

## Chapter 1

# A Capital Battle

After a week of wrangling on Capitol Hill, Congressional leaders presented the *Emergency Economic Stabilization Act* (2008) to a deeply skeptical legislature. Providing the US Treasury with a line of credit to buy up to \$700 billion in impaired securities represented the largest single government intervention in capital market governance since the New Deal regulatory architecture was designed and implemented in 1933–34. In announcing its “frozen” provisions, including enhanced regulatory oversight, mechanisms for the partial nationalization of an array of complex financial institutions and concomitant caps on executive pay within those that avail of the rescue, the Speaker of the House of Representatives, Nancy Pelosi, said the package was designed to send a clear message to Wall Street: “The party is over.”<sup>1</sup>

The proposed scale of the intervention was indicative of the continued—and worsening—dislocation in global capital markets. Despite warnings from President Bush that a failure to ratify would unleash catastrophe, House Republicans (and a sizeable Democrat minority) struck down the measure.<sup>2</sup> The decision reflected deep-seated ideational, practical and strategic reservations. It inevitably threw global markets into a tailspin. The Dow Jones Industrial Index immediately lost 7%, with \$1.2 trillion wiped off capitalization values. Taking their lead from New York, Asian and then European markets fell and continued to fall heavily throughout October.<sup>3</sup> Across the world, political and

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<sup>1</sup> “US Law Makers Publish Rescue Plan.” *BBC News*, 28 September 2008.

<sup>2</sup> The vote was defeated 228 to 205, with 133 Republicans and 95 Democrats voting against. Passage was secured in the Senate on Wednesday following adornments, including \$112 billion of unrelated tax breaks. Two days later, the bill returned to the House, where it was approved.

<sup>3</sup> By the end of the month, US and European markets had lost 25%. The S&P 500 Index was down 42% on the year; see M. MacKensie, N. Bullock, and D. Brewster, “Investors

regulatory leaders expressed anger and puzzlement at Congress. The Chinese securities regulator bluntly described US lending practices as “ridiculous,” “dangerous,” and “indefensible.”<sup>4</sup> Europe’s then trade commissioner intoned that it was necessary to reshape the global financial architecture. US politicians had, Peter Mandelson claimed, “taken leave of their senses.”<sup>5</sup> The Australian Prime Minister, Kevin Rudd, appealed to Congress to put global security above partisan self-interest. Rudd explained subsequently that concerted intervention was needed to nullify the effects of “extreme capitalism.”<sup>6</sup> It was far from clear, however, that the plan put forward and eventually agreed by the United States Congress was either workable or desirable. Notwithstanding international endorsement, there was something deeply unsettling about one arm of the US federal government offering to buy products from institutions under investigation by another for violating criminal law.<sup>7</sup> Moreover, the emphasis on providing emergency relief to the financial sector rather than immediate help to embattled homeowners or to industrial corporations who found access to credit curtailed, while perhaps understandable, risked undermining the legitimacy of the political system. In so doing, it called into question the efficacy of an underpinning social contract.

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Reel From Punishing Month,” *Financial Times*, 1 November 2008, 1. By the end of the year, global markets were decimated. Reykjavik had lost a staggering 94.4%; Moscow 72.5%, Dubai 72.4%, Bucharest 70.5%; Dublin 66.2%; Hanoi 65.9%; Shanghai 65.4%; Athens 65.3%; Vienna 61.2%; Lima 59.9%; Karachi 58.3%; Riyadh 56.3%; Cairo 56.4%; Brussels 53.3%; Oslo 52.8%; Mumbai 52.5%; Amsterdam 52.3%; Istanbul 51.6%. In the United States, the S&P 500 closed the year with a loss of 38%, the biggest loss since 1931, with bell-weather stocks such as Citigroup shredding 78% of its value and General Motors losing 87%, the biggest single decline.

<sup>4</sup> D. Gow, “Mandelson Calls for IMF Reform and a Voice for New Champions,” *The Guardian*, 29 September 2008 (Online Edition).

<sup>5</sup> Ibid; see also P. Wilson, “Europe Wants US Power Shift,” *The Australian*, 1 October 2008, 36.

<sup>6</sup> The crisis, he proclaimed, could be traced to the celebration in financial centers of the cultural values denigrated in the influential Oliver Stone movie, *Wall Street* (1987), see K. Rudd, “The Children of Gordon Gekko,” *The Australian*, 6 October 2008, 12.

<sup>7</sup> M. Philip, “Remarks Announcing Results of Operation Malicious Mortgage” (Press Conference, Department of Justice, Washington DC, 19 June 2008); for UK, see J. Hughes, “Mortgage Fraud Crackdown on Brokers,” *Financial Times*, 19 July 2008, 1. For background on lending practices, see G. Dell’Ariccia, D. Igan, and L. Laeven, “Credit Booms and Lending Standards: Evidence from the Sub-Prime Mortgage Market” (International Monetary Fund, Washington, DC, WP/08/06, April 2008).

For the contemporary industrialized state, this requires the provision of a functioning legal and regulatory framework that is informed by the interaction of rules, principles and norms. Within this framework, the banking system plays an integral part, both in driving wider economic activity and as a barometer for gauging whether trust is in fact warranted. As such, it is an example of a public good (i.e. a policy prescription that cannot be delivered solely by the market). Effective supervision is necessary to guard against the material and reputational costs associated with negative externalities. In this context, the global financial crisis is a scandal of monumental proportions. Effective and efficient capital markets depend on confidence in the integrity of financial institutions, in the regulatory apparatus and, ultimately, trust between market participants and financial intermediaries. Self-evidently, trust like solvency is now in very short supply, and confidence has evaporated. The collapse of Bear Stearns and Lehman Brothers, Washington Mutual, and Wachovia, along with twenty-one other banks in the United States alone, and dubious, if not criminal, underwriting practices exacerbate a wider metastasizing problem that cuts across the global banking firmament. In the process it highlights profound difficulties with financialization (i.e. the process by which the productive economy has been displaced politically, culturally, economically, and ideationally by a reliance on financial alchemy).

The former CEO of Commonwealth Bank of Australia and now head of the Future Fund, the country's own Sovereign Wealth Fund, David Murray, has reflected that "everybody got carried away by the concept of a "millionaires factory" which was not culturally good. Where you don't want your brightest, or at least too many of them, is in jobs which spend time interpreting or arbitrating rules. This is not really effective work and a lot of investment banking is that type of deal structuring, which is not very constructive. It produces over-engineered stuff that is the first to break when anything goes wrong."<sup>8</sup> Asymmetric information flow, variable capacity—or willingness—to use internal management systems, market mechanisms or regulatory enforcement tools, led to a profound misunderstanding of national and international risks associated with the rapid expansion of structured finance products such as securitization. Deepening market integration ensured that risk, while diversified geographically, remained undiluted. As the Nobel

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<sup>8</sup> E. Connors, "Future Fund Chief Sees Day Of Reckoning For Banks," *Australian Financial Review*, 14 January 2008, 1, 38.

Laureate Joseph Stiglitz put it in excoriating testimony to Congress, “securitization was based on the premise that a fool was born every minute. Globalization meant that there was a global landscape on which they could search for these fools—and they found them everywhere.”<sup>9</sup> From northern Norway to rural New South Wales, local councils bought securitized products on the basis of misplaced trust in the efficacy of internal controls, the strength of independent directors to hold management to account, the attestation provided by external auditors, legal due diligence, the assurances of those providing corporate advisory services, including inherently conflicted rating agencies and, ultimately, the robustness of the overarching regulatory system at either national or international levels.

The seizing of credit markets also demonstrates the failure of piecemeal attempts to broker a regulatory solution. Until the Troubled Assets Relief Program (TARP) was proposed, economic policymakers in the United States and elsewhere had adopted a largely reactive approach. In the face of declining confidence, central banks enhanced the collateral accepted in return for short-term financing. In the case of the Federal Reserve, the range of institutional actors availing of its discount-lending window was stretched to—and arguably surpassed—formal legal power.<sup>10</sup> Each intervention was designed to provide reassurance about the resilience of individual banks, their capacity to deliver on counterparty obligations and the integrity of the overarching system. Paradoxically, the injection of liquidity reinforced rational fears that counterparty obligations could not be delivered on. Banks, fearful

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<sup>9</sup> Evidence to House Committee on Financial Services, “Regulatory Restructuring and the Reform of the Financial System,” Washington DC, 21 October 2008 (J. Stiglitz). For discussion of “an ideological agenda [which] has pushed excessive reliance” on capital adequacy standards,” see J. Stiglitz, “Principles of Financial Regulation: A Dynamic Portfolio Approach” (2001) 16 *World Bank Research Observer* 1 (arguing that “despite its long history, financial market regulation is poorly understood” and suggesting the need for strong regulation to address “failures in the banking system [which] have strong spillovers, or externalities, that reach well beyond the individuals and firms directly involved”: at 2).

<sup>10</sup> P. Volcker (Speech delivered at 101<sup>st</sup> Meeting of Economic Club of New York, New York City, 10 April 2008). Volcker, a former chair of the Federal Reserve, argued that the erosion of trust and replacement of relational with transactional imperatives created a crisis of such magnitude that “the Federal Reserve judged it necessary to take actions that extend to the very edge of its lawful and implied powers, transcending certain long embedded central banking principles and practices”: at 2.

of even overnight exposure, refused to lend to each other. The problem thus transmogrified from a liquidity crisis to a systemic solvency one.

