

# **The Financial Crisis as a Crisis of Democracy: Towards Prudential Regulation through Public Reasoning**

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## **Abstract**

The purpose of this paper is to analyze the impact of the 2007-2010 financial crisis on our understanding of democracy and to use insights from political theory, namely the concept of public reasoning, in order to strengthen prudential regulation. The financial crisis could be understood as a challenge to our understanding of democracy. Before the crisis there was a widespread conviction that democracies were not only morally superior to authoritarian forms of government, but were also better positioned to deal with severe economic and financial turmoil. Systemic events that exceed purely cyclical ups and downs were believed to be confined to the less democratic parts of the world. The crises in Asia and the post-soviet states of the 1990s seemed to confirm this.

The recent financial crisis, however, has been a crisis in and of the West, while some authoritarian regimes have done much better. It raises the question whether democracy can really produce outcomes that are superior to those of other forms of governance and create a just society. Three answers are possible. First, the belief in the greater resilience and stability of democracies might be wrong and democracy might be part of the problem, giving too much deference to special interests. Second, issues of democracy and financial stability might be unrelated and one form of government might be just as good as another for the goal of financial stability. Third, the crisis might have been the result of democracy deficits on the domestic or international level.

To explore this question, I choose as a starting point Amartya Sen's comparative theory of democracy that combines output and input oriented aspects. Sen considers "public reasoning" as the key mechanism through which democracies achieve better outcomes than authoritarian regimes. The paper then looks into some of the causes of the crisis that have been identified in the literature. It shows that each of these causes can be understood as a lack of public reasoning. Indeed, I claim that there is an intrinsic relationship between the prudential regulation of financial markets and public reasoning. Public reasoning is destined to optimize decision-making under conditions of uncertainty, which is exactly what prudential regulation is about. This insight has important consequences for the design of the regulatory architecture and the interpretation and application of domestic and international law relating to financial market regulation. Enabling public reasoning should be the guideline for both in policy-making and legal interpretation.

**Keywords:** Financial Crisis, Financial Regulation, Democracy, Global Justice, Consequentialism, Amartya Sen, Capabilities, Public Reasoning, Deregulation, Financial Indicators, Financial Supervision.

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## **Introduction: The Financial Crisis as a Challenge for Democracy**

Most analyses of the causes of the 2007-2010 financial crisis take an economic point of view. They conclude that the crisis emerged as the result of a mix of misguided financial regulation, wrong monetary policies, and irresponsible market behavior. As a consequence, the strategies devised for the overhaul of financial regulation rest on purely economic considerations, too. On a deeper level, however, the crisis seems to go beyond a merely economic incident requiring an equally economic response. Rather, the crisis also seems to have shattered the self-confidence of Western societies. It gave evidence of their vulnerability and declining strength. Such a fundamental challenge to the Western way of life might also challenge the credibility of that particular idea that underpins the Western world: Democracy.

Since the era of the enlightenment, democracy has been the intellectual trademark of the Western hemisphere. One can distinguish two different, but related approaches to democracy and the reasons why one should endorse it. On the one hand, some consider democracy as morally superior to autocratic regimes, because only democratic institutions are just and respect the autonomy of the individual. This is the input-oriented, transcendental approach to democracy. The second approach includes more practical, more earthly aspects: Democracy and the individual liberties that go with it are believed to render better results, afford greater welfare to a larger number of people. In this paper I will rely on the approach devised by Amartya Sen in his book "The Idea of Justice". Amartya Sen stresses the latter, output-oriented, comparative approach to democracy. In his view, justice is not only a question of *ex ante* morally just institutions. Rather, justice is about *actually* reaching envisaged outcomes and avoiding manifest injustices. Nevertheless, Sen draws a lot on input oriented, transcendental theories of democracy, in particular on the work of John Rawls, in order to avoid important drawbacks of the comparative approach.

Sen argues that democracy is preferable as a form of government because it facilitates the achievement of effective justice. For example, he argues that famines are typically less the product of fate or bad climatic conditions, but rather of government mismanagement. They afflict

only non-democratic or weakly democratic states.<sup>1</sup> Sen believes that the superior performance of truly democratic states and in particular their capacity to better protect against remediable disasters is due to the fact that they enable “public reasoning”. For example, Sen shows that the lack of democratic government in colonial India, including the absence of free media and a voluntary practice of ‘silence’ among elites, were responsible for the 1943 Bengal famine, which had a death toll of 2,000 persons per week.<sup>2</sup> By contrast, in democratic societies, responsive and transparent governments stand in a dialogue with citizens and other levels of government. This ensures that they get the necessary information in time. Civil society as well as a free media produce a constant flow of reliable information from the governed to the governing, protect neglected groups, and contribute to the formation of values such as birth control and smaller families, which reduce society’s exposure to future disasters.<sup>3</sup> In addition, periodic elections provide governments with a strong incentive to prevent disaster from happening.

Until 2007, one might have believed that this rationale did also apply to financial markets. Since the Great Depression in the 1930s, no major financial breakdown had shattered economic prosperity in the Western hemisphere to a comparable extent. Certainly, there were cyclical fluctuations, stock market crashes, bank defaults, and periods of protracted stagnation, but none of these events came anywhere near to the impact of the great Depression. In particular, from about the beginning of the 1980s until 2007, Western economies experienced what became known as the “Great Moderation”. They enjoyed an environment of constantly stable financial conditions and reliable growth. Financial crises came to be seen as a monster of past, dark ages that had been domesticated. Wild populations of this species seemed to survive only in societies with low democratic standards.<sup>4</sup>

At first glance, the financial crisis of 2007-2010 seems to disprove the belief in the stabilizing role of democracies. It hit some of the most democratic states. Did Sen get it wrong and produce a theory whose flaws had become evident even before its publication in 2009? Can we still say after the crisis that democracy is the form of government most conducive to justice? Is the

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<sup>1</sup> A. K. Sen, *The Idea of Justice* (2009), p. 342.

<sup>2</sup> *Ibid.*, p. 339.

<sup>3</sup> *Ibid.*, p. 335.

<sup>4</sup> For data corroborating this claim see below, II.2.

financial crisis merely the result of a lack of democracy, of a failure of insufficiently democratic institutions?<sup>5</sup> Or is democracy genuinely unable to protect against such crises because its processes are prone to capture by special interests and produce fallacious regulation?<sup>6</sup> Or is democracy largely neutral and the form of government irrelevant for financial stability and the actual fate and well-being of people?<sup>7</sup>

In the following, I try to take up this challenge for democracy. I first argue that democracy and its underlying idea of autonomy implies more than a merely transcendental promise, namely the prospect of better outcomes for people than autocratic regimes, or at least to prevent massive disasters. Following Sen, I measure outcomes in terms of “capabilities” (I.). I further make the empirical claim that 2007-2010 financial crisis constitutes a major catastrophe, or, in Sen’s words, a “clearly remediable injustice”,<sup>8</sup> measured by its effect on welfare, and thus on the capabilities of people in many Western economies (II.). In the following step, I analyze the relationship between the causes of the financial crisis and democracy, understood here as the capability to engage in public reasoning. It turns out that many of the factors responsible for the financial crisis can be understood as deficits in public reasoning. Both market participants and regulators lacked the information, tools and institutional structures for sufficient public reasoning. The section concludes that this correlation is not coincidental, but that there is instead an intrinsic relationship between prudential financial regulation and public reasoning. Public reasoning is geared towards optimizing decision-making under conditions of uncertainty (III.). The last section deals with the ramifications of this insight for the reforms undertaken in the aftermath of the financial crisis. It has consequences for both institutional design and legal reasoning. Public reasoning should guide policy-making as well as the interpretation of the regulatory framework (IV.).

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<sup>5</sup> With respect to the responsibility of the EU for deregulation A. Fisahn, "Europäische Union in der Legitimationskrise", 42 *Kritische Justiz* (2009) 104-115.

<sup>6</sup> This would be the implication of Stigler’s thesis, see G. J. Stigler, "The Theory of Economic Regulation", 2 *The Bell Journal of Economics and Management Science* (1971) 3-21.

<sup>7</sup> C. Möllers, *Demokratie - Zumutungen und Versprechen* (2008), p. 22.

<sup>8</sup> Sen (note 1), vii.

## **I. The Promise of Democracy: Justice and Capabilities**

### **1. Two Perspectives: Input and Output**

What is the value of democracy as a form of government? As I said in the introduction, two different approaches are possible in answering this question. The first approach focuses on the input aspect of politics: Democracy is preferable as a form of governance for transcendental (i.e. *a priori*) reasons, because it establishes a morally just institutional framework for the exercise of public authority. The second approach emphasizes the outcomes of politics: Democracy is preferable for instrumental reasons, because it facilitates the advancement of public welfare.

#### **a) Input: Transcendental Approaches**

The liberal-contractualist tradition in political theory focuses on the *transcendental argument*. Essentially, the argument for democracy of this position is that only some form of democracy is able to guarantee individual autonomy. John Locke, Immanuel Kant and Jean-Jacques Rousseau are among the patron-saints of this theoretical tradition. The disenchantment of man and society in modernity has made it next to impossible to make *a priori* moral arguments grounded on natural law or reason. Therefore, modern contractualist theories like those by John Rawls and Jürgen Habermas take into account the possibility of reasonable disagreement and value pluralism that pervade modern society.

John Rawls' "Theory of Justice" of 1971 provides a moral justification for modern liberal democracy and the elements we commonly associate with it like constitutions, rights, free speech and the separation of powers. If the members of a given society found themselves in an original position situated behind a veil of ignorance, i.e. if they had to decide on the principles ordering their society without knowing which position in society they would ultimately occupy,<sup>9</sup> they would agree on an order that corresponds to our understanding of modern democracies. This order would be based on the two overarching principles of justice, the liberty principle, according

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<sup>9</sup> J. Rawls, *A Theory of Justice* (1972), p. 17ff., 136ff.

to which each individual has an equal right to basic liberties (including political liberty and freedom of speech) compatible with similar liberties for others, and the difference principle, which permits social differences among people only insofar as they are to everyone's advantage and as everyone has the chance to improve his situation.<sup>10</sup> Rawls measures and compares the social situation of individuals by reference to the amount of social primary goods they possess, such as "rights and liberties, powers and opportunities, income and wealth".<sup>11</sup> The exercise of power in society requires a democratic constitutional framework. Only such a framework respects the basic liberties<sup>12</sup> and contains backstops against their infringement, such as the rule of law.<sup>13</sup> Liberty also requires that decisions affecting the constitutional framework are rationally acceptable to all and not tainted by idiosyncratic interests. For that, they need to be justifiable by public reasoning, i.e. by reasons acceptable to all, such as common sense or widespread scientific insights.<sup>14</sup> Supreme Court judgments constitute an ideal example of public reasoning.<sup>15</sup> Also, citizens should ideally base their votes on public reason.<sup>16</sup>

In "Between Facts and Norms", Jürgen Habermas makes an argument for democratic forms of government that is similar to Rawls' theory in the result, though different in reasoning. Like Rawls, he considers it as a major challenge for modern, pluralistic societies to set up an institutional scheme for the exercise of public authority that is respectful of individual autonomy. For how should one subject individuals to moral judgments underlying public authority which they cannot support? According to Habermas and in contrast to Kant, pure reason alone does not provide a sufficient basis for universalizable moral claims any more. People may rationally disagree. One cannot presuppose in every society an overlapping consensus like it exists in the US today.<sup>17</sup> Also, history and the nature of man are unavailable as bases of justification.

