-prudential regulation post-crisis.

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[377] Llewlyn, D., (1999), The Economic Rationale For Financial Regulation, FSA Occasional Chapters on Financial Regulation Series 1, at https://www.fep.up.pt/disciplinas/pgaf924/PGAF/Texto_2_David_Llewellyn.pdf [accessed on 8th November, 2018]

[378] Crockett, A (2000), 'Marrying the micro- and macro- prudential dimensions of financial stability', Remarks by Mr Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the Financial Stability Forum, before the Eleventh International Conference of Banking Supervisors, held in Basel, 20-21 September 2000 at https://www.bis.org/review/r000922b.pdf [accessed on 8th November 2018]

Post-GFC it was recognised that systemic risk could not merely be addressed through micro-prudential regulation alone. There was a growing understanding that the micro-prudential toolkit did not have the necessary mechanisms to address broader issues arising from contagion. Macro-prudential regulation is aimed at ensuring the safety and soundness of the UK financial system at a more holistic level. It 'takes into account the interactions among individual financial institutions, as well as the feedback loops of the financial sector with the real economy, including the costs that systemic risk entails in terms of output losses'.[379] It is worth noting at this stage – as is evident from the quote above - that macro-prudential regulation is also largely justified in the literature using a financialised narrative predicated on the economic rationales for regulation. This narrative describes the costs to the public purse from systemic risks. It is macroprudential regulation within the broader heading of prudential regulation that is of particular interest to the development of parallel arguments in relation to macro-conduct regulation, although substantive political rationales for regulation in addition to economic rationales will be adopted to develop these parallel arguments.

Conduct regulation – in its current form - is typically described in the UK, as consisting of the regulation of market conduct and, a 'consumer protection' agenda. This nomenclature is termed vague because it ignores the notion that consumer protection more generally could be a valid motive for prudential regulation too, but is used particularly in the UK to refer solely to those elements of conduct regulation that engage with protecting both retail and wholesale consumers. The regulation of market conduct alongside issues of investor and consumer protection are fairly well described[380] in the literature.

Literature in the areas of market integrity and investor protection largely engages with regulatory protections through the market mechanism with solutions such as greater and better-quality disclosure to investors, management of conflicts of interest, increased transparency, creating a level playing field through addressing activities such as insider trading, front-running etc, and so on, providing the remedy for market failure[381]. Although less well-described in the finance literature, there has been an increasing trend (even pre-GFC, but particularly after the GFC) to look beyond the pure investor protection aspects of conduct

[379] European Central Bank, (2014), Financial Stability Review, May 2014, pp 135-141, [online], available at https://www.ecb.europa.eu/pub/fsr/shared/pdf/sfcfinancialstabilityreview201405en.pdf??666514071375fbc9111c22effdacff9f [accessed on 24th November 2016]

[380] MacNeil, I., (2015), Rethinking conduct regulation, *Butterworths Journal of International Banking and Financial Law,* 30(7), pp 413-420

[381] MacNeil, I., (2015), Rethinking conduct regulation, *Butterworths Journal of International Banking and Financial Law,* 30(7), pp 413-420

regulation and grapple with the protection of a wider set of consumers.[382] In practice, in the UK this has resulted in a well-developed consumer protection agenda that goes beyond solely investor-protection facets and includes a range of regulations that span the product and consumption life cycles such as design, pre-sales, marketing processes, service and complaints, client classification, client money, client reporting, product review, protection of vulnerable consumers etc. Some of these topics such as the protection of vulnerable consumers have gone beyond the narrow confines of simply correcting market failures, but have intentionally[383] not engaged with the substantive political rationales for regulation.

It is worth making a small digression here to quickly recap some of the concerns regarding the use of an allied economic theory termed the 'trickle-down' theory, that underpins the arguments in the primacy of markets school of thought in much of Anglo-Saxon approaches to financial regulation [384]. As mentioned in the previous chapter, the 'trickle-down' effect has been described coarsely by the economist J K Galbraith as the view that 'If you feed the horse enough oats, some will pass through to the road for the sparrows'.[385] The idea is that if those at the top do well, businesses and individual further down the chain will benefit from their spending and largesse. It has been applied to markets more generally and financial regulation more particularly because the trickle-down approach to regulation more generally and to the conduct regulation agenda more specifically, because within a financialised discourse the market construct is central, and the broader objective of welfare enhancement, is achieved through primarily protecting the providers of capital and ensuring the integrity of the market mechanism as a source of price discovery. To a more tangential extent, there is the allied aim of preventing claims on the state caused by the collapse of regulated firms. Regulation – in this view - is aimed at protecting investors and shareholders (ie the capital providers). This in turn, allows their capital to be employed in productive ways engendering growth and productivity thereby allowing the rising tide to lift all boats. On account of the primacy of markets, Anglo-Saxon conduct regulation literature has therefore been concerned with ensuring that regulated

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[382] Georgosuli, A., (2011), The FSA's 'Treating Customers Fairly' (TCF) Initiative: What is So Good About It and Why It May Not Work, *The Journal of Law and Society,* Vol 38, Issue 3 at http://tinyurl.com/yxk74e9r [accessed on 27th March 2019]

[383] Olsen, N., (2017), From Choice to Welfare: The Concept of the Consumer in the Chicago School of Economics, *Modern Intellectual History*, 08/2017, Volume 14, Issue 2 pp 507-535 at https://doi.org/10.1017/S1479244316000202
[accessed on 8th April, 2019]

[384] MacNeil, I., (2015), Rethinking conduct regulation, *Butterworths Journal of International Banking and Financial Law,* 30(7), pp 413-420

[385] Galbraith, J.K., (1982), 'Recession Economics', *The New York Review of Books,* issue dated February 4, 1982 at https://www.nybooks.com/articles/1982/02/04/recession-economics/ [accessed on 8th November 2018]

financial entities can honour their claims (or be unwound effectively), that investors are protected and that the market has integrity.

Although the trickle-down effect is contradicted by large amounts of evidence[386] in practice, notably by campaigns for tax justice,[387] it remains an implicit, largely hidden and under-examined basis for much discourse within the market paradigm. Consequently it is often taken for granted and provides subtle underpinnings for many of the deliberations on the rationales for conduct regulation. The effect of employing trickle-down economics in market-based approaches to regulation is that there is an implicit and pervasive view in many of the arguments for regulation, that wrongly conflates the protection of the financial well-being of the firm and of its capital providers with what is the right regulatory course of action to protect societal stakeholders. Regulation is justified by the argument that if investors are protected, this will allow them to make capital commitments. Investor returns are re-distributed from a societal welfare standpoint through the trickling down within society of the effects of their investment making society as a whole better off through the increased production and through the wealth distribution in society by the spending of investors. But the protection of consumers when seen through the 'trickle-down' lens is justified by consumers' ability and willingness to participate in markets and buy / consume the financial products that the investors have contributed to generating.[388] Note that this still lies within the financialised paradigm of counting consumers and investors (ie those with the means and ability to participate in financial markets), not citizens or civil society stakeholders. The interest in market integrity similarly is to allow investors to be able to trust the markets, so they will invest. This is evidenced clearly through the post-crisis mainstream and industry narratives of 'rebuilding trust' in the financial system.[389]

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386 Dabla-Norris, E., Kochhar, K., Suphaphiphat, N., Ricka, F., Tsounta, E., 'Causes and Consequences of Income Inequality: A global perspective', IMF Staff Discussion Note at https://www.imf.org/external/pubs/ft/sdn/2015/sdn1513.pdf [accessed on 8th November 2018]

387 Sikka, P., Wilmott, H. (2013), 'The tax avoidance industry: accountancy firms on the make', *Critical Perspectives on International Business*, Vol. 9 Issue: 4, pp.415-443, at https://doi.org/10.1108/cpoib-06-2013-0019 [accessed on 8th November 2018]

388 Olsen, N., (2017), From Choice to Welfare: The Concept of the Consumer in the Chicago School of Economics, *Modern Intellectual History*, 08/2017, Volume 14, Issue 2 pp 507-535 at https://doi.org/10.1017/S1479244316000202 [accessed on 8th April, 2019]

389 Carney, M., (2013), Rebuilding Trust in Global Banking, Remarks by Mr Mark Carney, Governor of the Bank of Canada and Chairman of the Financial Stability Board, to the 7th Annual Thomas d'Aquino Lecture on Leadership, Lawrence National Centre for Policy and Management, Richard Ivey School of Business, Western University, London, Ontario, 25 February 2013 at https://www.bis.org/review/r130226c.pdf [accessed on 8th November 2018]

This broadened conduct agenda which includes the protection of consumers and investors in retail and wholesale environments, although a step forward from pure investor protection, therefore remains entrenched[390] in a more market-dominated welfare economics approach to regulation. The protection of investors and consumers is seen in a very instrumental way as benefitting the market. It could also be argued that it is therefore predicated upon enabling wealth extraction for those with finance capital. This approach therefore fails to engage with the more substantive political motives of regulation[391] and fails to justify regulation in terms of what society needs from regulated financial entities and how they should behave. Instead it is framed and justified by what the financial markets and entities need to do in order to continue society's contributions to them, as capital providers and consumers. The emphasis even post-crisis therefore, for many firms and regulators has been on justifying regulation as a means for protecting financial entities' financial status or reputation. Allied efforts have therefore been directed at enhancing communication in line with this, such as the use of mechanisms supporting disclosure and transparency to rational actors. The debate is framed around the discourse of offering choices to rational actors who then take responsibility for their choices[392] (which we will see in the following case study of USS), rather than on the underlying factors that make the system and its institutions, people and processes trustworthy[393] and contributory to societal needs and outcomes.

In the UK, this focus on consumer protection therefore can be seen time and time again as being a response to scandals or serious failures and the perceived need to justify trust in the system. Given the visible and widespread failures to regulate the behaviours of financial intermediaries as they engaged with consumers in regulated sub-sectors such as insurance and pension schemes, buyers of credit products including loans and mortgages, together with consumers of advice from regulated financial intermediaries, the regulator responded by tightening its consumer protection agenda. It is arguable that this kind of regulatory response is intrinsically drawn from the more fundamental commitment to market primacy, because the aim is to restore trust in markets, so as to enable what is seen as its efficient functioning. The UK

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[390] Ireland, P., (2010), 'The Financial Crisis: Regulatory Failure or Systems Failure', *The Future of Financial Regulation,* Oregon

[391] Harnay, S., (2016), The influence of the economic approaches to regulation on banking regulations: a short history of banking regulations, *Cambridge Journal of Economics*, Vol 40, Issue 2, pp 401-426

[392] Olsen, N., (2017), From Choice to Welfare: The Concept of the Consumer in the Chicago School of Economics, *Modern Intellectual History*, 08/2017, Volume 14, Issue 2 pp 507-535 at https://doi.org/10.1017/S1479244316000202
[accessed on 8th April, 2019]

[393] O'Neill, O. (2018) Linking Trust to Trustworthiness, *International Journal of Philosophical Studies,* Volume 26, Issue 2, pp 293-300 [online] at https://doi.org/10.1080/09672559.2018.1454637 [accessed on 10th November 2018]

regulator has clearly conducted reviews of cross-sectoral issues, market studies and what it calls thematic reviews.[394]

Across both prudential and conduct regulation, regulators also exercise their powers to oversee the regulatory perimeter (including ensuring fitness and propriety and the meeting of threshold conditions), governance, culture, enforcement and so on, as these have a significant bearing on the execution of the prudential and conduct responsibilities. Depending on regulatory remit, they may also have objectives and powers in relation to the promotion of competition, preservation of the domestic market, prevention of financial crime and so on, that may sit alongside their prudential or conduct regulation mandate. These regulatory objectives – notably the one on competition – further entrench the marketised, financialised narrative of financial regulation

How can post-GFC learning about macro-prudential regulation be applied to conduct regulation

The comments within this section seek to engage with two key findings from the analysis of the causes of the global financial crisis and to use them to introduce a new insight to the development of conduct regulation.

The first of these is the step-change in regulation after the crisis when it was more broadly acknowledged that a solely micro-prudential approach to prudential regulation, was based on the false premise that the resolvability of individual firms would form an effective mitigant and forestall system-wide distress. In hindsight, it was obvious that this assumption was incorrect. Tarullo (2013) refers to this change as shaking up the 'intellectual foundations' of regulation[395] leading to the introduction of a macro-prudential approach to prudential regulation to partner micro-prudential regulation.

[394] Financial Conduct Authority (2016), Thematic Reviews webpage on the Financial Conduct Authority website, originally published on 05/05/2016last updated on 04/09/2018 at https://www.fca.org.uk/about/supervision/thematic-reviews [accessed on 10th November 2018]

[395] Tarullo, D., (2013), Speech at the Yale Law School Conference on Challenges in Global Financial Services, New Haven, Connecticut, [online] at https://www.federalreserve.gov/newsevents/speech/tarullo20130920a.htm [accessed on 2nd November, 2018]

The second is the growing recognition of the role of financialization[396] and the pre-eminence of the market paradigm, in engendering the GFC.[397] Because financialization increases the power of finance capital, creates greater scope for regulatory arbitrage, understates contagion and results in a lop-sided system, winnings are harvested for financiers, and civil society stakeholders pay the price. For example, trading in commodities derivatives causes serious hunger and deprivation to ordinary people in developing / food-producing countries.

In the more developed market economies where financial interests have power, regulation is considered a burden on finance capital and is condoned as a necessary evil that must be minimised. Light-touch regulation that engages with issues in a minimally invasive manner is the norm. These approaches were extensively used and form a significant part of the pre-crisis narrative[398] around regulation. However, the post-crisis narrative amongst regulators and indeed academics studying regulation, while it acknowledges[399] the issues of the neglect of contagion, widespread misbehaviour[400] and opposition to regulation, continue to frame regulation using pre-crisis market-centric economic rationales.

While there is a superficial engagement with these issues, there is a marked lack of practical regulatory will in the UK to refocus the rationales for public-interested regulation towards the substantive political rationales for regulation rather than towards the economic rationales for regulation. An example of the continuation of engagement with the market paradigm lies in how the FCA now engages with competition as part of its regulatory remit. There are widespread examples of mis-selling (PPI),[401] mispricing (interest rate hedging products and investment management), poor complaints handling (retail banking and SME lending), hidden charges and fees (credit cards), collusion manipulation and rate-fixing (LIBOR), facilitation of structures and instruments that deliberately undermine govt policy and taxation arrangements (Paradise and Panama chapters revelations), miscommunications to consumers and policy holders (pension

[396] Krippner, G., (2012), *Capitalizing on Crisis,* Harvard University Press

[397] Palley T., (2013), 'Financialization: What It Is and Why It Matters' in *Financializatio*n. Palgrave Macmillan, London

[398] Brown, G., (2006), Speech by the *(former)* Chancellor of the Exchequer, the Rt. Hon Gordon Brown MP at the Mansion House, London on 21st June 2006 archived within the National Archives at http://webarchive.nationalarchives.gov.uk/20100407173744/http://www.hm-treasury.gov.uk/speech_chex_210606.htm [accessed on 12th November 2018]

[399] Crooks, E., (2008), 'The Watchdog Who Should Have Barked Louder', *Financial Times* Lombard Opinion column, September 19th 2008 at https://www.ft.com/content/70b08710-8691-11dd-959e-0000779fd18c [accessed on 12th November 2018]

[400] Parajon Skinner, C., (2016), Misconduct Risk, *Fordham Law Review*, at https://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=5176&context=flr[accessed on 12th November 2018]

[401] Ferran, E., (2012), Regulatory lessons from the payment protection insurance mis-selling scandal in the UK, *European Business Organization Law Review*, 13(2), 247-270 at doi:http://dx.doi.org/10.1017/S1566752912000171 [accessed on 8th April 2019]

transfers) and the deliberate exacerbation of information asymmetry and moral hazard problems through the creation and use of complex structures and instruments. Yet, the regulatory approach in the UK has continued to deal with this at an individual firm-level or at a thematic level on an ad-hoc basis at best. There is little holistic challenge of misconduct within the industry at a more macro-level. This challenge seems like an obvious necessity given the widespread evidence of regulated firms across the regulatory landscape participating in financial activities in a manner that often games the system, re-engineers rules, captures regulators and lobbies for its own interest in a manner that seriously impinges upon the democratic rights of other civil society stakeholders.