The precipitous decline in real estate prices was exacerbated by “mark to market” accounting rules. These required institutions to value portfolios that were trading, if at all, far below rational levels. A market price, of a sort, was found with the decision by Merrill Lynch to off-load a large proportion of its asset-backed securities to Lone Star at 22 cents on the dollar. When combined with advantageous lending terms needed to secure the transaction, the effect was to further depress broader market values. A similar dynamic was apparent in the spike of foreclosures. This pushed prices on a downward trajectory. It made it exceptionally difficult for borrowers with even large equity stakes in their properties to find refinancing. Not surprisingly, as the level of mortgage default soared so too did the London Inter-Bank Offered Rate (LIBOR). Those institutions that required short-term financing found it impossible to survive, never mind compete. By the end of September, the contagion had spread to the multi-trillion dollar commercial paper market, necessitating further government intervention. The situation reached such critical proportions that the International Monetary Fund warned that the world was on the verge of a “systemic meltdown.”<sup>11</sup>

The crisis has already cost \$3 trillion dollars and is estimated to cost a further \$1 trillion by the end of 2010. Market capitalization of financial stock across the world has dropped dramatically. Data compiled by Thomson Reuters is exceptionally sobering. In March 2007, Bank of America was valued at \$225.3 billion. By late January 2009, this had fallen to \$36.7 billion. JP Morgan Chase fell to \$74.8 billion from \$170.9 billion. Goldman Sachs had dropped to \$25.4 billion from \$82.1 billion, and Citigroup had fallen to \$17.2 billion from \$250.4 billion. Major international banks have seen similar drops within the same timeframe. HSBC has declined from \$200.5 billion to \$86 billion, while UBS has fallen to \$32.8 billion from \$123.9 billion.<sup>12</sup> These dramatic falls have had a profound impact on the banking sector’s capacity to lend. Capacity is likely to be further stretched as short-term commercial debt becomes due throughout 2009. With many countries already in recession, banks are exercising even more caution despite interest rates approaching zero

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<sup>11</sup> D. Strauss-Kahn (Press Conference, International Monetary Fund, Washington DC, 11 October 2008).

<sup>12</sup> K. Guha and A. Beattie, “Pressure Builds For Action On Bank Crisis,” *Financial Times*, 22 January 2009, 3.

in the United States and 1% in the United Kingdom, the lowest in history. In many jurisdictions these cuts have not been passed through to consumers. In the United Kingdom and Australia, for example, low rates are only available if considerable equity stakes are pledged as collateral. While de-leveraging is necessary, the short-term consequences are severe and getting worse.

In many ways the situation we face across regulatory regimes was inevitable and avoidable. The influential investor Warren Buffet has pointed out that the current crisis has exposed a huge amount of “financial folly...You only learn who has been swimming naked when the tide goes out—and what we are witnessing at some of our largest financial institutions is an ugly sight.”<sup>13</sup> It is an appalling vista that Buffet had warned about openly in his influential annual Berkshire Hathaway newsletter. Buffet had caused a major stir in 2003 with this public rebuke to regulators for their unwillingness to tackle the systemic risk associated with financial engineering.

The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear.... Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts... In our view...derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.<sup>14</sup>

The continuing chaos on global markets reflects the collateral damage from the detonation of these weapons. The first overt sign of contamination came in July 2007 when the US investment bank Bear Stearns announced that two of its hedge funds, which had been valued at \$1.5 billion at the end of 2006, had become worthless. The more aggressive of the two, High Grade Structured Credit Enhanced Leverage Fund, had no capital. The more conservative High Grade Structured Credit Strategies Fund had lost a staggering 91%.<sup>15</sup> As analysts from BNP Paribas noted on August 8, 2007, in unself-conscious deference to Buffet’s metaphor, the securitization market simply vaporized. The

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<sup>13</sup> *Berkshire Hathaway Annual Report* (2008) 3.

<sup>14</sup> Berkshire Hathaway, *Letter to Shareholders* (2003) 14.

<sup>15</sup> For background analysis of the failure, see G. Morgenson, “Bear Stearns Says Battered Hedge Funds Are Worth Little,” *New York Times*, 18 July 2007, A1.

Paris-based bank suspended withdrawals from three of its own asset-backed hedge funds because of a “complete evaporation of liquidity in certain market segments of the US securitization market.”<sup>16</sup> This, the bank claimed, made it “impossible to value assets fairly, regardless of their quality or credit rating.”<sup>17</sup> The note marked the moment the crisis turned global. Institutional investors retreated en masse from esoteric debt instruments and those most closely associated with their provision, marketing, insurance and rating.

Just weeks later, a leading and particularly aggressive United Kingdom mortgage specialist, Northern Rock, failed. Scenes of customers queuing to withdraw deposits fuelled fears of a banking run not seen in the United Kingdom since the collapse of Overend Gurney & Co in 1866. Overend’s reliance on an emaciated deposit base and its excessive concentration on wholesale funding prompted Walter Bagehot to observe that its business strategy was “so reckless and so foolish, that one would think a child who had lent money to the City of London would have lent it better.”<sup>18</sup> A damning Treasury Select Committee report into “The Run of the Rock” one hundred and forty one years later found market actors remained oblivious to the danger of recklessness derived from self-deception.<sup>19</sup> According to the Treasury Select Committee, the “absence of sufficient insurance and a failure to arrange standby facility or cover that risk, meant that [Northern Rock] was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007.”<sup>20</sup> The fact that the

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<sup>16</sup> Cited in F. Norris, “A New Kind of Bank Run Tests Old Safeguards,” *New York Times*, 10 August 2007 (Online Edition).

<sup>17</sup> *Ibid.*

<sup>18</sup> Cited in “The Run on the Rock” (Treasury Select Committee, London, 24 January 2008) 7.

<sup>19</sup> *Ibid.*, 3. A similar reliance on wholesale markets has the primary cause of the failure of HBOS, a much larger bank in the aftermath of the Lehman Brothers bankruptcy in September 2008. In a joint statement to the Treasury Select Committee, the former CEO and chairman said they were “profoundly sorry” but claimed that “unprecedented global circumstances affected virtually all the top banks in the world and HBOS specifically.” They claimed that HBOS did not invest in sub-prime but in “highly rated AAA asset backed securities,” a defense that was designed to offload responsibility to the credit rating agencies; see A Hornby and Lord Stevenson, “Memo to Treasury Select Committee,” Westminster, 10 February 2009, 38.

<sup>20</sup> “The Run on the Rock,” above n 18, 19 (Furthermore, the report found that the business model was clearly stated. As such, the shareholders were either greedy or gullible in not challenging the strategy. The report notes that “in a market environment

Financial Services Authority acknowledged ignoring red flags is described as a “substantial failure of regulation.”<sup>21</sup> In a statement to the Treasury Select Committee, Lloyds Banking Group, which took over the failed HBOS, articulated the scale of the organizational and regulatory accountability failure.

At a global level, risk was mis-priced and the sophistication of the new instruments out-paced the ability to manage and understand their long term implications particularly in a less benign economic environment. However, this lack of understanding was not just an issue for the banks. Regulators and Central Banks around the world did not always grasp the inter-dependencies in the financial system and the true nature and scale of the risk being taken by some banks. There was also a general lack of understanding of the dependency of the major economies on non-bank financing. To be fair this was always going to be difficult due to the sheer complexity of the system.<sup>22</sup>

In March 2008, the financial services contagion crossed the Atlantic. A \$22 billion hedge fund controlled by the Carlyle Group, which was registered in Guernsey, listed in Amsterdam, but administered in New York, collapsed. The calamitous failure of Bear Stearns underscored the growing severity of the crisis. Bear Stearns, the fifth

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shareholders as a whole must be viewed as taking a risk from which they sought a reward and for which they are paying a price”: at 20).

<sup>21</sup> Ibid, 24 (The report concludes “the FSA did not supervise Northern Rock properly. It did not allocate sufficient resources or time to monitoring a bank whose business model was so clearly an outlier; its procedures were inadequate to supervise a bank whose business grew so rapidly. We are concerned about the lack of resources within the Financial Services Authority solely charged to the direct supervision of Northern Rock. ... In the case of Northern Rock, the FSA appears to have systematically failed in its duty as a regulator to ensure Northern Rock would not pose such a systemic risk, and this failure contributed significantly to the difficulties, and risks to the public purse, that have followed”: at 34). In a stunning mea culpa, the FSA acknowledged that it had failed to regulate Northern Rock appropriately; see FSA, *Annual Report* (2007/8). It argued, rather unconvincingly, that this did not invalidate the principles of risk-based regulation, but was rather a failure to apply it. The chief executive, Hector Sants, argued that he was “determined that the FSA will not be defined by the Northern Rock incident, but rather by our response to it. We have demonstrated our willingness to examine ourselves critically and to learn lessons from our mistakes—a quality we believe is central to giving the financial services industry and consumers confidence in the FSA. Like any thoughtful organization, we cannot and do not claim infallibility”: at 9: at 42).

