Financial Regulation before and after the GFC

Course Outline

- 1/ Why regulate?
- 2/ The phases of financial regulation before the global financial crisis: from Bretton Woods regulation to neoliberal deregulation and financial globalisation
- 3/ “The System Worked” and how the authorities and the G20 re-regulated after the GFC

Why Regulate?

"Free banking" in the US 1837-1863

Each state-chartered bank could issue its own banknotes

State government bonds were required to back cash

What is today's equivalent?



Even steakhouses began circulating their own scrip.



The flaws of “free banking” (ChatGPT, 9 October 2025)

- 1/ Lack of a uniform and reliable currency
- 2/ Poor quality of collateral (state bonds not very reliable)
- 3/ Bank failures and “wildcat banking”
- 4/ Absences of a lender-of-last resort
- 5/ Geographic fragmentation (in contrast to the US tariff-free market)
- 6/ Recurring “panics”

What is today’s equivalent?

Key objectives of regulation (based on DeepSeek, 9 October 2025)

1/ to ensure systemic stability and prevent financial crises

2/ to protect consumers and investors

3/ to promote market integrity and efficiency

4/ to prevent financial crime

5/ to enhance macroeconomic stability to ensure functioning of the payments system

Sketch Jasper Carrot: “a large-scale nuclear attack […] would completely disrupt the banking system…”



The Inherent Trade-Offs (ibid)

- Compliance costs
- Reduced innovation (after the GFC, Paul Volcker: “the only thing useful banks have invented in 20 years is the ATM”)
- Moral Hazard – when institutions believe they will be “bailed out”
- Adair Turner: the fundamental trade-off is that growth needs credit, but debt finance always becomes risky.

The Great Crash and Great Depression

The Stock Market crash spilled over into the wider economy, via bank failures (with knock-on effects in Europe – contributing to the rise of fascism and Nazism – and ultimately World War II)

Post-crash regulation

(A Brief History of Financial Regulation in the USA, SideDrawer, April 10, 2025):

1/ Glass-Steagall Act 1933: separated commercial & investment banking; and created the Federal Deposit Insurance Corporation (FDIC);

2/ Securities Act of 1933: information – “truth in securities”

3/ Securities Exchange Act of 1934: to oversee the exchanges

The Post-World War II World of Monetary and Financial Stability

Building on the 1930s:

1/ Credit allocation, credit controls, interest rate setting (Regulation Q): reserve requirements

2/ Limited capital mobility as most countries had capital controls

3/ Exchange rates were fixed (though adjustable)

1970s - Stagflation and Deregulation

The breakdown of “Fordism”, the end of Bretton Woods (1971) and the first oil-shock (1973-4) led to stagflation in the 1970s, which in turn provoked a progressive paradigm shift in policies towards neoliberalism

> monetary policy to control inflation

> tax cuts

> deregulation of economic activities, including banking as of 1980s

> “market discipline”