Therefore, this thesis argues that many of the myths arising from a financialised approach to markets dominant prior to the crisis remain staunchly in place even post-crisis. While the narratives of systemic risk and contagion have taken root within the prudential discourse allowing the macro-prudential approaches to have a role, there is little recognition of the need to address these issues from within the conduct agenda. These myths are that:

- the conduct of specific financial intermediaries and the disposition of financial markets as a whole, are dichotomous and mutually exclusive. This is the main argument that matches the broader macro-prudential argument.
- the background conditions against which stakeholders and the real economy interact with financial intermediaries or financial markets, are largely fair, and any instances of poor conduct / misbehaviour, are aberrations from the norm
- policy makers (and citizens) do not need to draft regulation that consults with and protects a wider range of stakeholders. They should focus their attentions on owners of finance capital (i.e. investor protection)[402] and overcoming the irresponsibility or information asymmetries that affect a small number of weak participants who, to all intents and purposes, should not be participating in the markets anyway (because they are incapable of understanding sophisticated markets) and who, for the most part, should only interact with the markets through more sophisticated financial intermediaries who will protect their interests and are best placed to price risk and reward in the markets.

The changes to conduct regulation suggested by this chapter therefore mirror some of the trajectory in the changes from a micro-prudential approach to prudential regulation to a more nuanced balance of micro-prudential and macro-prudential regulation post-crisis. They also

[402] Friedman, M., (1962), Capitalism and Freedom, 1982 edition, University of Chicago Press [online] at http://circuloliberal.org/livros/capitalismo-e-liberdade.pdf [accessed on 14th February 2018]

take forward the critiques implicit in requiring the removal of a purely economic approach to regulation

Macro-conduct regulation

Currently the structure of financial regulation in the UK, appears somewhat lopsided when the structures of prudential and conduct regulation (the twin-peaks) are viewed side by side. As discussed above, prudential regulation is sliced into micro-prudential and macro-prudential regulation,[403] offering the possibility for regulatory policy-making and intervention at the level of the individual firm (micro-prudential) and at a more systemic-level (macro-prudential) with associated tools and techniques and complementarities. Conduct regulation[404] on the other hand is conceived as market-conduct regulation and consumer protection regulation. While superficially it may appear that market conduct regulation would look at markets more holistically, in reality market conduct regulation is designed to deal with the oversight of primary and secondary markets within the securities industry. Consumer protection regulation has largely evolved according to the challenges of retail financial services consumers.

From a theoretical perspective, there is a clear imbalance when drawing parallels between prudential and conduct regulatory interventions. Given that many of the insights into regulatory framework improvements post-crisis are largely in the prudential domain and have been perceived through the valid lens of macro- versus micro- issues, it would be valuable to make that understanding more symmetric on the conduct side through extending the parallel branch of the regulatory tree and recalibrating the classification of conduct regulation so as to take account of the systemic implications[405] of misconduct.

It is also worth making the point at this stage that the narrative of both market conduct and consumer protection regulation post-crisis was aimed at restoring trust in the financial system and encouraging / retaining consumption of financial products and services playing to a financialised narrative that places the well-being of the financial sector at the heart of

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[403] Tucker, P., Hall, S., Pattani, A., (2013), Macroprudential Policy at the Bank of England, *Bank of England Quarterly Bulletin*, Q3 2013, [online] at https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2013/macroprudential-policy-at-the-boe.pdf?la=en&hash=04FF3BF0E925A41CA47F56671ECE0A4D8E0331F5 [accessed on 23rd February 2019]

[404] Financial Conduct Authority, 'Market Conduct', FCA Handbook, [online] at https://www.handbook.fca.org.uk/handbook/MAR.pdf [accessed on 23rd February 2019]

[405] Parajon Skinner, C., (2015), 'Misconduct Risk', *Fordham Law Review*, Vol 84, Issue 4 at https://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=5176&context=flr [accessed on 1st December 2018]

regulatory initiatives. If instead we take a slightly different perspective and examine the need for trustworthiness of the financial sector, not just from the point of view of the sector's needs but from the view of what the real economy needs, then there is significant room for improvement in the ways the regulatory architecture is currently cast in the conduct space.

One question that might be asked is: isn't market conduct regulation the answer that addresses systemic risks on the conduct side? By its very definition does this not have market-wide aspects? The answer is that, in practice, regulatory actions including enforcement for market misconduct are taken at an entity-level, making this form of regulatory activity quite micro-focussed in real terms. Consumer protection regulation similarly does not have a simple micro-dimension because the issues of misconduct that fall into the consumer protection bucket have serious system-wide implications that necessitate a more system-wide approach to their regulation. Exploring the wider social and economic costs of misconduct, Parajon-Skinner (2016) points out the differing treatments given to prudential regulation vis-a-vis conduct regulation. She points out that regulators reacted to the global financial crisis by engaging more holistically and systematically with risk types that are traditionally calculated using quantitative models. Yet the systemic dimensions of misconduct were not acknowledged in the same way. Despite evidence of industry-wide misconduct, the systemic aspects of the risks arising from misconduct were neglected[406]

The only exception in the UK regulatory approach on conduct regulation is in the tool termed as a thematic review.[407] These reviews are described by the FCA as mechanisms they use 'to assess a current or emerging risk regarding an issue or product across a number of firms in a sector or market. It can focus on finding out what is happening and suggesting ways of tackling the problem'. Although such thematic reviews can have a broader sub-sector-wide or sector-wide focus, they still do not compensate for the lack of a systematic approach to misconduct, because these reviews are generally done on an ad-hoc basis on issues of importance, and may have no regular standing or repetitive systematic inclusion in the regulatory calendar. Also, by their very nature, they focus on themes of importance driven reactively by issues of the day, rather than on pre-emptive, proactive approaches to systemic risk.

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[406] Parajon Skinner, C., (2015), 'Misconduct Risk', *Fordham Law Review*, Vol 84, Issue 4 at https://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=5176&context=flr [accessed on 1st December 2018]

[407] FCA website, (2018), Thematic Reviews, [online], at https://www.fca.org.uk/about/supervision/thematic-reviews [accessed on 30th November 2018]

It is also worth noting historian Niklas Olsen's observations that the existing approach to regulation is based in Chicago school ideology, and undermines and negatively reconstructs regulation in respect of the substantive political rationales for regulation. Olsen notes that those who support this ideological position 'shared the ambition of rethinking how the functions of the state could be redefined to secure a free market and individual freedom. The positive notion of the state — and other political institutions — as the guarantor of a competitive order is crucial to the way in which these neoliberals sought to distinguish their project from the political economy of so-called classical liberalism'.[408] This positive notion of the state is integrally bound with what is also a singularly weak bounded approach to the scope of what regulation and regulators should do as encapsulated by the FSA's pre-crisis penchant for 'light-touch' regulation and for allowing firms to envision their own business models[409] without regulatory challenge of anything other than the micro-prudential consequences. These approaches were severely criticised for contributing to the GFC.[410]

Noting the lessons from the GFC, what then becomes obvious is that there is no space on the conduct-regulation classification for a meaningful engagement with issues that span the financial system as a whole. Endemic misbehaviour in the system, that is often bolstered by this lack of oversight, for example, is not tackled, and for certain serial offenders amongst the regulated entities, the cost of the regulators' fines and penalties for misconduct is often viewed by the firms as the 'cost of doing business'. This resonates with the findings from the prior chapter's analysis of causes of the GFC.

This theoretical gap is therefore addressed by introducing a more orderly approach of providing systematic and holistic regulation of misconduct that engages with systemic dimensions of conduct risks and the associated possibilities of contagion. This, in essence, is the primary scholarly contribution of this chapter. The chapter suggests that as a parallel to macro-prudential regulation, we must take a more holistic view of conduct and recognise that behavioural issues should not be viewed in isolation but in the context of their linkages within

[408] Olsen, N., (2017), From Choice to Welfare: The Concept of the Consumer in the Chicago School of Economics, *Modern Intellectual History*, 08/2017, Volume 14, Issue 2 pp 507-535 at https://doi.org/10.1017/S1479244316000202 [accessed on 8th April 2019]

[409] Financial Conduct Authority, (2014), Final Notice against Lloyds Bank Plc and Bank of Scotland Plc dated 28th July 2014 at https://www.fca.org.uk/publication/final-notices/lloyds-bank-of-scotland.pdf [accessed on 8th April 2019]

[410] MacNeil, I. , (2010), The trajectory of regulatory reform in the UK in the wake of the financial crisis, *European Business Organisation Law Review*, 11 (4). pp. 483-526 at http://eprints.gla.ac.uk/41807/1/41807.pdf [accessed on 8th April, 2019]

the financial system and beyond. They can be transmitted across the system to create, amplify or transform systemic shocks and failures.

Macro-conduct regulation is aimed at evaluating, overseeing and ensuring the effective management or mitigation of the system-wide sources, transmission and consequences of misconduct, so as to effectively address negative consequences for societal stakeholders and the real economy. It must be noted that there is both a complementarity and a tension between micro-and macro- conduct oversight. This is similar to the tension[411] between macro-prudential and micro-prudential supervisory objectives. There is likely to be a valid and meaningful tension between what might be applicable to conduct supervision at a firm-level vis-à-vis the regulatory oversight and tools applied at a sub-sectoral or sectoral level. This is because the micro-conduct regulation is aimed at addressing idiosyncratic instances of misconduct that are specifically at a regulated entity-level while the latter is more attuned to the real economic impact of the creation and transmission of systemic failings.

Using a welfare-economics narrative, the role of macro-conduct regulation could partially (and this is an important qualifier because there are multiple other roles) be described as ensuring that the regulated financial industry internalises the systemic impact of its misconduct. To do this, macro-conduct regulation must be able to grapple substantively with the externalities that the regulated financial system imposes upon the economy. In this role, it can also provide useful proactive data and signals that help to shape not just macro- and micro-prudential and micro-conduct regulation, but also fiscal policy, monetary policy and the regulatory perimeter. How and why this could and should be done is discussed further below.

As discussed when explaining the causes of the global financial crisis, much of the energy and reform that was undertaken post-crisis has been blunted by financialization. Macro-conduct regulation could help to sharpen the application of regulation by returning to first principles about the nature and purpose of finance. We are well aware that too little finance acts as a barrier to economic development. But as Shaxson (2018) points out, many economies are now suffering from a different blight, known as the finance curse, meaning too much finance of the wrong sort.[412] This offers an important prompt to re-examine from first principles what society

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[411] European Central Bank, (2014), Special Feature C, *Financial Stability Review*, May 2014, at https://www.ecb.europa.eu/pub/pdf/fsr/art/ecb.fsrart201405_03.en.pdf?0ee45487b0d8552eb4ec32396d2702c7 [accessed on 21st February 2019]

[412] Shaxson, N., (2018), *The Finance Curse,* Bodley Head*,* London

needs and wants from finance, and what scale finance can legitimately have in a well-functioning economy. One natural reaction to such a proposition would be to recognise that re-examining the fundamental purpose and remit of finance and financiers in a democracy would require democratic deliberation. In such a democratic discussion, power arrangements would need to be reconfigured to genuinely put citizens' views front-and-centre.

However, such democratic deliberation can be undermined if elected parliamentarians have to perform this examination without a meaningful understanding of the scale, complexity, scope and mechanics of financial markets and instruments, as well as their application in the economy, which may differ from their theoretically envisaged purpose. This makes it important for regulators to participate in a meaningful way to inform such deliberation by providing both data and insights and to help ensure that legislation has depth and can hold the regulated community to account where needed.

One of the key areas for macro-prudential and macro-conduct regulators to be able to provide intelligence could be in the area of credit-extension and debt. Montgomerie (2018),[413] explains 'while policymakers have focused their efforts on trying to reduce the level of public debt, rising levels of household debt have been ignored'. In doing so it is helpful to understand which types of financial instruments and causes are fuelling the build-up of debt and what segments of the economy the credit and debt bubbles are operating in. This is not just a case of understanding the numbers at a holistic level (something governments could solely rely on central banks and macro-prudential regulators for), but also to understand the behavioural aspects of the credit extension (macro-conduct), both across financial intermediaries extending credit and across the indebted individuals or commercial entities taking on the debt. Contributions from macro-conduct regulators could be envisaged to help answer questions such as:

- which types of regulated financial entities are extending credit in the economy, what proportion of unregulated entities are extending credit or credit-like solutions (ie the pre-crisis problem of shadow-banking)
- what business models are being used, what forms is the credit-extension taking, in terms of instruments or innovations being developed,
- what is the narrative accompanying the sale and what are the techniques that are being used to sell the credit,
- who is "buying" the credit and why,

[413] Montgomerie, J., (2018), Curbing the Debt Economy, *New Thinking for the British Economy*, pp 112-121, Open Democracy [online] at https://drive.google.com/file/d/1IqNRG_c75D6nlGrKTxh569rfr1ybF7AC/view [accessed on 21st February 2019]

- what is such credit being applied to - is there a productive or speculative purpose
- to whom are the gains being apportioned
- are there any instruments that are resulting in leakage or improper use,
- are the rates at which credit is being extended consistent with monetary policy aims and so on.

Many regulators shy away from appearing to drive or be driven by governmental policy because regulatory independence is seen as a key way to emphasise regulatory legitimacy. Majone (2007) notes that 'These non-elected bodies' legitimization is normally based on a large array of 'non-democratic' justifications, but primarily the need for insulation from day-to-day politics and technical expertise'.[414] Meaningful macro-conduct regulation would therefore not just require a more nuanced application of the regulatory toolkit but the development of strengths and resources in areas that have hitherto been considered best left outside the regulatory ambit.[415]

In this regard, key areas of change include allowing such macro-conduct regulation to engage more clearly with the substantive political rationales for regulation that are currently articulated through fiscal and monetary policy (ie through progressive taxation and the use of inflation and unemployment targeting). A combined fiscal, monetary and macro-micro approach to regulation would allow the state to have control over the real economy by exerting control over its enablers in finance.

Invoking the power of such a regulatory understanding of purpose, instrument, market and entity would however help provide a more nuanced application of monetary and fiscal policies, as well as engaging with the challenges posed by financialization. It would help to have more holistic responses across different policy spheres and using different instruments, one segment of which would be carried out through regulatory policy, supervision and enforcement at macro- and micro- levels, while others may require complementary actions using monetary and fiscal policy instruments. Some issues may be remedied by including certain types of entities within the regulatory perimeter to ensure appropriate regulatory oversight of the provision of

[414] Majone, J., 'From the Positive to the Regulatory State', Journal of Public Policy, Vol 17, No 2 pp 139-167 [online] at https://www.jstor.org/stable/4007608 [accessed on 17 March 2019]

[415] Griffith Jones, J., (2017), 'What makes good conduct regulation?', Speech at event at Cambridge Judge Business School, Cambridge on 14th February 2017 [online] at https://www.fca.org.uk/news/speeches/what-makes-good-conduct-regulation [accessed on 21st February 2019]

such credit instruments, whatever forms they may take, to help cope better with financial and legal engineering. An example of this is including hedge funds and providers of private equity within the purview of the regulation. Others may require the education of or communications with consumers or those designing and selling certain types of financial instruments to help reconcile the notions of agency and personal choice with the structural issues that prevent informed choice. An example of this is yet others may require reconfiguration of the markets or addressing behavioural lapses through enforcement, taxation, withdrawal of money in circulation or closing loopholes.

Together, this recalibration helps to deal with both the contagion in conduct issues within the financial system and the need to think more holistically about the application of systemic levers and the interconnections between monetary policy, fiscal policy, moral suasion and financial regulation.