<sup>22</sup> Memorandum from Lloyds Banking Group, Treasury Select Committee, Westminster, 10 February 2009.

biggest investment bank on Wall Street, required emergency funding from the Federal Reserve of New York through a loan facility offered to and through JP Morgan Chase. Bear Stearns, which had a debt to equity ratio of 33:1 had attempted to quell “baseless speculation” by insisting that its “balance sheet, liquidity and capital remain strong”.<sup>23</sup> In the event it was insufficient. By Friday 14 March, such an approach could no longer be sustained. The chief executive officer, Alan Schwartz, was forced to issue a press release revealing the emergency capital injection: “We have tried to confront and dispel these rumors and parse fact from fiction....Nevertheless, amidst this market chatter, our liquidity position in the last 24 hours had significantly deteriorated. We took this important step to restore confidence in us in the marketplace, strengthen our liquidity and allow us to continue normal operations.” Ominously, the press release continued: “The company can make no assurance that any strategic alternatives will be successfully completed.”<sup>24</sup> The directors of Bear Stearns agreed for the bank to be sold in a deal that initially valued the institution at just \$2 per share. This represented a 90% discount on its closing price the previous Friday and was substantially less than the (rapidly declining) retail value of its corporate headquarters on Madison Avenue.<sup>25</sup>

Policymakers and banks consistently sought to underplay the extent of the crisis, claiming erroneously that it was both contained and containable. It is not surprising that while many leading banks were initially able to raise money through rights issues or capital injections from Sovereign Wealth Funds, the visual revelation of contamination

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<sup>23</sup> K. Kelly, S. Ng, and J. Strasburg, “In Dealing With Bear Stearns Wall Street Plays Guardedly,” *Wall Street Journal*, 13 March 2008, C1.

<sup>24</sup> Bear Stearns (Press Release, New York, 14 March 2008). Headlines the following day in the two leading global business newspapers demonstrate a revealing emphasis in tone and significance; see F. Guerrero, B. White, and K. Guha, “Wall Street Rescues Bear Stearns,” *Financial Times*, 15 March 2008, 1; G. Kelly, G. Ip, and R. Sidel, “Fed Races to Save Bear Stearns In Bid to Steady Financial System,” *Wall Street Journal*, 15 March 2008, A1.

<sup>25</sup> JP Morgan subsequently quadrupled its offer price, and agreed to subsume up to \$1 billion in potential losses. The revised deal had the full support of the Bear Stearns board, a calculation designed to stave off potential legal action from disgruntled shareholders; see JP Morgan and Bear Stearns, “Revised JPM-BSC Deal” (Press Release, New York City, 2 March 2008).

made each form exceptionally problematic.<sup>26</sup> As a direct consequence of this failure, we are witnessing what the chief executive of the ANZ, Mike Smith, famously described as “a financial services bloodbath.”<sup>27</sup> It was, however, largely self-inflicted.

The incapacity of institutional actors to exercise restraint was neatly encapsulated in a now infamous interview given in July 2007 by the then chief executive of Citigroup. Charles “Chuck” Prince swept aside concerns that excessive leverage created potential systemic solvency risks. “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We are still dancing.”<sup>28</sup> The now disgraced banking executive justified his confidence in modeling systems that had diversified risk. As Prince explained it, “the depth of the pools of liquidity is so much larger than it used to be that a disruptive event now needs to be much more disruptive than it used to be. At some point, the disruptive event will be so significant that instead of liquidity filling in, the liquidity will go the other way. I don’t think we’re at that point.”<sup>29</sup>

The rash of banking failures and forced resignations (including his own) since Prince’s interview reflects the deleterious combination of boardroom hubris, defective operational risk management systems and uninformed regulatory confidence.<sup>30</sup> This was, as noted above, an engineered crisis rather than the result of merely incompetent managerial or regulatory practice. It could not have happened but for the inculcation of an essentially ideological worldview that privileged innovation over

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<sup>26</sup> See, for example, R. Wachman, “HBOS 4bn Rights Issue is Massive Flop,” *The Observer*, 20 July 2008, B1; P. Thal Larsen, C. Hughes, and D. Shellock, “Banks’ Cash Calls Shunned,” *Financial Times*, 19 July 2008, 1.

<sup>27</sup> A. Cornell, “Smith Calm as Others Lose Heads,” *Australian Financial Review*, 19 February 2008, 52.

<sup>28</sup> M. Nakamoto and D. Wighton, “Bullish Citigroup is Still Dancing’ to the Beat of the Private Equity Boom,” *Financial Times*, 10 July 2007, 1; see also Stiglitz, “Principles of Financial Regulation,” above n 8 (arguing that reliance on capital adequacy standards lowers franchise value and “actually induce banks to engage in riskier behavior”: at 4).

<sup>29</sup> Nakamoto and Wighton, above n 26.

<sup>30</sup> For global overviews, see Financial Stability Forum, “Observations on Risk Management Practices During the Recent Market Turbulence” (Basel, 6 March 2008); Financial Stability Forum, *Report of Financial Stability Forum on Enhancing Market and Institutional Resilience* (Basel, 12 April 2008); J. Lipsky, “Dealing with the Financial Turmoil: Contingent Risks, Policy Challenges and the Role of the IMF” (Speech delivered to the Peterson Institute, Washington DC, 12 March 2008); President’s Working Group on Financial Markets, *Policy Statement on Financial Market Developments* (Washington DC, March 2008).

security. Crucially, it retained cogency despite the increasing empirical evidence that undermined the practical and normative value of such an approach. This generated, in turn, a new (but defective) risk paradigm informed by naivety and ignorance. While most extreme in the United States, its rationale was inculcated across the globe. In large part the misguided insouciance could be traced directly to the now questionable policy choices adopted by Alan Greenspan. As chairman of the Federal Reserve, Greenspan presided over a flight from reality. He noted “irrational exuberance” in the stock market in the 1990s but after the dot com crash at the turn of the millennium, his subsequent interest rate reduction strategy inflated an even larger bubble that encompassed residential and commercial property markets, credit card and auto loan sectors. It also provided the financing for the emergence of private equity as a dominant global force in the mergers and acquisitions market. Greenspan held that securitization and derivative contracts allowed for the quantification of risk. Financial innovation, he proclaimed, had generated a “new paradigm of active credit management.” For Greenspan, “the present health of banking is a dramatic testament to both the management skills of bankers and the ability of regulators and legislators to adapt, albeit slowly, to change.”<sup>31</sup>

The initial housing collapse in the United States placed the world on collective notice of the potential costs associated with this suspension of disbelief. It also highlighted the interconnections within global capital markets, which, in turn, explains why the toxin could spread with such ease. The decision by US authorities to allow Lehman Brothers to collapse in September 2008 triggered the explosion of this much more serious problem. The current chairman of the Federal Reserve, Ben Bernanke, now maintains that “there was no mechanism, there was no option, there was no set of rules, there was no funding to allow us to address that situation.”<sup>32</sup> The US Treasury and Federal Reserve performed a stunning volte-face, however, the day after the investment

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<sup>31</sup> A. Greenspan, “Banking” (Speech delivered at American Bankers Association, New York City, 5 October 2004).

<sup>32</sup> B. Bernanke, “Stabilizing the Financial Markets and the Economy” (Speech delivered at the Economic Club of New York, New York City, 15 October 2008); see also J. Cassidy, “Anatomy of a Meltdown,” *New Yorker*, 1 December 2008, 49 (citing an interview with Ben Bernanke in which he states “with Bear Stearns, with all the others, there was a point when someone said, ‘Mr. Chairman, are we going to do this deal or not?’ With Lehman, we were never anywhere near that point. There wasn’t a decision to be made”: at 62).

bank was forced to file the largest bankruptcy in history. The decision to rescue the insurance company American International Group through an initial injection of \$85 billion, which has since mushroomed to \$150 billion, but not Lehman Brothers was based on the fear that the collapse of the former would hasten enormous capital outflows from the remaining investment banks.<sup>33</sup> Even this rescue was not enough to quell growing fears that despite policymakers attempt at mollification, the governance of the global financial sector was hopelessly compromised. It is this realization that has animated decisions by the United States and other jurisdictions to engage in the most sweeping overhaul of financial regulation ever seen.

Despite criticism of the United States model in many European capitals—and discernible *schadenfreude*—in truth the continent has fared little better. The forced nationalization of Northern Rock, Bradford & Bingley, along with the implosion of Royal Bank of Scotland and HBOS demonstrates the hollowness of superiority claims about the risk-based principles-driven model of banking regulation exported by the United Kingdom.<sup>34</sup> Ostensibly more cautious oversight on the continental mainland has proved equally defective. As the negotiations on Capitol Hill continued over the weekend of September 26–28, the Dutch, Belgian, and Luxemburg governments attempted to nationalize large components of Fortis, a flagship European financial services

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<sup>33</sup> For an examination of the critical role played by AIG in the financial architecture, see G. Morgensen, “Behind Insurers Crisis, Blind Eye to a Web of Risk,” *New York Times*, 27 September 2008, B1; J. Nocera, “Diary of a Monumental Nightmare,” *Australian Financial Review*, 3 October 2007, 64–65.

