A critique of post-crisis structural and prudential bank regulation: the UK case

A thesis submitted to the University of Manchester for the degree of Doctor of Philosophy in the Faculty of Humanities

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Ian Crowther

Alliance Manchester Business School
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Abstract

The University of Manchester Ian Crowther
Doctor of Philosophy:
A critique of structural and prudential post-crisis regulation: the UK case

The 2007 financial crisis created a problem regarding the best way to regulate the UK’s banks. The previous regulatory system failed to see the crisis coming and was unsuccessful at anticipating or intervening to prevent what became an expensive state and taxpayer bailout. The nature of pre-crisis self-steering or light touch regulation was bound up in politics and policy, neoclassical economic theory and the mainstream practice of risk management in banks. Mainstream practitioners in these fields were under pressure to re-regulate banking.

This doctoral research provides a critique of arguably the two most important regulatory responses post financial crisis: structural and prudential regulation. Specific focus is given to the way banks are organised via the Independent Commission on Banking’s Vickers Report and its concept of hybrid-ring fencing, together with Basel III’s algorithm for managing the way banks have arbitrated capital adequacy and risk weighted assets historically. Finally, a natural experiment is undertaken by way of a case study to assess the politicisation of the Basel III process of de-risk and recapitalise and its impact on Lloyds Banking Group plc. A further critique on how the behaviour of senior bank managers can change during crises is revealed. Through a theoretical reconceptualisation, this novel research pushes against the functional description of bank management behaviour in mainstream financial management textbooks and asks whether a broader definition is warranted.

A multidisciplinary framework and approach to research was adopted through literature of politics, financialisation and heterodox economics. This design proved useful in allowing a critical interpretation of the limits of post-crisis regulation to unfold, alongside a broader recognition of the regulatory impact on the stability of UK banks and the financial system. A methodological framework of mixed methods and pragmatism supported a sequential-exploratory research design. This enabled a qualitative and quantitative approach to developing research questions, data collection, data analysis and its interpretation. Different types of data were analysed in developing the critique: primary data from ultra elite semi-structured interviews, and secondary data from a rich database of publicly available documentary sources, such as reports from politics, regulators, academia and industry, together with financial data from bank management presentations, audited accounts, regulatory disclosures and small firm company returns.

Research findings expose the limited nature of structural and prudential regulation on UK banks. Revealed is what can be described as a complex politicised management of re-regulation post-crisis through conduits of legal statute, quasi state bodies and intervention, long held and deep seated institutional arrangements that allow meso-corporatism through epistemic community, and regulatory problem solving guided by sympathy towards the status quo of mainstream approaches to economics and scientised risk management. Also uncovered is the way elites in bank management act as bricoleurs and continue to benefit from the disintermediation of post-crisis prudential regulation. Empirical evidence is disclosed that reveals personal enrichment of the manager from a taxpayer owned bank. There is a clear on-going tension and disconnect at the conjunction of crisis event and mainstream response by regulators and regulation, whilst firms and managers react to be compliant but continue acting as bricoleurs in the struggle to gain competitive advantage via arbitrage. Alternatives are required to solve these problems rather than utilising the limited approach of historic frameworks and substituting parts of a broken machine.
Declaration

I, Ian Crowther, declare that no portion of the work referred to in the thesis has been submitted in support of an application for another degree or qualification of this or any other university or other institute of learning.
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Dedications

I would like to make two dedications. Firstly, I would like to dedicate this thesis to my father, Stuart Crowther, who sadly passed away during its completion. Naturally, my father played an instrumental part in my life, providing everything I ever needed. I would like to recognise his invaluable support as a parent here. I miss him greatly; his influence in my life was profound. I will strive to become the role model he was, acting on stoic values and life lessons he taught me, and to be happy, as this is all he ever wanted for me. Rest in peace, Dad; I love you.

Secondly, I would like to dedicate this thesis to my PhD Supervisor Mick Moran, who also passed away during its completion. Mick’s death came as a great shock; his passing was sudden and unexpected. I consider myself fortunate to have received the benefit of Mick’s academic knowledge and intellectual stimulation throughout the PhD process. I made it in the end, Mick; the sum total of which is in no small part down to your encouragement, patience, selflessness with time, and a willingness to convene at short notice. Thank you. Rest in peace, Mick.
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Firstly, I would like to thank Alliance Manchester Business School for their part-scholarship. I would not have been able to undertake this thesis without funding. Secondly, and crucially, I would like to thank my primary PhD Supervisor, Ismail Ertürk, who has provided invaluable intellectual guidance throughout this thesis and has contributed to my development with opportunities for teaching, conference and academic apprenticeship. Finally, I would like to thank a number of people including: Mum, Sister, Sarah, Isobel, George, my wider family, Tom and Shirley, and friends, for their unconditional support and love. Ismail, Mick and my family have helped me to survive the PhD experience. My family have read several draft chapters of the thesis and now have a healthy indifference for financial matters; kind and timely reminders followed, noting there is more to life than politics, banking and regulation.
Glossary of Terms

BCBS: Basel Committee Banking Standards
BofE: Bank of England
BoSIF: Bank of Scotland Integrated Finance
CEO: Chief Executive Officer
CET1: Common Equity Tier 1
CoCos: Contingent Convertible Bonds
CRD IV: Capital Requirements Directive
CRESC: Centre for research on Socio-Cultural Change
FCA: Financial Conduct Authority  FSA: Financial Services Authority  GDP: Gross Domestic Profit
GSIFI: Globally Systemically Important Financial Institutions
HBoS: Halifax Bank of Scotland
HoC CPA: House of Commons Committee of Public Accounts
HoC TC: House of Commons Treasury Committee
ICB: Independent Commission on Banking
IMF: International Monetary Fund
ISAF: Integrated Structured & Acquisition Finance
JV: Joint Venture
LBG: Lloyds Banking Group plc
MiFID: Markets in Financial Instruments Directive
MMR: Mixed Methods Research
NPL: Non-Performing Loan
PCBS: Parliamentary Commission on Banking Standards
PRA: Prudential Regulation Authority
ROE: Return on Equity
RWA: Risk Weighted Assets
SIFI: Systemically Important Financial Institutions  SPERI: Sheffield Political Economy Research Institute  UK: United Kingdom
Reading maketh a full man; conference a ready man; and writing an exact man. Abeunt studia in mores.

Francis Bacon, ‘Of Studies’, 1601
Chapter 1. Research Overview

1.1. Introduction and Background

Banking in the post financial crisis period has been characterised by regulatory transformation. There is a long history of markets regulating and deregulating through political command-like structures, principally in reaction to past crises, institutional practices and theory (Moran 2002). Post 2007, the banking industry faced the challenge of finding a way to regulate banking in modern day capitalism. The pre-crisis system of self-steering and light touch regulation had failed to prevent a state bail-out in which the private losses of firms were socialised and paid for by the taxpayer with the intention of repayment at a later date (Engelen et al. 2011). The role and influence of politics and mainstream economics prior to the 1986 financial big bang (Financial Services Act 1986), created a foundation for deregulation to occur (Centre for Policy Studies 2006). Arrangements in the way financial markets were organised through the relationship of state and corporate firms – meso-corporatism – loosened restrictions on competitive practices between London and international markets. The withdrawal of restrictions on trading within domestic securities markets began the deregulation process in earnest (Moran 1990, p.56). What followed was a series of significant changes to ownership and trading practices across the City, connecting London with New York and Japan, the other market hubs of trade and competitive markets, and leading to the globalisation of British firms through their acquisition by foreign multinational companies (Ibid, p. 57). Moran illustrates how these distinctly liberalising institutional, market and policy measures influenced the regulation of financial markets. At the heart of this regulatory transformation was the struggle of states to gain competitive advantage, not only through
domestic arrangement as noted above, but also through external influence. British regulatory transformation was also a reaction to market based regulatory changes and practices in the United States of America. The reforms were typified more by institutional, codified and juridified structure. The UK followed with the Financial Services Act 1986 and an attempt to build a statute based system that allowed wide and loosely defined practices in terms of the way investment markets were to operate. To a large extent, this accounts for the corporatist nature of the system that later evolved (Bank of England 1986, p.373; Moran 1990). Deployment of the above strategy allowed the City of London to compete in a more dynamic and increasingly interconnected world of market based capitalism, inclusive of finance and banking.

Pre 2007 financial crisis, banking regulation was also underpinned and shaped by the evolution of neoclassical accounts of economics (Ricardo 1891; Walras 1896; Hayek 1944; Samuelson 1948; Merton 1971), followed by the theory of free and efficient markets (Friedman 1962; Fama 1970) that went on to influence politics, public policy and the notion of self steering regulation. The mainstream belief in economics and politics was to let the market take control of economy and finance. To facilitate these ambitions, the removal of regulatory red tape by way of statutory control became normalised practice in the management of banking and finance in the City of London. A globalised strategy of economic transactions through highly networked banking institutions was created to compete for GDP and taxable income through Margaret Thatcher’s post 1979 ‘service economy,’ in which the City of London and the banking sector were to play a central role leading up to the crisis in 2007. Bipartisan political viewpoints supported this strategy in the UK during the pre-crisis period. David Cameron, as leader of the opposition Conservative Party in 2006, stated that the “lessons of the City are clear. Low tax. Low regulation. Meritocracy. Openness and
Innovation. These are the keys to success” (Cameron 2006). In his 2007 Mansion House speech, the Prime Minister and leader of the Labour Party, Gordon Brown, stated that the UK economy would succeed and grow through stability by “advancing with light touch regulation…. and stability through a predictable and light touch regulatory environment was a strength in making the right long term decisions for the economy” (Brown 2006). Both Cameron and Brown, as well as Chancellors Alastair Darling and George Osborne, rejected their pre-crisis opinions on regulation post 2007. Brown claimed that his “views were an error in judgement and conceded that he had bowed to pressure from the City to regulate banks more lightly than he should have” (Evening Standard 2010). Cameron attempted to make political capital from this admission, eventually using it as a hook to create change in regulatory organisation after the Conservatives came to power in 2010. Organisational change was achieved by transferring regulatory responsibility from the Financial Services Authority to the Bank of England in 2013 through new institutional bodies, those being the Financial Conduct Authority (FCA) and Prudential Regulatory Authority (PRA).

**Research Problem**

Notwithstanding the history and events of UK deregulation post 1986, the mainstream view of the economy was that it should be governed by the free market: all seeing markets, perfect markets, and markets as super computers (Mirowski 2013). Consequently, self-steering or light touch policy and regulation was mandated via the UK regulator and supervisor at the time of the 2007 crisis, the Financial Services Authority (FSA). The FSA failed in its supervisory role and proved unable to anticipate or intervene prior to the financial crisis in August 2007 (Turner and Financial Services Authority (Great Britain) 2009). Lord Turner, previously Chairman of the FSA, said in
the 2008 audit report that “it was right to criticise the regulator for failures in allowing the risky expansion of Northern Rock” post nationalisation. These problems had originated in the subprime mortgage crisis in the United States of America (Adrian and Shin 2008) and there was “insufficient focus on capital, liquidity and asset quality in the debacle at Royal Bank of Scotland” (FSA 2011; Turner and Financial Services Authority (Great Britain) 2009). Here the two influences in financial regulation referred to by Moran above can be seen, along with the impact of different systems, both domestic and international, on each other. The FSA as regulator was tasked with managing financial services through light touch regulation; hence, these supervisory failures require wider context. “Deficient rules on bank capital and liquidity resulted from decades of policy errors at the highest levels which allowed the banking system to transition to excessive leverage and inadequate liquidity”, (Turner and Financial Services Authority (Great Britain) 2009). Regulators, central bankers, politicians and banking elites all failed to see the crisis approaching – something that Queen Elizabeth questioned during a briefing by the London School of Economics on the turmoil of international markets (Pierce 2008). She received the following reply during a 2012 tour of the bank from Sujit Kapadia, an economist and financial policy expert at the Bank of England: “the City got complacent and many thought regulation wasn’t necessary” (Neate 2012).

Also bound up in the reason for the failure of the self-steering and light touch regulatory environment in 2007 is the theory of risk management and the way this has been applied and managed by senior banking elites and driven by technocrats working within institutions such as the BoE and regulatory bodies / political commissions (FSA, PRA and (ICB 2011). Post 1986, when banking and finance saw a period of deregulation as described above, they were also being controlled by an increasingly institutional, codified and juridified structure. Legislation and statute was one plank of this approach,
while codification of prudential regulation was another.

The Basel Accords (I, II and III) are a set of microprudential regulations. The accords transformed over time and began with Basel I, published in 1988 by the Basel Committee on Banking Supervision (BCBS) with a view to establishing new risk management practices through minimum levels of capital for bank (BIS 2014). Minimum capital requirements are important in banking, while a stable banking system is crucial to the ambition of government and long-term growth projections for a state and its competitiveness in global capitalism (Admati and Hellwig 2014). From a business and consumer viewpoint, access to finance should be widespread, just as electronic payment systems are required to maintain the circulation of capital. It is essential that banks are trustworthy and a source of stability during any stage in the economic cycle. When the wider economy goes into recession or crisis, or an economic event transpires, the organisation of a bank in terms of activity and structure (ICB 2011; ICB and Vickers 2010) along with capital level, assists in keeping the firm stable and able to absorb losses from a crisis in market confidence and debt deflation. Plans to resolve these problems can be made and implemented, or the market can correct or allow for an orderly failure of a bank in the case of bankruptcy (Bell and Hindmoor 2015; Bell and Hindmoor 2017). Capital levels act as a buffer and provide a layer of protection against negative economic events. Without this buffer, the macroeconomic stability of a bank and a state can be threatened. However, in 2004 Basel II created a new framework based on three pillars: (i) minimal capital versus risk – partly premised on a bank’s proprietary model and measurement of risk; (ii) supervision – regulatory supervision of a bank’s risk and capital adequacy in order to understand its underlying profile and assess whether minimum capital levels are in line with risk taken; (iii) market discipline – the intention being to create effective disclosure and greater transparency through reporting whilst allowing
investors to reward prudent risk management (Caruana et al. 2004). The Bank of International Settlements argued that Basel II changed the perspective of banking regulation (BIS 2014). The design of financial risk management through complex modelling of microprudential regulation, proprietary to each bank and across international supervisory jurisdictions, allowed a different perspective on risk management to develop. Ultimately this fresh perspective led towards regulatory arbitrage of risk weights and capital adequacy – in which banking firms capitalised from weaknesses in the construction of the regulation, which positively impacted their performance in markets (Mariathasan and Merrouche 2014; Ferri and Pesic 2017). There were distinct weaknesses in the proprietary models (internal ratings based (IRB) approaches) for assessing the underlying risk of bank balance sheets, allied to the regulatory capital being maintained by banks against this risk and unexpected losses prior to the financial crisis in 2007 (Engelen et al. 2011). Moreover, loss occurred at the point of crisis when the risk weights of Basel II were applied correctly. At the fulcrum of these changes, and a precursor to post-crisis development, was the regulator’s ideology regarding the way banks should be managed in terms of capital levels. Mainstream theory on efficient markets and self-steering light-touch regulation appeared to have eroded, and as the Chief Economist at the Bank of England, Andy Haldane, has stated, “regulatory thinking has gone through an elegant 180 degree shift” (SPERI 2014).

In addressing the above shift in ideational thinking about banking regulation, it is argued that the structural power of business is reduced throughout periods of transforming banking regulation by changing ideas of state leadership – often through technocratic arm’s- length bodies that change institutional arrangements through wide-open politicisation of banking reform (Bell and Hindmoor 2017). Moreover, the financial elite of the City and financial firms have used long standing relationships between state
and finance to lobby the power of government in order to shape institutional arrangements towards specific self interest whilst developing a strong ideology around the way regulation should interact with banking and finance (Wigley 2008; Turner and Financial Services Authority (Great Britain) 2009; Bischoff 2009; Johal et al. 2014).

The failure of theory and regulatory practices and its effect on banking in the run up to the 2007 financial crisis, and the progression of regulatory transformation in the post crisis era through the shaping of new institutional arrangements and processes, together create a multifaceted problem which can be addressed by completing a political-technical analysis and assessment.

1.3. Scope of Research

This research addresses three specific issues contained within the research problem discussed above. Empirical research is conducted into structural and prudential problems in UK post-crisis regulation through multidisciplinary literature of financialisation and heterodox economics, intertwined with the politics of regulation, in order to develop an alternative interpretation and critique of the way regulatory transformation has provided solutions to the risk weight manipulation of Basel II and the idea of how banks are structured to solve state bail-out of too-big-to-fail banks. From an epistemological perspective, this research is situated within the mixed method paradigm and adopts a pragmatic philosophical approach, which allows for a comprehensive political-technical study of whether solutions have been found through the process of regulatory transformation. The thesis attempts to fill a gap in literature by using empirical enquiry to evaluate and explain specific elements of post-crisis structural and prudential banking regulation, providing solutions by addressing the influence and impact of financialisation and mainstream economics on technical aspects of transformation and considering the
mainstream response. The study involves the collection and analysis of primary and secondary qualitative and quantitative data through a series of ultra-elite interviews (defined in the methodology chapter; Ch. 3.4.4) along with descriptive statistics, accounting and company return data from a variety of documentary evidence and audited reports. This approach critically evaluates and discusses post crisis banking regulatory solutions with a view to establishing where problems exist and improving the stability of bank business models and the wider financial system.

1.4. Research Aim and Objectives

My own experience of banking in the City of London pre and post financial crisis was the basis for this research project. Having spent fourteen years working for various banking institutions in the City of London (1999-2013), my experience of banking regulation either side of the financial crisis prompted technical questions as to why the sector faced so many problems. I worked principally within the fields of Private Equity leverage buy-out origination and proprietary trading. Reflexively speaking, the ability to place myself within the research project and ask questions became apparent. Having worked in and witnessed the rapidly expanding cycle of high-risk credit from the late 1990s through to 2007, and conversely through a period of market contraction into 2013 during the implementation of the microprudential regulation of Basel II, I was able to observe regulatory practices in real time. Experiencing the impact of Basel II implementation on bank business models, economic performance and innovation within UK banking provided empirical understanding to support what I later learnt from literature, some of which features in this research. My banking career sits behind the drive and genuine motivation to study structural and prudential banking regulation in the post-crisis era. Developing an alternative understanding of micro and macroprudential
regulation premised upon a political-technical understanding fills a gap and makes a contribution to literature.

This doctoral thesis aims to analytically study and critically discuss UK post-crisis structural and prudential bank regulation through literature of financialisation and heterodox economics and also investigates how the politics of regulation is intertwined in the process of transformation. The purpose of this study is to develop and frame specific problems in these fields. It aims to provide an alternative understanding of the management of the regulatory change process by the Basel Committee on Banking Standards, the Independent Commission on Banking and UK domestic regulators the Prudential Regulatory Authority and the Financial Conduct Authority, to solve the failures of theory, microprudential regulation and the practice of risk management prior to the 2007 financial crisis. The study critically examines pre-crisis mainstream economic theory and its ability to impact post-crisis transformation, whilst also investigating the technical elements of risk weighted assets and capital adequacy in Basel II and its transformation to Basel III. Examination and assessment of the adapted, substituted and new elements of regulatory frameworks are conducted in and of themselves and then through a natural experiment (defined at Ch. 6.1) Using the example of Lloyds Banking Group Plc, the empirical impact of structural and prudential banking regulation is traced along with the way management chose to respond in one situation through de-risk and recapitalisation of bank balance sheets, whilst differently through regulatory circumvention and managerial bricolage (a concept defined at Ch. 7.4).

This study has several academic objectives that lead to findings and recommendations:

- A comprehensive and critical review of antecedent literature to establish an
understanding of banking as a regulatory problem pre and post financial crisis; a review of underlying mainstream / heterodox economics, and financialisation theory that has proved useful in developing empirical chapters of the thesis on structural and prudential post crisis UK banking regulation. Essentially, this review will form the basis to explain the way regulatory transformation has progressed and the tensions between politics, institutions, elites and banks.

- A critical empirical study regarding UK post-crisis structural and prudential bank regulation using: (i) the above multidisciplinary body of literature, via (ii) a mixed methods approach and the use of a cultural economy lens to analyse and explain how the process of regulatory transformation occurs.

- An empirical study of the impact of regulatory transformation of microprudential frameworks on a UK bank and the way elites in banks respond to these changes in managing banking firms thereafter.

- A theoretical investigation and explanation of the way managers or banking elites manage regulatory change within banking firms by reconceptualising financialisation literature based on empirical data from the forensic piecing together of public management, audited and company account information.

- The development of recommendations premised on the findings from the empirical and theoretical research carried out in the thesis that could improve the stability and certainty of banking in the post crisis era.

1.5. Research Questions

In order to achieve the aims and objectives of this thesis, the study attempts to answer the following research questions:
• Will the macroprudential shift in banking regulation and the UK response of ring fencing end too-big-to-fail? (Chapter 4)

• Has the reform of UK post-crisis bank regulation been too limited? (Chapter 5)

• PART A: What are the effects of prudential post-crisis regulation on UK banks (the case study of Lloyds Banking Group plc)? (Chapter 6)

• PART B: What are the implications of the Basel algorithm on management behaviour in banks (the case study of Lloyds Banking Group plc)? (Chapter 7)

Initially, the first research question stemmed from my personal experience in banking pre 2007 financial crisis and my observations on regulation via the workplace. However, conversations developed within data collected from ultra-elite interviews, and interview analysis assisted in framing the research question. The failure of efficient markets and light touch regulation, together with uncertainty of risk and instability of the banking system, become central concerns that run through the thesis document. The research question comprises two sections. The first section looks at the regulatory transformation that follows mainstream theoretical economic failure and can be divided into three questions: (i) Is a form of theoretical renewal possible, and if so, by what process? (ii) how does mainstream economics feature in this debate? and (iii) if the previous theoretical framework failed, then would an alternative macroprudential model work to improve certainty and stability, and if so how would this attach itself to heterodox theory? The second part of the research question addresses structural attempts to solve too-big-too-fail. Sir John Vickers led the Independent Commission on Banking and developed what was to become arguably one of the most important UK post-crisis regulatory transformations – ring fencing. Questions are asked that develop a narrative of the way technocratic elites form a para-governmental body or commission and manage a
process that shapes, develops and concludes with the concept of ring fencing. How was the commission formed, who was involved, what was the process, what was discussed, debated and analysed and how were conclusions rationalised and recommendations made? Ultimately, this research question draws these two elements of regulatory transformation together. This critical approach leads to a comprehensive understanding of the way UK post crisis regulatory transformation has been managed through a critical approach.

To answer the above series of questions an approach is considered and developed using Hall’s typology of policy change and ‘third order change’ in financial regulation (Hall 1993). Underlying the failure of pre-crisis theory and policy are theoretical and epistemic challenges that receive consideration through an examination of both mainstream economics pre crisis (neoclassical and neoliberal) and the potential for a new macroprudential framework to emerge (Walras 1896; Ricardo 1891; Arrow and Debreu 1954; Keynes 1935; Friedman 1970; Fama 1970; Minsky 1992; Ball and Sheridan 2004; Borio 2003; Borio and White 2004; Borio and Drehmann 2009; Borio 2010; Bernanke 2007; Summers 2005; BIS 2014). This literature is applied to the creation of a policy change framework bridging Hall’s third order change to a revised viewpoint on macroprudential control of economy through Keynesian uncertainty, Minskian inherent endogenous instability and Borio’s progressive approach to theory on disequilibrium and control of financial cycles (discussed in detail in Chapter 2 Literature Review). In response to the challenges above, literature in economics and financialisation is considered in the way banking ontology has changed through transformation in the banking industry and the question of whether adapted mainstream theory and dynamic stochastic general equilibrium (DSGE) modelling is capable of governing banking in the 21st century. To assist in strengthening the mainstream approach to banking regulation,
the structural bolstering of banks is considered through the ICB’s Vickers report and the concept of ring fencing. To answer whether there are limitations in changing the structure of banks through ring fencing and alternative approaches, a political economy approach is adopted in order to deconstruct the report. This allows a critical examination of the subject through empirical Chapter 4 of the thesis.

The second research question approaches UK post-crisis regulation through an ethical and technical framing of regulatory transformation and rule substitution (Hancher and Moran 1989). This chapter describes the City of London avoiding attempts to regulate public interest in finance firms (Hood 1991; Power 1994a), resulting in continued self-steering and light touch regulation heading into the financial crisis in 2007, and contrasts this with the hierarchical command-like system in the US (Moran 1990; Majone 1994). The ethical framing of UK post crisis regulatory transformation addresses Moran’s point on the creation of codified and juridified elements of regulatory transformation (Banking Reform Act 2012, MiFID I and II, MAD) via a detailed examination of a series of scandals: Libor, Payment Protection Insurance and Interest Rate Hedging (Moran 1990; Wheatley 2012; HoC CPA 2016). What follows is a discussion on reform and the way unethical behaviour is addressed and shaped by the regulator (FCA 2015b), along with a consideration of whether the response was effective or indeed limited through a financialisation and shareholder value analysis (Froud et al. 2000; Williams 2000; Froud et al. 2002; Froud et al. 2006; Ertürk 2008; Engelen et al. 2011).

The second part of the chapter addresses a technical framing of UK post-crisis regulatory transformation. This technical framing is aimed at the Bank of England’s notion of resilience through microprudential regulation and Basel III. The mainstream paradigm of risk management remains a dominant and vast field of study, covering a wide and varied functionalist approach (see Chapter 5 for detail). A critique is developed by
questioning Basel regulation and its calculative method and practice of algorithm (Langley 2013; Langley 2014; Gay and Pryke 2002; Ertürk et al. 2013a), the variable of risk weighted assets (RWAs) and the part it plays in calculating capital adequacy, all of which were involved in pre-crisis banking and the requirement for state bail-out of banks (Engelen et al. 2011). As a response to crisis and clear regulatory arbitrage, Basel III was transformed through rule substitution and a revised rating based approach rather than model replacement; however, to what effect, increased resilience or further regulatory arbitrage through management and manipulation? Chapter 5 critically evaluates the ethical and technical framing of UK post-crisis regulatory responses.

The third research question is split into two sections, Part A and Part B (in Chapters 6 and 7 respectively), which are connected by observing management behaviour in banks when responding to UK post-crisis banking regulation. Part A addresses the functionalist process of de-risk and recapitalisation of banks through Basel III and a UK bank between 2009 and 2015 (Lloyds Banking Group). Part B considers a different approach by bank management to regulatory response (Basel III) through management bricolage and the takeover of HBoS plc by Lloyds TSB Bank plc, which eventually became Lloyds Banking Group plc. The third research question develops a natural experiment that applies research from Chapters 4 and 5 to the above questions. In Part A, it is of particular interest to empirically trace the process by which the executive at Lloyds Banking Group managed the positive and negative effects of Basel III on balance sheet assets through capital accretive management and a series of management, audited and regulatory disclosures (Lloyds Banking Group plc, 2008-2015). The chapter considers how Basel III affects the management mind-set in responding to UK post-crisis regulation and the implications for risk weighted assets, regulatory capital and return on equity. Part B uses a Minskian framework (Minsky 1982; Minsky, Hyman 1992) to empirically trace
the behaviour of a senior managing director regarding assets originated at Bank of Scotland (BoS) through a department called Integrated Finance. It also traces a management driven regulatory circumvention as a process of arbitrage through two further nodes of opportunism and considers the effect of this on both the bank and the managing director. To capture this behaviour, a reconceptualised form of management bricolage is considered allied to the above behaviour and in contrast to the capital accretive balance sheet management witnessed in Part A. A question is posed as to whether the mainstream functionalist description of bank management fully considers the role and behaviour played by management during periods of economic fragility or crisis.

1.6. Research Contribution

There are several unique contributions in this doctoral thesis. Whilst a number of studies exist in the field of post crisis regulation, the main theoretical contributions are made by empirical enquiry and the provision of an alternative framing of UK debates relating specifically to banking (ring fencing and Basel III) using the literature of heterodox economics and financialisation, intertwined with the politics of regulation and its transformation. A detailed examination is conducted into the way these literature fields and the politics of regulation underpin structural and prudential transformation through mainstream risk management practice and the role of institutional shaping of the field. This results in a critical understanding of the way banking regulation is controlled and managed by politics and technocratic elites such as the ICB, FCA, PRA and BCBS. An original contribution is made regarding the impact of politics and post-crisis regulatory reform in Basel III on a UK bank’s performance by conducting a natural experiment. An empirical case is developed with respect to the way the process of de-risk and recapitalise operates through functionalist management and capital accretive decision making; this
is done to demonstrate a politicisation of the impact of the reform and substitution of elements within Basel III on capital adequacy, regulatory capital and return on equity. A unique theoretical contribution is also made by using the term bricolage (Engelen et al. 2010) to describe how firms behave and innovate in financialised capitalism and how managers behave inside banking firms during periods of crisis and economic fragility. This approach contrasts with mainstream finance literature on functionalist explanations of bank management by focussing on how managerial elites develop risk management practice that redirects focus towards alternative factors such as self interest and personal enrichment. The unique focus and originality of this research is thus created through analytical lenses of regulatory politics and cultural economy, as the influence and role of these fields come to bear in shaping and later evolution of the transformation process.

In conducting this research, an original contribution is made to UK post-crisis structural and prudential regulation through a mixed method and pragmatic philosophical approach connected to a multidisciplinary framework of data collection and data analysis from which the findings flow. This is a creative way of approaching technical subject matter in an empirical way in order to grant alternative theorisation, critical analysis and explanation of the regulatory transformation process. As noted above, other studies have reflected upon the way heterodox economics, financialisation and the above analytical lenses have been applied concerning different subject matter. This study, however, applies this framework to UK post-crisis specific elements of structural and prudential banking regulation and makes pragmatic recommendations from the research findings.
1.7. Thesis Structure

This doctoral thesis comprises eight chapters that progress as follows:

- Chapter 1: (Overview) The introductory chapter presents the main subject matter of the study. Also covered are the scope of this research, its aims and objectives, how these are linked with research questions and how the study attempts to answer them. A brief outline of the original and unique contributions made by the research is given, in terms of theory, method and recommendations connected to research findings.

- Chapter 2: (Literature Review) This chapter provides a review of antecedent literature pertinent to the examination of both structural and prudential elements in this thesis. It includes a multidisciplinary focus on financialisation and heterodox economics and the way in which the politics of regulation is intertwined in the framing and shaping of reform and transformation.

- Chapter 3: (Methodology) This chapter explains the overall methodology for the thesis, its philosophical and epistemological assumptions, and both the design and approach utilised in conducting the study. The methodology chapter also contains detailed literature and justifications to support the above, in addition to detailing the methods used both to collect information from primary and secondary sources (qualitative and quantitative data) and to analyse it, inclusive of analytical lenses employed. Also discussed are the validity and reliability of the research and its associated findings, together with the field of ethics and its involvement in the research.

- Chapter 4: (Empirical Work) This chapter analyses empirical research output from ultra-elite interviews and documentary evidence in relation to Research
Question 1. It studies the process of transformation in UK post crisis structural regulation and proposes a framework for macroprudential change. The chapter analyses the political role and influence of para-governmental commissions on shaping regulatory transformation and asks whether it solves the problem of too-big-to-fail in banks.

- Chapter 5: (Empirical Work) This chapter analyses empirical research output from ultra-elite interviews and documentary evidence in regard to Research Question 2, focussing on both the ethical and technical framing of UK post crisis prudential banking regulation. The chapter questions whether a series of regulatory responses have been too limited.

- Chapter 6: (PART A Empirical Work) This chapter analyses empirical research output from ultra-elite interviews and documentary evidence with regard to Research Question 3 (Part A). A natural experiment is conducted by applying research from Chapter 5 and looking at both the positive and negative effects of Basel III on a UK bank between 2009 and 2015. A politicisation of management decision making in relation to de-risk and recapitulation of a bank’s balance sheet is traced and the impact of this on risk weighted assets, capital adequacy and return on equity is examined.

- Chapter 7: (PART B Empirical Work) This chapter analyses empirical research from ultra-elite interviews and documentary evidence in regard to Research Question 3 (Part B). Continuing the natural experiment, and in contrast with Part A, the chapter traces management behaviour in banks that moves away from the more mainstream functionalist description of the banking role. Through a Minskian framework, the manager’s circumvention and bricolage of Basel III to create material value through assets once owned by a state owned
bank is traced through three separate opportunities at BoS-HBoS, Lloyds Banking Group and a leading secondary market trader of assets. A question is asked as to whether the functionalist description of bank management is sufficient to capture the way managers behave in periods of economic fragility or crisis.

- Chapter 8: (Conclusion) This chapter presents a restatement of the thesis in terms of the approach to the research and its findings with reference to research questions and synergised recommendations. Furthermore, research contributions are outlined with additional recommendations that discuss improvements for stability and certainty through regulation. Finally, the chapter highlights suggestions for further research in this field connected to the empirical chapters of the thesis.
Chapter 2. Literature Review

2.1. Introduction

This review sets out a survey of antecedent literature that proved useful in developing the empirical chapters of the thesis. Central to both the United Kingdom’s post crisis response to financial instability and the research questions herein are important issues surrounding the limitation of both micro and macroprudential regulation, together with Vickers’ ring fencing for controlling banks operating in a networked financial system, alongside the question of whether the implications of these reforms anticipated the post-crisis situation. Questions addressed in the thesis connect with the literature fields of politics, financialisation and heterodox economics through a political economy approach. The literature contained within these fields is vast, and a substantive review of these fields is beyond the scope of this thesis. In order to provide a boundary to the review, however, the survey has focused upon central themes of financial instability and ideas that rethink this instability within structural and prudential regulation, along with the impact of these fields on post-crisis UK banking.

2.2. Financialisation

Financialisation literature proved particularly useful in Chapters 4, 5 and 6 of this thesis. It is a literature field that connects with the central thrust of the thesis: financial instability. Worth particular note is the way such literature connects with concepts of shareholder value, business models and the use banking firms have made of bricolage at the conjunction of market events in pursuit of finance led capitalism. These areas of literature are discussed below.
2.2.1. Financialisation and Regulation

Following the 1986 financial big bang in London, the deregulation of financial markets, the exponential growth in finance capital and its subsequent challenges after the financial crisis in 2007, academic scholars have taken an interest in the implications that this shift in economic management had and continues to have on the economy and society more broadly.

Financialisation is becoming a mainstream field of research through various interdisciplinary fields – economics, geography, sociology, political science, anthropology, art and cultural studies – many of which have grappled with the power of finance and its roots at the heart of economic, financial and political life. The wholesale expansion of financialisation literature explains how academic studies are moving beyond the original boundary of the social sciences (Engelen and et al. 2011, p.113).

Over the past 40 years, and characterised by liberalism and globalisation (Crotty 2003; Epstein 2005), one of the concepts used to describe the above ideational power shift from Fordism and latterly Toyotaism to post-industrial economy, is ‘financialisation’.1 This thesis considers the connection between financialisation and the instability of markets and banking, while also paying attention to literary findings on banking regulation and the way banks operate within the financial system. During the period when financialisation developed, notably the early 1970s onwards (Epstein 2005), descriptive US statistics (see Fig.1) illustrate a steep rise in regulatory filings, demonstrating an ascending trend in what firms were asked to disclose (from six to 87 pages over a 36 year period to 2015). Evidence of regulation increasingly aligns itself with periods of financial

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1 The origin of the term financialisation and its first usage are somewhat uncertain. Kevin Philips first used the term in two of his books, “Boiling Point” and “Arrogant Capital”, describing the bifurcation in the normal capitalist means of production and financial based economy (Philips 1993; Phillips 1994).
innovation (Merton and Bodie 1995), as the structure of financial markets and financial institutions change. Attempts to harness such measures in regard to the stability of the financial system were stymied and encouraged a conjunctural market whereby banks in particular innovated with different products or moved to change their business model with regard to improving its performance in competitive markets. For example, capital regulation of securitisation invited off-balance sheet regulatory arbitrage (Calomiris 2010). Before the increase in financial regulation, (late 1970s in Fig. 1), the mainstream within economics describes a period of ‘Great Moderation’ free of serious economic event or crisis; moreover, this occurred throughout a period of significantly less regulation (Stock and Watson 2002).

\[2\] For an example see the case study of Barclays’ ‘Protium SPV’, which illustrates this point (Crowther and Ertürk 2016).
Fig. 1 After Great Recession: Pages in Bank Regulatory Filings Upsurge


Notwithstanding the above arguments and empirical evidence of increasing regulation, a narrative of liberalisation and deregulation re-emerged from earlier debates in the late 1970s regarding globalisation, through to the 2007 financial crisis, forged by international political economists (Eichengreen 2003; Eichengreen 2008; Bloch and Sametz 1977). Politics as a process is inherently wrapped up in financial regulation (Moran 2010). In politics and government literature, Moran describes state intervention and regulation as the driving force to override those business interests hostile to radical reform in financial markets (Moran 1990). Moreover, deregulation became synonymous with the term financial revolution, which Moran claims is far from the truth and fails the scrutiny of empirical investigation in the UK, much like the US in Fig. 1, as regulation
increases (Moran 1990). The elementary demarcation between regulation and deregulation requires disentangling. The destabilisation narrative began with the ‘financial big bang’\(^3\), and in the UK, the 1986 Financial Services Act came into being. A statute based system replaced previous loose corporatist arrangements and became the scaffold from which a corporatist system unfolded: what Moran terms ‘meso-corporatism’\(^4\), which:

“….catches the key features of arrangements at the sectoral level: the appropriation of a regulatory role by private interests; the transformation of private, voluntary association into authoritative bodies; the restriction of political and economic competition” (Moran 1990, p.15).

The 1986 Act defined new institutions for governing markets, such as the Securities and Investments Board, which was manned by City mandarins, and “was designed to be more responsive to, and controlled by private interests” (Moran 1990, pp.58–59). The power of private financial interests sprang from the platform of regulatory transformation, or revolution, and meso-corporatism, leading to a rise in the influence and power of financial markets over the economy. Moran claims that this action is primarily connected to the collapse of militarism, the end of World Wars, the ensuing boom in the economy, the end of Communism and the Cold War, and increasing competition between states on the stage of what eventually became a progressively globalised economy (1989;

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\(^3\) An agreement in 1983 (The Restrictive Trade Practices Act) between Prime Minister Thatcher and the London Stock Exchange settled an anti-trust case and led to a wholesale increase in market activity from a subsequent plethora of measures (termed the ‘Financial Big Bang’), designed to alter the structure and basis of the way in which financial markets operate in the UK.

\(^4\) Cawson defines the term (1985, p.11): “…refers to a fusion of the processes of interest representation, decision making and policy implementation with respect to a more restrictive range of issues than the system steering concerns of macro-corporatism.
2017). Adjusting to the liberalisation of markets and a repurposing towards an epoch of finance-led capitalism, financialisation describes the increasing power and influence held by banks over firms and households (Froud et al. 2007; Aalbers 2008; Stockhammer 2010; Wilmott 2010; Stockhammer 2011; Engelen and et al. 2011; Sawyer 2013).

Entangled within the financial revolution and liberalisation was the creation of fiat currency in 1971 and monetary expansion post termination of the Bretton Woods system, which was present throughout the Great Moderation, 1940s to 1970s. The fiat monetary system was taken up internationally by States and became a fundamental part of ‘mainstream order’ in western economies. The main effect of this was to open up the potential for destabilising sovereign state balance sheet, followed by increasing globalisation of trade and imbalance in the financial system (Portes 2009). There was a significant increase in the rate of crisis and economic imbalance after the abandonment of Bretton Woods, as Fig. 2 illustrates below.

Firms interacting with liberalised and deregulated markets experienced emerging finance-led capitalism (Krippner 2005) and a destabilised economy:

“I define financialization as a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production” (Krippner 2005, p.174)

A change of macro-pattern developed from illustrating how firms ‘accumulated’ profits through financial channels in liberalised markets. This proved to be a significant

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5 Meaning each State operating within the system adopted monetary policy that provided a maintainable exchange rate by coupling its currency with the value of gold.

6 The switch from Hegemonic Stability Theory and Bretton Woods to secure post WWII economic order, to destabilisation through deregulation, was illustrated by the undisciplined use of power by the US and neglect of its balance of payments during the end stage of Bretton Woods (Jones 2001, p.101).
step in developing financial instability. Krippner (2005) develops financialisation literature by demonstrating a shift in perspective from Arrighi (1994) and Philips (2003), both of whom were primarily conceptual rather than empirically focussed. Empirically, Krippner claims that the process of accumulation occurs through a shift in executive decision making by firms concerning future investments – from production and use of commodities – and that this derives profits from financial channels such as the use of shares, bonds and financial derivatives.

**Fig.2 Frequency of Banking Crisis**

![Graph showing frequency of banking crises](image)

*Note: Chart illustrates the percentage of economies in each subgroup that were in a financial crisis in each year during the period 1800 to 2008.*

*Source: (Qian et al. 2011)*
The important factor here is “the changing nature of transactions in financial markets [and how this] informs the overall shape of economy dominated by financial activities”, (Krippner 2005, p.175). Furthermore, Reinert and Daastøl published a paper (based on a conference and subsequent work from 1998) which gives a bibliography of pre-crisis literature warning of instability resulting from such shifts in market operation (2011). It includes the following: Hilferding’s Finanzkapital (1910) and distinctions between creative capital and ‘grabbing capital’; Keynes’ warning of depressions arising when money shifts from industrial circulation to financial circulation (1930); Harold Macmillan complaining of his own party’s policy being dominated by what he described as ‘casino capitalism’ as he attempted to reduce class wars through his book, ‘The Middle Way’ (1938); and William Lazonick’s ‘wealth creation’ vs. ‘wealth extraction’ (1994). These papers discuss a shift to a financialised economy that increases instability, which proved to be the case in the period approaching the 2007 financial crisis.

2.2.2. Financialisation and Shareholder Value

The following discussion on shareholder value was of use in developing Chapters 4 and 5 of this thesis. Post deregulation in the UK and emerging from the US, the consultant advisory sector focussed firms on the concept of shareholder value (Engelen et al. 2011). Shareholder value is an umbrella concept capturing several financial metrics that assess the value of a firm\(^7\). The principal idea was equity or the ownership of the firm by shareholders (Stout 2013), and it was in the interest of the shareholders to extract maximum benefit for themselves in terms of dividend and share price appreciation. How to effect this action was noted as the principal-agent problem in orthodox theory.

\(^7\) Metrics vary from EVA (Economic Value Added), EBIT (Earnings Before Interest and Tax), MVA (Market Value Added), ROE (Return on Equity) and EPS (Earnings Per Share). See Oana (2014) for accounting description, calculation and debate on the impact of shareholder value on senior executives.
Shareholders sought a method to align their interests to the executives managing firms via remuneration and bonus-stock options through performance management.

According to scholars working within governance and financialisation literature, one distortion that resulted from this shift in concept was to define the success of firms operating in competitive markets via very narrow accounting terms (Froud et al. 2000; Froud et al. 2006; Faulconbridge and Muzio 2009; Pike and Pollard 2010; Wilmott 2010; Allan et al. 2016). This is unsurprising as executives were being incentivised to serve shareholders and had been oriented towards financial outcomes. Shareholder value developed further as executives and middle managers drove at increasing financial return by engineering the calculations that drove measurements, achieving market expectation and thus success, into which investors trade. Froud et al. (2006) illustrate an important point regarding a disconnect between shareholder expectations in competitive markets (i.e. success is the appreciation of share price), and what can realistically be delivered by executives and middle managers. Pressure to achieve returns forces managers to extract the increasing return on capital that shareholders expect. Froud et al. term these managerial endeavours as an engineering process of ‘alchemic transformation’, using accounting tricks that project firms towards the highest percentile of market winners. The authors address a host of empirical examples to demonstrate financial engineering amongst a number of sectors and firms8 (2006).

Post 1980s deregulation, investment in financial channels and its associated success in delivering impressive shareholder returns became a strategic option for firms. This is primarily due to the regular and short-term quarterly coupon payments that boost

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8 See Froud et al. 2006, ‘Financialisation and Strategy: Narrative and Numbers’ for examples and cases: GlaxoSmithkline, Ford and General Electric are discussed in detail.
cash flow and the ability to provide regular and increasing dividends to shareholders (Williams 2000). This approach suits the way modern competitive financial markets operate and the potential for creating higher returns by operating the ideals of shareholder value. Investing through financial channels and banking has advantages over the Fordist tradition (Ibid). Great potential to increase profit and cash flow via investing through the conduit of banks, capital markets and into financial instruments (loans, bonds, derivatives) was seen in financial results (Krippner 2005; Palley 2009). This route to firm investment produces superior returns whilst allowing for the reduction of both fixed and floating costs that a firm trading in the Fordist tradition would normally account for (see the case of General Electric, Froud et al. 2006, p. 299). This strategy creates an accounting, calculative and market metric advantage, thereby influencing the subsequent increase in stock market returns and encouraging investors to purchase shares. Furthermore, the longer-term costs of capital expenditure and innovation are reduced through investing via financial channels (Boyer 2000).

Another attraction of investing in financial channels is to reduce the costs of the traditional ‘Fordist’ firm, which are to some extent passed onto product innovation within banks. Using these savings on branding, brand equity, marketing and sales increases the potential for improving returns for the firm and its shareholders (Klein 2000; Ertürk and Solari 2007; Kimbrough and McAlister 2008). Conversely, investment and costs associated with the production of goods and services can reduce dividend payments to shareholders at least in the short-term, as it takes longer to realise the increase in profit and cash flow (Krippner 2005) and returns are also likely to be lower over similar periods of time. During this period, company executives found that cash and capital expenditure was best spent on risk and cost mitigation, which inflated their own remuneration whilst simultaneously improving firm return on equity.
In succinct terms, financial investments reward shareholders rapidly via a short-term investment strategy. Markets react quickly and positively to increasing firm returns and associated share prices through financial accumulation (Krippner 2005). Moreover, and importantly, executives were not always aware of market risks firms were taking in adopting such a financialised shareholder driven approach. As the market transformed from the Fordist model of production, innovation and the wage–labour nexus, it was subsequently replaced by the implementation of a financialised model (Boyer 2000).

Firm executives were not fully aware of the destabilising shift in market dynamics created at the macro level. As noted above, executives gave priority to shareholders, investment strategy and methods of profit generation. As a result of the boardroom shift in investment behaviour and the subsequent surge of capital into financial markets and associated instruments, instability increased within financial institutions such as banks, to which networked circuits of firm investments and banking re-hypothecation, collateral and liquidity management connect (Ertürk et al. 2012). These important issues were off the radar in terms of a firm’s strategic risk assessment as banks on the whole were rated as solid performers by the credit rating agencies prior to the 2007 crisis (Acharya et al. 2009). A series of interrelated imbalances were building within banks. Goodhart reports various products within the financial system (notably mortgages, commercial property and leveraged debt, in addition to innovations in securitisation and financial derivatives) which developed systemic imbalance (Goodhart 2013). The result of this was a continual leveraging of bank balance sheets to achieve increasingly higher returns whilst simultaneously increasing shareholder value in firms and markets (Hellwig 2010). Engelen et al. suggest that banking executives were focussed on income and return on equity strategies to achieve the target of 15%+ (2011). Davies and Green suggest that executives creatively utilised business models and balance
sheet liabilities – via off balance sheet securitisation⁹ – to minimise downside in mark
to market losses whilst arbitraging Basel regulation and capital adequacy (2008).

2.2.3. Financialisation and Bank Business Models

In the preceding paragraphs, a connection is detailed between several interconnected
financial circuits. This includes the way in which the development of the concept of
shareholder value gradually transitions to instability in markets (Froud et al. 2000), and
how this is coupled to executive incentivisation to manage firms through financial
channels to accumulate profitability (Krippner 2005), which influences returns and share
prices for shareholders (Froud et al. 2006). Banking firms were certainly not immune
from this process of conceptual shift and subsequent financial ‘alchemy’ type
engineering as Froud et al. (2006) and Engelen et al. (2011) discuss. Central to such a
shift and the creation of instability is the idea of what banks ‘are’ and what they become
through the strategies of the institutional shareholder base (Lazonick and O’Sullivan
2000), further to how the change manifests itself by way of business model to produce
superior economic performance.

Banks are described in historical or orthodox economics and finance texts as
financial intermediaries, with the stock answer for their existence being that financial
markets are imperfect (Klein 1971; Benston and Smith 1976) with the consequent
existence of transaction costs (Leland and Pyle 1977) and informational asymmetries
(Engelen et al. 2011, p. 99). The evaluation of credit risk was something individual
households and many firms were incapable of conducting, thus creating information
asymmetry and the legitimacy and reason for banks to exist. The background to business
model change began in the early 1980s. A challenge was made to orthodox claims on

⁹ See Barclays’ Protium Case in Crowther and Ertürk (2016)
information asymmetry, transactional costs and imperfect markets and intermediation theory, towards a more functional rationale (Merton and Bodie 1995) that explains what banks do instead of why they exist (Engelen et al. 2011, p. 100). There were subsequent theories of risk transfer in wholesale markets, which noted banks as facilitators of market risk and a multitude of increasingly complex financial instruments that are offered by markets (Allen and Santomero 1997, p.1462). This latter shift plots a trajectory towards ‘risk management’ that eventually becomes the predominant analytic reason for legitimising banking operations and displaces the early 1970s literature entirely. Again, Allen and Santomero (2001) conclude that the traditional intermediation banking business was beginning to unwind and in its place was a new model driven by selling new products attracting fee income rather than taking balance sheet risk. The fee and distribution model was seen first in western economies, specifically the US and the UK, before its global presence.

As pointed out above, in corporate markets where the key incentive for executives and middle managers is the performance of firms for shareholder value purposes, something that is intrinsically linked with personal remuneration\(^\text{10}\), it becomes important to achieve certain accounting measures to demonstrate success. In banking, the key universal performance metric is return on equity, and 15% is the consensus for what banks aim to achieve (Engelen et al. 2011, pp. 108-109).

“Regulators like Haldane at the Bank of England conclude that when shareholder value driven banks attempt to reach unachievable or unrealistic return on equity targets and compete in a stock market environment, it encourages excessive risk taking

\(^\text{10}\) Firm executives receive high levels of remuneration irrespective of performance. In many cases, CEO remuneration increases for poor market performance post-crisis. Moreover, the case for performance related executive remuneration is weak as organisational size is one of the most important determinants of CEO remuneration vs. actual performance (Tosi et al. 2000; Conyon and Murphy 2000).
Regulators such as Haldane acknowledge that excessive risk taking has destabilised banking markets in attempting to achieve high return on equity; however, technical empirical evidence assists in how the literature describes this process unfolding. The fee driven originate and distribute model was created as a direct result of executives aiming to achieve the 15% return on equity target (Purnanandam 2010; Engelen et al. 2011). Business model literature points to banks originating assets and exposures to personal and business customers and keeping those liabilities on balance sheet at a cost to capital – which decreases the denominator in the return on equity calculation under the Basel accords. Engelen et al. (2011) suggest that banks began capital markets distribution, usually to buy-side clients through securitisation. These asset management firms that wanted different types of exposure\textsuperscript{11} were not governed by Basel, often paying above par prices for securitised bonds whilst not screening the underlying borrowers appropriately and relying on ratings agency review in regard to strength of ability to repay debts, the cash flows from which supported the securitised bonds (White 2010; Utzig 2010). Haldane (2009) has noted that the subsequent strength of bank performance resulting from such strategic business model changes has little to do with innovation or economies of scale, but is instead more akin to financial engineering (Engelen et al. 2011, p. 108).

What evolves from the shift in business model and associated financial engineering is a capital markets distribution platform across banking. The capital market distribution business describes the arbitrage opportunity banks were looking for in order

\textsuperscript{11} Property, mortgages, corporate loans through to sub-prime debt.
to bypass increases in risk weighted capital costs associated with Basel II and III by selling assets from the banks’ portfolios whilst increasing the fee base. This was a universal exercise across banks as the incentives for doing so were clear for return on equity (risk transfer of high risk weighted assets through securitisation or distribution off balance sheet), and amendments were made in Basel III to mitigate mis-incentivisation through capital requirements and liquidity ratios (BIS 2010). Furthermore, and of particular interest, was the way in which Basel misaligned risk management in what it perceived to be low risk asset classes which were weighted at zero (government bonds, gilts), banks lending to each other and AAA-rated firms, or residential-commercial mortgages that were secured or collateralised by property or cash – i.e. those assets the Basel algorithm encouraged banks to keep on balance sheet to reduce risk and leverage (see the table outlining Basel II Pillar 1 risk weights in Blundell-Wignall and Atkinson, (2010, p.4)). Goodhart points out that the risk management or reduction approach of Basel II produces unanticipated consequences; amongst the largest losses in post-crisis UK banks were exposures in residential and commercial property that Basel encouraged banks to maintain through lower risk weighted capital calculations (Goodhart 2013).

The above unanticipated and loss making consequences were also an omission that the Vickers report (ICB and Vickers 2010; ICB 2011) and its concept of ring fencing fail to acknowledge. Primarily, areas of the bank producing these assets would remain within the ring fence for risk and capitalisation purposes, alongside customer deposits, and would be pro-cyclical in terms of risk mitigation (see Goodhart, (2014), on separation of Casino and Utility Banking). Bell and Hindmoor discuss ideational shifts in power and the way in which structural power can be used to form economic policy (2017); whilst taking care not to make knowledge claims within an unfolding situation, they conclude, along with the Parliamentary Commission on Banking (PCBS 2012, p.50), that the
structural separation of retail and investment banking “will be of little value if, in the event of a crisis, the Government comes under irresistible pressure to bail out an insolvent investment bank for fear or otherwise of destabilising the financial system”. Moreover, and looking further afield, Hardie and Macartney extend this thesis, postulating that large universal banks or Globally Systemic Important Financial Institutions (GSIFIs) operating in varying jurisdictions and legal systems under differing nationally based regulatory reforms (Liikanen or Dodd-Frank from Vickers in the UK), which vary in strength of approach, quite rightly pose questions regarding what this means for the wider financial system in terms of contagion, losses and shielding the taxpayer (2016). How can universal banks operate across such national reforms and comply in each state, under bail-in conditions, bank resolution condition (whilst making headway, the ‘living will’ is still unresolved in terms of any solution to too-big-to-fail), Co-Co arrangements etc. (Hardie and Macartney 2016)?

In recognition of the above levels of technical complexity in devices of finance (Ertürk et al. 2013b), bank business models are not a key focus in mainstream finance literature. Mainstream finance literature discusses banking crisis through terminology of bank size, undercapitalisation and credit expansion preceding the 2007 event (ECB 2011; Bank of England 2012), and describes why the extension to Basel III and increased capitalisation, along with the reduction in the cyclicality of credit provision, becomes prevalent thereafter. However, after the de-risk and recapitalisation process between 2009 and 2015, banks began to increase balance sheet assets that became problematic in the crisis (mortgage and corporate debt, for example), whilst attempting to develop return on equity. This continued from 2015 onwards, banks became even larger in terms of asset and balance sheet exposure and regulation became more accommodating to larger banking firms, a problem Hardie and McCartney note was a pre cursor to the 2007 crisis
(2016). The following section of the review puts the above behaviour of banking firms into a theoretical context.

2.2.4. Financialisation and Bricolage

Employing the ‘bricolage’ concept proved useful in Chapter 6 of the thesis with regard to the functional view of financial innovation in firms and, as an example, how this can cause instability through securitisation. Within financialisation literature a critical approach is adopted via a reconceptualisation of financial innovation through banking firms behaving like bricoleurs. The argument is framed in terms of a conjunctural market event whereby banking firms react to regulatory response and innovate products and business models in order to create new revenues or to arbitrage regulation, for example (Engelen et al. 2010). Moreover, the activity of bricoleurs can provide substantial returns for shareholders and executives (Engelen et al. 2011). Chapter 6 reframes Engelen et al.’s 2010 paper through a post-crisis case study of a UK bank. The reframing places managerial behaviour central to the bricoleur rather than firms or banking firms.

2.2.4.1. Conjunctural Market Events and Bricolage

There were numerous financial innovations prior to the 2007 crisis. Chief amongst those were ideas, structures and enabling instruments or documentation that developed notions of risk management, risk transfer, balance sheet management and the democratising of finance whilst increasing the foundational capacity of the capital markets platform upon which its innovation base was formed. These ideals were portrayed much earlier by mainstream economists such as Merton and Miller (1986), who developed metaphors of successful and positive financial innovation whilst coupling the benefits with narratives of mainstream finance theory: “a strong, simple and positive story about financial
innovation serves as authority for pre 2007 benefits” (Engelen et al. 2010, p. 39). Prior to the 2007 crisis, and like Miller previously (1986, p. 460), central banks and regulators professed the benefits this type of innovation would have on the financial system (compared to what would have happened without innovation) and sanctioned developments wholeheartedly (FSA 2007; Bernanke 2007; Kent et al. 2007). The very risks that these eminent sources had clearly stated would be beneficial came to a sudden stop and began to unwind at the point of crisis. The consequences of unbridled financial innovation became problematic globally (Crotty 2009; Stiglitz 2010; Engelen et al. 2011). In the UK, trade narratives from finance were launched to mitigate any possibility of a more radical regulatory response (Wigley 2008; Bischoff 2009). As an example, innovative change to bank business models (originate and distribute) was not just about risk management and risk transfer, i.e. spreading risk through portfolio theory and recirculating capital, but was criticised as arbitrage of regulatory capital which subsequently increased bank returns (Houston et al. 2012). Following quarrels with mainstream innovation (Tett 2009; Tett 2011) and harnessing unregulated financial innovation – labelled as ‘destructive creation’ – what followed was a clear work-stream that regulators should carry out in terms of ‘catching up’ with fast paced innovation processes. At the same time the mainstream channelled a narrative of taking care not to throw the baby out with the bathwater – which became the rallying call – so as not to stymie creativity and dynamism in financial innovation (IMF 2007).

What the above does raise, however, is a series of intellectual questions on why financial innovation suddenly fails – if indeed we can describe financial innovation as true innovation (Horne 1985; Viñals and Berges 1988). When financial innovation fails at the conjunction of a material market event it becomes important to ask what tips the balance past the fulcrum point into instability. It is equally crucial to understand the
impacts and implications which emerge from financial innovation instability as the process and long tail of financial recovery continues. New forms of instability and unforeseen consequences can then occur as finance led capitalism evolves post crisis. To aid the thesis and its trajectory towards the politicisation of enforced regulatory capital losses and managerial bricolage, the framework of conjuncture and institutional or bank bricolage is used as a bridge to offer an alternative account that emerges within banks.

Engelen et al. (2010, pp. 33-63) craft an alternative account of innovation by reframing the process described above. A series of claims are made that push against mainstream explanations of innovation. The following points are discussed: (i) tautological problems and pseudo-innovation; (ii) narrow definitions of financial innovation that only create benefits to economy; and (iii) the considerable difficulty of measuring the success of innovation which suffers from a lack of empirical data upon which to ground sufficient argument. The general thesis of Engelen et al.’s paper (2010) grants weight to several viewpoints driven by power, similar to that of Froud et al.’s earlier work on alchemic transformation (2006) and the remaking of capitalism (2007), Ertürk et al.’s sociocultural account (2008) and construction of financial innovation (not weighted down by mainstream finance ideals of market problems), alongside social studies of finance literature on constructionism, performativity or ethnographic descriptions of what economists, and capital markets professionals and their tools do in the process of work (MacKenzie 2006; Muniesa 2014; Cetina and Preda 2012). These alternative accounts are set against the apolitical or mechanical view developed by innovation which focuses on solving mainstream market based problems encountered by financial intermediaries – asymmetric information, market and product pricing etc. – via the talented heroes of mainstream finance academe with new ideas and formulae in which they legitimise the remaking of capitalism and bring forth a new world (Bernstein 1992;
White et al. 1996, p.6).

Alternative accounts of innovation process (Ibid., p. 37) are offered at the conjunction of market events (p. 42) with practitioner or ex practitioner accounts preferred through what is described as improvised innovation (Augar 2000; Lowenstein 2002; Augar 2005; Knee 2007; Taleb 2008; Ellis 2009). Empirical case studies (JP Morgan: 2006 and Deutsche Bank: 2008, in Engelen et al. 2010) are discussed, highlighting the plight of proprietary trading and securitisation. The contingent, historically determined and fragile but lucrative financial innovations are developed through long chains of complex transactions, legal structures, bibles of legal documentation, multiple actors (banks, consultants, lawyers, insurers, accountants). The reason for financial innovation was to improve capital adequacy under Basel II through ‘alchemic’ risk transfer techniques (Duffie 2008; Acharya et al. 2009; Altunbas et al. 2009). An example would be buying an equal amount of AAA bond risk from the liability column of the securitisation to that of junk credit risk placed into asset column of the securitisation prior to the interest rate swap, which in turn increases capital adequacy as AAA bonds attracted less capital than junk loans, and increased return on equity.

These critical and somewhat negative accounts of financial innovation developed through financialisation literature are typically power driven and are of particular interest to the thesis. Above, the criticism and discussion is levelled at improvised innovation by a firm or financial institution. The necessary conceptual action that delivers innovation change is that of ‘bricolage’, which again pushes against mainstream explanations of rationality.

