



The Warwick Commission on  
International Financial Reform:  
In Praise of Unlevel Playing Fields

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# The Warwick Commission on International Financial Reform: In Praise of Unlevel Playing Fields

THE REPORT OF THE SECOND WARWICK COMMISSION



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## Preface

### Professor Nigel Thrift



“The Report provides an important revision to much conventional thinking”

The Warwick Commission on International Financial Reform is the second of its kind from the University, and aims to bring together knowledge from scholars and market practitioners to address issues of global economic importance. There are few topics of greater urgency than how to reform the international financial system in the midst of crisis. The issues involved in considering financial reform are very complex, and the stakes at play for citizens, private enterprise, and governments are high. The aim of the Warwick Commissions is to act as an independent autonomous body and bring together an interdisciplinary and experienced team of scholars and practitioners with no specified prior agenda. Through debate and discussion, the Commissions are charged with the duty of producing recommendations that are practical, progressive, and realistic. In this sense, the Commissions seek to enter into the public debate. Through this report, the current Commission has sought to answer an important question often absent from debates in the financial press: what is a financial system for? The answers provided in this report will strike many as controversial, especially the stress on empowering national regulation

rather than strengthening international cooperation around formal rules. Indeed, the Commission’s conception of the social need for ‘unlevel playing fields’ will upset some. The Warwick Commissions do not aim for universal consensus around broad and general principles, but aim to fuse together scholarly analysis with reflection on what reforms are most needed and most appropriate.

The Warwick Commission on International Financial Reform began its work in January 2009. The team of commissioners was selected to provide a wide range of skills and experience from both academia and the financial marketplace. I would like to give special thanks to Professor Avinash Persaud for being a particularly active Chair of the Commission and certainly one of the central voices in debates on international financial reform.

The original idea for the Warwick Commissions belongs to Professor Richard Higgott, our Pro-Vice Chancellor for Research and Founding Director of Warwick’s Centre for the Study of Globalisation and Regionalisation (CSGR). The current commission is directed by the new Director of CSGR, Professor Leonard Seabrooke,

a political economist whose research has concentrated on the connections between financial systems and welfare regimes. The other 10 commissioners are drawn from five continents and are a diverse group in terms of their academic backgrounds. Many of the commissioners are trained as political economists, including scholars oriented towards national welfare regimes and others concerned with international coordination problems. Other commissioners are trained as economists, including some who operate both in academia and are also finance practitioners. The Commission also includes a lawyer who specialises in international financial contracts. This combination of skills, knowledge and experience has provided the Commission with significant points of difference from which agreement had to be forged. Members of the Commission also engaged in evidence gathering sessions with key regulators and market participants in North America and Europe. The result is a report which tackles the big questions about how to regulate national and international financial systems head on. The Report provides an important revision to much conventional thinking about why financial markets should reflect a 'level playing field', and puts forward a strong argument for privileging the national to assist international financial stability.

The Commission, and its Report, reflect the University of Warwick's commitment to being involved in important international policy debates, as well as highlighting the impact that rigorous scholarly analysis can have on policy thinking. I anticipate that the Report

will be read by financial market practitioners, regulators, and academics who have an interest in exploring alternatives about how to regulate financial systems. I expect that the Commission's recommendations will enter policy debates and that, as the most acute effects of the crisis pass, they will provide some food for thought in answering the question: what is a financial system for?

I am delighted to take the opportunity in this Foreword to thank several organisations for their financial and in-kind support for the activities of the Commission: these include The Centre for Governance Innovation (CIGI) at the University of Waterloo and the Indian Council for Research on International Economic Relations (ICRIER), as well as the EU Framework 6 Network of Excellence on Global Governance, Regionalisation and Regulation (GARNET), The Centre for Trade, Policy and Law (CTPL) at Carleton University, Ottawa, and the Stiftung Wissenschaft und Politik, in Berlin for logistical and dissemination support. The Report is a genuine reflection of the ideas, inputs and efforts of all commissioners, both electronically and from their three meetings at Warwick in January, Berlin in March and Ottawa in June this year. Finally, in commending this Report to you, it gives me great pleasure to thank Professor Avinash Persaud and his commissioners for bringing the second Warwick Commission to fruition.

**Professor Nigel Thrift**

*Vice Chancellor, University of Warwick  
November 2009*

## Foreword Mark Carney



© Image courtesy of Bank of Canada

### “The Report should prove invaluable to policymakers at this critical juncture”

The recent global financial crisis has already cost tens of millions of jobs and trillions of dollars in foregone output. Its aftershocks will persist for years. To prevent an even more severe outcome, monetary and fiscal policies have been stretched to their very limits. In its wake, policymakers are determined to reshape the financial services industry. Given the stakes, it is imperative that reforms are governed by a clear understanding of what went wrong. The crisis demonstrated the importance of incentives; the dangers of conformity, the imperative that core markets are continuously open, and the value of matching risk to risk-bearing capacity. Most fundamentally, it exposed the fallacy of composition that strong financial institutions collectively ensure the safety and soundness of the system as a whole. Even the most vigilant micro-prudential regulatory regime can be overwhelmed by systemic risks.

Armed with these insights, the challenge is to develop and implement a macro-prudential approach to regulation. This requires focusing on the system as a whole rather than institutions; on the forest rather than the trees.

However, like ecosystems, financial markets are fiendishly complex, and macro-prudential regulations could have unintended consequences. Moreover, the interplay between new regulations and other policies should not be underestimated. In developing these tools, careful consideration must be given to policy frameworks, including finding the right balance between rules and appropriately constrained discretion.