<sup>34</sup> The FSA CEO remains wedded to his conception of what constitutes or should constitute effective regulation, see FSA above n 19 (“I believe the events of last year, including Northern Rock, support principles-based regulation; they highlight how important it is that firms’ management and the FSA focus on delivery of outcomes rather than just focusing mechanically on compliance with the rules. We therefore remain committed to pursuing more principles-based regulation and focusing on the outcomes that matter. We continue to believe that a successful financial marketplace requires innovation, the capacity for risk-taking, and competition — an approach which has served the UK economy and its financial markets well. A consequence of this philosophy is that we cannot guarantee there will not be failures. The inherent certainty that there will be failures within our framework results not just from this requirement to recognize that risks are unavoidable, but also that outcome-based judgments are essentially predictive and thus our judgments necessarily reflect the inherent uncertainty of forecasts”: at 10).

conglomerate.<sup>35</sup> An emergency line of credit ensured the temporary survival of Germany's second largest commercial lender, Hypo Real Estate. German saving banks have been particularly vulnerable to the dislocation on the credit derivatives market. Through trading operations in Dublin, which has emerged as a vibrant and freewheeling financial center, two banks have collapsed. The Irish Financial Services Regulatory Authority relied upon a "passport" system which off-loaded oversight responsibility to its German counterpart. The Dublin authorities proved equally deficient in regulating their own charges.

In the end it was perhaps fitting that the demise of the Celtic Tiger came as workers at Waterford Crystal, Ireland's premier luxury good exporter, occupied the now closed visitor center. Outside, they hoisted the "Starry Plough," the symbol of the Irish trade union movement, on the corporate flagpole. While providing the muscle for a revolutionary tradition, the Left never quite managed to exert a role on the economic trajectory of post-independence Ireland. The country now is coming to terms with a markedly changed global landscape in which the traditional safety valves of easy emigration and international goodwill have been closed. In part this could be attributed to the global dimensions of the crisis; no region has emerged unscathed. In part, it derives from schadenfraude across the world at the demise of a freewheeling and misgoverned market, where hubris trumped prudence and the country's reputation with the new United States administration has descended to that of an offshore tax haven that facilitates deception.

The scale of the calamity now facing Ireland far exceeds situations faced by any of its European partners. Throughout the boom, the population was encouraged to engage in an act of stunning self-deception. The swagger of the Celtic Tiger has wilted in the face of

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<sup>35</sup> Fortis was part of a consortium (along with Royal Bank of Scotland) that acquired ABN Amro in 2007. At the time the takeover was the largest banking consolidation ever. The Dutch government was obliged to take sole control of the bank's operations in the Netherlands, while the Belgian and Luxemburg components were to be sold to BNP Paribas for \$15 billion. A court in Belgium has temporarily blocked the sale in advance of shareholder ratification and threatened the government with a \$6.75 billion fine if it sought to disregard the ruling, see D. Jolly, "Belgium to Fight Ruling on Plan to Sell Fortis," *International Herald Tribune*, 17 December 2008, 11. The Supreme Court found that the Belgian Justice Minister and the Prime Minister's chief of staff had attempted to sway the initial decision by improperly telephoning the husband of the judge hearing the case at first instance, see J. Miller, "Belgium's Government Offers to Resign Over Fortis," *Wall Street Journal*, 20 December 2008, A8. The government subsequently resigned on 22 December 2008.

staggering regulatory, corporate, and political incompetence. Unsustainable property valuations created not just a speculative commercial and residential bubble but also a speculative economy. As the crisis intensified last September, Ireland took the unprecedented decision to provide an unlimited guarantee of all banking deposits. The move prompted large capital outflows from the rest of Europe, particularly the United Kingdom. It was designed to protect an increasingly strained domestic banking sector whose reckless lending has been instrumental in intensifying the scale of the crisis here. It is a criticism that can equally be applied to the regulatory and political authorities, which determined that it was necessary to retain consumer confidence, even when that confidence was, and remains, illusory. In essence the country degenerated into a crooked casino. Industry players set the rules of the game, unburdened by a political and regulatory elite mesmerized by financial alchemy. In a rare admission of failure, the Taoiseach, Brian Cowen, accepted “arrogance” played a role in transforming the country from “unknown prosperity to suddenly [facing] survival stakes.”<sup>36</sup>

The International Financial Services Centre became the symbol for some of the worst excesses of financialization. The staggering losses made by a leading businessman on the esoteric Contract for Difference market encapsulate just what wrong and why confidence in the probity of the Irish market is so low and the cost of serving external debt so high. Sean Quinn, a reclusive billionaire, was forced to admit he lost \$1.27 billion in the recently nationalized Anglo Irish Bank. It emerged that the entrepreneur’s family had amassed a 25% indirect interest in the bank through Contract for Difference options. The holding was reduced to 15% and converted to shares, with a consortium of business people taking a 10% stake in increments that did not surpass the 3% limit that forces disclosure to the Irish Stock Exchange. The nationalization of the bank in January 2009 crystallized the loss. The financing for these transactions came from the bank itself through non-recourse loans.<sup>37</sup> Quinn mused “we all got carried away a little” during the boom. He broke his silence after allegations arose that implicated him in the share support scheme. Quinn claimed the investment was made on behalf of

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<sup>36</sup> Brian Cowen (Speech delivered at the Chamber of Commerce Annual Dinner, Dublin, 5 February 2009), excerpted in H. McGee, “Cowen Says Recession to Cut Living Standards By Over 10%,” *Irish Times*, 6 February 2009, 1.

<sup>37</sup> *Anglo Irish Bank Annual Report 2008* (20 February 2009).

his wife and children. He conceded involvement in the transaction but insisted that there “was no impropriety in anything we’ve one in that bank....” Any money we put into shares was money we could afford to be without; in hindsight, we were too greedy.” The entrepreneur portrayed himself as a victim.<sup>38</sup> While there is merit in the argument that a disorderly public unwinding could have exacerbated the situation and caused panic earlier, the critical issue remains how the regulatory authorities allowed such a large problem to develop in the first place.

Crucially, the Irish government has accepted that it was aware as early as March 2008 of the size of the holding and the threats this posed to the stability of the bank and to the banking sector in general, as was the Financial Regulator. Both were involved in facilitating the transition, which not only involved the non-recourse loans advanced to prominent businessmen but also a series of circular transactions involving largest mortgage provider in the country, Irish Life & Permanent.<sup>39</sup> The decision by three directors of IL&P to step down on 13 February 2009 capped an extraordinary week for corporate Ireland. What made the resignations even more remarkable is that the chairman of the IL&P, Gillian Bowler, claimed the problem was not the transactions that led to their departure but the manner in which it was done. The only motivation in facilitating Anglo Irish Bank, she claimed, was to follow “a policy objective of both the Central Bank and the Financial Regulator that Irish financial institutions would work to support each other in the face of an unprecedented threat to the stability of the Irish financial system arising from the international credit crisis.”<sup>40</sup>

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<sup>38</sup> The interview was broadcast by RTE, the national broadcaster. All quotations come from J. Brennan, “Quinn Admits He Was Too Greedy as Losses Hit Euro 1 billion,” *Irish Independent*, 31 January 2009, 2; C. Madden, “Quinn Admits His Family Lost 1 Billion in Anglo,” *Irish Times*, 31 January 2009, 19; N. Brennan, “Quinn Says He Did No Wrong in Anglo Share Deal. For the Moment I Am Sceptical,” *Irish Independent*, 31 January 2009, 25. Quinn was not alone in using CFD instruments to engage in speculative activity. One report suggests that the mechanism accounted for “almost half of the activity of the Irish stock market just two years ago”; see E. Quinn, “Developers Lost E6 Billion Gambling on Stocks with Controversial Wagers,” *Sunday Tribune* (Dublin), 1 February 2009, B1; see also E. Quinn, “The Power of One,” *Sunday Tribune*, 1 February 2009, B5.

<sup>39</sup> The regulator claims now that it was misled, see C. Kenna, “Financial Regulator Believes It Was Misled By Anglo,” *Irish Times*, 20 February 2009, 1.

<sup>40</sup> “Statement by Chairman of Irish Life & Permanent,” (Press Release, Dublin, 13 February 2009). Regulatory and political authorities reject this interpretation; see Kenna, above n 39.

The finance director, Peter Fitzpatrick, and head of treasury, David Gantly, departed to salve the board's "strong disapproval of and disappointment with some of the specific measures used to support Anglo Irish Bank during 2008 and the fact that the board itself was not informed of the specific manner in which such support had been afforded".<sup>41</sup> In the early hours of 12 February, the board initially refused an offer by the chief executive, Denis Casey, to resign with his colleagues. He insisted later in the day, "having reflected on the situation with his wife and family overnight" and so the board relented. Bowler, accepting Casey's resignation with the "utmost regret", said it had been prompted by his "dedication and loyalty to the company".<sup>42</sup> The board changes followed the intervention of Minister for Finance who had publicly called on the board of IL&P to "face up to its responsibilities" after an emergency meeting with senior executives.

It is hard to know who has less credibility: the Minister, who admitted to the Irish parliament that he had failed to even read a report he had commissioned into the risks posed by Anglo Irish Bank; or the chairman and now outgoing chief executive of IL&P who were not informed of unilateral decisions that have irretrievably marred the reputation of their organization. The board statement describes Fitzpatrick and Gantly as men of "utmost integrity" and professionalism. It would appear they were victims of a misguided belief that supporting a corporate neighbor trumped any concern that the transaction seriously misled the investing public.