Conclusion

After the global financial crisis, the structure of prudential regulation was radically reformed. The new structure was built on the recognition that there are systemic aspects to risk, that cannot be dealt with through micro-level adjustments to the supervision of individual firms. It was acknowledged that existing structures of micro-prudential regulation coupled with high-level financial stability work and ad-hoc thematic interventions were insufficient to deal with the systemic risk issues in an orderly and thorough systematic way. Macro-prudential regulation seeks to address this gap in oversight by taking into account the effects of the interactions across different firms and systemic impacts thereof. This chapter makes a contribution to the scholarly literature on regulation by applying existing developments in regulatory theory from the parallel field of prudential regulation, to the study and practice of conduct regulation. In doing so, it makes a critical contribution by highlighting the narrow way in which conduct regulation is currently conceived. It also moves the narrative away from being focussed on consumers and shareholders (both defined by their access to finance capital), to a more holistic interpretation of civil society and citizen needs from financial regulation. In doing so, it develops the substantive political approaches within the public interest theories of regulation. Directions for further research are developed within the concluding chapter of this thesis as a whole.

Chapter 3: USS Case Study

This chapter is a case study of the Universities Superannuation Scheme (USS) as set out against the backdrop of the industrial disputes, and the financialization of Higher Education (HE). The case examines questions of inequality, justice, power, narrative distortion and harm production, that foreground an investigation into risk-sharing at USS. Drawing on two issues – one of prolonged employer underpayments into the USS Scheme and the second of supposedly prudent de-risking, the case illustrates how financialisation provides the underpinning logic for the erosion of civil society interests. Such interests include the interests of ordinary citizens within the UK and global communities within which USS operates. Using the two instances it particularly explores how financialisation can cause, and facilitate manipulations of the narrative around risk so as to legitimise the prioritisation of the interests of powerful actors. In doing this, the case observes how risk as an overarching term is conceived, and how this conception can include or exclude risks to civil society. It also explores how the gains or losses from risk-taking are apportioned and how the protections afforded to citizens by financial regulation are undermined. At its core, the case seeks to shine a powerful light on, in a financialised context, how risks are conceptualised, and how this leads to risks being distributed or re-distributed between elite actors and civil society, to the detriment of civil society and in particular, ordinary citizens. Given that pensions valuations are fraught with complexity, the case highlights how information asymmetry is exacerbated by financialised narratives around risk, that in turn undermine debate and citizen protections including those afforded by public-interest financial regulation.

Context

In 2018, circa 42,000 employees in the Higher Education (HE) sector undertook a 14-day period of sustained strike action.[416] This was followed up by 8 days of strike action in 2019,[417] and a further 14 days of strike action in 2020.[418] This unprecedented action caused significant and visible disruptions to the HE sector. The strike arose because employers, having negotiated reductions in pension benefits in 2016, had argued in 2017 and 2018 for the closure of the

[416] Bridge, P., (2019), Trade Dispute Letter sent on behalf of the University and College Union (UCU) to participating HE employers, [online] at http://www.uculeicester.org.uk/ucu/wp-content/uploads/2019/06/USS-Trade-Dispute-Letter-to-institutions.pdf accessed on 22nd June 2019

[417] Weale, S., Pidd, H., (2019), University strike: tens of thousands of staff walk out across UK, *The Guardian* newspaper, 25th Nov 2019 [online], at https://web.archive.org/web/20200203101355/https://www.theguardian.com/education/2019/nov/25/university-strike-staff-walk-out-uk-pay-pensions accessed on 3rd February 2019

[418] Jack, A., Cumbo, C., (2020), Universities face fresh strike over pay and pensions, *Financial Times* 19th Feburary 2020, (online) at https://www.ft.com/content/cc06eb18-5330-11ea-8841-482eed0038b1 accessed on 3rd March 2020

Defined Benefit (DB) segment of the Universities Superannuation Scheme (USS). Instead of employers continuing to bear the risk of providing a guaranteed pension sum to USS members in retirement, it was suggested that current and future employees would instead bear the risks of Scheme performance in entirety, because the Scheme would be turned into a Defined Contribution (DC) Scheme for future accrual, changing the fundamental nature of the Scheme.[419]

The strike action also motivated many university staff to use their multi-disciplinary skills to engage in the discourse about the Universities Superannuation Scheme (USS) pension. This work was able to unpick the narrative of how risk is shared between qualifying employers and members of the Scheme and also surfaced a wide range of questions including about risk, about the role of The Pensions Regulator, about university finances and priorities, and about the longer-term sustainability of the Scheme. These questions went beyond the typical level of scrutiny and enquiry regarding pensions decisions, which are typically predicated in the language of finance, and turned the discussion into a more holistic exploration of risk and pensions. The chapter will now examine some of these questions more closely.

This chapter's contributions to the literature lie in its unique investigation of the case of the USS pension fund, using not just the traditional lens of finance (and associated pensions modelling), but also scholarship from multiple disciplines. The case draws upon insights from history, regulation, accounting, sociology, political science, law, finance and actuarial science that recast some of the questions about risk, and the narrative around risk-sharing. It will provide a new multi-disciplinary vantage point for scrutiny of the issues on pensions using USS as its basis. Critical discussions are then animated around the public interest rationales for regulation - building upon work by scholars including Young[420] and Feintuck,[421] and around corporate governance and the use of the mechanisms of transparency and disclosure by Clarke.[422] These discussions also build on literature around power, narratives and inequality informed by scholarly work by Herman and Chomsky,[423] and Lukes,[424] the practical consequences for dissent

[419] Universities UK, (2014), USS Funding and Benefits – Consultation by Universities UK, at https://www.ox.ac.uk/sites/files/oxford/field/field_document/USS%20funding%20and%20benefits%20-%20consultation%20by%20Universities%20UK.pdf?source=post_page-------------------------- accessed on 23rd July 2019

[420] Young, I. M., (2011), *Responsibility for justice,* Oxford University Press, Oxford

[421] Feintuck, M., (2010), 'Regulatory rationales beyond the economic: In search of the public interest' in eds, Baldwin, R., Cave, M., Lodge, M., (2010), *The Oxford Handbook of Regulation*

[422] Clarke, T., (2007), *International Corporate Governance: A comparative approach*, Routledge, London

[423] Herman, E., Chomsky, N., (1998), *Manufacturing Consent*, Pantheon, New York

[424] Lukes, *S., (1974), Power: A radical view,* Macmillan, *London*

and critical investigation as discussed in a key work on the policing of dissent by Sikka et al.[425] It will also consider the works of scholars such as Tombs[426] and Simpson[427] that shine a spotlight on crucial aspects of harm production rather than on the traditional focus of risk management technique, for instance harm attenuation. The case study also builds on work in the area of financialization by scholars including Epstein,[428] Sawyer,[429] Palley,[430] Crotty,[431] and Krippner,[432] that also animate discussions in earlier papers within this thesis. This then allows us to see a different panorama of risks present in changes that have been or are to be made to USS, in addition to the more straightforward financial risks that are typically examined.

As this chapter is a case study there is no separate literature review section and the discussions of key papers are woven in and throughout the following discussion.

Methodology

The chapter employs a case study approach. Baxter and Jack (2008) point out that 'Qualitative case study methodology provides tools for researchers to study complex phenomena within their contexts. When the approach is applied correctly, it becomes a valuable method … to develop theory, evaluate programs, and develop interventions'.[433] Ruzzeni (2014) argues that 'case-based reasoning locates the ultimate source of our epistemic and moral intuitions in the

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[425] Mitchell, A., Sikka, P., Wilmott, H., (2001), Policing knowledge by invoking the law: Critical accounting and the politics of dissemination, *Critical Perspectives on Accounting*, Vol 12, Issue 5, pp 527-555 (online) at https://doi.org/10.1006/cpac.2000.0452 accessed on 3rd February 2019

[426] Tombs, S., (2019), 'Grenfell: The Unfolding Dimensions of Social Harm', in eds Mitchell, D., Pantazis, C., Pemberton, S., (2019), *Justice, Power and Resistance*, Vol 3, Issue 1, pp 61-88

[427] Simpson, A., (2019), 'The culture of moral disengagement and harm production in the City of London's financial services industry', in eds Mitchell, D., Pantazis, C., Pemberton, S., (2019), *Justice, Power and Resistance*, Vol 3, Issue 1, pp 115-133

[428] Epstein, (2005), *Financialization and the world economy,* Edward Elgar

[429] Sawyer, M., (2014), 'What is financialization?', *International Journal of Political Economy: a journal of translations*, (online) at http://eprints.whiterose.ac.uk/82350/ accessed on 3rd February 2019

[430] Palley (2007), 'Finanzialization: What it is and why it matters', Working Chapter Number 153, University of Massachusetts Amherst Political Economy Research Institute Working Chapter Series, presented at a conference on "Finance-led Capitalism? Macroeconomic Effects of Changes in the Financial Sector," sponsored by the Hans Boeckler Foundation, Berlin, Germany, October 26 – 27, 2007 (online) available at http://scholarworks.umass.edu/cgi/viewcontent.cgi?article=1124&context=peri_workingchapters [accessed on 21st August, 2017]

[431] Crotty, J., 'The Neoliberal Paradox' in ed. Epstein, G., *Financialization and the World Economy*, pp 77–110, Edward Elgar

[432] Krippner, G., (2004), What is Financialization, cited in ed. Epstein, G., (2005), *Financialization and the World Economy*, Edward Elgar Publishing

[433] Baxter, P., Jack, S., (2008), Qualitative Case Study Methodology: Study Design and Implementation for Novice Researchers, *The Qualitative Report*, Volume 13 Number 4, December 2008, pp 544-559 (online) at https://nsuworks.nova.edu/tqr/vol13/iss4/2 [accessed on 23rd July 2019]

concreteness and idiosyncrasy of particulars'[434]. Fry et al (1999)[435] explain the role of case studies in allowing readers to reflect upon the complexity and context of a particular problem or a particular example, while using the example in itself to illustrate the main themes of key societal questions. In the context of this, the use of a case study approach offers a microcosmic exploration of specific issues within USS, that play to the broader theme of this thesis, i.e. the role of financialization in corrupting discussions of risk and rebalancing power from civil society stakeholders towards elite interests. The case study approach also lends itself to engaging with the socio-economic questions around finance, which form the motivation for this thesis.

Reasons for case study approach

A case study approach has been adopted for this paper, for a few key reasons. USS, as one of the last surviving Defined Benefit (DB) pensions in the UK, may also be seen as something of an exemplar of a category of valuable societal retirement provision that, the evidence in this case suggests, has been ruthlessly eroded as a consequence of financialization, thus causing detriment to civil society stakeholders.

While the circumstances for the decline of different DB pension funds may vary, the case of USS helps illustrate the broader point about the imbalance of power between those trustees communicating about the health of a pension Scheme and ordinary members, even when highly skilled and knowledgeable. This imbalance of power can mean that even a healthy, cash-flow positive pension fund such as USS, can be misrepresented as being in financial difficulties to fit in with a narrative that suits powerful interests. USS, in this sense, is a contemporary exemplar of manufactured crises in finance, that lie at the confluence of inadequate corporate governance, narrow or misconstrued regulation, and neoliberal ideology, resulting in poor outcomes for citizens and consumers.

The issues around risk cited within this case study help to reaffirm a point made in the first chapter within this thesis. Financialization increases moral hazard, and causes financiers to take more risk because of a lack of accountability for their actions. Such behaviours cause artificial distortions in asset prices. This inhibits the interaction of aggregate demand and supply functions and affects how price is determined within the market mechanism. The USS case

[434] Ruzzene, A., (2018), Using case studies in the social sciences: Methods, inferences and purpose, Erasmus Journal For Philosophy and Economics, Vol 8 (1) [online] at http://ejpe.org/pdf/8-1-ts-1.pdf [accessed on 20th April 2020]

[435] Fry, H., Ketteridge, S., Marshall, S., (1999), *A Handbook for Teaching and Learning in Higher Education*, Kogan Page

study also provides continuity within the thesis by offering a contemporaneous example to illustrate another key point made in the first chapter on the global financial crisis of 2007. Similar to circumstances in that crisis, where there was seemingly no obvious single cause, there is a temptation to put the root cause of any serious issues down to happenstance or vagaries of the market. But further analysis about USS through the case study shows that there is a concerted effort to provide what McCluskey (2012) refers to as a veneer to cover up injustice[436] and the intentional expropriation of wealth by elites. Indeed, both unjust intent and preventable unjust impact are manifest in both the 2007 financial crisis and in the case of the erosion of the USS pension. Using the case study approach to draw this out permits a more nuanced exploration of the underlying issues marrying both theoretical precepts and real-world practice in a meaningful way. This helps to inform aspects of policy development that lie both at the core and on the periphery of the points made in this thesis within the first chapter on the financial crisis and the second chapter on macro-conduct regulation.

Limitations of the case study approach

While there are merits in the case study approach adopted in this chapter, it is clear that a case of this nature, dealing with a single entity, can, given its focus, only serve as a descriptive, illustrative and analytical aid to highlight certain key areas, rather than consistently providing generalisable findings.[437] Since this case study attempts to capture the complexity of the USS case, the learning derived would need appropriate modification for use in the case of other firms, given the specificity of attention on USS[438]. This case study does not seek to propose enhancements of the theory on pensions, but it can help to inform theoretical positions based on the evidence it provides.

How the case is developed

The case examines two key sets of decisions about risk-sharing. First the case examines underpayments. Then it evaluates the use of de-risking. Through both of these, the transfer of risk from employers to employees and the corresponding impact on the Scheme are discussed drawing links to financialisation. The case then briefly explores how the aims and objectives of The Pensions Regulator (TPR) have been interpreted in the context of Defined Benefit pension provision and more specifically in the debate around USS. The points made within the case connect around an exploration of the role of financialization in affecting the ways in which risk

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436 McCluskey, M., (2012), How the Unintended Consequences Story Promotes Unjust Intent and Impact, 22, *Berkeley La Raza Law Journal*, Vol 22, (online) at http://tinyurl.com/y59q476x [accessed on 12th August 2019].
437 Yin, R, (1989), *Case Study Research, Design and Methods*, Sage Publishing

438 McGloin, S., (2008), The trustworthiness of case study methodology, *Nurse Researcher,* Vol 16, Issue 1, pp

is apportioned. Financialisation, the case suggests, facilitates the transfer of risks from financial elites to citizens, and the transfer of rewards from citizens to financial elites.

Documenting the particular circumstances of USS, this chapter aims not just to engage with the specificities of USS, but also to use USS as an illustrative example to highlight various aspects of the thesis' underlying theme of financialization. The practical elaboration of the issue of financialization is set around Epstein's (2005) definition of financialization as 'the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies'[439]. In particular, there is a focus on the persistent enrichment of financiers, those who have control of capital and those who can benefit from institutional largesse, while the benefits and services to other stakeholders is steadily worn away.

This case study documents how some key corporate governance decisions appear inconsistent with the statutory duty of protecting members' (beneficiaries, current members and future members) interests. In doing so it draws attention to prolonged employer underpayments, the implementation of 'reckless de-risking', it briefly summarises issues with the use of a flawed valuation test known as Test 1, and decisions to change the articles of association of USS Limited in ways that reduce the powers of stakeholders.

The case study first charts the role of employer underpayments as a key contributor to the diminution of the fund. Using primary data, the paper reviews the context of such underpayments across three triennial valuation cycles between 1999 and 2008, as well as more recent attempts by USSL to explain these underpayments. The case study juxtaposes underpayments against the higher rates of contribution determined by the Scheme actuary as appropriate to meet future liabilities. It also notices the financial and economic context in which USS was operating at the time and the longer-term risks that the Scheme could have been exposed to. It then relates the reasons for and approval of, these underpayments to the underlying theme of financialization.

Then the case study looks at the process surrounding the valuation and in particular, more recent attempts to supposedly 'de-risk' the investment portfolio, in line with employers' risk appetite. The case study explores evidence of the way in which USSL proposes to undertake this 'de-risking' and offers an important insight into how financialization can erode the provision of

[439] Epstein, (2005), *Financialization and the world economy*, pg3, Edward Elgar Publishing, Cheltenham

real goods and services. The case attempts to show how this decision to 'de-risk' privileges employers over members, and how a financialized narrative is used to mask wider stakeholder detriment. To do this, the case also looks at the objectives of The Pensions Regulator (TPR) and key associated documents, to examine how TPR's focus on 'de-risking' through a movement into gilt-like instruments, has been misused to undermine viable DB (Defined Benefit) Schemes such as USS.