Bricolage has been used before in terms of describing and explaining financial innovation through fields of journalism and social studies of finance (Hildyard 2008; Muniesa 2014; Beunza and Stark 2003; Beunza and Stark 2004). These papers develop
analytic descriptions of finance design rather than that of random or market conjunctural reasons for firm innovation. Engelen et al. describe bricolage in Levi Straussian terminology:

“….in terms of thought process, bricolage is opposed to the scientific mode of thinking, encompassing in this case both techné and episteme, and seems to be, in its practical orientation and its implicit criticism of the ends – means model of human action, more related to metis as described by the anthropologist James Scott (1998)”, (2010, p. 53).

For Engelen et al. (2010), the bricoleur [in this case the banking firm] is seen as creating new risk structures through the means of conjunctural market events or event-based occurrences, which it experiences and then responds to, as opposed to the more rationalist explanation of science or the scientist creating events that change the world we live in (Lévi-Strauss 1966, p.22). Bricolage exposes the potential that practice can have on financial innovation and how this impacts the financial system in which bricolage operates – rather than through any particular mainstream theoretical dispensation which allows human action.

Engelen describes the important double relevance of bricolage as it combines market conjuncture and long complex chains of transactional events (Ertürk et al. 2012) with the bricoleur or multiple bricoleur engineers at various nodes of interjection as the transaction is performed (2010, p. 54). This critical explanation challenges the dominant rationalistic paradigm of financial innovation and is very much dependent on situation, conjunction and bricoleur ingenuity at a period in time, as well as being resource dependent – physical or intellectual. This explanation is used in Chapter 7 Part B;
however, instead of a firm or bank being the bricoleur, it inserts the manager post process of bank merger, the imposition of regulatory capital rules and losses and the way in which new structures are built by managers to exploit the nature of financial regulation within a state owned bank for significant personal remuneration.

2.3. Heterodox Economics and Financial Instability

The following subsections of the literature review, survey and augment three important areas for this thesis that were useful in writing Chapters 4 and 5:

- Keynes’ theory on uncertainty and how both micro and macroeconomic economic models can lead to instability;
- Minsky and his work on financial instability and the problems of aggregation of microeconomics when creating macroeconomic theory. Focus is given to why endogenous risk within the financial system should be preferable to the exogenous risk that New Keynesian Synthesis and the mainstream propose pre the 2007 financial crisis;
- Borio and his work on why the New Keynesian Synthesis and Dynamic Stochastic Models lack ability to manage macroeconomy and financially driven capitalism.

2.3.1. Keynes: Economics of Permanent Disequilibrium and Uncertainty

“Keynes without uncertainty is like Hamlet without the Prince” – Minsky, (1975, p.57).

The problem of uncertainty has surrounded economics and especially those who profess to model the economy through general equilibrium calculation (or ‘Dynamic Stochastic
General Equilibrium’ as it is now known), or question its applicability to the real economy the earlier Neoclassicals and New Keynesians (Neoclassical Synthesis) or the later Heterodox Keynesians. According to Post-Keynesians (within the heterodox faction), the neoclassical synthesis, in its later reinterpretation of Keynes, omitted an important variable in the model; some suggest ignored the proposition entirely (Peterson 1977; Davidson 1989) that being ‘uncertainty’ – and attempted to make calculative variables relating to the future as being knowable and therefore certain (Davidson 1982a; Davidson 1982b; Davidson 2007).

Keynes had a distinct theory on uncertainty in relation to his general theory (1937). Uncertainty as a problem relates to knowledge about the future and whether this is knowable in advance by rational economic men (1937, p. 214). Keynes recognised that dealing with uncertainty – primarily in relation to money and interest – would have an effect on the result of economic calculations and processes in reality (Stohs 1980). To a large extent, Keynes’ general theory was an attempt to rationalise uncertainty into economic theory (Kregel 1976). Keynes’ view on uncertainty is highlighted below:

“Actually, however, we have, as a rule, only the vaguest idea of any but the most direct consequences of our acts. Sometimes we are not much concerned with their remoter consequences, even though time and chance may make much of them. But sometimes we are intensely concerned with them, more so, occasionally, than with the immediate consequences. Now of all human activities which are affected by this remoter preoccupation, it happens that one of the most important is economic in character, namely wealth... thus the fact that our knowledge of the future is

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12 At this stage it is worth noting the difference between ‘Knightian Risk’ (1957) and ‘Keynesian Probability’ (1937), and how they relate to ‘uncertainty’. The two explanations differ but are often aggregated or confused as being similar or the same. See Lawson (1988) for the full debate.
fluctuating, vague and uncertain, renders wealth a peculiarly unsuitable subject for the method of the classical economic theory. This theory may work very well in a world in which economic goods were necessarily consumed within a short interval of their being produced” (1937, p. 213).

Keynes goes to great length in explaining how the consistently rational man, ‘homo economicus’, manages uncertainty (1937, pp. 214-219), given that in his opinion there is no scientific basis on which to form any calculable probability as to how the future can be modelled that will not, at some stage, result in sudden and violent volatility and therefore erroneous modelling outputs compared with reality. Three characteristics of rationality are offered to create the foundation from which the classicals attempted to create concrete value judgements of future probability (Keynes, 1937, p. 214):

- The present is a better guide to the future than the past. The future is largely ignored regarding the prospect of future change such are its characteristics that we know nothing of.

- Assume the existing state of opinion as expressed in prices, and its output based on a correct summing up of future prospects so probability can be accepted until something new or relevant enters the picture.

- Knowing individual judgement is worthless; market professionals therefore fall back on the endeavours of the world, which is better informed. Thus a consensus of the majority is accepted as the average. A society of individuals all copying each other leads to what is termed ‘conventional’ judgement.
Post this point (1937, pp. 216-217), Keynes discusses the way money as a store of wealth is utilised as a filler that rationalises the reality of what we don’t know about the future. In banking, for example, collateral, cash or additional equity would be taken to fill and protect against downside risk of a future breach of payment given that credit models attempting to look forward are based on the premise that past and current credit or business performance is not a good indicator of what an individual or firm will do in the future. This is much in the same way as regulators asking for additional Tier 1 equity (cash or cash equivalents) post the 2007 bank balance sheet instability. This is of significance, as New Keynesian market models (DSGE) were unable to calculate future uncertainty in 2007 due in part to microeconomics (Lucas 1976) being aggregated to macroeconomics as Keynes’ characterisation above predicted.

Keynes claims his explanation of uncertainty demonstrates the point at which stability breaks down and volatility damages the entrenched belief in such ability to forecast unknown characteristics. This points out a distinct difference between Keynes’ position on uncertainty and what became ‘New Keynesian’ theoretical abstraction and reality (1937, p. 215).

2.3.2. Minsky: Financial Instability

Minsky’s pre-analytic macroeconomic thesis on ‘instability within the financial system’ is underpinned by Keynes’ theory on ‘uncertainty’ and the volatility of private investment (Dymski and Pollin 1992). Minsky believed that investment decisions made within firms via their executive management and the sanction or rejection of credit applications by financial institutions was a primary cause and the first stage of inherent financial instability (Minsky 1986, p.349). Here, real investment or capital expenditure through credit and debt is connected to nominal financial conditions of the market
To a greater extent, these ideas place Minsky outside of mainstream or neoclassical economic theory, where the microeconomics of the individual as a unit of analysis, human rationality and behaviour, the maximisation of profits and human utility are aggregated to create an orthodox macroeconomic theory (Keen 2017). There were alternatives to this latter theory by Keynes’ student John Hicks, who thought his IS-LM model was compatible with microeconomics and presupposed that government intervention would come to alleviate the economic depression created by finance (Hicks 1980). However, Lucas disagreed and developed aggregation to macroeconomics from microeconomic foundations (Lucas 2003), arguing that this approach was superior to government intervention, which should be omitted completely. Lucas’ theory implies that exogenous forces create instability and therefore Hicks’ position does not meet with microeconomic theory (Lucas 2003; Hicks 1980). Lucas won support for the microeconomic aggregation theory and the New Classical Synthesis became mainstream thought (Hicks later diverted into New Classical Economics). However, Lucas’ theoretical legitimacy was challenged in the financial crisis of 2007 via a de-regulated financial market that witnessed severe instability, and without unconventional central bank policy and the stabilisation of markets post credit crunch, market stability rather than equilibrium is unlikely to have occurred. Hicks’ theory appears to have been nearer to the eventual reality.

A stylised fact of neoclassical economic theory in regard to financial stability is that a market can dynamically recalibrate to an equilibrium point post financial crisis or event without political intervention – a self-righting process. Supporting such a theorem is the research of Walrass, Arrow and Debreau and McKenzie (Weintraub 1979). Equilibrium theory later developed into complex mathematical DSGE modelling through
Lucas and elements of New Keynesian and Real Business Cycle traditions (Keen 2017).

In contrast with the previous paragraph, Minsky’s reading of Keynes drives at uncertainty being at the heart of boom and bust from private and firm investment and draws upon the conditions of what is now termed financialised capitalism. This is connected to the way central banks and politics intervene to avoid systemic collapse, without which the financial system may well have imploded without establishing equilibrium (Keynes 1937; Minsky 1992; Engelen et al. 2010; Goodhart 2014).

Crucially, however, Minsky agreed with Keynes’ position on uncertainty and explained that firms operating in competitive markets have investment obligations to service prior financial commitments linked to business projects, for example, or merger and acquisition activity (Minsky 1992). This gives rise to boardroom decisions and contracts, which drive management expectation of future profits and cash flows from investment over a set period of time. These investments carry significant uncertainty and credit risk with unknowable variables featuring in the calculation. Should future profits and cash flow projections prove erroneous, two things happen: firstly, if cash flows deteriorate, the ability of a firm to service its investment obligations diminishes; secondly, and following on from point 1, default risk increases without some form of equity cure (Moore 1994).

The example of commercial property markets is useful in the above regard; historically, the above network of pro-cyclical financial and interrelational cash flows on a large scale has propagated a debt deflation process in the property sector and has led to market instability as banks suffer significant losses from firm default and inability to service and repay debt (Borio et al. 2001). This type of scenario led Minsky (1992) to his eventual notion that there was ‘inherent endogenous financial instability’ within the financial system rather than exogenous forces at work – such as government regulation –
which mainstream neoclassical accounts of free market economics support (Wolfson and Epstein 2013, p.708).

Minsky asks whether crisis can happen again (1982) and suggests that crisis events are inevitable in free market capitalism:

“This instability, in my view, is due to characteristics the financial system must possess if it is to be consistent with full blown capitalism. Such a financial system will be capable of both generating signals that induce an accelerating desire to invest and of financing that accelerate investment” (Minsky 1969, p.224)

Minsky argued that after the Second World War there was no free market financial system. Various forms of crisis and recession occurred prior to Minsky writing ‘Can it Happen Again’; however, the collapse of firm profits was prevented by what he termed ‘Big Government’ and a conduit without which a pre-condition to deep and longer lasting recessions may have occurred (Minsky 1982, p. 13). Lucas, however, failed to look at prevention of crisis or depression and was more concerned about deriving macroeconomics from microeconomics and ascertaining how this theoretical approach had solved economic depression (2003, p. 1). Lucas’ approach led the path towards mainstream DSGE models that underpinned a lengthy spell of 35 years free from serious financial crisis (Lucas, 2004). Dymski has an alternative view and suggests Lucas was attempting to attack the Keynesian consensus. Lucas discussed macro-stability via the use of mean / variance measurement of GDP. Ultimately, Lucas ignores other all measures which weakens what appears to be a compelling case. Three years later, the 2007 financial crisis arrived and Lucas’ thesis failed to see the financial crisis approaching from the period known as the Great Moderation (Keen 2017).
There are limits to Minsky’s endogenous instability hypothesis and the application of his pre analytical work, meaning that the hypothesis on macroeconomic theory requires empirical investigation and analysis. According to Dymski (1997, p.507), Minsky has provided fertile ground for research with his ambitious theoretical development; however, given the incomplete nature of Minsky’s body of work, “it lacks solid theory of investment, picks selectively from Kalecki and Marx”, and to large extent requires significant empirical investigation to substantiate its foundation and claims.

2.3.3. Developing Minsky: Borio, the Macroeconomic Framework and Financial Cycles – Reducing the Impact of Equilibrium Modelling

“Macroeconomics without the financial cycle is like Hamlet without the Prince”, (Borio 2012, p.1).

Minsky (1986) tables various suggestions for reforming the financial system, inclusive of its endogenous instability and interconnection with the cyclical character of capitalist economies (see Chapter 13, pp. 327-369). Minsky also remained hopeful of analytical reconciliation with New Keynesians (Minsky, 1989) or New Classicals (Minsky, 1996, p. 362). Simply put, there is no simple solution to the problems of market instability; every gain or attempt at reform appears to have a significant cost or impact within interconnected complex financial systems. However, in 2001, and based upon a warning of continued financial systemic fragility, a somewhat unconventional but coherent set of ideas developed, linking to Schumpeter’s work on re-occurring cycles (1928; 1934) and Minsky’s earlier body of Post-Keynesian theory.

These ideas formed around the way in which financial systemic risks could be
mitigated. This entails the management of the endogenous instability of capitalistic boom and bust through managing financial cycles and developing a macroeconomic framework. There is a rich body of literature on post crisis market developments; however, relatively little analysis has been undertaken regarding different approaches to financial cycles, such as financial crises, asset price booms and credit-equity, compared with analyses of the full cycle of the market’ (Claessens et al. 2010).

Borio identified fragilities in the mainstream or New Keynesian DSGE approach in 2001, and in 2003 he developed a macroeconomic framework to demonstrate how his theory would operate to restrict the occurrence of fragility by tempering the peaks and troughs of boom and bust (Borio 2003; Borio and Drehmann 2009). Borio and his colleagues at the Bank of International Settlement, amongst others, developed a whole body of work, chief amongst these are the following papers: Borio et al. (2001; 2003; 2004b; 2009; 2010; 2012). Borio, like Minsky, notes the flawed logic in continuing with the DSGE model firmly anchored within the mainstream New Keynesian tradition (2012). This argument is supported by the previous Sonnenschein-Mantel-Debreu debate (Sonnenschein 1972; Mantel 1974; Debreu 1974) which concluded that microeconomic rationality assumptions have no equivalent implications in macroeconomics; i.e. microeconomics is not able to be aggregated from microeconomics as the Lucas Critique later argued (1976). Consequently, microeconomic assumptions have at least to some extent created instability through the DSGE model.

Post the 2007 financial crisis, economists and proponents of DSGE have attempted to map additional financial factors into the DSGE model; they have termed these ‘financial frictions’ on an otherwise best-case model that served the economy well up until 2007, and statistical trends supported this view (Blanchard 2016, p.2). Stock and Watson (2002) reported on ‘The Great Moderation’ and the manner in which the New
Keynesian approach tackled unemployment in the United States, which reduced by 11%, 8% and 6% respectively through the recessions in 1983, the 1990s and the early 2000s; also noteworthy was the reduction in inflation in 1980, 1990 and the 2000s from 15%, 6% and 4% respectively. Despite these metrics the great financial crisis happened in 2007.

However, Borio suggests that the mapping of additional frictions in the DSGE model is too conservative and does not go far enough. Borio’s framework and policy response calls for an improved understanding of business fluctuations by analysing financial cycles (Borio, 2012). Borio suggests that it is simply not possible to understand financial boom and bust through DSGE without understanding the financial cycle and the endogenous implications it contains (2012). Here, Borio is attempting to weaken the grip of an amended New Keynesian DSGE approach whilst developing the Minskian endogenous instability of financial systems and Schumpeterian cycles. An understanding of financial cycles incorporated into modelling by adjusting macroeconomic policy develops a compelling thesis for reform.

Borio understands the financial cycle as a sequence of “self reinforcing interactions between perception of value and risk that translate into booms followed by busts” (2012). Like Minsky, Borio links endogenous financial instability with volatility in the amount of private debt relative to income. In addition, volatility of asset prices that have been purchased with debt such as the earlier mentioned property example are salient to understanding mania-driven risk behaviour, speculative investment and crashes caused by debt bubble formation, as Kindleberger also brought to our attention (Kindelberger 1978).

The financial cycle itself has a much-reduced frequency compared with an average spread of 5-7 years of the business cycle. As illustrated below in Fig. 3, financial cycles can take several decades to develop in sufficient magnitude to create an increasing
likelihood of crisis, therefore it is difficult to understand how this is impacting the economy without overlaying the business cycle trajectory and associated economic events.

Here we can observe the development of the financial cycle from a period of economic liberalisation and globalisation in the early 1980s and, over longer periods, how the standard deviation of the financial cycle is completely different to the business cycle and becomes more volatile. Minsky discussed how ‘big government’ intervention prevented the collapse of profits and debt servicing; therefore, recovery from the ensuing recession occurs without a true market correction in value and price, and without sufficient debt deflation or reduction of debt leverage in firms or private investors.

Fig. 3 illustrates a form of debt super cycle developing from event to event over time. The logic here is that each time the market is rescued or diverted from a true correction via ‘big government’, the financial cycle from peak to trough extends and the standard deviation to its norm also increases, meaning that the severity of the next serious financial crisis may be so large that the government or central bank is unable to prevent a correction via intervention as the lender of last resort.

**Fig.3 Financial and Business Cycles in the United States**

![Financial and Business Cycles in the United States](image)

*Source: Drehmann et al. (2012), found in Borio (2012) p. 3.*
Orange and green bars indicate peaks and troughs of the financial cycle measured by the combined behaviour of the component series (credit, the credit ton GDP ratio and house prices), using the turning point method. The blue line traces the financial cycle measured as the average of the medium term cycle in the component series using frequency-based filters. The red line traces the GDP cycle identified by the traditional shorter-term frequency filter used to measure the business cycle.

Indeed, a larger amount of liquidity may be required at the next crisis event in addition to the colossal amount of monetary stimulus invested into the economy post 2007. A sizeable sovereign crisis may occur and the IMF may not be able to respond if a state becomes bankrupt or insolvent, and a systemic collapse amongst interconnected financial systems becomes increasingly likely.

Borio suggests that western economies may have been better off without economic development and innovation since the 1980s: globalisation, stable inflation, liberalisation and the de-regulation of markets. Both the tradition and the direction Lucas took in developing the New Classical Synthesis and subsequent DSGE models ignored financial factors without analysing financial cycles or the synchronicity of economic models at the country level and the correlation between different economic sectors, credit, price, risk and equity, both domestically and globally. The higher the global synchronicity of financial cycles, the longer and deeper the depression or recession episodes continue (Claessens et al. 2010).

Importantly, Borio suggests that central bankers have analytical tools to observe how the financial cycle develops in real time, and have the ability to place intervening actions to temper the peaks and troughs of the financial cycle and thus prevent hyper volatility or indeed the requirement to use unconventional monetary policy and stimulus
in the same volume as post 2007. Empirical analysis (Claessens et al. 2010; Borio 2012) provides an initial assessment of the way financial cycles shape a list of economic events and the extent to which standard deviation or the amplitude of super cycle development within the endogenous financial system evolves. This approach looks to re-anchor the relationship between credit, debt, value, risk and equity. Currently, the financial system creates imbalance and distortion that masks the increasing likelihood of crisis. Borio’s macroeconomic framework could allow policy makers to determine an improved path to sustainable income for firms and individual investors without the unconventional monetary policy or macroeconomic regulatory measures (Basel increased recapitalisation, which interrupted bank performance) taken by central banks post 2007 crisis (Borio 2009; 2012). Borio also notes the high likelihood of moving away from the orthodoxy of ‘equilibrium concepts’ and looks to the advantages of observing ‘disequilibrium’. Dymski suggests that Minsky retained some hope of government re-harnessing economic forces through a macroeconomic regulatory response (Minsky 1994), which could be through the development of Borio’s framework on financial cycles as it improves the resilience to crisis through macroeconomic policy. Borio’s body of work – albeit underdeveloped and suggesting a need for redesign of macroeconomic policy – was available to consider post-crisis as an alternative to an amended and limited DSGE model by means of additional ‘financial frictions’ or elements of behavioural economics, as proponents such as Blanchard conclude (2016, p.3). The more resilience can be added through proactive macroeconomic and regulatory responses, the better for a sustainable global economy into the future.

Since this time, there has been a continued challenge to the mainstream neoclassical paradigm via scholars such as Godley and Lavoie (2006) and Keen (1995; 2013). These scholars have taken up the theoretical framework of Minsky and Borio and
through empirical analysis developed ‘agent based modelling’ or computer based programs that simulate dynamic monetary economic models. This research also omits equilibrium analysis and promotes a financial sector in the model to demonstrate financial disequilibrium. The latter point was an important theoretical argument that New Keynesians failed to acknowledge: the DSGE models blinded them to the 2007 financial crisis as they observed exogenous fragilities whilst endogenous credit or bank debt was deemed neutral via the troubled and discredited loanable funds banking model – banks, debt and money failed to feature in theory or analysis (Krugman 2009) and perhaps this is why theoretical, empirical or indeed technical disputes fail to impact political discourse and policy in a meaningful way.

Both Borio (2012) and Keen (2013) recommended private debt relief post crisis so that firms and household debt liabilities could be repaid in part or full over time$^{13}$, rather than from what the economy received via unconventional monetary policy on interest rates and stimulus responses via quantitative easing. Central banks assisted with the immediate need for liquidity and financial system stability during the 2007/8 credit crunch and recapitalisation of bank balance sheets past the point of rescue. Haldane notes the above whilst also supporting asset prices in the market with unconventional monetary policy as the Bank of England interest rate dropped below the 2% level for the first time in its 315 history (Haldane 2015) and has ‘stuck’ there since, indicating that a reduction in rates is not a driver of growth when experiencing bank and sovereign debt crisis and its impact on the wider economy. The post-crisis central bank project, developed by panicked Neoclassicals, has unfortunately meant an elongated depression and a stymied spending response from households, who are often supported by cheap debt via

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$^{13}$ Keen’s Manifesto on his Debtwatch website includes a modern day debt jubilee injecting fiat money into accounts for all and repaying debt where liabilities are owed, while the rest receive cash on a staged basis so as not in to create inflation: www. Debtdeflation.com/blogs/manifesto.
manipulated interest rates (zero interest rate policy and negative interest rate policy), and firms who have reduced capital expenditure, often preferring to invest into rentier class assets searching for yield whilst increasing risk and bubble formation in different sectors, e.g. property, through exposing new forms of accumulation based instability (Krippner 2005). The central bank response could have been to help households and firms to repay debt and rebuild savings without the political choice of austerity, debt deflation and swathing cuts to state spending whilst the debt to GDP ratio continues rising in western economies (Borio 2012; Keen, 2013).

2.3.4. Rethinking and Rebuilding Macroeconomic Theory

“It is time for our subject to allow more room for, and show more respect for, those engaged in building, and using, policy models. These macroeconomists are now doing our equivalent of experimental physics. The second—and related—lesson is that there needs to be more pluralism. Just like in the sixteenth century, after the Christian Reformation, there may no longer be a true church. It is time to put the religious wars behind us” (Vines and Wills 2018)

Some 10 years post the 2007 financial crisis (and somewhat trifling in itself to understand why it has taken quite so long), it is refreshing to observe mainstream economists forming a fresh project via a critique of the long standing epistemological position and consequent inadequacies of DSGE models. In a recent publication of the Oxford Review of Economic Policy (Vol. 34, Issue 1-2, 2018), a schism appears to have opened within this faction of the mainstream, and it is assessed whether DSGE can ever hope to be fit for purpose in modelling the macro-economy. With circumspection, this level of scrutiny
and objection may have always underpinned the dominant perspective. Perhaps those holding similar views found the nature of concern unappealing. Lifting one’s theoretical head above the neoclassical ramparts to raise objection would have been problematic. The Great Moderation provided empirical support for Lucas’ theory premised upon New Keynesian micro foundations and the ‘good times’ model. The critical view is that a macroeconomic model that only operates to purpose in ‘good times’ may not be good enough. Whilst factions of the mainstream are split in their viewpoint, Post-Keynesians economists offer a different perspective on this debate. For them it is not about whether DSGE models are fit for purpose, but that all economists know the model is unfit – when contrasted with Global economic Model Oxford Economics, and WIFO forecasts), and the mainstream knows this to be the case (Breuess, 2018).

Post crisis, however, the need to ask searching questions is gathering momentum. Several contributions in the Oxford Review of Economic Policy (Vol. 34, Issue 1-2, 2018) note that the DSGE model was never fit for purpose. Blanchard notes his disappointment again (2018) and lays out five different types of model and variables within which he appears to throw off the theoretical and stifling straight jacket whilst also concluding, perhaps unhelpfully to the mainstream, that simplifying economic variables to cope with the modern macro-economy may not be possible: “introducing new variables may create fresh distortions which may be important at differing periods of economic cycle”. In short, the paradoxical nature of dynamic complex economic systems and the attempt to simplify model solutions to explain detailed operations whilst enabling policy makers to govern the economy is too much to ask – the tools for this role do not exist. Blanchard concludes that he believes in simplifying models but without any credible support for the claim. Others, such as Lindé, (2018) argue for a DSGE model that attempts to include the financial sector. In contrast, Haldane and Turrell argue for economic
pluralism and an interdisciplinary model for macroeconomics (2018). Other scholars, however, discuss a need to be less dogmatic and state that the negative approaches to microeconomics and its aggregation to macroeconomics are harming or stymieing progress (Ghironi 2018, pp.195–218). Ghironi’s principal conclusion in this paper is to demonstrate an unwillingness to throw the proverbial baby out with the bathwater. The idea is to keep the DSGE model focussed away from more radical alternatives and on revising microeconomic rigidities. Following this reasoning and adding further complexity, Wren-Lewis argues for combining DSGE with structural econometric models (Wren-Lewis 2018). A whole raft of ideas has been floated within the orthodox paradigm.

Furthermore, the overall conclusion of those leading this project and reviewing the papers is to maintain a form of DSGE. Whilst asking searching questions has promoted debate and challenge around post-crisis macroeconomics, it appears that the ‘micro foundations hegemony’ should be cast aside (Vines and Wills 2018, p. 29). This in itself can be viewed as a progressive and somewhat surprising statement. Such an assessment may lay the groundwork to a longer-term paradigm change if more radical alternatives (Borio 2012) can also be introduced through Haldane’s idea on advancing pluralism.

2.4. Conclusion

In summary, this review has discussed literature with particular regard to financial stability and the limits of structural and prudential regulation. Two distinct fields of financialisation and heterodox economics have been reviewed, along with the way in which the subfields pertinent to the research questions framed in the introduction relate to the thesis more broadly.
Subfields within the section covering financialisation contribute broadly to the empirical chapters of the thesis (Chapters 4, 5 and 6). The discussion looks at the regulatory and deregulatory landscape using meso-corporatism as a foundation for private interests to control the transformation process: these explanations are of assistance to Chapters 4 and 5 when developing arguments that concern hybrid structural change to regulation via the Independent Commission on Banking and the maintenance of the status quo of mainstream risk management that was in place after the financial crisis and throughout the Basel algorithm’s evolution. Shareholder value and bank business models have proved useful in developing an understanding as to why banks have so much power in developing the economy, why they focus on short-term revenues to reward shareholders and managers and how this shift can create financial instability. Chapter 5 discusses how business models connect with shareholder value by developing arguments about the management of accounting calculations within the function of risk management, the microprudential modelling of Basel and the way in which this related to capital adequacy and risk weighted assets to create increasing return on equity and financial instability. The concept of bricolage features in Chapter 7 (Part B), also in connection with shareholder value. Banking firms often behave in a manner that best serves themselves by gaming, manipulating or managing the firm in dissatisfactory ways, usually at the conjuncture of a market event when regulation is substituted or adapted. Here, mainstream risk management and prudential regulation has either missed points of arbitrage entirely, approved of bank behaviour and later realised its errors, or indeed is left to rethink its progression through a continuous process of Basel iteration in reaction to its limited ability to control financialised capitalism as firms become bricoleurs. Chapter 7 Part B invokes the concept of bricolage; however, instead of targeting the firm, it addresses managerial behaviour and suggests a broader definition of the way managers
behave versus the way mainstream functional literature describes the role in financial management textbooks.

Subfields within the heterodox and financial instability section of the review are of particular worth in Chapter 4 when discussing the reasons why economic theory failed in 2007, and in Chapter 5, when developing the limited scope of risk management to control the financial system through scientific calculation and prudential frameworks. Keynes and uncertainty head a discussion about the limited ability of calculation and financial models to forecast or predict the economy. Minsky followed this by demonstrating financial instability through inherent endogenous shock caused by the financial system and banking itself, as opposed to the mainstream view that attempts to manage exogenous shocks through the limited ability of DSGE modelling. Finally, Minsky’s perspective on inherent financial stability is developed further through Borio’s perspective on a new macroeconomic framework that manages the disequilibrium in markets via a reduction in the impact of boom and bust through financial cycles.

The central objective of this thesis is to critique structural and prudential reforms in regulation through a political-technical approach. The following chapter, therefore, will explain the research methodology, philosophical stance and research design employed in achieving the purpose and objectives of the thesis set out in the introduction.
Chapter 3. Research Methodology

3.1. Introduction

This chapter of the thesis describes the methodological approach adopted in conducting the research and subsequent empirical work. Firstly, and perhaps most importantly, the appropriate research method chosen and its underlying philosophical assumptions are explained in detail. Secondly, the research design employed to develop a technical critique of multiple areas in post-crisis banking regulation is described and explained, inclusive of the primary and secondary sources of information, data, numerical accounts and statistics. Thirdly, data collection, consisting of multiple techniques in both qualitative and quantitative approaches, namely semi-structured elite interviews, documents and reports in the public domain, and firms’ financial and statistical information, is discussed. Fourthly, analysis of the data collected, which was conducted in various ways and in accordance with literature, is also described. Finally, and of importance to methodological literature, the validity and reliability of the data and study are outlined, as are the ethical issues which are thoroughly considered.

3.2. Method and Philosophical Approach

There is a large and important body of literature covering research methods in social sciences. An initial consideration for the researcher is the selection of an appropriate method for the thesis. The method chosen is determined by the nature of the study undertaken, research objectives and questions that address specific subject matter. The nature of the research questions leads the researcher towards specific types of data and therefore the options available to collect and analyse the data in specific methodological
ways. Each method has philosophical assumptions underpinning its practice. The philosophical assumptions employed in specific research methods are underpinned by both ontological and epistemological considerations. In addition, there are implications that derive from the research method employed and for the research study being undertaken. Consequently, it is important for the researcher to understand these points and any limitations of the approach chosen, as this forms the foundation of the study, the basis for research and the type of conclusions or knowledge claims that can be made.

There are various methodological paradigms available to the researcher, which extend along a paradigm continuum, typically – positivist / post-positivist, mixed method – interpretivist / constructivist – and each, to larger or lesser extent, has a philosophical position outlining its ontological and epistemological justifications (Denzin and Lincoln 2011; Burrell and Morgan 1979). Whilst a detailed discussion on each of the paradigms and associated strengths and limitations is beyond the scope of this thesis, it is necessary to demonstrate that a cohesive and sound research strategy has been developed.

More broadly, and before sketching out a more in-depth discussion on the chosen method and its philosophical justification, it is necessary to outline the epistemological and ontological perspectives of the paradigm continuum. Typically, quantitative approaches to research are predicated upon a positivist paradigm, which lends itself to a hypothetico-deductive method of research (Popper 2002, p.536). In operationalising the research strategy, the focus is to begin by asking questions to form a hypothesis, then to quantify collected data and organise an appropriate experiment to test the hypothesis, and finally to attempt to make generalisable conclusions from the results. Here, the narrow and focussed premises of the hypothesis guarantee the conclusion.

In contrast with the former approach and the other end of the paradigm continuum is the interpretivist or constructivist approach. This strategy inductively
explores, investigates and explains to form an understanding premised upon significant detail, cases or patterns that form within the data being collected. Here, the researcher is encouraged to begin from a broad viewpoint and to look more in-depth at the subject under study whilst observing complexity within the data.

Ontologically and epistemologically, when conducting research quantitatively, the researcher looks at a single reality and is objective and removed from any interpretation whilst reporting on narrowly structured data and findings. Conversely, when working qualitatively, researchers reject an objective single reality and accept multiple realities in which participants involved in the study are observed and their individual positions are discussed, synthesised and reported upon subjectively. Epistemologically speaking, qualitative researchers enter the field with the intention of gaining granular detail from the participants involved as well as accessing information and data from those who, to a lesser or greater extent, have experienced and gained important context of the subject matter under study.

The paradigm selected for this thesis is mixed method research (MMR). The research is essentially weighted towards a qualitative approach whilst using quantitative data and analysis to develop story telling by overlaying quantitative data. Whilst there is no formal triangulation stage in the research design (cross comparing separate data collection and looking for divergence), the quantitative approach strengthens the explanation and understandings gained from the more in-depth qualitative strategy employed. This is described in literature as a sequential–exploratory research design (Creswell 2010, p.211) and discussed later in this chapter (see section 3.4.1). Quantitative use of data and analysis is predetermined premised upon the specific use of financial accounts, descriptive statistics and annual reports, which target specific debates, whereas qualitative methods allow the researcher to penetrate deeper in terms of granular detail,
rich data collection and allowing participants a voice in the research. As noted above, it is important to stress the extent to which the thesis is weighted qualitatively: epistemologically this means an abductive approach (Sanders-Pierce (1931): that sits between inductive and deductive approaches) is taken when researching UK post-crisis banking regulation without prior assumptions, hypotheses or theoretical attachment. In contrast, when applying a technical approach to data and triangulating a narrow and defined quantitative context, prior assumptions are utilised of necessity to focus on giving increased weight of argument and influence to qualitative explanation. Abduction explains the switching between qualitative and quantitative methods and so is a logical fit in addressing the research questions outlined in the introduction. The abductive approach to the empirical chapters in this thesis is warranted in order to reflect upon the research experience and data collected, sketch out the wides of the research objectives and questions posed in the introduction and ascertain the forms of knowledge that emerge, shaped by both participants and the researcher’s experiences. This is secured quantitatively by mixing data and triangulation and using descriptive statistics and accounting that clearly define the subject matter. In practice, of course, it is not uncommon to see some combination of qualitative and quantitative approaches.

3.3. Mixed Methods and Pragmatism

Teddlie and Tashakkori call mixed methods research (MMR) ‘the third methodological movement’ (2010, p. 285). There are internal quarrels within the movement as to what MMR is and how it should be named and defined (Creswell 2010; Greene 2007; 2008; Johnson et al. 2007; Tashakkori et al. 1998; 2003). The generally accepted or stylised definition of MMR is formed around methodological eclecticism (Hammersley 2002; Yanchar and Williams 2006), which combines qualitative and quantitative methods
whilst cancelling out respective weaknesses of both paradigms. MMR selects the best options from a diverse set of sources, systems or styles to thoroughly investigate the phenomenon and best inform the research. The MMR paradigm of research rejects the incompatibility or incommensurability thesis (formed from Gage’s (1989) sketch of adversarial ‘paradigm wars’ and epistemological differentiation, or ‘no common measure’ of the paradigmatic continuum outlined in Kuhn, (1962); Feyerabend, (1975); Guba and Lincoln, (1994)), which describes “an inappropriate mixing of qualitative and quantitative methods in the same study due to epistemological differences between paradigms that are purportedly related to them” (Denzin and Lincoln 2011b, p.295).

Importantly, Howe counters this key argument in the literature with his ‘compatibility thesis’ and expresses that combining paradigmatic methods is a good thing through pragmatism (1998). Teddlie and Tashakkori state nine important characteristics of MMR that follow a line of methodological pluralism, diversity, balance and compromise with important focus on the research question (or problem) in determining which methods should be employed in any study (2012, p.775).

Each methodological paradigm has a philosophical position. Pragmatism has an affinity with MMR, according to its proponents (Tashakkori et al. 1998), which goes back to Howe’s earlier paper (1988) and is also stated in Patton (1988). Pragmatism is an American methodological approach originating from the much earlier work of William James (1842-1910), John Dewey (1859-1952), Charles Sanders-Peirce (1839-1914) and Herbert Mead (1863-1931). Somewhat fortunately, on-going methodological discussions in literature have developed more sophisticated understandings of paradigms (Guba 1990); however, unfortunately, pragmatism was largely omitted from the wars that followed (Morgan 2014). Hence, pragmatism has, to a large extent, seen minimal exposure in clarifying its philosophical underpinning. Several reviews of pragmatism as
a system of research exist in literature (Creswell 2003; Tashakkori et al. 2003; Maxcy 2003; Somekh and Lewin 2004; MacKenzie 2006), and when connected with MMR, pragmatism has witnessed a heightened awareness and a nuanced philosophical connection (Johnson and Onwuegbuzie 2004; Morgan 2007; Biesta 2010; Tashakkori and Teddlie 2010; Pearce 2012; Hall 2013).

MMR emphasises the practical aspects of the paradigm as its episteme, which sidesteps the philosophical foundation of pragmatism and is something Denzin questions: the philosophical connection between method and philosophy (Denzin and Lincoln 2011; Denzin 2012). Biesta corrals the philosophical argument towards Dewey’s original postulate (Biesta 2010, p.97) and reorients pragmatism away from what he called abstract concerns (Epistemology and Ontology – Objective and Subjective), instead focussing upon human experience. A clear line of argument is made that “pragmatism should not be understood as a philosophical position, but rather a set of philosophical tools that can be used to address problems” (2010, p. 97). Dewy warned against ‘philosophical system building’, which, according to Biesta, “contributes to the dismantling of the objective – subjective epistemological dualism” which Burrell and Morgan produced (2010, p. 113; (Burrell and Morgan 1979). The conclusion, therefore, is to back-cast the results of research to understand whether the correct choice of method, tools and analysis has been employed. For Green and others within this field (Biesta, 2010; Johnson and Onwuegbuzie 2004), pragmatism results in a problem solving action-based process originating from a commitment to democratic values and progress rather than philosophical or abstract assumptions and values.

Returning to Denzin’s question on philosophical intellectual foundation, Morgan (2014) stresses a requirement to move beyond the narrow approach of Dewey and Biesta by enabling a stronger philosophical bond between MMR and pragmatism. This should
be achieved by emphasising the philosophical foundations of pragmatism. This would begin a process of progressive legitimisation, enabling its orientation to problem solving and the original work of Dewy. Morgan claims a distinct consequence of advocating pragmatism:

“...as a paradigm is to disrupt the reliance on metaphysical versions of the philosophy of knowledge as a lens for examining social research. Although this disruptive influence may not have been an intentional goal in the original pairing of pragmatism with MMR, pragmatism insists on treating research as a human experience that is based on beliefs and actions of researchers. This is quite different from characterising social research in terms of ontology, epistemology and methodology; even so, it does not imply the old approach was wrong. Instead pragmatism would understand the prior paradigm as a set of beliefs and actions that were uniquely important within a given set of circumstances. Since then, circumstances have changed in ways that call for a new methodological agenda” (Morgan 2014, p.1051).

Morgan notes that it is up to researchers to alter the mainstream way of thinking about the methodological philosophy of knowledge. This type of change has occurred previously and Morgan provides an example from the 1980s when philosophy of knowledge arose as a paradigm for understanding the nature of social research (2014, p. 7). This literature suggests that it is time to accept a move away from the purist objective / subjective abstract metaphysical route of methods (Burrell and Morgan, 1979) and ways of conducting research. It calls for an approach that heads back towards methodological linguistic roots – the study of methods. Here pragmatism shifts the ‘how’ question
towards actions: how do researchers make choices about the way they conduct research; why do researchers make the choices they do, and what is the impact of making one methodological choice over another? These are old questions, but making them central to the philosophical connection between pragmatism and MMR is important in order to justify its progressive route forward. This explains why time has been spent on what otherwise might seem to be a digression in the history of ideas.

This thesis will utilise the articulation method in pragmatism. This permits the researcher to logically build the argument in reference to available literature, data and documents that address the research question. In doing so, Laughlin’s matrix and methodological framework is used to position the philosophical paradigm and narrow the choice of research method. Laughlin notes three non-deterministic labels which every research process comprises: theory, method and change choices as presented here:

**Fig. 4 Laughlin’s 3D Model**

| Characteristics of Alternative Schools of Thought |
|---------------------------------|-----------------|-----------------|
| **Theory Choice: Levels of Prior Theorisation** | **High** | **Medium** | **Low** |
| **High** | Positivism (L) | Realism (L) | Instrumentalism (L) | Conventionalism (L) |
| **Medium** | German Critical Theory (M) | Symbolic interactionism (L) (Kuhn) |
| **Low** | Marxism (M) | Structuration (L) | French Critical Theory (L) | Pragmatism (L) | Symbolic interactionism (L) (Blumer) | Ethnomethodology (L) |

*Source: Laughlin (Laughlin 1995, p.70) to assist with research model selection: Theory on X-axis, Methodology on Y-axis and change choice on X-axis (demarcated by bracketed H,M,L symbol adjacent to the theory).*
Set out against a debatable but interesting perspective on how the philosophy of method has evolved (Idealism–Positivism, Kant and Comte; Critical–Subjective–Objective: Hegel, Frichte, Dilthey and Weber), a discussion granting substance and colour to Fig. 4’s model (Laughlin, 1995, pp. 69-79), this part of the subsection describes and explains Fig. 4, and its three separate axes.

Firstly, the X-axis refers to the level of ‘prior theorisation’ which assists the researcher in forming a perspective or nature of a world-view and what may or may not constitute knowledge (Parvaiz et al. 2016). Laughlin describes a high level of prior theorising as a marker to an assumed material world with a high level of generality already in existence through empirical data and research (1995, p. 70). A medium level of prior theorising notes that generalisations of reality are possible, yet they maintain a ‘skeletal’ existence which requires empirical detail to grant meaning (1995, p. 81). A low level of theorising assumes that the world is not material (being a projection of the mind), and learning from prior studies and theory is inappropriate, potentially corrupting the diversity and detail of the investigation (Pavaiz et al. 2016, p. 70).

Secondly, the ‘methodological choice’, the Y-axis, refers to how the research or study is conducted. This axis demonstrates reliance upon the internalised power of the researcher, or is best described by a purely theoretical approach to the research questions under study. Laughlin describes a high level of methodological choice in which a method has theoretical definition, and a specific route or path to follow. Here the investigator’s own interpretations are nullified by the phenomenon under scrutiny and subjectivity is removed. A medium level of methodological choice for the investigator is to produce a design containing a methodological approach which sets out ‘skeletal rules’ that govern practice. At a low level of methodological choice, the investigator is involved in observing the phenomenon and subjectivity is preserved. Here there are no pre-defined theoretical
considerations of the resultant outcome (Laughlin, 1995, p. 70).

Thirdly, the ‘change choice’ axis concerns the researcher’s attitude to preserving or changing what is being investigated. At a high level of change, the investigator perceives inadequacy and feels a requirement for immediate change. At the middle level, the researcher develops a strategic focus to change that allows specific aspects of function but similarly demonstrates a preference to challenge the status quo. Finally, at the low end of the axis, the researcher perceives no problem in maintaining the status quo.

In placing Laughlin’s (1995) conceptual view into a framework that covers MMR and Pragmatism, Fig. 5 (below) adapts Laughlin’s complete, skeletal and non-human representation of theoretical and methodological dimensions with reference to justifying its appropriate use with MMR, Pragmatism and the L,L,L, approach. The top three sections set out the choice of theory, the role of the researcher and the chosen approach in the methodological process, while the bottom two sections focus on methodological data narrative and data collection.

Regarding the choice of theory, pragmatists will abductively move between what Patokorpi calls a retroductive process – the spontaneous conjectures of instinctive reason – and finding or forming a hypothesis or theory which may explain or provide an understanding to an element of surprising information or unexpected observation (Patokorpi 2006, p.73). At the low level of theoretical choice, there is no feed into a selection, and so this is ignored. In pragmatism, the role of the researcher is complete with control over the subjectivity, which highlights the separation between theory and method selection.
Fig. 5 Laughlin’s Adapted Framework

Source: Laughlin (2004): representing theoretical and methodological dimensions for MMR and Pragmatism (L, L, L), with reference to methods and data collection in this thesis.

Morgan (2007) notes that all researchers have a worldview in which they believe, their own unique interpretation. A pragmatist can therefore reject his or her own complete subjectivity and adopt inter-subjectivity by accepting an external reality which produces the best or desired outcome (Pansiri 2005, p.198). This is pragmatism in action and lies between the objective–subjective dividing line in methodological philosophical literature,
taking the Kantian–Fictean line and the demarcating branch between Dilthey (1833–1911) and Weber (1864–1920). Inter-subjectivity allows researchers to draw upon the duality of objective–subjective before presenting findings as a social reality (Morgan, 2007), which is where Tashakkori and Teddlie connect with MMR (Tashakkori et al. 1998; 2003).

Laughlin and Creswell (2003; 2004) provide a clear rationale for the connection between the research question, pragmatism, the data narrative and data collection. As mentioned previously, research questions are the priority along with the choice of data collection method that will produce the level of detail required to best inform or address the study in question. Hence what is described above is pragmatism as a justifiable foundation for the mixed method researcher (Parvaiz, et al. 2016).

### 3.4. Research Design

The previous subsection of the thesis has established a basis for adopting MMR and a pragmatic stance to selecting methods that best inform the research questions set out in the introduction, and it explains why some time has been spent on theoretical literature. In order to operationalise MMR, an open and flexible approach to selecting the requisite set of methods is required. The empirical chapters of the thesis contain qualitative explorative enquiry and transition sequentially to quantitative and descriptive statistical approaches. Essentially, research design is an action plan or a guide to the way the study unfolds in a coherent way. This is important for several reasons. Assuming the research design is followed, claims can be made relating to the reliability and validity of the research and the conclusions drawn. In pragmatism, the selection of the correct methods for collecting and analysing data is important, so it is essential to set the choice out via a methodological and process driven framework (adapted as above, Laughlin, 1995).
Methods are also dependent upon other factors such as available resources, funding, time, travel and access to participants and databases, and this will be discussed.

3.4.1. Research Process Model

The first point to address is the research design process. A description of the strategy and visual model, as well as the basic procedures that have been used, will follow. This thesis utilises a ‘sequential–exploratory’ process design that illustrates how qualitative and quantitative methods are being combined by separate and distinct processes (Creswell 2009, p. 211). This is different from multi-method research in the methodological literature (Brewer and Hunter, 1989). The process is set out in Fig. 6

**Fig. 6 Sequential-Explorative Model**

![Sequential-Explorative Model Diagram](image_url)

*Source: Creswell (2009)*

The first phase of work is qualitative data collection and analysis, followed by a second phase of quantitative data collection and analysis that builds upon the results of the first qualitative phase. As Creswell notes, “at the most basic level, the purpose of this
strategy is to use quantitative data and results to assist the interpretation of qualitative findings” (2009, p. 211). The approach involves the researcher exploring a phenomenon but also expanding upon the qualitative findings. Literature describes this two-phase approach as “straightforward to describe and report” (Creswell 2009, p. 211). There are some limitations in terms of the time it takes to complete both phases of data collection and subsequent analysis. There are also important decisions to make about which findings to progress from the qualitative phase(s) of the research process (single themes, multiple themes, comparisons etc.). The chosen findings are then combined with quantitative data and analysis thereafter.

3.4.2. Adapted Design

Having discussed the background literature and sequential-explorative model, the following design allows a coherent explanation regarding the way the qualitative and quantitative phases of work unfold and how this shaped the subsequent empirical chapters of the thesis. Phases of work will be described here, followed by a more detailed discussion of the types of methods and analysis undertaken, along with signposts to where this impacts the empirical chapters of the thesis.

Phase 1 of the research design began with eight elite semi-structured interviews. In line with pragmatist theory and Laughlin’s model (2004), there was no prior theoretical ideal or basis; I was guided by my previous employment in banking, which caused me to believe that there were significant problems in banking regulation pre and post financial crisis. The semi-structured interviews were a route to establish a set of common themes that could be used as a basis to form research questions. Three specific but common and connected themes emerged. The interviews included discussion of the differing viewpoints and perspectives of elites in their fields who were involved to a lesser or
greater degree in the financial crisis (central bankers, regulators, politicians, academics).

The subject matter was grouped into themes from a simple narrative analysis of interview conversations, allowing the basis of the research questions to flow from the ‘voices of elites’ directly involved in the cut and thrust of the crisis with the researcher interpreting the data (King 2004, p.11).

**Fig. 7 Phase 1 Sequential-Explorative Model**

Source: Author’s visualisation and adaption after Creswell (2004)
From the initial elite interview narratives and emergent themes, research questions were crafted as outlined in the introduction and in line with the pragmatist philosophy of no prior theoretical framework or assumptions. The nature of the research questions guides the researcher to the type of data required to investigate the phenomenon. Along with a relatively small but important set of narrative based arguments collected from the semi-structured elite interviews, documents under the research question headers contained the bulk of qualitative data examined in answering the research questions. Using a political economy approach and a cultural economy lens (explained later in this chapter), these were subsequently applied to the data and findings were contextualised into a story which requires corroboration, strengthening and validating through Phase 2 of the sequential-explorative model, as Creswell and Tashakkori and Teddlie discuss (2004, 2003). Phase 1 provides for a general explanation and understanding of the research problem.

**Fig. 8 Phase 2 Sequential-Explorative Model**

![Phase 2 Sequential-Explorative Model](image)

*Source: Author's quantitative visualisation and adaption after Creswell (2004)*
Phase 2 of the sequential-explorative research design builds upon the findings from Phase 1, the content of which guides the researcher to new sources of quantitative data. Under the RQ headings are independently, professionally produced and verified sets of data in the form of audited accounts, Bank of England Committee reports and data, regulatory data analysis and publicly available quarterly management reports from banks to shareholders, along with year-end annual returns of firms registered at Companies House. Using technical accounting analysis, a number of results were generated which supported the qualitative findings in Phase 1 of the research design. The quantitative data, results and subsequent analysis refines and explains Phase 1 in greater depth, adding quantitative rigour to explanation and understanding in answering the research questions. Post this stage, an abductive step follows where a back and forth process develops a coherent and compelling set of arguments by mixing the qualitative and quantitative phases of research.

Further to the explanation of the research design process, the following paragraphs add detail to the headline sources of data and indicate where the analysis has been utilised in the empirical chapters of the thesis.

### 3.4.3. Documentary Sources of Information and Evidence

Various forms of documentary information and evidence exist to support researchers. Documentary or secondary sources of data are considered to be the largest and predominantly used body of information available. The field of information is vast. In this thesis, the materials used are wide-ranging, including written reports by governmental or political committees, statistical data compiled by independent or audited professionals and articles and storylines from broadsheet newspapers. The thesis
uses secondary documentary sources to corroborate evidence and strengthen original or primary sources of data, notably elite interview recorded transcripts (Yin 2003). It is important to select the correct form of secondary data to apply (qualitative or quantitative) in creating and developing coherent arguments within each research question. Care has been taken to ensure this occurred throughout the thesis to ensure the quality of research validity has been both strengthened and improved by using multiple sources of data – this will be detailed in later subsections on validity and reliability of information and research ethics. ‘Secondary’ is a useful shorthand for a rich range of sources in the public domain – it can and does include a great deal of hard statistical data, as well as information about the behaviour of actors. The term does, of course, acknowledge that when we study a set of events more or less in real time we cannot do what historians do with the benefit of hindsight – go to primary sources, the exchanges written and otherwise that actors engaged in as they struggled to make decisions.

Secondary sources of documentary information inform all four empirical chapters of this thesis. Firstly, the second part of Chapter 4, through analysis of published reports, gives a critical account of the way in which subsequent re-regulation is controlled and corralled through quasi-political elite committees (Independent Commission on Banking or Vickers Report and its implications on too-big-to-fail) via a shared epistemic community. Secondly, Chapter 5 uses published regulatory data to explain the expansive nature of post-crisis re-regulation in response to several smaller scale but nonetheless significant crises (data used on Libor manipulation, mis-selling of various types etc.), whilst focussing primarily upon data from the Basel Committee and Bank of England reports that assist in setting out the ‘limited’ nature of post crisis attempts to reform the Basel algorithm (v. II and v. III) and its implications for capital adequacy and the financial instability of banking. Finally, Chapter 6 Part A and Chapter 7 Part B present and analyse
data from various forms of management accounts, audited accounts, company disclosures on regulation, company filings and returns. The analysis considers the impact of Basel III and a UK bank and establishes evidence in support of management bricoleurship. To develop the notion of post-crisis instability, a UK bank is examined through detailed forensic analysis of annual and quarterly bank management reports together with small firm annual returns to develop an internal departmental case which is thoroughly investigated to politicise (1) the impact of banking regulation on bank losses at the macro level, and (2) at the micro level, how senior front office managers (rather than firms) use this information for self gratification whilst operating inside and outside of state owned banks.

It is important to note that the level of analysis from secondary data sources has had a two-fold effect. Firstly, the analysis has assisted significantly in developing socio-political and technical-macro/microprudential contextual knowledge within the empirical chapters of the thesis. Secondly, analysing secondary data also helped to articulate argumentation from primary fieldwork and interview participants’ commentary.

3.4.4. Ultra-Elite Interviews

Within the literature of qualitative methods, interviews are considered to be the most extensively utilised method of collecting data for use in academic research (Drever 1995; Berg 2001; Cassell and Symon 2004; Holstein and Gubrium 2004; King 2004; Flick 2008; Kvale 2008; Kvale and Brinkmann 2008). A research interview is defined as a conversation for gathering information in which the researcher coordinates the process of conversation and asks questions with the interviewee, who responds (Easwaramoorthy and Zarinpoush 2006). Flick adds that the purpose of interviews “is to reveal existing knowledge in a way that can be expressed in the form of answers and so becomes
accessible to interpretation” (2016). The idea of this approach is to gain the view and perspectives of the interviewee (King 2004). Alongside many books on qualitative methods, Bryman suggests that interviews range through a continuum: structured, semi-structured and unstructured (2001). The semi-structured and unstructured types of interview characterised by Burns (1999) increase the levels of flexibility and lack of structure from which terms such as in-depth, informal, non-directed, open ended, conversational, narrative etc. stem (Edwards and Holland 2013). This thesis uses ultra-elite interviews as a method to collect qualitative data. The concept of ultra-elite interviews is defined as interviewing members of an ultra-elite – the thin layer of individuals with the greatest influence, prestige and power in an institutional sphere. The concept notes techniques of legitimising a tailoring of the interview to elites with specialist knowledge and qualifications – for this thesis, those who are amongst the leading intelligentsia in their respective fields in high finance, economics, regulation, banking and central banking. The use of ultra-elite interviews is appropriate alongside the mixed method research paradigm and a pragmatist philosophical perspective and framework (Creswell 2004). Ultra-elite interviews are an in-depth form of interview as the type of information to be collected is often complex, detailed and technical. The type of interview selected was ‘semi-structured’. The premise of this type of interview is to ask open-ended questions and capture ‘specific information’ whilst allowing the participant to discuss his or her own ideas, with the interviewer periodically asking additional questions and probing further around areas of interest or refocussing the conversation if required (Berg 2004; Flick 2006). Furthermore, this thesis involved interviewing high status elites (who can be termed ultra-elite) within politics, central banking, regulation and academia via a face-to-face conversation where possible, or remotely via telephone where time, distance and cost were problematic. Other formats
of interviewing, such as focus groups or collective forms, would be impractical due to the inability of coralling time-restricted high status elites in one place, and the type of detailed information required may not be available outside of a one to one discussion – not least because people might be unwilling to debate their individual perspectives amongst others. Elite interviews are hard to conduct, especially by a doctoral student without elite contacts. They have well recognised limitations, which is why they are only one part of a battery of methods used in this thesis. However, they contain very useful gems of information for researchers that are not discussed elsewhere amongst alternative forms of literature. In addition, secondary data would be difficult to tease out in a group scenario.

There is a significant and detailed body of literature around researchers’ own experiences and ways of preparing and conducting elite or ultra-elite interviews (Zuckerman 1972; Bryman and Cassell 2006; Stephens 2007; Harvey 2011). There are several important factors and methodological dilemmas to consider (Mikecz 2012; Delaney 2007; Thomas 1993). Fig. 9 sketches out the interview plan for the study.

**Fig. 9 Interview Plan for Study**

<table>
<thead>
<tr>
<th>Step 1: Preparation</th>
<th>Step 2: Gaining Access</th>
<th>Step 3: Collecting Data – The Interview</th>
<th>Step 4: Follow-up Post Interview</th>
<th>Step 5: Analysis &amp; Couple with MMR Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Snowball Sample Strategy</td>
<td>Craft Individualised Covering Letter</td>
<td>Explain Study and Purpose of Interview</td>
<td>Confirms and Clarify Interview Rules</td>
<td>Address Methodological &amp; Practical Amendments</td>
</tr>
<tr>
<td>Prepare Interview</td>
<td>Craft Formal Email Request</td>
<td>Manage Interview Process</td>
<td>Seek Additional Contacts</td>
<td>Review with Phase 1 &amp; Phase 2 Qual-Quant Analysis &amp; Interpret</td>
</tr>
<tr>
<td>Select Interview Type</td>
<td>Follow-up with Secretary</td>
<td>Seeks Additional Contacts</td>
<td>Create Journal Notes Post Interview</td>
<td>Verify and Question via Industry Experts</td>
</tr>
<tr>
<td>Develop Interview Guide</td>
<td>Repeat Letter Stages if Required</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: Adapted from Thomas (1993)*
Amongst the most important considerations is the selection or identification of a target population of participants (Sargeant 2012). As noted above, the critical people to approach for interview for this thesis were high status elites. The interviewees were selected on the basis of availability due to the very narrow niche and technical nature of the subject matter and expertise required. Additionally, the participants hold high office or have prominent roles in their respective fields and it can be difficult to gain access to them.

A snowball sampling technique was used at the end of each interview to gain insight into finding willing and knowledgeable participants (Atkinson and Flint 2001; Browne 2005; Goodman 2011), with care taken to avoid the pitfall of interviewing people from similar viewpoints and backgrounds and to remove clear bias from small samples of participants (Biernacki and Waldorf 1981). Gaining consent to interview was problematic, as are other issues pointed out in the literature (Ostrander 1995; Sabot 1999; Bird et al. 2002; Thuesen 2011; 2012).

As above, literature outlines different ways of gaining consent to interview. These range from quickly building rapport with the participant and acquiring trust – which in this thesis was to some extent assisted through supervisory introduction rather than cold calling alone (the latter being the prevalent method of contact) to, where possible, establishing the interviewer’s credentials and experience early on and acknowledging that the language of finance and the City is understood. The latter point also helps to avoid cross-cultural differences that can lead to misunderstandings and problems in analysing the data (Mikecz, 2012). In addition, it is imperative to keep a critical distance whilst conducting the interview by resisting the temptation to challenge the participant’s position.
It is important to prepare the interview or participant guide and the associated questions or prompts recommended by the literature (Wengraf 2001). The participant guide was issued to the interviewee along with a consent form (see Appendix B & C to examine pro forma documents). The elite interview method allows a direct approach, which drives at securing insightful commentary from the participant that will assist in answering the research questions (Aberbach and Rockman 2002; Bird et al. 2002; Dexter 2006; Stephens 2007). The interview participants are encouraged to speak at length on particular topics. The researcher ‘actively listens’, which becomes a natural way of interacting with the participant regarding further probing questions around areas of interest (Guion et al. 2001). In the scope of this thesis, the elite interview played a dual role. Firstly, analysing the data established connected themes in post-crisis banking regulation which were subsequently used to sketch out research questions. Secondly, sections of the primary source narrative were used as secondary data to support analysis and the development of argumentation during Phase 1 of the research design. There are also practical limitations regarding semi-structured ultra-elite interviews. As well as the difficulty of a Ph.D student contacting potential elite interview participants, telephoning and following up, preparing a participant guide, questions and consent requests, travelling to interviews and conducting the interview with the associated time and cost involved, there is also the post interview process. This can involve lengthy transcription or manual matching of themes within primary recorded or digital data and analysing this output through to findings. This can be a time consuming process.

3.4.5. Data Analysis

Prior to describing how data is analysed within the thesis, it is important to set the scene by detailing a particular lens through which the analysis has taken place and is applied
to primary and secondary data.

3.4.5.1. Cultural Economy Lens

To assist the nature of qualitative analysis, this thesis uses a lens of cultural economy. Cultural economy concerns itself primarily with the rise of elites who dominate the mainstream economics profession and its overall hegemonic position over society in the cultural performance and pursuit of prosperity (Gramsci, 1891-1937). The lens of cultural economy is a fairly recent and unique approach to the analysis of economy and society with which this thesis is concerned (MacKenzie 2006; Pryke and Du Gay 2007; Langley 2008; Davis 2012; Langley and Leyshon 2012; Bennett 2013; Thompson 2014; McFall 2015; Hardin 2017). It is useful to point out the distinction between the two approaches of political and cultural economy. The political economy approach is to observe problems concerned with accumulation, growth and stability and the way in which new devices and apparatus affect quantity and relation within a financialised economy. However, in the 1990s and following the cultural turn, fresh concerns arose that connected economy to varying discourse(s), creating a separation between this and political economy above (Jameson 1991; Ray and Sayer 1999; Thrift 1999; 2000; Du Gay and Pryke 2002).

Cultural economy is an expanding literature and has several strings to its analytical bow with regard to elements such as performance, performativity, human practice and the relations and connections between economics and politics (Bourdieu and Johnson 1993; MacKenzie 2003; Callon 1998; Butler 2010; Callon 2010; Cochoy et al. 2010; Du Gay 2010).