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<sup>10</sup> Ibid., p. 60.

<sup>11</sup> Ibid., p. 62.

<sup>12</sup> Ibid., p. 198, 221ff.; on the majority principle see p. 230; further J. Rawls, *Political Liberalism* (1993), p. 336-8.

<sup>13</sup> Rawls (note 9), p. 235ff.

<sup>14</sup> Rawls (note 12), p. 212ff.; J. Rawls, "The Idea of Public Reason Revisited", 64 *University of Chicago Law Review* (1997) 765-807.

<sup>15</sup> Rawls (note 12), p. 231ff.

<sup>16</sup> Ibid., p. 219f.

<sup>17</sup> E. Kelly, "Public Reason as a Collective Capability" (2011), manuscript, p. 11.

Instead, Habermas points to our communicative practices for a possible solution.<sup>18</sup> Even though people might disagree on many aspects of the organization of society, everyday language devises a way for the integration of pluralistic societies. Members of such societies might find agreement on acceptable policies by taking recourse to communicative action. This is a mode of communication in which participants may not argue with interests, but need to make non-egoistic, non-idiosyncratic arguments, such as moral, ethical, and pragmatic reasons. In an ideal setting, i.e. under the conditions of a fair, sincere discourse free from domination, the ensuing decisions may be rationally acceptable to everyone.<sup>19</sup> In order to enable such a kind of discourse in society for decisions on the exercise of public authority, an institutional framework needs to be put in place that ensures deliberation and guarantees participatory rights. Only the constitutional arrangements of liberal democracies with professional parliaments and judicial review (including judicial review of the acts of parliament) may satisfy these conditions.<sup>20</sup>

Although moral reasons seem to militate for the adoption of an input-oriented approach to democracy, the theories supporting this approach face some difficulties. First, they are based on certain idealizations which might be at odds with the reality of the societies whose institutional arrangement these theories pretend to reconstruct. For example, transcendental approaches assume that people will act rationally, that rational behaviour will come along without much further ado. They do not provide for a script if it doesn't.<sup>21</sup> Behavioural economics teach us that this might be more often the case than we would feel comfortable with.<sup>22</sup> By focusing on input only, contractualist theories tend to put a blind eye on the consequences that might ensue from a violation of these rules of rationality. This criticism should be directed in the first place against Rawls' theory, as Habermas' theory includes a stronger feedback-loop in the form of continuous discourse and deliberation in civil society.<sup>23</sup> Also, in contrast to other contractualists, Habermas does not assume that, granted participatory rights and fundamental rights like free speech, people will be suddenly able to act in self-determination and fight for their needs. Rather, he welcomes a

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<sup>18</sup> J. Habermas, *Faktizität und Geltung* (1992), p. 15-7.

<sup>19</sup> *Ibid.*, p. 43. This draws on J. Habermas, *Theorie des kommunikativen Handelns*, Band 1 (1981), p. 384ff.

<sup>20</sup> Habermas (note 18), chapter IV., in particular p. 208ff., see also p. 527ff.

<sup>21</sup> Sen (note 1), p. 67ff.

<sup>22</sup> Cf. C. Jolls, "Behavioral Law and Economics", *Yale Law & Economic Research Paper* (2006).

<sup>23</sup> Habermas (note 18), p. 57, 215f.



shift from a formalist-Weberian understanding of the rule of law towards a more social understanding which understands fundamental rights not only as negative.<sup>24</sup>

Second, transcendental theories do not provide for a standard by which one could measure and compare different solutions. In Habermas' account, this is all left to deliberation. And Rawls' difference principle, for example, does not entail a standard that would allow to figure out which of different options better satisfies the requirement of equal access to public office for all. It only narrows down the range of acceptable options.<sup>25</sup> Although there might be good epistemological reasons for this lack of comparative standards, it does not always satisfy the practical need for choosing among different available solutions which all entail their specific problems.<sup>26</sup> At least a settled minimum standard might be advisable so that policy makes no member of society fall beyond a certain level of well-being.

Third, transcendental theories frequently cherish an idealized picture of representation. They assume that modern parliaments constitute a fair representation of citizens' preferences.<sup>27</sup> By contrast, social choice theory claims on the basis of mathematical models that institutions and mechanisms of democratic representation cannot reflect and reproduce divergent individual preferences to the extent that we wish them to do. The reason for this is just that elections, polls and evaluations are huge simplifications of complex patterns of data and preferences.<sup>28</sup>

Fourth, many transcendental theories address issues of global justice only incompletely.<sup>29</sup> It is difficult to construe an ideal institutional setting on a global scale. A directly elected world parliament is widely held to be a practical impossibility. There is at best no more than a rudimentarily homogeneous worldwide electorate or public opinion to support such institutions. On the other hand, the representation of individuals on the international level by their states also has certain drawbacks. Acts adopted by consensus among states reflect individual preferences

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<sup>24</sup> Ibid., p. 472ff.

<sup>25</sup> Sen (note 1), p. 96ff.

<sup>26</sup> Ibid., p. 17.

<sup>27</sup> This does not apply to the (strictly transcendental) theory of C. Möllers, "Expressive versus repräsentative Demokratie", in R. Kreide (ed.), *Transnationale Verrechtlichung. Festschrift Brunkhorst* (2008) 160-182.

<sup>28</sup> Sen (note 1), p. 91ff., with references to the Social Choice Theory by Kenneth Arrow.

<sup>29</sup> Ibid., p. 67ff.

only in a highly indirect, distorted way and seriously violate the idea of equality of votes.<sup>30</sup> Governments that lack any democratic standing cannot be seriously considered to represent their citizens at all. For this reason, Rawls confines the reach of his theory of global justice to democratic states.<sup>31</sup> For similar reasons, Habermas proposes to limit their competence to the most pressing questions of peace and security.<sup>32</sup> Yet these strategies do not address the risk that state action might compromise the interests of people living elsewhere on the globe which have no voice in domestic institutions.<sup>33</sup>

## **b) Output: Comparative Approaches**

The *instrumental* or *comparative argument* for democracy, by contrast, does not run the risk of idealizations and blindness for practice of the kind observed with transcendental theories. Comparative approaches have been advanced by writers in the utilitarian tradition. These theories argue that institutional arrangements should be such as to maximize the aggregate outcome for society as a whole. The institutional arrangements that utilitarians suggest along this line of reasoning often amount to some form of democracy. For Jeremy Bentham, measuring the aggregate outcome implied giving everyone's benefit equal weight.<sup>34</sup> John Stuart Mill also considered democracy as necessary for the maximization of aggregate happiness, which is his measure for outcomes. Democratic processes would be useful for determining what happiness is in the first place, which Mill considered a difficult task that presupposed freedom of opinion.<sup>35</sup> Nevertheless, he strongly argues for representative forms of government, since not everyone could possibly have the adequate knowledge necessary for the advancement of society.<sup>36</sup> Richard

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<sup>30</sup> J. H. H. Weiler, "The Geology of International Law - Governance, Democracy and Legitimacy", 64 *Zeitschrift für ausländisches öffentliches Recht und Völkerrecht* (2004) 547-62.

<sup>31</sup> J. Rawls, *The Law of Peoples* (1999).

<sup>32</sup> J. Habermas, "Hat die Konstitutionalisierung des Völkerrechts noch eine Chance?" in J. Habermas (ed.), *Der gespaltene Westen* (2004) 113-192.

<sup>33</sup> For a detailed elaboration of this point see Sen (note 1), Chapter 6, in particular p. 138ff., 141ff.

<sup>34</sup> The principle of utility is defined in J. Bentham, *An Introduction to the Principles of Morals and Legislation* (2nd edn., 1823 (repr. 1907)), p. 2.

<sup>35</sup> J. S. Mill, *On Liberty* (1859 (2006)), p. 71ff.

<sup>36</sup> J. H. Burns, "Utilitarianism and Democracy", 9 *The Philosophical Quarterly* (1959) 168-171.

Posner considers the rule of law as an important tool for the maximization of wealth in society, as it enables the welfare-enhancing effects of property rights and free markets.<sup>37</sup>

Critics of utilitarian theories, however, point out that it is highly difficult to determine an appropriate measure for outputs from a solely output-oriented perspective. Whatever this concept may be, whether it is considered happiness,<sup>38</sup> satisfaction,<sup>39</sup> or wealth-maximization,<sup>40</sup> it cannot be defined or measured in a fair and just manner except through a transcendently justified institutional arrangement for decision-making. Everything else would be paternalistic.<sup>41</sup> Interestingly enough, this problem has led to controversies even within the comparative camp. Thus, Karl Marx accused Bentham of a lack of consideration for the difficulties involved in establishing what people really want<sup>42</sup> – only to end up with an even more paternalistic theory. By contrast, Mill’s theory advocates freedom of expression for exactly that reason.<sup>43</sup>

Further, transcendentalists regard it as problematic that utilitarian approaches do not consider liberty or human dignity as a value in and of itself. This might have important practical consequences. In extreme cases, a huge disadvantage for a few might be outweighed by comparatively higher net advantages for society as a whole.<sup>44</sup> This might be at odds with our moral sentiment which considers some kinds of behaviour, such as euthanasia, as intrinsically repulsive and unjustifiable.

## **2. Is There a Middle Way? – Amartya Sen’s Comparative Approach**

### **a) A Precursor: Hermann Heller**

Given the difficulties implied in either of the two mentioned perspectives, it seems tempting to

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<sup>37</sup> R. Posner, "Utilitarianism, Economics, and Legal Theory", 8 *Journal of Legal Studies* (1979) 103-140, at 123-7.

<sup>38</sup> Bentham (note 34).

<sup>39</sup> G. F. Hourani, *Ethical Value* (1956).

<sup>40</sup> Posner (note 37), p. 1ff.

<sup>41</sup> Möllers (note 7), p. 22.

<sup>42</sup> K. Marx, *Capital*, vol. 1 (1887), chapter 24, section 5. Marx makes this point quite clear by calling Bentham “that insipid, pedantic, leather-tongued oracle of the ordinary bourgeois intelligence of the 19th century” (ibid.).

<sup>43</sup> Supra, note 35.