The controversy centers on a series of circular transactions in March and September, which were characterized as deposits rather than bank loans. The effect was to flatter the books of Anglo Irish Bank, which was hemorrhaging customer deposits in both March and by late September was at risk of immediate failure. The explanation provided by both Anglo Irish and IL&P lacks sufficient detail. We still do not know who made the decision and why. Furthermore, it is unclear whether the representatives at Irish Life Assurance (the IL&P subsidiary used to effect the transaction) knew the purpose and, if not, why not? The fact that neither the Financial Regulator nor the Department of Finance appear to have questioned the March transactions may have provided support for a misguided belief that saving corporate Ireland was more important than transparency and accountability. The conceit is staggering

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<sup>41</sup> Ibid.

<sup>42</sup> Ibid.

and demonstrates a complete lack of understanding of international regulatory developments either within IL&P or within the Financial Regulator, a member of the International Organization of Securities Commissions.

Late on the night of 20 February 2009 the Irish government authorized a highly edited release of the confidential report into the stability of the Irish banking system. The 43-page extract focuses only on Anglo Irish Bank and covers three separate presentations (27 September, 27 November and 17 December). It discloses that in the week prior to the announcement of the Irish government blanket guarantee, Anglo Irish Bank experienced a \$6.9 billion run on deposits. The report also found that the bank had a concerted exposure of more than \$640 million with just 15 key account holders. According to the report

From a review of the loan files it is evident that personal guarantees and net asset statements are obtained from borrowers. While these show the borrowers' net worth in a favorable position it must be noted that collateral valuations, in particular property, in the current environment may be significantly lower and realizing some of these collateral assets may be difficult. However, given the satisfactory performance of the book to end of August 2008 it is not anticipated by Anglo management that forced 'fire sales' of collateral will occur.<sup>43</sup>

The presentation to government on 27 September showed that it was clear that the bank's available for sale financial assets, totaling \$2.43 billion, were in fact "difficult to value and probably illiquid."<sup>44</sup> The revelation may have provided the impetus for the rushed decision to provide the guarantee. By the end of November the difficulties associated with the Anglo Irish trading model became painfully apparent. PriceWaterhouseCoopers note

Anglo has built up strong relationships with its key customers. Management state that this strategy of developing deep relationships with what it deems to be the strongest operators is deliberate. From our review of the larger loans in the portfolio it is evident that a small number of key customers are involved in a large number of transactions and represent a significant proportion of the loan portfolio. Anglo considers itself able to attain a thorough

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<sup>43</sup> "Project Atlas—Anglo Irish Bank" (Report Prepared for Irish Financial Services Regulatory Authority, 20 February 2009) 18.

<sup>44</sup> *Ibid.*, 19.

understanding of its client's business, finances and relevant risks, which are continually reassessed in face-to-face client meetings often held weekly. There are a number of customers which are not currently on the Bank's watch, notable or impairment lists all of whom exhibit potentially serious short-term liquidity issues.<sup>45</sup>

The third phase of the reporting, which was presented on 17 December highlighted a broader systemic problem.

There is currently a large over-hang of unsold higher density residential units in these areas accounting for a number of years supply and on top of this there are sites without planning permission in relation to which developers are hoping applications will be processed when local authority infrastructure and planning issues are resolved. Successful disposal of the current and 'pipeline' stock will take many years and appear unlikely to occur at current unit price levels. There are likely to be significant losses for individual developers.<sup>46</sup>

The situation has become even more critical for the Irish government because the preeminent planning authority, An Bord Pleanála, revoked partial planning permission for a \$1.9 billion office, retail, and residential development in a pristine and exceptionally affluent inner suburb. The land for the development, which had as its centerpiece a 37-storey tower, was bought for \$485 million in 2005. Dublin City Council had approved the bulk of the scheme but rejected the landmark building, much to the consternation of Sean Dunne, the flamboyant developer. In appealing the decision Dunne was banking on his capacity—and those of his backers—to bully the city into acquiescing in the destruction of the city's Georgian heritage. An Bord Pleanála disabused Dunne and his backers of their arrogance. The decision called into question the probity of the planning process in Dublin, the lack of due diligence within the banks in extending the loans to Dunne in the first place and the commitment of the government to ensuring transparency and accountability within the political and corporate sector.<sup>47</sup>

According to the planning authority, it was “not satisfied the proposed development would bring about a high-quality environment for

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<sup>45</sup> Ibid, 24.

<sup>46</sup> Ibid, 32.

<sup>47</sup> See F. McDonald, “How An Board Pleanála Shot Down Dunne Plan and Buried Celtic Tiger,” *Irish Times*, 31 January 2009, 8.

future occupants”; the density was criticized as “gross overdevelopment and over-intensification of the site,” which is held was “highly obtrusive and [would] seriously injure the visual amenity of the area.”<sup>48</sup> Crucially the authority found that the entire development conflicted with the City Council’s own development plan. While it is not to be expected that bankers should have a detailed knowledge of planning law, the grandiose ambitions of the project, its variance with the architecture of the affluent suburb that houses some of the most influential citizens in the state, made it far-fetched that approval would be given. It is perhaps not surprising that a subsidiary of Royal Bank of Scotland, Ulster Bank, is most exposed to the \$312 million that Dunne sought and received for the site. The decision to comprehensively reject this kind of development is likely to have a sharp impact on commercial land values in the Irish capital, adding further to the liabilities faced by the banking sector.

The Irish government has attempted to quell investor concern about the viability of the major surviving Irish banks by authorizing a recapitalization valued at \$8.98 billion, split between the Bank of Ireland and Allied Irish Bank. The move was immediately discounted by the credit rating agencies, which downgraded both banks. Moreover, the security of blanket guarantee seriously exposes the Irish exchequer. It is indicative that the cost of Irish debt is spiraling. The differential between ten-year Irish and German bonds now stands at 2.08%, six times that recorded in May.<sup>49</sup> Ireland has gone from poster child of globalization to the symbol of corporate, regulatory, and political failure.

The fate of Anglo Irish Bank and the “golden circle” of investors provide a fitting epitaph for the Celtic Tiger. A series of unanswered questions remain as to why the government made the decision to provide a blanket guarantee. In particular did it make the calculation solely on the basis of an evaluation of the Anglo accounts or were similar problems apparent in the other banks? To date the Irish government has not provided a convincing explanation as to why it will not disclose the names of the individuals provided with preferential borrowings from Anglo Irish to buy into the bank immediately prior to the blanket

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<sup>48</sup> O. Kelly, “Dunne Denied Permission For Ballsbridge Project,” *Irish Times*, 31 January 2009, 8.

<sup>49</sup> D. Doyle, “Irish Outlook ‘Appropriate’ After Cuts Moody’s Says,” *Bloomberg*, 4 May 2009 (Online Edition) (reporting that Moody’s Investment Services retained a “negative” watch rating on Irish debt, even after the announcement of \$2.52 billion budget cuts from the public sector).

guarantee. The Supreme Court has already ruled that confidentiality cannot be assumed if there is a suggestion of wrongdoing and the public interest must be protected.<sup>50</sup> Until those questions are resolved it is unlikely that private capital will return to the Irish banking sector. This makes nationalization ever more likely at a time when the cost of servicing sovereign debt has escalated.

In short, the political and regulatory elite has lost all credibility in either identifying the problem associated with Contracts for Difference or fashioning a coherent response once the effects became clear. The extent to which Contract for Difference bets drove stock market activity in Ireland was reinforced by the decision in 2006 to amend the Finance Act to provide it with tax-free status. The amendment was put forward by the then Finance Minister, Brian Cowen, on what he termed official advice following representations from industry. Now Cowen clamors without irony for the Irish people not to “wallow in self-doubt” but reignite an “entrepreneurial can-do spirit that has brought us to where we are today.”<sup>51</sup> Ireland’s unemployment rate has mushroomed to 9.1%; according to the Taoiseach himself, living standards are expected to decline 10% and the country faces the real risk of bankruptcy. The Credit Default Swap market is now actively betting that Irish bonds will default. Significantly, the rating agencies have downgraded the state’s own credit score, an indication that international markets are unconvinced that Ireland’s political and regulatory elite have the capacity or willingness to affect meaningful change.

Moreover, blanket guarantees merely mask the problems associated with irresponsible lending. The drip feed of revelations and now the partial publication of the PriceWaterhouseCoopers report that the Minister did not even read demonstrate how problematic the initial decision to safeguard Anglo Irish was; not just for the country but also for the dynamics of European integration. Such mechanisms undermine European Union competition law. Following the Irish move, Greece, Denmark, Sweden, Austria, and Spain adopted similar strategies. Germany—which had been most vociferous in its initial objections—provided a political pledge to secure all banking deposits. The political decisions to place national banking security over European solidarity provided the most telling indications that contagion had become a

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<sup>50</sup> *National Irish Bank v RTE* [1998] 2 ILRM 233 (allowing the national broadcaster to divulge information about a potentially illegal tax evasion scheme).