The case also elaborates on how the prioritisation of employer interests, regulator's philosophical predisposition to closing DB pensions, and the regulatory focus on the Pension Protection Fund (PPF) tie in to the broader theme of financialization, typically to the detriment of the longer-term real economic value generated by Defined Benefit pensions. In doing this, the case study juxtaposes a number of key things: risk-sharing within USS, the efforts to raise the trajectory of member contributions, the role of the TPR, and TPR's preferred approaches to conceiving, measuring and addressing risk. The focus is on the narrative, on how the gains from finance and risks are apportioned, and on how the protections afforded to citizens by financial regulation can be undermined by financialization. The paper also sets out how these concerns are consistent with Palley's (2007) observations that 'financial markets, financial institutions and financial elites gain greater influence.... impacts are to (1) elevate the significance of the financial sector relative to the real sector; (2) transfer income from the real sector to the financial sector; and (3) increase income inequality and contribute to wage stagnation'. [440]

Overview of the Scheme and its current financial position

History of the Scheme

Sir Douglas Logan's (1985) published account[441] of the birth of USS, explains how USS was set up in 1975 in response to concerns such as the lack of certainty of retirement benefits, complexity for individuals planning independently for how to invest contributions from employers and employees, that would pay out in retirement [i.e. the risks of a DC-style scheme], and inequity in risk-sharing especially for low-paid employees. These core concerns for members have resurfaced and serve as lodestars for any discussions of benefit reform almost

[440] Palley (2007), 'Finanzialization: What it is and why it matters', Working Chapter Number 153, University of Massachusetts Amherst Political Economy Research Institute Working Chapter Series, presented at a conference on "Finance-led Capitalism? Macroeconomic Effects of Changes in the Financial Sector," sponsored by the Hans Boeckler Foundation, Berlin, Germany, October 26 – 27, 2007 (online) available at http://scholarworks.umass.edu/cgi/viewcontent.cgi?article=1124&context=peri_workingchapters [accessed on 21st August, 2017]

[441] Logan, D., (1985), *The Birth of a Pension Scheme: A History of the Universities Superannuation Scheme*, Liverpool University Press, Liverpool

half a century later.[442] A dispute over the attendant risks arising from these factors and how this risk should be shared between employers and employees set against pay and conditions and management's priorities, has culminated in a pitched battle over the future of the Scheme.

The nature of USS and implications for the risk profile of the Scheme

USS is a funded, multi-employer, last-man standing, open, immature scheme. This affects the risk-profile of the Scheme in the following ways:

USS is a funded scheme. The Scheme acquires 'dedicated assets to cover the Scheme's liabilities'.[443] That means the employer systematically sets aside payments to cover the liabilities. These reflect 'arrangements where there is an accumulation of assets, mainly financial assets, from contributions, with the explicit objective of ensuring all, or a major part of, payment of the future benefits from these assets'.[444] This funded status is important because the progression towards paying off liabilities is gradual and planned, and therefore allows the Scheme to weather adverse outcomes better.[445] The funded status of the Scheme is also important from the point of view of the employers' desire to move to DC and the apportionment of risks from allocations of Deficit Recovery Contributions. Both these points will be discussed further in this paper. For purposes of regulatory safeguards, the Scheme is however not deemed entirely risk-free, as it is not fully underwritten by a sovereign. That said, the Scheme does not have the kind of exposure of a sudden agglomeration of risk as one might see in a Scheme backed by a single employer on a 'pay as you go' basis. [446] A funded Scheme is reliant on the Trustee for the effective management of its assets and the associated income streams, in order to meet its liabilities in the long-term. The Trustee's decisions can have a material influence on the practicalities of risk-sharing between employers and members. The Scheme is thus exposed to risks arising from how the trustee conceptualises risk and corresponding decision-making in relation to investment management. It is also key that both employers and

[442] University of Cambridge, (2018), USS FAQ's for scheme members (original dated 16th February 2018. Version cited includes updates as of 9th March 2018), [online], at https://www.staff.admin.cam.ac.uk/general-news/uss-faqs-for-cambridge-members [accessed on 22nd June 2019].

[443] Organisation for Economic Cooperation and Development, (2005), Private Pensions, OECD Classification and Glossary, (online) at http://www.oecd.org/finance/private-pensions/38356329.pdf [accessed on 24th June 2019].

[444] Office for Official Publications of the European Communities, (2004), Eurostat Classification of funded pension schemes and impact on government finance - 2004 edition, at https://ec.europa.eu/eurostat/documents/3859598/5884325/KS-BE-04-002-EN.PDF/ccfc8b5a-a45e-4444-b467-3d2e1cab8d7e [accessed on 30th June 2019].

[445] Schwarz, A., (no date), Why consider a Funded Pension Scheme, Presentation by World Bank lead economist, [online] at siteresources.worldbank.org/INTPENSIONS/Resources/395443-1279057176326/2Session5_Anita.pdf [accessed on 30th June 2019].

[446] Schwarz, A., (no date), Why consider a Funded Pension Scheme, Presentation by World Bank lead economist, [online] at siteresources.worldbank.org/INTPENSIONS/Resources/395443-1279057176326/2Session5_Anita.pdf [accessed on 30th June 2019].

members monitor the conduct of the Trustee to ensure the funds collected are being deployed in a judicious way that is consistent with the collective nature of the Scheme. This is an important area of attention for this paper.

USS is a multi-employer scheme. The Scheme pools together the pensions contributions and risks of a range of HE institutions and allied employers. A multi-employer status facilitates the portability of pensions – a key factor in allowing for mobility and transfer of specialist skills in our sector, benefitting the real economy. The multi-employer status impacts certain key risks in the Scheme, that are reduced further through increased pooling across different member institutions, thus allowing for the funding costs of the Scheme to be lowered. This reduction in funding costs can be of significant benefit to both employers and members. Even the largest institutions in numbers constitute less than 5% of the membership. This means that all institutions – both big and small – benefit from pooling of risks, with the smallest institutions particularly benefitting. It is also worth noting that USS is an industry-wide Scheme and the funding as well as the risks must be viewed differently from a single-employer Scheme or one with a small group of employers. This is particularly important when examining factors such as the strength of the employer covenant and how The Pensions Regulator should engage with the Scheme.

USS is an exclusive scheme and there are significant costs for discontinuing participation in the Scheme. USS is the only pension Scheme that member institutions can offer to their qualifying employees (with some exclusions for institutions' legacy pension schemes), with severe penalties for breach of exclusivity. Employers wishing to leave the Scheme are penalised if they intentionally breach exclusivity through what is termed as a Section 75 debt or buyout that 'could be a very large payment'.[447] For example, Trinity College, Cambridge (the most recent withdrawing institution) is expected to be charged circa £30 million[448] for leaving the Scheme, although it has only circa 100 members in the Scheme. There are very few HE institutions with the financial wherewithal to make such a decision on a considered basis. This means that as long as the rules entrench exclusivity, the Higher Education sector in the UK remains active at current or increasing levels, and member institutions do not go rogue by using Special Purpose Vehicles (as suggested by certain unprincipled advisers)[449] to off-roll employees from the

[447] Universities Superannuation Scheme, (circa 2016), Employer debt page on USS website, [online], at https://www.uss.co.uk/employers/application-procedures/employer-debt [accessed on 22nd June 2019].
[448] Cambridge UCU, Open letter to the Council and Fellows of Trinity College, Cambridge (updated 8 June), (online) at http://www.ucu.cam.ac.uk/open-letter-to-the-council-and-fellows-of-trinity-college-cambridge/ [accessed on 22nd June 2019].
[449] Stones, N., (2019), Big Problem, Think Small, 8 am playbook on researchbyresearch.com at https://www.researchresearch.com/news/article/?articleId=1379552 [accessed on 17th July 2019].

participating employer's books, the Scheme will continue to have a healthy pipeline of new entrants, replenishing the multi-employer pool both in terms of intergenerational changes and with regard to the depth of the pool. In a sector like Higher Education with a sector-wide Scheme like USS, where a range of employers with different strengths and sizes participate in the Scheme, this element entrenches an emphasis on mutuality, strengthens what is termed as the 'employer covenant, and binds together employers in a fairly unique way. Aside from the pure financial gain, that remains the standard narrative of discussions around risks and pensions, what this reinforces is the sense of collegiality, collaboration and community that are central to the nature of the kind of self-reinforcing collaborative research structures that are vital to the survival of the sector itself and add real economic value, but are not reflected in financial measurement techniques.

USS is a last-man standing Scheme. The last-man standing arrangement in the Scheme is an interesting and relatively rare arrangement nowadays. It protects the pensions of members in case of an employer collapse, by transferring the defaulting employer's liabilities to the remaining employers in the Scheme; this continues in a chain until the Scheme has to close due to the default of the last employer in the Scheme. Given the mutuality of research and the transferability of students and staff in the sector to higher-strength institutions, having a last-man-standing Scheme, offers both real and financial value. Members benefit from knowing their pensions are secure even if their sponsoring institution collapses. Employers also benefit, because, in the absence of what is colloquially termed 'a doomsday scenario', it is unlikely that the largest institutions will end up carrying all the liabilities. While the risks for stronger institutions, of taking on other weaker institution's liabilities may seem significant, the reality is that on account of USS being a funded Scheme, money has already been set aside for a significant proportion of any departing employer's liabilities. Relatively high rates of deficit recovery contributions are currently set aside by employers to avoid such eventualities. Indeed, the benefit of this arrangement isn't just to members. Employers also benefit from the pooling of risks, because the Scheme has reduced running costs. USS received a significant reduction in the statutory costs levied in respect of the Pension Protection Fund (PPF) because potential access to the PPF does not arise until the last employer becomes insolvent. This therefore not only makes the Scheme particularly viable, it also makes the charges paid to the PPF lower, lowering the cost burden on all employers and members. In 2017 employers were motivated[450] to close DB.[451] Given that USS is a last man standing Scheme and therefore relatively strong,

[450] Callard, F., The drive to convert to DC: A short history, USSBriefs 1 at https://medium.com/ussbriefs/the-drive-to-convert-to-dc-a-short-history-15079dc18182 [accessed on 22nd July 2019].
[451] Universities UK, (2014), USS funding and benefits – consultation by Universities UK at https://tinyurl.com/yy9sxy4e [accessed on 22nd July 2019].

both ‘reckless’ de-risking and the imposition of larger deficit recovery contributions (DRCs) allow employers to justify their agenda to close DB. These two strategies may particularly benefit employers because they provide a higher headline rate to communicate to members, while actually paying off employers’ own underpayments ahead of Scheme closure. This also helps put an upper bound on employer contributions to the DC Scheme in the future, because DRCs only stay as long as the DB section remains open. In a last-man-standing funded Scheme that employers may wish to close, de-risking benefits employers because they use current contributions to bear costs that they might have to contribute to were the Scheme to close. There are also arrangements available if any employer no longer wishes to participate in the Scheme. In such a case, the departing institution is permitted to buy-out the liabilities it supports in the Scheme. The departing institution’s debt (also known as a Section 75 debt), is assessed not just in relation to the contributions of the employer but also in relation to what coverage of liabilities it brings to the covenant.

USS is an open scheme, which means that for employees of the sponsoring employers, the scheme is open to all eligible employees. This is different from other schemes, where participation in a DB scheme may be closed to new joiners. Given the pyramidal structure of seniority of employment in HE, the new contributions streams strengthen the cash flow of the Scheme increasing its viability. Being an open Scheme, essentially allows USS to continually refresh risks through the introduction of new Scheme members’ contributions and typically long-term pension provision horizon, and thus reduces the risk profile of the Scheme through pooling of risks with longer-standing members of the Scheme. That is, new entrants to the academic profession joining USS from a range of employers allows for pooling risks across regions, nations and generations. Having younger members replenish the Scheme through their greater emphasis on contributions rather than benefits, restores the balance of the Scheme, and allows the Scheme to undertake greater (calculated) risks and therefore greater returns, than would normally be present for a Scheme with an ageing cohort. This helps to enhance and ensure benefit stability for ageing members and allows the Scheme to benefit from different asset classes for investment purposes. It also facilitates the use of a range of financial instruments for risk management rather than only having to choose elements that are specific to the upcoming benefits of say an ageing-cohort of members. This enhances the Trustee’s ability to prudently use an appropriate proportion of higher risk - higher return investments in the Scheme, and permits better outcomes for all members, given that pension scheme investment horizons should be longer-term in nature. From a risk point of view, close attention must also be paid by the trustee to inter-generational risk transfers.

USS is an immature scheme. In an immature scheme the bulk of liabilities is not deemed to have already accrued, there is not a finite time horizon to scheme closure and the scheme still remains relevant to employers. In the context of USS, what this means is that the volume of new members entering is in excess of those leaving the Scheme.[452] This immaturity of the Scheme should in theory pre-empt the need for greater liquidity and much lower volatility in the portfolio because although there is a need to pay benefits for the members who are retiring or experiencing morbidity of outcomes, a much more significant proportion of members continues to pay in contributions. This strengthens the cash-flow position of the Scheme reducing the risks of Scheme non-viability. While there is a continued excess of contributions over benefits and the expert view is that stability of cash flows is expected over a 50-year period,[453] it is argued that such as long-term positive cash-flow implies the sustainability of the Scheme in the long-term, allowing Trustees to override short-term considerations.

The nub of the dispute

As of 2018, USS Limited (USSL), the corporate trustee to the Scheme, safeguards £64bn in Scheme assets[454] for over 350 Higher Education (HE) and allied employers, and the Scheme covers approximately 400,000 members.[455]

USS' accounts[456] (2018) reveal that the Scheme receives £2.2bn in contributions and pays out £2bn in benefits. Not only is the Scheme currently cashflow positive, it also does not, at this time, draw on the returns on its investments, let alone on the fund itself to pay out benefits. The Scheme is expected to remain cashflow positive for the next 50 years.[457] This is very significant because it suggests that in the foreseeable future, there is only a relatively small risk of not being able to pay pensions.

[452] USS Joint Expert Panel, (2018), Report of the Joint Expert Panel, (online) at http://www.ussjep.org.uk/files/2018/09/report-of-the-joint-expert-panel.pdf [accessed on 22nd June 2019].

[453] Joint Expert Panel, (2018), First Report of the Joint Expert Panel, September 2018 (online) at https://ussjep.org.uk/files/2018/09/report-of-the-joint-expert-panel.pdf [accessed on 22nd June 2019].

[454] Universities Superannuation Scheme, (2018), Report and Accounts for the year ending 31st March 2018, [online], at https://www.uss.co.uk/how-uss-is-run/running-uss/annual-reports-and-accounts [accessed on 22nd June 2019].

[456] Universities Superannuation Scheme, (2018), Report and Accounts for the year ending 31st March 2018, [online], at https://www.uss.co.uk/how-uss-is-run/running-uss/annual-reports-and-accounts [accessed on 22nd June 2019].

[457] USS Joint Expert Panel, (2018), Report of the Joint Expert Panel, (online) at http://www.ussjep.org.uk/files/2018/09/report-of-the-joint-expert-panel.pdf [accessed on 22nd June 2019].

Yet as of 2017, USS has calculated a £7.4bn 'past service' shortfall[458] in the Scheme meaning that on what is termed a 'technical provisions' basis, the Scheme's liabilities exceed the Scheme's assets, providing the grounds for USSL to ask employers and members to consider contributions increases and/or reductions in Scheme benefits.

The 'deficit' is calculated by USSL using what is called a triennial valuation, although more frequent valuations may be undertaken in cases where, in the eyes of the corporate trustee, something significant has changed with respect to the Scheme's risk profile. The valuation achieved through actuarial modelling is then used to inform various investment decisions as well as to underpin proposals for contributions changes or changes in the benefits offered to members.

It is this 'deficit' calculated by USS that is at the heart of current and previous disagreements between University and College Union (UCU), as the representative of members of the Scheme, and Universities UK (UUK), representing employers.