<sup>44</sup> Rawls (note 9), p. 33.

produce a theory of justice (or of democracy) that takes both perspectives into account. Hermann Heller's idea of Social Democracy is a precursor of such a unifying approach. Put in very simple terms, he intended to mate the idea of liberal democracy with increased distributional justice and the establishment of the welfare state. In line with Marx and Engels he argued that the formal equality characterizing liberal democracy was a deception and that it in fact contributed to substantive inequality and the disenfranchisement of the working class. However, he did not speculate for a revolution by the proletariat. Instead, he suggested that liberal democracy itself would equip the proletariat with the means to change society in accordance with the rules of liberal democracy. Since the proletariat constituted the majority of society, it could assume power and implement welfare policies that would improve distributive justice.<sup>45</sup> The benefits of the welfare state would also increase support for democracy among the majority of the population and protect democracy against Bourgeois attempts to install an authoritarian regime like the Fascists in Italy.<sup>46</sup> But as much as Hellers argument seems to start at the comparative end of the theoretical spectrum, it ends up rather at the transcendentalist end. It establishes a one-way street that rests on the assumption that if one only allows free play to the institutions of liberal democracy, they will necessarily produce just outputs: Once liberal democracy is set up and running, it will most certainly safeguard society both against the misery of bourgeois class society and against totalitarian regimes. There is no feedback mechanism if it doesn't. In addition, this theory has little to offer to postmodern, pluralistic post-class societies where the dividing lines between the groups of society are much more complex.

### **b) Amartya Sen and the Concept of Capabilities**

In his 2009 book on "The Idea of Justice", Amartya Sen advocates an approach that is grounded in the comparative tradition, but adopts ideas about the relationship between communicative reasoning and justice which have been developed in the transcendental camp, namely by Rawls and Habermas. As a work in the comparative tradition, the book does not aim at establishing an ideal institutional framework for a just society, but to provide guidance for real societies in making decisions that lead to comparatively better outcomes. Unlike other comparative

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<sup>45</sup> H. Heller, "Rechtsstaat oder Diktatur?" in H. Heller (ed.), *Gesammelte Schriften*, vol. 2 (1930) 443-62, at 448-9.

<sup>46</sup> *Ibid.*, p. 451ff.

approaches, Sen's theory takes into account that societies usually have to choose under conditions of uncertainty among several available, equally rational alternatives, none of which presents itself as an ideal solution, that people have fundamentally different preferences, and that it is usually not sufficient to fix the institutional framework, because no matter what that framework is like, people might still act irrationally or negligently, or pursue special rather than general interests. Also, the theory takes into account the potentially global reach of local or domestic decisions.<sup>47</sup>

Instead of sketching out an ideal institutional setting, Sen proposes the concept of capabilities a measure for the evaluation and comparison of political outputs. Capabilities stand for the *actual* opportunity to pursue one's objectives, not only for the theoretical possibility to do so like Rawls' concept of primary goods, and for the actual capacity to choose between different objectives. The latter capacity has significance in a situation where a person is forced to opt for an objective she would have chosen anyway.<sup>48</sup> The concept of capabilities thus provides the requirement for taking outcomes into account. At the same time, it recognizes that people are of different factual strength and live in different circumstances. But even though capabilities are geared towards measuring outcomes, Sen wants them to be defined and weighted in an input-oriented way. This aspect of Sen's theory addresses the most serious criticism of comparative approaches, that of paternalism. Instead of happiness or welfare, Sen's starting point is liberty, individual autonomy, which he considers an *a priori* value.<sup>49</sup> Capabilities are to be defined in light of the fact that they are not a fixed, objective given, but that objectivity can only emerge as intersubjective acceptability. Also, capabilities do not represent any aggregate value that relates to the society as a whole or to a specific group, but look at individual freedom. Indeed, I believe that this focus on liberty, on individual freedom as an *a priori* value on which the concept of capability is based brings Sen's theory in the end very close to a transcendental theory that double-checks whether institutions actually achieve the outcomes one expects them to achieve.<sup>50</sup>

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<sup>47</sup> Sen (note 1), p. x, 90, 106ff.

<sup>48</sup> Ibid., p. 228ff.; A. K. Sen, "Human Rights and Capabilities", 6 *Journal of Human Development* (2005) 151-166.

<sup>49</sup> Sen (note 1), p. 299.

<sup>50</sup> H. S. Richardson, "Mapping out Improvements in Justice: Comparing v. aiming" (2011), manuscript, seems to make the same point in arguing that both Sen's and Rawls' theories are ultimately about ends.

### c) Defining and Ensuring Capabilities: Public Reasoning

Indeed, Sen's theory of capabilities has implications for the form of government one may expect to find in a just society. Sen claims that democratic forms of government enhance capabilities because they enable and foster *public reasoning*. Originally, public reasoning is a Kantian expression<sup>51</sup> that plays an important role in the work of John Rawls ("public reason"). According to Rawls, the most fundamental questions of a society and its constitution should be settled through public reason (but not necessarily ordinary legislation and decision-making). Rawls assumes that the exercise of power is only legitimate if it is based on a constitution that all may be expected to accept as reasonable and rational. This "duty of civility" obliges power yielders to give reasons justifying their choices on fundamental questions of the constitutional design of society, and to grant a right to be heard to those affected by the decision.<sup>52</sup> Rawls sees the US Supreme Court as the ideal typical institutions for public reasoning.<sup>53</sup>

Sen shifts from reason to reasoning, putting the emphasis on the process instead of the result and giving the concept a broader ambit. Not only fundamental questions of constitutional significance need to result from public reasoning. Rather, as all questions might become political (a point made already by Weber),<sup>54</sup> they require public reasoning. In particular, public reasoning helps to decide which capabilities to endorse, how or whether to weight them and how to evaluate and rank the alternatives available for their realization.<sup>55</sup>

The argument for the capabilities enhancing effect of public reasoning proceeds in two steps. First, Sen argues that public reasoning is indispensable in order to agree on a choice and the weighting of a concrete set of capabilities that a given society should guarantee.<sup>56</sup> In contrast to Rawls' public goods, Sen refuses to provide a general list of capabilities or concept of

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<sup>51</sup> I. Kant, "Beantwortung der Frage: Was ist Aufklärung?" in *Abhandlungen nach 1781*, Akademie-Ausgabe, vol. 8 (1784) 33-42.

<sup>52</sup> Rawls (note 12), p. 212ff.; on the questions that must be subjected to public reasoning see *ibid.*, p. 214f.

<sup>53</sup> *Ibid.*, p. 231ff.

<sup>54</sup> M. Weber, "The Profession and Vocation of Politics", in P. Lassman and R. Speirs (ed.), *Max Weber: Political Writings* (1919 (1994)) 309-369.

<sup>55</sup> Sen (note 1), p. 17, 241ff.

<sup>56</sup> *Ibid.*, p. 241ff., 326.

distributive justice. He keeps the issue deliberately open and submits it to public reasoning.<sup>57</sup> Although reasoned judgments might turn out to be wrong or disadvantageous, decisions resulting from a process of *public* reasoning are ethically superior just because they try to include different views in producing a reasonably acceptable justification of their decisions and reduce the idiosyncracies following from one particular viewpoint only.<sup>58</sup> Reasoning by one isolated individual only would hardly be considered objective and neutral in a pluralistic society. Rather, it needs to take into account different viewpoints, those of the members of a given society as well as those of affected non-members.<sup>59</sup> This is what public reasoning is about, and it comes very close to Habermas' concept of deliberation, although Sen moves from the idea of general representation to one of stakeholder representation.<sup>60</sup>

The second argument for the necessity of public reasoning (and thus for a democratic form of government) does not relate to inputs, to the selection of capabilities, but to outputs. Public reasoning enhances the realization of capabilities. It allows decision-makers to collect the necessary information and assess and weight their different policy choices in light of their effects on capabilities. Public reasoning does not necessarily lead to perfect, ideal results, but might prevent severe, "clearly remediable injustices".<sup>61</sup> By way of example, Sen recalls that famines in rural India (as well as in other parts of the world) disappeared with the installation of democratic government. He attributes this to the improvement of public reasoning in post-colonial times.<sup>62</sup> In this respect, the virtue of public reasoning rests on different factors:

- Public reasoning leads to *transparency* and ensures that crucial information about risks for, or the preferences and needs of, different groups gets passed on to decision-makers.<sup>63</sup>
- It also fosters *accountability* of governments which need to publicly justify their decisions and withstand rethorical attacks, whether or not they face re-election.

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<sup>57</sup> Ibid., p. 233.

<sup>58</sup> Ibid., p. 39ff., 122; A. K. Sen, "Human Rights and Capabilities", 6 *Journal of Human Development* (2005) 151-166, 163.

<sup>59</sup> Sen (note 1), p. 124ff., 155ff.

<sup>60</sup> See below part I.3.b.

<sup>61</sup> Sen (note 1), p. ii.

<sup>62</sup> Ibid., p. 338-343.

<sup>63</sup> Ibid., p. 232.

- Further, the *media* and educational institutions may increase the quality and reach of public reasoning.
- And finally, public reasoning enables appeals to *values* that strengthen “good”, principled policies.<sup>64</sup>

This second aspect of public reasoning is of central importance to the present paper. The subsequent arguments will mainly refer to this, rather than the former aspect of public reasoning.

These two reasons why justice requires public reasoning reveal the intimate connection between democracy and justice. Proper public reasoning that enables both a determination of capabilities that respects individual autonomy and their protection against remediable catastrophies requires a society which is based on transparency, participation and meaningful dialogue involving all parts of society. Sen believes that such public reasoning is only possible in democracies.<sup>65</sup> One might add that only democracies endorse the idea of freedom that underlies the very idea of capabilities. Democracy is therefore a preferable form of government. Sen goes to great length to demonstrate that democracy and public reasoning are not as culturally contingent as one might think.<sup>66</sup>

One caveat should be added: I do not pretend that Sen’s theory is the correct or only way to view democracy or justice. Rather, Sen’s capabilities approach devises a useful and defensible way of inquiring into the relationship between democratic forms of governance and people’s actual lives. Since this is the central this paper seeks to address, Sen’s theory seems to be a reasonable pick.

### **3. Critical Assessment of Sen’s Theory**

#### **a) Empirical Issues: Stability in Autocracies**

Several potential objections to Sen’s theory should be considered. In the first place, one could challenge it on empirical grounds. Sen bases much of his argument on the disappearance of famines with the advent of democracy in developing countries. One could make the point that the

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<sup>64</sup> Ibid., p. 37, 335ff.

<sup>65</sup> Ibid., p. 326.

<sup>66</sup> Ibid., p. 327ff.



positive effects of public reasoning are limited to famines and do not help to prevent other cases of manifest injustice. With respect to the financial crisis, one could particularly argue that the governments of non-democratic states like China had a much easier time in taking the measures they considered necessary in order to stabilize their financial system before and in the aftermath of the crisis. For example, China unilaterally imposed a countercyclical capital buffer on its financial institutions even before the crisis,<sup>67</sup> a measure that has now been proposed by the Basel Committee after extensive deliberation<sup>68</sup> and yet needs to be implemented in most member jurisdictions. Likewise, government stimulus in the aftermath of the crisis and the Fed's use of its emergency powers under Section 13(3) of the Federal Reserve Act in order to set up credit and liquidity facilities provoked considerable opposition.

However, one should not be blinded by the apparent efficiency of authoritarian regimes. Taking again the example of China, it is questionable how stable its financial sector really is. Financial markets in authoritarian regimes sometimes work very differently. Thus, the adoption of countercyclical capital buffers does not necessarily increase stability. Due to implicit government guarantees, Chinese financial institutions with the lowest capital ratio tend to have the lowest probability of default.<sup>69</sup> In addition, one should not forget how heavily China was affected by the crisis, which rendered about 20m unemployed.<sup>70</sup> Its timely recovery also has to do with the export orientation of its economy. Since not all parts of the world were equally affected by the crisis, exporting states could still find markets for their products. The same is true for Germany.