<sup>51</sup> Cowen, above n 35.

pandemic. Taken together, these initiatives also made a mockery of attempts in Paris to generate a coordinated response.

With the Irish government leading the unilateralist charge, the British government took the most comprehensive action. The indecision that had accompanied the policy response to Northern Rock the previous northern autumn was replaced by a steely determination to shore up the banking sector and the legitimacy of the overarching system of oversight that informed London's claim to challenge New York as the preeminent major global financial center. The British Chancellor of the Exchequer authorized the purchase of controlling interests in three of its major banks in a coordinated \$600 billion rescue package that involved \$64 billion in direct recapitalization, the provision of short-term loans and inter-bank lending guarantees.<sup>52</sup> The decision reflected a seismic change in governmental thinking about the efficacy of markets and undermined much of the theoretical cogency of the merits of associational democracy in the financial sector.

The calamitous events in Europe after the passage of emergency measures in Washington demonstrate the continued fragility of the banking sector. From Paris came the deeply embarrassing announcement that one of France's largest saving banks, Caisse d'Épargne, had lost \$807 million in a trading strategy based on the erroneous belief that equity markets would stabilize. The loss was galling for the bank because it was in the process of closing down its proprietary trading unit.<sup>53</sup> It was, perhaps, more galling for the country because it followed a series of regulatory failures, most notably the exposure of an alleged rogue trading scandal at Société Générale earlier in the year. Across the border in Germany the country's second largest bank, Commerzbank, received a \$13.7 billion capital injection in return for a 25% government stake. If the banking sector was under siege within the European Union, outside it Iceland faced even more pressing problems.

The government, which nationalized the country's third largest bank, suspended all trading in major financial stock and proposed sweeping legislation because of an imminent threat of national bankruptcy. The crisis temporarily passed only when the International

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<sup>52</sup> Government Statement on Financial Support, Department of Treasury (Press Release, London, 8 October 2008).

<sup>53</sup> S. Daneshkhu, "Latest Controversial Trading Bet Brings French Banks Into Question," *Financial Times*, 18 October 2008, 9.

Monetary Fund provided emergency financing.<sup>54</sup> Lack of controls was also apparent in Hong Kong. CITIC Pacific announced it had lost \$1.89 billion on “unauthorized” trades on the direction of the Australian dollar to fund the expansion of the group’s iron-ore business in Western Australia. This was not an example of a lack of oversight over a junior employee. The Group Finance Director authorized the trade. Both he and the Group Financial Controller were summarily dismissed and the Chinese state-controlled parent, CITIC, provided an immediate \$1.5 billion loan to offset losses.<sup>55</sup>

Australia, which has been relatively well insulated from the impact of the credit crisis, in part because high interest rates dampened speculative activity and in part because of a well-regarded “twin-peak” system of oversight that splits regulatory authority between an aggressive securities regulator and a cautious prudential one, was not to prove immune. The niche financial engineers were decimated. Allco Finance, which led the private equity consortium to take control of Qantas, went into administration in November 2008 after posting a loss of AU\$1.73 billion, one of the largest in Australian history. Macquarie Group, known colloquially as the “Millionaires Factory”, flagged a profit downgrade as it sought to shore up its balance sheet by exiting the margin-lending sector. It announced that in the last quarter of 2008 “market conditions were exceptionally challenging for almost all of Macquarie’s businesses, adversely impacting levels of business activity and profitability.”<sup>56</sup> Its smaller rival Babcock & Brown faced imminent collapse because of conditions imposed by domestic and international banking syndicates.<sup>57</sup>

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<sup>54</sup> The IMF approved a \$2.1 billion emergency loan for Iceland on 24 October 2008, as well as \$15.7 billion for Hungary (6 November) and \$16.4 billion to Ukraine and has announced plans for a \$2.4 billion rescue package for Latvia (19 December). The Icelandic government collapsed in January 2009.

<sup>55</sup> Y. Lee and L. Santini, “CITIC Pacific May Face Big Hit on Currency Wagers Gone Bad,” *Wall Street Journal*, 21 October 2008, C2. At a closed meeting on 19 December 2008, shareholders approved CITIC’s acquisition of HK \$11.6 billion of convertible bonds and assumption of two thirds of the losses from the currency trade debacle. The bonds, if converted, would give CITIC a stake of 57.66%, double its initial position; see C. Chan, “Citic Pacific Bail-Out Is Best Option, Says Chairman,” *South China Morning Post*, 20 December 2008, A2.

<sup>56</sup> S. Murdoch, “Macquarie’s Woes Deepen,” *The Australian*, 9 January 2009, 15.

<sup>57</sup> For background on the implosion of Babcock & Brown, see K. Maley, “Life on the Margin: How Green Blew Up Babcock,” *Australian Financial Review*, 20 February 2009, 1.

In Australia the problems centered less on the commercial banks than on the implosion of critical residential and commercial property trusts. These promised excessive rates of return and engaged in excessive risk. In an effort to offset the potential risk associated with foreign banks scaling back their operations, the federal government announced the creation of an AU\$4 billion package designed to shore up commercial real estate prices, despite concerns of the Reserve Bank of Australia. The package was justified on the grounds that it would protect construction jobs. The opposition leader, Malcolm Turnbull, himself a former Goldman Sachs executive, claimed, with reason, that the government was merely delaying a necessary and inevitable price correction.<sup>58</sup> A further problem is that the decision to intervene to allow the rolling over of commercial debt may make it easier for foreign banks to exit the market, secure in the knowledge that they would be made whole. The problems are magnified because a low deposit base requires the major domestic banks to enter into global commercial money markets. The freezing of this source of capital forced three major banks to tap the Future Fund for capital. The process, although defended as a commercial decision, remains clouded with secrecy. No information has been divulged about the size or terms of the loans; this cuts against international attempts to ensure that state-owned asset pools make decisions solely on commercial grounds.<sup>59</sup>

It is the United States and Europe, particularly Ireland and the United Kingdom, however, which continue to face the most severe practical and normative problems of banking oversight. The IMF released a devastating outlook report noting the need for “extraordinary public intervention to prevent a meltdown of the U.S. financial system....The disruptions in the U.S. financial system in September have heightened the risk of a systemic financial crisis in Europe further, though a full-blown crisis remains improbable and recent actions by the authorities should help in this respect. Nonetheless, additional banks may fail, as implied by their very high risk spreads and market doubts about

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<sup>58</sup> P. Coorey and P. Hartchner, “Rudd Snubs Reserve Bank,” *Sydney Morning Herald*, 28 January 2009, 1.

<sup>59</sup> D. Uren and S. Parnell, “Banks Turn to Future Fund,” *The Australian*, 7 October 2008, 1. The Future Fund subsequently provided emergency financing following the sudden withdrawal of GMAC and GE from the domestic auto-market; see P. Maley, “Car Dealers Saved by \$2 Billion Financing Package,” *The Australian*, 5 December 2008, 1.

the viability of their business models.”<sup>60</sup> Although the report suggested that the scale of intervention required to deal with the solvency issues are not as pronounced in Europe, it warned of “the serious risk of backtracking on European financial integration. Addressing the concerns raised by cross-border spillovers of actions taken by national authorities will require movement towards more joint responsibility and accountability for financial stability in Europe.”<sup>61</sup> By December the IMF noted that the lack of consistency meant there was a profound need for coordinated financial market, fiscal and liquidity measures.<sup>62</sup> In the United Kingdom, the government sought to place the continuing dislocation in a global context. Gordon Brown warned of the profound risk of de-globalization and concomitant threats to global order unless action was taken to ensure that financial stability was restored.<sup>63</sup> It was, many in the markets feared, too little too late. A leading hedge fund manager warned that “the City of London is finished, the financial centre of the world is moving east. All the money is in Asia. Why would it go back to the West?”<sup>64</sup> The same applies to the retail sector. Many of the leading shopping chains on the British High Street are likely to be put on the market following the collapse of Bauger, an Icelandic retail chain. Bauger had expanded into Britain at the height of the boom to such an extent that it controls 10% of the high street. Bauger filed for credit protection after its leading lender, itself now nationalized by Reykjavik, withdrew funding. On the streets of the United Kingdom and other

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<sup>60</sup> *Europe: Dealing with Shocks* (International Monetary Fund, Washington DC, October 2008) 8-9.

<sup>61</sup> *Ibid*, at 10.

<sup>62</sup> D. Strauss-Kahn, “The IMF and its Future” (Speech delivered at Banco e Espana, Madrid, 15 December 2008).

<sup>63</sup> On 19 January 2009 the government announced the establishment of a state-owned insurance scheme to enable banks to dispose of impaired assets. In a pre-announcement interview, Brown argued that “one of the necessary elements for the next stage is for people to have a clear understanding that bad assets have been written off.” See G. Parker, L. Barber, and J. Eaglesham, “Brown Orders British Banks to Come Clean,” *Financial Times*, 17 January 2009, 1. The chair of the influential Treasury Select Committee, John McFall, was less diplomatic. “We have got to go back again with a bigger sum because, quite frankly, the banks in my opinion haven’t been honest enough about the toxic assets on their books.” See “Brown To Announce Bank Bailout Plan,” *BBC News*, 18 January 2009; for domestic criticism of the plan, see “UK Banking Plan Faces Criticism,” *BBC News*, 19 January 2009.