The role of USSL

The Scheme's performance is dependent on employer contributions, employee contributions and investment returns. At each valuation, the required contribution rate is assessed by the Scheme Actuary, and changes to this rate are used to recalibrate contributions so as to ensure that scheme liabilities can be successfully met in the long-term. The Pensions Regulator requires[459] that employers adhere to such contribution rates, and it is the duty of the Trustee to ensure that such requirements are suitably met, or to take action where this is not the case. USSL has a key role to play in calculating the Scheme's financial health through its extensive control over the modelling that underpins the valuation of the Scheme.[460] Since it was originally set up, the Articles of Association[461] have entrusted USSL with acting in the best interest of members (past, present and future) in a variety of ways. This includes, but is not limited to, interpreting pensions law and pensions regulation, evaluating and interpreting regulations and legislation, and translating these into how risks are perceived and modelled.

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[458] Tayyebi, A., (2019), Scheme funding report of the actuarial valuation: Universities Superannuation Scheme as at 31 March 2017, [online], at https://www.uss.co.uk/how-uss-is-run/running-uss/funding-uss/actuarial-valuation [accessed on 22nd June 2019].

[459] The Pensions Regulator, (2014), Code 03: Funding Defined Benefits, (online) at https://www.thepensionsregulator.gov.uk/en/document-library/codes-of-practice/code-3-funding-defined-benefits-#d02f967c5b214b50bbb3994284bcaf79 [accessed on 22nd July 2019].

[460] Leech, D., (2018), Is there really a USS deficit : USSbriefs 7, USSBriefs website, (online) at https://medium.com/ussbriefs/is-there-really-a-uss-deficit-26dcd9e01f3e [accessed on 22nd July 2019].

[461] Alsops Stevens Bateson and Company, (1974), Memorandum and Articles of Association of Universities Superannuation Scheme Limited, (online) at https://beta.companieshouse.gov.uk/company/01167127/filing-history [accessed on 16nd July 2019].

USSL also has an important role to play in driving investment decision-making at USS Investment Management (USSIM), its captive investment management subsidiary. USSL also provides the documentation and preparatory papers for discussions on the Joint Negotiating Committee (JNC) between UUK and UCU. USSL also runs the JNC secretariat.

USSL as a lynchpin

USSL thus plays an important role in facilitating key decisions that result in the realities of risk-sharing. It is not just at the heart of the implementation of agreements regarding risk-sharing between employers and employees, but also in making nuanced judgements or arguments regarding implementing the investment management strategy. It therefore also has a key role in interpreting, identifying and prioritising risks; devising risk-mitigation strategies; and in assessing how risks are distributed inter-generationally and across different members categories. Its contributions can influence the narrative of the discussions between employers and members. It therefore becomes important how USSL adds to the narrative, whom USSL may favour or not favour, how USSL discharges its responsibilities towards members and how it interprets and manages risk. The ideological biases at USSL therefore have a significant impact on risk-sharing within the scheme.

Leech (2018) points to the absence of what he terms "economic pluralism" in the pensions discourse more generally.[462] A similar concern about USS' ideological biases are raised citing the ideological nature of these views of USSL. Leech notes that 'on the one hand is the view that investing in equities has a high probability of achieving a high return in the long run, through the equity premium. This is the 'patient capital' view, for which there is (arguably) considerable empirical support, often attributed to Ben Graham and followed by Warren Buffett, and traditionally followed by pension schemes. On the other hand, is the view, deriving from the newer random walk model of modern finance theory, that risk increases in the long run. There is no long-run equity premium and all investment is essentially short term speculation. This approach underlies the current accounting rules for pension assets and liabilities on company balance sheets.'

[462] Leech, D., (2018), USS is a special case: 17 questions for the Joint Expert Panel, USSBriefs 28 on USSBriefs website, (online) at https://medium.com/ussbriefs/uss-is-a-special-case-17-questions-for-the-joint-expert-panel-dfdb605cae7f [accessed on 22nd June 2019].

Test 1 is an internal test within the valuation and is used by USS to determine how close the Scheme is to being self-sufficient if it were effectively closed within 20 years time. It is defined by USS as 'a test designed to measure whether or not the long term risk in the DB section of the scheme is within the risk appetite agreed between the Trustee and the sponsoring employers. The test checks that the difference between self-sufficiency and technical provisions in 20 years time does not become too large for the employers to support'[463]. First Actuarial, independent actuarial consultants, expressed frustration when they noted that the USS investment strategy is being determined by a monitoring metric in the valuation, which in itself is flawed. This creates a recursive loop, in that a deterioration in the monitoring metric would drive the further erosion in the Scheme as a result of Test 1, meaning that monitoring metrics create a self-fulfilling prophesy. Given that pensions benefit from, and should reflect, long-term perspectives, using a short-term metric to erode longer-term value is perverse and causes danger.

<u>Employer underpayments</u>

This section highlights instances of the Trustee calibrating contributions in a manner that misallocated risks.

Three cycles of underpayments

In this section of the chapter, decisions to maintain a lower level of contributions than deemed actuarially required (also referred to in this section as employer underpayments), after the 1999, 2002 and 2005 valuations, are discussed. Risk-sharing is then analysed in the light of decisions that reduced the size of employers' contributions, using as their basis a purported surplus in the Scheme.

The 1999 decision not to increase employer contributions

In its 1999[464] valuation, in consultation with the Scheme Actuary, USS moved from a 'projected unit' method to a 'market value' approach. Under the new methodology, the value of the scheme's current assets was marked to market as of the valuation date. Since at the time over 80% of the scheme's assets were held in equities, whose market prices are characteristically volatile, this type of change had a substantial effect on the value placed on the balance sheet.

In 1999, the market was nearing the peak of the 'dotcom' bubble[465]. Returns were inordinately high. 'From 1974 to 2000 the average real return on UK equities was 13%, compared with a

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[463] USS (2017) Actuarial Valuation, 1 Sep 2017, Universities Superannuation Scheme

[464] Universities Superannuation Scheme (2000), Universities Superannuation Scheme Report on the Actuarial Valuation as at 31 March 1999 at https://www.uss.co.uk/~/media/document-libraries/uss/how-uss-is-run/av-archive/1999-valuation.pdf [accessed on 22nd July 2019].

[465] The dotcom bubble was driven by rising equity market expectations of the returns to be generated from the growth in the internet and other technology innovations

twentieth century average of about 5.5%'. [466] Markets in 1999, at a point immediately prior to the collapse of the 'dotcom' bubble in early 2000, were demonstrating something similar to investors' irrational exuberance during bubbles. Equity markets were noticeably overinflated and investment returns were abnormally high. Laux and Leuz (2010)[467] point out that 'Market prices can deviate from their fundamental values for various reasons, be it a liquidity crunch or limits to arbitrage'. As a result, a change in accounting methodology resulted in a market-value-based valuation that showed a surplus of £1.4bn whilst the actuaries noted that if 'exactly the same assumptions adopted for the 1996 valuation' had been used, the 1999 valuation would have shown a deficit of £1.2bn. [468]

The Scheme's valuation was submitted in March 2000, when this market position was evident to market participants in equity markets. The market's position was also evident to USS' own management as was reflected in p.14 of USSL's 1999 annual report and accounts, where they cite an 'exceptionally positive investment climate'.[469] The Scheme's transition to a 'mark-to-market' approach within the valuation, at this time, should therefore have been considered with a great degree of caution, especially when a 0.25% decline in investment return could lead to a deficit. Expert investment managers, the Scheme Actuary and USSL, in their role as Corporate Trustee, who were entrusted with the protection of members' interests, should therefore have been particularly cautious about the use of any such notional surplus as grounds for proposing an underpayment by the employers. As the valuation date was March 2000 (which coincidentally was also the month in which the dotcom bubble burst), such caution should have been expected, rather than exceptional. It is worth noting that the collapse of equity markets after the dotcom bubble led to circa $1 trillion being wiped off the Nasdaq in the space of one month between the 11th of March and April.[470]

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[466] The Pensions Commission, (2005), A New Pensions Settlement for the Twenty-First Century: The Second Report of the Pensions Commission at https://webarchive.nationalarchives.gov.uk/+/http:/www.dwp.gov.uk/publications/dwp/2005/pensionscommreport/main-report.pdf

[467] Laux, C., Leuz, C., (2010), Did Fair-Value Accounting Contribute to the Financial Crisis? *The Journal of Economic Perspectives*, Vol. 24, No. 1 (Winter 2010), pp. 93-118 at https://www.jstor.org/stable/25703484 [accessed on 27th July 2019].

[468] Universities Superannuation Scheme (2000), Universities Superannuation Scheme Report on the Actuarial Valuation as at 31 March 1999, (online) at https://www.uss.co.uk/~/media/document-libraries/uss/how-uss-is-run/av-archive/1999-valuation.pdf [accessed on 22nd July 2019].

[469] Universities Superannuation Scheme (2000), Appendix G of Universities Superannuation Scheme Report on the Actuarial Valuation as at 31 March 1999, (online) at https://www.uss.co.uk/~/media/document-libraries/uss/how-uss-is-run/av-archive/1999-valuation.pdf [accessed on 22nd July 2019].

[470] Geier, B., (2015), What did we learn from the dotcom stock bubble of 2000?, Time Magazine, March 2015

In 2000, the USS actuarial valuation, even under the market value method, recommended an employer contribution rate of 16.3%.[471] However, the Trustee after discussion with the employers, agreed to allow them to contribute a lower rate of 14%. Thus, decisions made by the Corporate Trustee in conjunction with the Scheme Actuary (Mercers, then and until 2020), instead of showing caution, permitted employers to underpay. The purported grounds were reported to be the surplus, which itself should have been treated with great caution because of the change in accounting methodology.
The USS Trustee thus failed to properly protect the interests of Scheme members in this time of obvious economic instability[472] including its expected impact on pension funds. The presence of a notional surplus in an overinflated market was instead misused to justify a reduction in employer contributions. More recently responses from USS CEO Bill Galvin[473] to a campaign of complaints from members regarding historical underpayments, do not clarify whether any precautionary mechanisms were put into place at the time, to ensure that employers were bound to a commitment to make good any such underpayments in adverse circumstances (for example, where the valuation might turn out to have been over-optimistic).

Even in the absence of a planned safety net for this specific decision, pension fund trustees are required[474] to monitor the schemes on an ongoing basis. To do so they may undertake a range of activities including interim valuations, reviews of positions and assessment of rates of contribution. At the time of the valuation, that crash could and perhaps should have been a trigger for re-evaluating fund management decisions including the effects on the fund of the change in accounting methodology.

That the valuation was approved by the Board on 23rd March 2000, is perhaps the biggest sign of wilful blindness, in that by this time, the dot com bubble had burst, and it would have been obvious to Board members that the mark to market valuation of the portfolio as at 31st March 1999 bore little resemblance to real prices after the bubble had burst.

The 2002 valuation

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[471] Universities Superannuation Scheme (2000), Appendix G of Universities Superannuation Scheme Report on the Actuarial Valuation as at 31 March 1999, (online) at https://www.uss.co.uk/~/media/document-libraries/uss/how-uss-is-run/av-archive/1999-valuation.pdf
[accessed on 22nd July 2019].

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[473] Galvin, B., Response to letter of complaint (online), at https://academicfreedom.watch/index.php/node/27 [accessed on 22nd July 2019]

Moving forward to the next triennial valuation in 2002,[475] the Scheme still enjoyed a positive cashflow, but the notional surplus had diminished. What is more, this surplus had depleted much more quickly than anticipated. In fact, the main section surplus, which had been expected to last over 11 years at the reduced employer contribution rate, had instead dropped rapidly from £606.4mn to £87mn in just 3 years (the overall deterioration in surplus was from £1443mn to £162mn;). This should have set off alarm bells for the Trustee. Instead, a misjudged decision was taken to erode a significant proportion of what remained of the notional buffer.

With the consent of the Scheme actuary, employer contribution rates were maintained at 14%, even though this figure continued to be below the contribution rate required by the actuarial valuation, which calculated 14.25% with respect to future service. Given the experiences of the changes in financial markets valuations and the significant erosion of the investment return component of the fund, this decision is of significance, particularly given that the conclusion of the valuation was that the Scheme was only just on an even keel: 'the assets of the Scheme at the valuation date were 101% of the accrued liabilities based on projected Pensionable Salaries'. At a time when the sustainability of investment returns was clearly in doubt, this decision to maintain an artificially low employer contribution rate could be seen as a failure to properly protect the interests of beneficiaries. Considering that a DB fund relies on both contributions and investment returns to sustain itself, the fall in investment returns should have necessitated a rethinking of the continuation of artificially low employer contribution rates.

The 2005 valuation

Data provided at the next triennial valuation in 2005[476] confirms that this was a risky strategy, with a deficit of over £6.5bn accruing as a result. This took the overall valuation of the fund from an £87mn surplus in 2002 to a £6.5bn deficit three years later. The 2005 actuarial valuation notes that the 'assets of the scheme at the valuation date were 77% of the accrued liabilities based on projected pensionable salaries with a past service deficit of £6,568 million'. This was a

[475] Universities Superannuation Scheme (2003), Actuarial Valuation as at 2002, (online) at https://academicfreedom.watch/node/23
[accessed on 22nd July 2019].

[476] Universities Superannuation Scheme (2003), Actuarial Valuation as at 2002, (online) at https://academicfreedom.watch/node/23
[accessed on 22nd July 2019].

natural result of investment returns that were around £3bn below expectations. In spite of this, and the fact that the actuarially determined rate was now calculated to be 14.3%, employer contributions were allowed to remain at 14%. Member contributions remained unchanged.

Subsequent member complaints

In 2018, several USS members wrote to the corporate Trustee to ask for details about the period of employer underpayments, and to highlight concerns about the role that underpayments played in causing the deficit that in turn was being used to support the move from DB to DC. This was then shared with other members through electronic and other communications during the period of UCU industrial action.

Rather than the typical process in any financial services firm, of complaints handlers acknowledging or responding to the request, (once the issue became more public), a few months later USS CEO Bill Galvin responded[477] on behalf of USS in a letter that was later made public on the USS website. In it Galvin did not comment about whether concrete assurances were taken by USS from employers so as provide an adequate buffer for adverse circumstances. There is also little evidence in the letter of USSL sending warnings to members of the potential detrimental consequences of prolonged underpayment by employers.

Commentary regarding Trustee conduct in relation to underpayments

The Trustee's repeated prioritisation of the employers' preferences in these three periods offers certain warning signs. Trustees have a duty to protect and prioritise the interests of members. Given the lack of Trustee resistance to continuing low employer contribution rates, the Trustee will find it hard to demonstrate that members' interests were adequately protected. Through its decisions on contributions rates, the Trustee appears to have actively eroded any buffers that might provide the Scheme members with comfort in times of distress. At the time of writing this chapter, it has been made clear by an independent crowd-funded activist group (Academics for

[477] Galvin, B., Response dated 23rd May 2018 to member complaints regarding underpayments (online) At https://academicfreedom.watch/index.php/node/27 [accessed on 17th February 2020]

Pensions Justice), that a conservative QC has agreed that union members have a valid case against USSL for breach of trust.[478]

There is no publicly available evidence of any, let alone substantive, clear or candid, consultation by the Trustee alerting members to this disproportionately swift deterioration of the purported surplus, or raising red flags about the potential detriment to members and the potential inter-generational unfairness of changes to the Scheme that might be necessitated by allowing employers to allow their underpayments to be cross-subsidised by a supposed surplus. Nor is it clear from any publicly available information, given the actuarial mandates for higher employer contributions, why the Trustee did not pursue employers more effectively to maintain their contributions at the appropriate level suggested in the valuation by the Scheme Actuary. It can be conjectured that Trustees may have simply fallen in with what they perceived to be the employers' preference (which was always below the actuarially mandated rate of employer contribution), putting downward pressure on the Scheme's assets.