Finally, one should not forget that authoritarian regimes are generally much more prone to special interest capture than liberal democracies where such practices will be detected and prosecuted more rigorously. The annual Corruption Perception Index of Transparency International shows a strong correlation between democracy and low corruption levels.<sup>71</sup> That correlation seems to be

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<sup>67</sup> Speech by Wang Huaquin, Vice Chairman, China Banking Regulatory Commission, 26 June 2010, <http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=201007210339137CBE126B75FFDDE305CD598400>.

<sup>68</sup> Basel Committee on Banking Supervision, "Basel III: A global regulatory framework for more resilient banks and banking systems", December 2010 (hereinafter referred to as Basel III), para. 136ff.

<sup>69</sup> I would like to thank Prof. Woo for the information which stems from her own experience.

<sup>70</sup> J. E. Stiglitz, *Freefall* (2010), p. vi.

<sup>71</sup> [www.transparency.org](http://www.transparency.org). There are notable exceptions, though. For example, in the 2010 report, Singapore, Hong Kong, and Qatar are among the Top 20 states (Qatar, though, was arguably among the most liberal Arab states before

quite consistent over time.<sup>72</sup> The Asian crisis of the 1990s showed the destabilizing effects such crony capitalism may have.<sup>73</sup>

### **b) Public Reasoning without Institutional Enforcement? - The Need for Accountability Mechanisms**

What are the essential properties of public reasoning? What does it need for public reasoning to facilitate justice on a global level? Sen is not particularly explicit on this point, but mentions some features and requirements of public reasoning throughout the book. Accordingly, public reasoning is a process of open and informed scrutiny of the reasons for a specific decision. Following the example of Adam Smith's impartial spectator, public reasoning should not be limited to the members of a specific group, but have a potentially global reach and include the voices of all whose interests are affected by a certain policy.<sup>74</sup> Free speech and a functioning media are preconditions for that,<sup>75</sup> as well as the virtue of transparency. Some of the core aspects of democracy support the inclusion of a large number of voices in public reasoning, namely "political participation, dialogue, and public interaction".<sup>76</sup> Public reasoning eventually contributes to the formation of values that hold society together and protect minorities against the majority, such as human rights.<sup>77</sup>

Absent from this list are some of the basic institutional features which transcendental approaches usually associate with democracy, such as representative parliaments, courts for the enforcement of individual rights, and periodic elections. This is not surprising, as Sen deliberately avoids these issues and tries to stay in the comparative camp. However, the crucial question is whether the features of public reasoning which Sen mentions are enough to bring forward a just society and just institutions. Surely, decision-makers are bound to give acceptable reasons for their decisions,

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the 2011 revolutions in the area). Notable exceptions in the other direction are Italy (rank 67), Greece (rank 78), and India (rank 87).

<sup>72</sup> H. Heller made already the same observation. See note 45, passim.

<sup>73</sup> P. Krugman, *The Return of Depression Economics and the Crisis of 2008* (2009), p. 82f.

<sup>74</sup> *Ibid.*, p. 402ff.

<sup>75</sup> *Ibid.*, p. 327, 335ff.

<sup>76</sup> Sen (note 1), p. 326.

<sup>77</sup> *Ibid.*, p. 336f. and 355ff.

but in a pluralistic environment, this rules out only the most extreme positions. While Rawls' idea of public reason requires some fundamental consensus in society,<sup>78</sup> Sen is much more aware of the possibility of fundamental disagreement.<sup>79</sup> What if there are huge power imbalances among different groups of affected people, which structurally disadvantage one group? How should one protect the integrity of public reasoning against powerful special interests? Is this really possible without some of the traditional institutional features of transcendental theories?

To find an answer to this question, it might be useful to contrast Sen's view of public reasoning and the "objectivity" it is supposed to create with Habermas' idea of communicative reasoning. Both Sen and Habermas identify language as the fundament of public reasoning and a precondition for understanding.<sup>80</sup> However (and assuming away for a moment the problem that different stakeholders might speak different languages), Sen and Habermas attribute different functions to communicative reasoning. Habermas makes a marked distinction between moral reasoning, which is general and universal, and law-making, which is concrete and specific. In law-making, not only moral considerations, but also strategies and bargaining play a role. This seems unavoidable, if one accepts that one can reasonably disagree on specific policies – as Sen does.<sup>81</sup> As a backstop, Habermas provides institutional remedies: Accountability mechanisms such as decision-making by representative parliaments, periodic elections of public officials, and judicial enforcement of fundamental rights ensure that legislative decisions remain acceptable.

Is it possible to reach objectivity in law-making and to avoid excesses and abuses without such institutionalized accountability mechanisms? I do not think so. As long as the principal decision-makers are markedly different from those affected by the decisions, there is little hope that public reasoning alone will significantly improve without appropriate institutional mechanisms. Although Sen is right in his analysis of the flaws of standard transcendental models of representation, representative committees might reduce the parochialisms of powerful states or epistemic communities of bureaucrats, and the prospect of periodic elections or re-appointments might motivate decision-makers to actually engage in public reasoning. And although I agree

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<sup>78</sup> Rawls (note 12), p. 223.

<sup>79</sup> E.g. Sen (note 1), p. 220.

<sup>80</sup> Ibid., p. 121f.; Habermas (note 18), p. 26f., 32ff.

<sup>81</sup> Habermas (note 18), p. 187ff.

with Sen that Human Rights are perfectly valid as ethical claims and do not have to be legalized under all circumstances,<sup>82</sup> the success stories of the European and Inter-American Courts of Human Rights prove how much institutionalization matters and how important judicial review is for accountability.

This all does not contradict Sen's view that the principal value of democratic institutions and practices lies in the facilitation of public reasoning and the creation of accountability through it. Nevertheless, in light of the foregoing I would stress that approximately representative and responsible institutions are indeed a precondition for just decisions and for public reasoning to produce effective accountability. Democratic institutions and practices and public reasoning depend on each other. Neither of them works well without the other. Also, it is hard to imagine fair and impartial decisions about the *content* of capabilities (the first function of public reasoning) in the absence of transcendently justifiable institutions. One cannot measure the measure for measuring outcomes by the outcome. That would be evidently circular. Thus, Sen's theory of justice remains incoherent and unless combined with a transcendental institutional approach.<sup>83</sup>

To me, it therefore seems necessary to supplement Sen's concept of public reasoning with the institutional ideas put forward by Habermas. Habermas' theory of deliberative democracy is as close as it gets from the transcendental side to Sen's concept of public reasoning, a point which Sen recognizes himself.<sup>84</sup> He also seems to share with Habermas the idea that public reasoning should not be confined to institutions, that there should be constant exchanges of information between the public and decision-makers, supported by free speech and media. And both agree that deliberative decision-making does not presuppose a fundamental societal consensus in order to reach objectivity ("rightness" in Habermasian terminology, as opposed to truth), but can be brought alive by merely procedural means.<sup>85</sup>

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<sup>82</sup> Sen (note 1), p. 355ff.

<sup>83</sup> Sen, *ibid.*, p. xii-xiii, seems to see this point himself.

<sup>84</sup> Sen (note 1), p. 39ff., 324f.

<sup>85</sup> Habermas (note 18), p. 277.

Nevertheless, it seems appropriate to mitigate some of Habermas' institutional requirements. What I learned from Sen is that one should not be overly demanding when it comes to elections and representation. A lack of representation might be compensated by strong communicative trajectories between decision-makers and stakeholders which produce effective accountability. And a lack of legitimacy through universal elections might be compensated by transparency requirements, judicial accountability, or term limits. If one keeps the goal of public reasoning in mind, understood as a fair and impartial process free from domination (as Habermas would say), it is possible to imagine more than one institutional model satisfying this threshold, some of them better than others. For example, in the absence of a world parliament, accountable and transparent global institutions whose principal officers are subject to a rigorous and public selection procedure would not be ideally perfect – but better than secretive circles of unaccountable experts.

On another note, the preceding argument shows again that one should not overstretch the distinction between transcendental and comparative ideas of justice. Sen's theory rests on many transcendental assumptions, and Rawls and Habermas also require actors to think about the outcomes of solutions and to compare them.<sup>86</sup> However, Sen liberates the idea of public reasoning from some of the metaphysical dust that sits on it in Rawls' theory or on Habermas' idea of deliberation. It is the idea that reasoning or deliberation leads to the right results. Sen refrains from making any claim as to the rightness of the outcomes, and in this respect his theory is indeed different. Therefore, deliberation does not need to be charged with the pretention that it leads to perfect, right or true decisions. It just leads to less imperfect, less predictably flawed decisions.

### **c) Liberal and Libertarian Critiques of the Capabilities Approach**

Two further critiques might be raised against the capabilities approach of Sen. First, Professor Dworkin and other proponents of “luck egalitarianism” might object to the capabilities approach that it is no different from an approach focusing on equality of resources. He favors a model

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<sup>86</sup> Richardson (note 50), p. 5.

which focuses on resources and which allows people in the original position to buy insurance against handicaps which hamper their ability of transforming resources into capabilities.<sup>87</sup> Amartya Sen, however, gives convincing reasons why a resources-based and a capabilities-based approach are still significantly different. The most pertinent reason seems to me to be that a resources-based approach relies on the wisdom of an atomic insurance market to provide the necessary compensation, while Sen prefers to subject this decision to public reasoning.<sup>88</sup> I feel more comfortable with this situation, which protects individuals against the failures of the insurance market.

Second, it must be admitted that the capabilities approach appeals to an idea of social justice, one of the most controversial concepts of political thinking in the 20<sup>th</sup> century. Friedrich Hayek launched a famous attack on it, arguing that the idea of social justice was nonsensical in a free society.<sup>89</sup> Spontaneous orders could not be expected to lead to ideally just results.<sup>90</sup> The individual actor did not follow a grand design for the achievement of social justice. Only in economies which did not allow for spontaneous ordering, in other words, only in state-directed economies, social justice would be a meaningful category.<sup>91</sup> However, once one takes the thrust of Hayek's critique seriously, namely his aversion against grand distributional schemes which he considers incompatible with liberal economies, it becomes clear that it does not apply to the capabilities approach. The concept of capabilities refers to the needs of the individual person, to her freedom and opportunity to actually reach her objectives. What the concept does not do is to set up a grand distributional scheme. That should silence Hayek.

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<sup>87</sup> R. Dworkin, *Sovereign Virtue: The theory and Practice of Equality* (2000), 65ff.

<sup>88</sup> Sen (note 1), p. 265f.; see also E. Anderson, "Defending the Capabilities Approach to Justice", in H. Brighouse and I. Robeyns (ed.), *Measuring Justice: Primary Goods and Capabilities* (2010) 81-100.

<sup>89</sup> F. A. v. Hayek, *Law, Legislation and Liberty*, vol. 2: *The Mirage of Social Justice* (1976).

<sup>90</sup> *Ibid.*, p. 62.

<sup>91</sup> J. Tomasi, "Hayek on Spontaneous Order and the Mirage of Social Justice", *Hayek Lecture* (2007).