<sup>64</sup> J. Rogers, “View of the Day,” *Financial Times*, 22 January 2009, 25.

countries across Europe, resentment is rising, with large-scale protests taking place from Moscow through Riga to Athens and on to Paris.

While disputation continues about what should be done, there has long been fundamental agreement on the severity of the crisis and its implications for regulatory design.<sup>65</sup> Ultimately, the seizing of the global securitization and wider credit markets stem from the combination of an emaciated conception of what constitutes effective corporate governance, skewed incentives that privilege chrematistic transactional-based banking and the flimsiness of a wider regulatory structure predicated on risk reduction rather than maintenance or strengthening of longer-term societal needs. Accountability proved elusive because of essentially ideographic and therefore incommensurable representations of what fealty to the concept entail. The problem intensifies as one cascades through the mechanisms used to measure performance.<sup>66</sup> The restraining power associated with enhanced transparency and disclosure within and among accountability dimensions has also been eroded.<sup>67</sup> The securitization of risk was, after all, perfectly legal. The risks were disclosed but discounted by allegedly sophisticated investors, who, in the main, jettisoned reason in the search for yield. The progressive revelation of such willful ignorance on the part of those entrusted to manage retirement savings is exceptionally disturbing. It is rendered even more so when assessed against a background in which these same institutional investors advocated raising the proportion of funds that could be invested in alternative asset classes.

Resolution of these issues requires close examination of the reasons behind failures within individual institutions. Limiting intervention to the micro-level of an individual bank or financial services firm without securing stewardship rights through guaranteed common

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<sup>65</sup> For United States, see T. Geithner, "The Current Financial Challenges: Policy and Regulatory Implications" (Speech delivered at Council on Foreign Relations, New York, 6 March 2008); B. Bernanke, "Risk Management in Financial Institutions" (Speech delivered at Federal Reserve Bank of Chicago, Chicago, 15 May 2008); for Europe, see C. McCreevy, "International Financial Crisis: Its Causes and What to Do About It" (Speech delivered at Alliance of Liberals and Democrats for Europe, Brussels, 27 February 2008); for United Kingdom, see R. Lomax, "The State of the Economy" (Speech delivered at the Institute of Economic Affairs, London, 26 February 2008).

<sup>66</sup> M. Bovens, "Two Concepts of Accountability" (Paper presented at the Kettering Foundation, Dayton, Ohio, 23 May 2008).

<sup>67</sup> For critique suggesting that transparency does not necessarily improve oversight but rather can cloud it, see H. Tsoukas, "The Tyranny of Light: The Temptations and Paradoxes of the Information Society" (1997) 29 *Futures* 827.

equity stakes pre-ordains future failure. The accountability deficit transcends individual corporate stewardship, however. More fundamentally, it reveals a crisis in confidence in the rationale and structure of financial regulation itself. As such, the design of effective and flexible regulatory and corporate governance rules, principles and norms to address the interlinked and intractable problems in both the financial and real economies has become a global policy imperative. The extent of government intervention required to stabilize financial markets has fundamentally transformed the conceptual and practical dynamics. The power and influence of the state within the regulatory matrix has been augmented considerably. The unresolved question is what the state will do with this power. In the United States, the process will define the Obama presidency.

As the Bush administration entered into its final weeks, the chairman of the Securities and Exchange Commission, Christopher Cox, penned an extraordinary opinion piece that captured the enormity of the changes in the American corporate and political landscape.<sup>68</sup> Castigated throughout the crisis as ineffectual—the Republican presidential nominee had publicly called for his sacking in September—Cox appealed for the retention of the free market economy principles on which America was founded. Those principles underpin “our emphasis on private ownership [that] is directly tied to America’s dedication to individual freedom. It is in our DNA....Our constitution is a brilliantly crafted system of checks and balances to prevent that abuse by limiting government’s authority over individuals—including in the economic realm, where we’re guaranteed our constitutional rights to liberty and property, to freedom from expropriation, and to freedom of contract.”

Acknowledging the profound failures associated with the model, he posited the need to “take exceptional care to preserve the premise of well-ordered markets that underlies our enforcement and regulatory regime. Maintaining the arm’s length relationship between government, as the regulator, and business, as the regulated, is essential. Otherwise, when the government becomes both referee and payer, the game changes dramatically for every other participant.” For Cox, “it is incumbent upon federal policy makers to ensure that the extraordinary actions of the past months are understood to be temporary, and constructed so that they are self-liquidating. Since government programs do not on their own go

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<sup>68</sup> C. Cox, “We Need a Bailout Strategy,” *Wall Street Journal*, 11 December 2008, A16.

away, there has to be a deliberate design to eliminate them, and a relentless adherence to execution of that plan. Anything short of this will almost certainly guarantee eternal life for these vast new federal roles.”

The extent to which large sections of the financial sector are now fully nationalized or are surviving because of public largesse raises profoundly difficult questions, particularly for those wedded to the narrow conceptions of corporate accountability found in the law and economics tradition. They tend to challenge the right of the state to intervene in the governance of a private entity. The democratic accountability deficit is displaced by the emphasis on the “sovereign” right of the shareholder to enter into a free association.<sup>69</sup> These private ownership rights are transferred to the collective, which is invested with a distinct, if artificial, legal personality. The normative emphasis remains on the “personality” component rather than its “artificiality.” This emaciated conception of individual rights is given a democratic gloss through the corporate constitution.<sup>70</sup> Depending on political persuasion, autocracy or democratic centralism are perhaps better facsimiles for the reality of organizational control, albeit one that has limited recourse to the courts. Judicial intervention tends to focus on procedural rather than substantive matters. Adjudication of the consequences of organizational culture and the impact this has on (un) ethical decision-making is left to the corporation itself to decide because of the reluctance of the courts to second-guess business decisions taken within legal parameters (e.g. in good faith, with adequate cognizance of the long term interests of the corporation and without a material interest in the transaction).

The duties and responsibilities owed by the owners of the corporation to wider society are bypassed by characterizing the corporation as nothing more than a “nexus-of-contracts.”<sup>71</sup> This

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<sup>69</sup> R. Hessen, *In Defense of the Corporation* (1979) 115.

<sup>70</sup> For an approach suggesting the need to take the corporate constitution seriously, see S. Bottomley, “From Contractualism to Constitutionalism: A Framework for Corporate Governance” (1997) 19 *Sydney Law Review* 277; S. Bottomley, *The Constitutional Corporation, Rethinking Corporate Governance* (2007).

<sup>71</sup> See F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (1991). For an updated approach, see R. Kraakman, P. Davies, H. Hansmann, and G. Hertig, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2004). Although Kraakman and his co-authors view the corporation as encompassing more than a nexus of contracts, as the subtitle of the book suggests, they still couch company law in instrumental terms. Outside the narrow realm of corporate law, organizational theorists now conceive the corporation in much more complex terms; see, for example, R. Scott, *Organizations, Rational, Natural and Open Systems* (2003).

facilitates suspension of critical thinking about the social construction of the corporation. It also limits the grounds for intervention to whether an alleged breach is enforceable in the company law courts (which, in large measure, it is not unless explicitly forbidden under either standard or tailor-made articles of association). This conceptualization places arbitrary and artificial boundaries on the form and function of corporate law and capital market regulation. The emphasis on procedure over substance transacts around rather than resolves what should be the public policy response to the question of what constitutes the appropriate obligations for corporate ownership.<sup>72</sup> More perniciously, it limits the legitimacy of state intervention by suggesting a dichotomous relationship between the beneficence of economic freedom to contract and the deleterious consequences of regulatory intervention.<sup>73</sup> Indeed, it spawned an entire sub-disciplinary legal field, most notably through the work of Frank Easterbrook and Daniel Fischel. Their most celebrated essay postulates that the “corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to set the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy.”<sup>74</sup>

Easterbrook and Fischel maintain that wider social issues are and should remain outside the purview of the market, citing approvingly Adam Smith in defense of the proposition that “the extended conflict among selfish people produces prices that allocate resources to their most valuable uses.”<sup>75</sup> In this context, the role of corporate law is solely “to establish rights among participants in the venture.”<sup>76</sup> For Easterbrook and Fischel, the key normative advantage of such an approach is that it “removes from the field of interesting questions one that has plagued

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<sup>72</sup> P. Ireland, “The Myth of Shareholder Ownership” (1999) 62 *Modern Law Review* 32 at 33.

<sup>73</sup> See JK Galbraith, *The Affluent Society* (1959); see also S. Marglin, *The Dismal Science* (2008).

<sup>74</sup> F. Easterbrook and D. Fischel, “The Corporate Contract” (1989) 89 *Columbia Law Review* 1416 at 1418.

<sup>75</sup> *Ibid.*, 1422.