The Trustee also appears to have reverse-engineered the required contribution rate to what was seen as a rate within the employers' preferred range of contribution rates. Comments on page ii of the actuaries' covering letter for the 2005 valuation[479] suggest that another guiding force for the mis-named 'Maximum Funding Requirement' (not a maximum level for funding at all but essentially a threshold at which the USS pension fund would begin to lose tax rebates), may have also been one of the driving forces in guiding conventional actuarial wisdom.[480] It is also clear that it drove employer preferences at a time when the Scheme was a balance-of-costs Scheme i.e. employers who would have previously been content with building a surplus as this offered them tax efficiency on their investments, now wished to benefit from the purported surplus and reduce costs, while a broader agenda of marketization of higher education began to gain an early foothold. Given that it was a balance-of-costs Scheme, this ostensibly led to an openness by USSL executives to wearing down the surplus in order to allow employers to achieve tax efficiency given that larger surpluses in the pension Scheme were attracting the attention of tax authorities, and the broader narrative economically was one of markets booming and pension funds achieving good results for employers in this context. This was

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[478] Academics for Pensions Justice (2019), Academics for Pensions Justice : Big News, Update dated Oct 4th 2019 [online] at www.crowdjustice.com/case/fightforpensions [accessed on 5th December 2019]

[479] Universities Superannuation Scheme (2006), Actuarial Valuation as at 2005, (online) at https://academicfreedom.watch/node/23
[accessed on 22nd July 2019].

[480] Davis, E., (2007) BBC News website Evanomics column dated 2nd April 2007 (online) at https://www.bbc.co.uk/blogs/thereporters/evandavis/2007/04/that_pensions_raid.html [accessed on 22nd July 2019]

achieved at an industry level by allowing employers to benefit from the estimations of buoyant markets.[481]

In this USS case, this was a particularly egregious blunder because any such surplus was an illusory or phantom surplus purely caused by accounting mechanics resulting from a change in accounting methodology as explained above. In effect, to help ensure that the Scheme continued to be tax-exempt, the Trustee called on the purported surplus. This was first done initially at a time when the surplus was exaggerated purely as a result of changes to accounting methods. This then precipitated a serious deficit when the over-inflated asset values corrected themselves. Employers benefitted from being able to underpay, while USSL executives were able to benefit from appearing to show as much largesse to employers as other pension fund managers and trustees. This demonstrates their fundamental lack of regard for risks to the Scheme and its beneficiaries. All the while, attention was paid to the short-term financial interests of employers and to the interests of those managing the fund. The fact that even in a balance-of-costs Scheme, it is the *members' interests* that are the subject of the USS Trustee's duty, makes their behaviour worth noting.[482]

The USS CEO, Bill Galvin appears to be both dismissive and cavalier in his response[483] to the genuinely held concerns of members. He subverts any meaningful discussion by noting that 'historically, employer contribution rates have not been particularly relevant for members as, prior to 2011 (when the concept of cost-sharing was first introduced by stakeholders via the Joint Negotiating Committee), their contribution rate was fixed'. This consideration of members' interests would be essential in order for the USS Trustee, and Bill Galvin as CEO of USS Ltd, to fulfil the duty to Scheme beneficiaries.[484]

USS Ltd's failure to challenge the employers' desire for continued underpayments reflects the Trustee's practice of paying attention to employers' interests, as advocated by the employers' representation bodies (UUK and the Employers Pension Forum, or EPF). Anecdotal evidence suggests that until the strike of 2018, the vast majority of Scheme members appear to have been

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[481] The Pensions Commission, (2004), Pensions: Challenges and Choices: The First Report of the Pensions Commission At http://image.guardian.co.uk/sys-files/Money/documents/2005/05/17/fullreport.pdf

[482] The Pensions Regulator, (2014), Code 03: Funding Defined Benefits, (online) at https://www.thepensionsregulator.gov.uk/en/document-library/codes-of-practice/code-3-funding-defined-benefits-#d02f967c5b214b50bbb3994284bcaf79 [accessed on 22nd July 2019].

[483] Galvin, B., Response (dated 23rd May 2018) to member complaints regarding underpayments (online) at https://academicfreedom.watch/index.php/node/27 [accessed on 17th February 2020].

[484] The Pensions Regulator, (2014), Code 03: Funding Defined Benefits, (online) at https://www.thepensionsregulator.gov.uk/en/document-library/codes-of-practice/code-3-funding-defined-benefits-#d02f967c5b214b50bbb3994284bcaf79 [accessed on 22nd July 2019].

unaware of these drops in contributions and the adverse effect on the Scheme position. Instead, UUK, the EPF and USS have insisted that the deficit represents a crisis in need of rapid resolution, while glossing over their historic role in allowing it to be created over the course of several valuations. This shows a fundamental and continuing disregard for the interests of scheme beneficiaries. Questions have also been asked about the role of the trustees nominated by the union, although they were only a minority of the Board.

There is also a lack of acknowledgement, on the part of the employers, of the role they played in eroding the fund in a reckless manner during the period of the underpayments. There is no recognition whatsoever that this may in any way have contributed to the position the fund is in now. This mirrors responses by top bankers such as HBOS CEO Andy Hornby to the Global Financial Crisis of 2007 when he put the causes of the crisis down to happenstance.[485] In fact, in a tweet dated 26th of March 2018, responding to allegations of underpayment, USS employers, represented by the lobbying body Universities UK attempted to justify the underpayments by pointing out that they 'carried on paying a substantial contribution of 14% of salaries'.[486] This echoed Bill Galvin's comments cited above that there was nothing untoward in the underpayments at all. On a subject such as pensions, such framing can have particularly pernicious consequences. This is because pensions are a fairly complex topic and many members would expect to rely on the expertise of fiduciaries on such issues. In particular, Galvin's framing helps quiet the moral and political outrage that such harm might otherwise inspire. It therefore appears cynically and cleverly crafted to undercut any public pressure that might be mounted to induce regulatory or parliamentary scrutiny of the employer underpayments and USS Limited's own role in permitting it. It also seeks to prevent any restorative justice that might be induced from such pressure.

Manufacturing consent: Deficits, risk and de-risking

Drawing on the discussion within the financial crisis chapter which explored the ways in which the discourse on risks and their management can be financialized, this segment of the case study examines the creation of artificial deficits and the use of so-called 'de-risking'. It has been implied by employers and by the USS Trustee,[487] on multiple occasions, that this de-risking

[485] McCluskey, M., (2012), How the Unintended Consequences Story Promotes Unjust Intent and Impact, 22 Berkeley La Raza Law Journal, Vol 22, (online) at http://tinyurl.com/y59q476x [accessed on 12th August 2019]
[486] Universities UK, (2018), Tweet dated 26th March 2018 (online) at https://twitter.com/UniversitiesUK/status/978260360443686919?s=20
[accessed on 22nd June 2019]
[487] University Superannuation Scheme Limited, 2017, 'UUK responds to USS's consultation on funding proposals', (online) at https://www.uss.co.uk/how-uss-is-run/valuation/2017-valuation-updates/uuk-responds-to-usss-consultation-on-funding-proposals
[accessed on 5th January 2020]

removes risks to the Scheme and the natural assumption in general discussion is that by extension all stakeholders of the Scheme benefit from lowered risks. In reality, risks to Scheme members and civil society stakeholders are increased by the adoption of what one expert terms 'reckless prudence'.[488] Developing ideas discussed within the seminal work of Herman and Chomsky (1998),[489] this section explains how a manufactured deficit and associated discussions of acceptable and unacceptable levels of risk, are used to shape the narrative on how risks are distributed between employers and controllers of finance capital vis-à-vis pension scheme members and civil society. The section documents how approaches to de-risking within USS can counter-intuitively increase risks, particularly to members of the pension scheme. It also documents how risks are actually exacerbated by the regulator only engaging with, and being interested in risks to a very narrow set of stakeholders.

TPR and public interest rationales for pensions regulation

Pensions are extremely large institutional aggregators and mobilisers of long-term savings. Open, immature defined benefit pension schemes offer a valuable source of security for citizens in retirement. They also have a fairly infinite investment horizon and therefore also offer a valuable source of long term capital for investment in the real economy. Well-managed pension funds can enhance or erode stability in the economy through the way their assets and liabilities are managed. A pensions regulator motivated by public interest objectives should therefore typically be cognisant of the effects that pensions have on a wider range of stakeholders, including notably pension scheme members and civil society stakeholders.

The statutory objectives of TPR are:

- to protect the benefits of pension scheme members
- to reduce the risk of calls on the Pension Protection Fund (PPF)
- in relation to the exercise of its functions under Part 3 only, to minimise any adverse impact on the sustainable growth of an employer
- to promote, and improve understanding of, the good administration of work-based pension schemes, and
- to maximise compliance with the duties and safeguards in the Pensions Act 2008'.[490]

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[488] Cooper, G., Reckless prudence: how investment sponsor risk-aversion is breaking USS, USSBriefs Number 35, (online) at https://medium.com/ussbriefs/reckless-prudence-how-investment-sponsor-risk-aversion-is-breaking-uss-ea9a88d694 [accessed on 5th January 2020]

[489] Herman, E., Chomsky, N., (1998), *Manufacturing Consent*, Pantheon, New York

An interest in protecting the 'benefits of pension scheme members' is first on the list suggesting that the regulator does have a clear duty towards members of pension schemes. In reality, while this is mentioned as the first of the statutory objectives, TPR's interpretation of this objective has largely in practice been focussed on protecting accrued benefits, rather than on ensuring sustainable ongoing benefits that provide retirement security and a viable defined benefit pension scheme for all members (in the way the term members is defined by TPR) including potential new joiners to the scheme. TPR's emphasis on protecting benefits of pension scheme members is therefore being interpreted in the context of its second statutory objective, which is to ensure that the PPF is protected. Such protection against calls on the public purse inherently offers certain protections to taxpayers, but as described below must be weighed up against other costs to the same taxpayers or citizens. They are also justified in terms of retaining confidence in the financial system more generally and pensions savings more specifically.

Examining this carefully, this level of focus on accrued benefits, while useful to ensure guaranteed pensions are paid, is largely also useful for two things. Firstly, for ensuring there is a lower likelihood of calls on the public purse to ensure those pensions are paid. Secondly, it subtly sustains a pipeline of assets under management by the pension scheme trustees and their appointed investment managers i.e. in the language of Epstein's definition of financialization, to sustain the mechanism via which financial intermediaries' business interests remain protected. These assets under management would continue to be sent the financiers' way irrespective of their fund's true performance, through the imposition of mechanisms such as automatic enrolments,[491] and as long as the pensions paid out and the prevailing wisdom/compulsion is for employers and employees to continue to invest in pensions. Note at this stage, that this would apply whether or not these were defined benefit pensions with guaranteed payments in retirement or defined contribution pensions without. However, there is little evidence of TPR's interest in ensuring that the pension schemes can meet other stakeholders' (for example, members') long-term needs such as for security in retirement.

The TPR's preoccupation with the PPF and ensuring that the pensions product remains is further visible in how they specifically outline their responsibilities

'We are responsible for:

[491] The Pensions Regulator, (no date)., Employers section of The Pensions Regulator's website [online] at https://www.thepensionsregulator.gov.uk/en/employers [accessed on 6th March 2020]

- making sure employers put their staff into a pension scheme and pay money into it (known as 'automatic enrolment')
- protecting people's savings in workplace pensions
- improving the way that workplace pension schemes are run
- reducing the risk of pension schemes ending up in the Pension Protection Fund
- making sure employers balance the needs of their defined benefit pension scheme with growing their business'[492]

This emphasis on 'reducing the risks of pension schemes ending up in the Pension Protection Fund' carries through into the TPR's DB Funding Code,[493] which is one of the primary pieces of regulation affecting defined benefit pension schemes. This is because the funding code determines how the Scheme's assets are assessed

A review of the Funding Code,[494] in entirety, for the purposes of this paper, suggests that TPR's approach to appropriately funding DB pension schemes is also fraught with the presumption that DB Schemes are to be treated either as mature schemes, or as schemes that employers are expected to need to or want to abandon. A combination of these assumptions and prejudices against DB, and the emphasis on reducing risks to the Pension Protection Fund results in TPR's regulatory approaches to funding that are developed with the presumption that Schemes need to be what is termed 'self-sufficient' within a relatively short period of time.

Practical implications of the regulatory context

This emphasis on self-sufficiency can be seen as a heavily prudent way - consistent with the timeline of unwinding a typical single employer fund - of ensuring there is little risk of accrued benefits being paid through calls on the PPF. While this approach to Scheme funding may be appropriate in certain circumstances or for a single-employer, mature pension Scheme, it is unjustifiable for a multi-employer, immature pension scheme like USS.

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[492] The Pensions Regulator, (no date)., About us – What we do section of The Pensions Regulator's website [online] at https://www.thepensionsregulator.gov.uk/en/about-us/what-tpr-does-and-who-we-are [accessed on 6th March 2020]

[493] The Pensions Regulator, 2014, Code of Practice No 3: Funding Defined Benefits, July 2014 [online] at https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/code-03-funding-defined-benefits.ashx?la=en&hash=78A43F4600045677464D4947092E965B8F77FF2C [accessed on 5th January 2020].

[494] The Pensions Regulator, 2014, Code of Practice No 3: Funding Defined Benefits, July 2014 [online] at https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/code-03-funding-defined-benefits.ashx?la=en&hash=78A43F4600045677464D4947092E965B8F77FF2C [accessed on 5th January 2020]

Povey (2018) points out that 'Instead of making use of the real returns of its investments and reducing these returns to allow for a level of prudence to achieve a 'best estimate' of expected returns'.[495] TPR (despite publicly denying such a predisposition) is known to use what is termed a Gilts+ estimate. This figure is worked out using the notional investment required, if all investments were in government bonds, to estimate the cost of future pensions. The use of government bonds within this estimate is driven by the belief that government bonds are the safest assets. However, given the trade-offs between risks and return, it is clear that safe assets such as government bonds provide much lower returns over the long-run horizon of a pension fund, as compared to equities[496]

Pensions consultants Hymans Robertson note that Gilts+ 'give a good sense of the cost of matching the benefit payments with one of the lowest risk matching assets. They are also a proxy for buy-out costs – in other words, the cost of securing all scheme liabilities with an insurer. And they move in similar ways. There's no getting away from the fact these are an indicator of what it could cost a scheme to largely de-risk and deliver benefits with a low risk of members losing out. For sponsors, it's the price of exiting from the DB merry-go-round'.[497]

What the regulator is implying, by asking pension fund trustees to evaluate the Gilts+ figure, is for them to assess how much it would cost to cover the liabilities through an insurer if employers were to abandon the Scheme. While such a figure might be worth considering, to assess in a highly conservative manner, the buy-out cost of a closed, mature pension Scheme, funding valuations to be guided or driven by this metric, overestimate the liabilities. This makes such a valuation an absurdity in the case of USS as the Scheme is open and immature. It is even more absurd for this to happen when the Scheme is a multi-employer Scheme with the covenant that USS has, not to mention USS' associated long-term cash-flow positive status.

Povey (2018) points out that a Gilts+ valuation also causes serious fluctuations in the Scheme's position from valuation to valuation. Not only does it provoke a serious system-wide problem by stimulating an artificial demand for gilts by those pension schemes seeking to 'de-risk' by moving more of their portfolio into gilts because the equities they currently hold are perceived by the regulator to be too risky (discussed further below), it also creates an entirely inordinate

[495] Povey, M., (2018), Defending Pensions: A Fight for All Our Futures, USSbriefs 37, [online] at https://medium.com/ussbriefs/defending-pensions-a-fight-for-all-our-futures-4b425cc9f360 [accessed on 22nd June 2019]

[496] Povey, M., (2018), Defending Pensions: A Fight for All Our Futures, USSbriefs 37, [online] at https://medium.com/ussbriefs/defending-pensions-a-fight-for-all-our-futures-4b425cc9f360 [accessed on 22nd June 2019]

[497] Hatchett, J., 2017, DB pensions: what CFOs need to know, Blog for Hymans Robertson (online) at https://www.hymans.co.uk/insights/blogs/blog/db-pensions-what-cfos-need-to-know/ [accessed on 8th March 2020]

focus on the funding deficit that the Gilts+ valuation artificially creates at a time when gilt values are artificially inflated.