## II. The Impact of the Financial Crisis on Capabilities

### 1. Measuring Capabilities: GDP and Beyond

After having argued that democracies are expected to better enhance the capabilities of their citizens than authoritarian regimes because of the greater public reasoning they invite, I would like to take the next step of my argument and show that some Western democracies did not quite live up to this expectation during the Financial Crisis. In fact, I claim that the Crisis has arguably decreased the capabilities in the hands of the citizens in the United States and some European states and amounted to what Sen would call an “injustice”.<sup>92</sup>

This claim raises the question how increases or decreases in capabilities can be measured. The question is complicated by the fact that capabilities are no fixed measure. Rather, as has been discussed, they need to be defined by the communities themselves, with human rights providing some basic standard. Nevertheless, the debate between Dworkin and Sen has also revealed that resources are an important factor for capabilities. Even though resources do not always smoothly translate into capabilities, they have the crucial advantage that they can be measured more easily.

How to measure resources? One might, first of all, think about the Human Development Index (HDI), an index that was co-developed by no-one else than Amartya Sen himself. This index has been praised as an alternative model that goes beyond per-capita GDP and is more sensitive to distributional concerns. It therefore includes life expectancy and educational level as additional factors for the ranking which are meant to put a premium on social justice. However, HDI has been criticized for being highly contingent upon GDP.<sup>93</sup> Perhaps it is for these reasons that Sen now comes back to GNP and GDP as proxies for capabilities and well-being, although he admonishes that it would be better to measure them directly and to keep an eye on unequal distributions of resources.<sup>94</sup>

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<sup>92</sup> Of course, the crisis also affected citizens in other states, notably non-democratic ones. But since this claim concerns democracies only, there is no need to pay attention to such states.

<sup>93</sup> E.g. M. McGillivray, "The Human Development Index: Yet Another Redundant Composite Development Indicator?" 19 *World Development* (1991) 1461-1468.

<sup>94</sup> Sen (note 1), p. 225f.

While I recognize the point of Sen's concern with GDP, I guess that they are appropriate indicators for developed economies which, if compared to the rest of the world, are blessed by a relatively equal distribution of resources. GDP measurements are also quite reliable for these economies with sophisticated accounting systems and tax administrations.<sup>95</sup> It can therefore be said that less GDP usually amounts to less capabilities in such states. In addition, and in order to accommodate Sen's distributional concerns, it seems wise to include unemployment data, in particular long-term unemployment, which affects people more as it leads to serious declines in status. Less employment is almost certainly less capabilities, especially as it tends to affect most seriously the most vulnerable groups of society.

In addition, I will use public debt as a proxy for the capacity of the state to implement social justice. Further, the indicator for financial crises developed by Reinhart and Reinhart might illuminate the severity of the past financial crisis compared to previous cyclical developments, or even the protracted economic problems of the 1970s.<sup>96</sup> I think it apposite to use this indicator, since the focus of Sen's theory is exactly on severe crises creating major disruptions in public welfare.

## **2. Performance of Western Democracies during the Crisis: Decreasing Resources**

The indicators thus identified show that Western economies experienced losses in the resources necessary to ensure capabilities. Those losses also seem to go beyond the normal cyclical downturns and is in some respects without precedent since the Great Depression. This is the reason why Reinhart and Rogoff call the 2007-2010 crisis the "Second Great Contraction".<sup>97</sup>

As regards GDP, Reinhart and Reinhart project the changes in real per capita GDP in the two years subsequent to a crisis against the GDP of the peak year. They compare the 2007-2010 crisis with 15 previous crisis episodes in advanced economies. The resulting graph shows that increases

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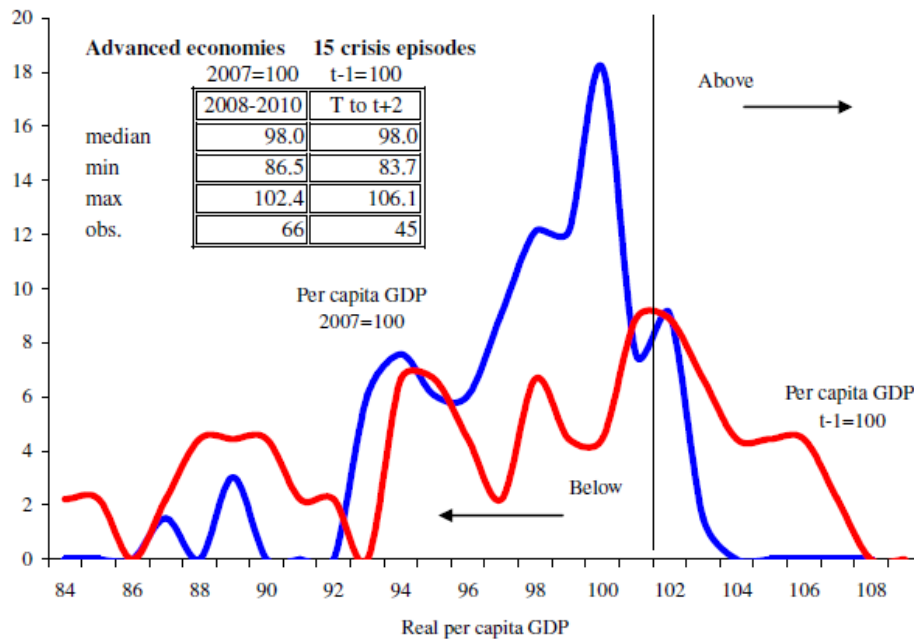
<sup>95</sup> For developing and emerging economies, power consumption might be a better indicator.

<sup>96</sup> C. M. Reinhart and V. R. Reinhart, "After the Fall", *National Bureau of Economic Research Working Paper* (2010).

<sup>97</sup> C. M. Reinhart and K. S. Rogoff, *This Time Is Different. Eight Centuries of Financial Folly* (2009).



and decreases in GDP are more evenly distributed during “normal” crisis episodes, where only 60 percent of the countries included experienced output decreases. During the 2007-2010 crisis, 82 percent of all observed countries experienced a decrease.<sup>98</sup>



As regards unemployment, meanwhile data has become available which illustrates the protracted breakdown and slow recovery of the US job market, which is unprecedented by other crises in the aftermath of the Second World War.<sup>99</sup>

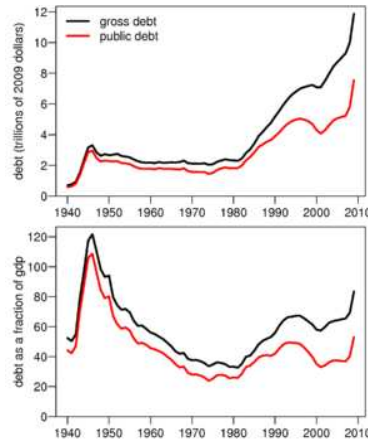
The situation does not look much better in Europe, though. Recent OECD unemployment data reveals that about half of the OECD member states experienced a steep rise in unemployment between the end of 2007 and the beginning of 2009, which has remained at this level ever since.<sup>100</sup>

<sup>98</sup> Reinhart and Reinhart (note 96), p. 10f. The graph uses projections from the IMF World Economic Outlook for 2010.

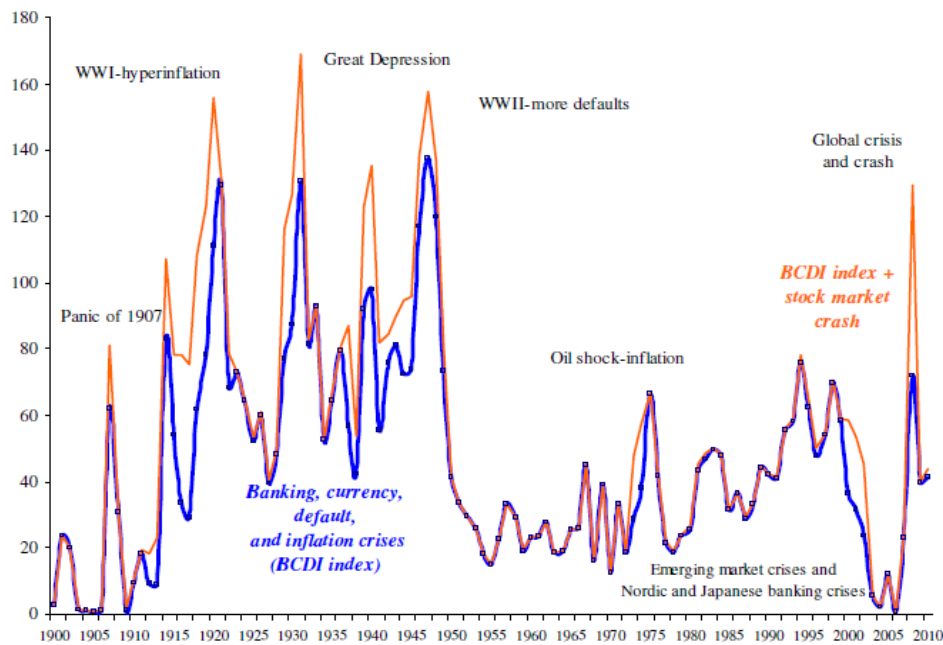
<sup>99</sup> See, e.g., Business Insider, “The Scariest Job Chart Ever”, 5 March 2010, <http://www.businessinsider.com/chart-of-the-day-the-scariest-job-chart-ever-2010-3>.

<sup>100</sup> EU <http://stats.oecd.org/index.aspx?queryid=251>, data retrieved on 24 May 2011.

Rising state deficits speak an even clearer language. In the United States, to choose to a drastic example, both total public debt and debt relative to GDP have sharply risen as a consequence of the 2007-2010 financial crisis in a way unprecedented since the Second World War.<sup>101</sup>



Finally, coming to the crisis indicator by Reinhart and Reinhart, the period from 2007-2010 stands out in the post-war period in terms of the sheer accumulation of crises. The graph uses the



aggregated numbers of banking, currency, sovereign default and stock market crises.<sup>102</sup>

<sup>101</sup> Source: Wikipedia, retrieved on 21 February 2011.

Except for the unemployment charts, what this data does not reveal are the consequences of the crisis on the level of distributive justice. Nevertheless, the data shows high general welfare losses in terms of GDP decline and a socialization of costs reflected in rising sovereign debt. Also, with respect to the concern for capabilities, it is important to note that unemployment never reached its pre-crisis level in the history of financial crises.<sup>103</sup>

### **III. Public Reasoning and the Causes of the Crisis**

#### **1. Insufficient Public Reasoning and the Crisis: Hypothesis and Claims**

Having established that the financial crisis arguably had a negative impact on capabilities, I try to show in this part that some of the causes of the crisis can be understood as a lack of public reasoning in financial regulation – on the national as well as on the international level. This claim is not as bold as it might sound at first sight. All I want to do is to shed a new light on some of the causes of the crisis that have been revealed in the by now extensive literature on the issue, and show that deficits in public reasoning can be understood as a root cause. I do not want to add any fundamentally different causes of the crisis. Nor do I want to claim that the lack of public reasoning is the only possible explanation.