Self-regulation / “light-touch” regulation

Alan Greenspan



13th Chairman of the Federal Reserve

In office

August 11, 1987 – January 31, 2006

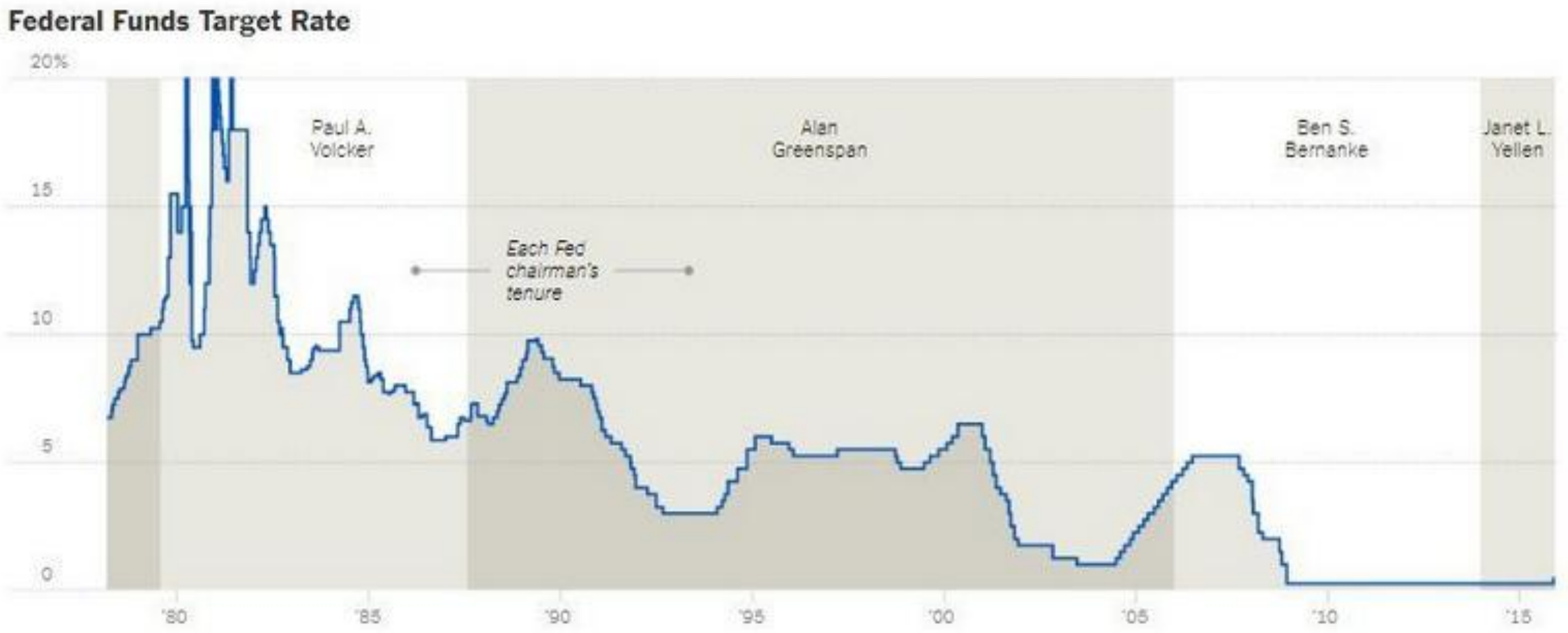
President	Ronald Reagan
	George H. W. Bush
	Bill Clinton
	George W. Bush

Greenspan – a true believer in “self-regulation” (economic individualism: Objectivism by Ayn Rand: “the concept of man as a heroic being”)

Government regulation is difficult, and not very effective > self-regulation

De-regulation of banking, and no regulation of derivative trading

The Great Moderation and the “Greenspan Put”



“Clean not lean” during bubbles and crashes > moral hazard

“The System Worked” after the GFC (Drezner)

- The Fed and other central banks stepped in to support markets

- Governments provided short-term fiscal support

(Although there was a shift to austerity in Europe, in 2010, following Rogoff & Reinhart’s work on public debt and growth)

- A (re)newed drive to regulate finance

Coordination through the G20

	Argentina	Cristina Fernández de Kirchner[20]	President
	Australia	Kevin Rudd[20]	Prime Minister
	Brazil	Luiz Inácio Lula da Silva[20]	President
	Canada	Stephen Harper[20]	Prime Minister
	China	Hu Jintao[20]	President
	France	Nicolas Sarkozy[20]	President
	Germany	Angela Merkel[20]	Chancellor
	India	Manmohan Singh[20]	Prime Minister
	Indonesia	Susilo Bambang Yudhoyono[20]	President
	Italy	Silvio Berlusconi[20]	Prime Minister
	Japan	Tarō Asō[20]	Prime Minister
	Mexico	Felipe Calderón[20]	President
	Russia	Dmitry Medvedev[20]	President
	Saudi Arabia	Abdullah bin Abdul Aziz[20]	King
	South Africa	Kgalema Motlanthe[20]	President
	South Korea	Lee Myung-bak[20]	President
	Turkey	Recep Tayyip Erdoğan[20]	Prime Minister
	United Kingdom	Gordon Brown[20]	Prime Minister
	United States	**George W. Bush**[20]	**President**
	European Union (European Commission)	Jose Manuel Barroso[20]	President





President Bush and the other summit leaders at a working dinner in the East Wing of the White House.