An expert at pensions consultant Hymans Robertson explains that 'Essentially UK pension schemes seem willing to pay ever higher risk premiums for gilt assets, meaning demand is running way ahead of supply". He points out based on analysis from experts at Schroders, that pension schemes own 80% of long-dated index-linked gilts with demand vastly outstripping the market by a ratio of five to one. In the presence of increasing demand from pension funds for this kind of asset, this deficit in supply coupled with a hunger for these assets affects how much it costs to source them, and also affects investment decision-making. The consultant adds that this 'contributes to a focus on the balance sheet presentation of the problem – in other words, the deficits.'[498]

For a fund such as USS that is open, immature, and with a significant investment in equities that may be used in order to generate the necessary levels of return required in the long-term without taking excessive risks, a Gilts+ approach, based on financial economics techniques of discounting, can also vastly overestimate the deficit. This is because the returns are artificially depressed to the levels of those achievable by gilt-yields, rather than reflecting the returns that could be generated by its actual portfolio of assets. UUK sought to capitalise on this in 2017 by pretending the deficit in the DB plan was unsustainable. It sought to close the DB scheme on false pretences.

Broader implications of funding code assumptions

The funding code is intentionally structured to suit the assumption that DB pension funds are mature, with an emphasis on self-sufficiency and in unwinding the gilts+ deficits within a short time to reduce dependencies on sponsoring employers by increasing contributions and changing the balance of assets. This appears to be the preferred approach of the regulator, although there are notes in its most recent funding code consultations that the regulator at least acknowledges that such an approach at the minimum runs the risk of over-funding and 'trapped surpluses'.[499] Later within the same document they reiterate that 'Our view is that the risk of

[498] Hatchett, J., 2017, DB pensions: what CFOs need to know, Blog for Hymans Robertson (online) at https://www.hymans.co.uk/insights/blogs/blog/db-pensions-what-cfos-need-to-know/ [accessed on 8th March 2020]

[499] The Pensions Regulator, 2020, Consultation document - Defined benefit funding code of practice , March 2020 [online] at https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-funding-code-of-practice-consultation.ashx
[accessed on 8th March 2020]

trapped surplus is remote and manageable'.[500] The framing of the narrative in the consultation pits this against, what is specifically depicted as the risk of a 'cliff-edge'.[501] The following table from the TPR's defined benefit code of practice consultation, discussing technical provisions within open DB schemes, illustrates this point.

[500] The Pensions Regulator, 2020, Consultation document - Defined benefit funding code of practice , March 2020 [online] at https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-funding-code-of-practice-consultation.ashx
[accessed on 8th March 2020]
[501] The Pensions Regulator, 2020, Consultation document - Defined benefit funding code of practice , March 2020 [online] at https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-funding-code-of-practice-consultation.ashx
[accessed on 8th March 2020]

Illustration 1:

Option	Pros	Cons
Same approach as closed schemes	☑ All schemes (open and closed) are treated consistently. ☑ If an open scheme were to close to new entrants or close to future accrual in the future, its TPs would be unchanged. Therefore, there would be no 'cliff-edge' effects in liabilities/deficits associated with scheme closure.	☒ Potential for over-funding/ trapped surpluses (if scheme remains open).
Lower TPs as longer investment horizon	☑ Reflects the longer investment time horizon an open scheme has compared to a closed scheme.	☒ Inconsistent treatment of open and closed schemes. ☒ Causes a 'cliff edge' whenever a scheme closes to new entrants and/or future accrual.

Source: Table 31 in consultation document on the Defined Benefit Code of Practice [502]

[502] The Pensions Regulator, 2020, Consultation document - Defined benefit funding code of practice , March 2020 [online] at https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/db-funding-code-of-practice-consultation.ashx
[accessed on 8th March 2020]

Due to its narrow financialized interpretation of its duties, broader public interest objectives for a good pensions regulator, including for example harnessing resources via pensions savings as a way to mobilise productive investment in the real economy, are not explicitly mentioned in the TPR's statutory objectives. They also do not appear to feature in meaningful ways in key documents such as the DB funding code or the recent consultation cited above. There is also no evidence of regulatory interest in any elements of broader economic and societal detriment arising from large pensions funds such as USS, concentrating their investments in gilts, i.e. in lending with a low-risk, low-return approach that might not be suitable for the investment needs of the economy, as a result of buying gilts. The current situation is therefore reminiscent of a gilts bubble in 2006 when pension fund demand for gilts resulted in a 'dramatic fall in the real yield on long-dated gilts'.[503] The bursting of such a bubble could wreak havoc on the sustainability of member pensions, but would also create economic chaos, due to the role of pension funds as institutional investors. This could have serious transmission effects within the real economy. Regulators should be concerned about these civil society implications. However there is little recognition in the funding code of the view that pensions are only as sound as productive activity in the economy now. There is also little understanding of the broader point that pension savings must be invested in productive real economy investments in order to deliver the jobs and contributions that are needed to pay our pensions into the future.

Manufacturing consent

In their seminal work[504] on how discourses can be shaped by powerful actors, Herman and Chomsky (1998), suggest that there are five filters in the transmission of information via the mass media to civil society audiences. The original filters include ownership, advertising, sourcing, flak and ideology. Hermann and Chomsky's model explained the use of these filters by American media to determine how news is presented. They argued that those with power and control over the narrative, can determine the discourse. This allows them to filter out topics and opinions that are considered undesirable, as a result of these five filters. The end result is that alternative ways of critically engaging with the issues cease to exist in any meaningful way. This case study does not specifically examine the role of the mass media in transmitting the dominant ideology of neoliberal market capitalism. Instead it applies Herman and Chomsky's work to how the narrative about the pension fund is controlled and shaped by three different groups. Firstly, by USSL, due to its role as the Trustee and arbiter of information to members.

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[503] Coggan, P., Burgess, K., (2006), Gilts Bubble Savages Pensions, *Financial Times* dated January 18 2006, (online) at https://www.ft.com/content/2d0378ca-885f-11da-a25e-0000779e2340 [accessed on 12th March 2020]
[504] Herman, E., Chomsky, N., (1998), *Manufacturing Consent*, Pantheon, New York

Secondly, by TPR, which as the regulator is seen as a trusted source of information about the health or otherwise of a pension fund. Thirdly, by employers, due to their powers to communicate to their employees about the affordability or otherwise of Defined Benefit pensions.

In this transposition to the context of USS, the filters have the following meaning. The first three of Herman and Chomsky's five filters are ownership, advertising and sourcing. Ownership relates to the size and profit-seeking attempts of those in the media. Advertising relates to stable sources of revenue required by media organisations to cover basic costs. Sourcing refers to the symbiotic nature of the relationships between the media and sources of information, which intensify economic necessity and reciprocal interest. At USS, the three filters tie in well with noting that USSL senior management are incentivised to continue a productive relationship with the employers. This is because employers in turn appoint a significant number of Board members of USS, determine the larger share of the contributions paid into the fund . Employers can also therefore influence the funds under management, of USS Investment Management (USSIM) a captive investment management subsidiary of USS, which offers a lucrative bonus structure, not inconsistent with the asset management industry more generally. Senior staff at USSL, including the current CEO, share a revolving door[505] with employers and The Pension Regulator. Concerns about funds under management and a shared approach to questions of prioritisation and risk, as well as cognitive regulatory capture, can in turn contribute to influencing USSL management and TPR to act certain ways to insulate their own future salaries and bonuses.

There is little tolerance of dissent. This is underlined by the recent removal from the USSL Board of UCU members' representative and eminent statistician Professor Jane Hutton, for daring to question elements of the way in which deficits were being determined. Despite whistleblowing to the TPR, Professor Hutton's views only came to light after she was dismissed by USSL.[506] Such high-profile attacks on dissenters and the ruthlessness with which they are dealt with, further entrenches a culture of self-censorship by those in both Trustee and regulatory roles. In these circumstances, critical contributions that question the fundamentals of the discourse are replaced by a range of opinions that lie within an acceptable range of dissenting discourse and the typical critical functions performed by independent trustees and

[505] Rowley, D., (2012), In Depth: All to Play For, *Pensions Week* issue dated May 7, 2012, (online) at https://search-proquest-com.idpproxy.reading.ac.uk/docview/1011578657 [accessed on 8th March 2020]

[506] Callard, F., Chitty, A., Ganz, A., Grocott, C., John, J, Marris, C., Papoulias, S., Rocha, L., (2019), The Insider: Jane Hutton and USS: USS Briefs 83, USSBriefs website, (online) at https://medium.com/ussbriefs/the-insider-jane-hutton-and-uss-d350ba5457ae [accessed on 8th March 2020]

regulators, cease to have meaning and depth. This mirrors concerns about the policing of dissent in the accounting industry through the use of lawfare techniques, as explained by Sikka et al.[507]

It is the employers' interest that the regulation also prioritises. TPR requires USSL to formally consult with employers in a meaningful way, with respect to contributions increases for example, as a relic of regulation that emphasises the responsibility of the Trustee to the employer. In a pension fund such as USS where costs are shared 65-35, the absence of meaningful consultation with members further undermines a duty to members. Similarly, TPR in its close and continuous supervisory relationship with a high impact fund like USS meets with USSL and employers on a regular basis (in a monthly or more frequent pattern). The meetings with members are few and far between, with the members representative trade union, University and College Union (UCU), at one stage highlight'ing that it had struggled to be permitted one meeting with a regulator in a period of over 24 months[508].

The final two filters in Hermann and Chomsky's model, flak and ideology can also be effectively transposed to this context. Flak refers to negative responses by powerful forces to any dissenting discussions in the media. These criticisms are used to influence the media and narrow the acceptable range of discourse. A good example of the employment of flak to suppress dissent amongst Trustees and regulators is evident in the discussions of the whistleblowing by Professor Jane Hutton. In a letter[509] 11th October 2019, from Professor Sir David Eastwood, chair of USS to participating USS institutions, flak is used to suppress discussion of the substance of Professor Hutton's allegations around the misrepresentation of the USS deficit. Instead Prof Eastwood's letter seeks to cast doubts about Professor Hutton's professional competence by suggesting she did not discharge her duties as a Trustee in the manner expected.

Ideology, the final filter, is used to exploit public concerns and distrust to legitimise narratives preferred by powerful interests. These involve the deployment of anti-ideologies to change the narrative and draw attention away from the core of the issues being considered, into an irrational discussion, based on fear and mistrust. In addition to the vilification of Hutton

[507] Mitchell, A., Sikka, P., Wilmott, H., (2001), Policing knowledge by invoking the law: Critical accounting and the politics of dissemination, *Critical Perspectives on Accounting*, Vol 12, Issue 5, pp 527-555 (online) at https://doi.org/10.1006/cpac.2000.0452 [accessed on 3rd February 2019]

[508] Morrelli, C., (2020), Outgoing negotiator's update to UCU National Dispute Committee, May 2020

[509] Eastwood, D., (2019), Letter to USS institutions dated 11th October 2019, (online), at https://www.uss.co.uk/news/all-news/2019/10/investigation-into-nonexecutive-directors-conduct [accessed on 8th March 2020]

described above, this filter is exemplified by the language intentionally used by both employers[510] and Prof Sir David Eastwood as chair of trustees, pointing[511] to the chaos and anarchy that would be caused within the sector including the possibilities of redundancies and large-scale cutbacks, if de-risking were not immediately carried out in the way, they would prefer. For example, Universities UK in a February 2018 letter note that 'If an increase in employer contributions were to be imposed, funding would have to be found from elsewhere in university budgets – from teaching and research, from staffing costs and from student services. It could lead to widespread redundancies, hurting both staff and students. And there would be no guarantee that the scheme would be in a more stable place at the next valuation, leading to further cost increases, more significant reductions in future pension benefits, and more cuts'.[512] The emotive choice of language is clearly not intended to be an honest discussion of facts, but a whipping up of sentiment based on the ideological position being presented as such, so as to allow for fear to be sown about contrary views proposed by the UCU.

How deficits calculated using Gilts+ approaches affect the USS pensions discourse

Using Herman and Chomky's model[513] discussed above, a manufactured deficit, can be perversely marshalled within the discourse to achieve the hidden aims of powerful actors. In the case of USS pensions, the Gilts+ approach has been used very effectively to erode and cause the beginning of the end for Defined Benefit provision. This has been done in three main ways.

Firstly, the calculation of deficits using the Gilts+ methodology has caused the deficits to appear worryingly large at every valuation in the triennial valuation cycle. This means that the valuations have moved away from acting as opportunities for small course corrections as they are intended to be, but instead have a significantly higher effect on the long-term viability of the pension fund. Soederberg (2014),[514] in her analysis of how debt and poverty reinforce each

[510] Universities UK, (2018), Open letter to USS pension scheme members dated 22nd February 2018, (online) at https://www.kent.ac.uk/human-resources/pensions/documents/UUK-pensions-open-letter-feb-18.pdf [accessed on 13th March 2020]

[511] Rust, S., (2018), USS: Further delay to funding agreement risks regulatory action, IPE, article dated 19th December 2018, (online) at https://www.ipe.com/uss-further-delay-to-funding-agreement-risks-regulatory-action/10028716.article [accessed on 13th March 2020]

[512] Universities UK, (2018), Open letter to USS pension scheme members dated 22nd February 2018, (online) at https://www.kent.ac.uk/human-resources/pensions/documents/UUK-pensions-open-letter-feb-18.pdf [accessed on 13th March 2020]

[513] Herman, E., Chomsky, N., (1998), *Manufacturing Consent*, Pantheon, New York

[514] Soederberg, S., (2014) *Debtfare States and the Poverty Industry: Money, Discipline and the Surplus Population*, Routledge, London

other explains how poverty is entrenched by policies that justify exploitation of the poor because those offering credit to the poor adopt a flawed, financialised logic in a microcosm to justify excessive interest rates, which then all but guarantee further entrenchment of debt and poverty. Similarly, a narrative of thrift, rational behaviours by employers and prudence accompanying discussions of the deficit has helped to legitimise extremely draconian and unjustified measures based on limited evidence. These measures have evolved over a very short space of time given the significance of potential impact of such changes on members, and given the broader evidence of USS' positive cashflow stretching into the long-term. In the case of USS, this narrowing of the narrative to purely focus on the deficit was particularly acutely obvious in the discussion[515] of the changes that were announced in 2017 to change the Scheme from a DB Scheme to a DC Scheme. The deficit in this case was intended to absolve employers of their responsibilities of the Scheme, using a spurious narrative of the Scheme being in financial difficulties and therefore needing to change form.

Secondly, an argument has been advanced that the deficit causes too much risk to sponsoring employers, and also creates uncertainty in terms of their ability and the ability of the fund to sustain not just pensions, but jobs, research and allied work in the longer term.[516] This has prompted some employers to consider leaving the Scheme, thus eroding the mutuality, discussed further above that provides a great source of stability to the Scheme. For example, in May 2019, Trinity College Cambridge, one of the wealthiest employers with a very small membership, left the Scheme despite having to pay a price estimated at circa £30mn, which was a very questionable way of insuring against risks.[517]

The size of the deficit in these triennial valuations has also prompted the decision that such risks must be removed through de-risking. This de-risking has been conceived by USS as operating through its investment strategy. The objective is to remove the investment risks that might be created by the uncertainty in relation to self-sufficiency caused by the Scheme's investment in equities. This is then achieved by USS by making supposedly prudent investment strategy choices to replace equity-style investments by debt-style investments. Despite the fact

[515] Eastwood, D., (2017), Letter dated 21st August 2017 to Frank Field MP, (online) at https://www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/Response-from-Prof-David-Eastwood-re-Universities-superannuation-scheme-21-08-2017.pdf [accessed on 8th March 2020]
[516] Titcomb, L., (2017), Letter from The Pensions Regulator to the Work and Pensions Select Committee (online) at https://www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/Letter-from-Pensions-Regulator-to-Frank-Field-re-Universities-superannuation-scheme-07-09-2017.pdf [accessed on 8th March 2020]
[517] Trinity College Cambridge, (estimated 2019), College Notice: Trinity College and USS, (online) at https://www.trin.cam.ac.uk/about/college-notices/trinity-college-and-uss/

that this introduces more risks[518] for members of the pension scheme because the move to debt instruments actually reduces the rates of return and increases the longer-term risks of non-payment of pensions, this strategy is considered to be de-risking, because it removes the uncertainty in the investment performance of the assets. Debt instruments provide greater certainty, even if that certainty is of lower return. This circular logic in turn leads to the Scheme appearing more financially unsustainable, and posing inordinate risks to members and employers, which in turn prompts further de-risking, exacerbating the problems.