The cultural economy lens, however, describes useful concepts of ‘holography and infelicity’, which can be applied to data in this thesis. Holography tends to focus on
the ‘whole’ and generalises about the nature of discourse. Nevertheless, what is required in the application of holography to thesis data is to reconstruct relationships, in this case between economic discourse and the economy as a subject and ontology, irrespective of the opinions of mainstream scholars and elites. In this context, language and technique of communication lead to discourse, which shapes, frames and fills a space with economic actions that flow from this. Holography will allow a deconstruction and reconstruction of the whole.

Infelicity can occur in relationships where there is a perceived difference between what is narrated and what subsequently occurs in reality or how something occurs in reality and is then described in narrative form. This is also a performative relationship between language and action. This is described in the literature as a ‘gap between saying and doing’ or ‘promise and outcome’, and discussed as the performative-constative distinction through locutionary and illocutionary acts (Austin 1961; Austin 1975; Dinneen 1972). Dinneen suggests that “by uncovering [latent] connections, Austin tears down, as it were, any iron curtain between performative and constative,” or saying and doing, and therefore describes a rejection of a black and white distinction between the two in favour of connections which can credit or discredit true / false or value / fact analysis (1972, p. 515).

The analysis of utterances or, in this thesis, what is said by elites in their professional lives, reports, interviews and written narratives, is of great significance when set against the economic reality of qualitative and quantitative data, reports, statistics or accounting. This process opens up a perspective of analysis that, for example, has a direct relationship with financialisation and the consequences of shareholder value (Chapter 5), or in post-crisis regulatory transformation through quasi-political committees (see Chapter 4 and the ICB).
Analysis through a cultural economy lens can result in any number of misconceptions, misrepresentations, misfires, misexecutions or misinvocations where human actors and institutions have a distinct ability to influence the behaviour of each other (Butler 2010; Mackenzie 2003).

As a consequence, the cultural economy lens has been useful for analysing verbal and written narratives of elites in their fields and for deconstructing language and reassembling it with the use of both qualitative and quantitative secondary data in order to establish numerous angles and arguments in the process of developing empirical chapters.

3.4.5.2. Qualitative Data Analysis

Having described the process of using the cultural economy lens, what follows is a discussion on how the practice of data analysis unfolded. Creswell (2007) notes that there are no fixed boundaries around the process of qualitative data analysis. A qualitative strategy is governed more by practicality of analysis, deriving qualitative findings from data and drawing conclusions via researcher interpretation (Dey 1993; Huberman and Miles 1994; Ritchie and Spencer 1994; Miles et al. 2013). Existing within this literature are guidelines that ‘facilitate’ qualitative analysis. However, the typical analytic task is to work with large data sets with the ultimate decision-making founded upon interpretation of available knowledge (that is abductively shaped in MMR) to answer the research questions.

For this thesis, there were seven ultra-elite interviews recorded digitally at approximately 40 minutes in length. The interview process was described earlier in Fig. 9. A decision was made not to transcribe each interview as much of the narrative had already been described in the literature – hence there was no requirement to use software
based technology – and the analysis (post a manual matching of themes in Phase 1 of the research design) involved consistently extracting statements of particular worth by reflexively thinking about journal notes made immediately post-interview, the digital data itself and the researcher’s position within it. At the same time, each point at issue was dealt with in an iterative fashion to answer the research questions (Bryman and Cassell, 2006). Content analysis was also dismissed as a qualitative analysis technique (Elo and Kyngäs 2008). As Berg notes, content analysis is better suited to positivist type studies that require full transcription, coding the data and subsequently quantifying the material from which findings are made (2004).

Following the qualitative analysis of primary data, the findings were matched with secondary qual-quant data sources manually on an iterative point-by-point basis and connections drawn between them as outlined in the adapted Phase 1 and 2 sequential-explorative model (Creswell 2007). Whilst the researcher must be completely engaged with the research data, it is also important for the transcription and qualitative-quantitative analysis to be congruent with the methodological design and philosophical underpinning of the study. To justify the approach taken, Halcombe and Davidson question whether it is necessary to undertake full transcription, “In a mixed method research design which has interviews as a means of data collection the use of a reflexive and iterative analysis process represents a cost effective, constructive and theoretically sound process through which to manage verbal interview data” (2006, p.42). The research design and strategy generated a large amount of work, not in terms of verbal interview transcription, but with multiple sources of qualitative-quantitative data to control, manage and safeguard via three separate hard drives to avoid data corruption or loss.
3.4.5.3. Quantitative Data Analysis

Phase 2 quantitative analysis is utilised to augment, corroborate and strengthen qualitative material (Zohrabi 2013) but it does more: it is an independent source of data for the whole thesis that helps with verifiability and allows the researcher to triangulate alternative sources of data and draw upon unbiased conclusions. Also significant at this juncture is the quantitative contribution through the researcher’s own experience as a director in the banking sector. This was valuable in collecting and analysing the accounting and financial data.

As Fig. 8 illustrates, the findings from Phase 1 support the selection of suitable quantitative data to collect. Multiple quantitative sources were identified as per the model. The analysis of this data was approached in a three-pronged fashion. Firstly, statistical data was sought from various independently and verified sources – regulatory reports, Bank of England reports and websites and political committees. Accounting details and statistics were extracted and used to support narrative based arguments via a simple matching process (see Chapters 4, 6 and 7). Secondly, audited accounts, small firm returns and bank quarterly management reports aimed at shareholders were analysed via standard and accepted accounting practice. This was done to identify the correct quantitative data that allows results to inform and shape new explanations or understandings when applied to Phase 1 qualitative findings. Generally accepted accounting principle (GAAP) analysis was conducted via an understanding of the technical aspects of firm performance and the way in which a balance sheet, profit and loss and cash-flow statements are connected to regulatory disclosures (see Chapters 5 and 7 Part B) through detailed notes to the accounting data (Kothari et al. 2010). Thirdly, forensic accounting, a term coined by Peloubet (1946), was undertaken. There is a considerable body of literature on forensic accounting, ranging from the macro level or global finance of states and multinational
enterprises to a micro level of large domestic firms and small to medium size enterprises (Jones 2011; Chinn et al. 2013; Bashin 2017). Forensic accounting is more challenging than GAAP analysis. Particular to this thesis, the difficulties arose primarily because banks are extremely good at attempting to hide information they want sheltered from public scrutiny. Conservative accounting strategies in themselves create positive stock market movements, so it is not surprising that firm executives follow this line of reasoning by publishing minimum amounts of data and explanation (Francis et al. 2013). Narrative based explanations in quarterly and annual audited accounts that make important connections between regulation, policy and management decision-making, which are key to this thesis, are more often than not unavailable, or are at least clouded in missing links or lacking defined data points to make necessary observations and calculations. Given that this type of intellectual challenge forms the central thread of the problem, particularly in Chapter 6 Part A, it was important to make the connections myself through piecing together accounts and narratives from multiple data sources, over several years, when accounting treatment or data can suddenly change format intra-period and is sorted or sifted by different type, geography or product – or vanishes completely – making it difficult to make connections. Expert opinion was sought from those working and compiling the data, and where necessary, redirecting without compromising employee integrity. This latter point on compromising integrity is crucial for the maintenance of industry contacts and a good interview participant base and is dealt with by asking qualifying questions rather than immediately presenting a specific or targeted hypothesis. It is best practice to make several enquires, out of logical sequence, around the problematic issue or numbers. When the data is interrogated again later and reassembled, the results can lead the researcher towards an improved understanding. Using this approach with quantitative data also assists data verifiability and validity, which remains
a conservative feature of a GAAP and industry shaped analysis supported and verified by industry based expert assistance.

3.5. Reliability and Validity of Research

With regard to the quality of information in research, methodological literature places great focus on both validity and reliability (Morse et al. 2002; Golafshani 2003; Brinkmann and Kvale 2005) while Lincoln and Guba discuss the importance of an inquirer persuading his or her audience that research findings are worth paying attention to (1985, p.290). Reliability involves testing or evaluating research as a way of information elicitation. Validity is concerned with the accuracy of the findings or results being measured and how these compare with the research purpose and objective whilst representing the reality of the phenomenon being studied. Reliability and validity have roots in positivism (Winter 2000, p.7) and are typically described in quantitative terms (Joppe 2000, p.1) many of which may not apply to the qualitative research paradigm (Stenbacka 2001). For example replicability of result is not necessarily important to qualitative researchers (Glesne and Peshkin 1991). “Unlike quantitative researchers who seek causal determination, prediction and generalisation of findings, qualitative researchers seek instead illumination, understanding and extrapolation to similar situations” (Golafshani 2003, p.600; Hoepfl 1997). Having understood paradigmatic difference, it is important to evaluate qualitative findings through the lenses of precision, credibility and transferability, a significant point for this thesis (Winter 2000; Hoepf 1997). In quantitative research, credibility is dependent on instrument construction, while in qualitative research, “the researcher is the instrument” (Patton, 2001, p. 14). Ergo, when “quantitative researchers speak of reliability and validity they are talking about whether research is credible, while the credibility of qualitative research depends
on the ability and effort of the researcher (Golofshani 2003, p. 600). Therefore, trustworthiness, rigour and quality are paramount issues in the qualitative paradigm (Golofshani 2003, p. 604). Every opportunity must be taken to remove bias and increase the researcher’s truthfulness of proposition through triangulation of evidence from multiple sources (Denzin 2012).

With regard to this thesis, which is primarily a qualitative study, a number of measures were taken to establish rigour and triangulate information, as well as to avoid researcher bias where possible. A detailed research design (MMR) was drawn up, several data sources (primary and secondary, qualitative and quantitative – different forms of documentary evidence) were utilised, interview participant perspectives from different industries (albeit a small sample) were sought and the practical process and procedure of the MMR Pragmatist sequential explorative model was adhered to. This enhances credibility and trustworthiness and supports a persuasive case for paying attention to thesis conclusions.

3.6. Research Ethics

Ethical considerations in research have seen a more prominent focus in recent years. Previously, “academics in business and management tended to rely on ethical codes developed by researchers in related fields to inform practice” (Bell and Bryman 2007, p.63). In the mid 2000s an aspirational project began, noting that the reliance on other fields was not enough in the belief that business and management scholars faced different contextual factors whilst conducting research that should be explored and a code of ethics produced (Ibid, p. 75). Responsibility for ethical principles, such as reciprocity – defining the relationship between the researcher and the society or subject being studied – ultimately resides with decisions made in the course of data collection and in the hands
of practitioners (Barnes 1999).

A stylised fact amongst qualitative research handbooks states that practitioners face several ethical issues in the course of entering the field, collecting data, analysing data and disseminating findings from academic studies (Creswell 2003; Miller et al. 2012; Denzin and Lincoln 2017). Researchers are required to provide an holistic approach whilst covering specific elements such as those in this thesis: setting out a clear and defined research study and explaining both purpose and research objectives; clarifying the role of both interviewer and participant; describing how the data from the interview will be collected; explaining any issues around confidentiality in order to cover risk participation; gaining participant confidence to discuss personal viewpoints and opinions as well as consent so the interview can proceed; and finally, indicating the eventual purpose for which any findings could be used, e.g. journal publication. It is therefore important to remain professional as a researcher both in terms of preparation and conducting fieldwork and in covering underlying ethical research issues with participants.

As noted above, several processes are contained within the organisation of primary data collection for this thesis, i.e. ultra-elite interviews. However, ethical literature supports this, noting that ‘informed consent’ is of key importance, primarily due to reasons of anonymity, which some elites are keen to maintain (e.g. Chatham House Rules), and for the purposes of rigorous procedure, as consent is deemed an integral part of the research study and design (Berg 2001; Flick 2008; Miller and Boulton 2007; Cooper and Schindler 2011; Miller et al. 2012; Marshall and Rossman 2014). In preparing for ultra-elite interviews in this thesis, the researcher approached secretaries and doorkeepers to establish contact and to ascertain whether a conversation could progress. Prior to seeking consent, the researcher prepared a detailed participant guide (see Appendix B) setting out purpose, roles, data management and safe keeping and detailing
who would have access to the data and how confidentiality would be maintained. The
guide made it clear that it was the choice of the participant to withdraw consent at any
stage of the process given the voluntary nature of involvement, and provided full contact
details of both the researcher and the supervisory team at the University. Premised upon
the terms set out in the guide, the researcher signed off the consent forms and all
participants reciprocated with signed, dated forms and returned them as requested ahead
of the interview (see pro form document in Appendix C). The interview guide promised
anonymity; hence the researcher prepared a code for each of the participants so that names
would remain private. People are referred to by numbers only in the main body of the
thesis (see Appendix A for Interviewee Table).

3.7. Conclusion

To summarise, this chapter has presented the methodological approach of MMR that
underpins this thesis. An explanation of the philosophical stance of pragmatism
supporting the MMR paradigm has also been given. Coupling with method and
philosophical stance are explanations of the research design employed for devising
research questions, data collection and analysis. Importantly, reasons for believing in the
research including validity and reliability alongside ethical considerations have been
discussed.

The empirical chapters that follow comprise two distinct phases. Chapters 4 and
5 deal with two specific problems in financial regulation: structural and prudential
responses post crisis, and contain a critical analysis of both. Chapter 6 Part A and Chapter
7 Part B form a natural experiment that places the content of Chapter 5 into context by
way of a Lloyds Banking Group case study that details a politicisation of Basel regulation
in the de-risking and recapitalisation process of banks. Whilst the definition of bank
management through functionalism is questioned in Chapter 6 Part A in the way risk is managed, a very different position emerges in Part B through a case study that bridges the Lloyds Bank takeover of HBoS and observes banking elites acting outside of functionalism whilst circumventing post-crisis regulation.
Chapter 4. Macroprudential shift in banking regulation and the UK response of ring fencing: ending Too-Big-To-Fail?

“Macroprudential policy seeks to safeguard the stability and resilience of the financial system as a whole both by using prudential policy for macroeconomic ends – for example in managing the financial cycle – and by addressing risks related to structural features of financial institutions and markets. In the latter regard, the priorities range from ending too big to fail to improving the resilience of financial market infrastructure” - Mark Carney, Mais Lecture at Cass Business School, City University, London 18 March (2014)

4.1. Introduction

The process of deregulation post the financial big bang has been at the forefront of free market ideology and is central to the struggle for comparative advantage, given that the financial markets were amongst the richest of prizes in terms of economy (Moran 1991). As a direct consequence of competing for financial business and income streams, the political view on regulation was to minimise its impact wherever possible by removing restrictive red tape and increasing taxation income for the UK Treasury. One of the primary arguments post financial crisis was the banking market was not regulated in any meaningful way and banks were able to operate on an unfettered basis through light-touch regulation. It is suggested these purposeful actions from both politics and regulatory institutions resulted in market uncertainty, financial instability and latterly crisis in 2007. Regulation then became a primary post-crisis response and significant focus was then placed on re-regulation of banking markets. Since the 2007 financial
crisis, however, understanding the political-technical struggle for financial re-regulation of banks demands that the UK case is understood, as it received amongst the most comprehensive attention and process in the global economy. The regulatory response has been wide-ranging; of particular interest to this chapter, however, is the macroprudential shift in UK post-crisis regulation and whether building regulatory resilience was the ambition of regulators rather than solving a central problem of the financial crisis, that of too-big-to-fail. Too-big-to-fail in the context of this research question was initially defined as a colloquial term in 1984 by United States Congressman Stewart McKinney (Dash, 2009). McKinney noted that specific banking firms were of such a large size and were so interconnected that any failure or insolvency event would be disastrous for the wider financial and economic system. The significance of too-big-to-fail in this chapter is to ask whether UK post-crisis regulatory responses through macroprudential policy have solved instability issues into the future.

The organisation of this chapter follows the following principles. The first section provides background and briefly sketches out Hall’s typology of policy change. Secondly, Hall is employed to shape the beginning of a discussion that progresses the development of an epistemic challenge to the way in which economic theory contributes to the debate on too-big-to-fail and to whether it understands what banking is. This initial work is more than background, and is designed to argue the case as to why alternative accounts of economic theory may have proved useful in the redesign of macroprudential regulation post crisis and fits within a financialised market based economy. Thirdly, and something that is crucial to understand, is the way UK politics reacts to the debate around too-big-to-fail and provides structural change in post-crisis financial regulation. This section asks what that process was and how it was formed and framed, and also provides a critical account of the central propositions of the Vickers Report produced by the
Independent Commission on Banking. The question is posed as to whether the timing, characterisation and nature of the Vickers Report have contributed to a corporatist bias through groupthink. These principles form the basis for addressing the research question by examining how economic theory and mainstream literature on banks perceived banking prior to the 2007 financial crisis. This is problematic in itself as progression to solving too-big-to-fail using economics is challenging. Alternative responses are channelled through a political and technical hybrid structuring of the way firms are organised, and this is then explored to ascertain whether there are limitations in this approach to solving too-big-to-fail. Additionally, a political explanation is offered that describes what actually occurred and why.

4.2. Hall’s Typology

Economic theory, regulatory policy and its transformation process, together with the implications of what literature describes as a hybrid structural solution to banking crisis, are covered in this chapter (Hall 1993; Baker 2013b; 2013a; 2015; Bell and Hindmoor 2015; Hardie and Macartney 2016). A convenient starting point and hook upon which to develop this chapter is Peter Hall’s three orders of policy change, which the varieties of capitalism literature subscribes to (1993). The intention is not to scrutinise the typology, or prove or disprove its worth. Using Hall instrumentally proves advantageous as it becomes possible to organise a wider set of questions from which the policy change process in financial regulation stems.

Hall’s policy change typology (see Table 1 below), is differentiated into three orders and two distinct columns: (i) macroeconomic change, and, (ii) financial regulation change. Broadly speaking, the distinctions between the orders are summarised below.
(1993, pp. 280-281):

Table 1: Hall’s Typology of Policy Change (1993)

<table>
<thead>
<tr>
<th>Feature</th>
<th>Macroeconomic Policy</th>
<th>Financial Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Order Change</td>
<td>Quick, Technocratic</td>
<td>Slow, Political</td>
</tr>
<tr>
<td>Second Order Change</td>
<td>Quick, Technocratic</td>
<td>Slow, Political</td>
</tr>
<tr>
<td>Third Order Change</td>
<td>Slow, Political</td>
<td>Quick, Technocratic</td>
</tr>
<tr>
<td>Type of Crisis</td>
<td>Slow Burning - Economic Stagnation</td>
<td>Dramatic &amp; Explosive- Financial System Malfunction</td>
</tr>
<tr>
<td>Sequence</td>
<td>$1 + 2 - 3$</td>
<td>$3 - 2 + 1$</td>
</tr>
</tbody>
</table>

Source: (Baker, 2015)

- First Order: an analytical process driven by Helco’s work on social learning (1978); interests and ideals pursued by policy makers shared by policy legacy or meaningful reactions to previous policies; (ii) capacity of states to act autonomously from society; and (iii) interpretative power of elites over pluralistic accounts.

- Second Order: amending the instruments of policy change without re-orientating underlying goals and objectives.

- Third Order: wholesale policy changes reflecting historical experience.

Baker states that ‘macroeconomic policy change’ fits with Hall’s framework (see column 1 of Table 1 above) (2013b). Hall’s classic account of macroeconomic transition from Keynesianism to Monetarism and how this underpins the eventual change in government strategy to privatisation under Thatcher’s 1980s government is compelling (1993). What is questionable, however, is whether wholesale policy
change reflects the historical experience of those involved in the process of regulatory transformation post crisis.

4.3. Theoretical and Epistemic Challenge

Hall’s description of policy change to financial regulation describes how monetarism connects to macroprudential regulation. Explaining how theory and practice correlate within periods of policy change provides fertile ground for typology. Hall’s example, however, also allows a critical and epistemic challenge to the opinion of economic theorists as to what was happening at the time of 2007 financial crisis and thereafter. This challenge also correlates with what transpires in policy and legislation as a reaction to too-big-to-fail via the Vickers Report, which arguably was the single most important transformation in post-crisis UK regulation.

Quite rightly, Hall notes that financial regulatory change is sudden and is driven by a technocratic elite. This description was mirrored in the Vickers Report, which was drafted over an 18-month period and published in September 2011. The Independent Commission comprised market elites in their respective fields (ICB, 2011) contained within a quasi-political but temporary vehicle of regulatory change. Before entering into an essential debate about how the Independent Commission on Banking was established, formed and framed, it is key to position the Vickers Report in the context of economic history and tradition in order to establish the foundation points which theoretically underpin the reports.

Hall describes monetarism as the force that characterised mainstream orthodoxy in economic control after a successful period of pre and post Second World War Keynesian economics (1951-1973) and a period of ‘stagflation’, which importantly, Keynesian models had failed to predict or explain (Skidelski 2009). Stagflation
contributed to a doctrinal shift in economic theory and a public policy framework towards monetarism. Beginning with Friedman and Schwartz’s (1963) detailed study of the Monetary History of the United States 1867-1960, the theoretical and intellectual framing culminated in Friedman’s 1970 exposition on a framework for monetary analysis. The theory and practice of monetarism can be characterised by the macroeconomic effect of controlling the supply of money as the guiding principal for stabilising the economy. From 1973 onwards, monetarism gained traction, primarily because of the way it professed to control economic stability via inflation-based targeting of economy and a flex in currency exchange mechanisms (Ball and Sheridan 2004). Central to the theoretical propositions of monetarism is an intellectual framing of Keynesian principles that were duly abandoned by Friedman and Schwartz as managing economy and regulation through government and financial institutions that created problems rather than solving them. Over several decades (1979-2007), macroeconomic stability or the Great Moderation (Bernanke et al. 2013) explanations that placed increased output stability firmly in the court of monetary policy, structural changes in monetary inventory and perhaps elements of good luck (Summers 2005). The sustained period of stability had distinct implications for policymakers, who were guided by a growing confidence that together with micro-prudential regulation and supervisory controls, central bank monetary policy had the measure of markets and could govern solely and without remedy from alternative economic theory or prudential measures of structural reorganisation. The above is of course centred on the US case; however, similar phenomena were experienced in most developed industrialised economies categorised as the G714 albeit with some variation over a decade. Under the auspices of microprudential regulation, the Basel

14 See Summers 2005, pp. 9-11 for a series of tables that illustrate the phenomena in Australia, France, the United Kingdom, Canada, Germany, Japan and the United States.
Accords (I, II and III: see Chapter 5 for details) were implemented from 1988 onwards in an attempt to prevent excessive risk taking in banks.

Notwithstanding the close relationship between what became institutionally led ‘conventional monetary policy’ via the United States Federal Reserve, together with the Basel Committee on Banking Supervision and microprudential policy, the Bank of International Settlements claims that they failed to deal with the peak and trough, or boom and bust cycles of economy in the run up to the financial crisis (BIS 2014). Minsky developed a theory to explain cycles of economy via inherent endogenous instability of the financial system (Minsky, 1992) and prior irreducible uncertainty (Keynes, 1935). How the concepts of endogenous instability and irreducible uncertainty couple with finance or financialised economy to create conditions for the next economic crisis is of significance15 (Arrighi 1994; Martin 2002; Krippner 2005; Froud et al. 2006; Ertürk 2008; Van der Zwan 2014). Financial markets typified as free from big government and hard-wired regulation were to run out of luck. The above literature describes a lack of control exercised via the nexus of microprudential regulation, monetary policy and regulatory supervision. In large part these fields of regulatory control were responsible for the global financial crisis in 200716, as macroprudential models of economy such as DSGE failed to predict the 2007 financial crisis and the end of Bernanke’s Great Moderation. The above scrutiny and challenge of mainstream economic theory demonstrates a failing intellectual thought process:

“The crisis of our time is not about financial or economic bankruptcy; the real crisis of our time is about an intellectual bankruptcy: the bankruptcy of mainstream economic

15 See literature review Chapter 2 for in-depth discussion.
16 Amongst alternative academic frames, narratives and discourse that challenge mainstream orthodoxy, such as market expectation, financial innovation, regulatory arbitrage, shareholder value and management bricolage (Engelen et al. 2010).
The above critique outlines a coherent macroeconomic interdependence that reveals an irreducible uncertainty within the financial system. Keynes had discussed uncertainty based upon his experiences of the Great Depression in the US economy in the late 1920s (Skidelsky 1996). Minsky developed Keynes’ viewpoint on uncertainty by discussing the impact of exogenous shocks in classical accounts of economy, and the inability of such accounts to justify or explain the transition of markets into instability over long periods of time. Minsky’s position is to some extent vindicated empirically through a financialised banking system and financial crisis in 2007 (Minsky 1992).

Before questioning whether post-crisis theoretical justifications of Keynes and Minsky correlate with a requirement for macroprudential regulation, the manner in which crisis allows a rethinking process to evolve must be set out. The 2007 financial crisis and too-big-to-fail provided a platform to re-evaluate theory that underpins financial markets. Historically, thinkers from the Austrian circle (Hayek, Von Misys, Popper, Knight and Stigler et al.) and those attending liberal Mont Pelerin Society meetings in 1947 began discussing free market economics, or at least market economies free as possible of government and politics (Hayek 1944; Mirowski and Plehwe 2009; Djelic and Sahlin-Andersson 2006; Djelic and Sahlin-Andersson 2006; Djelic and Quack 2010; Djelic and Hond 2014). The early neoclassical economists (Jeavons, Samuelson) knew that markets were not infallible and that a night watchman was required to oversee a recovery when exuberance or instability, recession or depression occurred. From 1973 onwards, these ideas were abandoned by economists from the Chicago School of Economics (Friedman, Fama, together with others such as Merton), who began a new brand of neoliberal economics that constructed financial markets as free, omniscient and with access to all
knowledge and prices simultaneously; they viewed the market as a huge super computer that knew more than any government or regulator (Mirowski 2013). Furthermore, like the 19th century liberals, Adam Smith’s invisible hand played its part (Rothschild 1994; Arrighi 2007; Ashraf et al. 2005), as did the physics of David Hume (2016), in which all atoms gravitate towards each other to find general equilibrium; markets were equated to scientific law-like rules which were created from Ricardian and Walrassian neoclassical accounts of theory (Ricardo 1891; Walras 1896; Barro 1974), and were latterly developed by Arrow and Debreu (1954) and advanced towards DSGE mathematical models (Tovar 2009) through Nobel Laureate Lucas who observed that macroeconomics could be realised through aggregating micro- foundations (1976).

Heterodoxy suggests that neoclassical notions such as those mentioned above were propositions made to enable their models to function, rather than being empirically observed in reality (Van den Berg 2014). This is not to suggest that such propositions were constructed to misrepresent reality. Such notions were coherently applied and made sense at that time in economic research and modelling; however, they appear to have a heuristic form of power which allows them, albeit in redefined or amended ways, to continue shaping economic policy after a considerable economic shock or crisis. Ten years post the 2007 financial crisis, the debate on economic theory continues as to what the reaction and amendment to theory should be to assist an alternative approach and an improved representation of the way economy transitions over periods of time.

4.4. Policy Transition

Having described the theoretical and epistemic challenges of neoclassical and neoliberal accounts of economics and the way they affected macroeconomic policy, it can now be questioned how a transition to new theory occurs when a systemic event or economic
shock happens. A theoretical framework is offered to illustrate a process via Hall’s ‘third order policy’ change typology (1993):

**Fig. 10 Hall’s Third Order Change to Financial Regulation Revised**

This framework sets out how a theoretical decoupling mechanism operates and how epistemic transition begins to occur. On the left side of Fig. 10, neoliberal theory (Fama and efficient markets) at the point of crisis is challenged as it failed to predict or explain the 2007 crisis, much like stagflation and Keynesianism in the 1970s. This theory feeds into the post-crisis period across the timeline at the top. The fulcrum of challenge is depicted at the centre of the diagram by what Hall calls the gestalt flip (Hall 1993, p. 279), or what cultural economy literature describes as a point of ‘misfire’, when politics detaches from old ideas and theories on recognition of a serious problem, i.e. theory
breakdown. A renewal process begins when the requirement for new ideas is realised and an alternative theoretical framework becomes a necessity, usually through political channels (Butler 2008). This approach, as discussed in the previous subsection, detaches from Fama and efficient markets (1970) and aims to replace this with other tools better situated and alternative frameworks founded upon previous academic research (Baker 2014). A shift or theory building occurs, according to literature (Kuhn 1962; Lakatos 1976), and a new world must be seen afresh, with alternative approaches deemed necessary via regulators (Turner 2009) and central banks (Haldane 2012; FPC 2015; Kohn 2016), which are subsequently developed into institutional machinery to provide a way forward. The post 2007 financial regulatory shift was towards a macroprudential framework of economy, given the uncertainty and inherent endogenous instability within markets (Keynes 1935; Minsky 1977).

4.5. Keynes and Minsky

Before addressing the importance of macroprudential shift, it is vital to understand the theory that underpins it as described on the right hand side of Fig. 10. The insights of two important academic ideas describe the foundation for a series of papers that develop a macroprudential framework (Borio and White 2004; Borio and Drehmann 2009; Borio 2010; 2012).

Firstly, John Maynard Keynes (1883-1946) had an unconventional and highly pragmatic approach to the matter of economics (Skidelsky 2009). According to Skidelsky, a prominent British economic historian and official biographer of Keynes, there is evidence that, “Keynes eschewed mathematical modelling and theoretical approaches to economics in favour of concrete realism” (Skidelsky 2009; Wray 2009). The search for realism led to Keynes developing a negative viewpoint regarding
probabilistic modelling of economy that underpins the neoclassical account. Keynes describes probabilistic modelling as flawed logic (Skidelsky 2009). Calculations of such importance to economy overlooked the uncertainty within equation variables and the way they were being assembled to rationalise or predict likely outcomes. These methods were being taught in business schools, economics and other humanities-based subjects where interdisciplinary academic activity was pursued (Burks 1979; Morrow and Morrow 1994). Probability-based models had a direct impact on economy – inclusive of Bayesian theory (Shafer 1976) as they were utilised in decision-making by policy makers in government in a series of different issues (uncertainty in game theory for example – Nash, (1950; 1950; 1953; 1996), not least climate change and contemporary crisis in the environment (Stern 2007; 2008).

Keynes noted three constituent elements of probability, which he termed cardinal, ordinal and irreducible, and described their use in demarcating the types of risks policymakers could calculate and utilise, along with ways this should be done (O’Donnell 1991; Skidelsky 2009, p. 8). For the neoclassical account of economy, however, the risks neo-classicists were attempting to address – general equilibrium and efficient markets, for example – fell within the third category of being irreducible to calculative variables. Additionally, mathematics as an exact science would naturally be imprecise, as its answer is founded on incorrect input and misdirection, especially where preconceived notions of human behaviour had been created to enable neoclassical propositions of economy to hold. The latter description of mathematical models describes the problem of isomorphism and is an example of a constraining process that forces variables to resemble other units facing the same set of conditions and leads to homogeneity and increased risk. Economic ideas are unsuccessful in mathematical equations because they fail to translate into something readily useable, or are representative of reality (DiMaggio and Powell
Developing Utility Theory or notions of humans as rational actors (Rational Choice Theory) assists the stability of neoclassical models where uncertainty exists (Jevons 1871; Freidman, 1953; Arrow 1959). Whilst these stabilising preconceptions in models may well have been founded on the best of intentions, post-crisis empirical observation (Bank of England unconventional monetary policy, for example zero interest rate policy, negative interest rate policy and quantitative easing) points to the opposite reaction of humans as individual units of economy. As interest rates are lowered, humans fail to increase investment at lower rates, and according to the neoclassical account they invariably act irrationally by saving and deleveraging debt, which creates further counter cyclical reduction in aggregate demand, further reduction in interest rates towards the zero lower bound, irrespective of central bank intervention and any attempts to force inflationary pressure or indeed increase the volume and velocity of money into the financial system. The way interest rates and the nature of uncertainty are modelled illustrates the impact of unconventional macroeconomic policy on the economy. This results in procyclicality and an increasing likelihood of a prolonged recessionary environment regarding the way these transmission mechanisms impact economy and compress the zero lower bound (Borio 2010; Borio 2011; Borio 2014a; Borio 2014b; Lavoie 2016).

Secondly, and similarly, monetarist models of economy attempt to model exogenous shocks to the financial system. Money and debt, for example, are taken as neutral via the Quantity Theory of Money (QToM), which describes “money supply as having a direct, proportional relationship with price level” (Friedman 1972). For example, “if the currency in circulation increased, there would be a proportional increase in the price of goods” (Friedman, 1972). Minsky challenges the QToM, and states that “the instability hypothesis treats banking seriously as a profit seeking activity where bankers
understand innovation assures profits ……this innovative characteristic of banking and finance invalidates the fundamental presupposition of orthodox QToM to the effect that there is an unchanging money item whose velocity of circulation is sufficiently close to being constant: hence, changes in the money’s supply, have a linear proportional relation to a well defined price level” (Minsky 1993, p. 6). Therefore, Minsky posits an alternative theorem via his instability hypothesis, which focuses on inherent endogenous risks within the financial system and the way financial risk transitions through a cycle to create instabilities as the supply of money and debt increases in the market (Minsky 1992).

After the financial crisis, the above is indeed a problem for Neoclassicals. Banks are described in mainstream literature as financial intermediaries. Given their neutral effect on economy, i.e. the volume of money invested into the economy via loans only affects price and not the interest rate, what is the point of banks if they merely redistribute capital; should they exist at all (Engelen et al. 2011, p.99)? Minsky sees the problem differently. He perceives banks as intrinsic to the problem of financial instability rather than being neutral. Minsky observes endogenous instability in his classic study that addresses his instability hypothesis (1992). The paper does not use complex mathematics, equations or calculus to develop what he describes as three agents of change within the financial system: (i) Hedge, (ii) Speculative and (iii) Ponzi (1992). Moreover, Minsky uses descriptions, connections, structure and knowledge of how banking institutions lend money to describe the way uncertainty and instability occur through cycles in economy. Minsky’s famous quote (1982, p. 101) that “stability – or tranquillity – in a world with a cyclical past and capitalist financial institutions is destabilising”, demonstrates the effect the growth and contraction of aggregate private debt has on financial markets (Fisher 1934; Moore 1979; Minsky 1980; 1982; 1983; Keen 1995). This approach is both contested and refuted by mainstream economists who counter that private debts are
nothing but redistributions that should have no significant macroeconomic effect under
the loanable funds model (Robertson 1934; Ben Bernanke 2000; Krugman 2012).

The above paragraphs sketch out problems with the neoclassical accounts of
economic theory and the way in which, when placed in a crisis situation in 2007, its
preconceptions of operation were challenged. It is argued that both uncertainty and
endogenous instability, post crisis, provide a rational platform from which to develop new
structures in economic theory (towards a macroprudential framework). A new trajectory
would allow improved control over the way economic cycles perform, which both
neoclassical and neoliberal theories fail to describe adequately.

4.5.1. Towards a Macroprudential Framework or Restructuring of
Banking

A progressive approach to the challenges of neoclassical and neoliberal economic theory
would be to abandon elements that create problems and harness others that attach to
alternative theories that appear incompatible at one level but reconcilable at another,
perhaps more pragmatically. As Haldane and Turrell (2018) have suggested, perhaps an
interdisciplinary model for macroeconomics is possible, and reconciliation, as Minsky
had hoped for, may be attainable. The literature review (Chapter 2) discusses Borio’s
framework in detail, considering how it would operate through a disequilibrium analysis
and the reason it is an improvement on mainstream theory and DSGE models operating
alone or as a supplementary tool to economic policy analysis (Tovar 2009). It would be
possible to observe pressure building in the financial system and use macroeconomic
policy to attempt to temper the peaks and troughs of financial cycles (Drehmann et al.
2012) that dominate economy to the extent of the depth and length of the crisis or
recession. This is not a solution to too-big-to-fail; however, it would prevent the degree
to which emergency funding, bail-out, state ownership and bank resolution would be required without the need for excessive capitalisation of banks and crushing bank return on equity ratios (Borio 2012). Quite how reconciliation would take place between DSGE and Borio’s framework whilst underlying mainstream economic theory remains at odds between equilibrium and the disequilibrium of Borio would need to be rethought. Two interesting questions arise from the failure of the switch to Borio’s framework: (i) given that society is operating in a financialised economy where banking and debt played a material function in the 2007 crisis, what does mainstream theory of economics and finance perceive banking to be and how has this created further problems which Borio’s framework could have minimised?; and (ii) if mainstream theory is unhelpful and economics is beginning to consider a shift away from equilibrium based models without resorting to a new macroprudential framework, then are we left with ‘structural’ bolstering of the financial system and will this solve too-big-to-fail? The banks will be considered first.

4.6. Banking Ontology

Banks changed ontologically from the 1980s onwards. Mainstream finance theory and textbooks continue to depict banks as neutral, stand alone entities, acting as financial intermediaries involved in practising principal-agent theory, information asymmetry and lending using their balance sheet and loanable funds business model (see Engelen et al. 2011, pp. 99-103, for a discussion on the evolution of bank business models). Banks employ business models that change during economic cycles and at specific events or market conjunctures (Engelen et al. 2010). Banking models have shifted previously and have been described under the terms “retain and reinvest, downsize and distribute in firms” (Lazonick 2015), or ‘originate and distribute’. The latter relies on a capital
markets framework to operate whilst increasing shareholder value through rising return on equity via arbitraging capital costs and making fee based income (Lazonick and O’Sullivan 2000; Engelen et al. 2011; Crowther and Ertürk 2016). Business model activity plugs into global networks of international finance, bond markets, financing conduits and asset backed securitisation markets and involves third party agents such as private equity and pension, hedge and bond funds, to name but a few. The devices of finance have also changed to fill vacuums created by market conjuncture (regulation, legislation or crisis) in order to maximise opportunity for shareholders (Ertürk et al. 2013). Currently, banks operate capital markets distribution strategies via securitisation and engage in practices of collateralised debt obligations (CDOs), collateralised loan obligations (CLOs), mortgage backed securities (MBS) and synthetic CDOs, and they use syndication as a means of distributing assets around the globe, knowing that banks are required to invest in higher risk products if they are to compete, increase return on equity and be successful in markets (Crowther and Ertürk, 2016). Banks also engage in practices of dark pool trading (Buti et al. 2011) and operate funding conduits using their own credit rating to provide cheaper funding to their important clients, such as hedge funds via investment bank prime brokerage services (Duffie 2010).

No longer does a bank see its primary business as being a utility of economy, or consider its purpose to be facilitating GDP growth. Now a bank operates with itself, with its principals and agents at the centre of the business model as a means to make money via the concept of shareholder value (Engelen et al. 2011). As the literature review notes (see Chapter 2), banking is central to the financialisation of economy (Van der Zwan 2014; Aalbers 2008; 2009), a concept that describes the dominance of banking and finance and its impact on economy and society (Ertürk 2008; Engelen et al. 2011). Financialisation now impacts almost all areas of economy and society and describes how
finance and banking penetrate the lives of everyday citizens with ever increasing measure (Martin 2002). The concept of accumulation (Krippner 2005) and shareholder value (Froud et al. 2006) also bears witness to the impact financialisation has on firms and markets (see Chapter 5 also). In contrast, some critics of financialisation take a different view conceptually and suggest limits of its use as it becomes mainstream in literature (Deutschmann 2011; Doucette and Seo 2011; Christophers 2015). In market-driven financialised capitalism, and with banking in particular, shareholders are a priority, and together with market analysts, they see return on equity as a key focus rather than utility of economy, which would then provide returns as a consequence of serving customers (Turner 2009; Engelen et al. 2011). Although, as we have seen post crisis, the FCA wants banks to prioritise customers in business models, this is not necessary to make money and is an on-going debate in the culture of banking (see Chapter 5). Returning money to shareholders is a contracted internal control mechanism: the CEO must achieve this to hit key performance indicators, increase the dividend and facilitate an increase in share price (Jensen 1994) as well as see value flourish through increasing remuneration, stock options and gold plated pension arrangements. A critical discourse in corporate governance considers rules on CEO pay and suggests that a combination of theories rather than principal-agent alone would benefit risk taking in banking (Tosi et al. 2000; Chen et al. 2011).

Banking became an asset class of its own under the heading of ‘financials’ and reported in financial media. Pre crisis, investors flocked towards superlative return profiles as banks dominated economy and bourses around the world. Banks became central to economy through different forms of organisation, practice, innovation and technology. They became powerful institutions, built through merger and acquisition post the 1999 repeal of Glass-Steagall in the United States, which had separated banking
activity and practice post depression in the late 1920s (Moran 2009). The Gramm-Leach-
Biley Act replaced Glass-Steagall and opened the way to a modernisation of financial markets that also occurred in Britain (Moran 1984). Banks operate regionally, nationally and internationally, supported by a globalisation of finance, banking and capital (Berger, Young and Genay 2000). However, as globalisation sceptics note, this is not strictly true, and the concept itself is used fashionably rather than being scrutinised (Hirst and Thompson 1997). It is nearer the truth to say that banks dominate old Anglo-Saxon and advanced economies which are centred in hubs of practice, notably New York, London and Tokyo, amongst other decentralised bourses (Hirst et al. 2015), which to a large extent fund the global marketplace, including the majority of BRICS and developing nations. Notwithstanding this, banking is not global and does not reach all geographies and sovereign jurisdictions from the three central hubs (Hirst and Thompson 2002). Despite these tempering criticisms, banks are powerful firms operating for themselves.

In addressing the central point of this chapter, too-big-to-fail, it is important to describe the above change in banking ontology and the way alterations to markets and models have allowed capital to be released across international networks of finance. The control and flow of money occurred through deregulated banking markets via a process described in the UK as the financial ‘big bang’ after 1986\(^\text{17}\) (Moran 1991). Moran claims that this change was shaped by the British state, which played a central role in the revolution in financial markets. This viewpoint was in stark contradiction to the prior characterisation of the state as weak, liberal and diminishing in its power to control sectional interests of finance that lobby and influence the direction of regulatory travel. As markets have developed, banking conducted business through long chains of complex

\(^{17}\text{Triggered by an anti-trust case between the Office of Fair Trading and the London Stock Exchange – via the Restrictive Trade Practices Act 1956, which led to an explosion of merger activity in banks and financial markets.}\)
transactions (Ertürk et al. 2012; Gabor 2016) and often via interconnected networks of financial institutions. The literature on financial interconnectedness emerged from globalisation and the way banks experienced contagion during the height of the financial crisis in 2008-2009 (Hirst and Thompson 2002; FSB 2011; 2012; Claessens 2012). Interconnectedness refers to the way in which banks (amongst other financial institutions) are connected to each other, either by direct or indirect means (Bank of England 2015). Direct interconnectedness describes transactional relationships between banks, for example an interbank loan through the London Interbank Offer Rate (Libor). The implication here is the more direct the relationship, the higher likelihood that contracting parties (of which there can be several in a transaction) can be affected by default and one can trigger a contagion type relation with the other (Claessens 2012). Indirect interconnectedness describes actions of banks that can impact other banking institutions not directly connected through contract type relation. An example of this was Lehman Brothers conducting a volume of non-performing loan sales to alleviate capital adequacy problems, which impacted prices of all assets in the distressed market place through distortions in available liquidity and the dumping of assets to realise a quick sale (Acharya et al. 2009).

Andrew Haldane, Chief Economist at the Bank of England, went to great lengths in trying to develop a debate by arguing that the financial system operates like an interconnected ecosystem, and he introduces complexity theory to describe the way in which it functions (Haldane 2009; Cooper 2011). Haldane progresses this discussion in his ‘The Dog and the Frizbee’ speech, which addresses the way in which the system is interconnected and too complicated to be governed with complex regulation and how this may indeed create further uncertainty instead of control (Haldane 2012). The OECD and Blundell-Wignall et al. agree with Haldane and discuss evidence on interconnectedness,
suggesting that banks, as GSIFIs, cannot be controlled through microprudential regulation, or Basel III capital rules alone (2014, p. 7). It is questionable whether post-crisis regulation has understood the ontological change in banking and the clear messages from both Haldane and the OECD. Given the perception of banks by neoclassical and neoliberal economics detailed in previous sections, the above ontological changes that characterise modern day banking also appear disconnected. Haldane is suggesting that economic theory and regulation requires rethinking using a more radical frame in order to deal with ontological changes and the complexity of too-big-to-fail.

If mainstream economic theory and microprudential regulation were not enough to govern modern day banking, then would the addition of structural changes in the way banks are organised make a material difference and a compelling argument that solves too-big-to-fail?

4.7. Independent Commission on Banking: The Vickers Report – a structural solution to Too-Big-To-Fail?

The following subsections of this chapter outline how politics and regulatory institutions respond to the financial crisis. The initiation of how reform processes begin through a series of commissions is discussed and analysed through previous reports in this field. This research asks questions regarding whether the ideas for reform specific to the UK present quasi-structural solutions to the problem of too-big-to-fail?

The analysis begins with the task faced by the Independent Commission on Banking (ICB) and the Vickers Report, produced in 2011, was a challenging one. The commission was attempting to find a neat solution to financial stability and competition in the British banking system, and the most crucial and contentious issue it faced was structural reform of banking. This problem stems from the concept of too-big-to-fail as a
consequence of the financial crisis in 2007. Too-big-to-fail is a concept asserting that certain globally or nationally systemic banking institutions (or corporations, inclusive of insurance companies) became so large and interconnected that any collapse or failure of an individual firm could be catastrophic to the whole economy and so the institution should be saved through government support, funded by taxpayers. Looking deeper into the ICB’s purpose, the idea was to formulate responses to:

- Reducing systemic risk by exploring issues surrounding the size, scale and function of banks;
- Mitigating moral hazard (i.e. taxpayer bailout);
- Looking at how banking firms can fail and reducing the impact this has on the financial system.

The language used in the reported description of purpose has already moved away from proposing solutions and instead uses terminology such as reducing risk and mitigating moral hazard. The implication is that this already acknowledges the direction of eventual conclusions, i.e. there may not be a solution. However, as the Bank of England Governor Mark Carney points out in the quotation at the head of this chapter, perhaps it is about building resilience, and the best way to go about doing so.

The ICB was expected to cut through the challenges of 30 plus years of deregulated markets – otherwise referred to as ‘self-steering’, or ‘light touch’ under the fundamental principles of financial regulation (Hancher and Moran 1989; Brunnermeier et al. 2009). This regulatory backdrop, supported by mainstream economics theory, assists in developing banking innovation, management bricolage and regulatory arbitrage, as well as explaining how banking ontology had in effect changed the way banks do business.
via shifting business models (Engelen et al. 2010).

However, the purpose we define here is of significant importance. The Vickers Report is a primary documentary source that shapes the progress of UK post-crisis banking reform. The following principles underlie the organisation of this chapter. Firstly, it is important to construct the manner in which the ICB was formed and identify the agents of regulatory transformation. Secondly, the way the ICB framed the debates within the report and arrived at decisions is key to the eventual recommendations. One way of structuring the discussion is via a framework of acts and omissions – i.e. what was missed in terms of ideas and alternatives, and what was included and channelled into the thought process of the ICB. Subsequently, it will be important to place this into a wider context of analysis and determine how the ICB was influenced by other research carried out previously and at a similar point in time. Finally, this subsection of the chapter will ask whether the shaping of post-crisis UK regulatory reform has solved too-big-to-fail, and will question the extent to which the politics of ‘commission’ based regulatory transformation has centred on corporate bias rather than the resilience that protects against moral hazard.

4.7.1. ICB Formation

As post-crisis responses to regulation progressed, the reform agenda being debated and legitimised was at the national level and marginalised from the democratic scrutiny of Parliament. At the time, the Chancellor George Osborne announced proposals to reform the supervisory structure of UK financial services in his Mansion House Speech in June 2010 (Osborne 2010). Within these proposals, Osborne also announced the establishment of the ICB, the purpose of which was to consider structural solutions to moral hazard, and which was to be led by Sir John Vickers (alongside Commissioners
Bill Winters, Martin Taylor, Clare Spottiswoode and Martin Wolf).

Engelen et al. (2011) state that earlier periods of economic and social reform had featured self-confident elite players such as John Maynard Keynes and Richard Beveridge, who played a significant role in the reform process. In the pre and post Second World War period, social reformers occupied prominent positions in society, and when crisis reared its head, this allowed altruistic policy elites to have an influencing role on the social reforms that followed. Earlier, in 2008, United Kingdom Financial Investments (UKFI) had been established to manage the government’s shareholdings in what were wholly owned or minority stakes in UK banks post bailout. This quasi government vehicle sat at arm’s length from banking, but was overseen by corporate elites from the City and was marginalised from the democratic gaze of Parliament. The first two chairmen of UKFI were ‘City grandees’ – John Kingsman and Philip Hampton – who were friendly or sympathetic to the corporate cause; this, coupled with representatives such as Glen Morano, insulated the workings of arm’s length agency from the accountability of Parliament (Engelen et al. 2011). At this point, the ICB was being inserted into an old pattern of institutional arrangement that slotted in between agencies and the democratic state (Moran, 1991; Engelen et al. 2011) and was led by a mixture of technocrats and City based elites.

The ICB Chairman, Sir John Vickers, is described by the British print media as a safe pair of hands (The Telegraph 2010; Wilson 2010; The Guardian 2012) that had managed to craft an impressive career: Drummond Professor of Political Economy at Oxford University; a servant of public office as Chief Economist at the Bank of England; and subsequently Director General of the Office for Fair Trading (2000-2005). Bill Winters is described as a shrewd investment banker and influential operator within the arena of European capital markets (Telegraph, 2010). This report suggests that Winters
had a glittering 33-year banking career with a résumé studded with names such as JP Morgan, Standard Chartered and Credit Suisse, which gave a corporate focus. Martin Taylor is described as having split his career between journalism (Reuters, 1974, and Financial Times 1978), business (Courtaulds’ Chief Executive, 1984-1990, and WH Smith, 1999-2003), banking (Barclays, 1994-1998), and public office (Bank of England Financial Policy Committee 2013), amongst other senior roles in business. Clare Spottiswoode (CBE) is reported as a feisty consumer champion (Telegraph 2010), and has held a plethora of senior board and non-executive positions, mainly in energy and gas companies. Finally, Martin Wolf (CBE) is a trained economist and an influential advocate of globalised free markets. Wolf is said to be influenced by Hayek and his book Road to Serfdom (Loffe 2009) and had a career at the World Bank until 1981. However, since 1987 he has worked at the Financial Times as an Associate Editor, and since 1990 as Chief Economics commentator.

There is a twofold reason why a potted history of the Commissioners involved in the ICB is valuable. Firstly, they all have in common an elite education at Cambridge or Oxford University, progressing to high office often with a peerage. Secondly, and more importantly, their backgrounds and employment history, along with the periods in which they have traded or been involved with corporations at senior levels have created a niche network of people with established connections in public office and the City. What in effect occurs is the establishment of a quasi-political agency (ICB) with an arm’s length relationship to the City which nevertheless maintains a close network of lifelong elite business relationships fused together by operating within a corporatised and financialised economy driven by long established tropes of shareholder value driven business models. Much like the effect of UKFI on government held shareholdings in banks (Engelen et al. 2011), the ICB also closed off the potential or possibility of a more radical answer to the
question of what should have been done about the banks. How was this achieved?

In September 2010, the ICB issued a call for evidence (ICB and Vickers 2010). The call requested responses from the financial, banking, business and academic community as to how structural issues could be addressed. It is crucial to sketch out the key themes and issues in the Vickers Report that addressed structural reform and too-big-to-fail.

4.7.2. Omissions

In response to the ICB’s call for evidence, there were a number of important contributions that could have provided suitable alternatives or solutions to too-big-to-fail. Chief amongst these alternatives were ‘narrow banking’ (Kay 2009; Kotlikoff 2010; Kay 2016), ‘full separation of retail and investment banking or alike,’ to be used in conjunction with other remedies (Benston and Harland 1990; Blundell-Wignall 2011; Ertürk 2011), and the development of Prompt Corrective Action (PCA), a pre intervention to avoid the need for awkward ring fencing (Goodhart 2008). These alternatives would arguably have been an improvement on the ring fencing recommendation (to be detailed later in the chapter) to the Treasury and Government in September 2011.

However, the ICB’s final report fails to rationalise such alternatives. The report discusses alternatives in a matter of few paragraphs (pp. 44-45) and fails to give an adequate reason or analysis, or indeed to explain what empirical work had been carried out on the evidence gathering exercise via the ICB’s 2010 call. This in itself is a distinct weakness of the final report which went on to shape government policy and the future structure of banking services in the UK. Indeed, what rationale or purpose lay behind the call for evidence? By implication, one may infer that the ICB was listening to market
practitioners but also had a firm mind in terms of which way the conversation and debate should be focussed. The Commission members would do very little of the analytical work; moreover, a small army of professionals at the Bank of England would have been assisting in analysis and considering reform options. If this is correct, then where is the analytical work that justifies the Commission’s direction? A senior ICB member (Interview 6) alluded to the process of a data room exercise in which banks provided information to the ICB that was to remain confidential, probably due to the market sensitivity of the data. However, this does not preclude reporting a headline or stratified analysis of the data, maintaining anonymity, which then supports the commission’s recommendations.

4.7.3. Acts

The debate and its themes appear to have been narrowed down by the ICB’s Interim Report in April 2011 (ICB and Vickers 2010). This report is key in terms of channelling the deliberations and consideration of reform options that appear in the final report. The ICB claims to assess reform options through a framework of cost-benefit, a quantitative form of analysis that began post World War II around the practice of cost effectiveness and was developed to aid managers and decision making: see Mishan and Quah, (2007). The epistemic background to cost-benefit analysis came via engineering and project management, which was later developed into public administration and new public management (Quade and Rand Corporation 1971; Hood 1991; 1995; Hood and Dixon 2015). However, in the context of the ICB report, this practice is noted as an imprecise and complicated method of analysis, indicating a level of complexity such that the method is incapable of calculating accurately to aid decision making (ICB 2011 p. 45, paras. 2.91–2.94). Notwithstanding this, the interim and final reports discuss the relative advantages of a concept known as ring fencing versus minimal discussion on the cost
benefit of full separation of retail and investment banking services (Ibid. p. 8 and p. 63, Chapter 4, para. 4.4). Kotlikoff suggests that only five paragraphs of the final report were dedicated to Narrow Banking, one of the alternatives to ring fencing (ICB 2011 p. 44, para. 3.22), or as he terms it, ‘Limited Purpose Banking’. The alternatives to ring fencing appear to have been dismissed with little given in the way of reason, cost-benefit analysis or empirical discussion (2012, p. 14; Ertürk 2008). Ring fencing is the main concept considered by the ICB for creating financial stability in the British financial banking system and addressing too-big-to-fail. The objective of ring fencing is to isolate and protect banking activities crucial to the British economy whilst protecting its depositors and the taxpayer from funding future bailouts. Ring fencing separates assets, function and operations of retail banking divisions, inclusive of payment systems and money transition services that underpin the flow of economy, from those of a higher risk nature such as the activities of investment banking within the same holding company structure. The structural solution of ring fencing would also work together with the risk management approach of microprudential regulation such as Basel III, and additional capitalisation of the holding company structure (see Research Question 2 and framework in Fig. 11). The idea is to leave both retail and investment banking under the same holding company, i.e. maintained within the concept of a ‘universal bank,’ and gain the benefits of operating such large institutions (ICB 2011, p. 11). However, the retail bank would be ring fenced and governed by a separate executive management board, and its operations would not be affected by risk elsewhere in the holding company.
Alternative structures were considered by the ICB, via a process of stacking – i.e. the retail bank could own the investment bank, or indeed vice versa (Interview 6). The option of the investment bank owning the retail bank was discussed:

“…we did not argue against this point; however, given the cultural issues that were even worse in the Libor scandal, I am much happier with the sibling structure, which is akin to the American Holdco structure and is far healthier than any of the stacking options” (Interview 6).

Via ring fencing and allowing universal banking to continue, the ICB is recommending an uneven playing field by minimising the competition for equity and debt that an investment bank would require under a universal banking holding company structure compared with those investment banks operating as stand-alone businesses. Keeping a universal bank whole under Basel III would mean increased capitalisation for
the entire operating entities under the holding company, thereby subsidising higher risk activities in the investment bank which creates the bulk of return on equity that banks are expected to make via market and analyst expectation. Both sides of the bank, retail and investment, were implicated in the financial crisis in 2008, and are risky:

“Both sides of banking, retail and investment, are risky. I never liked the utility-casino metaphor. I think it is doubly wrong. I think a lot of investment banking is very productive and worthwhile to society; to say it is all about people gambling is wrong and the utility piece implies that retail banking is dead safe, which is also incorrect” (Interview 6).

Whilst this is undoubtedly the case, the risks involved in retail and investment banking are very different in nature. When attempting to capitalise the holding company structure as one under Basel III, new capitalisation weightings reduce these risks to levels that are controllable together. It is questionable whether it would not have been a better idea to split the banks and have them capitalised separately but report into one operating company, define their individual risks more accurately rather than one feeding the other with confused incentives and the market expecting returns geared to individual activity – i.e. retail banking at 6-8% ROE and Investment banking 15%+. Here, a senior academic and former Bank of England Monetary Policy Committee member suggests:

“One of the things Vickers got wrong was what went wrong in the banks. The categorical mistake of assuming the difficulty with the banking system was with the derivatives and the trading book and it wasn’t. The real problem was property lending, housing and commercial real estate lending which of course came from the
retail bank and therefore they came up with the wrong answers [re ring fencing]”. (Interview 5)

Compounding the issues witnessed at Bear Stearns and Lehman Brothers (Strange 2015) retail banking was in large part the originator of mortgages that were developed into securitisation structures via mortgage-backed securities (MBS) (Aalbers 2008; Langley 2010; Engelen et al. 2011; Fabozzi 2016). However, post crisis it became clear that the retail bank is also very risky when considering lax underwriting standards and the leverage employed on the bank’s balance sheet to provide such services. The leverage used to fund mortgage business suggests that retail banking was being pushed to become a high performer and create additional return on equity – as was seen in the examples of Northern Rock and HBoS (HoC TC 2008; PCBS 2013; FCA and PRA 2015). For universal banks, ring fencing would not have solved these issues and the capitalisation problem would still affect market and financial stability (Bell and Hindmoor 2015). Furthermore, even with the increased capitalisation of Basel III and resolution instruments, such as contingent convertible bonds (CoCos) that trigger when capitalisation ratios fall to a specific level to support risk and the bank’s balance sheet, it is highly likely that this would still have been a material issue for ring fenced banks in 2007 (see Chapter 6 for discussion). Pushing banks into higher risk products and services to succeed in markets plays into Minsky’s description of the way risk builds endogenously in bank business models and how customers move through the hedge, speculation and ponzi descriptions of risk taking over time (Minsky, 1992, pp. 6-7). If, however, retail banks were fully separated and the operating company was not expected to take higher risks to contribute to 15%+ return on equity (Engelen, 2011) in order to fund investment banking risk, then the tax
payer would have been sheltered from the ramifications of a ‘full’ bail-out, meaning that the impact on taxpayers might have been significantly less.

It might not have been necessary to layer in new financial instruments such as CoCos for additional loss absorbency or to estimate whether Basel III or UK domestic arrangements would be enough (BoE, 2015).

There are two important issues here. Firstly, it is problematic to connect universal banks with the positive argument for ring fencing and keeping giant banking firms whole. Ertürk notes that little empirical evidence is available to make such a connection (Ertürk, 2011). As well as several compelling arguments regarding the way investment banks use retail banking credit ratings for bonus generation whilst also awarding them cheaper funding from which to create higher risk assets, a number of studies have concluded that there are minimal benefits to large universal banks (Ertürk, 2011, p. 11). The ICB notes in its interim report (ICB 2011, p. 8) that a full separation might prove the strongest firebreak from contagion and shocks. However, it goes on to make a firm point about the loss of the benefits from universal banking. A point made very clear in the final report is that the efficiencies and funding benefits gained by investment banking from universal banking would be lost through full separation and that this is unnecessary in terms of increasing transactional costs of investment banking services, which would be laid off on to customers thereby making London less competitive as a global hub of business (ICB 2011, p. 8). However, in an interview with a senior ICB commission member, a stark contradiction was revealed when a question was asked, premised on the final ICB report, as to whether there are benefits to keeping universal banks whole when literature suggests otherwise:
“One thing we signalled again and again, that we were hungry for, was empirical evidence on synergy benefits of keeping retail and investment bank together, and virtually nothing came out of the exercise. I thought it was quite telling, as the argument against structural reform is losing synergy benefits. So we, [ICB] said tell us about them, what are they, give us numbers? Again, very little came back. [Here I pointed to Ertürk’s paper, noting literature and academic studies suggesting little reason for universal banks to remain whole, and he said] that is correct, [and handed me a textbook from a colleague noting the same]” (Interview 6).

It is not that we are to make sense of such contradictions in the report; however, there exists an inherent complexity and difficulty in grounding the report in empirics and correlating this with contrasting statements in interview data. At the very least, it prompts further questions as to why the final report places such emphasis on the benefits of universal banking. The ICB went on to suggest the following, again without a published justification or direct comparison through cost benefit analysis:

“The Commission believes that ring fencing would achieve the principal stability benefit of full separation but at lower cost to the economy”. (ICB 2011, p. 11)

Banks and financial practitioners responded to the ICB’s interim and final reports and in particular to the above point on ring fencing. There were several warnings given alluding to the problematic nature of ring fencing: Barclays plc (2011) noted that ring fencing would reduce competitiveness; Lloyds Banking Group plc (2011) suggested that the proposed ring fencing changes would reduce the availability of credit to the economy; the British Bankers’ Association (2010) suggested that ring fencing would
prolong recovery from recession; and there were moves by both HSBC and Standard Chartered Bank suggesting that they would move their headquarters from London (Vale 2015). Such a move could result in a serious loss of taxable income and employment. Banking firms use these arguments as leverage to reduce regulation at a time when neither HM Treasury nor the Government would have relished having to explain such developments.