At the outset, I should emphasize that the purported lack of public reasoning should not be equalled with a lack of rational behavior. As of now, there seems to be a dispute between authors who follow the efficient market hypothesis and claim that insufficient information enticed otherwise rational actors to make bad choices,<sup>104</sup> and authors who claim that all the necessary

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<sup>102</sup> Reinhart and Reinhart (note 96), p. 5. For a definition of what counts as a crisis, see Reinhart and Reinhart, *ibid.*, as well as Reinhart and Rogoff (note 97), chapter 1.

<sup>103</sup> Reinhart and Reinhart (note 96), p. 15.

<sup>104</sup> The National Commission on the Causes of the Financial and Economic Crisis in the United States stresses intransparency as a major factor leading up to the crisis in its 2011 Final Report (hereinafter “The Financial Crisis Inquiry Report”), e.g. p. xixf., 352, 386, 410. This view finds support in the literature. See e.g. Peter Scheer, “Lack of Disclosure the Root Cause of the Financial Crisis”, *Huffpost Business*, 7 October 2008, referring to lending standards; V. V. Acharya et al., “A Bird's-Eye View - The Financial Crisis of 2007-2009: Causes and Remedies”, in V. V. Acharya and M. Richardson (ed.), *Restoring Financial Stability* (2009) 1-56, 26 and *passim*, referring to counterparty exposure and executive compensation; V. V. Acharya et al., “Derivatives: The Ultimate Financial Innovation”, in V. V. Acharya and M. Richardson (ed.), *Restoring Financial Stability* (2009) 233-249, 241-3,

information was available, but that actors made bad choices because human rationality is bounded.<sup>105</sup> This paper does not directly address this dispute. Sen clearly distinguishes rationality from reasoning. Rationality is a category which is used in order to characterize the usefulness of a specific choice for a specific goal. Accordingly, a person acts irrationally if she does something which is a less than optimal strategy to reach her goals. Reasoning, by contrast, refers to the processes by which people *actually* make their choices. A choice is reasonable if it takes into consideration all relevant information and views, including expected short-term and long-term consequences, and if the reasons underlying the choice survive critical, impartial scrutiny.<sup>106</sup> Public reasoning is thus about the quality of the information which provides the basis of a decision.

In light of this concept of reasoning, I claim that many factors of the crisis which have been identified as such in the predominantly economic literature can also be read as deficits in public reasoning. In particular, I make the following three claims:

- 1) Regulatory and supervisory decisions were based on simplifying indicators which lacked the necessary granularity.
- 2) The fragmentation of regulatory standards and supervisory structures led to decisions that were based on insufficient information.
- 3) Deregulation and the underlying market ideology hampered public reasoning by silencing dissenting views.

The following subsections elaborate on each of these claims in detail. Note that all these claims relate to the lack of public reasoning on the part of supervisors and regulators and the choices they made in the exercise of their authority. I am well aware that similar lacks of reasoning could

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referring to OTC derivatives; X. Freixas and C. Laux, "Disclosure, Transparency, and Market Discipline", *Center for Financial Studies Paper No. 11* (2011), 27, 30ff., referring to credit rating agencies and financial statements. Insightful on the economic significance of transparency C. Kaufmann and R. H. Weber, "The Role of Transparency in Financial Regulation", 13 *Journal of International Economic Law* (2010) 779-797.

<sup>105</sup> G. P. Miller and G. Rosenfeld, "Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008", 33 *Harvard Journal of Law and Policy* (2008) 807-840; E. Avgouleas, "The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case for Reform", 6 *European Company and Financial Law Review* (2009) 440-475.

<sup>106</sup> Sen (note 1), Chapter 8.

be found in the decision-making of market participants.<sup>107</sup> They followed the logic of exactly the same simplifying indicators, made use of the fragmented regulatory and supervisory structure, and were misguided by the same values. Nevertheless, since the overall theme of this paper is democracy, and since sound public reasoning (as the key aspect of democracy in Sen's understanding) is expected from those exercising public authority,<sup>108</sup> I will not go into this issue.

## **2. Simplifying Indicators as Impediments to Public Reasoning**

Public reasoning in financial supervision before the crisis suffered from serious overreliance on simplifying indicators. In the years previous to the crisis, supervisors in Western, developed economies excessively relied on microprudential indicators which aggregated complex fact-patterns into crude binary or numeric figures. Those indicators include capital requirements and the indicators used to calculate them, such as credit ratings; stress tests; and accounting standards.

Of course, indicators are always and almost by definition simplifications, simplified figures expressing complex fact patterns. And financial market supervision certainly cannot dispense with indicators entirely. Rather, well-designed indicators can give supervisors a first-glance assessment of financial firms as well as important clues about market trends. However, thorough public reasoning requires more than a checkbox-like approach to supervision based on simplifying indicators, but to take a second look and to also retrieve information that is not reflected in the indicators. This is the thrust of the idea of impartiality that stands behind public reasoning: It requires decision-makers to also take into account the other perspective, in this case, the perspectives that are concealed, rather revealed, by indicators. Indicators can only be the starting point, at least as long as they have important and well-known limits. The information that forms the basis of sound decision-making needs to be more complex. Thus, the quantity of information matters, but also its quality and granularity.

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<sup>107</sup> This is the focus of Miller and Rosenfeld (note 105).

<sup>108</sup> On the concept of public authority cf. A. v. Bogdandy, P. Dann and M. Goldmann, "Developing the Publicness of International Public Law: Towards a Legal Framework for Global Governance Activities", 9 *German Law Journal* (2008) 1375-1400.

This subsection elaborates on the three mentioned indicators in more detail. Naturally, these indicators also determined the decisions of market participants. However, their significance for supervisors seems to be the key to the problem: Market participants often behave rationally in that they design their business strategies so as to conform to supervisory requirements. Once it turns out that supervisors go beyond crude indicators and question the soundness of financial firms in more intensive ways, it is not unlikely that business strategies will follow.

### **a) Capital Requirements: The Discrepancy between Regulatory and Economic Capital**

Capital requirements are one striking example of supervisory over-reliance on numbers. Some supervisors confined themselves to ensuring that the financial firms within their jurisdiction met the mathematically calculated minimum capital standards. They did not do much to question the wisdom of the underlying mathematical calculations and verify whether they were sufficient in each case given the risk profile of the financial firm under scrutiny.

Certainly, the mathematical formulas for the calculation of capital requirements concerning credit, market and operational risk stipulated in pillar 1 of Basel II are important tools for prudential supervision. They provide a global minimum standard and establish a level-playing field below which individual supervisors must not fall. Nevertheless, the Basel Accord does by no means imply that this is where supervisory control should stop. To the contrary, pillar 2 of Basel II recognizes the need for further-reaching supervisory control. In particular, supervisors need to go beyond the minimum capital requirements of pillar 1 and ensure that the internal risk management of financial firms looks at risks which pillar 1 does not fully (or not at all) take into account.<sup>109</sup> In fact, the calculation of capital requirements under pillar 1 amounts to a considerable simplification of the risks faced by financial firms. There is quite a broad gap between the required regulatory capital and economic capital, i.e. the capital which a prudential manager of a bank or other financial firm with a specific risk profile would hold in order to protect it against default.

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<sup>109</sup> Basel Committee, “International Convergence of Capital Measurement and Capital Standards”, Comprehensive Version, June 2006 (hereinafter referred to as Basel II), para. 719ff.

For example, Basel II pillar 1 capital requirements did not take liquidity risks into consideration. This is entirely left to pillar 2 and thereby to prudential regulators interested in a thorough assessment of risks.<sup>110</sup> This proved to be fateful during the crisis. Thus, the Office of Thrift Supervision (OTS) did not recognize on time that AIG had assets on its balance sheet which looked relatively sound from a credit risk perspective, such as super-senior Credit Default Swaps (CDS). However, when the market for these assets collapsed, AIG was downgraded and faced collateral calls by its CDS trading partners which it could not meet. OTS Acting Director Scott Polakoff later testified before congress:

“You will also see that where OTS fell short, as did others, was in the failure to recognize in time the extent of the liquidity risk to AIG of the ‘super senior’ credit default swaps in [its] portfolio. In hindsight, we focused too narrowly on the perceived creditworthiness of the underlying securities...”<sup>111</sup>

Some authors anticipate that Northern Rock, Bear Stearns, and Lehman would not have experienced the sort of difficulties they did had their liquidity risks been taken better care of.<sup>112</sup>

Another example of risks not covered by pillar 1 capital requirements which would therefore have required supervisory concern under pillar 2 is wrong-way risk.<sup>113</sup> Again, AIG provided a textbook example of how things can go wrong if no attention is paid to this factor. AIG wrote insurance (CDS) worth dozens of billions of US dollars for CDO composed of subprime mortgage loans. As a consequence, it was highly exposed to the default risk it was supposed to insure. When that market collapsed and nonperformance of CDO increased, AIG faced downgrades and could not live up to its obligations without massive government assistance.<sup>114</sup>

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<sup>110</sup> Basel II, para. 741.

<sup>111</sup> Statement of Scott M. Polakoff, “American International Group: Examining what went wrong, government intervention, and implications for future regulation”, before the Committee on Banking, Housing, and Urban Affairs, US Senate, 5 March 2009, [http://www.ots.treas.gov/\\_files/87171.pdf](http://www.ots.treas.gov/_files/87171.pdf), p. 6.

<sup>112</sup> S. Hanson, A. K. Kashyap and J. Stein, "A Macroprudential Approach to Financial Regulation", *Journal of Economic Perspectives* (draft 7/2010), forthcoming, manuscript p. 15.

<sup>113</sup> Cf. Basel II, para. 777(xi).

<sup>114</sup> On wrong-way risk e.g. V. V. Acharya et al., "Centralized Clearing for Credit Derivatives", in V. V. Acharya and H. S. Richardson (ed.), *Restoring Financial Stability* (2009) 251-268, 265.

The biggest shortcoming of Basel II pillar 1 capital requirements, though, might have been the absence of systemic risk factors. Their static nature produced anti-cyclical effects during the crisis, when financial firms under distress deleveraged at the same time in order to meet the minimum capital requirements. This caused nothing less than a credit crunch.<sup>115</sup>

There were, however, not only risks that were explicitly excluded, or not fully covered by the Basel II capital requirements. More than that, the calculation of capital requirements itself relied on crude indicators that were inconducive to the kind of public reasoning necessary for supervisory decision-making. Basel I, which was, and still is, applicable in the United States to most financial institutions except for the largest ones, assigns risk weights for assets largely according to their type and regardless of the default risk of the counterparty.<sup>116</sup> Basel II corrects this deficit by shifting from asset types to counterparty default risk as the decisive criterion for the determination of credit risk-related capital requirements.<sup>117</sup> However, under the standardized approach, Basel II uses credit ratings as a means for calculating credit risk.<sup>118</sup> From the perspective of public reasoning, this is as much an improvement as a switch from pestilence to cholera. Apart from the conflicts of interest that tainted the impartiality of credit ratings particularly for complex, structured products,<sup>119</sup> credit ratings are just another indicator with the purpose of breaking down complex fact patterns into simplifying, linear categories. Since credit rating agencies mostly use mathematical models instead of sound, individualized risk assessments, a lot of information gets lost in that process.<sup>120</sup> For example, just like Basel II pillar 1 and many supervisors, credit rating agencies paid little attention to liquidity risks, or they considered insurance an asset, regardless of the wrong-way risks of the insurer. Also, credit ratings lack granularity in that they do not distinguish between different categories of risk which might bring a rated instrument into trouble. Further, good ratings for securitized instruments, even though they were accomplished on questionable bases of information, decreased the need

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<sup>115</sup> Hanson, Kashyap and Stein (note 112).