<sup>76</sup> *Ibid.*, 1428 (Easterbrook and Fischel do note, however, circumstances where the corporate contract can be trumped. As the state, “the argument that contracts are optimal applies only if the contracting parties bear the full costs of their decisions and reap all of the gains. It applies only if contracts are enforced after they have been reached. The argument also depends on the availability of the full set of possible contracts. If some types of agreements are foreclosed, the ones actually reached may not be optimal”: at 1436).

many writers: what is the goal of the corporation. Is it profit (and for whom). Social welfare more broadly defined. Is there anything wrong with corporate charity? Should corporations try to maximize profit over the long run or the short-run? Our response to such questions is: ‘Who Cares?’<sup>77</sup> This conceptual framework was always empirically questionable. The scale of intervention now required to stabilize global banking turns it into farce. The multifaceted nature of the contemporary crisis provides an opportunity to “rethink” the nature and function of the corporation and the capital markets in which it is nested. In particular, it focuses attention on the externality costs imposed by characterizing the corporation as an essentially private actor.

Notwithstanding the rhetorical power of the “invisible hand” metaphor, the laissez-faire contractual account of governance it ordains is, at base, a political construct. What constitutes the optimal level of intervention is contingent on the variable interaction of material and ideational factors. These include the depth, liquidity and importance of capital markets, interest group organizational power and international regulatory trends. The extent and direction of change are further determined by the environmental impact of professional norms and behavioral mores on the formal and informal nodes supporting the structural architecture. The complex interaction of these vectors determines who is given voice, authority and legitimacy within the overarching regulatory matrix. A critical mediating factor is the ideational terms of reference set by the wider political firmament. As Christopher Stone makes clear, legal frameworks operate within two distinct languages of control. One the one hand, there is “law’s routine operating level: the language of rules and regulations, statutes and opinions. Transcending that is the legal meta-language of policy statements and principles, the chat of academicians, many of whose terms never descend into the operating language but which serve to assess, direct and nurture it.”<sup>78</sup> Corporate responsibilities are framed by the capacity of institutional actors to influence what constitutes the limits of outside interference on capacities to contract within both domains. In this context, the falsification of the normative benefits of laissez faire economics extends far beyond what Hugh Collins terms “the productive

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<sup>77</sup> Ibid, 1446.

<sup>78</sup> C. Stone, “Corporate Vices and Corporate Virtues: Do Public/Private Distinctions Matter” (1981) 130 *University of Pennsylvania Law Review* 1441 at 1442.

disintegration of private law.”<sup>79</sup> To be truly effective, a regulatory system must operate with integrity (i.e. irrespective of whether the regime is rules-based or relies on an enabling system of oversight, it must be informed by a single, coherent set of overarching principles that delineate the rights and duties of all institutional actors).

The problems associated with a lack of integrity in capital markets are not new but the global financial crisis has made satisfactory resolution of them critical. As Edward Mason noted in 1958, the rise of the corporation had a profound impact on the “carefully reasoned” laissez-faire defense offered by classical economics, which held that “the economic behavior promoted and constrained by the institutions of a free market system is, in the main, in the public interest.”<sup>80</sup> For Mason, the defense rested on foundations that “depended largely on the general acceptance of a reasoned justification of the system on moral as well as on political and economic grounds.” The emergence of major corporations, immune from meaningful controls, along with its “apologetics” within the management literature “appears devastatingly to undermine the intellectual presuppositions of this system” without offering “an equally satisfying ideology for twentieth century consumption.”<sup>81</sup> As such, “the entrepreneur of classical economics has given way to something quite different, and along with him disappears a substantial element in the traditional capitalist apologetic.”<sup>82</sup> Despite Mason’s misgivings, the economic conception of the corporation as a “nexus of contracts” extended well beyond the boundaries of the economics tradition. Alan Greenspan’s admission that he was “partially” wrong in his deference to the capacity of the market to exercise necessary restraint marks a step forward. Greenspan, however, cautioned lawmakers not to rely on a command and control approach. “Whatever regulatory changes are made, they will pale in comparison to the change already evident in today’s markets. Those markets for an indefinite future will be far more restrained than would any currently contemplated new regulatory regime.”<sup>83</sup> Major job losses across the sector will

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<sup>79</sup> H. Collins, *Regulating Contracts* (1999) 59.

<sup>80</sup> E. Mason, “The Apologetics of Managerialism” (1958) 31 *Journal of Business* 1 at 5. See also Galbraith, above n 63, 6–17.

<sup>81</sup> *Ibid.*, 6, 9.

<sup>82</sup> *Ibid.*, 10.

<sup>83</sup> Evidence to House Committee on Oversight and Government Reform, Washington DC, 23 October 2008 (A. Greenspan). For discussion of blame, see J. Reed, “Crisis Has Resulted From Honest Misjudgments By Finance Sector” (Letter to Editor), *Financial*

lengthen the restraining order. This is particularly important in New York. It is reported as many as 78,000 jobs could be lost.<sup>84</sup> While the securities industry (5% of total employment and 25% of earnings) has borne the public brunt of announced and planned job losses, the collapse of confidence has a wider spillover effect on professional and business services, including legal and accounting corporate advisory, as well as advertising.<sup>85</sup> A similar reality is dawning in London.<sup>86</sup> The challenge for a now weakened financial sector and for society is to build corporate governance and capital market regulation in ways that emphasize duties and responsibilities as well as corporate rights. Here progressive corporate law scholarship provides a useful starting point.<sup>87</sup>

Orts, for example, argues that it is impossible to “corporate law involves the simultaneous pursuit and coexistence of a number of ends or purposes, with the mix a predominance of different values depending on particular legal contexts.”<sup>88</sup> For Orts then, “the technical rules of corporate law are primarily about structuring economic organizational power.”<sup>89</sup> This, in turn, draws one’s attention to the essential political nature of corporate governance design. It also suggests the need to take into account “a complex array of normative values, not only economic values which themselves are often divided and difficult to fathom but also values of abiding by the law and other principles of ethical business behavior.”<sup>90</sup>

Untangling and ordering the precise public duties and responsibilities of an entity endowed with distinct contractual rights is inordinately complex. The policy problem is how to order those principles in a coherent and acceptable manner so as to strengthen political legitimacy. Legitimacy requires commitment at three interlinked

*Times*, 21 October 2008, 14; D. McDonald, “Crisis Caused By Negligence and Incredible Stupidity” (Letter to Editor), *Financial Times*, 24 October 2008, 10.

<sup>84</sup> J. Bram, J. Orr, and R. Rosen, *Employment in the New York-New Jersey Region: 2008 Review and Outlook* (Federal Reserve Bank of New York, 22 October 2008) 5.

<sup>85</sup> *Ibid.*, 4 (The report further notes “each securities job is estimated to generate 2.3 other jobs by spurring demand for business and professional services...and real estate as well as other services such as hotels and restaurants”: 5).

<sup>86</sup> A. McDonald and C. Bryan-Low, “Turmoil Batter’s London’s Status as Financial Center,” *Wall Street Journal*, 22 October 2008, A1.

<sup>87</sup> E. Orts, “The Complexity and Legitimacy of Corporate Law” (1993) 50 *Washington and Lee Law Review* 1565.

<sup>88</sup> *Ibid.*, 1566.

<sup>89</sup> *Ibid.*, 1582.

<sup>90</sup> *Ibid.*, 1612.

levels. At its most basic level, legal validity is necessary (based on the need for wide compliance to legal rules). At the middle level, there is a need to test for empirical legitimacy (i.e. the degree of warranted or unwarranted public confidence in the structure of economic relations). Overarching this is the need to assess systemic legitimacy (i.e. the extent to which the processes of corporate governance reform are tied to rational or ideational terms of reference').<sup>91</sup> This is, by necessity, an ongoing process. At any given moment, contingent resolution depends on the capacity of ideational forces to create, maintain, or undermine two critical and interlinked components: problem identification and problem parameters. The crisis has now produced a paradigmatic tipping point. The unprecedented nature of central bank intervention mirrors the admission by the chair of the most influential lobby group in investment banking that he “no longer believe[s] in the market’s self-healing power.”<sup>92</sup>

While it may be inopportune to engage in structural reform in the midst of a crisis, it is clear that the normative advantages of embedding a corporate form of associational democracy without reference or subservience to wider societal goals have been falsified. The critical policy challenge is to fashion an alternative framework that safeguards security without compromising innovation. Given the reality of globalization, it is not plausible to retreat to national-based uncoordinated approaches to financial regulation. Sustainable reform necessitates fundamental changes to both the structure and purpose of the global financial architecture. The necessary first step is to ascertain how the underlying problem is defined, to account for and order competing interpretations, and to evaluate the impact of proposed solutions. This requires, in turn, an investigation of how ideational terms of reference set the parameters of what constitutes rational policy responses. Methodologically, this requires a thorough anatomical investigation of the form, purpose, and substance of the complex legal reality that underpins corporate and regulatory decision-making.<sup>93</sup>

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<sup>91</sup> Ibid, 1617; see more generally, J. Parkinson, “Legitimacy Problems in Deliberative Democracy” (2003) 51 *Political Studies* 180.

<sup>92</sup> Josef Ackerman, chairman of Deutsche Bank, quoted in J Randall, “When the Going Gets Tough, Banks Yell for Nanny,” *Daily Telegraph* (London), 26 March 2008 (Online edition). See also L. Blankfein, “Do Not Destroy the Essential Catalyst of Risk,” *Financial Times*, 9 February 2009, 13.

<sup>93</sup> The “institutional autopsy” heuristic is used to great effect in C. Milhaupt and K. Pistor, *Law and Capitalism* (2008) 45-46.