Literature also critiques the ICB’s belief in the above ring fencing statement. Bell and Hindmoor reveal three distinct points, drawn from political economy publications which they have summarised: firstly, the hybrid structural reform of ring fencing:

“...will be of little value if, in the event of a crisis, the Government comes under irresistible pressure to bail out an insolvent investment bank for fear of otherwise destabilising the entire financial system”(2014, p.466).

This statement implies that ring fencing retail banks may not secure them from a large economic shock, or indeed the collapse of a giant investment bank either in the UK or in a foreign jurisdiction – contagion and interconnectedness provide significant risk that is not considered fully with regard to their impact on ring fenced banking institutions.

Secondly, and perhaps most pertinently, the banks that have failed post the 2007 crisis, namely HBoS, Bradford and Bingley and Northern Rock, were practising normal banking business, e.g. mortgages, personal loans and commercial property transactions – all of which would fall within the strict ring fence arrangements. As stated above, many of these business activities were heavily involved in the financial crisis and subsequent
securitisation problems with MBS. It is possible, however, to go further than Bell and Hindmoor on this point by suggesting that the ICB has failed to look at the underlying business models of banks and the way in which they interact with return on equity at the micro level of banking business.

Has the ICB understood that retail banks create instability via property transactions (Minsky 1992)? The previous statement from a senior ICB member would suggest this was understood. However, in the case of HBoS, it was also a failure of internal controls, poor executive management and a severe imbalance in the funding process that created a catastrophic problem in the bank’s business model (PCBS 2011, p. 18, para. 48-53). Risk assurance was provided by the group’s audit committee, internal audit, and the divisional credit risk committees, all of which stated that they had found nothing untoward via examining their individual areas and models (PCBS 2011, p. 18, para. 51). So who was in control? Surprisingly, the regulator knew about issues of balance sheet instability, but failed to do anything about it. The FSA was culpable in neglecting to carry out its role as financial supervisor via the light touch regulatory framework (PCBS 2011).

When the credit crunch occurred, the homogeneity in the way banks fund their operations via the London Interbank system created a liquidity shock, and banks held on to surplus capital rather than lending it to the overnight or short term liquidity markets (Brunnermeier 2009). HBoS was unable to access short-term markets to fund regulatory capital, deposits or lending (HBoS 2015). Simply put, the bank had been over-leveraging its balance sheet versus its capital base in an attempt to increase its return on equity to compete and be successful in markets. Higher return on equity means employing more risk unless it is adequately funded with risk weighted equity, a problem that HBoS was pushing in the opposite direction by reducing its risk weighted equity in order to create
even higher returns. Banks were also playing games of regulatory arbitrage in attempting to lay off risk via credit default swaps to reduce their equity buffer even further by only having to account contingently for AAA insurance risk, often via an investment bank, which pushes return on equity higher. Ultimately, this strategy resulted in a call to the Bank of England in 2008 and a request for emergency loans (ELA – emergency liquidity assistance) when markets seized up and the HBoS treasury function was unable to fund the bank’s balance sheet (PCBS 2011).

Subsequently, and coupled with Bell and Hindmoor’s previous point, it appears that neither the ICB nor HM Treasury has considered how this type of risk would be mitigated through ring fencing. These examples in UK banking, which resulted in the catastrophic failure of giant banking institutions, would in all likelihood have still occurred had the ICB’s ring fence been in place. Why were these issues not considered, given that the HBoS interim report was published in April 2011, when the data was available to the ICB?

The third claim is that the ICB’s ring fencing arrangements will be renegotiated through industry lobbying and regulatory capture over time (PCBS 2012 p.43). Some of the more material points that were developed post Vickers, such as electrification of the ring fence via the Parliamentary Commission on Banking Standards, were certainly renegotiated in part. Electrification was recommended due to the notion that banks would challenge the ring fence at some stage. Andrew Tyrie, Chairman of the PCBS, suggested that this process was required and would help to maintain and buttress ring fencing by discouraging banks from gaming the rules (PCBS, 2012, para. 163). Finally the robustness of this case has been negotiated away and the ring fence can only be electrified given certain circumstances. Moreover, CRESC scholars at the University of Manchester have deepened the analysis by outlining the case for regulatory closure rather than capture. A
cultural analysis is developed whereby political actors create storylines to shut down debates such as those over ring fencing or electrification, or narrow them into a frame that allows policy to form around them. It becomes imperative to respond by developing and telling a compelling story in return and thus re-opening democratic opinion:

“....regulatory closure is not the same as regulatory capture of public choice economics where firms seek to capture regulation and selfish, rent seeking special interests usually win at the expense of an indifferent public” (CRESC, 2009, p. 18).

4.8. Close Down and Narrow: a replicated but influential narrative?

Storytelling via political actors in both finance and government has featured in the past. Cultural economy literature, or a cultural political economy approach (see Chapter 3 methodology for detail) allows a study of narratives that can be used to interrogate political spheres of public life such as the ICB’s Vickers Report and its predecessors (Thrift 2000; Du Gay and Pryke 2002; Law 2002; Miller 2002; Jessop 2004; Pryke and Du Gay 2007; McFall 2015). Previous to the ICB report in 2011, there were a number of influential post-crisis reports that developed a form of storytelling via narratives, which can be analysed to spot patterns in approach and to see if a similar trajectory is followed in Vickers.

A typology is offered (Table 2, below) which sets out and analyses important post-crisis reports in an attempt to place the ICB’s Vickers Report into a wider contextual perspective and to explore whether there are patterns forming in how British regulatory transformation occurs. Have previous reports influenced the way in which the ICB has addressed structural reform in Britain?
Post-crisis reports can be divided into two distinct ideas. Firstly, there are reports guided by the idea that banking acts in uncertain ways that had a catastrophic impact upon the financial system. These ideas were founded on the concept of global finance and interconnectedness and the way in which this leads to increased uncertainty and crisis. They favour an intellectual approach that asks what can be done in order to reduce uncertainty or interconnectedness and therefore minimise the probability of financial crises happening in the future. This idea surmises Minsky’s premise that the fundamental issue with banking and finance is endogenous instability, which materialises from within the system itself (Minsky 1992). This approach is geared to reducing the uncertainty of too-big-to-fail, if indeed it is a political decision to keep giant universal banks in place (Crowther and Ertürk 2016). Secondly, there are reports that look upon the problem of crisis and too-big-to-fail very differently. These ideas are founded upon rationalising the importance of banking and finance to the City of London and recognising how crucial a competitive marketplace London is as a hub of global finance. The aim of these reports is to convince politicians and policymakers, via a non party political narrative of ‘constructive contribution’, of the nature of the fundamental issues within the financial system, supported by data and report writing from elite consultants such as McKinsey & Company. This type of rationale is heavily underpinned by the theory of markets and they way they can control the excesses of global finance themselves (Fama 1970). By implication, this narrative was aimed at minimising the impact of regulation and interference via politics that would negatively affect the ability of businesses to function efficiently, create profits and provide taxation in order to assist Government in post-crisis economic recovery. This is described by Moran as ‘corporate bias’ in his discussion on the financial markets revolution in the UK (1991).
The following table sets out four important post-crisis reports, together with purpose, recommendations and a brief analysis: the subsequent paragraphs flesh out details of the impact on regulatory transformation with a view to too-big-to-fail:
Table 2: A Typology of Post-Crisis Reports:

<table>
<thead>
<tr>
<th>Documents</th>
<th>Published Date</th>
<th>Source</th>
<th>Affiliation</th>
<th>Purpose</th>
<th>Key Recommendations</th>
<th>Analysis</th>
</tr>
</thead>
</table>
| Wigley Report      | Jun-08         | Party Political (Conservative) & City Elites | Co-opted    | • Review competitiveness of London’s financial centre                   | • Focuses on capital creation for the UK  
• Flags significant challenge in maintaining current position  
• Points to Elite CEO and firm ability to create enhancements to City performance and national contribution | • Political lobbying via City elites  
• Fails to discuss re-regulation or cause of crisis  
• Establishes narrative of financial contribution to national economy  
• Omits serious debate on post crisis costs and net contribution. Attempts fear approach to prevent re-regulation |
| Turner Review      | Mar-09         | FSA                                         | Technocratic | • Review causes of financial crisis and the regulatory response required to create a stable and effective banking system | • Higher capital adequacy  
• Reform to liquidity  
• UK Bank resolution  
Macrouprudential analysis necessary  
Supervisory approach via macroprudential approach |
| Blischoff Report   | May-09         | Party Political (New Labour) & City Elites   | Co-opted    | • Examine medium - long term challenges to London’s competitiveness in international financial markets | • Promotes vital role of financial services sector to UK economy  
• Comparative UK advantage  
• Points to ongoing global challenges which need capital - environment etc.  
• Integrating international financial services into UK economy  
• Promotes co-operative partnerships government, industry & finance re policy making |
| ICB Vickers Report | Sep-11         | Independent Commission on Banking           | Technocratic | • Reforms to improve stability and competition in UK banking.            | • Macrouprudential regulation by the Financial Policy Committee curb financial volatility  
• Information problems equal supervision can never be perfect so banks are “disciplined” by market forces and robust regulatory framework  
• Ring fencing = structural reform |
|                    |                |                                             |             |                                                                         | • Accommodative ring fencing stance based on co-opted Elite City opinion and requirement for structural reform  
• Call for evidence and ideas regarding banking were largely ignored and not assessed in the report.  
• Ring fencing conclusions not supported empirically in the report |

Source: Author
In analysing reports within the typology, it is interesting to see how they evolve in both time and political space. For this reason this section of the chapter will be approached by addressing the reports in chronological order.

4.8.1. Wigley Report

The Wigley Report was published in June 2008, nearly 12 months after the crisis began in August 2007 (Wigley 2008). Bob Wigley chaired the report, and at the time was Chairman of EMEA (Europe, Middle East and Africa) at Merrill Lynch investment bank. The report contained the views of City elites from across the spectrum of London-based financial business. The data was gathered via interviews and workshops. The people involved included chairmen, CEOs, managing partners, heads of research, heads of investment, executive directors and heads of strategy in sectors such as banks, investment banks, think-tanks, HM Treasury, consultancy, law, insurance, accountancy, pensions and private equity: a total of 62 named practitioners (a non exhaustive list – meaning some did not wish to be highlighted in the report – the list can be viewed at: Wigley 2008, Appendix 1, pp. 47-49).

At this stage in the crisis timeline, banking and the City environment were coming under increasing scrutiny for being the primary source of the collapse of markets and the plummeting in share prices, and for setting in motion what was to become an elongated economic depression. The central aim of the Wigley report was to put forward a case for London being a strong centre of capital creation for the United Kingdom, with the City both a necessary and a significant part of the economic recovery if the Government wanted a firm response to crisis. The City needed to respond in order to temper the rising disquiet and prevent it from reaching a point where a radical departure from the status quo towards re-regulation would be reviewed and recommendations
progressed. The report focuses on the way in which London is a “unique asset of great value” (Wigley 2008, p. 18) and a centre for jobs (exhibit 5) and taxation (exhibit 6) by outlining its contribution to net capital inflows (exhibit 1 and 7) and financial activity compared to other centres such as the United States, Japan, Hong Kong, Singapore, France and Germany (exhibit 2). It also discusses the way London supports top ranking Initial Public Offerings (exhibit 3) and its importance in contributing to UK economy (exhibit 4). The report then tackles London’s competitiveness (Wigley 2008, p. 20) and the way it perpetuates a fear of losing business to foreign climes, leading to reduced taxation and assistance from the City in contributing to economic recovery.

4.8.2. Turner Review

The Turner Review was published in May 2009. The purpose of this critical report was to establish a route to creating a stable and effective banking system. These issues had not been a focus of the Wigley report; moreover, it could be suggested that criticisms of the finance industry were purposely avoided by Wigley and replaced by a deep focus on the functionalism of competition. Underpinning Turner’s report are the theoretical approaches of both Minsky and Borio’s intellectual work (Minsky, 1992; Borio, 2003, 2004, 2009, 2010) on endogenous instability and an emerging framework of macroprudential regulation. These concepts look to manage both business and financial cycles inherent in the financial system itself, and to more effectively mitigate and manage an interconnected and networked economy.

Several important messages are drawn from the Turner report (2009). Firstly, the undercapitalisation of bank balance sheets heading into the crisis is key. Crucially, a low average of between 2-4% Tier 1 capital was available to banks for loss absorbency when the crisis occurred (Ibid. p. 55). However, and perhaps of more significance, there was a
failure to recognise the purposeful maintenance of low Tier 1 capital and capital adequacy ratios which promoted higher return on equity and improved success in markets as being the driver of instability – shareholder value was an inherent and fundamental cog in bank business models connected to systemic instability (See Chapter 5 for details). Secondly, the way banks access liquidity needed reform due to the heterogeneity of agency and market interconnectedness, and when a credit crunch occurs, markets seize up, creating a destabilising event, i.e. banking firms are unable to access funding to balance capital structures. Finally, bank resolution can be achieved by allowing the institution to fail without affecting the taxpayer’s purse – however, not without addressing one of the primary causes of instability that leads to the need for resolution: bank business models (Crowther and Ertürk 2016). Equally important is safeguarding the financial system so the contagion-like response of banking networks witnessed in 2007 is prevented through a structural firebreak. Although an orderly wind-down through loss absorbing debt and diluting shareholder value through resolution instruments can provide additional resilience to small bank runs or domestic economic shocks, this does not go far enough in addressing a major economic shock where the use of CoCos could create an equity fore sale or the taxpayer backstop could be required again after ring fencing is implemented (Baker 2013; 2015; Bell and Hindmoor 2015).

4.8.3. Bischoff Report

The Bischoff report was published immediately after Turner; only two months separate the documents (Bischoff 2009). The timing of the Bischoff report is not insignificant in attempting to influence politics as to how the market should be shaped post crisis. In line with Wigley, Bischoff repeats post crisis tropes; this time the report co-opts New Labour politics and the then Chancellor of the Exchequer, The Rt Hon. Alistair Darling, MP.
The report highlighted London as a continuing economic success story post Thatcher and attempts to justify why a free market is best suited to the City, and without explicitly stating it, why regulatory reform should be avoided. Historically speaking, these narratives were a continuing format from the marketisation of economy under the 1980s Conservative front bench, and they were subsequently adopted by New Labour through Blair and Brown, returning to Cameron and Osborne pre crisis under the Conservatives (CRESC 2009, p.21). The story of ‘strong economy and its social usefulness’ permeates politics through time and space, pre and post crisis, and it became a central focus to which City elites and the Bischoff report responded in light of Turner’s criticisms and response to Wigley. Without reiterating a similar assessment to Wigley above, the Bischoff report pushes the competition and market forces argument again as a preeminent and primary controller of the financial system, rather than re-thinking economic theory or indeed examining how a structural solution through a macroprudential framework may assist. There is a marked resistance to considering the way the City environment acts upon the financial system and shifting the focus back towards the status quo of the pre-crisis period and the free market focus on Britain’s financial service driven economy.

4.9. Epistemic Community and Reversion to the Status Quo

This subsection of the chapter attempts to explain both how and why there has been a return towards the status quo of pre-crisis theoretical understanding of regulation, which creates a continuing framework of response (ICB 2001; Bischoff 2009; Turner 2009; Wigley 2008). CRESC (2009), go further back in the historical reporting of a financial nature, reviewing the Wilson Committee (1980) and the Macmillan Committee (1931) to compare and demonstrate the stark difference in political approach, i.e. involving
heterodoxy. Historically, intellectual input and criticism from voices outside of the mainstream were employed in the review process. In contrast, what is witnessed in recent reporting is an epistemic community-based shaping of regulation observed through long-standing institutional arrangements as discussed above. The concept of ‘epistemic community’ is invoked here to underpin a heuristically informed explanation of the way politically connected groups containing technocratic elites (regulators, prominent captains of industry, senior politicians, Bank of England personnel) craft an accommodative but hybrid structural solution on financial regulation and how a theoretical post-crisis status quo is achieved that is arguably biased towards corporatism.

The concept of epistemic community is well established in politics and policy-making literature. It originates from policy network analysis in British political science (Haas 1992; 2015; Dowding 1995), but rather than being a theory, it metaphorically characterises a shared framework of understanding (Helco and Wildavsky 1974). Richardson and Jordan had used concepts of ‘policy network’ and ‘policy community’ previously, indicating links between civil servants and favoured interest group organisations (1979). By 1982, ‘policy community’ was broadened to capture an institutional based conception, given the idea of communities being distinguished by ‘commonality of interest’ (Richardson, 1982), and later Maloney et al. (1994). Succinctly put, epistemic community is understood as a number of connected groups with a common sense of culture and understanding about the nature of problems and decision-making processes within a given domain:

“There has been no attempt to categorize or formalize the concept [epistemic community] and its uses by providing a typology, hence a relaxed metaphorical usage continues based on characteristics within policy-making arenas” (Dowding,
4.9.1. Emergence of Para-Governmental Organisation

Post crisis, a reorganisation of politics began in terms of the governance of regulatory change and the more serious challenges involved in rescuing the financial services sector. A number of quasi-governmental vehicles were established to manage public administrative business whilst remaining at arm’s length from the politics of everyday government. As discussed above, two vehicles that emerged from this period were para-governmental temporary structures or commissions: United Kingdom Financial Investments and The Independent Commission on Banking, as described above. These vehicles were supposed to be independent, or at arm’s length from government, but were anything but in reality. Senior positions on the committees were filled by ex-City employees or elite technocrats who expressed values inherent within a marketised system alongside a permissive line on how bankers should be treated post crisis (Engelen et al. 2011; Moran and Williams 2011). At a time when Europe was establishing good bank-bad bank structures to resolve underperforming balance sheet assets, the UK government took a different route and encouraged a takeover of HBoS plc by Lloyds TSB Bank plc. Lloyds TSB plc was the only bank that was able to conduct a transaction of such magnitude as it had not felt the same quantum of losses as other UK banks that were involved in subprime debt and CDO securitisations. The takeover made the whole issue far more of a challenge to solve as absorbing HBoS’ balance sheet and its associated losses turned out to be far more significant than outlined at the outset and were not discussed with shareholders to gain consent for the transaction (HoC TC, 2009). UKFI as a quasi-governmental vehicle was designed to steer and manage the stakeholders involved and to look after the taxpayer’s investment in bailed-out banking institutions.
However, in reality, such vehicles normally transition towards accommodative solutions that benefit the City, at least in large part. Recently, UKFI and the Government decided to sell the UK’s investment in Royal Bank of Scotland, at the strike price of £3.30 per share on its total bailout debt of £45bn, which appears unobtainable (Arnold 2016). If banks operating in a market environment are so keen on making 15%+ return on equity, why is a similar return on investment not applied to the outstanding bailed out debt that arose from the taxpayer backstop, grossed up annually and applied to the outstanding debt and repaid in full? This would be the correct approach if UKFI were looking after its shareholders’ interests – i.e. the UK general public, whilst selling the debt and shares off to wealth classes at c. £1.50 per share after the Office of Budget Responsibility wrote down UKFI’s position by 50% for a second time in six months at a total cost to the taxpayer of c. £22bn (Sheffield 2016).

The above are notable examples of the way epistemic communities organise themselves through an apparent control of appearing arm’s length from government, with an aligned management-political interest within a field (Fligstein and McAdam 2012). Epistemic communities operate through temporary para-governmental organisations that close down and narrow debates. Such structures and organisations allow an interpretive description of the way outcomes are managed and controlled. At the very least, epistemic communities accommodate the industry in which there is a deep seated interest of those involved in decision making. A public narrative is portrayed that delivers a requirement or necessity for their actions and often without much in the way of debate supported by empirical evidence, i.e. rhetorical story-telling.
4.9.2. Making Sense of the ICB’s Decision to Ring Fence Retail Banking

The ICB produced another report whilst operating at the level of epistemic community, pursuing a similar accommodative theme as described above. It follows a line of post-crisis reports that accommodate the overarching importance given by the banking industry to the economic strength of the UK and its competitiveness on the global stage. The ICB appears to be making autonomous decisions in steering the ship of structural change in banking firms through choppy waters, giving the impression that the taxpayer is central to the Commission’s concern: however, it comes up short in providing a solution to too-big-to-fail, or indeed in protecting the taxpayer backstop from future impact in the event of a further serious crisis. According to a senior ICB figure:

“I am very comfortable with what we did in the political follow-through, what’s essentially cross-party support from both houses - if anything legislators were pushing for more radical rather than less. We are a few years on now; banks are always going to push back, but I think Andrew Bailey and Co. are very robust now so I simply don’t understand some of the noises in the city the last couple of years. I can see why they are unhappy about the bank levy but ring fencing is a very bad point for them to discuss. It’s dumb, ring fencing is exactly the right thing to have done; even if it was the wrong thing to have done it’s certainly not going to be undone now” (Interview 6).

Importantly, the long-standing epistemic community supporting these aims leads us back towards a risk management culture rather than simplification of the system via full separation and macroprudential control of bubbles and business cycles. Furthermore, there is little consideration of more radical reform of managing ecosystems. Haldane
(2009) does not believe that complex risk management and microprudential regulation can control the financial system. He calls for simplicity in the financial system as “it becomes increasingly difficult for regulators and market participants to vouch for the accuracy of capital ratios and they are no longer verifiable or transparent” (Haldane 2009, p. 4). Members of the ICB have specific epistemic beliefs regarding the way markets operate, based on their collective experiences. It becomes clear that ring fencing accommodates an epistemic belief that markets containing banking firms can be controlled through macroeconomics and microprudential regulation (Basel III), as well as through a hybrid structural reform of ring fencing. This implies that a risk management culture of problematising the challenges of interconnected and networked GSIFIs can be managed through a hybrid response of protecting retail banks. However, as demonstrated above, this is unlikely to have been the case in the past, and would indeed be unlikely in the future, should another serious event occur. Even though Basel III has been amended, experts in this area conclude that Basel is a pro-cyclical system of regulation and could well make the situation worse, as risk weightings in the Basel algorithm will still be arbitrated and manipulated in banks (Blundell-Wignall, Atkinson and Roulet, 2014; Ferric and Persic 2017).

To compound matters further, the suitability of para-governmental commissions as a conduit for change in periods of crisis must be questioned, given the patterns in response exposed over time. Whilst there may have been one or two moderates on the ICB panel who wanted to promote a more radical perspective compared with the hardliners, in this instance the Chair of the committee may have chosen a stance on how to deal with matters of intransigence at an early stage in proceedings in order to comply with a publishing date and establish an agreement to take matters forward to Parliament. Here, the practicalities of accommodation may be significant in terms of the shaping of
reports. It is questionable whether this really is the way forward for such important matters of state, and it may go some way to explain the rather fuzzy edges around the way theory, practice and regulatory transition become misaligned with the crisis event, or in this case solve too-big-to-fail.

4.10. Hall Revisited

In the context of developing this chapter, a problem has been created, albeit inadvertently, regarding Hall’s typology as discussed at the head of this chapter. The explanation and understanding given suggests that third order policy change is not governed by the historic experience of technocratic elites, but by common epistemic beliefs shared among elite groups operating at varying levels of power within political and quasi political institutions. This is to some extent overcome by the third limb in the first order (see Table 1 and undernoted explanation), which deals with the interpretive power of elites over pluralistic accounts. This allows the technocrats some leeway in drawing back from theoretical shifts or indeed the need for an alternative concept, irrespective of how it is dealt with empirically. History suggests that technocratic policy change was dealt with very differently when contrasted to the Wilson and Macmillan reports mentioned earlier and by inviting various stakeholders to the debate and allowing an intellectual conversation to flow. In much the same way as the valuable work the Treasury Select Committee does today (rather than the way the US Federal Reserve manages economic policy via the August 2016 Jacksons Hole meeting and inviting policy advisors who fit the epistemic belief rather than heterodox or critical economists), this at least looks and feels like the correct approach to such an important matter at a time of critical importance. Epistemic community, however, appears to narrow and control the debate rather than open it up to a thorough and frank discussion which may
contain opinion from social reformers. Unfortunately, the above account and analysis suggest that the personnel involved in the process of regulatory change have shared norms with the community in which it sits, and reveal routes that lead back to the status quo process of risk management they prefer. Hall’s policy change typology needs to be addressed and amended to suit the patterns and concepts noted here.

4.11. Conclusion

Attempting to describe technocratic policy change using Hall’s typology post the failure of economic and risk management theory in 2007, demonstrates a lack of coherency between these fields, despite evidence from the 2007 crisis that change was required and prior theory could no longer be justified to underpin empirically driven policy-based decision making. Nevertheless, the conceptual framework is useful in understanding the logic of change; had it been applied rather than through business interests and power, a transition towards macroprudential regulation could have been possible and implemented with ideas to solve too-big-to-fail.

However, when drawing this chapter’s analysis points together, its contribution in 2018, 10 years after the financial crisis, demonstrates how power and influence of technocrats and those with influence that employ the same epistemic belief system revert to the status quo of orthodox economic and risk management theory and mainstream finance interpretation in order to continue a connection between event, theory and empirical data as if no problems inhabit this space or reform is required. Those who influence these processes both politically and technically ignore the possibilities of solution and reform. Settling for political and market expediency through the promise of building resilience is preferred through overly scientised theory which has since been roundly criticised in the heterodox fields of economics and business management.
literature.

Trying to understanding and explain what has occurred using Vickers and technocratic policy change leads us towards a disordered, muddled and at times confused perspective and way forward. The once heralded and well trodden path of connecting theory, data and empirical result appears to have been cast aside. What appears from the disorder is political expedience underpinned by little more than failed theory. In the past, failed theory would have been replaced through heterodoxy and a wider base of viewpoints having a genuine place at the table of change. Instead, the wider and critical perspectives were sidelined with the appearance of selected personnel and quasi committee’s that listen to a narrow range of ideas that can be assembled in an incoherent way, supported by politics of the treasury and Westminster. The critical viewpoint is discounted without establishing a detailed analysis or discussion in published reports such as Vickers as to why this occurred. Applying this strategy has brought about significant criticism in the aftermath of regulatory change.

The argument developed here is for the disruption of technocratic policy change and its management controlled through quasi-political and temporary commission based decision-making. The establishment of a politically and business independent vehicle to decide on regulatory transition is important. Without substantiating or evidencing its case empirically, the Vickerscommission recommended an accommodative stance, a hybrid structure of ring fencing, which is unlikely to have captured key elements of the crisis in retail banking or microelements of the way banks are funded and mismanaged. Indeed it is arguable whether this is building resilience in the system never mind a solution to too-big-to-fail.

Importantly, the shaping of regulatory transition by the epistemic community or independent commission based mechanism has the means to steer its recommendations
back towards the same economics and risk management theory that was dominant position pre crisis, despite critical literature from academics, BIS, OECD and numerous think tanks. There is little in the way of published empirical evidence as to why Vickers takes an accommodative stance, adopting a hybrid structural change in ring fencing and pushing regulation back towards a scientisation of risk that interconnects with exogenous macroeconomic control and the Basel framework. This has significant problems, which even the Bank of England’s senior FPC members such as Haldane have noted. Consequently, in 2018 and moving forward, independent commission based vehicles are not the best route to conduct this type of enquiry, given the epistemic community at work and a retrenching backwards in terms of mainstream finance theory re-taking control.
Chapter 5. The limits of regulatory reform: has the reform of UK post-crisis bank regulation been too limited?

5.1. Introduction

This chapter examines Research Question 2: has the reform of UK post-crisis bank regulation been too limited? The central thrust of this work is to look at the limitations and post-crisis challenges of banking risk and the way this impacts banks. A description of regulatory transformation is offered through an ethical and technical framing of the post-crisis period, whilst drawing upon risk management and financialisation literature. This chapter will be split into two distinct sections. Firstly, a brief political introduction heads the debate, asking a simple question: why did the regulatory state transform policy in most areas of economy but omit the powerful City of London and leave it deregulated? This leads into the ethical framing of regulation, asking what has occurred as a result of a self-regulated or a self-steering system. Secondly, a technical framing develops through analysis of Basel III and its microprudential framework. Here, particular reference is made to capital adequacy, risk weighted assets and the question of whether this approach has distinct limitations. There is a distinct temporal logic in how the Basel material is presented in the latter subsections of the chapter. It is necessary to unpack how the Basel Accords have developed over time, both pre and post crisis (predominantly), in order for the reader to understand the series of significant technical problems that have occurred, and how the regulators have responded. The research asks to what extent has regulatory reform been too limited?
5.2. Ethical and Technical Frame

Through an immediate requirement for financial stability, the UK regulatory response attempted to tackle the ‘technical’ impacts of crisis first. There then followed a series of significant unethical banking industry practices that required an ethical response via legislation. The ethical framing through legislation point towards how important ‘soft law’ became in post-crisis regulatory debate. By the term soft law, we determine a set of legal responses that have a binding force as either Acts of UK parliament or decisions by regulatory bodies, but are somewhat weaker than law that prevents or solves a problem regarding the impact and effect banks have in regulating their ongoing behavior within the financial system. A starting point is to describe what is meant by ethical and technical. Firstly, the ‘ethical’ framing refers to the legislative response, via the Banking Reform Act 2012, which was an attempt to tackle problems such as the Libor scandal and similar phenomena such as Payment Protection Insurance. Secondly, the ‘technical’ framing focuses upon the microeconomic (the way banking firms behave) and microprudential (the resilience of bank balance sheets to shocks) elements, in this case, the response of Basel III regulation. In observing post-crisis regulation within these frames, a critical debate unfolds that grapples with regulatory responses and connects this with the continuing challenges at the ethical and technical level of response.

5.3. Regulatory State and Policy

As Hancher and Moran inform (1989), it is best to see regulation and deregulation as comprising two separate processes: (i) changes to the structure or rules embodied in regulatory systems; and (ii) disturbances to the stability of those systems due to the inability of system ‘governors’ to function effectively. Rule change within regulation usually transitions through three actions: (i) cancellation, (ii) substitution, and (iii)
systematisation (Ibid. p.130). These can be expanded as follows: (i) cancellation or abolition is a rare event; rule substitution is a commoner process: a rule is replaced by one that is narrower; and systemisation involves cancellation through repealing out-dated or unused statute or pruning sets of rules that are unnecessary complex. After the financial crisis of 2007, which brought about disequilibrium and instability in the global financial system, a political project began that attempted to pin a convincing label on the transformation and substitution\(^\text{18}\) of financial regulation in the UK.

The United States operates a hierarchical command and control-like regulatory system (Moran 1991; Majone 1994). By contrast, and until 2013, the UK was identified by the “uncoupling of government from regulation and operated a system of self-steering” (Moran 2002), or self-regulation, otherwise described as politically sponsored light touch regulation in finance (Engelen et al. 2012) via the Financial Services Authority (FSA) (Zimmerman 2009; Lodge and Wegrich 2011; Tomasic et al. 2010). Whilst banking is not a public business, it is a regulated business with a public interest. The City of London’s exceptionalism is considered to be its avoidance of the great command-like changes in public policy-making and policy-delivery summed up in Hood and Dixon’s study of New Public Management (1991). According to Power’s compelling account of audit explosion (1994b) the City also avoided governance as a reaction to ‘club government’ and an ambitious system of corporate surveillance via reconfiguring institutional form into inspection bodies to manage risks in financial firms. Neither of these ideas transformed financial regulation in the City of London. A simple question arises as to the impact self-steering or light touch regulation had on banking.

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\(^{18}\) ‘Transformation’ meaning new regulations or new elements of regulation and ‘substitution’ meaning amendments to current regulation.
5.4. UK Banking Regulation Post-Crisis

August 2007 marked the beginning of the global financial crisis and a different approach to the way UK banking regulation is managed both politically and technically. In order to give a wider contextual view of the post-crisis environment, this subsection will first discuss the highlights of post-crisis regulatory transformation. To emphasise the sheer scale of financial regulation that has developed in banking, several important topics will be reviewed. How this transformation is connected to various market events is discussed in order to advance an alternative perspective around the impact of regulation using the ethical frame discussed above. The central and perhaps most crucial task is to develop a line of enquiry that asks whether the reform agenda has been too limited.

5.4.1. Regulatory Transformation Landscape

There have been numerous transformations to financial regulation during the post-crisis era. Technical Basel reforms were underway pre crisis, with a time lag of approximately four years between the crisis and the ethical response beginning in 2012. Ethical responses will be addressed first. In contrast to the technical regulatory response, the ethical type came later in Britain via statute and the 2012 Financial Services (Banking Reform) Act. This legislation was a direct attempt to re-establish trust in financial systems after the Libor rigging scandal. Libor was the subject of review by Martin Wheatley, Managing Director of the FSA, in 2012 (Wheatley 2012). The report generated several policy recommendations in respect to Libor processes rather than addressing allegations of wrongdoing or culpability at the personal or firm level. Regulators progressed these issues afterwards, with some differences depending on the respective jurisdiction involved. The Libor response was, of course, one of a number in the legal framework. Examples of other responses include MiFID I and II (2007 and
2010 – Markets in Financial Instruments Directive), European Union responses that are incorporated into UK law and manage the behaviour of bank employees whilst conducting business in shares, bonds and unit collective investment schemes and derivatives. There have also been other amendments in Europe such as MAD I and II (Market Abuse Directive); however, the UK has opted out of these arrangements.

5.4.2. Libor

Initially, the UK ethical response was aimed primarily at two market events. The 2008 Libor scandal emerged shortly after the financial crisis. Libor was a conspiracy-type rigging of the referenced interest rate (Wheatley 2012) used by banks to fund sterling based lending and nearly all derivative trades\(^\text{19}\) – this market is important as it is estimated by Bloomberg at over £300 trillion in contracts (Finch and Vaughn 2018). Banks also use the Libor interest rate to borrow and lend money to each other in order to cover balance sheet positions and support various types of transactions (e.g. funding large syndicated loans and structured products such as securitisations), and it is used as a variable in the calculation of the interest that the bank passes on to its customers. In summary, individuals at several large banks, including Barclays, Royal Bank of Scotland and Lloyds, manipulated interest rates (Wheatley 2012) where they required it to be in order to keep institutional borrowing costs within defined parameters. The strategic purpose of the manipulation was fourfold but interconnected: (i) to make bank balance sheets look healthier, (ii) to maintain the ability of banks to raise funds at cheaper rates, (iii) to keep the majority of customer transactions in profitability for the bank, and (iv) to prevent the banks from further losses post crisis should the interest rate move against them (MacKenzie 2008; Koblenz et al. 2012; Ashby et al. 2012;

\(^{19}\) See Mackenzie (2008) for detailed description of how the process of Libor operates.
McConnell 2013; Ashton and Christophers 2015). For banks, this polarised tactic of defending their balance sheet whilst attacking rates to maintain a manipulative influence over income was important. Any material interest movement affecting the funding rate can erode the profitability of fixed rate or base rate transactions conducted by the bank, and if the rate can be manipulated in the right direction via cartel-like behaviour, the bank can increase profitability, which in turn affects its return on equity. Another important element of the Libor scandal is the remuneration of traders involved in the rate setting. Traders’ bonuses were stapled to metrics that moved the bank towards safety and profitability, but not through employee cartel manipulation. The outcome was an attack by executives on the traders’ bonus pot, which contributed towards the large institutional fines levied at banks involved (Thompson and Jenkins, 2013). The British Bankers Association was stripped of its role in governing the Libor rate setting process, as it was “careless in policing the process, and the system did not have the required checks and balances in place” (Wheatley 2012; Wells 2013, p.28).

The individuals and traders involved in the process of setting the daily rate conspired with each other via trader communications in the course of their daily employment and when socialising after work (Wheatley 2012). The rate is set by auction process and takes the average bid for money by the banks involved, allowing for the removal of outliers either side (Rebonato 2002; MacKenzie 2008). Libor traders conspired via a cartel-like arrangement ahead of the auction and organised ‘low or high ball’ bids in order to skew the rate in their favour (FSA 2013). There were several concerns raised by the Bank of England and external firms over Libor submissions (FSA 2013, pp. 19-25). These concerns were not addressed despite being communicated widely, which leads to a concern that regulatory oversight was being managed too narrowly. Consequently, traders may have been committing fraud via the Libor
submission system, and criminal acts were observed through individual taped conversations and online messaging, usually through Bloomberg terminals. These communications highlighted that the traders were well aware of what they were doing in rigging the rates. An example of a typical conversation is a trader at Barclays calling a trader at Bank of New York:

“Hi guys, we got a big position in 3m Libor for the next 3 days. Can we please keep the fixing at 5.39 for the next few days? It would really help. We do not want it to fix any higher than that. Tks a lot” (The Telegraph 2012).

Tom Hayes was given a fourteen-year prison sentence after earning £4.8m in salary and bonuses at UBS and Citigroup from 2005 to 2010 (Topham 2016). Hayes claimed that he was operating within grey areas and that he had no prior compliance training – he believed he had done nothing wrong. Claims were made at trial and evidence was presented involving unethical bribing of traders with cash, football tickets and restaurant trips. The convicted stated that his managers – up to and including the CEO – were aware of his behaviour, implying institutional unethical behaviour (Dakers 2015).

The regulatory landscape from an ethical frame changed post the Libor scandal. It was clear that self-regulation and light-touch supervisory oversight no longer formed the correct approach, and tighter and more transparent regulation was needed over the rate setting process and the way traders conduct themselves, with the correct checks and balances in place to prevent abuse for either institutional or trader benefit. Whilst the Libor scandal awoke the regulatory imagination in terms of how to manage such challenges in the post-crisis era, what followed was a series of scandals that arose through a free self-regulation, light-touch model.
5.4.3. Payment Protection Insurance

The second important event to prompt an ethical response was the PPI (Payment Protection Insurance) scandal, which concerned the mis-selling of insurance to bank customers. The mis-selling of banking products was reviewed by the House of Commons Committee on Public Accounts (HoC CPA 2016). The practice and process of PPI describes customers taking out loans or credit facilities with the bank and subsequently being offered insurance in case of unfortunate but specific events transpiring: redundancy, sickness or infirmity, or loss of regular income. In a change of business model in which banks originate transactions for fees and distribute risk rather than keep risk on balance sheet to avoid attributing regulatory capital – ‘originate and distribute’ (Crotty 2009) – bank employees became a sales force in retail, corporate, structured finance and sales consultancy in investment banking. In retail banking, employees were not trained appropriately to be selling insurance based products, but were targeted via the balance scorecard to hit sales figures and continuously mine the customer database for opportunities – customers perceived that they were being mistreated by bank staff in a survey conducted by ‘Which’ that was submitted in evidence to the House of Commons Banking Standards Committee (2009, line 32 in written evidence). This type of revenue was commonly referred to as cross sales income and did not require regulatory capital – an efficient way of increasing returns by optimising the blend of income through ‘capital management strategy’, according to Babel et al. at McKinsey and Company (2012). This was attractive to the bank as it was recognised as income from fees, which, short of minimal cost to be deducted for overhead and salaries, flowed through the bank’s income statement directly to profit, thus increasing return on equity and share price far more efficiently. Another important point related to mis-selling is the failure of retail bank
employees to inform customers of terms and conditions when selling insurance products – the small print is often complex and there can be important omissions that need careful explanation (Banking Standards, 2009, ‘Which’ Evidence, line 28). Given that most customers were not financially sophisticated and did not have in-depth product or market knowledge, this became a sizeable mis-selling problem.

In corporate banking, insurance was contracted with SMEs (small and medium sized enterprise customers) and was often bolted on without conversation and assumed to be part of the package. Many customers signed these contracts without being aware of the bolted on insurance. The banks incorrectly assumed that SME customers were sophisticated enough to realise both the risk of and reward for taking such insurance protection. These products ranged from interest rate hedging instruments to the occasional sale of more complicated interest rate swaps that were totally inappropriate (FSA 2012). Banks were interested in making fees from this type of transaction to increase fee-generated income without significant capital cost or impact on regulatory reserves. Again, these events are important and are closely tied with the way banks behave unethically in the financial market place, how they are managed and how employees conduct themselves in the ordinary course of everyday life in a bank.

The subsequent legal and regulatory response has been to promote active ownership of a risk and control framework in banks and across the finance industry (Kaminski and Robu 2016). All banking personnel who face customers and sell regulated products have tailored programs for the type of role and products at issue. The training usually comes in the form of qualification or compliance assessment and testing. The majority of bank staff will be tested monthly on elements of compliance (security, data breach, confidentiality etc.), which underpins the new risk culture in banking and attempts to mitigate further damage of this nature by measuring the competence of staff around
material risks.

5.4.4. Interest Rate Hedging Products

In 2012, another scandal hit banking via the mis-selling of IRHPs (Interest Rate Hedging Products), a type of derivative product, by nine British banks. Examples of such products include structured collars, caps and swaps. These products help customers to mitigate the risk of interest rate movement. IRHPs were sold en masse to unsophisticated clients not trained in treasury management or sophisticated methods of managing interest rate risk. Banks sell these products to customers so that debt, interest and cash flow of the business can be managed within known parameters during the contracted period of financing. In theory, this allows companies to mitigate risks and keep a business from experiencing underperformance, stress or default. For example, a collar product can assist customers if rates fall, whereas caps protect customers if rates rise and swaps help when customers are trading across currency borders and wish to swap income or debt in one currency to another to maintain comparative advantage. Customers also take risks on the way in which markets will move, and take contracts out to make money from the movement alone – also known as contracts for difference; most banks do not engage in this practice in itself, but it can be packaged with other offers or products. These financial instruments can also be mixed, so a cap and collar can be integrated, for example: depending on what customers are trying to do or opinion on which way interest rates will move over the period concerned, the bank can make deals cheaper by offering the cap if customers will sell the collar rate within the same transaction. This means that the customer is protected if rates rise; however, if they fall below a specified contracted rate

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20 The banks involved were Allied Irish Bank (UK), Bank of Ireland, Barclays, Clydesdale & Yorkshire Banks, Co-operative Bank, HSBC, Lloyds Banking Group, Royal Bank of Scotland and Santander UK. See BoE FCA website for detail: Available at: [Cawson 1985](https://accessed 13 December 2015).
then the customer pays the difference to the bank.

If the underlying financing to the IRHP is sizeable, such as a large syndicated loan involving thirty to forty banks, and the lead arrangers of the transaction supply interest rate management products, it can mean a significant increase in the risk adjusted return on equity for the bank in that particular transaction – crudely put, fees drop to the bottom line free of material funding cost and raise equity returns efficiently. The importance of this account and explanation rests on the detail and complexity of these transactions and to whom they are being sold. If IHRPs are sold to Chief Financial Officers or Finance Directors who are trained accountants and have experience of treasury management within mid to large size corporations or limited companies, then knowledge of IRHPs can be assumed. However, as has been the case with the majority of British banks, this type of complex product has been sold to unsophisticated customers, such as small businesses or SMEs, which have little need, knowledge or experience in these matters.

Banks were overly keen to make fees from selling IRHPs, premising this on relationship trust between bank and customer. Trust was mismanaged to increase return on equity. Even in the corporate world, where company officers are trained executives or accountants and are knowledgeable about risk based products, banks were selling IRHPs stapled to structured loans (common in structured finance legal documentation), so the business was asked to take the insurance product whether it wanted to or not – the bank thought the firm a better credit risk if the customer took the protection. IRHPs, underwritten for a significant fee, formed part of the company’s risk mitigation profile within the bank’s credit risk assessment exercise. Risk mitigation underpinned the bank’s approval to financing and supported its strategy. Moreover, the bank persuaded its customers that it was even more important to take IRHPs on transactions of a high-risk
nature, leveraged or structured loans and repayment of the same through cash flow based models. Products associated with the business’s cash flow, such as IRHPs, were described as essential to mitigate market risk and manage cash flow and repayment of facilities. Moreover, the customer had no choice about where to buy the insurance, and the lender’s behaviour was anti-competitive as the insurance was part of the package at a price the bank wanted to charge, often after the competitive process of arranging the loan between other institutions had fallen away. The transaction was often subject to taking risk mitigating insurance which has the effect of increasing the bank’s return on equity. This example contributes to an emerging illustration of the way banks use financing, risk modelling, credit assessment and enforced anti-competitive cross-selling strategies to enhance risk adjusted returns and how these metrics encourage positive share price performance in competitive markets. Often, when the risk adjusted return calculations were completed, the financing income alone (i.e. loans or debt) was not enough to overcome the internal risk-adjusted hurdle rates to approve the transaction. Without cross sales income from IRHPs, PPI and numerous other products sold by the banks, risk adjusted return hurdles were not possible given the increase in regulatory capital for the debt banks kept on balance sheet. It was the mis-selling of products through cross selling and the fee this produced (pensions, factoring, insurance, hedging etc.) that enabled the total financing package to progress through processes of underwriting, syndication or bilateral transaction, depending on the nature of the deal.

5.4.5. Fines and Claim Payments

How has reformed regulation and legislation addressed unethical behaviour in banking institutions? The way unethical behaviour within banks has been addressed is primarily through fines from the regulator and repayments to customers in an attempt to encourage
senior management of banks to promote an ethical culture in banking communities. To place these unethical scandals into perspective, Libor fines run into several billion pounds for the biggest UK high street banks involved, with major settlements still to arrive from regulators, although Barclays and HSBC took a balance sheet provision for the eventual fine with £1.25bn and £1.2bn entries respectively (Treanor 2015). The Financial Conduct Authority responsible for PPI reports claim payments to customers of £37bn from 2011 to July 2016 and the number continues to rise month by month (FCA 2015a; 2016a; 2017a). Both Lloyds and Royal Bank of Scotland have been fined in the region of £500m for mishandling PPI claims (Elliott et al. 2010). The regulator agreed with banks that they should investigate IRHP conduct going back to 2001. To the first quarter of 2016, IRHP mis-selling has resulted in the sending of over 18,000 redress determination letters to customers and a total of over £2bn in redress being paid out along with a further £450m in consequential losses (FCA 2016b)\textsuperscript{21}.

Fines and repayments to customers have had a negative impact on the performance of banks in markets. It is not certain, however, whether this alone has been a compelling enough ethical response to curtail the behaviour of banks and employees when the gains, benefits, and bonuses are so material that risks remain worth taking. “As both Rajgopal and Shelvin (2002) and Sanders and Hambrik (2007) have indicated prior to the crisis, the pursuit of higher share prices connected with incentives lead some managers to seek maximising their personal gains and disregard risk to shareholders” (Tse

\textsuperscript{21} There have been a number of other smaller scandals not covered in this section of the chapter that continue to point at unethical behaviour in banks despite regulatory supervision and warnings, legal redress, continual fines and media attention. Notable amongst these smaller claims are money laundering at HSBC which led to $1.9bn in fines by the US regulator and £28m by the Swiss regulator in its private bank in Geneva: please see: Mollenkamp and Wolf (2012). In addition, Barclays was fined a further £72m for handling financial crimes risk inappropriately in November 2015. Barclays, however, was given a 30% discount for early stage I settlement and admitting to acts and omissions involved – suggesting that the FCA approves of discounting, like a plea bargain, which rewards better profits, stock price and stress testing rather than being punished or to promote improved future behaviour. Please see: FCA (2015c).
2011, p.55). Unequivocally, Hillman notes that bank fines are ineffective in disciplining banks and correcting culturally embedded issues (2013). Hillman claims regulators should target enforcement at the individual level, which happened in the case of Tom Hayes, yet scandals reoccur and fines continue.

5.4.6. Legislative Response

The Financial Services (Banking Reform) Act 2012 is a statute-based response to the unethical behaviour witnessed in the above series of scandals. The FCA wanted to impose higher standards of conduct on banks via legislative reform. Its objective was to place customers and their needs at the centre of the banking model. The FCA prefers that profits and banking business flow from providing a service to customers. However, bank shareholders, executives and those with powerful business interests prefer to maintain the status quo of the shareholder value model versus the stakeholder value model (Freeman 1994; Smith 2003; Sundaram and Inkpen 2004; Danielson et al. 2008; Hellwig 2010; Engelen and et al. 2011). Proponents of shareholder value in literature suggest that 2007 was more of an accident in the financial system and that the shareholder value model should be continued. Additionally, stakeholder models that would capture customer focus are not well designed or thought out and are unable to compete with shareholder value. Opponents in literature suggest that stakeholder models are far more inclusive, redistributing wealth from finance more evenly, and claim that shareholder models are defective and require a redesign that would include fairness to customers, a focus of the FCA. Noting these tensions, has legislation been a successful approach?

Standard and Poor’s claims that banks wish to avoid large regulatory fines that impinge upon stock market performance and create additional bad publicity whilst attracting unwanted media attention (Titcomb 2015). Crucially, banks have changed
operations internally in response to regulatory fines. They have paid attention to the FCA and PRA narrative and have tightened sales processes and strategy and bolstered risk appetite frameworks. Banks have increased both the tone and significance of internal compliance based training, and risk audit teams are more visual in the process of business and decision-making. Compliance, as a business unit within banks, has witnessed significant growth, highlighting the importance of satisfying the regulator with evidence that banks have customers in the forefront of their mind if not in their business model. McKinsey (2012, p.2) notes that “banks should see the review of compliance and control as an opportunity to articulate clear expectations and behavioural guidelines for their employees and to define the quality and integrity of products and services they offer to their customers”. There have also been efforts via compliance design of Know Your Customer policy (KYC), to tackle functional controls around customers, such as legal, bribery and corruption controls, anti money laundering safeguards, the 1970 Bank Secrecy Act and information or data security. As customers are not central to the bank business model, however, the cost to the banking firm of implementing these resources is significant as it impacts return on equity and market performance, which leads back to the shareholder value model again. Bank executives focus on how to minimise fines and the impact this has on the bank. For example, on-boarding and annual checking of customers via KYC and AML is completed more effectively and efficiently by banks now, which has been problematic in the past, as the sheer size of this operation across banking has created a cottage industry in the eyes of investors (Kaminski and Robu 2016). Care must be taken by regulators to ensure that banks are not paying lip service to a growing risk management culture and regulatory solution. It is argued that there is a lack of institutional knowledge of crisis and associated phenomena within senior management and executives in banks. Knowledge should form an important part of the solution, particularly around
risk management (Holland 2010). However, have these regulatory responses been enough?

It is worth spending time here to explain the calculative accounting relationship between fines and the way this impacts shareholder value. In the UK, the FSA investigates a wide range of misconduct issues (from failing to file reports, to inadequate money laundering or the more publicly focussed mis-selling), and makes announcements to the market regarding the firms involved and the level of the fine, all in one movement. Fines are a cost charged to a firm’s profit and loss statement, debiting profits; this flows through and crystallises as a negative movement in the cash flow statement, meaning that there is less money to service business costs, or to pay dividends, buy back shares or reinvest in the business as capital expenditure. Armour et al. (2017) state that accounting is not the correct measure to evaluate the impact fines have on shareholders. The fine is not direct or indicative of the loss to shareholders. The 43 post-crisis enforcement cases between 2001 and 2011 produced an average negative multiplier of 1.43x on the banks market capitalisation, equating to c. 9x the size of the fine. The market appears sensitive to the FSA’s action on fines, illustrating the reputational damage these actions have in the market.
Table 3: Top 20 Global Banks: Total Fines 2008-2016

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>BAC</td>
<td>46.13</td>
<td>44.59</td>
<td>1.00</td>
<td>45.59</td>
<td>100.29</td>
</tr>
<tr>
<td>JPMC</td>
<td>17.11</td>
<td>30.84</td>
<td>2.79</td>
<td>33.63</td>
<td>58.65</td>
</tr>
<tr>
<td>MS</td>
<td>22.81</td>
<td>11.48</td>
<td>12.89</td>
<td>24.37</td>
<td>49.33</td>
</tr>
<tr>
<td>RBS</td>
<td>3.20</td>
<td>10.48</td>
<td>11.03</td>
<td>21.51</td>
<td>26.07</td>
</tr>
<tr>
<td>LBG</td>
<td>5.86</td>
<td>16.87</td>
<td>3.60</td>
<td>20.47</td>
<td>29.71</td>
</tr>
<tr>
<td>CITI</td>
<td>11.31</td>
<td>15.46</td>
<td>2.04</td>
<td>17.49</td>
<td>30.75</td>
</tr>
<tr>
<td>JPM</td>
<td>2.04</td>
<td>17.43</td>
<td>2.57</td>
<td>17.05</td>
<td>27.12</td>
</tr>
<tr>
<td>BARC</td>
<td>3.28</td>
<td>6.78</td>
<td>6.64</td>
<td>13.42</td>
<td>17.36</td>
</tr>
<tr>
<td>HSBC</td>
<td>4.09</td>
<td>8.50</td>
<td>2.89</td>
<td>11.39</td>
<td>17.66</td>
</tr>
<tr>
<td>WFC</td>
<td>3.91</td>
<td>9.38</td>
<td>1.46</td>
<td>10.84</td>
<td>18.57</td>
</tr>
<tr>
<td>GS</td>
<td>3.77</td>
<td>9.25</td>
<td>1.46</td>
<td>10.71</td>
<td>14.76</td>
</tr>
<tr>
<td>BNP PA</td>
<td>1.76</td>
<td>7.39</td>
<td>2.93</td>
<td>10.32</td>
<td>12.22</td>
</tr>
<tr>
<td>CS</td>
<td>2.72</td>
<td>4.55</td>
<td>3.93</td>
<td>8.48</td>
<td>11.46</td>
</tr>
<tr>
<td>UBS</td>
<td>24.88</td>
<td>4.06</td>
<td>2.59</td>
<td>6.65</td>
<td>32.66</td>
</tr>
<tr>
<td>NAB</td>
<td>1.86</td>
<td>2.40</td>
<td>1.12</td>
<td>3.52</td>
<td>5.84</td>
</tr>
<tr>
<td>SAN</td>
<td>3.04</td>
<td>1.90</td>
<td>0.56</td>
<td>2.46</td>
<td>6.09</td>
</tr>
<tr>
<td>SOC GEN</td>
<td>1.44</td>
<td>0.50</td>
<td>1.90</td>
<td>2.40</td>
<td>3.85</td>
</tr>
<tr>
<td>CBK</td>
<td>1.07</td>
<td>1.61</td>
<td>0.29</td>
<td>1.90</td>
<td>3.09</td>
</tr>
<tr>
<td>SCB</td>
<td>0.33</td>
<td>0.83</td>
<td>0.08</td>
<td>0.91</td>
<td>1.66</td>
</tr>
<tr>
<td>ING</td>
<td>0.49</td>
<td>0.61</td>
<td>0.30</td>
<td>0.91</td>
<td>1.86</td>
</tr>
</tbody>
</table>

Source: Data CCP Research Foundation (2017), information and table adapted by Author

It would be making a leap to extrapolate from the same multiplier to the total conduct costs 2008-2016 of £464 billion for the top 20 banks, or £96 billion for the four UK banks listed in 4th, 5th, 7th and 9th place respectively: RBS, Lloyds, Barclays, HSBC (see Table 1); however, it certainly indicates why bank executives needed to pay attention to fixing the fines and is something to which shareholders need to apply market discipline. Another £19bn in UK fines was forecast through to 2017, covering all unethical practices, including Libor and PPI.

Banking reform legislation was attempting to promote correct ethical behaviour underpinning a strong centralised long-term customer relationship central to a bank’s
culture. With such a relationship in place, the bank supports the needs of the clientele from which its profits and returns are connected. The banking sector appears to have misplaced this important connection in its business model, placing profits, cash flow, and delivering shareholder value front and centre, despite the trite and somewhat infelicitous rhetoric in customer literature that attempts to reinforce the importance of customer relationships. The reframing of business model by the regulator from the priority of return on equity and the shareholder value to one focussed on a customer centric approach would likely demonstrate a reduction in regulatory fines. Fundamentally, what has actually been observed is a reactionary risk management response connected to the imposition of fines with senior bankers complaining that the costs are too high (Kaminski and Robu 2016). Consequently, a knee jerk reaction takes place, along with a wholesale expansion of compliance departments, which drives a change in ethical behaviour but arguably for the wrong reasons. Largely, the response to fines is financially driven, through the concept of shareholder value and its effects on returns rather than through a change in ethical behaviour by banking institutions, including putting the customer first. The narrative from management consultants involves improving risk management culture in banking and reducing costs through efficiency drives (Babel et al. 2012). Other consultants pitch assistance to both “public and private firms in developing sustainable compliance and risk management programs to manage, monitor, exploit and identify risks which through process and technology can improve effectiveness and manage costs” (Deloitte 2017). There is no discussion about customers. The priorities of purpose and outcome seem to be misaligned but continue playing to the financialisation of banking.

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22 There are competing views here. Phillip Augar presented this viewpoint in a recent conference on Banking Culture at the British Academy (27th April, 2018). Martin Wheatley, in his response, disagreed in part, as it is clear banks have made material profits without customers featuring in any way central to a bank’s business model. Why do banks need to make business model changes if all that is required is to tighten processes that reduce regulatory fines?
business and the forces of shareholder value on the banking model. This is the central reason for addressing and realigning banks’ market-based incentives rather than hitting banks with fines and ineffective statute which they will circumvent via innovation, arbitrage, and bricolage methods assisted by external consultancy (Engelen, 2010 and 2011).

Have lessons really been learned from the crisis and the way regulation is being reformed? Arguably, the response has been too limited and ineffective when contrasted with the regulatory objectives under which long-term customer centric models become the norm and a new culture in finance is developed. Following the above 2016 fines imposed on Lloyds, a further charge of £117m was levied in August 2015 for unfairly mishandling PPI claims, this after the bank had been instructed to make the process more efficient (FCA 2015e). The FCA has extended the deadline for accepting PPI claims to August 2019 (FCA 2018), although analysts suggest that the worst is now over for UK banks (Cobley 2017), with Moody’s also confirming that the majority of legacy litigation issues have been resolved (for example, US banks with retail mortgage backed securities, Deutsche Bank with Russian Mirror Trading, Barclays’ disclosure problem with its 2008 rights issue). With higher regulatory capitalisation, the credit reference agency suggests that it is unlikely banks will have on-going problems with fines impacting performance at lower levels (2017). British banks are expecting to provide additional money against losses associated with the PPI deadline extension. Lloyds put aside a further £710m to support customer claims in 2017; however, as the FCA states, the bank has improved its claims handling process since the fine noted above (FCA 2017). The continued unethical behaviour of banks supports the above evidence and viewpoint that banks are not taking the regulator seriously in placing the customer central to their business models. It appears that some banks are not treating regulators and the legislative response appropriately as
they continue to display unethical behaviour. Fines do not seem to be creating a new culture in banking, nor indeed has this type of punishment encouraged change in bank business models via a customer centric focus. If the legislative response has a limited effect through impacting the financial performance of the business alone (and with a deteriorating effect from 2017 onwards), then what alternatives are available for the regulators to focus on?

5.4.7. Alternatives

What kind of alternative solutions would encourage firms to change their behaviour and adopt an ethical banking culture? Connecting regulation with the board and employees at divisional level may prove more successful. Questions should be asked as to whether this alternative is enforceable in large organisations of, say, 100,000 employees – can an individual CEO be criminally liable under Section 36 of the UK Financial Services (Banking Reform) Act 2013 (up to seven years’ imprisonment and unlimited fine) under criminal terms of strict liability? This appears unlikely after the crisis, given the reduced potential for serious breach of legislation several years post event. Attempting to find personal culpability within the firm or finding evidence of wrong doing in terms of CEOs being vicariously liable for employee actions is particularly difficult. Connecting the criminal act with knowledge of criminal practice at boardroom level is a challenging burden of proof post event or with any unethical practice. Although the FCA and PRA can act under the 2013 Banking reform Act, it appears that even with strict liability rather than ‘mens rea’ (guilty mind) or ‘actus reus’ (guilty act) culpability or fault, the regulation lacks teeth both in terms of having limited application and as a way of capturing a deeper level of responsibility and accountability to assist the formation of a new culture. Of course, CEOs have the responsibility to establish and implement the
appropriate measures and processes to ensure that employees are knowledgeable of what is expected of them in terms of behaviour and that they know the law and potential consequences should they be found guilty of breaking regulation. The alternative for banking regulatory reform is to make those managing firms at board level, or CEOs at divisional level, liable for the behaviour of people working within banking institutions. Embedding personal responsibility within the banking sector, rather than concentrating on financial firms alone, has been a keen focus of the FCA\textsuperscript{23} (2016; 2017).

**Fig. 12 Overview of Senior Managers and Certification Regime**

Source: Adapted from Deloitte EMEA Centre for Regulatory Strategy (2017).