<sup>116</sup> 12 C.F.R. Part 325, Appendix A.

<sup>117</sup> This applies in principle to both the standardized and the IRB approach.

<sup>118</sup> Basel II, para. 50ff.

<sup>119</sup> M. Richardson and L. J. White, "The Rating Agencies. Is Regulation the Answer?" in V. V. Acharya and M. Richardson (ed.), *Restoring Financial Stability* (2009) 101-115, 104ff.; J. Mathis, J. McAndrews and J.-C. Rochet, "Rating the Raters: Are Reputation Concerns Powerful enough to Discipline Rating Agencies?" 56 *Journal of Monetary Economics* (2009) 657-674.

<sup>120</sup> The Financial Crisis Inquiry Report, p. xxv.



for companies generating the underlying loans to care about lending standards.<sup>121</sup> Miller and Rosenfeld call this “oversimplification bias”: Given the complexity of financial markets, market participants tend to cling to simplifying indicators and fall prey to a peculiar tunnel vision. Impressed by the mathematical crispness and seeming rationality of credit ratings, they take them at face value and forget to complement them by sound, evaluative judgments.<sup>122</sup> One may add that it was perfectly rational for market participants to do so as long as supervisors did not care and focused on hard numbers.

Credit ratings are not the only case of a lack of public reasoning through oversimplifying models. Rather, this seems to be the case with about any model applicable under pillar 1 of Basel II. By now it is well-known that models for the calculation of market risk, such as value-at-risk (VaR), which is to be used by financial institutions making use of the Internal Models Approach,<sup>123</sup> suffer from limited data sets. Normally, VaR models only comprise data from roughly the past 25 years. As financial crises evolve in much slower cycles, this is barely sufficient.<sup>124</sup>

Summing up, capital requirements and the subsidiary indicators used to calculate them such as credit ratings or VaR, proved to be too crude a measure for supervisors to rely on, given that supervisors should make their decisions on the basis of sound public reasoning. Nevertheless, a number of supervisors did just that and did not second-guess the outcomes of the mathematical calculations. Not only the OTS should be blamed in this respect, but also the British Financial Services Authority for its trademark “light-touch approach”.<sup>125</sup> The Bank of Canada proved that the opposite strategy works, namely that sound, reasoned supervision, which takes a close look at the risk profile and business strategy of each individual bank, is possible in a developed economy with global players among its financial firms.<sup>126</sup>

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<sup>121</sup> Acharya et al. (note 104), p. 14.

<sup>122</sup> Miller and Rosenfeld (note 105), p. 829.

<sup>123</sup> Basel II, paras. 701(iv), 718(lxx)ff.

<sup>124</sup> Reinhart and Rogoff (note 97), p. xxviii.

<sup>125</sup> Cf. Financial Services Authority, “The Turner Review”, March 2009, p. 86ff.

<sup>126</sup> See below III.4.b.

## **b) Internal Models and Stress Tests: Privatized Reasoning Unchecked**

Stress tests are another instance of simplifying indicators which hamper public reasoning on the part of supervisors. The Basel II framework allows financial firms to use their own internal risk assessment methods for the calculation of certain risks instead of the standardized approaches provided in the Basel II framework. This can be characterized as nothing but a shift from public to private reasoning which bears the risk of self-interested abuses of discretion in the design and application of internal models. In addition, the use of internal models for risk assessment entails potential pitfalls which even a non-self-interested bank could hardly escape. Most of these models use statistical assumptions about correlations which are based on a limited amount of historical data. For example, most institutions use VaR models for evaluating market risk under the Internal Models Approach. However, as I pointed out above, VaR models have severe shortcomings.<sup>127</sup> They rely on historical data for downside events, which might not go back far enough in order to cover rare events of exceptional distress (“fat tails”). Also, VaR models for Basel II only need to consider asset value depreciations that might occur within a holding period of up to 10 days, while financial firms might hold assets in the trading book for significantly longer periods, leading to larger potential losses. In addition, VaR is often calculated for each portfolio separately, while aggregate losses might be larger.

Basel II obliges financial institutions to use stress tests as an antidote against the shortcomings and risk of abuse of internal models. Stress tests are simulations that second-guess the assumptions underlying traditional models for risk assessment. During stress testing, a financial firm calculates the value of a given asset portfolio under adverse economic and financial conditions which are unlikely to occur, but not entirely unrealistic. Thus, financial institutions choosing the IRB approach for measuring credit risk,<sup>128</sup> or the Internal Models Approach for measuring market risk,<sup>129</sup> or their internal models for the assessment of counterparty credit

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<sup>127</sup> In more detail J. R. Aragonés, C. Blanco and K. Dowd, "Incorporating Stress Tests into Market Risk Modeling", *Derivatives Quarterly* (2001) 44-49.

<sup>128</sup> Basel II, paras. 434ff.

<sup>129</sup> Basel II, "Revisions to the Basel II market risk framework", February 2011, para. 718(1xxvii)ff.

risk,<sup>130</sup> need to stress their assumptions. Pillar 2 directs supervisors to double-check internal stress tests.<sup>131</sup>

Ironically, though, the stress tests carried out by financial firms before the crisis often fell victim to simplifications which were similar to the known simplifications of the models they were supposed to fix. The financial crisis revealed that most financial firms did not carry out sound stress tests. The root cause of this is that, like with VaR and other statistical models, the value of stress tests also hinges on the underlying assumptions. The Basel Committee has studied the shortcomings of internal stress tests in detail.<sup>132</sup> It revealed the following problems:

- Internal stress tests used scenarios that were not conservative enough. Stress test scenarios tended to simulate certain past crises and ignored the possibility that future crises might look differently. This might have been the result of an incentive bias,<sup>133</sup> since banks had nothing to gain but trouble from the use of more severe scenarios.
- Financial firms applied stress tests to each portfolio separately and did not take account of possible correlations among their portfolios. This might have been the result of complexity bias,<sup>134</sup> since portfolios were managed separately and only fully understood by their managers.
- Financial institutions blindly relied on statistical correlations of asset price developments instead of exercising sound judgment as to whether these past correlations would continue in the future in light of new products and market developments. Again, this might have been the result of complexity bias. It is difficult to argue against seemingly authoritative statistical data with purely subjective projections.
- As in case of capital requirements, stress tests were not sensitive enough to certain kinds of risk, such as liquidity risks.
- Financial institutions carried out stress tests without substantial involvement of board members and senior management, which adversely affected communication about stress

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<sup>130</sup> Basel II, Annex 4, paras. 55f.

<sup>131</sup> Basel II, i.a. paras. 726 (general); 738, 778(iii) (market risk); 765ff., 777(i) (credit risk).

<sup>132</sup> Basel Committee, "Principles for Sound Stress Testing Practices and Supervision", January 2009, p. 8ff.

<sup>133</sup> Cf. Miller and Rosenfeld (note 105), p. 815ff.

<sup>134</sup> Ibid., p. 813ff.

test results and follow-up. Again, complexity bias might have prevented higher levels to get involved in the seemingly technical issue of stress testing.

Thus, both the scenarios used for stress testing and their implementation were deficient. The tests suggested a false impression of safety and soundness. And just as with capital requirements, supervisors did not double-check the stress testing methodologies of the firms under their jurisdiction carefully enough to spot the shortcomings. Under Basel II, financial firms enjoy considerable leeway in the development of their stress tests. They need to design stress tests which are appropriate for the specific risks of each of their portfolios. This was, and is, a highly subjective standard. Only few accepted standards have emerged, for example for the scenarios for market risk stress testing. Other methods such as stressed VaR scenarios are still in an experimental state. In such a situation of decision-making under conditions of uncertainty, public reasoning would have required taking a second, closer, and possibly “independent” look at the stress testing methodologies of financial firms. Supervisors did not realize that discretionary choices require discretionary, case-sensitive supervision, not checkbox-like ratifications of the results of internal risk management. They did not set up an adequate counter-weight to the “privatization” of reasoning brought along by the use of internal models.

### **c) Off and On the Balance Sheet: Playing Blindman’s Buff**

Off-balance sheet items caused further deficits in public reasoning. Once financial firms remove assets from their balance sheet and pack them into SIVs or conduits, they receive capital relief. Basel I required no regulatory capital for off-balance sheet vehicles, while Basel II allowed for reduced capital requirements, stipulating sometimes no more than a 20% risk weight.<sup>135</sup> However, those reduced requirements did not take sufficiently into account the fact that financial firms usually extended liquidity and credit enhancement to their off-balance sheet vehicles. This improved the ratings of the vehicles, but it also involved risks, namely the risk that the assets would return to the balance sheet of the financial firm in case the vehicle came into trouble.<sup>136</sup>

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<sup>135</sup> Basel II, paras. 82ff.; for credit risk mitigation through collateral, insurance, or else, see also paras. 109ff.

<sup>136</sup> V. V. Acharya and P. Schnabl, "How Banks Played the Leverage Game", in V. V. Acharya and M. Richardson (ed.), *Restoring Financial Stability* (2009) 83-100, 85, 87.

This is what happened during the crisis, sometimes even on the basis of implicit guarantees which banks as the sponsors of a vehicle had to extend for reputational reasons.<sup>137</sup>

Again, the chosen indicator was misleading. Balance sheets were supposed to provide information about a bank's liabilities, and by moving assets off the balance sheet, liability was thought to end. Only that it didn't, because of the neutral effects of guarantees on capital requirements.<sup>138</sup> And again, supervisors failed to second-guess their indicators and make a thorough assessment of the risks arising from such explicit and implicit guarantees.

The list of simplifying indicators leading to a lack of reasoning on the part of supervisors could be extended. Reinhart and Rogoff observe similar off-balance sheet difficulties with respect to sovereign debt.<sup>139</sup> And the entire shadow banking sector was built on the fact that regulation related to actors and their specificities, not to economic activities. Legally very different actors could engage in activities which were economically identical. For example, money market mutual funds had more or less the same economic function as traditional savings accounts. However, they lack the insurance and other regulatory requirements which the latter underlies and are therefore more risky.<sup>140</sup>

It is not only supervisors who are to be blamed for a lack of reasoning. Market participants were just as blinded by crude indicators as supervisors, or intentionally made use of this crudeness. Nevertheless, as this paper investigates the relationship between democracy and the financial crisis, I focused on the deficits in the exercise of public authority. Of course, public reasoning is not always a piece of cake. Opaque markets like the OTC derivatives market, and complex products need to be understood and analyzed with care. But complex, integrated markets need supervisors living up to that challenge.

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<sup>137</sup> M. Richardson, J. Ronen and M. G. Subrahmanyam, "Securitization Reform", in V. V. Acharya et al. (ed.), (2011) 469-489, 473.