Source: https://en.wikipedia.org/wiki/2008_G20_Washington_summit

… and worked… through Covid

- After massive financial market instability in March 2020
- The authorities stepped in… massively
- Monetary & fiscal support have been substantial
- But – significantly – the Trump administration did not coordinate policies.
- In Europe (and UK) – an effort not to repeat mistakes of moving to austerity too quickly. Support for keeping workers in their jobs (Germany pursued this policy after the GFC)

G20 and Basel III

- Apart from dealing immediately with the GFC, G20 initiated principles of re-regulation, including:

- Higher reserve ratios and liquidity requirements:
  - Stronger Common Equity Tier 1 (CET1) capital (mainly common stock (i.e. shares): *CET1/RWA ≥ 4.5%* l ratios of risk-weighted assets.
  - Plus "capital conservation buffer": mandatory 2.5% RWA
  - And "discretionary counter-cyclical buffer" (national regulators may require) 2.5%
  - Additional Tier 1 (AT1) Capital Requirement (Basel III+/IV): 1.5% RWA

  Therefore, total Tier 1 capital requirement is: **CET1+AT1=4.5%+1.5%=6%**

  In practice (according to GPT-4, 17 October 2023) US banks today have Tier 1 capital ratios of between 12% and 16% or higher, and in the UK 13% to 17%+

Bank balance sheets

Traditional commercial bank

Assets	**Liabilities**
Reserves Short-term loans Long-term loans Other instruments	Deposits Short-term debt Long-term debt
	Shareholder equity

Large (multifunctional/universal) bank

Assets	**Liabilities**
Cash	Deposits
Loans	Other debt (mostly short-term)
Trading and other assets	Long-term debt
	Equity

Source: Anat Admati & Martin Helwig, *The Bankers' New Clothes*, Princeton University Press, 2013.

Risk-weighted assets

- **Banks have assets**, including central bank reserves, cash holdings, securities and loans. The riskiness of these loans varies, depending on collateral.
- Government bonds > mortgage-backed securities > unsecured loans (like consumer credit)
- These are weighted to give an idea of banks' overall asset risks, and hence their capital requitements. See https://www.investopedia.com/terms/r/riskweightedassets.asp

- Liabilities: check (cheque) and deposit accounts, borrowings, bank capital (net worth, funds from selling equity, retained earnings)

Liquidity

Leverage ratio *CET1/Total exposure ≥ 3%*

CET1: common equity tier 1 (such as common stock and retained earnings) total exposure all consolidated assets, including non-balance sheet assets

- Liquidity coverage ratio (LCR):

$$LCR = \frac{\text{High quality liquid assets}}{\text{Total net liquidity outflows over 30 days}} \geq 100\%$$

New regulatory structures

- Monitoring of 30 Globally-systemically important banks (G-SIBs)…

  … by the Financial Stability Board (FSB), the Basel Committee on Banking (BCBS) and national authorities.

  Involving stress-testing

- Macro-prudential regulation of finance

Other post- GFC measures

- Bank resolution procedures (“living wills”) have been established, to bail-in private investors.

- Standardised derivatives are now traded on exchanges (central counter-parties - CCPs).

- Stronger consumer protection for households.



London Clearing House

Potential weaknesses of post-GFC regime

- Much new regulation
- Little or no structural change in banking and finance
- Too-big-to-fail has become an even bigger problem
- Shadow banking activities – probably not regulated enough
- The essential nature of global finance seems unchanged

Takeouts

- Long phases of deregulation and regulation of finance due to the inherent trade-offs between free finance and state control
- Major crashes lead to regulation
- Significant regulation after GFC – through international cooperation
- No structural reform
- Resilient to Covid-19 shock & to the rise in interest rates since late 2021 – so far
- Currently, a new phase of push-back against regulation
- Macro-indicators (monetary policy and fiscal policy) are stretched –
  is this a "fuite en avant"?