The Warwick Commission Report goes to the heart of these issues. Refusing to treat the recent crisis as a special case, it examines the causes of financial crises in general. With its sophisticated grasp of how the credit cycle operates, innovative reform proposals, and considered treatment of the political economy of regulation, the Report should prove invaluable to policymakers at this critical juncture.

**Mark Carney**  
*Governor of the Bank of Canada*

## Foreword

# Andrew Sheng



## “The global public good is being consumed by unfettered greed and momentum trading”

The Warwick Commission is to be congratulated on taking a fresh look at the challenges facing international financial reform. The current global financial crisis demonstrated unequivocally that the world is unbalanced and will always be in a state of constant change.

Recognising that requires a systemic and system-wide view, not the partial view of mental and bureaucratic silos that tries to manage the global beast with local laws and local mindsets.

Globalisation has forced us to deal with the problem of collective action at the local and global level and to avoid a race to the bottom or a Tragedy of the Commons. The global public good is being consumed by unfettered greed and momentum trading.

Financial regulators cannot be lone Dutch boys putting their fingers in the dyke. They need to have the courage to warn the community when they see risks coming and to lean against the wind, but they cannot do it alone.

What this crisis has shown is that when values and mindsets are narrow and overspecialised, we end up with fallacies of composition that cause individuals and institutions to act in self-interest or preservation and that can lead to unsustainable bubbles or bust.

For this reason, the Warwick Commission tries to challenge the orthodoxy and should be congratulated for its recommendations and suggestions for understanding that there is no self-equilibrating stability, but a dynamic evolution where we need to encourage diversity of thinking to get more balanced markets than uniform thinking that herds into one direction.

**Andrew Sheng**

*Chief Adviser to the China Banking Regulatory Commission*

## Foreword Lord Adair Turner



“On all the issues it addresses, it is able to challenge conventional wisdoms, free from the constraints which inevitably influence the thinking of official authorities involved in complex international discussions”

In the wake of the last two years’ financial crisis major reforms of global financial regulation are under way. These will result in higher bank capital and liquidity requirements, changes in accounting policy, and new policy approaches to currently ‘too big to fail’ financial institutions.

These reforms reflect considerable consensus on the causes of the crisis, and much of that consensus will likely stand the test of time. But there is a danger we will over-react to specific features of this particular crisis, that we will fail to identify actions which can guard against future risks, and that the detailed processes of international negotiations will lead to divergence from the initially identified priorities.

It is therefore essential that, even as we rapidly progress towards clearly appropriate change, we continue to step back, think through the fundamental causes of this and other crises, and ensure that the reform programme is focussed on what really matters. The Warwick Commission’s Report does this very effectively.

Its focus on the credit cycle as the key driver of financial and macro-economic instability is correct and crucial, and the Report rightly identifies the danger that apparently sophisticated risk management and regulatory techniques, seeking to draw inference from observed market prices for assets and risks, can themselves generate instability of asset prices, of maturity transformation, and of credit extension.

The Report therefore draws a strong distinction between macro prudential and micro prudential regulation, rightly arguing that the latter cannot be effective without the former. Amid all the efforts devoted to reform of global micro-regulation, we must keep returning to this insight. While the argument for macro-prudential approaches has been accepted in principle, regulators and central banks have not yet defined how we will put in place this most crucial element of the policy response.

The Report also puts down a powerful challenge to the current primary focus on ‘home country’ regulation and supervision, arguing strongly that a greater focus on separately capitalised and regulated national subsidiaries would create not only more resilient financial institutions but also greater freedom for emerging market economies to address tricky macro-economic issues, such as volatile capital flows.

Not everyone will agree with that conclusion: but that is the value of a Report such as this. On all the issues it addresses, it is able to challenge conventional wisdoms, free from the constraints which inevitably influence the thinking of official authorities involved in complex international discussions. Its analysis of regulatory capture as essentially an intellectual process (capture by ideas rather than by interests) and its insistence on the need to consider the right sizing not only of specific institutions but of finance in total are particularly useful.

Its willingness to make strong arguments therefore makes this Report a most important and timely input to policymakers. As we struggle with the details of specific issues, we can lose sight of the big picture, and fail to address the most important priorities. This Report can play a valuable role in guarding against that danger.

**Lord Adair Turner**

*Chairman of the Financial Services Authority, U.K.*

# The Commissioners

**Professor Avinash Persaud**  
**Chair**

*Chairman, Intelligence Capital and Emeritus Professor of Gresham College*

**Professor Leonard Seabrooke**  
**Director of Studies**

*Professor of International Political Economy, Director of the Centre for the Study of Globalisation and Regionalisation (CSGR), University of Warwick*

**Dr Heribert Dieter**  
**Co-Director**

*Senior Fellow, German Institute for International and Security Affairs (SWP) and Associate Fellow (CSGR), University of Warwick*

**Professor Mark Blyth**

*Professor of International Political Economy, Brown University*

**Professor Anna Gelpern**

*Associate Professor, American University Washington College of Law*

**Professor Stephany Griffith-Jones**

*Financial Markets Director, Initiative for Policy Dialogue, Columbia University*

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*Director and Chief Executive, Indian Council for Research on International Economic Relations (ICRIER)*

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*Professor of International Financial Strategy, Warwick Business School and Managing Director, BlackRock*

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*Professor Avinash Persaud, Chair, The Warwick Commission*