The broader marketised context of higher education provides the impetus for employers to support this de-risking strategy, because their pensions liabilities appear less volatile on their balance sheets, when the deficit appears less volatile. The removal of volatility then makes them appear to have more manageable liabilities on their balance sheet. This management of deficit is then turned into the discourse of employers being prudent and needing to close Defined Benefit schemes because the risks are too high.[519] This plays into the hands of those who see this as a good way to legitimise jettisoning DB pension liabilities within their balance sheets, so as to free up their balance sheet for the kinds of speculative real estate and capital markets transactions that are associated with the marketised university.[520]

Thirdly, an argument has been made that increased contributions need to be paid by both employers and members, in the short-term – again, on the pretext that long-term funding targets need to be met – thus feeding the narrative DB, is 'too expensive' or is even 'unaffordable' for sponsoring employers or for members, even in the shorter term and therefore drastic change needs to cut in immediately.[521] The USS Joint Expert Panel notes that the USS opt-out rates are 'considerably higher than the national average'[522]. This seems like a counterintuitive position for potential members of a healthy, growing, unique DB Scheme to

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[518] Salt, H., Benstead, D., (2018), Report for University and College Union: Three Questions on the USS 2017 valuation prepared by First Actuarial LLP, (online) at https://www.ucu.org.uk/media/9971/First-Actuarial-three-questions-on-the-valuation/pdf/firstactuarial-3questions_nov18.pdf [accessed on 8th March 2020]

[519] Universities UK, (2018), Open letter to USS pension scheme members dated 22nd February 2018, (online) at https://www.kent.ac.uk/human-resources/pensions/documents/UUK-pensions-open-letter-feb-18.pdf [accessed on 13th March 2020]

[520] Barnett, C., The financialisation of Higher Education and the USS dispute, USSBriefs blog, (online) at https://medium.com/ussbriefs/the-financialisation-of-higher-education-and-the-uss-dispute-9231b9458699 [accessed on 8th March 2020]

[521] Universities UK, (2018), Open letter to USS pension scheme members dated 22nd February 2018, (online) at https://www.kent.ac.uk/human-resources/pensions/documents/UUK-pensions-open-letter-feb-18.pdf [accessed on 13th March 2020]

[522] USS Joint Expert Panel (2019), Second Report of the USS Joint Expert Panel, December 2019, [online] at http://ussjep.org.uk/files/2019/12/JEP2-Final-Report.pdf [accessed on 20th January 2020]

take. Employers' communications which often seek to highlight the size of the deficit. The presence of a deficit and the increasing contributions unsurprisingly create a spectre of uncertainty for members and have an impact on factors such as opt-out rates. These communications do not however contextualise that a pensions deficit is a modelled estimation of the circumstances in the future, and that while the Scheme is cash-flow positive, this estimation may not reveal the whole picture of USS' financial health. Employers have also created targeted communications to emphasise their contributions to the Scheme that cherry-pick data to illustrate how much they are paying into the Scheme[523]. This then results in scaring members into leaving the scheme assuming it will fail or in making the Scheme too expensive for lower-paid members, thus ensuring many who would otherwise have stayed in the Scheme, feel unable to continue. This direction of travel has been evident more generally with DB pension schemes closing to new accruals or to new members[524] and more specifically, particularly in the case of USS.[525]

The increases in risks to members takes place in a context where there is grave information asymmetry between marketised employers, retaining highly qualified actuarial advisors and lobbyists such as Universities UK to advance the case made by their management and negotiate on their behalf. This superiority in small groups of powerful elites (management within employers in this case), causes for collective action problems to reinforce the manufacture of consent caused by a financialised assessment of risks. This assessment not just prioritises financial risks that are of importance to employers but prevents a discussion of the holistic range of risks that might apply to members and civil society, if de-risking through increased exposure to gilts for example, actually reduces risks to the Scheme as a whole.

Conclusion and suggestions for further research.

This chapter looks at how the concept of risk has been framed in Universities Superannuation Scheme (USS) pension dispute. It examines some of the history of USS, right up to the present, examining the unprecedented and ongoing dispute which has had such a significant impact on

[523] UniversitiesUK as USSEmployers, (2019), Infographic: Defined Benefit pensions in the UK and university spending, [online] at https://ussemployers.org.uk/briefing-resources/videos-graphics-and-media/concluding-208-valuation/infographics-defined-benefit-pensions-uk-and-university-spending [accessed on 20th March 2020]

[524] Thurley, D., (2019), Defined benefit pension scheme funding regime, Parliamentary Briefing (online), at https://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN04877 [accessed on 5th January 2020]

[525] Joint Expert Panel (2019), Second Report of the Joint Expert Panel, (online) at https://ussjep.org.uk/files/2019/12/JEP2-Final-Report.pdf
[accessed on 5th January 2020].

higher education. The chapter reviewed two main areas, employer underpayments and the strategy of de-risking. Both affected the health of the Scheme. The case study adopts perspectives from different disciplines to examine how the understanding of risk can be moved from a holistic discussion of risk to a narrow conception of risk, that ignores the wider arrays of risk posed by changes to the management of funds and distribution of risks within the pension scheme. Adapting Hermann and Chomsky's five filters model to the discussion of de-risking, the case study explores how powerful elites can distort narratives and suppress dissent so as to preserve and entrench their own interest.

The chapter shows how a financialized interpretation of risk can be manipulated to privilege some, while creating potential detriment to others. In the example of USS this reinforces a lesson from the GFC that financialization places 'more aspects of economic and social life at the risk of volatility from financial instability and, conversely, places the economy and social life at risk of crisis from triggers within particular markets'. [526]

Suggestions for future research include an analysis of employer communications to members in the context of Hermann and Chomsky's five filters. It would also be interesting to explore how financialisation can create and reinforce what Soederberg[527] has (in the context of credit extension) described as 'debtfare'. Parallels could be explored in relation to evisceration of pensions, particularly in the context of high levels of casualised employment within Higher Education.[528]

[526] Sawyer, M., (2013), What Is Financialization?, *International Journal of Political Economy*, Vol 42, Issue 4, pp 5-18 [online] at 10.2753/IJP0891-1916420401 [accessed on 26th February 2019]

[527] Soederberg, S., (2014), *Debtfare States and the Poverty Industry*, RIPE Series in Global Political Economy, Routledge, Oxon

[528] Megoran, N., Mason, O., (2020), Second Class Academic Citizens: The dehumanising effects of casualisation in higher education, [online] at https://www.ucu.org.uk/media/10681/second_class_academic_citizens/pdf/secondclassacademiccitizens [accessed on 15 March 2020]

Conclusion

This thesis has been set out in the form of three chapters, that traverse disciplines and in some ways time horizons too.

Chapter one looks back in time at the causes of the global financial crisis (GFC) that began in 2007. When the GFC originally unfolded, its effects were devastating. This provided a strong case for a radical overhaul of the system, and immediately after the crisis, such change was acknowledged by both industry insiders and civil society stakeholders as necessary.[529] Yet, over a decade after the crisis, even mainstream financial commentators acknowledge that while 'the stagflation of the 1970s brought a counter-revolution *(when)* the 1980s saw a radical change of ideas on the role of the state and markets, the goals of macroeconomic policy and the job of central banks',[530] the GFC has not brought about any fundamental transformation. The chapter critically examines each of the causes, and identifies the levers for such a radical overhaul. It clarifies the need to conceive risk and regulation more holistically, so as to go beyond simply conceiving regulation as a response to the direct financial costs of risk to a small range of stakeholders. For example, the dominant component of the discussion post-crisis, particularly within regulatory and practitioner circles, was framed in terms of protection of taxpayers or the direct financial costs of the crisis, rather than in terms of the broader costs (both financial and non-financial) borne by civil society, as a result of the crisis. This prevented a fuller exploration of the range of harms imposed upon civil society.

The centrepiece of the thesis and its key contribution to the scholarly literature in the area of financial regulation, is chapter 2 that uses the GFC as a springboard to look ahead and provide a conceptual basis for structurally reforming UK financial regulation. The chapter focusses on the substantive political rationales for regulation, within the public interest theories of regulation and it explains how conduct regulation should and could be animated by these substantive political rationales. Looking back at the causes of the crisis, the chapter sets out the evolution of prudential regulation as a response to the issues highlighted by the crisis. Although macro-prudential regulation, as a concept, has been discussed since the 1970s,[531] regulatory policy-

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[529] Cohan, W., (2015), How Wall Street's Bankers Stayed Out of Jail, *The Atlantic,* September 2015 issue at https://www.theatlantic.com/magazine/archive/2015/09/how-wall-streets-bankers-stayed-out-of-jail/399368/ [accessed on 20th April 2020]

[530] Wolf, M., Why so little has changed since the financial crash, *Financial Review* Opinion column dated 5th September 2018, [online] at https://www.afr.com/world/why-so-little-has-changed-since-the-financial-crash-20180905-h14y4o [accessed on 24th February 2019]

[531] Clement, P., (2010), The term 'macroprudential': origins and evolution in Bank for International Settlements, *BIS Quarterly Review,* 1st March 2010 [online] at https://www.bis.org/publ/qtrpdf/r_qt1003h.pdf [accessed on 11th February 2018]

makers, particularly in the UK, have traditionally practised prudential regulation in the form of micro-prudential regulation.[532] Micro-prudential regulation has been justified as addressing systemic risks through regulatory oversight to ensure that financial firms at a more individualistic level were able to either honour the financial claims they had committed to, or be unwound without distressing the system. The expectation in this is that each individual entity being financially sound would enable the system as a whole to be sound too. Ad-hoc thematic regulatory interventions and somewhat more systematic approaches through a high-level approach to financial stability[533], have also accompanied this micro-prudential regulation. The latter have taken place through co-ordinating mechanisms between Her Majesty's Treasury, The Bank of England and the regulator. The GFC has proved that this approach to prudential risks was unable to cope with systemic risks effectively. Macro-prudential regulation adopts a more systematic approach to regulatory interventions at a systemic level. Drawing a parallel with macro-prudential regulation, the chapter highlighted the systemic nature of conduct risks. It offered the rationale and structural mechanism for a cognitive shift in the way conduct regulation is conceived.

The third chapter looks at how the notion of risk was and is framed in the dispute around changes to the £74bn Universities Superannuation Scheme (USS). It is an exploration of the certain elements of the history of USS, with bridges to the present, examining the ongoing pensions dispute disrupting higher education. The chapter reviewed two main areas, employer underpayments and the strategy of de-risking adversely affecting the health of the Scheme. Examining the narrative around each, it sets out how a financialized interpretation of risk, can be harnessed to privilege some, while creating potential hardship for others. In the microcosm of USS, this reinforces a lesson from the GFC that financialization places 'more aspects of economic and social life at the risk of volatility from financial instability and, conversely, places the economy and social life at risk of crisis from triggers within particular markets'.[534]

The chapters in the thesis have evidenced the role of financialization as the catalyst for many of the socio-economic and democratic challenges that are faced by civil society. Financialization introduces risks not just to financial markets and the real economy, but also to democratic

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[532] European Central Bank, (2014), Financial Stability Review, Special Feature C, pp 135-140, [online] at https://www.ecb.europa.eu/pub/pdf/fsr/art/ecb.fsrart201405_03.en.pdf [accessed on 20th April 2020]

[533] House of Commons Treasury Select Committee, (2014), Reform to the institutional framework on financial stability, Chapter 5 in report titled Banking Crisis: regulation and supervision, at

[534] Sawyer, M., (2013), What Is Financialization?, *International Journal of Political Economy*, Vol 42, Issue 4, pp 5-18 [online] at 10.2753/IJP0891-1916420401 [accessed on 26th February 2019]

debate and, as a result to citizens, through the corruption of narratives surrounding the reform that is sorely needed to address socio-economic challenges foisted on society by global finance. In doing so, the thesis seeks to concentrate the attention of scholars on the insidious role that financialization plays in subverting genuine regulatory reform particularly after crises.

Each of the chapters intentionally avoids using a mono-disciplinary lens. Instead the chapters examine problems with finance by marshalling relevant insights from the work of scholars across different disciplines to develop a cross-disciplinary vantage point. In critically examining and carefully selecting these insights, the thesis seeks to have as its motivation, the need for finance to be driven by the needs of society rather than creating self-referential mechanisms and structures that entrench socio-economic barriers. The aim is to squarely and critically confront and challenge what Tombs (2015) drolly refers to as 'the non-ideological work of the liberal orthodoxy *(that is)* highly ideological and politicised'.[535]

Directions for future work

Due to the diversity of the sources and the multiplicity of intellectual roots that they are drawn from, the analysis within the thesis offers many avenues for further research within specific disciplines or in integrating multiple disciplinary strands.

One potential avenue for study relates to the way risk transformation is conceived within the theory of financial intermediation. Within the study of qualitative asset transformation, risk transformation is thought of as being an adjunct of size, maturity or liquidity transformation. The conceptualisation of financial firms solely as intermediaries can mask the role that financial firms play in creating new risks. Such new risks are introduced as a result of their size, their ability to lobby, or to make campaign contributions that alter regulation, their power in shaping the narrative around finance and so on. As such the risks that they introduce are not solely attributable to their role in purely facilitating the economic transactions that grease the needs of society. This facilitative role however has traditionally been put forward as the justification for their prioritisation within rescue packages. In grappling with the role of financial intermediaries in introducing or creating new risks, rather than just being valuable conduits of risk arising from the transformations of size, maturity or liquidity, societal resources could then be prioritised in different ways to facilitate any rescues in times of failure.

[535] Tombs, S., (2015), Crisis, What Crisis? Regulation and the Academic Orthodoxy, *The Howard Journal*, Vol 54 No 1, pp 57-72, [online] at 10.1111/hojo.12114 [accessed on 24th April 2020]

Another allied area of study developing the theory of financial intermediation could be framed around the role of banks in creating risk through money creation. The theory requires significant recalibration because more recent mainstream evidence and acknowledgement of longer-standing works of scholars including Werner (2014),[536] many contemporary academic explorations of finance, do not effectively acknowledge the power that money creation affords banks, and how this in turn affects democracy and policy formation. It would be useful to re-examine and reframe this using the updated paradigms.

On a separate theme, scholarly work in the area of regulation could be developed in the conduct regulation space, moving away from a marketised and financialized framing of stakeholders as consumers or providers of financial services. This could take multiple forms – particularly in reframing how many of the existing checks and balances against risk, reinforce inadequacy of citizen protections by implementing regulation using the frame of consumer protection. It would also be useful to explore how the notion of vulnerability may be expanded in the context of financialization This would help to consider and re-balance the way in which regulators and regulation contribute to ongoing exploitation of the vulnerable. Further work is also required in examining the role of regulators in perpetuating the violence imposed by financial hardship. This could be developed using the literature related to social harm.

On the topic of USS, there is significant room for further work around the governance and accountability of those managing this pension fund. This is particularly relevant in the light of the exclusion of experts who provide dissenting views. Such work could be developed through the use of information obtained through Freedom of Information requests and documents, previously marked as confidential, that have been leaked by whistleblowers. The proliferation of a financialized conception of education as a result of concerted action by the Higher Education (HE) lobbying bodies such as Universities UK (UUK), the Employers Pension Forum, the Universities and Colleges Employers Association (UCEA) and that of university vice-chancellors and senior managers, is another interesting avenue for future study.

More broadly, within the study of corporate governance, work could be carried out in relation to whistleblowing, expert involvement, citizen fora and mechanisms for dissent, that allow for greater accountability of those within positions of power. This and other work could help

[536] Werner, R., (2014), Can banks individually create money out of nothing? — The theories and the empirical evidence, *International Review of Financial Analysis,* Vol 36, Dec 2014, pp 1-19, [online] at https://doi.org/10.1016/j.irfa.2014.07.015 [accessed on 24th April 2020]

advance scholarship in education, corporate accountability, state accountability, financial regulation and criminology, amongst others.

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