An overhaul of the Approved Persons Regime occurred post recommendation from the PCBS. In 2016, the regime outlined in Fig. 12 above came into force, with extensions to this as shown in Table 4 below. The ‘Senior Managers and Certification Regime’ aims to identify senior managers and detail their responsibilities, often by

\textsuperscript{23} FCA CP17/25 & CP17/26: extend the SM&CR to managers and to insurers now under these policies.
prescription. At the same time it sets out maps of the firm’s management and outlines governance arrangements’ (FCA 2017). Expectations regarding the conduct of senior managers are set out in compliance training, and there is a requirement to notify the FCA when a breach of conduct occurs (FCA 2017)\textsuperscript{24}

Table 4: FCA Outlines Revised Framework for SM&CR

<table>
<thead>
<tr>
<th>Extension to Senior Managers Certification Regime</th>
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<tbody>
<tr>
<td>1 Five Conduct Rules that will apply to all financial services staff at FCA authorised firms. This simple set of rules means that individuals must act with integrity, act with due care, skill and diligence, be open and cooperative with regulators, pay due regard to customer interests and treat them fairly, and observe proper standards of market conduct.</td>
</tr>
<tr>
<td>2 The responsibilities of Senior Managers will be clearly set out and, should something in their area of responsibility go wrong, they can be personally held to account. The Senior Managers will be approved by the FCA and appear on the FCA Register.</td>
</tr>
<tr>
<td>3 Under the Certification Regime, firms will certify individuals for their fitness, skill and propriety at least once a year, if they are not covered by the Senior Managers Regime but their jobs significantly impact customers or firms.</td>
</tr>
</tbody>
</table>

Source: FCA 2016

As Andrew Bailey has said, “robust accountability for senior managers in financial institutions is a crucial part of the effective functioning of the economy… you can delegate tasks but you cannot delegate responsibility” (2016c). This responsibility also includes middle managers and their duties. Consultants recommend a series of ‘reasonable steps’ to be taken by bank management for non financial risks post control related failures in the industry\textsuperscript{25}, inclusive of training managers, issuing conduct rules.

\textsuperscript{24} The FCA notes that the Senior Managers and Certification Regime for Banking is subject to a further consultation process that finishes on 3\textsuperscript{rd} of November 2018. The consultation will consider amendments to the regime.

\textsuperscript{25} See PPI (Lloyds, RBS, Barclays, HSBC), London Whale (JP Morgan), Libor (Deutsche, RBS, UBS, Rabobank), Rouge Trader (Soc Gen), AML (HSBC), Tax Evasion (UBS).
and assessing managers’ fitness, propriety and effectiveness via the certification process (Kaminski et al. 2017). This responsibility is also now part of regulation and compliance training within UK banking institutions. At the desk training features quarterly at all UK banking institutions and normally carries an 80% pass rate. The maintenance of such compliance testing is monitored divisionally, with heads of department informed when statistics fall below acceptable standards. This is aimed at providing motivation rather than being seen at trading floor level as a form of business interruption.

The industry response to both the FCA and PRA regarding individual responsibility has been reported in various ways. Two HSBC directors left the banking industry in 2014, claiming that the higher standard of care required by the FCA and the individual responsibility and criminal charges by the PRA were going too far (Farrell 2014). Banks are claiming that post-crisis regulatory reforms are inhibiting their ability to work – something Hellwig suggests is a fantasy, as increased capitalisation reduces the required rate of return on equity and makes it easier to lend, a benefit that can be passed on to customers (2010, pp. 12-13) – and deterring candidates from joining their executive boards. Andrew Tyrie, who chaired the Parliamentary Commission on Banking Standards, is reported as saying that he was unfazed by such resignations. There is a large body of literature on regulatory capture via industry lobbying and story telling (as discussed in Chapter 5). However, critics such as Kwak (2016) suggest that it is important to push back against these efforts and mechanisms of influence, as it has been seen previously that regulators may side with industry groups and operate through self-interest and epistemic communities.

Having discussed the various ethical challenges faced by the industry and the reform landscape in UK banking regulation, it could be argued that there are distinct limitations to these approaches and there is certainly no silver bullet to prevent the
reoccurrence of banking scandals. Neither a single response nor a group of responses appears capable of solving the repetitious nature of scandal. This chapter will now progress to the technical framing of post-crisis regulatory transformation in order to consider the risk management and prudential aspect of the debate. Here, an argument will be presented for further limitation but with particular focus on the way Basel III regulation is manipulated through risk weighted assets (RWAs).

5.5. Risk Management

The post-crisis technical response to regulatory transformation is a growing body of work that is developing additional levels of what regulators and the Bank of England call resilience. The literature includes (i) transformation of financial institutions and a switch of regulatory responsibility from the FSA to the BoE, and the creation of the regulatory agencies Prudential Regulatory Authority and Financial Conduct Authority; (ii) Basel III (2011-2014) and the European Union’s CRD IV (2011, Capital Reserve Directive), which implement the three pillars of credit, liquidity and market discipline, with added measures for counterparty risk, capital buffers and leverage; (iii) the Independent Commission on Banking and its published document commonly referred to as the Vickers Report, which deals with restructuring of banks via its concept of ring fencing and competition; and (iv) bank stress-testing, which looks at scientific risk management techniques of assessing the strength of bank balance sheets and their ability to absorb losses based on future events, typically market corrections or exogenous shocks of a significant nature that could affect networked contagion such as witnessed in 2007.

Risk management literature is important in banking regulation, with the risk management paradigm dominating banking discourse. The activity of banks is discussed in a wide and varied body of risk management literature covering the more orthodox
functionalist approach of audit, accountancy, corporate credit risk and practices of finance such as value at risk and Black-Scholes, as well as more critical approaches as outlined below. The field is considerable, and amongst other debates, examines how different forms of banking risk (credit, market, liquidity and stability) are mitigated, monitored and controlled by various models and calculations. Such practices are connected to objects of finance, including devices and mechanisms that are addressed in the remainder of this chapter. These issues prove interesting to academics developing different critiques of the dominant functionalist approach in many fields, including Business and Management (CRESC 2009), Economics (Blundell-Wignall and Atkinson 2010; Mirowski and Plehwe 2009; Mirowski 2013), Sociology or Science and Technology Studies (Callon 1998; MacKenzie and Millo 2003; MacKenzie 2006; MacKenzie et al. 2007; Callon 2010; Muniesa 2015), Geography (Langley 2014; de Goede 2005; Leyshon and Thrift 2007) and Cultural Studies (Pryke and Du Gay 2007; Miller 1986; 2005). There is a distinct set of critical literature that centres in on these issues, for example Science and Technology Studies, which observes how social, political and cultural values affect science and innovation, and Cultural Economy, in which a particular contribution is made towards the politicisation of risk management and the purposeful or ambiguous nature of device and calculative method (Langley, 1992; du Gay and Pryke, 2002; Ertürk, 2013).

A critique of risk management is developed in this subsection of the chapter by referring to Basel regulation and its calculative algorithm. Using a pragmatic blend of concepts and theories from critical literature, an account of Basel regulation is offered that demonstrates the distinct limits of its application via a risk management approach. The ambiguity of calculation and manipulation of data distorts capital allocation to regulatory reserves.
So why is this important? The purpose of risk management is to allow a mathematical calculation to manage or mitigate the impact of negative events that may lead to heightened risk or to maximise profit-making opportunities by minimising risk potential. There is a specific concept known as ‘risk weighted assets’, or RWAs, that forms a central proposition of both the Basel II and III models and the denominator in the capital adequacy ratio (see Fig. 13) which attempts to ensure that banks are adequately capitalised when market events or exogenous shocks occur. Empirical insight is developed regarding the handling of RWAs within banking institutions via the credit risk management process and the manipulation of Basel regulation via modelling and decision making in departments within banks, such as structured finance, where lending attracts higher levels of capital due to greater credit risk being taken. The purpose of this section of the thesis is not only to review and critique technical regulations, but also to look at processes of credit risk in which manipulative actions are played out.

5.5.1. Basel III Reforms and Risk Weighted Assets

The technical response to post-crisis regulatory transformation is provided through a third amendment of the Basel Accords. Basel I was implemented in 1988, its objective being for banks to observe minimum capital requirements. Basel II was published in 2004 and implemented during the period preceding the financial crisis in 2007 (jurisdiction dependent) via a combined process of enhancement or addition, and rules based substitution (Moran 1989). Regulators suggested that Basel II created increased resilience by adapting its algorithm and instructing banks as to which operational risks should be encapsulated in calculations (the three pillars within the model are (I) minimal capital requirements, (II) supervisory review and (III) market discipline), making Pillar I more sensitive so that banks attribute the correct amount of capital to balance sheet
credit risk taken. To be fully implemented by 2019, Basel III extends and supersedes areas of Basel II by developing its three pillars, again by rule substitution and adding capital adequacy, market liquidity risk, a leverage ratio and stress testing. This subsection will focus on capital adequacy in the Basel III model, and a problematisation that banks were not carrying sufficient levels of capital to absorb losses via a rapid decline in aggregate market prices in August 2007.

Prices of stocks, property (residential and commercial), commodities, currency and underlying collateral plummeted shortly after the crisis began. Market prices continued to fall day after day, creating severe deficits on bank balance sheets that treasury teams struggled to cover via liquidating assets for cash (par and distressed portfolio sales), lending against better quality assets (Repo market), borrowing from the interbank market overnight or for short periods (Libor) or attempting to collect on insurance contracts (credit default swaps), all of which meant protecting the balance sheet from counterparty risk that other banks would default and fail to pay (Brunnermeier 2009). To give one example of this process, banks had taken protection for negative shocks (usually for credit risk rather than systemic instability) via credit default swaps (CDS) – essentially this is an insurance contract that allows the insured party to claim on either a collection of assets or individual names (a Marks and Spencer Group plc bond, for example) in the event of a default event occurring. In the market scramble for cash to absorb loss positions, a series of banks and insurance companies began claiming from each other, executing their contractual entitlement in which referenced assets in the underlying legal contract are exchanged to the insurer at a specific value, and a cash payment is moved the other way, with a premium being paid to the beneficiary in order to make the insured party whole at par value or as noted in the contract (see Stulz, 2010, for instrument detail). In terms of counterparty risk, banks had to keep a 20% contingent
capital reserve of the CDS contract value against a default of the insuring bank or firm (many of which were usually investment banks or insurance companies), which the three leading rating agencies, Moody’s, Fitch and Standard & Poor’s, rated incorrectly as AAA counterparts, i.e. low risk of payment default (Crotty 2009; Acharya and Richardson 2009; White 2011; Opp et al. 2013). Capital was absorbed quickly as CDS and market devaluation process maintained trajectory. Banks and insurance firms began to default through a series of pro-cyclical margin calls, sell-offs, mark to market losses and further margin calls (Engelen et al. 2011), and eventually failed to pay the CDS contracts out – key institutions in a network of CDS protection (American International Group Inc., amongst others) had not been maintaining high enough capital reserves to cope with widespread contagion risk and deterioration in asset value (Harrington 2009; FCIC 2011; Erkens et al. 2012). Eventually, banks required recapitalisation assistance from central banks (the Bank of England in the case of the UK) to support them as lender of last resort and to bail out private losses of banking institutions, creating a moral hazard event. This was a wholly unacceptable position, according to central bankers and critics of bank-induced financial crisis (Haldane 2009; 2010; King 2009; Engelen et al. 2011). A logical question to ask, therefore, would be why banks engaging in risk-based activities had not been maintaining high enough levels of capital to absorb losses.

5.5.2. Shareholder Value

Literature from the field of financialisation can offer an explanation as to why banks had been maintaining such low levels of capital reserves. Banks had been thinly capitalised or inadequately capitalised for many years. Engelen et al. (2011, pp. 158-159) report that Basel III required a modest increase in Tier 1 capital from 2 to 3.5 per cent by 2013, i.e. assets had become an increasing percentage of its shareholder equity base – this is also
known as gearing in accounting, or leverage in risk management discourse. When the ratio between assets and equity becomes unstable, i.e. leverage or gearing becomes too high, it leaves banking firms open to a capital adequacy problem in which the requirement for Tier 1 capital is multiples of times higher than Basel III in 2013, and arguably higher than the optimal 10-14% set out in the Bank of England Financial Stability Paper (BofE 2015). Bank of England Governor Carney set out the 2019 projection of UK bank capital at 11% which (when coupled with additional resolution instruments such as CoCos) remains well within the central bank’s Basel III revised framework (Guerrera and Pimlott 2010; BofE 2015). Bankruptcy is possible as rapid and negative price movements absorb Common Equity Tier 1 capital. The balance sheet of a bank must be able to withstand economic shocks to survive and regulatory capital is important in protecting against those risks as well as preventing the requirement for future taxpayer bail-out.

One explanation for the pursuit of thin capitalisation and low capital adequacy cover in firms is ‘shareholder value’ (see literature review for discussion). The way in which banking firms have been financialised, i.e. are driven by the power of finance and markets, has influenced executive decision making which in turn effects how bank business models adapt (Froud et al. 2006; Crowther and Ertürk 2016). One key issue within the concept of shareholder value and its effect on firm behaviour stems from theory that privileges equity as being the main beneficiary of surplus profits and cash flow – usually to the requirements of institutional shareholders (i.e. those who carry the most voting rights and sway upon how the executive manages the firm), rather than via a stakeholder model, for example, which features other parties, such as employees who benefit from being managed differently (Lazonick and O’sullivan 2000). Essentially, shareholder value in the context of a banking firm needs to be understood as an institution
competing amongst a market of other banks of differing size and complexity. Firm management and strategy is driven by market expectation, i.e. what the market expects from the firm’s performance. Return on equity, the amount of net income returned to investors as a percentage of shareholders’ equity, is the key metric and market driver in the performance of banks. Simply put, the calculation of return on equity is net income divided by equity, usually expressed as a percentage. Contained within the equity figure or shareholder funds and found within the denominator of the calculation, is the bank’s capitalisation reserve. The capitalisation reserve is an amount of money kept aside in case of exogenous or endogenous shocks such as market or bank-induced crises, or conjunctural events that provide large negative swings in asset prices. By reducing the capital reserve, the management of the bank can inflate return on equity.

Blundell-Wignall (2010) examines options taken by executives to reduce capital reserves via moving assets off balance sheet and securitising them – a process of recycling capital and distributing assets that creates fee-based income for banks and stakeholders involved, lawyers, accountants, consultants and asset managers. Crucial to understanding this strategy is following the movement of assets off balance sheet. Management decision making to move assets off balance sheet allowed banks to report artificially higher amounts of capital as a percentage of risk assets remaining on balance sheet. The special purpose vehicle housing the securitised assets off balance sheet was not captured in the Basel algorithm which only calculated on balance sheet assets. Increasing return on equity as a market metric encourages a rise in share price – a positively accreting capital adequacy ratio, produced by reporting a reduced capital requirement, equates to a lower total equity figure divided into the same or increased income equals improved income per share.
5.5.3. Barclays’ Protium SPV

An example that reveals the ability of banks to conjuncturally relocate risks, arbitrage the Basel II algorithm regulating a bank’s capital adequacy ratio and manipulate return on equity, is the case of Barclays’ Protium SPV (see Crowther and Ertürk 2016, pp. 280-282). Barclays created a fund in the Cayman Islands called Protium Finance LP. The primary purpose of the fund was to improve the bank’s capital adequacy ratio under Basel II and reduce its volatility in earnings through mark-to-market accounting post the financial crisis in 2007. The bank transferred $12.3 billion of its toxic balance sheet assets to a special purpose vehicle within the Protium Fund (liabilities involved in pre distribution warehousing of RMBS (residential mortgage backed securities) and CLOs, collateralised loan obligations). These assets were identified for securitisation but marked for trading in terms of accounting treatment (versus hold to maturity), meaning that the assets would have been marked daily according to falling market prices, thus creating significant losses if the transfer had not occurred (Salz and Colins 2013; Bell and Hindmoor 2015; Kay 2009; 2016). A group of Barclays’ managers left the bank as part of the asset transfer strategy and opened an asset company called C1 to manage the assets of the Protium SPV. The Protium Fund borrowed a 10-year loan of $12.6 billion to purchase the assets from Barclays; the additional funding, in all likelihood, was to cover a myriad of costs: consultancy, diligence, agency fees and legal documentation. The transfer and loan allowed Barclays to report reduced capital adequacy under Basel II whilst improving return on equity. Barclays’ audited accounts reported the Protium transaction as shareholder value enhancing by: (i) reducing the volatility in earnings; (ii) increasing risk adjusted return on equity, and (iii) securing long term access to a specialist management team who knew the assets. There was, however, to be further complications for Barclays.
Basel III substituted regulatory rules (Moran 1989) on capital adequacy and removed the arbitrage opportunity by bringing off balance sheet transactions within the calculation. This created an accounting problem for the Barclays plc. In 2010, Barclays bought the transferred assets back from Protium for £6bn, a drop in price caused by mark to market losses, creating a negative cash flow on the deal of £1.7 billion (Barclays plc 2011). The Wall Street Journal reported Basel III effects on the Protium transaction. A tripling of regulatory capital against the loan to Protium prompted Barclays to repurchase the assets, as maintaining the vehicle would have meant a negative return on equity (Nixon 2011). Barclays also suffered a loss of £735m from winding down the Protium Fund and SPV; however, the Basel III algorithm could not prevent the managers who moved to the Cayman Islands from receiving contracted fees.

The wider context of the above example involves the failure of de-risking and regulation to account for the legal tricks played by banks to disintermediate regulation for shareholder value purposes; it also includes banks that are driven by this type of model and managers who facilitate transitory mechanisms for personal enrichment. Connected with Basel III and its capital adequacy calculation, the following subsections will discuss a regulatory response to regulatory capital via the use of risk weighted asset values and the failure to realise the impact of financialised mismanagement of banks and the drive for shareholder value.

5.5.4. Problematisation of ‘More Capital’

Notwithstanding the clear alignment of reducing regulatory capital with the way shareholder value is used by management within financialised banking institutions, the regulatory response was to ensure that banks maintain increased capital rather than to address the underlying concept of capital adequacy and risk weighted assets by changing
the damaged parts of the algorithm that malfunctioned and was manipulated (Blum 2008). It is more likely to be the case that politicians and policy makers at the Treasury, alongside technocrats and econocrats within central banks and reformed regulatory bodies such as the PRA and FCA, where the work of economic research is conducted, had no toolkit to fix the system. In short, this collaboration of elites in their respective fields was unable to coral a common narrative and way forward, other than to suggest that the authority on matters of finance should rest with those operating within the mainstream economic intelligentsia, where ideas of economic theory are coupled with the practice of mainstream finance. This is important because, as outlined in Chapter 4, it develops an epistemic community to solve problems which guides the eventual result.

There were, however, serious credibility issues that required fixing as mainstream pre-crisis theory relied upon deregulated markets and practices of risk management to control the economy, as also pointed out in Chapter 4. Here there was a crushing defeat for the neoliberal economic perspective, as this approach had failed. Taking control, the state solved the immediate and crucial problem of bailing out the banks; however, instead of pressing on and demanding a more radical restructuring of banks that would serve the economy and society rather than the banks themselves and their executive managers and shareholders, what followed was the conception of UKFI, which was to manage the Government’s ownership of Northern Rock and RBS, along with a minority shareholding in Lloyds Banking Group plc. Vitally, UKFI operated the management of government shares at arm’s length from the scrutinising eyes of democracy in Parliament, and similarly to the Independent Commission on Banking, this allowed a managed approach to the situation (Engelen et al. 2011). This engineered result has been described by Engelen et al. as a hijacking of the post-crisis reform agenda via a combined set of elites, technocrats, econocrats and City executives to ensure that there was a
minimum of fuss, and that the status quo would be managed without material restructuring of institutional arrangements whilst vested corporate interests would be re-secured through Haldane and King at the Bank of England, who are the product of economics rather than market practice (2011, pp. 199-201). The regulatory response, allied to Basel III, was therefore to adapt the risk management based microprudential framework by substituting the formulation of risk weighted assets within banking risk from that of Basel II, which then affects the amount of capital adequacy cover the bank has and the likelihood of it being able to absorb losses in the event of economic shock.

It is important to note how Basel regulation transitions post crisis. Capital adequacy is discussed in the following paragraphs, together with the key purpose and objectives of the Basel III amendments. Fig. 13 outlines how the capital adequacy calculation operates through its two constituent elements (i) regulatory capital, and (ii) risk weighted assets. The calculation numerator will be dealt with first: Fig 13 illustrates how Basel II transitions to Basel III’s minimum capital requirements, increasing both the total capital requirement in percentage terms, but also the way the minima are formulated through new buffers and reserves.

The Capital Conservation Buffer is designed to ensure that banks build up reserves outside periods of stress; GSIFI CET1 applies to GSIFIs, which are required to maintain higher levels of capital given their significance and impact on the network of banking institutions and the potential contagion effects that create widespread instability and potential for liquidity dissipation. The Counter Cyclical Buffer CET1 is “a buffer of capital to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth that have often been associated with the build-up of system-wide risk” (BIS 2018).
Fig. 13 Basel Accord Transition: Breakdown of Regulatory Capital

Source: BoE Financial Stability Report, 2015

The requirement for new reserves has been attributed to the failure of Basel I and II in the financial crisis of 2008 (Blundell-Wignall, 2010), and is also seen as an attempt to increase the financial strength of banks so as to avoid a similar event reoccurring. The denominator in the capital adequacy calculation is formed of risk weighted assets (RWAs). OECD literature (Blundell-Wignall 2009) discusses the challenge of RWAs but only touches upon it. The argument is advanced further in a later paper, which suggests that banks derive proprietary risk weighted asset calculations premised upon what is termed ‘subjective input’ (Blundell-Wignall 2010, p. 6). RWAs are an important constituent variable of the capital adequacy calculation problematised by risk management in the requirement to increase capital and reflect the appropriate amount of regulatory capital according to balance sheet risk. Contained within Pillar 1 of Basel II is a definition of capital adequacy or minimal capital to deal with losses that
occur through economic shocks. Basel II describes RWAs as a calculation of banking
risks that cover credit, market and operations. RWAs are defined by Blundell-Wignall
as a “complex method that assesses these risks separately – credit, market and operation
– and adds them together via a defined calculation:

\[
RWA= \{12.5(OR+MR) + 1.06*\text{SUM}[w(i)A(i)]\}\ (2010, \text{p. 3})^{26}
\]

The RWA calculation under Basel III, however, will substitute calculations in
Basel II for higher amounts of CET1 and CET2 between 9.5 and 11.5% of adapted risk
weighted assets. The point here is not to delve into the algorithm and mathematics but
to look at how these risks are calculated in UK banks, which, after a period of
consolidation, are largely SIFIs – Systemically Important Financial Institutions, due to
their size and complexity, and then to observe the ‘subjective input’ via credit modelling
that assists in producing the calculation.

First, it is worth setting out how UK banks have performed since the substitutions
of RWA mechanics within capital adequacy as well as detailing the various stages of
Basel framework evolution as capital requirements increased (Basel frameworks: I, II,
II.5 and III). In this analysis, UK banks are the subject of evaluation through accounting
data and published accounts. Graph based examples (data from annual reports: HSBC plc,
Barclays plc, Royal Bank of Scotland plc and Lloyds Banking Group plc) examine how
the transformation of regulatory framework in Fig. 13 impacts these banks. The key
capital adequacy metrics reported on by banks are (i) Tier1 CET1 Ratio and Total Capital
Ratio and (ii) Fully Loaded CET1 Ratio and Fully Loaded Risk Based Capital Ratio^{27}.

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26 Weightings of different asset classes and ratings that affect the calculations can be seen in Blundell-Wignall (2010, p. 4)
27 (ii) The UK is an EU member state and banks also restate regulatory capital for CRR and CRD purposes: CRR: Capital Requirements Regulation Directive (2013/36/EU); and CRD IV: Capital Requirements Directive
These ratios assess how much more capital, versus Basel II, is held for risk assets on the balance sheet (both on and off balance sheet assets and vehicles). 2005-2017 bank data for these ratios is displayed in Table 5 and capital adequacy is shown in graphical form in dashboard Fig. 14 below. What this data demonstrates is the impact of the changes in Basel framework on these banks over a 12-year period. As the Basel frameworks have been adapted by substitution\(^{28}\), the amount of capital develops steadily in a linear fashion through all eight graphs in Fig. 14.

Also worthy of mention is the way the increase in capital adequacy has affected the return on equity of these banks throughout the sample period, which as noted, has an influence on bank performance in markets and share price. The inverse relationship between increasing capital adequacy and declining return on equity is plain to see between Figs. 14 and 15 throughout the de-risking and recapitalising process.

\(^{28}\text{In tandem with new pillars and control measurements (Leverage Ratio and Liquidity Ratio for example).}\)
Table 5: Capital Adequacy Data 2005-2017


(Tickers – LON: HSBA, BARC, RBS, LLOY)

|---------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|

| HSBC PLC |
|---------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Tier 1 Common Capital (CET1) Ratio (%) | 6.06 | 6.28 | 4.48 | 6.64 | 11.00 | 10.65 | 10.98 | 10.30 | 10.84 | 11.14 | 15.51 | 13.42 | 15.91 |
| Tier 1 Ratio (%) | 7.61 | 7.50 | 7.28 | 10.04 | 14.13 | 12.91 | 12.98 | 12.43 | 13.13 | 13.24 | 19.10 | 17.71 | 19.69 |
| Basel II Leverage Ratio (%) | NA | NA | NA | NA | NA | NA | NA | NA | 3.10 | 3.40 | 4.20 | 5.60 | 5.10 |
| Liquidity Coverage Ratio (%) | NA | NA | NA | NA | NA | NA | NA | NA | NA | 102.00 | 112.00 | 136.00 | 133.00 | 152.00 |
| Fully Loaded: Common Equity Tier 1 Ratio (%) | 6.06 | 6.28 | 4.48 | 6.64 | 11.00 | 10.65 | 10.98 | 10.30 | 10.84 | 11.12 | 15.50 | 13.42 | 15.91 |
| Fully Loaded: Tier 1 Ratio (%) | 7.61 | 7.50 | 7.28 | 10.04 | 14.13 | 12.91 | 12.98 | 12.43 | 13.13 | 13.24 | 19.10 | 17.71 | 19.69 |

| Return On Average Equity (%) | NA | 15.83 | 16.34 | 5.52 | 5.68 | 9.77 | 10.96 | 8.77 | 9.61 | 7.46 | 7.57 | 1.76 | 6.16 |
| Return on Equity (%) | 16.16 | 14.88 | 15.11 | 6.48 | 4.93 | 9.16 | 10.80 | 8.37 | 9.35 | 7.35 | 7.64 | 1.89 | 6.00 |

| Barclays PLC |
|---------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Tier 1 Ratio (%) | 7.02 | 7.72 | 7.56 | 8.60 | 12.97 | 13.45 | 12.91 | 13.23 | 15.73 | 12.95 | 14.69 | 15.58 | 17.22 |
| Basel II Leverage Ratio (%) | NA | NA | NA | NA | NA | NA | NA | NA | 2.97 | 3.70 | 4.50 | 4.60 | 4.50 |
| Liquidity Coverage Ratio (%) | NA | NA | NA | NA | NA | NA | NA | NA | 80.00 | 82.00 | 126.02 | 96.30 | 124.39 | 133.64 | 130.71 | 153.58 |
| Fully Loaded: Common Equity Tier 1 Ratio (%) | 6.66 | 7.42 | 4.73 | 5.62 | 10.04 | 10.77 | 11.01 | 10.77 | 13.19 | 10.31 | 11.37 | 12.36 | 13.29 |
| Fully Loaded: Tier 1 Ratio (%) | 7.02 | 7.72 | 7.56 | 8.60 | 12.97 | 13.45 | 12.91 | 13.23 | 15.73 | 11.45 | 12.88 | 14.22 | 16.09 |
| Return On Average Equity (%) | NA | 20.05 | 17.02 | 13.34 | 19.43 | 7.54 | 6.13 | 0.29 | 2.35 | 1.29 | 0.93 | 4.09 | -3.31 |
| Return on Equity (%) | 15.72 | 18.97 | 15.69 | 11.13 | 17.59 | 7.31 | 6.05 | 0.30 | 2.09 | 1.28 | 0.95 | 3.96 | -3.35 |
| Capital Adequacy Method | Reporting Date | British Pound Sterling | Baseline I | Basel II | Basel III
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<tbody>
<tr>
<td>Tier 1 Common Capital (CET1) Ratio (%)</td>
<td>2005</td>
<td>Basel I</td>
<td>6.06</td>
<td>6.28</td>
<td>4.49</td>
</tr>
<tr>
<td>Basel III Leverage Ratio (%)</td>
<td>2008</td>
<td>Basel II</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Liquidity Coverage Ratio (%)</td>
<td>2009</td>
<td>Basel II</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Fully Loaded: Tier 1 Ratio (%)</td>
<td>2010</td>
<td>Basel II</td>
<td>20.75</td>
<td>19.20</td>
<td>-2.45</td>
</tr>
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**Source:** Author, data from Annual Audited Accounts of HSBC plc, Barclays plc, Royal Bank of Scotland plc and Lloyds Banking Group plc.
Fig. 14 Graphs: Tier1 CET1 Ratios (& Fully Loaded): Linear Increase

Capital Adequacy Dashboard: HSBC plc, Barclays, plc, Royal Bank of Scotland plc, Lloyds Banking Group plc
Royal Bank of Scotland Plc

Lloyds Banking Group Plc

Source: Author, data from Annual Audited Accounts
Fig. 15 Bank Return on Equity: Collapse

Source: Author, data from Annual Audited Accounts
From 2016 onwards, and as regulatory capital metrics level off, return on equity is beginning to stabilise. This is due to two primary actions: (i) capital accretive decision making on bank balance sheet assets (see Chapter 6 for discussion), and (ii) the tapering tail of legacy conduct fines and the associated increase in net profits. Short of further scandals and subsequent fines being levied, it is likely that the focus on regulatory compliance will continue, albeit with a resumption in the ‘business as usual’ performance management of banking: a desire for growth, new revenue, efficiency savings, profit before tax, net interest margins, cost income ratios, continued asset quality, impairments and returns. From the return on equity graphs in Fig. 15 and the stability of regulatory capital in Fig. 14 it is clear that there is work to complete in terms of compliance and the minimising of legacy conduct fines whilst the banks appear to have managed balance sheet restructuring. Basel III, Pillar 3 disclosures on regulatory capital, coupled with year-end 2017 results, shed some light on this matter. Royal Bank of Scotland’s audited account statements show a reduction in RWAs of £494.9 billion between 2008 at its peak through to 2017 (Royal Bank of Scotland plc, 2008-2017); however, the bank spent 2017 managing conduct and litigation cases versus the US Federal Housing and Finance Agency ($5.5 billion settlement, FHFA, (2017)), and in 2018 was involved in the US Department of Justice RMBS investigation, in which an agreement in principle to pay $4.9 billion was reached (Royal Bank of Scotland plc 2018). The latter will continue to weigh on the bank’s results and return on equity in 2018 (Royal Bank of Scotland plc 2018), however, the bank broke positive ROE in 2017 for the first time since 2007 (Royal Bank of Scotland plc 2018). Barclays is in a similar position, but has distributed far less RWAs at £120 billion from the peak position at 2008 (Barclays plc Audited Accounts

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29 RMBS: retail mortgage backed securities – a pool of mortgages, the cash-flows from which are packaged, tranch into classes and sold to investors
Barclays has also been managing legacy conduct litigation and has settled a US Department of Justice legal case, also on RMBS, at $2 billion, and this will weigh on full year 2018 results (Barclays plc 2018). Notwithstanding these challenges, Barclays’ management is guiding investors towards a material rise in return on tangible equity of 11% for 2018 (Q1 2017 y-o-y: 2%, Barclays plc, Q1 2018 results), although this is a calculation based on adjusted earnings, i.e. net of significant costs, such as conduct fines, to demonstrate the underlying run rate of returns. HSBC is arguably the most advanced of the banks analysed in the sample. HSBC reduced RWAs to $277 billion from the peak position of $495 billion in 2008 (HSBC plc Audited Accounts 2008-2017). With a stable capital base, and consistent growth rate in revenues versus reduction in rate of growth to operating costs (positive jaws\(^{30}\)), the bank intends to restart a $2 billion share buy-back in 2018. As shown on the ROE graph in Fig. 15, HSBC has maintained a positive return performance outside of a blip in 2016; however, the bank has struggled to meet growth expectations and scrapped its 10% ROE target for 2017, hoping the share buy-back underpins the earnings issue in 2018. Lloyds Banking Group decreased RWAs by £282 billion from its peak in 2009, post HBoS takeover, and from early capital accretive decision-making, made steady progress in ROE through to 2014 as the bulk of RWAs were reduced. As the tail of PPI claims tapers off, and new business flows through from MBNA and Zurich Financial Services, ROE continues to increase with management forecasting a £1 billion share buy back programme in 2018 (Lloyds Banking Group plc 2018 Q1 Results). The banks are now signalling a reconfiguring of the cost base away from regulatory capital, balance sheet restructuring and progression towards rebuilding growth opportunities; this assumes that there are no impacts from Bank of England stress testing or material exogenous shocks (house price deflation,

\(^{30}\) A term in mainstream finance that calculates rates of growth – rates of operational costs
recession, Brexit, geopolitical problems), which may result in refocusing on the former
regulatory capital, RWA / capital adequacy management.

Moving away from the macro regulatory capital position, the way regulatory
capital can be managed at the micro level of transactional detail via ‘subjective input’
will now be investigated, including how this has historically created opportunity
for banks and employees to manage outputs in the capital adequacy calculation via
new empirical data. This is a contributory factor in the management and regulatory
arbitrage of RWAs; as noted previously, capital adequacy and regulatory capital both
affects return on equity and influences the share price of banks.

Accurately reflecting the risk of balance sheet assets in regulatory capital after
the financial crisis should be a crucial element of manipulation from Basel II (Blum 2008),
which Basel III should solve; however, it raises the question of whether substituted risk
weights in the calculation are limited in solving regulatory arbitrage opportunity and
whether this remedy falls short of critical concern.

5.5.5. Foundational IRB Approach

Within the Basel II framework, Pillar 1\textsuperscript{31}, the internal ratings-based (IRB) approach
allowed banks to input risk parameters to estimate regulatory capital through proprietary
models. The IRB approach allowed banks to develop probability of default for individual
transactions and underlying obligors. For Foundational IRB (F-IRB), however, banks are
instructed by regulators to use prescribed default measures for the loss they may
encounter due to an obligor’s default (LGD) and for RWAs, relating to calculating non-
retail balance sheet exposures (Tarullo 2008). The key source of literature in this field is

\textsuperscript{31} See BIS website for detailed 2005-2009 Basel II chronology and framework development:
https://www.bis.org/publ/bchsca.htm.
the OECD report on ‘Thinking Beyond Basel III’ (Blundell-Wignall 2010), which reviews the historical Basel framework and holds a negative view on the IRB approach. The main argument is that IRB creates pro-cyclicality i.e. “in business cycle theory and banking, this approach correlates positively with the state of economy”, rather than creating accurate output of regulatory capital supporting balance sheet risk. Blundell-Wignall suggests that IRB estimations are particularly poor within private banks as they rely on privately generated data – i.e. business forecasts generated by advisory consultants; moreover, banks that lend in public markets rely on market data, such as financial cycles, stock market prices and asset valuations, amongst other variables, and suffer from similar results (Blundell-Wignall 2010, p. 6). In addition, an accusation is made that the IRB approach has not really progressed since Basel I in 1988 via the external ratings approach (Ibid), and that based on IRB estimations, calculations can have wide tolerances, resulting in a need for the data input to be monitored for discrepancy.

Can projections of a business based on historical default data be accurate and credible in terms of retaining the correct amount of capital? Regulators responded to the above criticism, and the reformed Basel III framework points towards resilience by managing uncertainty in the model via Pillar II and supervising bank modelling. Annually, thousands of credit reports and financial models are drafted in UK banks that calculate regulatory capital via the IRB approach. How regulatory supervisors are to monitor the accuracy of ‘subjective input’ at the micro-level is a material challenge (Blundell-Wignall 2010). A far more difficult challenge facing regulators is the claim that they are reactionary and behind the curve in terms of innovation within regulatory models, coupled with the more substantive allegation that they are unable to predict new financial risks with any more success than the IRB approach.
Literature is helpful at this juncture in explaining the way manipulation and the gaming of models occur. Engelen et al. (2010; 2011) and Ertürk et al. (2013) offer an alternative explanation for why regulators are hampered by the way mainstream finance considers problems through scientific rationality, a risk management prism or industry functionalism: credit risk, liquidity risk, balance sheet risk, and so on, which form the essence of practice. The way risk managers think in terms of functionalism and risk models restricts the ability to consider alternative perspectives and solutions regarding banks that innovate to create arbitrage opportunity using bricolage. The concept of bricolage has been described in finance journalism and social studies of finance literature. Engelen et al. (2010, p. 53) describe how Hilyard (2008) uses financial bricolage as a descriptor for the actions of financial firms prior to the crash, whereas MacKenzie (2003) or Beuenza and Stark (2003) depict bricolage in a rationalist frame of theoretically guided bricolage rather than as something randomised or opportunistic. Engelen et al. (2010) use bricolage in Levi-Straussian terms (1966, p. 13) to describe the way firms create new risks at nodes of fragile chains when a specific opportunity presents itself at a point of market conjuncture – which regulators then respond to by transforming regulatory frameworks. These actions are fluid, flexible and creative, qualities that present a challenge to a mathematical algorithm such as Basel and to regulators in terms of advance understanding through risk management and scenario planning. Bank actions can collapse fragile regulatory chains that attempt to control finance, as described in the Barclays Protium case, and develop new chains, leaving the regulator to consider their structure ex-post and react once again after the event. However, because the risk weighted asset input to the capital adequacy calculation remains within the Basel III regulatory framework, it may leave room for further opportunity for the bricoleur and for arbitrage to continue (Engelen et al., 2011). Evidence of this reoccurrence post Basel III is
considered below in subsection 5.5.7. Before examining this evidence it is worthwhile to sketch out the A-IRB approach as a lead into examining whether arbitrage opportunity remains in the model.

5.5.6. Advanced IRB Approach

There was an opportunity for banks pre financial crisis to gain Advanced IRB approval from the Financial Services Authority. Banks were advised on the changes they needed to make in risk practice and modelling if they wanted to adopt the Advanced IRB approach. This approach is a more complex system of analysis running through a proprietary bespoke model where banks use their own model variables through an updated credit based risk management platform that looks back through historic default data. This enabled banks to regulate and “reduce the amount of capital it held for capital adequacy purposes” (BIS 2006), thus improving its return on equity. Two of the large UK high street banks, HBoS plc and Barclays plc, decided to employ this tactic and upgrade their systems and processes. The regulator signed off the advanced IRB approach for these banks pre crisis (HBoS plc 2007; Barclays plc 2008). HBoS dedicated 19 pages of its 2007 annual report to regulatory approval of the Advanced IRB approach from the Financial Services Authority by demonstrating its competency in risk and credit management of its balance sheet (HBoS plc 2007). The certainty and confidence felt by the Financial Services Authority in signing off the Advanced IRB approach must have been misplaced, as it became clear post crisis that the proprietary models being used were premised on insufficient historical default data from markets (Lloyds Interview 1, 2015; Bank of England 2017). To understand how this happened, it is necessary to comprehend the depth and age of the historical default data required; if these are not appropriate it can become problematic, as banks may produce unreliable calculations for managing the
quantum of regulatory capital to reserve. This issue was disclosed by the International Monetary Fund in 2001 in a letter sent by Stefan Ingves to the then Chairman of the Basel Committee on Banking Supervision, William McDonough, which fleshes out calibration issues in Pillar 1 of Basel II (Kupiec 2001). Regulators should have addressed calibration risks after receiving these warnings, but nothing was done until the development of the Basel framework several years later, something which will be covered later in this chapter. In assessing the impact Basel II had on the HBoS balance sheet, it was claimed risk staff had actually been relatively conservative under the auspices of the Advanced IRB approach, and they would have been able to reduce their capital ratios even further had they decided to go with the Foundational IRB Approach which fixed the loss given default ratio at 45%.

The output from this calculation fed into the capital adequacy ratio, rather than allowing proprietary bank models to use risk weights to calculate capital adequacy, thereby demonstrating the problem was with Basel and the IRB approach rather than with the risk department and its subjective input (Perman and Darling 2013 Ch. 17).

In 2013, the PRA, the new regulator at the Bank of England, advised banks to aim for the standardised IRB approach. The primary reason for the change in tack was the lack of depth in historical default data available to the banks for the products they were selling, (historic data on recessions, market events and bubbles in market economies), upon which these calculations were being made (Lloyds Interview 1 2015). Literature supports this position. Blundell-Wignall verifies that there has been a lack of depth in historical default data available to run quantitative models accurately across many products, despite prior approval having been received from the FSA. There is one caveat

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32 Essentially 45% LGD sets the minima of capital for default against balance sheet assets, which when set against historic default data, were viewed by the regulator as sufficient to cope with economic shock.
to this general regulatory guidance, which relates to HBoS and the 50+ years of UK based historical default data on residential mortgages that the regulator decided could be relied on (Lloyds Interview 1 2015). HBoS, now owned by Lloyds Banking Group, operates its residential mortgage book on the Advanced IRB approach; however, the rest of its balance sheet lending liabilities are on the standard IRB approach (Lloyds Interview 1 2015). What the above demonstrates is a rather more complex conundrum of the way in which precise mathematical calculations and models operate, versus the impurities witnessed in the implementation and supervision of Basel. Fratianni and Pattison (2015) state that Basel Accords can deviate at the national level by way of implementation. A conclusion is made “suggesting the way risk weighted asset dispersion at domestic level may prove easier to manage where supervisors apply some form of benign neglect” (Ferri and Pesic 2017, p.332). This literature implies that building resilience through supervisory agency and the practice of risk management contained within Basel III, Pillar II, has issues and limitations that have yet to be resolved.

5.5.7. IRB and Regulatory Arbitrage Post Basel III

Mariathasan and Merrouche (2014) observe the way proprietary-banking manipulated Basel II by gaming risk weighted assets and arbitraging the amount of capital set aside for default. The Basel Committee on Banking Supervision has worked for decades to create a framework containing an objective measure of risk. The major drawback has always been the fact that banks seek ways to prevent capital absorption (Ferri and Pesic 2017). The response of Basel III discussed tighter supervision of banks (Pillar II), but this was made increasingly difficult by the retention of risk weight calculations and the creation of additional levels of resilience in the framework (Pillar I: Minimum Capital Requirement, Leverage, Liquidity and Risk Coverage, Pillar II: Supervisory Review...
Process and Pillar III: Market Discipline). Basel III tightened the risk weights through individual exposures to classes of risk assets (sovereigns, banks, corporates, financial institutions, and so on) via a consultative process (BIS 2015; 2016, p. 24) that proposed increasing the amount of capital required for balance sheet lending, mainly through a Foundational Internal Risk based approach across banks (F-IRB), or the strict Advanced Internal Risk Based approach (A-IRB), under which, through application to the UK regulator and supervision, banks were required to prove they had technical experience and capacity to manage. The theory behind the A-IRB approach was that banks could reduce capitalisation levels through modelling proprietary historic default data to produce risk weights ‘appropriate’ to the correct asset class (mortgages, loans etc.) and were consistently applied across balance sheet exposures. Through modelling, banks could therefore reduce the capital asset ratio and increase return on equity within risk parameters approved by banking supervisors.

There are critics of the F-IRB / A-IRB approach and regulatory risk weights more broadly. Ferri and Pesic (2017) report an improved analysis of the IRB approaches through a database containing 239 EU banks between 2007 and 2013 via a RWA / Exposure at Default calculation (EAD), in order to avoid false positives in regulatory arbitrage data that in their opinion are present in previous literature using RWA / Total Assets. Contrasting F-IRB with A-IRB revealed the following: (i) regulatory arbitrage remains present in Basel III; (ii) it is likely to have materialised via risk weight manipulation within IRB modelling; and (iii) arbitrage was stronger within A-IRB banks than F-IRB banks. These findings indicate continuing problems with risk weights, when an alternative more pragmatic approach could have been considered much earlier instead of scientised calculative prudential modelling via manipulated risk weights. Even after the crisis and the adapted Basel III Accord, banking firms continue to conduct bricolage,
as Ertürk et al. (2010) and Engelen et al. (2011) suggested would be the case, with risk weighted asset calculations remaining present in Basel III prudential frameworks and opportunity existing for firms to conduct improvisation and bricolage.

5.5.8. Subjective Input

It is essential to understand how large UK banks operate proprietary bank risk management models, mostly governed by the Foundational IRB approach. Pre crisis, the whole process of credit management and assessment of risk was overseen via a regulatory system of self-steering (Moran 2002), or politically sponsored light-touch supervision (Engelen et al. 2011). Nevertheless, the Financial Services Authority, as regulator, approved two UK banks to operate the A-IRB approach pre crisis through Basel II. As noted previously, the IRB approach requires banks to calculate via estimation three particular measures, namely probability of default (PD), exposure at default (EAD) and loss given default (LGD) (Flores et al 2010). These three variables enable the user of the risk management model to assess the probability of default, exposure to the bank should a default occur, and the loss the bank is likely to face in the event of default, by inputting both qualitative and quantitative business information of the target company into the credit risk management model. The user inputs selected data, according to the credit process manual, usually from independent diligence reports or management information, sourced from audited accounts, and their own projections based on a upside, base case and sensitivity or bank case model, paid for and supplied by the bidder of the target company. This information runs to the extent of examining covenant levels in the legal documentation of the transaction and sensitising them in line with a downside ‘what if’ case.
The credit risk management system and model derives these ratios from the data input session. Data usually consists of three years’ historical financial data, current trading and two years’ projections (projections often extend to five years; however, the model discounts the uncertainty in achieving stretched targets), management information, qualitative data regarding the style and substance of management, inclusive of key executive board members (CEO, CFO, Operations Director etc.) and country risk data, which can draw on geopolitical issues through to the legal system operated in the country in which the target company operates (e.g. with banks in a lending situation, the friendliness of bankruptcy law towards secured creditors is relevant, as this affects expected loss at default estimations).

How front line staff assess risk via the credit risk exercise is important. Not only is the quality of data to be input at issue, but also the way in which the modeller uses the data within the model to create the variables required (LGD, EAD and PD). For a transaction to progress, the team originating or managing the transaction needs to clear internal hurdle rates that are known in advance through central communications from credit department colleagues. Another important aspect is the way data and structured mathematics form a decision tree of estimated calculations that are generated by the model operative; this allows credit directors to make decisions. One issue of particular interest is whether the bank is making the requisite amount of profit versus the amount of capital it must put aside for the risk being assumed in order to extend credit terms to a borrower or target company. The decision to lend is usually expressed as a model output ratio of RAROE (risk adjusted return on equity) on an individual transaction basis, versus LGD, EAD and PD, which have an internal hurdle rate. This data feeds into the RWA estimation in the denominator of the capital adequacy ratio, which in turn is used to form CET1 capital adequacy – between 9 and 11.5% of total risk weighted assets (see Fig. 13).
Credit risk models are usually branded off-the-shelf products used by many London-based banks (Moody’s Risk Calculator is an example of one such model), and they are then tailored to fit within a series of complex internal banking systems that control risk and loan management (sanctioning, limits, balances, accounts etc.). These systems have developed at different rates and with varying degrees of innovation, and they have often been bolted into the infrastructure of the bank piecemeal over time. There is no uniform approach across the banking market as to how risk is assessed or which models to use. However, banks are now supervised via Pillar 2 of Basel III – the complexity is high and provides another layer of challenge in regulatory arbitrage and the provision of appropriate levels of regulatory capital (Ferric and Pesic 2017). The process of system development and the layering in of new ideas and models over time is highly complex and temperamental, and creates what can only be described as a minefield of operational management. Recent examples of banks being taken over or merging, such as Lloyds and HBoS in 2009, have shown the challenges to be too large for information technology to bridge with software patches to paper over the cracks etc. Also, when transferring credit and risk data over to the Lloyds system, numerous human and computer errors were made at customer level, which when grossed up, also has an impact on the ability of risk colleagues to accurately estimate the appropriate level of regulatory capital required.

There are several models operating within the credit assessment exercise that develop a bottom up approach to assessing PD, EAD and LGD. The researcher’s own experience of proprietary credit risk modelling is highlighted below to illustrate a hypothetical case at Lloyds Banking Group. There is a mix of qualitative and quantitative appraisal. A number of reasons for making a credit assessment are dependent on who is conducting it and where the operative works – i.e. an associate director working in loan
origination will look at new customer relationships and conduct new lending opportunities, while a corporate support officer working in portfolio management will process an annual renewal requesting the sanction of the same facilities for a further 12 months, or perhaps an extension to a loan. Reasons for reporting using the risk management models can be positive or negative: positive reasons include new lending, extending facilities, annual reporting and renewal of facilities, while negative reasons include a breach of facilities, covenant amendment, covenant breach, poor financial performance and transfer to lending support.

The type of opportunity is important for the credit risk model, as there can be a multiplicity of reasons why the customer is looking for banking facilities. For the structured finance area attached to private equity lending, for example, a new transaction could be taking a public limited company into private ownership, or indeed the reverse. The transaction can also be differentiated by type: MBO (management buy-out: current management seeks new capital to support the transaction), MBI (management buy-in: owners or shareholders buy the company and look for new management after the transaction), IBO (institutional buy-out: equity instigates a sales process and can take current or new management for the transaction), BIMBO (buy-in management buy-out: equity employs management it has worked with previously). Each type of business purchase means a different type of transaction model is used which reflects specific risk and affects the model output. Simple features are important, such as the requirement for the model user to select the correct model type, as some models grant more benefit towards subjective input risk and consequently higher risk adjusted returns on equity than others and therefore create lower regulatory capital. Selection of the correct proprietary model was only a tick box exercise in the Lloyds Banking Group case discussed below, and is an element of the modelling process that can be easily
chosen or missed. Moreover, each model type the operator selects has its own pivot table of data underpinning the model that it uses to calculate PD, EAD and LGD, elements of which are hard coded under F-IRB. Personal experience suggests credit directors who approve transactions do not go into the granular detail of checking which models have been selected and used when data is presented to them for decision – they are interested in model outputs and consider the responsibility for assessing the correct model to lie with the user and a local credit team, with human errors possible. This is a simple example of how subjective input can affect model outputs.

There are key areas within the credit risk assessment process that rely more on the user’s experience than qualitative or quantitative information from diligence providers. Management is identified as one of the most under examined non-financial risks and under researched elements of the credit assessment exercise, and incidentally, one of the high probability risks to poor performance of the business plan, repayment of facilities and the achievement of appropriate risk adjusted returns by the bank. The recent Libor scandal and the way management and personnel of a particular business involved, rigged one of the world’s leading reference rates is an example of this. Banks, and in this case Lloyds, were lending to brokers involved in the Libor scandal. Lloyds, in its credit assessment of the broker, missed a clear risk in how the firm was governing its compliance regime. The broker’s senior management team failed to demonstrate any concern for what transpired in its part of the scandal. The FCA was scathing in its assessment and highlighted two specific problems with the broker that Lloyds was lending to: (i) autocratic management of the company’s trading staff; (ii) lack of oversight by the broker’s compliance department over its staff and expenditure. The

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33 The author was involved with a banking relationship which was borrowing from Lloyds, and was one of the companies involved in the alleged rigging of the referenced Libor rate (reported by the Financial Times alongside ICAP and Tullet Prebon: Fortado (2016)).
compliance regime had been overseen by one of its senior shareholders. Poor management of the compliance department culminated in excessive weekly spending on entertainment by staff involved in the Libor rigging scandal. Questions need to be asked as to how poor compliance was not picked up internally via its own risk and compliance department, unless it was picked up and then suppressed by the broker’s owners. In addition, why did the bank and the company’s other equity investors not pick up on the way the business was being run by its senior management, either through external pre transaction diligence or the bank’s own staff completing their work with management and equity sponsor?

Poor lending decisions underpinned by a misrepresentative analysis of management at the micro level of credit assessment relate to incorrectly prescribed allocation of risk capital via the Basel Standard IRB approach. The misallocation is then reflected in the capital adequacy ratio. Regulators have suggested that they do not wish to intrude on the way banks are being run at the micro level; however, Pillar II of Basel III provides for detailed oversight of the way banks are applying microprudential regulation, inclusive of Basel. This type of supervision is likely to increase as it is becomes clear, through surveillance and inspection, that the problems and challenges faced by banks in estimating risk weighted asset calculations remain current. An argument can be made, however, that regulators are under equipped in terms of the way credit systems operate at the micro level, and in their knowledge of the idiosyncrasies and granular detail contained within the proprietary models that generate important variables in the estimate (PD, LGD, EAD); this includes the way these variables are affected by poor lending decisions that correlate highly with reasons for default across a portfolio of different asset classes. This scenario culminates in pro-cyclical bubble building, as Blundell-Wignall points out. Inappropriate bubbles in
credit risk can form from modelling errors of various types and have been found in the aftermath of crisis at Banks such as HBoS and Lloyds. The post takeover entity Lloyds Banking Group plc disclosed up to £13bn of losses connected to wholesale errors in conducting commercial property transactions (primarily Irish HBoS debt) and the impact this has had on the use of bailout funds from the Bank of England (Daily Express 2009; This is Money 2009).

Another element of the credit assessment exercise and model in which subjective input can manipulate risk weights and capital adequacy is through inputting the new capital structure of a target company, the income the bank makes from it and how this is recognised by the model. All facilities, both committed and uncommitted (i.e. those that need a request to be drawn and those the bank is obliged to let the customer draw upon through contract or loan facility documents), tenor, margins, maturity and type of facilities (i.e. term loans and revolving credit facilities) are input into the model. Recognising income on uncommitted facilities is fraught with uncertainty, as the model user is attempting this calculation up front from estimated drawdowns in the bank case model. All cross sales income (CSI) derived from other areas of the bank (examples are pensions, hedging, international payments, insurance, factoring) are then added to the model. Attributing income from these elements can also be challenging to assess, as most banks count CSI as ‘wooden dollars’, i.e. similar to distributing cost accounting to relevant departments; however, this concept identifies agents involved (i.e. the relationship manager, trading floor sales and hedging, credit risk monitoring responsible for limits and sanctioning of requests), with each contributor able to make a claim against the income for purposes of targets, budgets and performance management without double counting it in the bank’s cash-flow. All income is derived or extrapolated from this data over the life of the loan and is contrasted against the underlying default data. This allows all income
to be adjusted according to specific risks pertinent to the model choice, as noted above,
such as those particular to geography, legal jurisdiction, country risk and industry. This
can be problematic in that the model user is estimating in year one what the subjective
inputs are going to be for the remainder of the transaction, which may be as long as seven
years for leverage finance transaction, although the vast majority of transactions refinance
much earlier. The model takes the estimated income data from loans (which are fixed
through interest rates and fees in loan documentation, so more stable and quantifiable)
and CSI income, the formulation of which is highly subjective and is often not discussed
at credit committee meetings. Albeit from internal return hurdles and experimenting with
post-crisis with RAROE models at Lloyds bank, debt and fee income alone does not create
a large enough return in itself through the foundational IRB approach where the LGD is
hard coded at 45%. It is cross sales income that provides the additional lift in income
levels to allow the transaction to be successful and meet the internal return hurdle rate,
usually set at 15% for leverage finance transactions at Lloyds. Cross sales income is
discounted back through the model via a hard coded beta to give a net present value (NPV)
of future income today. However, if CSI income is highly subjective and estimated from
year one as a projection, the discounting and NPV can at best be inaccurate. The results
from the model are then correlated with LGD, EAD and PD in regard to whether the deal
is sanctioned or not. The lack of certainty in subjective input has the potential to create
large anomalies in precise mathematics within models; consequently, it is highly likely
that the incorrect amount of capital is being reserved. One must ask whether the reported
return on equity calculations are correct, assuming that quantitative modellers assessing
the bank’s performance do so from transaction data at departmental level and above and
not from each individual transaction on a bottom up basis, as this level of granular detail
was not collected in the corporate areas of UK SIFIs.
The last few paragraphs have detailed some of the challenges facing regulators in managing the Advanced and Foundational IRB approaches, and then discussed the term subjective input as a way of describing the fragility of risk weighted asset calculation and the way LGD, EAD and PD are calculated via the credit risk exercise. These processes and models have potential for manipulation of data and process and therefore regulatory arbitrage; however, whether this is purposeful or not is a question for another paper. Nevertheless, the mere fact that subjective input of data at the micro level of credit risk exercise can distort the IRB approach, risk weighted assets and the capital adequacy ratio is unacceptable in terms of building financial resilience, and limits to some extent the ability of the regulator to ensure that banks have the appropriate financial strength to withstand economic shock.

5.5.9. High Level Basel III Reforms: Strengthening Vulnerabilities

As a post-script, an important development occurred from December 2017 onwards as the Basel Framework continued to adapt. The Basel Committee on Banking Supervision released an update to its consultative process and produced a high level summary of ‘strengthening reforms’ to the Basel III framework that will assist in avoiding the build-up of systematic vulnerabilities (BCBS 2017; PWC 2017). The important elements of the reform proposals for this thesis are found in the removal of the A-IRB approach for certain asset classes as well as the insertion of certain floors into the model, limiting the extent to which banks can lower capital requirements through subjective input. The following paragraphs will explain the change to previous rule substitutions in Basel III and give worked examples to highlight how the system operates going into 2018. The major change is a realisation that subjective input and on-going problems with risk weights require credibility restoration through (i)
enhancing robustness and risk sensitivities in the ‘standardised approach’ and (ii) constraining the use of model approaches.

A more granular approach has been adopted that deals with risk assets at the class level (exposures to banks, sovereigns, corporates, property, retail etc.), with recalibration of risk weights through ratings or grades; this replaces the previous F-IRB model. Other risk assets such as corporate debt must now be modelled through the standardised ratings approach, as the F-IRB and A-IRB approaches have been withdrawn. Table 6 below sets out the changes in risk weights through a standardised approach; however, as the following examples show in Fig. 16, the ability to reduce regulatory capital remains through managing exposures via credit default swaps and reinsurance markets, as Blundell-Wignall discussed previously (2010).

Example A in Fig. 16 highlights an unrated obligor borrowing £100m for general corporate purposes. Under the reforms set out in Table 6 Bank A lends £100m to an unrated borrower, meaning that 100% risk weighting of the 8% regulatory capital must be applied, creating an £80k regulatory capital charge. Under the previous model, the 100% charge was a flat weighting. However, credit risk now determines the extent to which discounts can be applied to reduce regulatory capital and incentivise banks to conduct lending according to risk factors. Notwithstanding this effect, however, Bank A is able to offset regulatory capital risk by offloading credit risk through a credit default swap contract with Bank B, which has an AA rating. Bank A’s risk now becomes contingent on being paid the credit default swap contract settlement should Firm A as the referenced obligor default. Table A highlights bank risk for an AA rated obligor as 20% weighting of the 8% regulatory capital, thus reducing Bank A’s exposure from £80k to £16k as Firm A’s risk is perceived differently in credit default swap markets. One of the key risks that featured in the 2007 crisis was the way in which credit default swap
contracts created a requirement for banks to contribute more capital as the referenced obligor’s credit risk deteriorated; however, what was not realised was the amount to which regulatory capital should have been increasing at Bank A should Bank B’s rating begin to deteriorate. There is now a revised credit value adjustment framework in place to capture the extent to which Bank B has the ability to settle its obligation if Firm A defaults. This means that Bank A would need to begin increasing the £16k regulatory capital charge depending on how much credit deterioration occurs. Furthermore, Bank B can offload its risk outside of the Basel framework to a reinsurer who is treated very differently under Solvency II regulations versus Basel III. Solvency II is arguably not as advanced as the Basel III framework and does not explicitly set out what an insurer’s regulatory capital should be under certain exposure scenarios or under credit default swaps. This, as Blundell-Wignall (2010) suggested, would create risk migration, disintermediation of markets and potential for instability of long interconnected chains of transactions in the financial system (Ertürk et al. 2010; 2012; IMF 2011). Following Blundell-Wignall’s calculations, the reinsurer’s risk culminates in a £2.2k regulatory capital exposure, meaning that between Bank B and the reinsurer, £61.6k of regulatory capital has been taken out of the financial system. This could result in less resilience to market shock and takes into account the amendments in Table 6 and the CVA, which would increase in challenging market conditions.

Example B concerns Firm A, which is rated A+ and takes out a £100m Mezzanine Loan, which is classed as subordinated debt under the Basel Framework in Table 6. Bank A lends £100m to Firm A; however, under Table 6, subordinated debt is now risk weighted at 150% of the 8% regulatory capital, creating a £1.2m charge, versus a 75% LGD under Basel II due to the inability of fixed term debt instruments to absorb losses. A similar process then unfolds through Bank B’s credit default swap contract with
SVA and then the reinsurance transaction. From an original regulatory capital charge of £1.2m, Bank B and the reinsurance firm have taken out £900k of regulatory capital from the wider financial system.

The above examples highlight the change in approach following the December 2017 Basel reforms and increased regulatory capital; however, the extent to which risk is transferred and migrated may continue to cause problems in the future.

Table 6: Revised Standardised Approach to Credit Risk

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<td>Grade C</td>
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<td><strong>Exposures to covered bonds</strong></td>
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<tr>
<td><strong>External issue-specific rating</strong></td>
<td>AAA to AA−</td>
<td>A+ to BBB−</td>
<td>BB+ to B−</td>
<td>Below B−</td>
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<td><strong>Exposures to general corporates</strong></td>
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<tr>
<td>Risk weights in jurisdictions where the ratings approach is permitted</td>
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<td><strong>External rating of counterparty</strong></td>
<td>AAA to AA−</td>
<td>A+ to BBB−</td>
<td>BB+ to BBB−</td>
<td>Below BB−</td>
<td>Unrated</td>
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<td><strong>Risk weights where rating approach is not permitted</strong></td>
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<td><strong>SCRA grades</strong></td>
<td>Investment grade</td>
<td>All other</td>
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<td>SME general corporate</td>
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<tr>
<td><strong>Exposures to project finance, object finance and commodities finance</strong></td>
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<tr>
<td>Exposure (excluding real estate)</td>
<td>Project finance</td>
<td>Object and commodity finance</td>
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<td>Issue-specific ratings available and permitted</td>
<td>Same as for general corporate (see above)</td>
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<tr>
<td>Rating not available or not permitted</td>
<td>130% pre-operational phase</td>
<td>100% operational phase</td>
<td>80% operational phase (high quality)</td>
<td>100%</td>
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<td><strong>Subordinated debt and equity (excluding amounts deducted)</strong></td>
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<tr>
<td>Subordinated debt and capital other than equities</td>
<td>Equity exposures to certain legislated programmes</td>
<td>&quot;Speculative unlisted equity&quot;</td>
<td>All other equity exposures</td>
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<tr>
<td>Risk weight</td>
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<td>400%</td>
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### Fig. 16 Basel Reforms and Standardised Approach

#### Firm A (AA-) Borrows £100m General Corporate Loan

<table>
<thead>
<tr>
<th>Bank A £100m (Unrated Corporate Loan)</th>
<th>Regulatory Capital</th>
</tr>
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<tr>
<td></td>
<td>Exposures to General Corporates</td>
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<td></td>
<td>£100m x (100% of 8%) = £80k</td>
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<table>
<thead>
<tr>
<th>Bank B CDS Contract (AA-) £100 Corporate Loan Counterparty: BBB</th>
<th>Plus Revised CVA Risk Framework</th>
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<tbody>
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<td>£100m x (20% of 8%) = £16k</td>
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<table>
<thead>
<tr>
<th>Re-insurance Contract CDS Spread + Regulatory Surcharge Coefficient 1.5% &amp; 50% weighting Off Balance Sheet Commitment</th>
<th>Plus Revised CVA Risk Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>8% x (£40k + £15k) * 0.5% = £2.2k</td>
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#### Firm A (A+) Borrows £100m Mezzanine Loan

<table>
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<th>Bank A Subordinated Mezzanine Loan £100m</th>
<th>Regulatory Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>External Rating Approach</td>
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<tr>
<td></td>
<td>£100m x (150% of 8%) = £1200k</td>
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</table>

<table>
<thead>
<tr>
<th>Bank B CDS Contract £100m Mezzanine Loan Counterparty: A+</th>
<th>Plus Revised CVA Risk Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>£100m x (30% of 8%) = £240k</td>
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</table>

<table>
<thead>
<tr>
<th>Re-insurance Contract CDS Spread + Regulatory Surcharge Coefficient 1.5% &amp; 50% weighting Off Balance Sheet Commitment</th>
<th>Plus Revised CVA Risk Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>8% x (£840k + £150k) * 0.5% = £59.4k</td>
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</table>

Source: Author, based on high level Basel III reforms set out in BIS (2017)
5.6. Conclusion

This chapter has answered the research question through a technical and ethical framing of the debate and has critically addressed the limited effect of post-crisis regulation on the banking industry. The chapter began with a political introduction asking why the City of London and its banks had been omitted from regulatory control pre crisis as a lead into the debates and regulatory transformation post crisis. Various implications have been discussed in terms of the vast amount of regulatory adaptation and substitution that has taken place as a consequence of disturbances in the stability of the financial system post crisis and the limited effect of rule change, as Moran (1989) described in subsection 5.3. The ethical framing deals with legislative effects and regulatory response to unethical scandals such as Libor and PPI, which were a direct result of the light touch supervisory model. The regulatory response was to deal with problems via legislation, fines and attempts to rebuild accountability into financial services, all of which have had an impact but have been limited in solving the challenges faced by regulators.

A key recurring feature in this chapter has been the management and gaming of risk models by banking firms or agents of the bank, either in order to increase performance in markets through shareholder value business models or to enrich individuals through the incentivisation on offer. Although the Basel Accords are now on their third iteration with more amendments forecast, elements of Basel III’s algorithm continue to be arbitraged and both risk weights and capital adequacy are distinct weaknesses that have yet to be solved. In addition, whilst precise mathematical models produce precise answers, there are impurities inherent in both the supervision of model implementation and external management and control of the way regulation is applied within banks, and this continues to attract criticism. Alternative ideas have also been presented by way of financial
bricolage as a compelling frame to describe how scientific rationalism via the dominant paradigm of risk management comes up short and why regulators and the functionalism of bank management has found challenge in developing risk management solutions through substitution and adaption of old frameworks. Eventually, reforms have developed to strengthen the Basel framework by fixing the approach banks have to calculating asset risk through its standardised model and limiting the extent to which banks can gain benefit through managing model outputs. The IMF drew attention to this realisation in 2001, but it was 16 years before the BCBS began to mitigate these issues by simplification rather than layering in complexity. Leaving RWA modelling in the Basel framework, however, could allow further bricolage and arbitrage opportunity in the future.
Chapter 6. What are the effects of prudential post crisis regulation on UK banks?

6.1. General Introduction

The next two chapters develop Research Question 3 (Part A and Part B) by approaching the study through a form of natural experiment. The term natural experiment in this thesis is defined as an empirical study that looks to assess the outcomes and impacts of post-crisis regulatory policy responses. This type of study is possible where there is a clear departure from the intentions of post-crisis banking regulation and how banks can be observed operating at the departmental and managerial level (Gerber and Green, 2011). Research Question 2 examined important post-crisis regulatory changes to UK banking. This chapter draws on original data supported by a novel conceptual framework and literature. Research Question 2 was examined in and of itself (a critical account of capital adequacy via RWA management), rather than by looking at how prudential regulation affects the banking firm. To elaborate and make sense of this approach, specific questions are asked relating to a UK banking firm and the various ways the Basel III algorithm has impacted banking business. An important element of the overall thesis is business power and the way in which this cuts to the heart of political judgement and viability of business; in this case, the City and banking (Moran, 2009). Moreover, it is essential in this section of the thesis to introduce politics into the bank de-risking process, and in particular the case of a systemically important financial institution (SIFI), HBoS plc, which became part of Lloyds Banking Group plc post takeover in 2009.

The effect regulatory transformation has had on banking is of importance for several reasons. Policy-making and the power of institutions such as the Bank of England
provide a foundation for describing the way in which microprudential frameworks such as Basel would impact, or indeed have already impacted, UK banks. The natural experiment in this chapter develops this point and is organised into two specific sub-questions in Chapter 6, Part A, and Chapter 7, Part B:

- **Part A**: How does Basel III interface with bank business models and what were its effects and implications on high-risk asset portfolios post the Lloyds / HBoS takeover?
- **Part B**: What are the implications of the Basel algorithm on management behaviour in banks?

Question 1, Part A, sketches out basic research on what the effects and implications have been for banking managers at Lloyds Banking Group plc and how the post-crisis business model has been managed due to the implementation of the Basel III algorithm. This question draws attention to the task that lay ahead of managers facing post-crisis regulatory change and the actions that were taken regarding balance sheet assets. The following paragraphs set out a quantitative and qualitative account of the capital accretive decision-making process that governs accounting metrics of Common Equity Tier 1 (CET1) alongside the increase in regulatory capital (used to describe the security buffer between the banking firm and the taxpayer bailing out private banking firms).

Question 2, Part B, ties into Part A and asks what the implications are for management behaviour at the conjunction of Basel III and for bank managers making accretive balance sheet management decisions. The intention is to develop a theoretical explanation as to how managerial behaviour adapts; this is done by way of a specific case
at Bank of Scotland Integrated Finance in which assets are traced through to the eventual takeover by Lloyds Banking Group plc. Mainstream literature describes the organisation of banking managers through functionalism; this is the essence of their role. This sub-question, however, proposes an original reconceptualisation of bank managers as bricoleurs throughout periods of crisis and fragile markets conditions. Having sketched out the principles underlying the organisation of the next two chapters, progression is made to Question 1.

6.2. Part A: How does Basel III interface with bank business models and what were its effects on high-risk asset portfolios post the Lloyds / HBoS bank takeover?

6.2.1. Introduction

Chapter 5 and Research Question 2 discussed and critiqued the Basel III algorithm, considering its openness to management of risk weighted assets and miscalculation of capital adequacy via its relation to both shareholder value and return on equity. The various responses and developments of the microprudential framework are critiqued through to a strengthened framework in December 2017 (BCBS 2017), with the caveat of arbitraging bank and insurance markets that reduces regulatory capital thereafter. Chapter 6, Part A, however, focuses on two important empirical issues, using Lloyds Banking Group as a case study. Firstly, numerous challenges are detailed, beginning with post-crisis Basel III regulation and the effect of this on banking risk. Secondly, Basel III also affects bank business models, so the regulatory impact at Lloyds Banking Group post the HBoS takeover is investigated. In this regard, banks have taken specific asset management decisions and actions to improve the dynamic and shifting relationship
between risk, income and market performance of the bank. Balance sheet management decision-making affects the denominator in the capital adequacy calculation via risk weighted asset calculations, and the numerator affects cash flow from those assets. The output from these decisions affects the all-important return on equity ratio, which influences share price movement and the way investors think about bank performance in markets.

To grant this process context, this subsection will demonstrate how management decision-making and action affects bank performance. A series of graphical and accounting representations is used to illustrate complex portfolio management decision-making and the way capital adequacy is managed through ‘capital accretive’ decision making. Secondly, there is a capital impact from management decision-making, which can be observed empirically. This work will highlight the macro impact from non-core reductions on the balance sheet (assets the bank no longer wishes to retain) and the positive feedback this has on risk weighted assets, which itself has a positive effect on the denominator in the capital adequacy calculation and improves return on equity. However, the other side of the return on equity calculation is the cash flow impact of this decision-making in crystallising loss making positions through asset distribution, which will again be highlighted through non-core reductions in balance sheet assets. Managing balance sheets assets off the bank’s balance sheet affects income or the numerator of the return on equity calculation, which in this case will be negative and can, together with additional capital requirements in Basel III, weigh on the bank’s share price over time. “The formal language of accounting principle offers a neutral set of accounting technologies for the practice of regulation in key areas of business life” (Moran, 2010, p. 224). Moran steers the principles and method behind the organisation of the following paragraphs.
The purpose of explaining the regulatory process graphically, in terms of the implementation of Basel III within a bank post crisis, is to demonstrate how capital accretive decision-making affects the way risk is managed through ‘de-risking and recapitalising’ bank balance sheets. The performance of the bank is affected by a regulatory enforced distribution of assets to improve the dynamic shaping of balance sheet risk. At the same time, an attempt is made to minimise the extent to which a bank’s cash flow is negatively impacted, thereby reducing return on equity. If Moran’s simple argument that “regulation in any domain in economic life [inclusive of financial markets] is a political affair…. which lies at the heart of relationships between the state and business” (2010, p. 224) is used as a starting point, then the following technical analysis allows insight into the way the politics of regulatory transformation impacts the de-risking and recapitalisation of banks. It is important to use a technical analysis to make sense of the way the political economy of regulation unravels, as this explains and provides a feedback mechanism regarding the net results of transformation.

The data for this exercise was collected primarily from management presentations to the City between 2008 and 2015, alongside detailed narrative from questions City analysts have asked of the CEO and CFO of Lloyds Banking Group. Banks and asset managers have become specialists in what must be disclosed to the market post crisis and may produce the minimal information possible. With this in mind, it has become very challenging to track the process of de-risking and its impact on specific product lines, including the way de-risking flows through RWAs and CET1 and finally the cash accounting and capital accretive nature of the process. The picture becomes harder to trace throughout time as executive management changes inside the

34 Of crucial importance to developing this basic research is public data released via Lloyds Banking Group plc investor relations website on a quarterly basis between 2008 and 2015 (Year end, quarterly reports together with executive narratives: Lloyds Banking Group plc, 2008, 2009, 2010, 2011, 2012, 2013, 2014 and 2015, are of particular note)
bank. Data may no longer be illustrated in presentations, or is depicted in a different way, and regulations or calculations may be amended intra sample period (IFRS or CRDIV fully loaded for example) and without the same measures being recalculated through a restatement process. This means that trends are challenging to track on a like for like basis over several years of accounting. With these limitations in mind, a set of graphical outputs will be presented which inform the narrative explanations behind decision-making and the impact of Basel III on bank risk and performance.

6.2.2. Lloyds Banking Group: De-risk and Run-off Assets

Robert Shiller notes that financial crises are conditioned by a collective misapprehension, or more specifically “a false popular model that had the effect of creating a blind spot to risk” (Shiller 2003). Jaime Caruana, General Manager of the Bank for International Settlements, poses a problem that it may be too early to distil elements of false models; indeed, there may well be a plurality in terms of explanations and blind spot risk (Caruana 2017). However, one important constituent of the false model was identified at the micro level of banks: they would manage proprietary risk models themselves, albeit under light touch supervision via the FSA, and this would somehow provide strength to the systemic nature of risk in banking. Research Question 2 establishes the reaction in terms of reform in Basel III. The starting point for engaging with this material is to establish the portfolio position of Lloyds Banking Group plc during 2009, post crisis and after its takeover of HBoS plc. The following table illustrates group loans and advances from 2010 through to 2015 (when this data was tracked via management information), which highlights outstanding lending over the 5-year horizon. Fig. 17 reflects the joint nature of the post-takeover Lloyds Banking Group balance sheet exposures:
The top trend line in Fig. 17 illustrates a decline in the bank’s loans and advances throughout the period 2010-2015. Group loans and advances are essentially debt and forms of working capital, which are products to finance firms’ long and short term trading requirements. The decline in trend reflects a 29.8% or £193 billion reduction in size of the bank’s balance sheet. The provision of new lending facilities to firms and customers reduces in line with distributive actions of assets already on the bank’s balance sheet. This highlights the challenge faced by politics post crisis in regulating financial markets to provide stability in the financial system, whilst simultaneously asking banks to provide financing to the wider economy to rebuild GDP and replenish Treasury coffers via taxation post bailout. Competing tensions between politics and business are clear. Government and central banks asked the banking sector to manage risk models...
differently through the Basel III microprudential framework to improve resilience and reduce instability in the financial system, whilst simultaneously wanting them to take heightened risk in a post-crisis market in order to assist economic recovery. Banks chose to comply with one side of this equation, notably Basel III regulation, and alongside improved supervision in banking through Pillar 2 of the framework, banks de-risked by reducing the size of on balance sheet portfolio assets. This process occurred from 2010 to 2015 at Lloyds Banking Group plc. As discussed in Chapter 5, Basel encourages specific bank behaviours, e.g. not lending to firms that the algorithm calculates as being higher risk – an example of this would be smaller firms and small and medium size enterprises (SMEs) with less experienced management and holding less collateral or management equity; such lending creates more credit risk for the bank and increases risk weighted assets, creating a need for increased capital adequacy. Roughly 50% of UK GDP is derived from SME revenues, and through Basel, they become materially less attractive for lending due to the impact this type of lending has upon bank performance and return on equity. What this demonstrates is banks signalling that they are unable to meet the competing tensions grappled with by politics. In a banking market instructed by regulation to de-risk balance sheet, often at losses, it makes little sense to be placing new facilities on balance sheet that arguably would necessitate higher amounts of regulatory capital when trading into an economy with an increasing risk trend.

Fig. 17 also outlines what are described as run-off assets. These assets are no longer desirable for the following reasons: (i) the bank labelled assets as non-core to the on-going business plan because they are higher risk under Basel III and create higher risk weighted assets when the bank is attempting to de-risk its balance sheet. The bank may sell certain non-core assets into secondary markets if the economics of a trade make a profit or minimise loss; or (ii) the bank can choose to let loans run off at maturity – no
refinancing—and ask the borrower to re-bank elsewhere. Of primary importance to this decision-making is a judgement on whether non-core assets are contributing positively to return on equity. If the risk-return calculation has become imbalanced through amendments to Basel III and the way risk weighted assets are now being modelled – i.e. regulation has been tightened which had previously been open to manipulation through proprietary models rather than a supervised and managed model – then freeing up the capital employed in supporting such lending becomes capital accretive (see next subsection). Finally, there is often opportunity to refinance transactions on renewed terms. This activity can increase the bank’s income from the advance and could be compelling enough to offset the increased risk from remodelling the risk weights; however, the interest rates charged to the firm or customer to reflect this dynamic could mean different financing alternatives are preferred, e.g. bonds or equity.

6.2.3. Capital Accretive Process

From 2008 to 2015, run-off assets shown in Fig. 17 reduced by 96%, or £179 billion, a considerable effort from management. From 2010 onwards, when run-off assets were tracked alongside loans and advances, an improving ratio can be seen between these variables: 30% in 2010; 2.7% in 2015. What is being described here is a ‘capital accretive’ process.

As part of the capital accretive process, the denominator in the capital adequacy calculation is formed in part from risk weightings applied by the Basel algorithm to different types of assets via a credit mitigation framework (see BIS, 2015, for tables on sovereign, corporate, property, currency, bad debt). Previously, these risk weightings were being managed to reduce the weights, lower the amount of equity needed to support the lending and improve ROE – i.e. net profit divided by a reduced amount of total
shareholder funds (which includes risk weights) will increase ROE. Increasing risk weights via improved accuracy and application of IRB modelling (i.e. reducing the subjectivity of model inputs via standardising LGD as an example – see Research Question 2) also increases the amount of capital the bank must place into shareholder funds and reserve via CET1 to allocate risk absorbing capital to the lending made by a bank to its customers. The change in IRB modelling and supervision (Pillar 2 of the Basel algorithm), in part, reverses previous manipulation of risk weights. Fig. 18 below illustrates the reduction in risk weighted assets in the years 2009 to 2015, principally through non-core and unprofitable advances being made to customers that prior to the crisis were increasing return on equity through proprietary modelling and manipulation.

6.2.4. Risk Weighted Assets and Non-Core Asset Reductions

When studying Fig. 18, it is important to note the way the reduction in non-core assets affects risk weighted assets. The data in this graph is split between core and non-core, with the red trend line displaying the total RWA for CRD IV. This graph illustrates the relationship between Fig. 17 and Fig. 18, regarding the way the reduction in advances and run-off assets affects total risk weighted assets – the correlative impact can be seen, as can the split between advances and core RWA, and run-off and non-core RWA. The following example explains the movements in detail.

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35 CRD IV is the EU Credit Regulation Directive to which Lloyds is subject through EU wide stress testing conducted by the European Banking Authority, in cooperation with the PRA.
Fig. 17 shows that total advances in 2010 were £648bn, compared with run-off assets of £194bn, which contrasts with Fig. 18 and total risk weighted assets of £406bn (62% of total advances), divided into £141bn non-core RWA and £265.4bn core RWA. As run-off assets reduce through to 2015, the non-core element of RWAs also reduces by 94%. This decline reflects a reduction in total RWAs to £223bn, but on total advances of £445bn (now having declined to 50% of total advances, a 19.4% fall in percentage terms). Even though non-core poorly performing loans have largely been removed from the balance sheet by 2015, which shows a capital accretive process (evidence of this will be shown in accounting table Fig. 22), it also suggests that the amount of CET1 increases in relation to total advances and risk weights and supports the advances at a much higher level of 11.5% UK Basel III regulatory capital (see Fig. 13) than was the case pre-crisis, when return on equity was far higher and Basel II stipulated 8% regulatory capital and
was being managed lower through proprietary modelling. This process of managing
balance sheet exposures demonstrates accretive decision-making that results in higher
capitalisation – as will be seen in Fig. 19 later – without the need for raising additional
equity.

6.2.5. Non-Core Asset Disposals

The majority of non-core asset disposals were conducted either by distributed non
performing loan sales (NPL), par sales, business sales or natural run-off between the
years 2009 and 2014, assuming that a loan had an average life of 3.5 to 5.3 years and
was not refinanced. Unfortunately, banks do not release detail on all non-core
transactions and tend to restrict disclosure in this regard, especially around price sensitive
information, i.e. details can affect share price and or hurdle rates for acceptable
transactions, especially whilst working on similar distributive processes via negotiation
with other parties or purchasers.

To grant context to the colossal volume of work involved in realising
Lloyds’ ambition to distribute over £179 billion of non-core assets (the majority from
2009 to 2012), hundreds of transactions every year would be needed to reduce non-
core lending. More importantly, the undernoted analysis can be read in terms of the way
the politics of regulation and risk management has imposed itself on banks. The level
of work, overhead costs, consultation fees and crystallisation of losses (revealed later)
required to conform to the Basel III framework would be significant. The actual
number of transactions to distribute such assets is not known or formally reported upon.

A search of Lloyds Banking Group’s formal disclosures has been conducted. Other

36 Average life of liabilities is not published in audited accounts or under different product instruments. As a
guide, the average life of a loan is premised upon weighted average maturity for all commercial and industry
loans between 2009 and 2014 as published by the FRED website: https://fred.stlouisfed.org/series/EDANQ.
than statements on sector lending or sector spot balances and provisions by segment, there is not sufficient detail of product areas to show which divisions were distributing assets and at what quantum’s. It is helpful to have this level of granular detail to analyse the origin of the non-core losses, which invariably connects to the business strategy pre crisis. The larger transactions listed in the search, often packaged together, are normally disclosed to the market, whereas others conducted individually or in smaller non performing loan sales do not have to be disclosed under IFRS 537, as they are booked as advances (IFRS 2005).

Over a three to four year period, however, it is estimated that between 750 and 1000 individual transactions would have been completed in addition to everyday banking business. It is important to give context to this in the analysis, as this is a material downsizing and de-risking of the bank’s balance sheet, and in terms of UK banks is likely to be second only to Royal Bank of Scotland. In searching for disclosure details, a compilation of public press releases and disclosures was gathered post takeover (see Appendix D). A simple calculation adding up the size of each disclosed transaction fails to correlate with the total non-core distribution from the balance sheet over the sample period; however, the headline numbers are reflective of the task UK banks have undertaken and help to explain the types of transactions the bank has conducted (the Bank of Scotland Integrated Finance transaction – listed in Appendix D on page 301 – will be revisited in Chapter 7).

37 IFRS 5 is an accounting regulation that describes treatment for holding assets held for sale rather than continuing operations. If a major asset or business that investors should know about (as it affects primary business and cash flow) is for sale, or is sold, then it is normally disclosed in the accounts. Smaller assets, such as single non-core loan transactions, will not be listed.
6.2.6. CET1 and Return on Equity

Side by side, we can see how graphs CET1 (Fig. 19) and ROE (Fig. 20) relate to each other, which helps to explain the movements in advances and non-core RWA. In relation to Fig. 19 below, 2013 saw CET1 recalculated on a CRD IV basis (the European standard for common equity Tier 1, fully loaded – theoretically a higher standard than that of the Bank of England UK Basel CET1 calculation: (See Fig. 13)), in which RWAs are expressed as a percentage of CET1 and then restated, historically to 2010. This demonstrates Lloyds, as a systemically important financial institution (SIFI) (vs. a Global SIFI bank which would have additional regulatory capital requirements), eventually exceeding the 13% mark (CET1 + additional Tier 1 + Tier 2 + capital conservation buffer + countercyclical capital buffer). Given Lloyds’ colossal effort to reduce non-core lending on a capital accretive basis, the increase in Basel III’s regulatory capital breakdown means that CET1 increases steadily in relation to a reduction in RWAs. The CET1 ratio rises from 7.1% in 2010 to 13% in 2015 the years in which the non-core RWA reductions were conducted – demonstrating the ‘inverse relationship’ between RWA assets and regulatory capital (adequacy). If Lloyds had not conducted the run-off and non-core distribution exercises, maintaining unprofitable advances and balance sheet positions, the bank’s return on equity would have been materially worse than in Fig. 20 below. Of further interest to the distribution of assets and capital accretive process is the way this would have affected stress testing by the Bank of England. Without making significant progress in de-risking the bank’s balance sheet through non-core asset sales, non current assets held for sale or what may be labelled discontinued operations (under IFRS 5), there would have been material pressure on passing the hurdle rate CET1 capital and leverage ratios in a stressed scenario (BoE, 2016), and an inability to pay dividends to shareholders if non compliant.
Lloyds Banking Group plc publishes annual movements in CET1 regulatory capital. Annual changes in CET1 are displayed as a movement bridge between periods. To illustrate the importance of de-risking and the effect on Lloyds’ CET1 caused by the reduction in non-core RWA and capital accretive management of the balance sheet, Fig. 19 below shows an increasing CET1 figure throughout 2010 to 2015, but it is overlaid by the annual ‘percentage impact’ (1.7% in 2010, and so on) of risk weighted asset decision making and distribution on the positive trend (e.g. in 2010, the increase in CET1 was 2.1%, and 1.7% of this was credited to the impact of capital accretive management of balance sheet assets). The annual bridge for CET1 contains various accounting items that are both positive and negative to the movement between years; however, between 2010 and 2014, the largest contributor to the annual increase was the management of RWA.

**Fig. 19 Lloyds Banking Group: CET1 / CET1 Restated CRDIV**

![Graph showing CET1 movements](image)

*Source: Author, premised on data from Lloyds Banking Group management presentations 2008-2016.*
Fig. 20, below, demonstrates the movement in return on equity throughout the same period for a group of UK banks and the way Basel III’s higher regulatory capital weighs on the denominator in the ROE calculation. Years 2006 to 2007 have been tagged on to illustrate where ROE was pre crisis whilst RWAs and capital adequacy were calculated via Lloyds’ own proprietary risk models – i.e. Lloyds 26% and 28% respectively, which is very high contrasted against the majority of its peer group.

High ROE magnifies the problem of banks that manage capital adequacy ratios lower to improve returns pre 2007 via Basel II. However, and significantly, the previous microprudential framework meant management actions that underpinned these movements were fully compliant (as explained in Chapter 5). High ROE driven by a low capital adequacy ratio (i.e. RWAs were managed according to proprietary models and arbitraging risk weights) artificially elevates bank return profiles (Ertürk 2013). The years 2008 and 2009 witnessed the impact of the financial crisis on bank performance. A collapse of ROE followed at Lloyds in 2009 and 2010, succeeded by a period or relative stability well below market expectation of 15%+ (Engelen et al. 2011), i.e. between -6% and +3% during the de-risk and recapitalise period between 2009 and 2015.
Barclays’ ROE continued to perform at a higher level during 2008 and 2009; however, the bank was later found to be manipulating off balance sheet management of assets through a complex off-shore legal SPV arrangement which required less regulatory capital. This allowed the bank to maintain a superior ROE compared with its peer group (See “Protium” discussion – Crowther and Ertürk 2016, p. 273). Challenges were also found in the numerator of the ROE calculation, i.e. net profit, which is impacted by Basel III costs, as well as both conduct fines and costs of implementing other forms of financial regulation, such as MiFID. It is worth splitting these costs to note the effect of Basel and other costs in the bank’s profit and loss statement. Net profit at Lloyds fell sharply post 2009, in part due to Basel III and additional capitalisation, but the fall was also caused by income reduction from distributing higher yielding non-core assets between 2010 and 2014. During this period, liabilities were allowed to run off through repayment or expiry,
whilst allocating lower amounts of capital to new lending in products with more prudent risk profiles (see Lloyds Banking Group plc 2017, results presentation, p. 2.). Lloyds discuss a prudent risk appetite and balance sheet profile as a distinct competitive strength when correlated with a strong capital position (although this has not correlated to an increase in ROE or an increase in market performance and share price, as profits have reduced materially 38. Net profit has also been impacted by regulatory costs from conduct fines39 (inclusive of on-going fines for mis-selling PPI and hedging), alongside other costs for implementing MiFID and Vickers’ ring fencing. Regulatory fines and costs of implementation are deductions from the bank’s profit and loss statement before the profit line. Hence, if banks continue to operate in a non-compliant fashion then the net profit line will be affected. This also explains why banks show different metrics to cover these fines, as they want to hide the effect of fines on the profit and loss statement by showing investors what the underlying run-rate of profitability would be ‘if’ the fines had not been applied. In this way they can project what the upside to returns will be ‘when’ or ‘if’ these conduct issues fall away.

On the denominator side of the ROE equation, capital adequacy from higher CET1 and Basel III regulatory capital, plus higher risk weighted assets from using the standard IRB approach to modelling (see Chapter 5 for details), leads to a compression of the return on equity metric from both sides of the calculation. This is why ROE performance has been very low at Lloyds Banking Group and its peers throughout the sample period.

39 2012-2016, total bank fines for poor conduct globally have been calculated at £264 billion: Lloyds Banking Group (£20.47 billion), alongside Royal Bank of Scotland (£21.51 billion). Both UK banks are ranked in the top 5 institutions fined for poor conduct – RBS 3rd, Lloyds 4th (CCP Research Foundation, 2017: http://conductcosts.ccpresearchfoundation.com/conduct-costs-results).
6.2.5. Non-Core / Run-off Portfolio and Accounting

As suggested above, there is sparse disclosure at Lloyds regarding granular detail at the departmental level as to the run-off / non-core portfolio. It is interesting to note which divisions, departments and products have seen the largest hits to performance, as this indicates where the problems have been within the bank and illustrates the way that distributive decision making washes through the accounting process to highlight its capital accretive nature. As noted above, without pushing the capital accretive process through, Lloyds’ ROE would have been materially worse than in Fig. 20. However, via piecing together data from management presentations alongside accounting information, the workings of the capital accretive process can be seen in more detail. Taking the year 2013, Fig. 21 highlights £64bn of run-off / non-core assets (which corresponds with the graph in Fig. 17) and quantifies the split by departmental structure, illustrating which entities are responsible for the largest non-core distributions.
This is helpful to the analysis as RWA reduction can be attributed to divisions and likely product lines. The total £64bn figure in 2013 is a 67% reduction in non-core assets throughout 2010-2013. The forecast at that time was to reduce the figure further into 2014 to £23bn and the actual result, which was an improvement to £17bn, is overlaid for comparison. The risk weighted assets associated with the £64bn non-core element are £39bn (Lloyds Banking Group plc 2014, p.19) which relates to the quantum of UK retail assets (mortgage debt that is collateralised, and so has a lesser risk weighting attached via the Basel algorithm), whereas the run-off assets listed in the Dec-13 column have a higher risk weighted assets figure of £31bn on a total of £33bn. This highlights the higher risk weighting in corporate and commercial real estate assets.

Post the ICB’s ring fencing recommendation, Goodhart (2010) notes that the problems of

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**Fig. 21 Non-Core and Run-off Portfolio**

<table>
<thead>
<tr>
<th>Total Assets</th>
<th>64</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK Retail</td>
<td>26</td>
</tr>
<tr>
<td>Dutch Mortgages</td>
<td>5</td>
</tr>
<tr>
<td>International Retail</td>
<td>11</td>
</tr>
<tr>
<td>Treasury Assets</td>
<td>3</td>
</tr>
<tr>
<td>UK CRE</td>
<td>7</td>
</tr>
<tr>
<td>Other Corporate</td>
<td>11</td>
</tr>
<tr>
<td>International Corporate</td>
<td>4</td>
</tr>
<tr>
<td>Dec-13 Non-Core</td>
<td>15</td>
</tr>
<tr>
<td>Dec-13 Run-Off</td>
<td>15</td>
</tr>
<tr>
<td>End 2014 Target</td>
<td>23</td>
</tr>
<tr>
<td>Int'l Retail &amp; Non Retail</td>
<td>17</td>
</tr>
</tbody>
</table>

Source: Author – data from LBG Prelims 2013
mortgage based debt, inclusive of a significant percentage of bank losses on commercial or residential mortgages would remain within the ring fenced entity. Goodhart points out that Vickers targeted the incorrect approach to structural regulatory response and resilience as ring fencing fails to protect the banks critical systems or the taxpayer from a bailout requirement.

Fig. 22 illustrates how capital accretive RWA accounting operates in terms of releasing capital back to the balance sheet and improving CET1. Cross-referencing with Fig. 18, the difference in non-core reduction between 2012 and 2013 is £33.9bn, which is highlighted in the 2013 column. It is curious to look at how non-core RWAs flow through Lloyds Banking Group’s annual results, so the numerical effect is seen through accounting treatment. In Fig. 22, RWA reductions are highlighted in billions:

Fig. 22 Non-Core Reductions – continue to be capital accretive

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss Before Tax (£m)</td>
<td>(1,839)</td>
<td>(3,315)</td>
<td>(3,664.0)</td>
</tr>
<tr>
<td>Post Tax Loss - Capital Consumed</td>
<td>(1,411)</td>
<td>(2,503)</td>
<td>(2,693.0)</td>
</tr>
<tr>
<td>Reduced RWAs (£bn)</td>
<td>33.9</td>
<td>35.9</td>
<td>35.1</td>
</tr>
<tr>
<td>at 10% - capital released £m</td>
<td>3,385</td>
<td>3,590</td>
<td>3,513.0</td>
</tr>
<tr>
<td>Decrease (Increase) in EEL (Excess Expected Loss from CET1)</td>
<td>589</td>
<td>131</td>
<td>(515.0)</td>
</tr>
<tr>
<td>Net Capital Released (£m)</td>
<td>2,563</td>
<td>1,218</td>
<td>305.0</td>
</tr>
</tbody>
</table>

Source: Author, based on accounting between 2011-2013 LBG results presentations

In 2013, the bank made a loss before taxation of £1.8bn and a post tax loss of £1.4bn. However, the reduction of RWA is layered in at £33.9bn. Importantly, the accounting treatment stated in the Lloyds accounts involves releasing 10% of the reduced RWAs back to the bank, as this non cash movement is no longer required to
support the lending, which has been distributed through non-core sales (Lloyds Banking Group plc 2014, p.39). In 2013, the capital release totals £3.4bn. There is also a decrease in excess expected loss from the reduction in non-core RWA assets, a movement that accounts for the re-addition (or deduction in 2011) of an over accrued loss expectation. In total, adding back the 10% capital release and the decrease in EEL creates a £2.6bn surplus to shareholder funds. In this way, the reduction in capital accretion nets back against the losses from the P&L account as stated at £1.4bn. The £2.6bn add-back to shareholder funds via RWAs would have increased ROE; however, in 2013, the ratio remained negative, highlighting the impact of Basel III and heightened regulatory capital on bank performance metrics. For purposes of clarity, 2012 and 2011 have been added as worked examples to demonstrate the point.

6.2.8. Conclusion

This chapter has reported on the effect of post-crisis regulatory change on Lloyds Banking Group and on the associated implications of this, as well as detailing the politicisation of regulatory reform and its effect on management decision-making. This reform aimed to ensure banking firms are compliant with amended post-crisis microprudential regulatory policy. The impact of Basel III and increased regulatory capital, when coupled with revised methods for calculating risk weighted assets, has been nothing short of crushing to returns and profitability throughout the de-risking and recapitalisation process. This has created significant managerial challenge and wholesale change in portfolio construction through various forms of difficult asset distributions in order to reach the hurdle rate CET1 ratio and regulatory capital requirements in Basel III.

At this point the chapter draws its constituent parts together and opens up
an alternative side of the research. The behaviour of managers at Lloyds Banking Group plc and the way they have managed the bank’s balance sheet post adopting the macroprudential framework of Basel III has been observed. There is a vast body of literature on management of firms; however, when related to the management of banks, its essence is described through functionalism. Finance management and academic textbooks describe bank managers in terms of the functions they carry out and the way they manage risk: credit risk, liquidity risk, interest rate risk, operational risk, exchange risks, regulatory risk and so on. The functionalism setting and description of bank management cannot be applied to Lloyds Banking Group plc’s adoption of the Basel III framework and the way it managed its balance sheet to become compliant. Furthermore, and in a different setting to observe whether functionalism applies, how can the behaviour of managers at HBoS be described pre crisis and through the takeover with Lloyds? An alternative way of describing the behaviour of senior managers in banks can be determined by analysing how the Basel algorithm has impacted management behaviour. This question will be addressed in the following chapter.
Chapter 7. PART B: What are the Implications of the Basel Algorithm on Management Behaviour in Banks?

7.1. Introduction

In this chapter, the final sub-question will be posed, asking what the implications of Basel’s algorithm have been on management behaviour in banks. In order to engage with this type of question, it is important to address the norms of functionalist bank management, as understanding these is essential to answering the question. The conclusion of the previous chapter touched on functionalism; however, a fuller description is offered here. Lock and Spender suggest that management roots itself, ruthlessly and systematically, as an expression of a ‘special group’ entrenched in an organisation (2011), and vested interests are usually underpinned by a dominant theory. It is a commonly held belief that bank management is underpinned by an integrated approach to the theory of risk management, which operates through economic assumptions of capital and its association with risk (Froot and Stein 1998; Jorion 2000; Rosenberg and Schuermann 2006; Aebi et al. 2012). To realise this association, banking management is tasked with the job of describing its role. Bank management is industry focussed and functionalised – credit risk, liquidity risk, interest rate risk, operational risk, exchange risk and regulatory risk are its managerial essence – according to academic textbooks, many of which are into several editions (Bascom 1997; Koch and MacDonald 2009; Rose and Hudgins 2010; Hillier 2016). It is questionable whether bank management behaviour fits the framing of functionalism as described in the case of HBoS pre crisis. Perhaps the problem can be stated more simply by questioning whether functionalism always fits this framing post crisis, after banks have implemented Basel
This chapter is organised along the following principles: firstly, to test the above question, a single but detailed business case is offered through a department called Bank of Scotland Integrated Finance found within the HBoS plc business.; secondly, a Minskian framework is developed to provide a scaffold for the examination of the case; thirdly, an asset management decision making process is followed through three separate opportunistic stages of development across two banks involved in a takeover process; and finally, an adapted theory from literature is offered to suggest that a wider explanation of management behaviour is required beyond what is described in mainstream texts.

7.2. Bank of Scotland Integrated Finance

The following case has been researched from a combination of concepts, observations and details outlined in previous chapters, publicly available reports from politics – parliamentary reports on bank crises; regulators (FSA / FCA / PRA); banks (audited accounts and quarterly investor presentations at HBoS plc (HBoS) and Lloyds Banking Group plc (Lloyds); and firm disclosures (annual returns at Companies House)). The methodological approach employed is a pragmatic mixed method, as set out in Chapter 3; in this case the method is founded on forensic accounting and the formulation of a coherent account from multiple sources of data. The case is organised as follows: a brief introduction to aid understanding, followed by a theoretical structure upon which the chapter is grounded, and finally, specific background information on the BoSIF business pertinent to how questions are presented regarding managerial behavior at different conjunctures and events.

As an aid to understanding how management behaviour is affected through...
regulatory change, a business case is offered through Bank of Scotland Integrated Finance (BoSIF). This was a departmental brand at Bank of Scotland, which became a corporate subsidiary of HBoS via the 2001 merger. HBoS as a brand remained, however the trading entity was closed and its assets were sold through a politically negotiated takeover with Lloyds TSB Bank plc in January 2009. This case is crucial in demonstrating how managers behave when a banking firm heads through a period of regulatory change and is confronted by markets in crisis and a business model showing signs of fragility.

Approximately 23% of the 2008 HBoS corporate loan book was attributed and categorised as ‘specialised industry lending’, which is where the BoSIF product was located inside the firm (PCBS 2013, p.55). This activity can be broken down into specific products and departmental brands, namely joint ventures (JVs) and integrated, structured and acquisition finance (ISAF), which functioned through high risk leveraged debt, with commercial real estate products structured into transactions in many cases. These businesses were entangled in the process of bank crisis and the failure of HBoS post 2007 (PCBS 2014, Annexe 1, p.54). BoSIF was an important business within the ISAF division, and it featured prominently within the HBoS growth strategy (PCBS, 2013). The 2001 annual report described ISAF as “a ‘market leader’ by number of management buy-outs for the past 10 years” (HBoS plc 2001, p.28). BoSIF operated in the leveraged buy-out market and its specific unique selling point was its offering, i.e. the business financed both equity and debt in the same transaction – an unusual combination of lending products. Traditional governance models encourage banks to separate debt and equity instruments as they are traded in different markets and are often split ‘private’ and ‘public’ (see examples of ‘good’ and ‘poor’ practice: FCA, (2015d)). Private and public markets have very different rules and regulations, which are managed through compliance departments and Chinese wall policies that, if improperly managed and the temptation
arises, can create clear opportunities for arbitrage and personal enrichment for banking practitioners. BoSIF convinced internal compliance officers of its capability to manage these market risks within the epoch of FSA light touch regulation (see Financial Services and Markets Act 2000, s. 137P – Control of Information, which governs regulated information within the same firm). The rules have been tightened significantly since; details of market abuse and insider dealing regimes alongside industry guidelines to market conduct can be found in Loan Market Association briefings (Loan Market Association 2013; Linklaters 2015).

7.3. Minsky
This section will draw upon the work of Hyman Minsky (1982; 1992), who dedicated a body of academic work to describing the process by which businesses such as BoSIF rise to prominence and why the high-risk nature of its lending activity becomes accepted normal practice as the market heads towards financial crisis. There is a consensus between Minsky and a number of post-Keynesian economists and critical thinkers that “stability creates instability” (1992). For Minsky, the explanation of rising instability over time had strayed too far from Keynes’ own ideas and required detailed examination, along with those of Hicks, who omitted to model ‘banks’ in the IS-LM model (1980), which observed the relationship between investment and money. Minsky described the way in which banks transition towards unstable markets (see Literature Review: Chapter 2, section 3.2) by switching between hedge, speculative and ponzi lending, which is an important factor in the formation of financial bubbles in markets (Keen 1995; 2013).

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40 The FCA changed tack in 2017, and instead of cherry picking cases of non compliance to deter practitioners from abusing insider trading regulations, it now pursues every lead via new methods of surveillance: 84 probes were initiated in 2017, with 30 convictions since 2009, reports Bloomberg via a freedom of information request Ring, (2017).
2017). John Maudlin, a leading US economist, summarises Minsky’s thesis in this regard:

“The more comfortable we get with a given condition or trend, the longer it will persist and then when the trend fails, the more dramatic the correction. The problem with long-term macroeconomic stability is that it tends to produce unstable financial arrangements. If we believe that tomorrow and next year will be the same as last week and last year, we are more willing to add debt or postpone savings in favour of current consumption. Thus, says Minsky, the longer the period of stability, the higher the potential risk for even greater instability when market participants must change their behaviour” (Maudlin, 2014).

Between 2003 and 2007, pre financial crisis, the UK market went on a long bull run (see Fig. 23, FT Data), throughout which banking markets progressed via a boom growth period and universal expansion, organically and through merger which contributed to the pre-crisis marketplace (See Fig. 24 for European merger and acquisition market by volume and quantum, Institute for Mergers, Acquisitions and Alliances, 2016). Both equity and M&A markets show material growth. These trends connect to a financialised economy in which an increasing percentage of GDP is created through finance capital and related activity (Epstein 2005; Krippner, 2005; Hilferding, 1981).

Importantly, pre financial crisis, market stability and rising market values created a situation in which banks changed strategies and products. Banks innovated into increasing demand in order to create different streams of higher yielding revenues. These activities contributed towards higher ROE, which influences positive movement in bank performance, capital gains on shareholdings, increasing dividends and significant bonuses
for bank managers and employees (Engelen et al., 2010). BoSIF was one business that traded into these tailwinds.

Fig. 23 UK Equity Markets Bull Run 2002-2007

![Graph showing UK Equity Markets Bull Run 2002-2007](source: Financial Times Data (FT.com, 2017)

Fig. 24 European M&A Market 2002-2007 by volume and quantum

![Graph showing European M&A Market 2002-2007 by volume and quantum](source: Website - Institute for Mergers Acquisitions and Alliances (IMAA, 2016)

7.3.1. BoSIF, Risk and Minskian Typology

BoSIF supported mid-market transactions in the £50-£500m debt range (See BoSIF
company information: Relationship Science, (2017). Between 2002 and 2007, the mergers and acquisitions market was particularly buoyant (See Fig. 24). Market liquidity soared as investors searched for high yield returns and the primary buy-out market was active. At the top of the market in 2007, pre crash, experienced private equity professionals were joining BoSIF. Paul Brooks (20 years experience, ex 3i, Charterhouse, PPM Capital), stated:

“Bank of Scotland’s Integrated Finance division provides innovative and highly competitive solutions to the financing of buy-outs which appeal particularly to management teams. This has resulted in the business achieving a significant and growing market share in a highly competitive market place. I’m delighted to have been invited to join the business and share with it my experience as Integrated Finance embarks on the next phase of its ambitious growth plans” (Private Equity Wire 2007).

The majority of transactions involving book-runners and mandated lead arrangers\(^{41}\) feature debt quantum’s between the mid-cap space (£150–£750m) to bulge bracket deals (£750m-unlimited). Typically, mandates for these type of transactions are awarded to larger investment banking firms via a competitive beauty parade selection process. The banks selected were usually the major players (United States investment banks) with established prime brokerage and traditional banking relationships – i.e. customers can borrow securities and cash to invest on a netted basis to achieve an absolute return. Investment banks had superior credit ratings and access to cheaper capital, and had a successful track record in both financing buy-outs and syndicating debt to market

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\(^{41}\) Senior and experience banks involved in arranging debt facilities

Given the above market environment, HBoS’ ambitious growth strategy and the launch of the BoSIF product into what was already a competitive space controlled by investment banks, meant that the business was introduced to transactions that were of considerable risk and with which the investment banks were not prepared to engage. In many cases, mid-market transactions encountered challenges of significant magnitude, and often banks rejected the opportunity to support the target company and its management team. Problematic transaction variables would include requests for too much leverage by management (debt:equity ratio), structuring issues in terms of which financing instruments to use, problems with shareholder agreements, disagreements regarding who should sit on the board, non executive directors, voting rights etc. The list of problems was a considerable one due to heightened risk and the complex nature of single bank debt and equity transactions.

Importantly, the above characterisation describes the type of transaction HBoS was prepared to engage with, and what was deemed to be an accepted norm at that time in the economic cycle. Traditionally, BoSIF would not be considered a staple business at the core of HBoS’ product base in corporate banking – nor would a high street bank making exceptional return on equity. However, due to competitive market pressure and stability in markets, which create a conjunctural space for new innovations such as BoSIF, there was an opportunity to make high ROE, making exceptional returns for shareholders and bonuses for employees. The bank continued to engage in these high risk-return practices to encourage an accreting share price. BoSIF maintained its ambitious growth plan and high risk-return/loss lending post-crisis under the mantra of ‘lending through

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42 Also see searchable databases that illustrate buy-out league tables in M&A, Equity, Bonds and Loans: Deal Logic and FT.com
Minsky offers a typology for markets, firms and investors as they head through various stages of market risk development and a period of stability. The stages are categorised as ‘hedge, speculative and ponzi’ (Minsky 1992; see Literature Review: Chapter 2, section 3.2). Ponzi was the final fragile stage in which the market participant had over extended its reach, taken on too much risk and no longer had enough cash flow to meet its interest and capital repayments (Minsky 1992). As Maudlin notes above, the size of the crash following the deflation of a credit bubble, or from a peak ponzi position, increases as the period of stability elongates (Maudlin 2014). BoSIF was a ponzi type business both with the risks it had underwritten and the assets it taken upon its own balance sheet whilst operating in a hybrid market of debt and equity. These types of transactions are normally conducted in spaces that private equity and investment banking are geared up to participate in, but such was the pressure to compete in markets that high street banks re-orientated themselves towards higher risk business and products (RBS had a similar business known as Structured Debt Solutions43 to compete post BoSIF’s initial success in bull markets). The level of underlying reserves HBoS had on balance sheet to absorb potential losses when the credit bubble deflated underlines the point that its business model was unable to support itself, including the BoSIF business and ISAF division. The level of underlying reserves HBoS had on balance sheet to absorb potential losses when the credit bubble deflated underlines the point that its business model was unable to support itself, including the BoSIF business and ISAF division.

The origination of BoSIF transactions created very high returns for the bank – but with high returns comes high risk. Profits were generated from a range of sources.

43 Structured Debt Solutions is now defunct and was returned to a separate debt and equity business with RBS International’s Division: https://www.rbsinternational.com/corporate/finance/g1/structured-finance.ashx
Primarily, BoSIF profits were created from capital gains raised from increasing the value of firm equity through an active management partnership process with the executive management team, in which sales, business process and cost of sales were a focus, whilst also providing expansionary or acquisition capital for growth. Ultimately, the sale of target company shares upon exiting the transaction released profits from the capital appreciation process. Profits were also generated from fees, origination-syndication-trading, and via high interest yielding coupons on the debt instruments given the nature of risk employed. Finally, the bank also made considerable profit from cross-selling products to the customer (currency hedging, interest rate management, factoring, asset backed lending). Banks have a large suitcase of products (Relationship Science 2017).

The financial crisis arrived in August 2007. Debt markets collapsed, and as illustrated above (Fig. 23 and Fig. 24), debt markets are correlated with a severe fall in equities (from 1 October 2007 to 1 February 2009 the FTSE fell from 6467 to 3760, a decline of nearly 42%). The Minsky Moment had arrived and the technical liquidity fix through the Bank of England via bailout came to the fore in 2008 (see Engelen et al. 2011, pp. 126-131 for an interesting debate on whether it was a Minsky Moment or an industry beyond technical control, also Davidson (2008) and Dymski (2009). In more technical terms, equity investments within banking firms require an accurate value and are adjusted in line with market volatility and Value at Risk accounting treatment – a statistical technique used to measure and quantify the level of financial risk of a firm’s liquidity or investment portfolio over a specified time frame (Saunders and Cornett 2014). Consequently, equity invested in target companies by BoSIF had to be marked to market. If there was no market from which to reference and make provisions against,

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44 There is a difference of opinion in literature as to whether this risk management technique is fit for purpose. Cherubini and Lunga (2001) and Woods et al. (2004) critically discuss VaR treatment and the way its accounting practice and institutional proliferation places bank credibility at risk rather than accurately quantifying financial risk for liquidity and investment.
as was the case in illiquid BoSIF transactions, due to the niche market in which the business operated and the size of transactions, then the positions were marked to ‘fair value’ and verified by internal credit partners, internal audit and independent external auditing. BoSIF marked down its equity investments prior to the Lloyds-HBoS takeover in January 2009. There were also leveraged debt instruments involved in these transactions which ranked ahead of equity in terms of security but were trading in secondary markets at a discount to par value. In theory, if debt is impaired and ranks senior to junior instruments such as equity, then the equity invested in the business is of minimal value, other than through securing a position in any prevailing negotiation in restructuring talks. Therefore, if senior debt in the transactions funded by BoSIF was being downgraded through illiquid asset calculations, it is likely that the equity portfolio was under water and required provision from balance sheet reserves.

7.3.2. Opportunity 1: Asset Write-downs

In the following section, the executive in charge of BoSIF will be referred to as Managing Director (MD). BoSIF made its debut in the early 2000s, and was supported by the bank’s announcement to increase its risk appetite and open its cheque book premised upon the considerably larger balance sheet of HBoS (Fraser 2012). MD’s behaviour was, as described in mainstream textbooks, to manage risk, liquidity, assets, capital, cash-flow and resources of the department. MD had assisted in creating and was now managing a hybrid-banking product that sat between private equity and corporate banking, taking risk positions that were outside of the bank’s normalised risk appetite and profile.

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45 Fair value accounting is a challenging field in itself that continues to evolve. A paper by Andrews (2011) flags the problematic nature of calculation and assumption that goes into pricing illiquid assets.
BoSIF was indeed part of the growth-return culture earmarked as part of the bank’s risk review (PCBS 2013), and was a conjunctural market opportunity created by the elongated cycle of market stability. Inside this period of stability, new forms of risk had been created which are referred to herein as Opportunity 1. MD was an important and highly influential character within the corporate and wider bank given the considerable contribution the department was making to return on equity – in excess of 51% in ISAF, 2006 (PRA and FSA 2015).

However, as the crisis unfolded MD came under fire, as did his superior Peter Cummings, the corporate bank’s CEO. MD continued to conduct high-risk BoSIF business until 2009, when he was forced to mark down the BoSIF equity portfolio by £900m, primarily due to overpaying for target companies whilst over ambitiously pushing for growth and ROE performance in fragile markets (PCBS 2013). MD’s actions were of course free from recourse to personal bonuses, options or pension contributions. Clawback legislation under the current PRA Capital Requirement Legislation (575/2013 and CP33/16) was not in force during 2009, although it is likely that MD would have been a ‘material risk taker’ under the legislation and subject to its restrictions (The Bank of England 2016). Cummings noted that it took HBoS a considerable amount of time to reduce asset growth post-crisis as it was under attack via issues “outwith its control” – the opinion of the regulator differed (FCA and PRA 2015, see para 84 and Part 3 - 3.14).

The FSA described the corporate division at HBoS as ‘culturally optimistic’ with an executive that was in ‘collective denial’ over its part in HBoS’ journey through the financial crisis (PCBS, 2013; FSA and PRA, 2015). MD is not mentioned in the aforementioned PCBS or FSA-PRA reports despite his role in creating significant loss making positions. BoSIF was responsible for a relative small quantum of assets amongst the large divisional exposures under the command of Cummings and the ISAF division.
Cummings had cast a shadow over the behaviour of MD, who remained outside of public scrutiny, however, his involvement is discussed elsewhere (Ebrahimi 2012). Newspapers reported MD stating the primary reason why the FSA failed to haul him before the PCBS (with a similar penalty to that which Cummings received, a £500k fine and lifetime ban from being a company director in the City), despite his close working relationship with Cummings as his most high profile managing director within the ISAF business (Ebrahimi 2012).

The crisis progressed, and in January 2009, a buyer was found for the failing HBoS bank. In the process of merger, Lloyds Banking Group (as it was renamed post takeover) decided to fully integrate the two banks (whilst maintaining established high street brands) rather than, as the US and parts of Europe had done, separate balance sheet assets to create a ‘good’ and ‘bad’ bank (Faucette et al. 2009). A leading spokesperson from the Independent Commission on Banking suggested that this was indeed a mistake (Interview 6). In doing so, senior personnel in the credit department flagged the likelihood of significant losses, the full extent of which was only realised in subsequent years – c.£11bn write-down in asset value on an original acquisition price of £12bn (Financial Times 2008). Part of this reduction in asset valuation was crystallising losses pertaining to the BoSIF equity investments, contained within Fig. 18, and the earmarked £189bn of non-core RWAs to distribute.

The Basel III algorithm and increased regulatory capital requirements meant that the risk adjusted regulatory capital to maintain the acquired BoSIF equity positions, even on a marked down basis, would have weighed considerably on capital adequacy, CET1 and ROE. Asset values continued to fall post merger and a second round of asset write-downs was carried out through ‘Project Lundy’ (see subsection 7.3.3).

In summary, Opportunity 1 had been an exercise to create a hybrid debt and
equity business in a stable bull market within a bank not noted for its risk appetite or position in the marketplace in order to create high ROE for the bank and bonuses for the MD. When the 2007 crisis occurred, significant write-downs in asset values were conducted and provided for prior to the merger with Lloyds, demonstrating that BoSIF had over extended itself and was unable to support its own business model.

7.3.3. Opportunity 2: Lloyds’ NPL Sale

Acquisition of BoSIF assets via the Lloyds corporate takeover of HBoS (£12.2 billion acquisition of HBoS on 18 September 2009, and subsequent government recapitalisation plan on 8 October 2009, with execution of the same on 13 October 2009: Lloyds received £20.3 billion for the combined Lloyds-HBoS entity (UKFI 2010)) meant that a senior executive was required to manage the on-going lending and equity investments that MD had originated. Lloyds was a traditional corporate lender and had not become involved in new lending innovations such as BoSIF. Executive experience of managing hybrid debt-equity investments at Lloyds was in short supply. Media reported on the potential synergies with Lloyds Development Capital, the bank’s own private equity firm (Real Deals 2009), however, such a reorganisation to exploit corporate synergies failed to materialise. The Financial Times reported on HBoS’ weak performance, in which the significant write-downs on initial BoSIF investments through the takeover process had occurred, and appeared surprised that Lloyds re-engaged MD in the merged entity (Croft 2009). MD’s role was to manage the old BoSIF business within a newly formed “Special Assets” department at Lloyds Banking Group. MD had been responsible for putting high-risk transactions (written down and provided for) onto the HBoS balance sheet and subsequently Lloyds’ balance sheet and, as noted previously, was handsomely paid for the task. Now MD at Lloyds Banking
Group, was awarded a second chance to take remuneration from working with these transactions and within a framework of a bailed-out taxpayer-owned banking firm. Any use of the word “special” in banking, whether it be a departmental name or a title, (e.g. ‘Head of Special Assets’, or ‘Head of Special Projects’) is normally a euphemism or placement card for a business or role that will not last long, or awaits strategic decision making (Croft 2009). Lloyds was never a traditional home for an integrated finance type business or its associated equity investment-return strategy.

Lloyds had targeted BoSIF assets for a further round of asset write-downs as it became clear that the bank was preparing ‘special assets’ for an NPL sale process as a result of realising that the bank was long on risk weighted assets, as noted in Fig. 18. BoSIF equity investments attracted considerable RWA premium, which weighed on the bank’s return on equity and market performance (see discussion in Chapter 6, section 2.3).

Alongside senior internal risk colleagues, MD was put in charge of this front-office work. After a profits warning at Lloyds Banking Group plc in February and May 2009, UKFI, the newly formed institution that owned and managed all shareholdings in UK banks on behalf of Government and taxpayer, made it very clear that banks must become worthy of a strong credit rating (UKFI 2009) and that this would be achieved in large part through orthodox de-risking (reducing RWAs) and recapitalising the joint balance sheet. The primary reasons for this were two-fold: (i) in order to encourage an improved CET1 ratio by working towards Basel III implementation targets (see Chapter 5, section 5.4, Fig. 13, and Chapter 6, section 2.6, Fig. 19), and (ii) UKFI and Treasury improved the probability of recovering bail-out funds from which repayment of the taxpayer was possible via sale of shares if point (i) was achieved. Assuming Lloyds

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46 Non Performing Loan sale – usually, investors or bidders are invited to a data room to analyse a portfolio of stressed / distressed assets and a secondary market auction and settlement process ensues.
Banking Group plc re-risked the balance sheet and improved its regulatory capital position, UKFI noted a ‘trading plan’ to sell the remaining shares in Lloyds in 2016/2017, and with the last sale taking place in February 2017, over £20bn has been recovered from a £20.3bn investment for an original 43% stake in the business. UKFI’s stake in Lloyds was under 2% of outstanding share capital in 201647 (UKFI 2016) and the Financial Times reported full repayment in April 2017 (Dunkley 2017).

Prior to the increase in regulatory capital through Basel III, banks learnt an expensive lesson from previous crises. The leverage buy-out crisis in the 1980s (also known as the Savings and Loans crisis; Ely, (1993); Curry and Shibut, (2000) meant that banks maintained portfolio construction instead of selling off assets at discount into the secondary market, as the bank and MD were proposing through the non Performing loan sale; however, the bank retained the assets, took the write downs and funded provisions in line with ‘fair value’, were patient, and waited for a recovery and market confidence to return. Asset values normalised as credit risk and liquidity returned and balance sheet provisions were released again. However, this process was not available to banks post the 2007 crisis due to the politics of Basel III regulation and building resilience through a de-risking and recapitalising strategy. The banks had to suffer material losses on swathes of balance sheet assets as noted in Chapter 6.

Many of the transactions executed by BoSIF suffered from the crisis by way of liquidity drying up and a discount in market pricing (Wagner 2007). Deterioration in credit risk was not the sole source of write-downs. As banks sold higher risk weighted asset portfolios by non performing loan sale to preserve regulatory capital and prevent accreting losses, asset prices collapsed still further and mark to market paper losses

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47 RBS, however, is a very different case, with UKFI still holding a 72% shareholding in the ailing UK lender (RBS 2017; UKFI 2016).
accrued which required provision (Shleifer and Vishny 2010). MD realised that a considerable chunk of the BoSIF portfolio was leveraged and suffered from this conjunctural market event on liquidity and Basel III, rather than being solely a problem of credit risk. MD understood that a secondary buyer, not regulated by Basel III, would be interested in BoSIF assets and noted that any purchaser could wait for the cycle to shift, as long as they had funding to maintain the equity, and return the transactions to the market at profit when prices normalised. MD was aware of the difference between a business with strong operating fundamentals that was suffering from technical market conditions and discounted pricing, compared to that of a business underperforming, also with discounted market pricing. Nevertheless, all asset prices were affected by liquidity and credit crunch irrespective of performance, whilst pricing on the underperforming transactions was driven more by credit risk and the probability of default. MD knew which deals in the portfolio were worth selecting, managing and returning to the market for a good return on investment. MD knew that Lloyds would only allow the sale of a blended portfolio of names (both performing and non-performing) otherwise the bank would be taking increased credit risk on the remaining assets alongside increased regulatory capital.

Post financial crisis, the summation of (i) Basel III regulatory capital charges, (ii) the leverage multiples then employed within the bank and (iii) a post-crisis balance sheet now owned by UKFI, meant that it was no longer feasible for Lloyds to wait for the market to return in terms of capital required to fund RWAs and to wait and see out the cycle. The need to de-risk and repay the taxpayer was a growing concern (see commentary - market share price fluctuations and share sales being pulled through book building, UKFI (2016). Lloyds also wanted to share in the benefits any non performing loan sale might eventually develop from market correction and the ease of conducting
such business outside of the Basel ring fence (which only affects banks, not secondary buyers of assets) and away from UKFI. MD must have been confident that BoSIF equity assets were being under priced due to scarcity of liquidity and the market being well offered – i.e. there were more sellers than buyers as banks were running similar de-risk and recapitalise strategies and trying to keep negotiations quiet and away from the limelight to maintain buoyancy in price and mitigate potential losses (see Appendix D, which outlines the quantum of deals at Lloyds and similar processes that were occurring in differing size and quantum across the UK and Europe).

In summary, Opportunity 2 was the employment of MD by the newly formed Lloyds Banking Group after he was responsible for the creation of BoSIF and the origination of a portfolio of assets that received a significant write down in value. Opportunity 2 positioned MD with vision to oversee how Basel III was to impact the ex-BoSIF portfolio and what the bank’s risk appetite to these assets was, given pressure from UKFI to improve the regulatory capital position in order to sell the banks shares at a solid exit price. This situated MD perfectly with the data required to inform his next decision.

7.3.4. Opportunity 3: Project Lundy

The bank decided on an alternative strategy. MD wrote BoSIF equity investments down again in 2010 via Project Lundy. Gross assets of c. £1.1bn in equity were sold to a secondary market player known as Coller Capital, which paid £480m and took a 70% share in a joint venture agreement (meaning that Lloyds effectively paid £206m for 30%). If Coller had paid £480m for a 70% share, the gross asset value of the complete portfolio

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48 Lloyds later capitalised on this in the eventual non performing loan sale through a requirement to hold a 30% interest in cash realised from the resale of transactions into the market place (see Project Lundy Ch. 7.34).
was £686m, meaning a write down of £414m or 38% haircut. This was in addition to the write down in 2009 of £900m, making the pre 2009 original asset value something in the region of £2bn, with a 2010 total reduction to the original book value of c. 66% or £1.3bn49 (Ebrahimi 2010; Lloyds Banking Group plc 2013; Coller Capital LLP 2012; Caird Capital LLP 2010). The BoSIF equity portfolio had lost c. 66% of its value through MD’s stewardship and two separate periods of involvement with the same transactions.

The related conjunctural crisis contingencies, along with the conditions that Basel III regulatory capital had created for banks, meant that Lloyds Banking Group was forced to conduct Non Performing Loan / equity sales. Through his re-engagement at Lloyds, MD was aware of the current performance of the BoSIF assets, as he was the only senior person across Lloyds Banking Group with experience in this marketplace and the requisite skill, inside knowledge of BoSIF assets and relationships with the borrowers. MD therefore approached Coller Capital, the eventual secondary market buyer of the BoSIF equity portfolio, and agreed an advisory-management contract with it under which his new business, Caird Capital LLP, upon exiting Lloyds, would manage the assets under Coller’s majority control (70%) and receive fees and carry interest in the form of dividends for management services. MD exited Lloyds to Caird Capital and some of the Lloyds staff transferred with the assets to Coller Capital under TUPE arrangements via Project Lundy (Lloyds Banking Group plc 2013).

The structure through which Project Lundy is executed is fairly typical of this type of ‘offloading’ transaction. Asset managers operating this type of structure in

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49 These numbers are estimations premised on piecing together information from several sources that have interest in the deal, namely publicly available data from newspaper interviews, company websites and tombstone marketing that purposefully hides the full transaction picture whilst leaking data that assists marketing of the stakeholders involved – i.e. Lloyds and Coller Capital. Stakeholders like to brag about deal-flow in a market governed by league tables and prestige, which flows from partial disclosure. However, interested parties, alongside journalism and audited accounting, fail to co-ordinate market responses over time and enough information becomes available to conduct a basic estimated analysis that allows a quantification of losses.
2010 were not subject to Basel III requirements and could hold assets at cost with minimal regulatory capital, thus making this type of transaction much more lucrative in terms of return on investment. Regulatory capital rules for asset managers are not as onerous or indeed as complex as those imposed upon banks (Jorion 1997; Saunders and Cornett 2014), although this is likely to change. Asset management regulation is in the midst of FCA scrutiny, with asset managers now being told to hold more capital against investments they make (FCA 2017b). In the future, profitability could be squeezed through reformed regulatory capital requirements (under AIFMS and UCTIS), and liquidity in these markets will be reduced, meaning that banks are unlikely to have the same exit strategy available to them should another crisis occur in the future or assets need to be offloaded.
Secondary market asset managers and, more broadly, asset managers across the spectrum are experts in disclosing the minimum information required and go out of their way not to disclose granular information regarding transaction data. Fig. 25 is a Limited Liability Partnership structure that has been pieced together from company filings, statutory accounts and company disclosures (Coller Capital LLP 2012; Lloyds Banking Group plc 2013; Caird Capital LLP 2017). At the centre of the structure is the asset holding entity, Cavendish Square (GP) Limited, which resides off-shore in Jersey and is not subject to IFRS standard of accounting and disclosure IAS 24, regarding related party disclosures (IFRS 2017). Therefore, the statutory accounts for Cavendish do not disclose
details of the assets or values of the BoSIF assets on its balance sheet. This makes it virtually impossible, in terms of the JV side of the structure, to determine the assets being managed and the exit values – short of observing transaction data as the 42 transactions are returned to the market\textsuperscript{50}. It is possible to track exit transactions as both the secondary purchaser and the banks that assist in funding the on-going purchase and trading finance like to talk about their successes in marketing literature; however, detail is again scant as the variables required to make calculations are obscured from view. Nevertheless, it is certain that the majority of names in the BoSIF portfolio are exiting well above the purchase price due to the management fees and exit dividends made by Caird through its public disclosure and audited accounts. It is worth noting and somewhat ironic that Lloyds Banking Group has been involved in funding several transactions in which Coller has exited BoSIF JV investments; essentially, Lloyds is helping to fund its own exit with new debt funding (30\% of JV equity) and taking fresh lending risk as market values climb again, albeit in the ‘new normal’ interest rate environment which serves the debtor rather than the lender (Forbes 2010). However, of more interest to this research is the management agreement between Caird and Cavendish and the development of its contractual arrangement with both the shareholders Coller and LBG, providing for the personal enrichment of shareholders in Caird Capital.

The shareholder agreement between ‘the fund’, Cavendish Partners (GP) Limited and Caird Capital LLP remains private, as may be expected (no disclosure). There is no detail in terms of how the fee structure works between the parties and what

\textsuperscript{50} Businesses within the portfolio of 42 names included Conran Restaurant Group, TM Lewin, Martin McColl, View Cinemas, Ainscough Cranes, D&D Restaurants, David Lloyd Leisure, Polypipe, Nylacast, Bifold, to name a few disclosed transactions. A post thesis project could involve identifying the portfolio of names and transaction data and attempting to calculate an estimated upside as to what Coller and Caird have made from the JV structure and how much money has hemorrhaged from taxpayer owned banks and the Treasury through post-crisis regulatory amendment and the interplay of RWA reduction, improvement of CET1 and halting further decline in ROE through accretive distribution of non-core assets.
Caird Capital is being rewarded for in terms of advisory and asset management\textsuperscript{51}. It is clear, however, that Caird was paid handsomely over the five year period 2011 to 2016 (the deal remains current), to the tune of £32.5m in fees and £2.6m in dividends, for taking no credit risk on the JV assets, and little or nothing in terms of financial risk, with the capital gains or losses being taken via the JV agreement between Coller and Lloyds to which Caird is not a party.

The offloading arrangement via secondary market sale has allowed a blockage in risk and regulatory capital to be removed at Lloyds Banking Group plc. The problem of ‘de-risk and recapitalise’ through heightened regulatory capital and the Basel algorithm is grounded in dominant theory from mainstream finance and the way it perceives solutions to these challenges through risk management and accounting. The functionalist-rationalist viewpoint does not consider the ‘secondary effects’ of these policy driven actions. So what are these effects?

One of the secondary effects, and something crucial to this argument, was arguably the fee payments made available to the JV partners as the BoSIF assets were exited, the profits from which should have been made available to taxpayer bailout repayment rather than 70% benefitting parties disintermediating the unintended consequences of the reformed Basel III regulatory capital system. This is important, as the politics and transformation of Basel III framework have forced first HBoS and then Lloyds Banking Group to reduce their equity positions in the BoSIF assets. To some extent, this provided for resilience via capital accretive decision-making; however, losses to the equity positions have occurred at several stages as the market deteriorated and

\textsuperscript{51} E.g. success fees and carried interest for exit above contracted hurdle rate, alongside a carried interest dividend – producing a return on cash that MD requires for his business, and he may also have invested in Cavendish as the asset holding entity so the asset manager Caird Capital was also working for a dividend as well as management charges and exit fees – an investment requirement Coller would likely have asked for.
throughout the Lloyds-HBoS takeover process when fair value was calculated for a sale. These assets became 43% state owned through the bailout rescue; however, 70% of the residual asset value after accounting markdowns that reveal fair value through the secondary trade to Coller Capital was lost. Lloyds will eventually take 30% of the exit price, which will make up for some of the 70% residual value lost through the initial trade; however, politically speaking, taxpayer value has been eroded and benefitted the pockets of secondary market asset management players rather than repaying bailout funding.

Caird completed a similar deal with Royal Bank of Scotland (RBS), another taxpayer owned bank, in 2015. Structured Debt Solutions, a subsidiary in RBS’ International Division, transacted both debt and equity into mid market size transactions (typically £150m-£750m debt size), and assets from that business were managed through a business known as Caird Shackleton LLP (Caird Capital LLP 2015). The details of this transaction remain scant; however, a similar asset write down exercise will have taken place at RBS through Basel III, together with a de-risk and recapitalise process alongside a comparable asset management decision making process, with losses provided for through taxpayer bailout funds. Furthermore, as we saw in 2015 and Fig. 20, RBS’ ROE performance remains negative, in fact materially worse than Lloyds’, and as such it has also been forced to conduct NPL sales of this nature. In fact, the PRA has made statements regarding the way RBS should meet its regulatory capital requirements under Basel III (December 2015 BoE stress tests, released in 2016, revealed a hypothetical adverse scenario on a CET1 ratio of 5.5% on a 7.1% CET1 Systemic reference Point), in order that UKFI is able to progress its 71% share ownership and recover taxpayer bailout funding, albeit at a considerable loss of £26bn, according to the Financial Times, premised on a share price of £2.71 and an original strike price.
to convert bail-in money to equity at £5.02 (Royal Bank of Scotland Group plc 2015; Financial Times 2017).

7.3.5. Conclusion

In answering the question “What are the implications of the Basel algorithm on management behaviour?”, the case of BoSIF has proved a useful vehicle to explore and observe a MD at work during a crisis period. MD weaved between opportunities, using his experience to guide his actions and steps and eventually crafting a route to personal enrichment from assets belonging to a state owned bank. Further questions follow from this analysis. How much money has been allowed to haemorrhage from taxpayer owned bank balance sheets via similar approaches to de-risk and recapitalise? It appears capital accretive decision making has occurred somewhat unnecessarily, with external parties such as Coller Capital and Caird Capital LLP making considerable amounts of fee-based profits through operationalising a strategy that circumvents the need for increased regulatory capital in Basel III. The way post-crisis regulation has been enforced through Basel III fails to distinguish between assets of dubious credit quality, that quite rightly should see prices reduced in secondary markets, and strong assets of high risk (e.g. leveraged MBOs), caught in the malaise of a market that is well offered where prices are depressed and banks are forced sellers due to heightened capital requirements. What is important now, however, is to make sense of this detailed case by describing the behaviour in theoretical terms; this is essential in providing a way forward towards questioning whether textbook descriptions of bank management and behaviour should be extended past the realms of functionalism.
7.4. Management Behaviour and the Bricoleur

The Levi-Straussian idea of bricolage provides a theory that connects to the conjunctural market event of crisis and innovative reforms in regulatory capital (Engelen et al. 2010). Engelen et al. note the importance of the way problems in finance shift within periods of fragility: “often things miscarry which highlights the need for more radical thinking about policy responses to the financial crisis” (Ibid, p. 33). An illustration of such a shift was the amendment of Basel IIIs algorithm and heightened regulatory capital, additional to the secondary unintended effects which these created across a range of problems, particularly (for the purpose of this research) in terms of management behaviour.

The concept of bricoleur is defined by Kincheloe’s paper (2001) as a far more skilled individual than Geertz’s handyman (1988) or the anthropologists who refer to a person who might assemble techniques and materials in order to form stories in a particularised form or local context (Lincoln, 2012). The type of bricoleur this thesis uses is a market professional who searches for nodes, nexuses, linkages, interconnections, fragile bonds between disciplines and between bodies of knowledge (ibid. pg. 694). Kincheloe’s describes this as, “‘boundary work’ that operates at the margins and liminal spaces between both formal knowledge and boundary knowledge” and at specific market conjunctures or events begins to form new risk structures to his or her own benefit (2001). When addressing the problem of management behaviour, it is crucial to consider its development away from the traditional orthodox definition of a manager in a banking firm towards a more complex definition of a manager as a bricoleur, operating at the nodes of opportunity in order to create new risk structures from events in de-risking banks (see Fig. 26). This new conceptualisation of the banker or manager as bricoleur is central to the politics of de-risking banks in the post-crisis economy. There have been many uses of
the term bricolage in finance literature and in a wider context (Ibid, p. 53); however, this research views managers as opportunists at the conjuncture of events with the chance to arbitrage, rather than using the scientific route to innovation and explanation through ‘techné and episteme’ (Ibid. p. 53).

The bricoleur’s logic and thought process attaches to a specific point in time within a long process of regulatory change, as illustrated by the Lloyds ‘Project Lundy’ example. At this point, the bricoleur makes decisions not by thinking as a functionalist risk manager (as described in textbooks), but by planning and executing a schema, as can be seen by the actions of MD. Moreover, at three defined moments in time, and via three distinct process chains in different financial firms, MD reacted to opportunism at specific moments. The logic of opportunity is described in Fig. 26 below and here in more detail:

- A bull run in markets, Minskian stability-instability and the opportunity for MD to innovate BoSIF into what can be described as a high risk-reward one-stop shop for debt and equity, a private equity player and a bank rolled into one entity;
- An opportunity for MD to reinvent himself through the Lloyds-HBoS merger and to manage the same BoSIF asset portfolio through an NPL sale, granting himself foresight over future direction of equity assets;
- An opportunity for MD to relocate and recast management behaviour outside of banking and away from the Basel algorithm by disintermediating mainstream banking regulatory reform and policy-making whilst allowing himself a virtually risk-free route to making considerable fee and dividend income from an asset management JV contract between Coller and Lloyds Banking Group.
These opportunities were premised upon MD’s own knowledge of the market, product and borrower(s), which made him the ideal candidate for the three posts, despite his high level involvement in losing 66% equity value in the businesses he and HBoS had chosen to lend to via the ill-conceived growth project and bank business model. Admittedly, part of the loss created by writing down assets values was down to market functionality and liquidity based pricing in which banks distribute debt portfolios in a pro-cyclical manner in reaction to regulatory transformation, rather than for negative credit risk of individual transactions.

**Fig. 26 Bricoleur Logic and Three Stages of Opportunistic Development**

![Diagram](image)

*Source: Author*

Whilst considering these nodes of opportunity as separate process chains, the opportunities taken by MD are connected laterally, extending the chain between various interlocking stakeholders. At the nodes of temporal alignment and interconnection between processes, resourceful and to some extent cunning action is taken that becomes paramount in recasting the bricoleur’s existence in fragile market
Here new risks are created via asset managers (Coller) within the wider shadow banking market. The same BoSIF equity supports inappropriately structured buy-out transactions for that period in the economic cycle, albeit re-priced now outside of the Basel framework via the arbitrag ed joint venture. At this point, regulators are chasing the shadow market in an attempt to regulate new risk structures as they catch on to the continuous reinvention crafted by the bricoleur at the conjuncture of market event and reform in regulation and continue attempting to arbitrage the situation – as witnessed through RBS and Caird Shackleton LLP.

**Fig. 27 Bricoleur Nodes of Opportunity**

*Source: Author*

So what does this mean for management behaviour in banks? The above example demonstrates new empirical evidence of the banking bricoleur seeking personal enrichment at the expense of the UK taxpayer via long chains of regulatory change. The ‘narcissistic society’ containing the investment banker or hedge fund manager both defined and driven by greed is a somewhat futile moral narrative and is generally unhelpful as an explanation for change of this type – such a rationalisation is to be
avoided (Engelen et al. 2010 p. 58). At the conjuncture of market event and management bricolage, MD was enabled by the opportunity of contingencies and conditions underpinning financialised capitalism, and by circumventing unforeseen circumstances of reform through the logic of the bricoleur. At three specific nodes in time and at the interconnection of process driven complex chains forming, MD played his part in creating new market risks as banks distribute portfolio risk whilst at the same time he enriched himself. Behaviour of the bank manager no longer falls squarely within the orthodox description as described by textbooks, as the tectonic plates of regulatory reform continue to move.

Through periods of market distress or indeed microprudential policy change, managers must be expected to shift-shape and move away from the traditional roles of managing credit, risk, liquidity and resources in banking firms. It is less certain whether regulators have the capacity to think beyond the rationalist-functionalist paradigm and scenario plan for the bricoleur’s reinvention. Indeed, during periods of crisis that promote change through innovation, regulation or policymaking, a change should be expected to long-standing mainstream finance explanations of the operation of capitalist economy through the logic of the banking bricoleur and as banking practitioners recast themselves into new roles entailing new types of risk and structure which are often unclear and not studied or understood. Without regulators or indeed politics breaking the chains of paradigmatic constraint, the process of conjunctural change and bricoleur logic are likely to continue through continuous complex financial form and re-form, with material success from MD’s perspective as he repeats the conjuring trick (Royal Bank of Scotland plc and Caird Shackleton LLP) and leaves regulators in his wake targeting opportunistic reinvention and a wave of risk that continuously adapts ahead of them.
In line with previous chapters of the thesis, this research has followed a similar but coherent line by addressing the consequences of post crisis reform. This research has extended previous analysis on bricoleurs by employing the description of de-risking and recapitalising policy of post-crisis regulation in Chapter 6 to explore a new understanding of what the profound unintended consequences are on bank managers operating at the departmental level in banks. What the empirical analysis shows is how managers behaviour can change from that of orthodox finance description contrasted to when macro prudential policy on bank capitalisation is implemented through Basel supervision. Observing behaviour through these conjunctures is of significance. It is the level of empirical micro analysis at the departmental level which breathes life into prior theory which reconceptualised how managers become bricoleurs (Engelen et al. 2010). This analysis opens an interesting space for researchers looking to revisit how managers in banking firms operate around the nodes of intersecting opportunity and conjunctural change and in this case circumventing intended macro prudential banking regulation. In effect, this provides an empirical blue print at a granular level using a mixed source of data and methodological processes. Applying this framing of bricolage can be developed and mapped on to a myriad of situations to form fresh new understandings. In this case, the research has shed light on extending what bank managers do inside of banks post-crisis. Moreover, how bricoleur logic bifurcates from orthodox theory on bank management demonstrates new trajectories from the intention of what regulators and policy aimed to deliver.

There were problems in studying bricolage and it is worth setting out several issues here alongside policy implications and whether bricolage is inevitable or not. Whilst regulatory policy continues to take its lead from orthodox risk management literature and theory, it is difficult to see how managerial bricolage can be prevented. It
is the precise nature of how risk management and regulatory change couple together and
drive the transition through the rationalist-functionalist paradigm that makes the
bricolage effect inevitable. Where the bank manager has an opportunity to reinvent his
or her role through newly created risk structures, is precisely the point at which
regulatory policy fails to constrict an evolving adaption that arguably, to greater or lesser
extent, could create fresh financial instabilities or ability for elite enrichment as set out
above. Furthermore, as risk management is focused on fixing problems that it encounters
rather than proactively ensuring the future is protected by thinking through potential
problems, its reactionary force leads to new opportunity, regulatory circumvention and
regulations that fails to capture new risk formation. In terms of studying bricolage, it
was challenging to find detailed information that allowed a granular analysis of the
situation depicted between MD's employment at Bank of Scotland through to his
eventual ownership of Caird Capital. A level of forensic accounting and a blend of data
sources were required through both a qualitative and quantitative analysis to reach a
considered opinion. Together, these points provided a significant hurdle to explaining
and providing a new understanding of what MD made happen during his post crisis
period of employment and how the reconceptualisation of bricolage can be applied. The
main implication of this research points to a requirement for a fresh approach to
regulatory transformation. Without addressing how regulation captures new risk
structures through innovating the transition process, bricolage could create any number
of novel problems that remain out of sight until such time as they become capable of
creating a problem of significance when its often too late to prevent damage. When
markets and banking institutions enter stress, recession, crisis, or periods of intense re-
regulation after a specific conjunctural event, it here that regulators should be observing
the financial processes that unfold as both banks and their managers have the potential
to create new profits streams whilst simultaneously building new risks. Whilst financial innovation could be controlled differently (regulatory testing before products and services enter live markets, or regulatory supervision runs parallel with the innovations process), it is necessary look at how individuals or managers enter bricoleur logic rather than where prior focus has been on the institutional or bank level setting.

7.5. Conclusion

The form of natural experiment conducted within empirical Chapters 6 and 7 of the thesis is connected to Chapter 5 by two specific ideas and a series of conclusions, which reveal strong and valid criticisms of the approach taken by post-crisis amendment to banking regulation. Firstly, basic research on how the politics of amending post-crisis microprudential change via the Basel III algorithm is sketched out and contrasted with decisions bank managers made regarding de-risking and recapitalising of Lloyds Banking Group. On the denominator side of the capital adequacy calculation, decision-making has an initial positive impact via the credit accretive process, and by reducing RWAs, cash flow heads back to the balance sheet through the distribution of assets to the market and through non-core run-off. However, despite this gain, an inverse relationship in heightened regulatory capital from Basel III exists that encourages higher CET1 and a strengthened balance sheet position, and therefore increases the cost of RWAs on a significantly reduced asset base. On the numerator side of the capital adequacy equation is the negative impact of Basel III and management decision-making on income and cash flow (i.e. a reduced size of balance sheet portfolio lowers RWAs, but also sees income fall from the distribution process and increased cost of a reduced RWA base), and the way this impacts ROE negatively and is likely to continue doing so, as can be seen from Fig. 20. These issues are under studied and
the accounting detail at the case level is challenging to reveal through a blend of qualitative, quantitative and descriptive accounting data. Nevertheless, it is interesting to witness the hard impact of a political reframing of post-crisis regulatory change on the bank de-risking process. Based on this analysis, there are material long-term negative consequences for the banking firm and its performance in markets, and through the reversion to risk management techniques and de-risk and recapitalisation of balance sheets, the market may well see further crises, as it is unlikely that increasing the quantum of equity and raising the ratio of CET1 would provide a solution to contagion. The spectre of further crises requires a strong push towards the use of Borio’s earlier mentioned analysis to prevent the formation of bubbles from the financial cycle of economy and to restructure banks away from the universal model and towards a modern day Glass-Steagall (separation of banking activity), in which banking stability would improve at the level of both individual firms and interconnected banking networks.

Secondly, this research examines new forms of post-crisis financialised capitalism, considering the effect of Basel III on the role of managers and steering away from the orthodox understanding of what bank managers are and what they do in executing the role. The central thrust of the research is to identify a change in behaviour through regulatory change. In periods of financial stress and market fragility, managers act very differently. Through three distinct periods of time, at HBoS, Lloyds and Caird Capital, MD exposes the banking firm to the creation of innovative credit structures through the logic of becoming a banking bricoleur. The case is made that senior front line managers use nodes of opportunity that emerge from the stability of markets over time (Minsky) and de-risking the bank via post-crisis regulatory change. Incredibly, the bricoleur has the ability to enrich himself by circumventing bank regulation and diverting cash and fees away from a state owned banking institution. The conclusion
from this research is that the orthodox understanding of bank manager behaviour changes in periods of crisis and so the traditional-orthodox understanding of the role becomes incomplete. One of the post-crisis changes to financialised capitalism is the way managers in banks behave during periods of financial stress and how new risk evolves through the creation of new credit structures, which regulators appear unable to predict with any certainty.

Furthermore, what is being highlighted across the empirical chapters of the thesis is the competence of orthodox risk management and market regulators operating within the paradigmatic restraint of risk management practices (including the Bank of England, FSA/ FCA, politicians, select committees and quasi governmental committees such as the ICB). Competence seems to be questionable, as regulators appear over ambitious to avoid major pitfalls by re-regulating and reforming macroprudential and microprudential frameworks. Vickers and the Basel III algorithm, in particular capital adequacy, are valid examples allowing conclusions to be drawn on regulatory misdirection and settling for a stymied partial and not fully considered remedy. What stems from this argument is the high potential for future problems should further crises occur, as these puzzles have not been solved.

A partial reason for the current difficulty faced by regulators is the on-going complexity involved in the post-crisis field of banking regulatory change. The inability of regulators to consider alternative approaches to regulation becomes clearer as the voices of Borio and Haldane appear to have become weaker with the passage of time. Yet many problems persist and, as has been shown here, new risk trajectories continue through the innovative banking bricoleur (inside the banking firm and outside in the wider shadow market). These problems are not properly understood within the orthodox framework of risk management and management behaviour in
banking.
Chapter 8. Conclusions

8.1. Introduction

The final chapter of this thesis presents conclusions drawn from this doctoral research. It begins by detailing the approach taken and the research methodology and then provides synthesised highlights of the findings in Chapters 4, 5 and 6, with specific recommendations resulting from the answers to the research questions. This chapter will also sketch out key contributions of the research, inclusive of the way theory and literature has been applied. A final subsection has been added to highlight areas of interest for future research.

8.2. Research Approach

This doctoral research provides a critique of post-crisis structural and prudential regulatory reforms in UK banking. Post-crisis banking regulation is a topical subject across several fields in literature: economics, governance, banking and geography. A detailed critical account centred on a UK political-technical analysis of what are arguably central elements of this period (Vickers Report and RWA manipulation in Basel III) is given, something less well covered from a political economy perspective. Several interconnected issues in post-crisis banking regulation are discussed, and throughout the thesis observations are made regarding the way political and orthodox scientific-technical responses and solutions were created, how they have performed and what the implications of findings are. As a consequence, it is argued that a study of this nature is required to explain and provide analysis towards an alternative framing and understanding of the subject matter. The empirical chapters of the thesis have
focussed upon central concerns of uncertainty and instability, using heterodox economics and financialisation literature in relation to these areas; some of the works cover areas of regulation, shareholder value and bank business models (Keynes 1937; Minsky 1982; 1986; 1996; Borio 2001; 2003; 2004; 2009; 2010 and 2012; Epstein 2005; Froud et al. 2000; 2006; Lazonick and O’Sullivan 2000; Lazonick 2011; Engelen et al. 2011), while other authors analyse the situation through a cultural economy lens (Hardin 2017; Bennett et al. 2014; Thompson 2014; Davies 2012; Langley and Leyshon 2012; Mackenzie et al. 2012; Caliskan 2009; Langley 2008; McFall 2008; Pryke and du Gay 2007). Application of this framework has re-problematised and politicised orthodox regulatory fixes in banking regulation. A natural experiment was conducted in Chapters 6 and 7 to evidence the effects of Basel III on a UK bank. A critical investigation of these matters provides a more pragmatic approach to banking regulation through theory and empirical evidence. The findings and recommendations support an improved regulatory framework and propose conditions under which a more stable and socially useful banking system could evolve. The ambition of this study is thus laid out in a number of objectives, discussed specifically in Chapter 1, section 1.4.

Ultra-elite interviews were conducted at the outset of this research in order to grasp central issues in banking regulation from high status elites in the field and to formulate interconnected research questions (see Chapter 3, section 4.4). This stage in the process was crucial, although not from the perspective of uncovering unspoken truths, but from observing the field and the way in which alternative accounts and perspectives from elites emerged, premised on their experience and technical abilities. From these insights, central concepts of uncertainty and instability developed and were articulated into research questions that directed the empirical work. These pivotal concepts were subsequently contrasted with mainstream and more critical accounts of the ICB’s
Vickers Report (ICB, 2011) to establish what antecedent literature had to say on the matters. Recent literature has focussed on observing the use of various business models to look at structural improvements, and determining whether the concept of ring fencing would provide for stability through a more mainstream and political economy approach (Hall 1993; Baker 2013; Baker 2015; Bell and Hindmoor 2015; Macartney and Hardie 2016). In broader terms, the more contentious elements of banking regulation were covered in the thesis (Libor PPI, fines), as well as the specific challenges of Basel II and III. Existing literature focussed more on risk management and technical components of scientific and calculative mechanics of risk weighted assets and the management of these by banks, which impacted their capital adequacy and return on equity. In contrast, this research develops a narrative that runs throughout the thesis and addresses the distinct limits of post-crisis regulatory responses to bank regulation, providing a comprehensive critical political-technical analysis of Vickers and RWA management in Basel II and III. This analysis results in a natural experiment observing how a UK bank responded to mainstream post-crisis solutions in Basel III, such as de-risk and recapitalisation of bank balance sheets. This work illustrates how management reacted to these regulatory responses by restructuring balance sheets and risk portfolios. This research has observed and analysed the impact management actions had on bank performance. Furthermore, and crucial to the limitations of banking regulation approach, the concept of ‘firm bricolage’ in literature (Engelen et al. 2010) is developed, and the way ‘managers’ also perform bricolage in periods of financial crisis and or long term recession is clearly demonstrated. This work is not covered in mainstream financial management literature.

Essential to mixed-method research and the pragmatic approach adopted through the exploratory-sequential research design (Chapter 3), a wide range of data sources
were utilised in the qualitative and quantitative analysis. A variety of sources were drawn upon, including primary data from semi-structured interviews, together with a much larger set of government, political and regulatory reports alongside economic descriptive statistics, audited account data and quarterly management banking reports, in order to build an in-depth discussion across the key issues and to mitigate any issues of methodological bias. This study has proved helpful in establishing political-technical knowledge regarding the challenges mainstream economic theory has faced in assisting banking regulation post-crisis, whilst utilising a more heterodox approach through a Keynesian and Post-Keynesian framework to critique the empirical work (See policy transition framework in Chapter 4). Moreover, it was imperative to draw out the importance of political impact, developing arguments that demonstrate how long-established institutional arrangements have provided a regulatory but limited response to the UK banking crisis. Furthermore, financialisation literature was of assistance in informing the debate through the concept of shareholder value, which in turn illustrated the way banks manage financial risk and arbitrage banking regulation to increase banking returns for shareholders.

The empirical chapters of this thesis address the research questions set out in the research overview (see Chapter 1, section 1.5), which required a comprehensive study into issues within post-crisis structural and prudential banking regulation, and provide an analytical exploration of the way Vickers and RWA management operate in banks. At the same time a critical explanation of the events after 2007 is given. Emerging from research findings are recommendations that could improve the limited nature of current mainstream approaches to banking regulation.

Initial empirical work was conducted through accessing eight ultra-elite or high-ranking officials from the following groups: central banking, regulation, academia,
politics, media and industry, all of whom were involved in assessing the wider implications of regulation, managerial decision making, and researching the ramifications of structural and prudential banking regulation. Analysis of UK post-crisis structural and prudential banking regulation was conducted primarily through literature in economics, financialisation and macroprudential regulation, as noted at the head of this chapter. Importantly, the way in which political literature is intertwined with these challenges, and how a cultural economy lens has been applied analytically to the data also form a valuable part of the multidisciplinary framework. This approach has resulted in a detailed investigation and critique into the limitation, uncertainty and instability of post-crisis banking regulation (Keynes 1937; Minsky 1975; 1986; 1992; Borio 2001; 2003; 2004; 2009; 2010 and 2012).

8.3. Research Findings and Recommendations

Whilst the intention is not to discuss all the conclusions of this thesis, the following paragraphs summarise the more important research findings and set them against the broader research questions and recommendations.

8.3.1. Research Question 1

The first research question (Chapter 4) deals with what was expected to be a shift towards macroprudential management of banking regulation and asks whether this would solve the problem of too-big-to-fail. This question initially arises from the way policy relating to regulation transformation operates around times of crisis. In the light of both the underpinning of policy by neoclassical economics and light touch regulation pre 2007, and the failure of these to anticipate or prevent the financial crisis, it made sense to address this problem by transitioning towards an alternative theoretical and
pragmatic regulatory framework using Hall’s typology as a starting point – via Keynes, Minsky and Borio (see Fig 10). However, this progressive move towards a macroprudential framework failed to materialise, and the reason for this is questioned. The study then addresses two specific questions in relation to the failure: (i) whether economists and regulators understood the changes in banking ontology and modern day banking, which are described in some detail, and (ii) whether the modern day ontology of banking is capable of being regulated through mainstream economic theory. To combat these problems and to bolster the theoretical and epistemic challenges that are developed, the study asks whether the financial system can be regulated through structural change as a way to solve the too-big-to-fail problem in banking. The ICB’s reports (2010 and 2011) on structural change and regulation in banking are scrutinised in terms of how the commission was formed, who was involved and its objectives and ambitions; more importantly, the process by which hybrid structural regulation transformed is examined, along with the way it was managed towards its final conclusions on the ring fencing of banks.

Findings from Research Question 1 centre on the theoretical and epistemic challenges posed to mainstream finance and economics. Focus is also placed on technocratic elites with long established epistemic beliefs in mainstream economic and finance theory, along with the way they: (i) control the banking system through limited theory and scientised risk within microprudential and structured regulatory frameworks, and (ii) have managed to continue doing so, retrenching towards the status quo of mainstream risk management practices after the 2007 financial crisis using para-governmental vehicles such as the ICB to secure this conclusion whilst also harnessing new structural concepts such as ring fencing. The study found that regulatory transformation and policy change no longer follows a requirement for linear or logical
interpretation between event, theory and empirical data. An observation and analysis of the ICB’s reports, and an attempt to understand the transformation process led by Sir John Vickers, revealed a muddled and at times confused perspective on the conclusions that led to ring fencing – as discussed in Chapter 4. There is little empirical evidence in the ICB’s reports of the commission considering the alternatives to structuring regulation vis-à-vis ring fencing. The study found that the establishment of the ICB vehicle and the selection of its members were completed through an epistemic community of interconnected and conjoined beliefs in the way banks should be managed through a risk management framework within a networked and interconnected banking system. The ICB’s linear approach to solving the problem of taxpayer bailout and direct discussion on the idea of ring fencing, fail to connect through theory and empirics. The ICB recommended a hybrid structure of ring fencing which the study finds unlikely to have captured key elements of the crisis in retail banking. Losses on commercial and residential mortgages, the largest during the crisis period in UK banking, would remain within the ring fence and require bailout. Another significant factor involves the ICB repositioning the report towards risk management and pre-crisis macroeconomic-microeconomic theory without thorough analysis of alternative options reported on via the BIS and OECD (2009 and 2016) (see Chapter 4, section 4.4). The ICB’s conclusions appeared to have favoured an accommodative stance rather than finding a solution to the too-big-to-fail problem. The ICB developed a hybrid structural form of regulation in ring fencing through long established institutional routes of influence and mesocorporatism (Moran 1991). This was evidenced by observing a typology of reports targeting policy influence, which provides empirical support to Moran’s viewpoint in an attempt to curtail regulatory reform in banking and finance more broadly post crisis (Wigley 2008; Turner 2009; Bischoff 2009). Furthermore, the conclusion
and recommendation of ring fencing is arrived at via the continued and limited scientisation of risk, which interconnects with exogenous macroeconomic control (vis-à-vis controlling banks through business models rather than organisation structure) and the microprudential framework of Basel, which has unintentionally created uncertainty and instability in the banking system and continues to do so (Ferri and Pesic 2017). Finally, the study concludes that the use of arm’s length commission based vehicles by technocratic elites and the logic of epistemic community must be questioned as a basis to provide solutions to issues of too-big-to-fail (or similar economic events). The continuation of this institutional arrangement is used to develop accommodative conclusions focussed on the interest and association of state and the City through mesocorporatism rather than to produce solutions to the problem of too-big-to-fail. A clear recommendation would be to revert towards a wider political approach involving heterodoxy and critical debate, technology, innovation and intellectual input from academia with a view to disrupting the narrowly framed business and economics epistemic community decision-making process (CRESC 2009).

8.3.2. Research Question 2

The second research question (Chapter 5) concerns an investigation into the reform of UK banking regulation and asks whether post-crisis responses have been too limited. This chapter of the thesis is led by a political analysis of the way the City of London avoided prior attempts to regulate and control finance and poses a question as to the implications of this (Hood and Dixon 1991; Power 1994). This chapter examines the ramifications of a self steering and light touch regulatory environment through an ‘ethical’ and ‘technical’ framework that organised necessary aspects and critical discussion of (i) legal responses through the 2012 Financial Services (Banking
Reform) Act, and (ii) Basel II and III manipulation and management of risk weighted assets through microprudential regulatory reforms.

Ethical considerations will be addressed first. The 2012 Financial Services (Banking Reform) Act was initially a reaction to the Libor scandal (Wheatley 2012) and then followed PPI and interest rate hedging, which quite rightly created public concern. These scandals are critiqued in detail, together with the way fines and the legislative response provided distinct limited solutions. The study finds that there is no silver bullet to prevent banking scandals from occurring as they have over time (Moran, 1991 p. 121), and that the legislative response has been reactionary, limited and ineffective, with fines continuing and increasing and a minimal number of convictions and prison sentences. The second part of this chapter addresses the technical framing of regulatory response through Basel III and the way banks have managed RWAs to manipulate capital adequacy, which in turn has influenced the creation of high return on equity. The concern here was the way banks created uncertainty and instability via management decision-making on RWAs and a desire to develop shareholder value and compete to be successful in markets (Froud et al. 2000; 2006; Lazonik 2000; 2008; 2011; Williams 2000; Engelen et al. 2011). Both banks and individuals should have been accountable for their actions in the process of delivering these results. A reoccurring feature throughout this chapter is the gaming of risk models and the way banks and individuals have managed and manipulated RWAs and associated capital adequacy ratios. Management of banking risk weights is considered through various ratings based approaches in order to improve the risk performance of banks and this form of model arbitrage is examined in terms of the way it can influence return on equity, stock market prices and the bonuses or enrichment of those who operate these functions.
Findings from the second research question address the ethical and technical issues outlined above. The ethical and legislative regulatory response was found to be of some value and does have an impact on the performance of banks in that it attempts to address culpability of individuals involved via the challenge of establishing accountability of managers. It has also driven action and change by imposing extremely large fines on financial services firms; however, such action and change has been limited and inadequate. The study observed the reaction of banks to ethical and legislative regulatory responses; these reactions are primarily driven by a desire to stop fines that affect market performance, rather than to address the deeper cultural problems in the way bank models are managed for market performance and the personal enrichment of banking elites (Engelen 2011). This chapter also discusses the technical regulatory transformation of microprudential frameworks required from Basel II to Basel III with regard to RWAs and capital adequacy. This section of the study analysed the faults of Basel II and through the continued lens of scientised risk management, the way Basel III transformed through rule substitution (Moran 1989), whilst increasing regulatory capital (CET1) alongside other forms of liquidity buffer. Findings from this section of the thesis demonstrated the reversing of pre-crisis management of RWAs to reduce capital adequacy and increase return on equity. The graphs in Fig. 14 provide evidence of the way regulatory transformation of Basel III and increasing CET1 affects return on equity of four UK banks. Return on equity reduced markedly post crisis due to losses and to negative percentage ratios prior to work beginning on de-risking and recapitalising UK bank balance sheets. There is a thought provoking section of Chapter 5 detailing various IRB approaches and the way banks input risk parameters to estimate regulatory capital through proprietary, foundation and advanced models. The key finding here is to highlight the extent to which regulatory arbitrage continues as
Basel has evolved, particularly through the advanced IRB approach (Fratianni and Pattison 2015; Ferri and Pesic 2017), which illustrates the limited effect of scientised risk management, the revised microprudential framework and IRB approaches. The fact that risk weights remain within the Basel III framework and were tightened exposes the system to further arbitrage in new ways (Ferri and Pesic 2017). The subjective input of data into credit risk models in banks created managed outcomes through arbitraging IRB approaches and associated metrics (Flores, 2010). The BCBS published high-level reforms to further strengthen Basel III systemic vulnerabilities and continued regulatory arbitrage (2017). These reforms bring the majority of corporate exposures back to a Standard IRB approach to restrict the way banks can manage model outputs. Action to rectify this situation has taken some 16 years after the IMF developed the initial argument in 2001, suggesting that model complexity in governing risk was problematic and open to arbitrage opportunity. This illustrates the limited capacity of a scientised approach to risk management and a clear weakness in complex internal ratings-based approaches to calculate risk weights accurately and prevent regulatory arbitrage in banking. Notwithstanding the restriction on the way banks manage risk models, the examples in Chapter 5, section 5.9 demonstrate that it remains possible to reduce capital adequacy in the system even after the microprudential reforms of Basel III in December 2017. The banking system remains open to further vulnerability (Blundell-Wignall, 2010), as the opportunity for regulatory arbitrage between markets and laying off or transferring risk through interconnected contracts remains a viable route to reducing capital adequacy in banks (differences in regulation between Basel and Solvency II regulations), and may well cause further problems in the future.
8.3.3. Research Question 3 Part A & B

The third research question is split into two parts and concerns the effects of post-crisis prudential regulation on UK banks. Part A addresses how Basel III interfaces with bank business models, while Part B asks what the implications of the Basel algorithm are on management behaviour in banks. Part A politicises the post-crisis mainstream approach to managing bank risk through a de-risk and recapitalise process. This research sketches out the effects and implications for senior bank management at Lloyds Banking Group (LBG) in managing its response to post-crisis regulatory reform along with the impact on the bank’s business model. Managers faced a considerable task in de-risking the LBG balance sheet, and this research carefully considers how this process unfolds via a capital accretive decision making process. Via original empirics, a quantitative and qualitative account of the de-risking process is given and the way the actions of management affect the accounting metrics of regulatory capital (CET1) is described in detail. Part B is connected to Part A and addresses the implications for management behaviour at the conjuncture of Basel III and accretive balance sheet decisions by bank managers. The research question asks whether there is evidence of management behaviour adapting in periods of crisis and significant economic recession. Mainstream finance literature describes the role of bank managers through functionalist explanations (Bascom 1997; Koch and MacDonald 2009; Rose and Conway-Hudgins 2010; Brearley et al. 2014; Hillier et al. 2016). The intention in this thesis is to demonstrate a theoretical explanation of the way management adaptation occurs and, given both opportunity and action, what it can become. This is done using a case study approach to the way a high risk portfolio of assets was managed pre and post Lloyds-HBoS takeover.
The findings of Part A relate to the way bank decision-making is redefined by Basel III. The question of how management observes risk and then manages assets to improve the relationship between risk, income and market performance is analysed in some detail. The research found both positive and negative results to de-risking the bank’s balance sheet and increasing regulatory capital, and the instability and uncertainty this brings through the cash impact of this process. These findings are expressed in terms of accounting and return on equity impact. The impact of Basel III was found to be considerable in terms of the way RWAs are calculated and managed to reduce portfolio risk, whilst decreasing the requirement for capital adequacy. This has a negative effect, however, of reducing return on equity ratios and impacting market performance negatively. Bank balance sheet construction has changed materially through the de-risk, recapitalisation and capital accretive decision making process. The research confirms how the de-risking process operates by piecing together detailed fragments of data from LBG quarterly management accounts between 2009 and 2015, which politicises the impact of how regulatory transformation has impacted a UK bank. Throughout the de-risk and recapitalisation process, managers of Lloyds Banking Group do not behave according to mainstream finance texts by controlling functionalist risk through the Basel III framework: portfolio risk, regulatory capital, capital adequacy, leverage and liquidity.

Furthermore, findings from Part B demonstrate a business case for the failure of functionalist management texts to describe how bank management behaviour can adapt during periods of financial crisis or elongated recession. A Minskian framework is sketched out and provides an anchor point to discuss how a senior manager at HBoS and Lloyds Banking Group – both state owned banks post crisis – managed the same high risk assets through three separate opportunities in order to reinvent and enrich
a senior managing director through what is described as managerial bricoleurship (Engelen et al. 2010; Scott 2010). Original empirics flow from this research, illustrating the unfolding of the three opportunities, the circumvention of regulation and the way this elite bricoleur crafted a route towards managing assets for personal enrichment. This case study and its detail on bricoleurship go beyond mainstream finance functionalist descriptions of bank management. A key feature of the management bricoleur is the way circumvention and arbitrage of regulation occurs via using personal experience and market based opportunity to adapt. In this case, the unintended effects of heightened regulatory capital allowed the bricoleur to create material wealth at each stage of asset origination and management processes: two banks and one secondary market fund – the latter creating over £35m in fee and dividend income in a relatively risk free way from assets owned by the state and bailed out banks (see Project Lundy in Chapter 7). This personal enrichment must be seen in direct contrast to the loss of c. 66% of the equity value in the assets he originated and managed across the two banks through the financial and post-crisis period. Senior bank management action at HBoS, first to invest and subsequently to de-risk the merged LBG balance sheet through Basel reforms, created these opportunities. There is a clear finding here that managers can transition away from the functionalist description of bank manager and can recast themselves by operating at the nodes of opportunity in ways regulators are unable to anticipate and can only react to ex-ante through further regulation. The 2007 financial crisis also created critical interest in investment bankers and CEO remuneration, and regulation was shaped towards capping bonuses and pay. However, de-risking created other forms of remuneration that escaped regulatory, public and critical attention as described in Chapter 7. What can be questioned here is the competence of mainstream risk management and regulators operating through these
paradigmatic restraints, which prevents them forecasting this type of behaviour. By observing and adapting to banking risk more pragmatically and proactively (Keynes, Minsky, Borio – see literature review, Chapter 2), this approach may provide fertile ground for improving the blinkered vision of mainstream regulators who fail to understand the bricoleur through microprudential and risk management frameworks.

8.4. Research Contributions and Recommendations

The following paragraphs outline the main theoretical contributions made by this thesis and make recommendations connected with findings of the research.

The main theoretical contribution of this thesis is to fill a gap in literature by evaluating and explaining through empirical enquiry, specific elements of UK post-crisis structural and prudential banking regulation. This study contributes to theory by explaining the influence and impact of mainstream economics and financialisation on technical aspects of structural and prudential regulation and describing the mainstream approach to providing solutions post crisis. A detailed examination of the way these literature fields underpin risk management practice and micro-macroprudential frameworks within pre- and post-crisis banking regulation is important, as it has directed and continues to direct practices in the field. This results in a critical understanding of how banks are controlled by politics and technocratic elites within para-governmental vehicles such as the ICB and regulatory institutions such as the UK FCA, PRA and BCBS. Furthermore, this study also fills a gap in literature regarding how the politics of regulatory transformation is approached via a lack of theoretical consideration or empirical investigation and through mainstream post-crisis regulatory responses, specifically in relation to the ICB’s account of ring fencing and Basel III’s evolution of risk weights and capital adequacy. Whilst there are academic studies in
these fields (Kay 2009; Kotlikoff 2012; Blundell-Wignall 2011; Goodhart 2011; Ertürk 2012), approaching research questions through an alternative framing allows a presentation of data, analysis and findings that culminates in a theoretical contribution, such as mesocorporatism through epistemic community in the ICB’s hybrid structural solution of ring fencing. No analysis by way of a natural experiment has been undertaken in literature, as far as I am aware, regarding the impact of politics and post-crisis regulatory reform in Basel III on the performance of a UK bank. Lloyds Banking Group is the subject of this analysis, which provides an in-depth empirical illustration of the way the process of de-risk and recapitalising a bank’s balance sheet operates. Moreover, a unique theoretical contribution is also made by reconceptualising the term ‘bricolage’: rather than detailing the way firms behave and innovate in financialised capitalism, it is used to describe the behaviour of managers within banking firms during periods of crisis and economic fragility. This contrasts with mainstream finance literature on functionalist explanations of bank management by focussing on the way managerial elites develop risk management practice and, at specific nodes of opportunity, are able to adapt towards self-interest and personal enrichment. Empirical chapters of the thesis support this contribution through accounting evidence and by piecing together company structures and fees reported through annual company returns. This study has clearly shown the influence of mainstream economics and financialisation on the way regulators and politicians think about problems in post-crisis banking. This guides insight as to the way the future is likely to unfold in the near term through the continued use of strategic risk management practices and microprudential regulatory frameworks; however, through new restrictions on model manipulation (BCBS 2017), a sense of improved control is witnessed that can reduce vulnerabilities created by the uncertainty and instability of these models whilst
diminishing the ability of banks to manage model outputs. This reform needs to be monitored and model output researched in terms of arbitrage opportunity and the way banks react to the restrictions. The study finds that the Basel regulatory frameworks appears to improve stability by developing restrictions on modelling to inform a more certain risk weight calculation; regulators have realised that arbitrage has continued through the evolution of microprudential frameworks since 2001. The wider regulatory environment to manipulate capital adequacy, however, remains open to managed model output through credit default swaps and reinsurance markets, and therefore instability in the banking system remains. Regulators must address the loopholes in risk management practice, as these issues circle back towards the social ramifications of uncertainty and instability of banking systems in which private losses may again become socialised at the taxpayer’s expense if banks are not capitalised appropriately or restructured further in the future through alternatives of narrow banking or activity separation (Kay 2009; Kotlikoff 2012). The post-crisis regulatory response to reform in banking, risk management practice and regulatory frameworks such as Basel has evolved, and has had some effect, but with limited efficiency, without solution and by returning to the status quo of pre-crisis scientised risk management through reformed and substituted elements of the microprudential framework and Basel algorithm.

More broadly, literature on financialisation and heterodox economics is more concerned with the power of finance over states, firms and members of the public, together with the plurality of economic thought, theory and methodology beyond mainstream neoclassical explanations of the way economy functions. This thesis, therefore, contributes to these broad fields of literature in specific ways by analytically presenting UK structural and prudential post-crisis bank regulation through empirical investigation and laterally through a natural experiment. Furthermore, findings of the
research also contribute towards financialisation literature, noting that bank models and concepts underpinning mainstream finance, such as shareholder value, remain fully integrated within financialised capitalism despite the significant transformation of regulatory landscape in banking post crisis. Return on equity and the performance of banks in markets remain an expectant priority of investors in markets, with the result that professional elites who are managing banks need to balance the requirements of regulatory reform whilst maximising the opportunity to compete in markets. This is done through their ability to arbitrage where possible and via new risk structures into which banks will innovate to create new opportunities at the conjuncture of future market events. Return on equity is beginning to stabilise and increase in some UK banking institutions, albeit at much lower levels than pre crisis. Nevertheless, the focus of management is to reduce fines, improve the quality of income, address the blend of portfolio risk versus income into the future (focussing on the relative short term) and develop fees using a distributive strategy from higher risk elements of banking versus the prior strategy of keeping these assets on balance sheet and manipulating regulatory capital. Regulators must observe these practices, as banks are likely to innovate away from regulatory restrictions and create new risk structures or distributive technologies – e.g. create a capital markets platform to distribute higher risk debt structures to a buy side shadow market relatively free of regulation. An alternative theoretical framework has been presented through Keynes, Minsky and Borio that would allow regulators to consider a progressive and pragmatic trajectory away from mainstream neoclassical economics and adapting DSGE models (see literature review, Chapter 2). This could further improve the stability of banking markets and assist in controlling financialised bank business models.
There are two significant methodological contributions in this thesis. First is the application of financialisation and heterodox economics using a cultural economy lens to analyse selected elements of post-crisis structural and prudential banking regulation. This is a novel framework and approach to providing a critique of post-crisis regulatory responses in these areas of the field. Secondly, the development of research questions through the above literature, using a mixed method pragmatic approach based on a sequential- explorative research design, has been unique in progressing this study. Developing answers to research questions using this framework and financialisation literature has also allowed a political economy approach to be adopted in questioning mainstream responses to post-crisis structural and prudential banking regulation. The above methodological contributions and approaches have proved useful in two ways: (i) as a synthesised set of antecedent literature that informs the debate in an alternative and critical way, and (ii) in the creation of a research design that allows a pragmatic and analytical application of primary and multiple levels of secondary data in order to mitigate bias.

8.5. Future Research

While acknowledging the limitations of this thesis, it is appropriate to offer a guide as to how further research will surmount some of these problems and to indicate how the research findings and recommendations of the final chapter could prove useful in developing a future research agenda.

Chapters 6 and 7 observe a single case to demonstrate in detail the way prudential banking regulation connects with bank losses whilst developing new and unforeseen risks that management bricoleurs look to leverage. It is challenging to generalise from a single case to a wider context. Consequently, further research is
required to observe management bricoleurs operating in different institutions of banking and finance, e.g. investment banks, hedge funds and asset managers, and using different devices, processes as conduits. The activity of the managerial bricoleur could emerge again in financialised capitalism as discussed. Searching for additional cases or examples could allow insight towards a generalisation and reclassification of banking or finance managers under certain conditions, such as crises or material industry change. It would also be interesting to review how UK regulatory experiences compare with those in the United States and, when policy response differs geographically, to ask whether bricoleurship endures under alternative frameworks in crisis or recessionary conditions.

Conducting such research could allow a typology of contingent conditions and situations to emerge under which the bricoleur develops improvisation at the nodes of opportunity. A typology may prove useful to identify when action could be taken to prevent financial instabilities in firms and systems. This research would also connect with banking culture, a subject yet to be tackled through regulation and Basel III. Banking supervision has been earmarked to manage culture within the industry on a case-by-case basis rather than through a soul-searching industry report as Wheatley previously advised (Wheatley 2012). As discussed, however, it remains doubtful whether the mind-set of supervision through risk management can control the opportunistic improvisation of the bricoleur. Other technology-based methods could be used to examine digital footprints and communication behaviour (e.g. in the Libor scandal) in order to identify potential bricoleurs and opportunistic behaviour within organisations. This, together with the above ideas for research, would be an interesting route to developing an improved culture in managing banking and finance firms through periods of instability, change or crisis.
Further research is required concerning the longer-term legacy effects of structural and prudential regulation, with particular reference to efficiency of the universal banking model and performance of ring fencing. It would also be interesting to delve into other types of literature and explore how theory could contribute towards alternative explanations and understandings regarding different ways in which banks could be structured.

Researching the longer-range legacy effects of ‘more capital’ and changes in regulatory capital through mainstream risk management practices would extend financialisation literature regarding the performance of banks and return on equity. Both monitoring and research are required when making connections between banking, firm and sectoral performance in markets as UK post-crisis banking regulation and financialised capitalism evolves, in order to draw attention to the unforeseen circumstances that continue to affect the sector.

It would also be of interest to observe how banking business models are reshaped as a consequence of reformed structural and prudential regulation. A contribution could be made to the literature concerning the way post-crisis regulation and its risk management practices are developing a ‘shadow banking market’. Another research possibility could involve the future direction taken by bank business models. Banks may develop towards a capital markets distribution platform, with banks continuing to earn fees from high risk debt and increasing ROE, but they may also develop in an alternative direction, and this would have an impact on regulation more broadly (extension of scope), risk management (can mainstream theory remain a foundation that underpins a wider marketplace?) and reform. This is an evolving area and may lead to an intricately networked and varied group of firms operating within a developing asset management system. Shadow banking is yet to be fully understood in terms of systemic
instability.
Chapter 9. References


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Chapter 10. Appendices

Appendix A: Interviewee Table

<table>
<thead>
<tr>
<th>Interviewee</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior Basel III Implementation Director – Lloyds Bank</td>
<td>19/10/2015</td>
</tr>
<tr>
<td>Senior Official FSA</td>
<td>24/03/2015</td>
</tr>
<tr>
<td>Senior BoE, Official and Academic</td>
<td>04/04/2015</td>
</tr>
<tr>
<td>Senior Official Independent Commission on Banking (1)</td>
<td>15/04/2015</td>
</tr>
<tr>
<td>Senior Academic, former BoE MPC Member</td>
<td>03/06/2015</td>
</tr>
<tr>
<td>Senior Official Independent Commission on Banking (2)</td>
<td>23/06/2015</td>
</tr>
<tr>
<td>Senior Journalist and Investment Banker</td>
<td>09/02/2015</td>
</tr>
</tbody>
</table>

Appendix B: Information for Research Participants

Thank you for agreeing to participate in the research project. Your participation in this research is voluntary, and you may change your mind about being involved in the research at any time, and without giving a reason.

This information sheet is designed to give you full details of the research project, its goals, the research team, the research funder, and what you will be asked to do as part of the research. If you have any questions that are not answered by this information sheet, please ask.

What is the working title of your thesis?
Governance and Regulation of UK Banking in the Post Crisis Era 2008-2015

Who is carrying out the research?
Ian Crowther is the principal investigator. Ian is a PhD student at the University of Manchester Business School and is a member of the People, Management and Organisations Division. Ian receives a scholarship from The University of Manchester Business School and its Executive Development Centre – this is the sole source of his research funding. His supervisors are Ismail Ertürk, who is a Senior Lecturer in Banking at the University of Manchester, and Professor Michael Moran, who is an Emeritus Professor of Government at the University of Manchester.

What is the research about?
The aim of this research is to analyse the Governance and Regulation of UK banking in the post crisis era 2008 - 2015.
The research will seek to understand and evaluate the changes in governance and regulation post crisis, how regulation is organised, what it is accomplishing, what are its key aims, and how this is being undertaken since 2008. There have been major structural changes to governance and regulation over the past 7 years: the central bank, the Bank of England, as regulator, what regulatory change has taken place in Basel III and more specifically to the UK – Vickers Report, and the effect this is having upon the UK economy. Interviews will be used to explain this phenomenon and understand qualitatively how changes to both governance and banking regulation impacts financial institutions, as well as the wider social ramifications of socio-economic decision making.

What groups of people have been asked to take part, and why? Politicians, practitioners, authors and academics have been asked to take part in the study. These are individuals who are at the heart and the periphery of the banking regulatory system and have in-depth experience and knowledge of such phenomena. These individuals have key knowledge of how governance and regulatory change has occurred post crisis, and the impact such regulation will have upon the industry and wider society.

What will research participants be asked to do? They will be asked to talk openly about their career, experiences in their specific role, and their own personal perspective and opinion. These interviews will last approximately 1 hour. The interviews will all take place over the next six months. There will also be feedback forms sent after the interviews so that the findings can be checked with participants. There will be no payment for the interviewees but all will be done to minimise any inconvenience.

What will happen to the information provided? Where possible and with permission, interviews will be recorded using a digital voice recorder. This is for the purposes of research only and these recordings will not be shared with other parties. The recordings will be stored on a secure PC. We will use pseudonyms for all participants taking part. Direct quotes will be used in academic outputs. Participants will be offered the chance to signal if they wish certain quotes/ events not to be included in the written outputs. If requested, participants, after the interview, will receive a short summary of the transcription.

What will be the outputs of the research? I will be producing a thesis where I will summarise my findings and recommendations. These will not include any quotes/ data that would make it possible to identify participants. There will also be several academic outputs (e.g. conference papers, academic articles), these will include quotes but every effort will be made to ensure anonymity.
Contact details
Researcher:

Ian Crowther Ian.crowther@mbs.ac.uk

Complaint procedure
If you wish to complain about the way in which the research is being conducted or have any concerns about the research then in the first instance please contact Ian Crowther.

Or contact Supervisors:
Ismail Ertürk or Professor Michael Moran Ismail.Ertürk@mbs.ac.uk Mick.Moran@mbs.ac.uk
Appendix C: Consent Form

Governance and Regulation of UK Banking in the Post Crisis Era 2008-2015

Ian Crowther, PhD Student at the University of Manchester

Please Initial Box

☐ 1. I confirm that I have read and understand the information sheet for the above study and have had the opportunity to ask questions.

☐ 2. I understand that my participation is voluntary and that I am free to withdraw at any time, without giving reason.

☐ 3. I agree to take part in the above study.

☐ 4. I agree to the interview being audio recorded

☐ 5. I agree to the use of anonymised quotes in publications

Name of Participant                Date                Signature

Name of Researcher                Date                Signature
Appendix D: Lloyds Banking Group plc disclosed transactions 2014-2015

92/09 15 October 2009

LLOYDS BANKING GROUP STATEMENT ON CERTAIN NON CORE DISCRETIONARY INVESTMENT MANAGEMENT ACTIVITIES

Lloyds Banking Group plc confirms it is in discussions with Rathbone Brothers Plc regarding the possible sale of assets relating to certain non core private client discretionary investment management activities, principally the Bank of Scotland Portfolio Management Service.

Discussions are ongoing but there is no certainty that a transaction will proceed. Lloyds Banking Group will provide a further update to the market in due course.

77/09 12 August 2009

LLOYDS BANKING GROUP ANNOUNCES ASSET MANAGEMENT PLANS

Lloyds Banking Group announced today that it has concluded a strategic review of its asset management businesses which will lead to some structural changes in the business, including the sale of Insight Investment Management Limited (Insight).

The Group has a strong investment management business and is the largest bancassurance provider in the UK. It sees significant opportunities to build on its success given its investment expertise, strong brands and range of highly effective distribution channels.

The main conclusions of the strategic review are:

The Group intends to transfer the investment management of the funds sourced from the Group’s Halifax and Bank of Scotland bancassurance businesses, the Bank of Scotland wealth management operation and the Clerical Medical intermediary franchise from Insight Investment to Scottish Widows Investment Partnership (SWIP).

SWIP will become a centre of excellence for the Group’s asset management activity. Based in Edinburgh, SWIP currently has £83 billion of assets under management and, after the intended transfer of approximately £42 billion from Insight, this will increase to approximately £125 billion.

Separately, and independently of this transfer, the Group is announcing an agreement in principle to sell Insight Investment to The Bank of New York Mellon Corporation. This sale will comprise Insight's external fund management operation which manages assets of approximately £80 billion for pension schemes, third party distributors, intermediaries and other corporates. The deal, for a total consideration of £235 million, comprising cash consideration of £200 million and equity consideration of £35 million, is expected to
complete in the final quarter of this year.

SWIP – a centre of excellence for asset management

Bringing together the Group’s asset management business under SWIP will provide significant scale benefits and reinforce SWIP’s position as a dynamic research-driven asset manager, providing a broad range of high quality products to both the Group’s insurance and wealth clients and, equally importantly, its external clients. Under the leadership of Dean Buckley, the Group expects to increase its investment management capability in Edinburgh over time to reflect the enlarged scale of SWIP’s business.

Consultation

The Group is consulting with the unions about the sale and the transfer. Until these consultations are complete, the precise colleague impact will not be known. However, it is anticipated that as part of this asset management consolidation there will be some role reductions.

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Jo Dawson, Wealth and International Director, Lloyds Banking Group said:

“As Lloyds Banking Group continues to develop and grow, both in the UK and internationally, it was essential that we undertook a thorough and robust review of our asset management businesses and future plans. Both SWIP and Insight are strong and well established asset managers but we believe Insight is better able to focus on developing its specialist external franchise outside the Group.

SWIP has been managing funds successfully for Lloyds TSB customers since 2000 as well as for a growing range of alliances, joint ventures and clients both in the UK and abroad. By positioning SWIP as a centre of excellence for the Group’s asset management activity we will create strong and sustainable value for our clients and shareholders.”

90/09 16 October 2009

LLOYDS BANKING GROUP TO SELL HALIFAX ESTATE AGENCY

Lloyds Banking Group plc announces that it has reached an agreement in principle to sell the Halifax Estate Agencies Ltd (HEA) business which operates through a network of 218 offices, including 93 franchise operations, to LSL Property Services plc (LSL). LSL is the parent company of estate agency brands Your Move, Reeds Rains and Intercounty.

The proposed transaction is expected to complete in January 2010 and will involve the
assumption of Halifax Estate Agency’s assets and liabilities for a cash consideration of £1. The effect on the Lloyds Banking Group accounts is not expected to be material. The Halifax brand is not included in the sale and, in time, the Halifax Estate Agency offices will be rebranded to either Your Move, Reeds Rains or Intercounty.

The decision to sell the estate agency business, which has been loss making for some time, follows a strategic review undertaken by the Group which concluded that an estate agency operation is no longer integral to its business model.

As part of the transaction, there are 121 Halifax banking counters located within the estate agent offices which will close early in the New Year. The vast majority of these locations have either a Halifax or Lloyds TSB branch within one mile.

Colleagues

It is anticipated that approximately 1,050 estate agency colleagues will transfer, on completion of the sale, under the Transfer of Undertakings (Protection of Employment) ‘TUPE’ employment legislation to companies within the LSL group. Lloyds Banking Group is consulting with its unions about the sale and the transfer of employees.

In addition, it is anticipated that as a result of the counter closures, up to 460 colleagues will be affected with the loss of approximately 360 full time roles. The Group’s preference is to use natural turnover, make less use of contractors and to redeploy people wherever possible to retain their expertise and knowledge. Where it is necessary for colleagues to leave the company, it will look to achieve this by voluntary redundancy. Compulsory redundancies will be a last resort.

The Halifax retail branch network is unaffected by this announcement and continues to operate as usual. The Group is firmly committed to a multi-brand strategy for its banking business and Halifax is one of Lloyds Banking Group’s key relationship brands.

Customers

For customers buying and selling property through Halifax Estate Agency there will be no change. On the completion of the transaction, there will be a smooth transition to LSL Property Services plc who will continue to market the property and assist in the transaction. All customers potentially affected by the counter closures will receive a letter informing them of the changes and letting them know about alternative banking facilities in their area.

David Nicholson, Managing Director of Halifax Community Bank, said: “Halifax Estate Agency is a well established business and, following a strategic review, we believe that it is better able to grow outside the Group with a strong existing player in the market such as LSL Property Services plc.”
“The Halifax brand is one of the strongest on the high street and remains integral to the Group. Halifax bank branches will continue to operate on the high street in England and Wales alongside Lloyds TSB and we are focused on growing and developing the Halifax business.”

Simon Embley, Chief Executive Officer of LSL Property Services plc added:
“The purchase of Halifax Estate Agency heralds a significant step forward in the growth of LSL and its associated estate agency businesses. We now look forward to embracing the opportunities that this move presents to us and, at the same time, ensure the high standards and reputation HEA are renowned for are maintained and built upon in the future.”

93/09 20 October 2009

LLOYDS BANKING GROUP ANNOUNCES SALE OF CERTAIN NON CORE DISCRETIONARY INVESTMENT MANAGEMENT ACTIVITIES

Lloyds Banking Group plc (Lloyds) has today announced the sale of the Bank of Scotland Portfolio Management Service (PMS) client portfolio and two directly invested discretionary private client portfolios of a similar service within Lloyds TSB Private Banking Limited (LTPB) to Rathbone Brothers Plc (Rathbones). The sale follows a detailed review of the Group’s private client activities which concluded that these discretionary investment management portfolios were no longer core for the Group.

In total the proposed transaction would envisage the transfer of around 6,000 customers with a total of c.£1.27 billion of funds under management (FUM) to Rathbones, subject to client consent.

Following completion of the proposed transaction, Lloyds will continue to manage £8.5 billion of assets under management for c.35,000 affluent and high net worth clients under its Investment Portfolio Management service which are not part of this transaction. There will be no impact on the day to day banking and lending relationships between the Group and its high net worth clients.

In addition to the sale, Lloyds is also pleased to announce the creation of an exclusive distribution agreement with Rathbones whereby affluent UK based clients of Lloyds with investable assets of between £250,000 and £2 million, whose portfolio needs require significant assets in directly held investments, will be referred to Rathbones. The agreement has an initial five-year term.

Total consideration payable for the businesses is based on a percentage of FUM transferable as at date of client transfer for PMS and the two portfolios of LTPB clients. Assuming that all of the client FUM of £1.27 billion transferred to Rathbones, total cash
consideration payable to Lloyds would be £35.4 million.

Consultation

Following the sale announced today, the Group expects approximately 40 role reductions in Edinburgh by the end of 2011. The Group’s policy has always been to use natural turnover and to redeploy staff wherever possible to retain their expertise and knowledge within the Group. The Group will work closely with Rathbones to understand what opportunities may be available for PMS colleagues who might be interested in joining Rathbones. Compulsory redundancies will be a last resort. A range of measures have been put in place to support colleagues through this uncertain time. The Group has consulted with the unions about the sale.

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No other assets are included in this transaction and the transfer does not include the Bank of Scotland Portfolio Management Service brand. No staff will be transferred to Rathbones in respect of the LTPB businesses.

Tom Woolgrove, Managing Director of UK Private Banking, Lloyds Banking Group, said:
"Lloyds has carried out a thorough review of its private client businesses and has concluded that a specialist provider would be better positioned to manage this particular service for our clients. Rathbones is a leading provider of discretionary direct equity investment management services in the UK and we look forward to working closely with them under the new distribution partnership."

90/09 16 October 2009

LLOYDS BANKING GROUP TO SELL HALIFAX ESTATE AGENCY

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The proposed transaction is expected to complete in January 2010 and will involve the assumption of Halifax Estate Agency’s assets and liabilities for a cash consideration of £1. The effect on the Lloyds Banking Group accounts is not expected to be material. The Halifax brand is not included in the sale and, in time, the Halifax Estate Agency offices will be rebranded to either Your Move, Reeds Rains or Intercounty.
The decision to sell the estate agency business, which has been loss making for some time, follows a strategic review undertaken by the Group which concluded that an estate agency operation is no longer integral to its business model.

As part of the transaction, there are 121 Halifax banking counters located within the estate agent offices which will close early in the New Year. The vast majority of these locations have either a Halifax or Lloyds TSB branch within one mile.

Colleagues

It is anticipated that approximately 1,050 estate agency colleagues will transfer, on completion of the sale, under the Transfer of Undertakings (Protection of Employment) ‘TUPE’ employment legislation to companies within the LSL group. Lloyds Banking Group is consulting with its unions about the sale and the transfer of employees.

In addition, it is anticipated that as a result of the counter closures, up to 460 colleagues will be affected with the loss of approximately 360 full time roles. The Group’s preference is to use natural turnover, make less use of contractors and to redeploy people wherever possible to retain their expertise and knowledge. Where it is necessary for colleagues to leave the company, it will look to achieve this by voluntary redundancy. Compulsory redundancies will be a last resort.

The Halifax retail branch network is unaffected by this announcement and continues to operate as usual. The Group is firmly committed to a multi-brand strategy for its banking business and Halifax is one of Lloyds Banking Group’s key relationship brands.

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95/09 26 October 2009

LLOYDS BANKING GROUP ANNOUNCES SALE OF EMPLOYEE EQUITY SOLUTIONS BUSINESS

Lloyds Banking Group plc today announces that it has concluded a strategic review of its Employee Equity Solutions (EES) business. This review has resulted in an agreement to sell EES to Computershare for a cash consideration of up to £40 million, subject to regulatory approval. The effect on the Lloyds Banking Group accounts is not expected to be material.

EES offers a complete share plan service to over 400 companies in 100 different countries. This includes a full range of share plans; such as all-employee, international sharesave plans, performance-based executive plans, UK tax approved plans and structured offshore trust and administration services. Computershare will continue to service all existing clients.

EES employs approximately 420 people across three main locations: Halifax, Jersey and Purley and it is expected that they will transfer, on completion of the sale, to Computershare. Lloyds Banking Group has consulted with the unions (Accord, LTU and Unite) and they will continue to be consulted throughout the transfer process.

The transfer is expected to complete by the end of the year, subject to regulatory approval.
6/10 11 February 2010

LLOYDS BANKING GROUP ANNOUNCES SALE OF 70% ESURE STAKE

Lloyds Banking Group is today announcing the sale of its 70 per cent stake in esure, the online insurer, to a management buyout vehicle to be called esure Group Holdings Ltd, led by esure chairman Peter Wood, for a cash consideration slightly in excess of book value in the Lloyds Banking Group accounts (31 December 2008: £185 million). As at 31 December 2008, esure had gross assets of £975.5 million (including assets backing insurance liabilities). The impact on the Group’s accounts is not expected to be material.
esure, which includes the Sheilas’ Wheels brand, was founded in 2000 as a joint venture by Peter Wood and the then Halifax plc. esure now offers home, motor, travel and pet insurance, using the internet as a primary sales channel.

Lloyds Banking Group is the largest provider of household insurance in the UK and primarily operates through two main brands; Lloyds TSB General Insurance and Halifax General Insurance. These operations provide household, motor, travel, pet, business, healthcare and creditor protection insurance products.

esure staff will continue to be employed by esure Services Ltd.

Archie Kane, Group Executive Director Insurance, Lloyds Banking Group said:
"This sale means we can focus our efforts on our core general insurance brands of Halifax and Lloyds TSB. Our priority is to deliver strong insurance products and excellent customer service across the general insurance business, thereby reinforcing our reputation as a market-leading insurance provider."

53/10 5 July 2010

LLOYDS BANKING GROUP ANNOUNCES THE SALE OF BANK OF SCOTLAND INTEGRATED FINANCE TO A JOINT VENTURE MAJORITY OWNED BY COLLER CAPITAL

Lloyds Banking Group plc announces today that it is selling a portfolio of 40 private equity investments in its Bank of Scotland Integrated Finance (BOSIF) business to a new joint venture called Cavendish Square Partners LP. The new joint venture will be majority owned (approximately 70%) by Coller Capital, a global leader in private equity secondary transactions, with Lloyds Banking Group owning a stake of approximately 30%.

The total cash consideration for Coller Capital’s majority stake is £332 million. This values the portfolio at approximately £480 million, which is a small premium to current book value. The impact of the sale on the Group’s accounts is not expected to be material. The Group held a competitive tender process before selecting Coller as its preferred bidder and will retain any associated corporate lending. The companies in the portfolio are UK headquartered trading businesses across a range of industry sectors and the Group’s retained stake will ensure that it will share in any potential future investment upside.

This transaction is in line with the Group’s strategy of divesting assets which are not core to its strategy and over the last twelve months the Group has now sold six businesses, raising over £750 million.
Coller Capital has decided to retain the existing BOSIF management team. It will transfer under TUPE into a newly formed management vehicle responsible for the day-to-day management of the portfolio. This will ensure continuity of management of the business.

The transaction is subject to certain conditions including regulatory approval, certain anti trust approvals, the transfer of the underlying investments to the joint venture and the TUPE transfer of the existing BOSIF management team to a newly formed management vehicle and is expected to complete in the third quarter of 2010.

Truett Tate, Group Executive Director, Wholesale, said:

"Through this transaction, we are crystallising value in these investments whilst retaining an interest in the investee companies with which we have had positive relationships for several years. This deal will ensure that we share in any future upside of our investments. We believe that the deal with Coller, a leading private equity investor, provides the investee companies with stability and support over the period ahead. This sale is part of our wider Wholesale Banking strategy of focusing on our core relationship based businesses."

74/10 27 July 2010

LLOYDS BANKING GROUP ANNOUNCES SALE OF ECUADORIAN OPERATION

Lloyds Banking Group plc announces today that it is selling its Ecuadorian branch assets and liabilities to Banco Pichincha for a cash consideration of up to US$25 million. The impact of the sale on the Group’s accounts will not be material.

The Ecuadorian business is primarily a corporate relationship bank operating through two branches and employing c.108 people. Total gross assets at 31 December 2009 were valued at US$170 million whilst the net assets for the business amount to US$25 million. The Lloyds private banking operations in Ecuador are not part of this transaction.

This transaction is in line with the Group’s strategy of divesting assets which are not core to its strategy and over the last twelve months the Group has now sold seven businesses, raising over £750 million.

The transaction is subject to certain conditions including regulatory approval and is expected to complete in the second half of the year.

126/10 17 December 2010

LLOYDS BANKING GROUP ANNOUNCES UPDATE ON IRISH PORTFOLIO
Since the release of its Interim Management Statement on 2 November 2010, the Group has seen a further significant deterioration in market conditions in the Republic of Ireland, with concerns over the country’s fiscal position leading ultimately to the approval of its application for EU-IMF financial support on 21 November. Market sentiment has continued to be negatively affected by uncertainty about the political situation and about the economic impact of the austerity measures introduced in the Irish Budget of 7 December.

As a result, we are concerned that any economic recovery in the Republic of Ireland may take longer to achieve, and that asset prices will remain depressed for longer, than previously anticipated. While the Board will continue to review the status of the Irish portfolio as the Group prepares its year end accounts, it believes that the recent significant deterioration in the Irish market will affect the timing and level of value realisation from this portfolio.

Therefore, the Board anticipates that, compared to 30 June 2010, approximately a further 10 per cent of the £26.7 billion Irish portfolio will become impaired by the 2010 year end. Furthermore, the Board believes that it is prudent to increase the level of provisions against the portfolio, and currently anticipates an increase in the impairment charge relating to Irish exposures for the full year 2010 to approximately £4.3 billion on a combined businesses basis. This would result in an increase in provisions as a percentage of impaired Irish loans to approximately 54 per cent at the 2010 year end.

Lloyds Banking Group will announce its full year results on 25 February 2011. 11/11 21 February 2011

LLOYDS BANKING GROUP ANNOUNCES VOLUNTARY AGREEMENT WITH THE FSA WITH REGARD TO CERTAIN HALIFAX MORTGAGE CONTRACTS

Lloyds Banking Group plc announces that it has reached a voluntary agreement with the FSA in relation to initiating a customer review and contact programme with regard to outstanding concerns with the variation of limits of some Retail mortgage contracts. This specifically relates to some Halifax mortgage customers, where the wording in the mortgage offer documents received by these customers had the potential to cause confusion.

This proactive agreement follows conversations between Lloyds Banking Group and the FSA to address this potential confusion. The relevant mortgages were written during 2004 – 2007 by Bank of Scotland plc under the ‘Halifax’ brand, and through the contact programme, goodwill payments will be made to affected customers. To effect these goodwill payments, Bank of Scotland plc has applied for a Voluntary Variation of Permission (VVOP) to carry out the customer review and contact programme to bring it within section 404F (7) of FSMA 2000.
The Group is committed to running its business with the highest levels of integrity and treating its customers fairly and therefore believes that a proactive co-ordinated programme to identify affected customers and make goodwill payments is the appropriate course of action.

Lloyds Banking Group is making a provision of £500 million in relation to the contact programme within its 2010 accounts which is expected to fully cover the payments.

68/11 8 June 2011

LLOYDS BANKING GROUP ANNOUNCES SALE OF HILL HIRE PLC

Lloyds Banking Group plc announces today that it has sold Hill Hire plc to US based Ryder System Inc for cash consideration of £151 million. The book value of the business is £167 million. The impact of the sale, which completed earlier today, on the Group’s accounts is not material.

Hill Hire is the leading provider of contract hire and rental solutions for trucks and trailers in the UK.

This transaction is part of the Group’s ongoing strategy to divest assets which are not core to its business.

Lloyds Banking Group plc is registered in Scotland no. 95000. Registered office: The Mound, Edinburgh EH1 1YZ

29 March 2012

LLOYDS BANKING GROUP ANNOUNCES SALE OF ITS ONSHORE BUSINESS IN DUBAI

Lloyds Banking Group (‘the Group’) announces today that it is selling its onshore Dubai business to HSBC Bank Middle East Limited.

The Group’s onshore presence in Dubai comprises retail, commercial and corporate banking business and the total assets subject to the transaction total £482 million as of 31 December 2011. The Group’s other private and expatriate offshore operations based in the United Arab Emirates are not subject to the transaction.

This transaction is in line with the Group’s strategy of reducing its international presence. The impact of the sale on the Group’s accounts is not expected to be material.

The transaction is subject to a number of conditions, including regulatory approval, and is expected to complete during the second half of 2012.
6 June 2012

LLOYDS BANKING GROUP ANNOUNCES SALE OF AUSTRALIAN CORPORATE REAL ESTATE LOANS

Lloyds Banking Group plc announces today that it is selling a portfolio of GBP 809 million Australian corporate real estate loans to AET SPV Management Pty Limited, a joint venture comprised of funds sponsored by Morgan Stanley Real Estate Investing and Blackstone for a cash consideration of approximately GBP 388 million. The impact of the transaction on the Group is not material due to the existing provisions taken against these assets. The sale proceeds will be used to repay debt.

The asset portfolio generated losses of GBP 183 million in the year to 31 December 2011. This transaction is in line with the Group's strategy of de-risking its balance sheet and reducing its non-core assets. Closing is expected to occur in the third quarter after obtaining necessary third party consents.

Commenting on the transaction, Dave Smith, CEO of Lloyds International Pty Ltd, said "This transaction further de-risks the Australian business, and results in a cumulative 92 per cent reduction of our real estate non performing loan portfolio. We continue in parallel to focus on growing the profitable core of our business".

14 August 2012

LLOYDS BANKING GROUP ANNOUNCES SALE OF INTEREST IN A PORTFOLIO OF PRIVATE EQUITY INVESTMENTS

Lloyds Banking Group plc (the Group) announces today that it has agreed the sale of a portfolio of private equity-related investments with gross assets of approximately £1,050 million and the transfer of undrawn commitments which are expected to be £220 million at completion (the Portfolio) to a fund (PE1 LP) financed by Coller International Partners VI for a cash consideration of approximate £1,030 million. After the reversal of the related available-for-sale reserve, the transaction is expected to result in a pre-tax gain for the Group. Following the sale, the Group will continue to manage the fund in return for a management fee, which is likely to be less than £10 million per annum. The sale proceeds will be used for general corporate purposes.

The Portfolio generated losses of £40 million in the year to 31 December 2011. This transaction is in line with the Group's strategy of de-risking its balance sheet and reducing its non-core assets.

The transaction is subject to certain conditions, including obtaining the approval of the relevant general partners, and is expected to complete in the fourth quarter of 2012.
7 September 2012

LLOYDS BANKING GROUP ANNOUNCES SALE OF OPERATIONS IN URUGUAY

Lloyds Banking Group plc (the Group) announces today that it is selling its Uruguayan retail, commercial and corporate banking operations, which currently operate as a branch of Lloyds TSB Bank plc, to Banque Heritage (Uruguay) S.A. The total assets subject to the transaction total £261 million as of 31 December 2011. The Group’s representative office in Uruguay is not included within this transaction.

This transaction is in line with the Group’s strategy of reducing its international presence and the effect of the sale on the Group is not expected to be material.

The transaction is subject to a number of conditions, including regulatory approval, and is expected to complete in 2013.

November 2012

LLOYDS BANKING GROUP ANNOUNCES SALE OF IRISH COMMERCIAL REAL ESTATE LOANS TO AN ENTITY AFFILIATED WITH APOLLO

Lloyds Banking Group plc (the Group) announces today that it has agreed the sale of a portfolio of Irish commercial real estate loans (the Portfolio) to Risali Limited, an entity affiliated with Apollo Global Management, LLC (NYSE: APO) for a cash consideration of £149 million. The transaction is not expected to have a material impact on the Group due to the significant impairment provisions held against the Portfolio, which are higher than the average across the Irish wholesale book because of the particularly distressed nature of these assets. The sale proceeds will be used for general corporate purposes.

The Portfolio generated losses of £202 million in the year to 31 December 2011. The gross assets subject to the transaction are £1,466 million. This transaction is in line with the Group's strategy of de-risking its balance sheet and reducing its non-core assets.

The transaction is expected to complete in the first quarter of 2013.

29 April 2013

LLOYDS BANKING GROUP ANNOUNCES SALE OF RETAIL BANKING OPERATIONS IN SPAIN

Lloyds Banking Group plc (the Group) is today announcing that it has agreed to sell its Spanish retail banking operations, including Lloyds Bank International S.A.U and Lloyds Investment España SGIIC S.A.U, to Banco Sabadell, S.A (Banco Sabadell).

The sale comprises the Group’s retail and private banking business and the local
investment management business in Spain. The business being sold consists mostly of retail mortgages and deposits, with a large portion of non-resident clients. The Group’s Spanish corporate banking operations, serving business clients, are not included in this transaction and will continue to operate as usual.

To ensure continued support for our customers in the Spanish market and in conjunction with the sale, the Group is also developing a collaboration agreement with Banco Sabadell which it is expected would involve exploring potential business opportunities in areas including retail, commercial, private banking, asset finance and asset management.

Under the sale agreement, the Group will receive shares equivalent to approximately 1.8 per cent of the total issued share capital of Banco Sabadell as part of the consideration for the sale. The Group intends to be a supportive shareholder of Banco Sabadell and has undertaken to retain the shares received under the sale agreement for a period of at least two years.

Total consideration will be payable in a mix of shares and cash. At completion Banco Sabadell will deliver 53.7 million ordinary shares out of their treasury holding with such shares being valued at €84 million (£72 million) by reference to the volume weighted average share price on 26 April 2013. An additional consideration of up to €20 million (£17 million) may be payable in cash within the next five years dependent on mortgage book margins.

As of 31 March 2013 the total assets of the sale were approximately £1,517 million, comprised almost entirely of customer lending, and customer deposits were approximately £670 million. The business reported a loss of approximately £43 million in 2012, which included an increase in the impairment provision as a percentage of impaired loans to approximately 90 per cent. The sale of the business is currently expected to lead to a loss on disposal of approximately £250 million in the Group’s accounts.

The sale is in line with the Group’s strategy of rationalising its international presence and ensuring best value for shareholders. The current senior management employed by Lloyds Bank International S.A.U and all of the staff of the Spanish retail operations will move across with the subsidiaries on sale. Any cash proceeds of the sale will be used for general corporate purposes.

The sale is subject to regulatory approval and is expected to complete in 2013 on disposal of approximately £250 million in the Group’s accounts.

The sale is in line with the Group’s strategy of rationalising its international presence and ensuring best value for shareholders. The current senior management employed by Lloyds Bank International S.A.U and all of the staff of the Spanish retail operations will
move across with the subsidiaries on sale. Any cash proceeds of the sale will be used for general corporate purposes.

The sale is subject to regulatory approval and is expected to complete in 2013.

10 May 2013

LLOYDS BANKING GROUP ANNOUNCES SALE OF PORTFOLIO OF UK COMMERCIAL REAL ESTATE LOANS TO AN ENTITY AFFILIATED WITH CERBERUS GLOBAL INVESTMENTS

Lloyds Banking Group plc (the Group) announces today that it has agreed the sale of a portfolio of UK commercial real estate loans (the Portfolio) to Promontoria Thames Limited, an entity affiliated to Cerberus Global Investments for a cash consideration of £325 million. The transaction is part of the Group’s continued non-core asset reduction.

The gross assets subject to the transaction are £527 million. The Portfolio generated losses of £47 million in the year to 31 December 2012. The sale proceeds will be used for general corporate purposes and the transaction is not expected to have a material impact on the Group due to significant impairment provisions held against the portfolio.

The transaction is expected to complete in the final quarter of 2013. 22 May 2013

PROPOSED PLACING OF SHARES IN ST JAMES’S PLACE PLC

Lloyds Banking Group plc (‘Lloyds’, or the ‘Group’) announces today its intention to sell approximately 77 million ordinary shares (the ‘Placing Shares’) in St James’s Place plc (‘St James’s Place’, or the ‘Company’), representing approximately 15 per cent of the Company’s existing issued ordinary share capital (the ‘Placing’). This sale follows the recent strong performance of St James’s Place shares, and the agreement by the sole bookrunner (‘the Sole Bookrunner’) to waive, pursuant to the original terms, the 365 day lock up agreed when Lloyds previously undertook a placing in March 2013. The sale will also increase the free float of the Company, thereby improving liquidity.

The Placing reflects the Group’s plan to meet its capital requirements through its strongly capital generative core business, continued progress in executing its customer focused strategy and further capital accretive non-core asset disposals, as confirmed in the Group’s update on its capital position announced earlier today, following the outcome of the Prudential Regulation Authority’s considerations in relation to the Group’s capital position.

Institutional shareholders will be sought for the Placing Shares on the Group’s behalf by the Sole Bookrunner through an accelerated bookbuild. The price at which the Placing Shares are to be placed will be agreed by Lloyds and the Sole Bookrunner at the close of the bookbuilding process. The result of the Placing will be announced as soon as possible
after the close of the bookbuilding process.

Following completion of the Placing, assuming the sale of a 15 per cent stake, Lloyds will hold approximately 21 per cent of the Company’s issued share capital. The existing 365 day lock-up agreed at the time of the prior placing in March will remain in place in respect of its remaining holding in St James’ Place, and in addition cannot be waived for at least 180 days from the date of completion. Lloyds continues to be supportive of the St James’s Place management team.

Information on St James’s Place

St James’s Place is a FTSE 250 financial services group that provides wealth management services to individuals, trustees and businesses. With around 140,000 wealth management clients and £39 billion in funds under management, the Company is well established as one of the UK’s leading wealth managers. As at 31 December 2012, the Company had gross assets of £33.8 billion.

Lloyds Banking Group plc is registered in Scotland no. 95000. Registered office: The Mound, Edinburgh EH1 1YZ

Effect of the Proposed Placing on Lloyds Banking Group

On completion of the Placing, assuming the sale of a 15 per cent stake, the Group will realise a gain on sale of approximately £40 million. On this basis, the Placing is expected to increase the Group’s core tier 1 capital by approximately £40 million, equivalent to an approximate 1 basis point benefit to its core tier 1 capital ratio (under current capital rules). On a pro forma fully loaded CRD IV basis, it is estimated that the Placing will increase the Group’s common equity tier 1 capital by approximately £500 million, equivalent to an approximate 16 basis points benefit.

The Group currently accounts for St James’s Place as an associate, reflecting the Group’s share of the Company’s profit within its income statement, and expects to continue to do so post sale. The statutory profit after tax but before minority interest attributable to St James’s Place in the Group’s accounts for the year ending 31 December 2012 was £76 million.

PLACING OF SHARES IN ST JAMES’S PLACE PLC

Further to its announcement on 22 May 2013 of its intention to sell shares in St James’s Place plc (‘St James’s Place’, or the ‘Company’), Lloyds Banking Group plc (‘Lloyds’, or the ‘Group’) announces that 77 million shares have been placed at a price of £5.80 per share (the ‘Placing’). The gross proceeds of the Placing are approximately £450 million.

Settlement of the Placing will take place on 29 May 2013. On completion, Lloyds will
hold 110 million St James’s Place shares (approximately 21 per cent of the Company’s issued share capital).

The existing 365 day lock-up, agreed at time of the prior placing in March, will remain in place in respect of Lloyds’ remaining holding in St James’s Place and, in addition, cannot be waived for at least 180 days from the date of completion.

**Effect of the Placing on Lloyds**

As a result of the Placing, the Group will realise a gain on sale of approximately £40 million. The Placing will increase the Group’s core tier 1 capital by approximately £40 million, equivalent to an approximate 1 basis point benefit to its core tier 1 capital ratio (under current capital rules). On a pro forma fully loaded CRD IV basis, the Placing will increase the Group’s common equity tier 1 capital by approximately £500 million, equivalent to an approximate 16 basis points benefit.

Following the Placing the Group expects to continue to account for St James’s Place as an associate, reflecting the Group’s share of the Company’s profit within its income statement. The statutory profit after tax but before minority interest attributable to St James’s Place in the Group’s accounts for the year ending 31 December 2012 was £76 million.

**LLOYDS BANKING GROUP ANNOUNCES THE SALE OF ITS INTERNATIONAL PRIVATE BANKING OPERATIONS**

Lloyds Banking Group plc (‘Group’) announces the proposed sale of its International Private Banking business to Union Bancaire Privée (‘UBP’) (‘Transaction’). The Transaction will include the business of the Group’s Geneva-based Private Bank, its branches based in Geneva, Zurich, Monaco and Gibraltar, and its representative office in Montevideo (the ‘Business’). The agency office in Miami is excluded from the sale. In connection with the Transaction the Group will also be closing the Dubai International Finance Centre based private banking business.

The Business offers a wide range of personalised banking, investment and planning services to high net worth individuals and families. UBP has an attractive proposition for the clients of our International Private Banking business and the senior client facing teams of the Business are expected to transfer to UBP on completion of the Transaction. To ensure continued support for our customers and in conjunction with the sale, the Group is also exploring potential business opportunities with UBP including possible client and product referrals.

The Group’s UK-offshore businesses including the Channel Islands, Isle of Man and Gibraltar will not be affected as a result of the Transaction. The Transaction builds on the commitments we made as part of the Group Strategic Review to reduce and simplify
our international presence and build our wealth business by focusing on the UK, Channel Islands and the UK Expat marketplace. Going forward, the Group’s wealth strategy is focused on serving mass affluent and affluent customers within the UK and Channel Islands, and those with UK connections.

As of 31 March 2013 the assets under management of the Business were approximately £7.2 billion and the total balance sheet assets were approximately £729 million. The Business reported a loss of approximately £50 million in 2012. The total consideration, payable in cash, for the Transaction is up to approximately £100 million, of which we expect to receive approximately £65 million at closing, with the rest deferred and payable in the two year period following completion of the Transaction, contingent upon the performance of the Business in that period. In addition the total assets figure includes other clients’ assets such as loans and derivative products which will be transferred to UBP at book value. The transaction is expected to result in an overall gain on sale and be capital accretive, although not material from a group perspective. The sale provides further evidence of the significant progress being made in simplifying the Group. The proceeds of the Transaction will be used for general corporate purposes.

The transaction is subject to a number of conditions, including regulatory approval, and is expected to complete in a number of stages, with the majority of the Business expected to transfer in the second half of 2013 and the remainder by the first quarter in 2014.

In addition to this transaction, and in line with its stated objective to reduce its international footprint, the Group has decided, in principle, to withdraw its presence in South Africa.

29 May 2013

LLOYDS BANKING GROUP ANNOUNCES THE SALE OF ITS MIAMI INTERNATIONAL PRIVATE BANKING OFFICE

Lloyds Banking Group plc (‘Group’) announces the proposed sale of its International Private Banking business in Miami (‘Business’) to Banco Sabadell, S.A (‘Banco Sabadell’). The Business offers a wide range of personalised banking, investment and planning services to high net worth individuals and families.

Banco Sabadell already has a customer focused, private banking business in Miami and as indicated when we announced the sale of our Spanish retail operations to Banco Sabadell in April we continue to explore how the groups can collaborate effectively. This agreement evidences where such collaboration can be beneficial for both our customers and the business. The senior client facing team of the Business is expected to transfer to Banco Sabadell on completion of the Transaction. The Group will be contacting clients shortly in relation to the Transaction.
The Group’s UK-offshore businesses including the Channel Islands, Isle of Man and Gibraltar will not be affected as a result of the Transaction. The Transaction builds on the commitments we made as part of the Group Strategic Review to reduce and simplify our international presence and build our wealth business by focusing on the UK, Channel Islands and the UK Expat marketplace. Going forward, the Group’s wealth strategy is focused on serving mass affluent and affluent customers within the UK and Channel Islands, and those with UK connections.

As of 31 March 2013 the assets under management of the Business were approximately £0.8 billion and the total balance sheet assets were approximately £35 million. The Business reported a loss of approximately £3 million in 2012. The total consideration, payable in cash, for the Transaction is up to approximately £8 million, of which we expect to receive approximately £4 million at closing, with the rest deferred and payable in the year following completion of the Transaction, contingent upon the performance of the Business in that period. In addition the total assets figure includes other clients’ assets such as loans and derivative products which will be transferred to Banco Sabadell at book value. The transaction is expected to result in an overall gain on sale and be capital accretive, although not material from a group perspective. The sale provides further evidence of the significant progress being made in simplifying the Group. The proceeds of the Transaction will be used for general corporate purposes.

The transaction is subject to a number of conditions, including regulatory approval, and is expected to complete by the end of 2013.

Based on 1 GBP: 1.16 EUR exchange rate
Lloyds Banking Group plc is registered in Scotland no. 95000. Registered office: The Mound, Edinburgh EH1 1YZ

31 May 2013

LLOYDS BANKING GROUP ANNOUNCES SALE OF PORTFOLIO OF US RMBS GENERATING CAPITAL BENEFIT OF £1.4 BILLION

Lloyds Banking Group plc (the Group) announces today that it has agreed the sale of a portfolio of US RMBS (residential mortgage backed securities) to a number of different institutions for a cash consideration of £3.3 billion. The transaction is part of the Group’s continued capital accretive non-core asset reduction.

The assets subject to the transaction have a book value of approximately £2.7 billion and as a result of the transaction the Group will realise a pre-tax gain on sale of approximately £540 million. The sale proceeds will be used for general corporate purposes.

As part of the same transaction the Lloyds TSB Group Pension Trust (No. 1) Limited also sold its share of the portfolio of US RMBS with a book value of £805 million, realising
a pre tax gain on sale of £360 million, which will reduce the deficit in the scheme.

Taking into account the gain on sale, the reduction in risk weighted assets and the benefit from the pension deficit reduction the sale is expected to increase the Group’s common equity tier 1 capital ratio, on a pro forma fully loaded CRD IV basis, by approximately 47 basis points (£1,400 million capital equivalent) and increase the Group’s core tier 1 capital ratio, under current capital rules, by approximately 33 basis points (£950 million capital equivalent).

The transaction is expected to complete in the first week of June.

In line with the transaction aggregation disclosure requirements of the UK listing rules we note that of the £2.7 billion portfolio, approximately £170 million has been sold to Goldman Sachs International Ltd for a cash consideration of approximately £200 million. The Group will realise a pre tax gain on sale of approximately £30 million on this portion of the portfolio.

June 2013

SCOTTISH WIDOWS – DIVIDEND PAYMENT TO LLOYDS TSB BANK

Scottish Widows Group Ltd (Scottish Widows) announces that, at its regular Board meeting scheduled for today, it was resolved to pay a dividend of £1.6 billion to Lloyds TSB Bank plc prior to the end of June 2013.

Scottish Widows will remain a strongly capitalised business. After the payment of this dividend, the IGD surplus for Scottish Widows is estimated to be £2.6 billion (1.5x cover) and the PRA Pillar 1 surplus for Scottish Widows plc, Scottish Widows’ principal life insurance subsidiary, is estimated to be £3.0 billion.

LLOYDS BANKING GROUP ANNOUNCES THE SALE OF HEIDELBERGER LEBEN

Lloyds Banking Group plc (“the Group”) announces that it has signed an agreement to sell its German life insurance business Heidelberger Lebensversicherung AG (“Heidelberger Leben” or “the business”) to a joint venture company owned by Cinven Partners LLP and Hannover Rück SE (“the buyer”), for a cash consideration of around €300 million, or approximately £250 million at current exchange rates.

Heidelberger Leben is a specialist provider of unit-linked pension, investment and life assurance products in Germany. The senior management employed by Heidelberger Leben will move with the business on completion of the sale. The business will continue to service the Group’s policies in Germany and Austria written under the Clerical Medical brand, under a long-term administration agreement.
The gross assets subject to the transaction are £7.2 billion, which are predominantly policyholder assets. In the year to 31 December 2012 the business reported a statutory loss of £38 million. The sale of Heidelberger Leben is expected to lead to a loss on disposal of approximately £330 million in the Group’s accounts but, combined with the sale of other assets, is currently expected to result in a benefit to the Group’s common equity tier 1 capital of approximately £0.4 billion upon completion, equivalent to an approximate benefit of 13 basis points on a pro forma fully loaded CRD IV basis. The cash proceeds from the sale will be used for general corporate purposes.

The sale is in line with the Group’s strategy of rationalising its international presence and ensuring value for shareholders.

The transaction is subject to regulatory approval and is expected to complete in early 2014. 21 August 2013
LLOYDS BANKING GROUP ANNOUNCES THE SALE OF A PORTFOLIO OF LEVERAGED LOANS

Lloyds Banking Group plc (“the Group”) announces today that it has agreed the sale of a portfolio of leveraged loans (“the Portfolio”) to ELQ Investors II Limited, a wholly owned subsidiary of Goldman Sachs Group, Inc., for a cash consideration of £254 million, with a further £2 million payable within 6 months if certain financial conditions are met. The transaction is part of the Group’s continued non-core asset reduction strategy.

The Portfolio, which has gross assets of £283 million, predominantly comprises UK based assets in a range of sectors including manufacturing and retail. The Portfolio generated profits of £11 million in the year to 31 December 2012.

The transaction will result in a small core tier 1 increase for the Group. The sale proceeds will be used for general corporate purposes.

The transaction is expected to complete by the end of September 2013. 24 September 2013
LLOYDS BANKING GROUP ANNOUNCES THE SALE OF A PORTFOLIO OF EUROPEAN COMMERCIAL REAL ESTATE LOANS

Lloyds Banking Group plc (‘the Group’) announces today that it has agreed the sale of a portfolio of European commercial real estate loans (‘the Portfolio’) to Promontoria Holding 76 B.V., which is an affiliate of Cerberus Institutional Partners V L.P., and Promontoria Holding 78 B.V., which is an affiliate of Cerberus International II Master Fund, L.P., for a cash consideration of €312 million, or approximately £263 million at current exchange rates. The transaction is part of the Group’s continued non-core asset reduction strategy.
The gross assets subject to the transaction are £371 million and in the year to 31 December 2012 generated profits of £4 million. The sale proceeds will be used for general corporate purposes and the transaction, although capital accretive on a Basel 3 basis, is not expected to have a material impact on the Group.

The transaction is expected to complete in Q4 of 2013. 10 October 2013

LLOYDS BANKING GROUP ANNOUNCES SALE OF AUSTRALIAN OPERATIONS

Lloyds Banking Group plc (‘the Group’) announces today that it has agreed the sale of its Australian operations to Westpac Banking Corporation. These operations principally comprise Capital Finance Australia Limited (CFAL), a provider of motor and equipment asset finance, and BOS International (Australia) Limited, a corporate lending business. The consideration includes approximately AU$1.45 billion for the shares in the operations and approximately AU$0.1 billion for the market value of derivative contracts, resulting in total consideration of approximately AU$1.55 billion, or approximately £0.9 billion at current exchange rates, which will be payable in cash. In addition an AU$0.1 billion pre-completion distribution will be made by the Australian operations.

The sale is in line with the Group’s strategy of focusing on the UK, rationalising its international presence and ensuring best value for shareholders. The sale will enable our country exit from Australia, which will be effected a short time after completion, although we will continue to support core UK-linked clients in Australia. The proceeds of the sale will be used for general corporate purposes.

The gross assets subject to the transaction are approximately AU$8.8 billion (£5.2 billion), and in the year to 31 December 2012 generated a profit before tax of £80 million. The sale of the operations is currently expected to lead to a gain on disposal of approximately £20 million. As a result of the sale, the Group will also write down a related deferred tax asset by approximately £350 million. As a result of this transaction we expect the Group’s common equity core tier 1 capital ratio, on a pro forma fully loaded CRD IV basis, to increase by approximately 20 basis points (approximately £550 million capital equivalent), primarily driven by the reduction in risk weighted assets.

The transaction is expected to complete by the end of 2013. 18 November 2013

LLOYDS BANKING GROUP ANNOUNCES SALE OF ASSET MANAGEMENT BUSINESS SCOTTISH WIDOWS INVESTMENT PARTNERSHIP

Lloyds Banking Group plc (Group) announces that it has agreed to sell its asset management business Scottish Widows Investment Partnership Group Limited (SWIP)
to Aberdeen Asset Management plc (Aberdeen) for an initial consideration payable in Aberdeen shares with a value of approximately £560 million, and a further deferred consideration, payable in cash, of up to £100 million, as described below. As part of the transaction, the Group will enter into a long-term strategic asset management relationship, whereby Aberdeen will manage assets on behalf of the Group.

The sale and strategic relationship are expected to result in a stronger asset management partner for the Group and its customers, combining Aberdeen and SWIP’s strengths across fixed income, real estate, active and quantitative equities, investment solutions and alternatives. SWIP’s management and employees will transfer to Aberdeen upon completion.

The sale does not include Scottish Widows, the Group’s life, pensions and investment business, which remains core to the Group.

In consideration for SWIP, the Group will receive approximately 132 million new ordinary shares of Aberdeen, equivalent to approximately 9.9 per cent of its enlarged issued ordinary share capital. Aberdeen has also committed to deliver additional consideration 12 months after completion calculated with reference to the amount by which Aberdeen’s volume-weighted average share price for the five trading days prior to completion (the “VWAP”) is below 420 pence but above a floor of 320 pence. To the extent the VWAP is below 320 pence, the Group has the option to terminate the sale. Based on Aberdeen’s share price of 427 pence at close on 15 November 2013, the Group’s shareholding in Aberdeen would have a value of approximately £560 million. In addition, further consideration of up to £100 million will be payable in cash over a five year period depending on the growth in business generated from the strategic relationship with the Group.

The Group intends to be a supportive shareholder and has agreed lock-up arrangements whereby, subject to certain exceptions, the Group will maintain its initial shareholding for at least one year, two-thirds of its initial shareholding for at least two years and one-third of its initial shareholding for at least three years. Further detail on the lock-up arrangements, which can be waived at any time by Aberdeen, is set out at the end of this announcement.

Based on Aberdeen’s share price of 427 pence at close on 15 November 2013, and assuming only the initial consideration is received, the sale of SWIP is expected to lead to a post-tax gain on disposal of approximately £190 million, including the write-off of approximately £320m of Insurance embedded value arising from the Group’s ownership of SWIP. On this basis, the sale of SWIP will increase the Group’s common equity core tier 1 capital ratio, on a pro forma fully loaded CRD IV basis, by approximately 11 basis points (approximately £310 million capital equivalent).
Lloyds Banking Group plc is registered in Scotland no. 95000. Registered office: The Mound, Edinburgh EH1 1YZ

The gross assets of the transaction were approximately £240 million as of 31 December 2012 with SWIP reporting a normalised profit before tax of approximately £85 million in 2012. Funds under management were £136 billion at 31 August 2013. Any cash proceeds realised from the sale over time are expected to be used for general corporate purposes. The sale is expected to complete by the end of the first quarter of 2014, subject to obtaining the necessary regulatory and other consents.

29 November 2013

LLOYDS BANKING GROUP ANNOUNCES THE SALE OF A PORTFOLIO OF CORPORATE REAL ESTATE LOANS

Lloyds Banking Group plc (the Group) announces today that it has agreed the sale of a corporate real estate portfolio (the Portfolio), to Promontoria Holding 89 BV, which is an affiliate of Cerberus Institutional Partners V L.P., for a cash consideration of €1,032 million, or approximately £860 million at current exchange rates. The transaction, comprising non-core European and Nordic loans, is part of the Group’s continued non-core asset reduction programme.

The gross assets subject to the transaction are £1,094 million, at current exchange rates, and the Portfolio generated losses of £7 million in the year to 31 December 2012. The sale proceeds will be used for general corporate purposes and the transaction, although capital accretive on a Basel 3 basis, is not expected to have a material impact on the Group.

The transaction is expected to complete by the end of 2013.

9 December 2013

Not for publication or distribution directly or indirectly, in whole or in part, in or into the United States, Australia, Canada, Japan or Republic of South Africa or in any other jurisdiction in which offers or sales would be prohibited by applicable law.

This announcement is not an offer to sell or a solicitation to buy securities in any jurisdiction, including the United States, Australia, Canada, Japan or Republic of South Africa. Neither this announcement nor anything contained herein shall form the basis of, or be relied upon in connection with, any offer or commitment whatsoever in any jurisdiction.

PROPOSED PLACING OF SHARES IN ST JAMES’S PLACE PLC

Lloyds Banking Group plc (‘Lloyds’, or the ‘Group’) announces today its intention to sell approximately 109 million ordinary shares (the ‘Placing Shares’) in St James’s Place plc (‘St James’s Place’ or the ‘Company’), representing approximately 21 per cent of St
James’s Place’s existing issued ordinary share capital, and comprising Lloyds’ entire remaining shareholding in the Company (the ‘Placing’).

The Placing follows the expiry of the 180-day unwaivable lock-up period agreed between Lloyds and the sole bookrunner (“the Sole Bookrunner”) at the time of the placing of shares in the Company announced on 22 May 2013 and the agreement by the Sole Bookrunner to waive, pursuant to its terms, the remainder of the longer waivable lock-up period agreed between Lloyds and the sole bookrunner.

The Placing reflects the strong demand in the market for St. James’ Place shares and will increase liquidity.

Institutional shareholders will be sought for the Placing Shares on the Group’s behalf by the Sole Bookrunner through an accelerated bookbuild. The price at which the Placing Shares are to be placed will be agreed by Lloyds and Sole Bookrunner at the close of the bookbuilding process. The result of the Placing will be announced as soon as possible after the close of the bookbuilding process.

Information on St James’s Place

St James’s Place is a FTSE 250 financial services group that provides wealth management services to individuals, trustees and businesses. With around 180,000 wealth management clients and £42 billion in funds under management as at 30 September 2013, the Company is well established as one of the UK’s leading wealth managers. As at 30 June 2013, the Company had gross assets of £41 billion.

Lloyds Banking Group plc is registered in Scotland no. 95000. Registered office: The Mound, Edinburgh EH1 1YZ

Effect of the Proposed Placing on Lloyds Banking Group

On completion of the Placing, assuming the sale of a 21 per cent stake, the Group will realise a gain on sale of approximately £95 million. On a pro forma fully loaded CRD IV basis, it is estimated that the Placing will increase the Group’s common equity tier 1 capital by approximately £670 million, equivalent to an approximate 24 basis points benefit.

António Horta-Osório, Group Chief Executive, Lloyds Banking Group said:

The Group launched its strategy in 2011 to reshape the business to concentrate on its core UK retail and commercial banking customers. As part of that approach, the Group has been reducing non-core businesses and addressing historic issues, while focusing on increasing net lending to its core segments. The sale of the remaining stake in St. James’s Place releases further resources and represents another step towards refocusing this
business on its core customers.

10 December 2013

Not for publication or distribution directly or indirectly, in whole or in part, in or into the United States, Australia, Canada, Japan or Republic of South Africa or in any other jurisdiction in which offers or sales would be prohibited by applicable law.

This announcement is not an offer to sell or a solicitation to buy securities in any jurisdiction, including the United States, Australia, Canada, Japan or Republic of South Africa. Neither this announcement nor anything contained herein shall form the basis of, or be relied upon in connection with, any offer or commitment whatsoever in any jurisdiction.

PLACING OF SHARES IN ST JAMES’S PLACE PLC

Further to its announcement on 9 December 2013 of its intention to sell shares in St James’s Place plc (‘St James’s Place’, or the ‘Company’), Lloyds Banking Group plc (‘Lloyds’, or the ‘Group’) announces that 109 million shares have been placed at a price of 630 pence per share (the ‘Placing’). The gross proceeds of the Placing are approximately £680 million.

Settlement of the Placing will take place on 13 December 2013. Following completion of the

6 December 2013

LLOYDS BANKING GROUP ANNOUNCES THE SALE OF A PORTFOLIO OF IRISH RETAIL MORTGAGES

Lloyds Banking Group plc (the Group) announces today that it has agreed the sale of a portfolio of non-performing Irish retail mortgages (the Portfolio) to Tanager Limited, an entity affiliated with Apollo Global Management, LLC (NYSE:APO), for a cash consideration of £257 million. The transaction is part of the Group’s continued non-core asset reduction programme.

The gross assets subject to the transaction are £610 million. The Portfolio generated losses of £33 million in the year to 31 December 2012. The sale proceeds will be used for general corporate purposes and the transaction, although capital accretive, is not expected to have a material impact on the Group, due to existing provisions taken against these assets.

The transaction is expected to complete in H1 2014.

09 December 2013

LLOYDS BANKING GROUP ANNOUNCES THE SALE OF A PORTFOLIO OF UK CORPORATE
REAL ESTATE LOANS

Lloyds Banking Group plc (the Group) announces today that it has agreed the sale of a portfolio of UK corporate real estate loans (the Portfolio) to Promontoria Holding 87 B.V., an entity affiliated with Cerberus European Investments, LLC for a cash consideration of £90 million. The transaction is part of the Group's continued non-core asset reduction programme.

The gross assets subject to the transaction are £147 million. The Portfolio generated profits of £1 million in the year to 31 December 2012. The sale proceeds will be used for general corporate purposes and the transaction, although capital accretive, is not expected to have a material impact on the Group.

The transaction is expected to complete by the end of 2013. 20 March 2014

SALE OF A PORTFOLIO OF EUROPEAN COMMERCIAL REAL ESTATE LOANS
Lloyds Banking Group plc (Group) announces today that it has agreed the sale of a portfolio of European commercial real estate loans to MELF S.à r.l, an entity affiliated with Marathon Asset Management LP, for a cash consideration of approximately €280 million, or approximately £235 million at current exchange rates. The transaction is part of the Group's strategy to reduce its non-core run-off portfolio.

The gross assets subject to the transaction are £494 million and in the year to 31 December 2013 incurred a loss of £(54) million. The sale proceeds will be used for general corporate purposes and the transaction is not expected to have a material effect on the Group, including on its capital position, due to existing provisions taken against these assets.

The transaction is expected to complete in the second quarter of 2014.

Aberdeen Asset Management PLC ("The Company")
Completion of the acquisition of Scottish Widows Investment Partnership Infrastructure fund management business

2 May 2014

Aberdeen Asset Management PLC ("Aberdeen" or the "Company") is pleased to confirm that following close of business on 1 May 2014 it has completed the acquisition of Scottish Widows Investment Partnership's Infrastructure fund management business. With the completion of the acquisition of the Infrastructure fund management business, Aberdeen has now completed the acquisition of Scottish Widows Partnership Group Limited and its related private equity and
infrastructure fund management businesses from Lloyds Banking Group plc ("Lloyds") announced on 18 November 2013.

In accordance with the Sale and Purchase Agreement, the final deferred top-up payment to Lloyds has been reduced from £39.4 million as announced on 1 April 2014 to £38.3 to reflect the completion of the Infrastructure acquisition. This will be payable to Lloyds at the end of a 12 month period following completion and Aberdeen is entitled, at its sole option, to make this payment either in cash or by the issue of additional new ordinary shares to Lloyds. The total consideration for the Acquisition including the deferred top-up payment is approximately £550 million.

Application has been made to The UK Listing Authority and The London Stock Exchange for a listing of 5,952,000 ordinary shares of 10 pence for consideration for the Infrastructure fund management business acquisition, to trade on The London Stock Exchange and to be admitted to the Official List. These shares shall rank pari passu with the existing issued ordinary shares of the Company and it is expected that admission will commence at 8.00am today, Friday 2 May, 2014.

4 June 2014

LLOYDS BANKING GROUP ANNOUNCES THE SALE OF A PORTFOLIO OF UK COMMERCIAL REAL ESTATE LOANS
Lloyds Banking Group plc (the Group) announces today that it has agreed the sale of a portfolio of UK commercial real estate loans (the Portfolio) to Promontoria Holding 109 B.V., which is an affiliate of Cerberus Global Investors, for a cash consideration of £352 million. The transaction is part of the Group's continued non-core run-off portfolio asset reduction programme.

The gross assets subject to the transaction are £536 million and generated a loss of £17 million in the year to 31 December 2013. The sale proceeds will be used for general corporate purposes and the transaction is not expected to have a material impact on the Group, including on its capital position, due to existing provisions taken against these assets.

The transaction is expected to complete in the second half of 2014.

30 June 2015

SALE OF TSB BANKING GROUP PLC
Lloyds Banking Group plc (the 'Group') notes the announcement by Banco de Sabadell, S.A. ("Sabadell") that Sabadell's offer for TSB Banking Group plc ("TSB") is now unconditional in all respects, following the receipt of all relevant regulatory clearances.

This effectively completes the sale of the Group's remaining 40.01 per cent stake in TSB to Sabadell for a consideration of approximately £680 million.
The sale of TSB represents the Group's continued delivery of its commitment to the European Commission ('EC') under the terms of the state aid decision. The Group will now seek confirmation from the EC of its compliance with its Retail business disposal commitment, which it expects to receive well ahead of the mandated deadline of 31 December 2015.

The Group continues to provide services to TSB under the Transitional Services Agreement.

Bonus Share Scheme

At the time of the initial public offering ('IPO') of TSB in June 2014, the Group implemented a bonus share scheme pursuant to which certain retail investors acquiring shares in TSB through the IPO and holding those shares to 25 June 2015 (12 months post IPO) would be entitled to receive a number of free and fully-paid up additional shares (the 'Bonus Shares').

In March 2015, with the support of the TSB Board, the Group announced it would pay any investors entitled to receive Bonus Shares the cash value of those Bonus Shares at the offer price. Such investors are expected to receive their cash entitlements on or around 17 July 2015.

30 July 2015
LLOYDS BANKING GROUP ANNOUNCES THE SALE OF A PORTFOLIO OF IRISH COMMERCIAL LOANS

Lloyds Banking Group plc ('the Group') announces today that it has agreed the sale of a portfolio of Irish commercial loans to a consortium comprising Ennis Property Finance Limited, an entity affiliated to Goldman Sachs; Feniton Property Finance Limited, an entity affiliated to CarVal; and Bank of Ireland, for a cash consideration of approximately £827 million at current exchange rates.

The gross assets subject to the transaction are c.£2.6 billion, of which £2.3 billion were impaired and in the year to 31 December 2014 they generated pre tax losses of c.£130 million. The sale proceeds will be used for general corporate purposes and the transaction is not expected to have a material impact on the Group but will be capital accretive (c.7bps).

The sale is in line with the Group's strategy of deleveraging its balance sheet by reducing run off assets and creating a low risk, UK focused bank. As at 30 June 2015, impaired loans as a percentage of closing advances for the Group were 2.7 per cent and provisions as a percentage of impaired loans were 55.1 per cent. On a pro-forma basis, the impact of this sale would be to reduce the impaired loans as a percentage of closing advances to 2.2 per cent and reduce provisions as a percentage of impaired
loans to 48.3 per cent. These compare with 2.9 per cent and 56.4 per cent at 31 December 2014, and 8.6 per cent and 48.2 per cent as at 31 December 2012. Following this transaction, the Group will have minimal remaining exposure to commercial assets in Ireland (<£30 million).

The transaction is expected to complete in Q4 of 2015. November 2015
SALE OF LLOYDS BANKING GROUP STAKE IN VISA EUROPE
As a member and shareholder of Visa Europe Limited (‘VE’), Lloyds Banking Group (‘the Group’) notes the announcement from Visa Inc regarding the proposed acquisition of VE to create a single global payments business under the Visa brand, and can confirm that it has agreed to sell its shareholding as part of this process.

The Group's share of the sale proceeds will comprise upfront consideration of cash and preferred stock. The preferred stock is convertible into Class A common stock, at a future date, subject to the satisfaction of certain conditions. In addition the Group may be entitled to deferred consideration, contingent on a number of variable factors including performance of Visa post completion of the sale.

The Group expects to report a pre-tax gain for the upfront consideration of approximately £300 million on completion of the transaction, which is expected to occur in 2016.

Placing, Lloyds will no longer hold any shares in St. James’s Place for its own account. 7 December 2013
LLOYDS BANKING GROUP ANNOUNCES THE SALE OF A PORTFOLIO OF UK CORPORATE REAL ESTATE LOANS

Lloyds Banking Group plc (the Group) announces today that it has agreed the sale of a portfolio of UK corporate real estate loans (the Portfolio) to Promontoria Holding 87 B.V., an entity affiliated with Cerberus European Investments, LLC for a cash consideration of £90 million. The transaction is part of the Group’s continued non-core asset reduction programme.

The gross assets subject to the transaction are £147 million. The Portfolio generated profits of £1 million in the year to 31 December 2012. The sale proceeds will be used for general corporate purposes and the transaction, although capital accretive, is not expected to have a material impact on the Group.

The transaction is expected to complete by the end of 2013.

PLACING OF SHARES IN ST JAMES’S PLACE PLC
Further to its announcement on 9 December 2013 of its intention to sell shares in St James’s Place plc (‘St James’s Place’, or the ‘Company’), Lloyds Banking Group plc (‘Lloyds’, or the ‘Group’) announces that 109 million shares have been placed at a price of 630 pence per share (the ‘Placing’). The gross proceeds of the Placing are
approximately £680 million.

20 March 2014

SALE OF A PORTFOLIO OF EUROPEAN COMMERCIAL REAL ESTATE LOANS

Lloyds Banking Group plc (Group) announces today that it has agreed the sale of a portfolio of European commercial real estate loans to MELF S.à r.l, an entity affiliated with Marathon Asset Management LP, for a cash consideration of approximately €280 million, or approximately £235 million at current exchange rates. The transaction is part of the Group’s strategy to reduce its non-core run-off portfolio.

The gross assets subject to the transaction are £494 million and in the year to 31 December 2013 incurred a loss of £(54) million. The sale proceeds will be used for general corporate purposes and the transaction is not expected to have a material effect on the Group, including on its capital position, due to existing provisions taken against these assets.

The transaction is expected to complete in the second quarter of 2014.

4 June 2014

LLOYDS BANKING GROUP ANNOUNCES THE SALE OF A PORTFOLIO OF UK COMMERCIAL REAL ESTATE LOANS

Lloyds Banking Group plc (the Group) announces today that it has agreed the sale of a portfolio of UK commercial real estate loans (the Portfolio) to Promontoria Holding 109 B.V., which is an affiliate of Cerberus Global Investors, for a cash consideration of £352 million. The transaction is part of the Group’s continued non-core run-off portfolio asset reduction programme.

The gross assets subject to the transaction are £536 million and generated a loss of £17 million in the year to 31 December 2013. The sale proceeds will be used for general corporate purposes and the transaction is not expected to have a material impact on the Group, including on its capital position, due to existing provisions taken against these assets.

The transaction is expected to complete in the second half of 2014.

26 September 2014

PLACING OF 57.5 MILLION ORDINARY SHARES IN TSB BANKING GROUP PLC (“TSB” OR THE “COMPANY”) BY LLOYDS BANKING GROUP PLC (THE “GROUP”)

Further to the announcement released on 25 September 2014, Lloyds Banking Group plc announces that it has sold 57.5 million ordinary shares (the “Placing Shares”) in the
Company, representing approximately 11.5% of the Company’s issued ordinary share capital, at a price of 280 pence per share (the “Placing”) raising aggregate gross sale proceeds of £161 million.

Following completion of the Placing, which is expected to take place on 1 October 2014, Lloyds Banking Group plc, through Lloyds Bank plc (a wholly owned subsidiary of Lloyds Banking Group plc), will continue to hold approximately 50% of the Company’s ordinary shares. It is expected that Lloyds Banking Group plc will continue to consolidate the Company’s results in its accounts.

Lloyds will no longer hold any shares in St. James’s Place for its own account.