<sup>138</sup> See the comprehensive study by V. V. Acharya, P. Schnabl and G. Suarez, "Securitization Without Risk Transfer", *Working Paper* (2010).

<sup>139</sup> Reinhart and Rogoff (note 97), p. xxxi ff. and part III.

<sup>140</sup> Financial Crisis Inquiry Report, p. 27ff.

### **3. Fragmented Regulation and Supervision of Integrated Markets**

Another factor preventing sound public reasoning in the run-up to the crisis was the fragmented nature of international financial regulation as well as the supervisory structure. The integration of global financial markets during the last two or three decades was not paralleled by a comparable integration in international financial regulation or supervision.

Although non-binding international agreements like Basel II set a minimum standard, financial regulation as applied by supervisors still essentially consists of domestic (or European) law. International structures for supervision like the Basel Committee are relatively weak compared to domestic supervisors. As a result, domestic law-makers and supervisors focused on their jurisdiction and its needs and advantages while disregarding other perspectives or failing to pass on crucial information. The ensuing parochialisms (as Sen would say) led to frictions in the regulatory structure that caused part of the damage. And supervisors were not accountable for that damage because it was caused elsewhere, beyond their jurisdiction – at least as long as the crisis had not yet become systemic. In this case, the frictions were mostly horizontal in nature: Several jurisdictions and actors operated in parallel to each other, without full knowledge of what the other one was doing and how one's acts affected them.<sup>141</sup>

#### **a) Fragmented Standards**

From Sen's perspective, fragmented regulation bears the risk of parochialisms. If people not represented in the community, or with diverging views, do not have a voice in the political process, the ensuing regulation might produce externalities just for those groups. In financial market regulation before the crisis, such regulatory fragmentation was possible because of divergencies in regulatory standards across jurisdictions.

Regarding cross-jurisdictional fragmentation, the case of Lehman Brothers' Repo 105 provides a textbook example. Lehman Brothers used the difference in UK and US accounting rules for a

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<sup>141</sup> Sen's example of famines in colonial India is characterized by vertical frictions, see note 1, p. 338ff.

peculiar, and in the end illegal, kind of regulatory arbitrage. A few days ahead of the date of the American holding company's 10-K or 10-Q filing,<sup>142</sup> on whose balance sheet the liabilities of subsidiaries have to be consolidated,<sup>143</sup> LBIE, the UK subsidiary of Lehman Brothers, entered into repo agreements. According to a controversial view held by lawyers to LBIE, LBIE was permitted to count these repo agreements as sales under Accounting Standard SFAS 140 and thereby effectively remove them from their balance sheet without recording the duty to repay the cash received under its liabilities. It used the cash proceeds from these repo 105 to temporarily pay back other liabilities and thereby reduce its overall leverage.<sup>144</sup> While LBIE's accounting firm (and possibly the FSA as well) knew about this practice and approved of it, US regulators were not aware of the difference in the application of SFAS 140. Lacking this knowledge, sound public reasoning could not come along.

While the example of the Lehman Brothers Repo 105 arguably involved some criminal energy, there were other perfectly legal arrangements which allowed global financial firms to economize on capital thanks to diverging standards across jurisdictions. For example, Lehman Brothers channelled most of its non-retail products through its Swiss subsidiary Lehman International Finance AG, a multibillion company with only 14 employees. Under Swiss capital regulation, Lehman was not subject to any capital requirements as long as the enterprise did not engage in retail business.<sup>145</sup> This made the entire conglomerate more leveraged and more fragile, and increased the risks for all market participants, including retail investors who bought Lehman certificates. This shows that fragmented regulators might take decisions which are not well reasoned because they exclude the views of those who might be affected by the externalities produced. However, if the purpose of such regulation was to produce externalities, then the lack of public reasoning is that the regulation in question did not need to be justified vis-à-vis the views of those potentially affected.

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<sup>142</sup> 1934 Securities Exchange Act, Sections 13 and 15(d).

<sup>143</sup> Basel II, para. 20ff.

<sup>144</sup> Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner's Report, available at <http://lehmanreport.jenner.com/>, p. 766ff.

<sup>145</sup> C. Severin "Lehman's langes Begräbnis", Neue Züricher Zeitung, 8 July 2010, [http://www.nzz.ch/finanzen/nachrichten/lehmans\\_langes\\_begraebnis\\_1.6472110.html](http://www.nzz.ch/finanzen/nachrichten/lehmans_langes_begraebnis_1.6472110.html).

## b) Fragmented Supervisors

The fact that participants on integrated global financial markets are supervised by a large number of dispersed supervisors with limited competencies led to deficits in public reasoning in various respects. First, it is by now well understood that the fact that there had been little systemic (or macroprudential) oversight, neither on the domestic, nor on the global level. Supervisors focused on the microprudential supervision of individual firms, but were hardly required to take the perspective of the financial system as a whole and worry about its stability.<sup>146</sup> In addition, those global bodies which might have been able to exercise some kind of systemic oversight lacked an adequately pluralistic composition. Before 2009, the Basel Committee was a very exclusive circle of central bankers and bank supervisors from 13 developed economies.<sup>147</sup>

The limited competence of some supervisors also created difficulties on the domestic level. For example, the United States with its highly fragmented supervisory structure experienced conflicts among supervisors which exhibited less concern for microprudential, or even macroprudential soundness, and more for their turf. The case of the OTS and its failure to adequately supervise AIG has received much attention. US law basically permitted financial conglomerates, through smart desing of their firm structure, to basically choose their preferred regulator.<sup>148</sup> The OTS, a relatively small regulator, received a considerable part of its funds through fees from AIG.<sup>149</sup> Although the Federal Deposit Insurance Company (FDIC) had repeatedly criticized the way in which the OTS categorized AIG under US capital requirements, the OTS remained passive for a long while. When it ultimately downgraded AIG by several notches, it triggered a shock.<sup>150</sup> This case is highly interesting from the perspective of public reasoning. At first sight, the involvement of several regulators should be beneficial, since it might ensure that different views are taken into

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<sup>146</sup> See only Squam Lake Working Group, "A Systemic Regulator for Financial Markets", Working Paper 4 (2008); Scott, JIEL 2010. This criticism is all but new. Cf. H. Tietmeyer, "International Cooperation and Coordination in the Area of Financial Market Supervision and Surveillance", *Report to the G7 Finance Ministers and Central Bank Governors* (1999), p. 4.

<sup>147</sup> Until 2009, only Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden Switzerland, the UK and the US were members of the Basel Committee.

<sup>148</sup> Financial Crisis Inquiry Report, p. xviii.

<sup>149</sup> *Ibid.*, p. 54.

<sup>150</sup> Statement of Scott M. Polakoff (note 111), p. xx.



account in supervisory decision-making.<sup>151</sup> However, in the case at hand, self-interested reasons prevailed and public reasoning did not come along. This might have had to do with the absence of truly *public* reasoning, i.e. with the lack of public embarrassment or any other sanctioning mechanisms, as well as with a lack of accountability and obligation to justify one's decisions to those affected by them (which, in this case, probably comprises no less than the entire world).

Apart from outright competition, supervisory fragmentation on the domestic level also led to information deficits. Not all supervisors always had all the information they needed. A case in point is Northern Rock. When it got into trouble, the Bank of England as the lender of last resort had to make a decision whether to provide liquidity or not, which, following Bagehot's rules, would have required the bank to be generally solvent.<sup>152</sup> However, the Bank of England did not have the necessary microprudential information, because supervision was in the hands of the Financial Services Authority.<sup>153</sup>

Further sources of deficient public reasoning through fragmented structures are mutual acceptance regimes. They make it easy for one regulator to create externalities in another jurisdiction which serve its own self-interest, and without having to ask anyone, or give them reasons, or being in any other way accountable to the affected people. Examples from within the European Union abound. Lehman Brothers preferred the Irish supervisor for its light touch approach, but once the securities thus approved had received a "European passport",<sup>154</sup> they were marketable throughout the union. And the freedom of establishment required European supervisors to accept on their territory branches of banks sitting in other member states, even if they were insufficiently supervised, as in the case of Icelandic banks.<sup>155</sup> With respect to non-member states, the European Union eventually decided to require that home states make a consolidated supervision of financial conglomerates in a way that is "equivalent" to EU

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<sup>151</sup> For the different basic supervisory models see H. Davies and D. Green, *Global Financial Regulation: The Essential Guide* (2008), 156ff.

<sup>152</sup> W. Bagehot, *Lombard Street. A Description of the Money Market* (1873), chapter VII.

<sup>153</sup> H. S. Scott, *International Finance* (2010), 220.

<sup>154</sup> Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, OJ L 177, 30 June 2006, p. 1-200.

<sup>155</sup> Financial Services Authority (note 125), p. 36ff.

supervision.<sup>156</sup> However, the light-touch approach of the Securities and Exchange Commission, which granted capital relief in exchange for voluntary supervision, transformed unregulated investment banks into “consolidated supervised entity”.<sup>157</sup> This sufficed to meet the “equivalence” standard of the European directive. Mutual acceptance regimes thus impoverished the information available to supervisors.

In sum, the persistence of fragmented regulations and standards in a highly integrated market allowed local parochialisms not only to thrive and persist, but it also gave them more leverage, enabling them effectively to spread beyond the borders of their jurisdiction without including the views of those affected in regulatory or supervisory decision-making. The dangers of such lacks of information and of regulatory competition become all the more clear if one takes a closer look at the Canadian counter-example. Canadian regulators frequently exchanged all necessary information and tried to cooperate, instead of compete. The country mastered the financial crisis remarkably well.<sup>158</sup>

#### **4. Values: The Move towards Deregulation**

##### **a) Deregulation in the Financial Sector**

Amartya Sen argues that values are important in order to bring along through public reasoning the choices which enhance capabilities. Values support the coming along of public reasoning and thereby indirectly strengthen “good” (i.e. objective, impartial) policies. However, Adam Smith stressed already the need to avoid parochialism in value formation.<sup>159</sup> Arguably, this was not the case with respect to the value of deregulation in the run-up to the crisis.

Since about the beginning of the 1980s, with the taking of office of the Reagan administration in the US and the Thatcher government in the UK, neoliberalism and its idea of deregulation

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<sup>156</sup> Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002, OJ L 35/1 of 11 February 2003.

<sup>157</sup> “Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities”, SEC Release No. 34-49830, 20 August 2004.

<sup>158</sup> See below part III.4.b.

<sup>159</sup> Sen (note 1), p. 45.

became the principal trend on the ideological catwalk.<sup>160</sup> These and aligned governments used international organizations, such as the OECD or the International Financial Institutions, to spread the news and push through deregulation in about all policy sectors which related to the economy.<sup>161</sup> The fruits of this move did not take long to ripen. The repeal of Glass-Steagall in the US in 1999, or the light-touch approach in the UK, figure prominently among the examples. Dissenters were put under severe pressure. For example, it took the OECD a long time to accept the more regulated, state-managed Danish approach to labour market policy.<sup>162</sup>

It is obvious that such practices were out of sync with the idea of public reasoning. Disagreeing voices were not heard, leading to an unjustified cherishing of deregulation that glossed over its disadvantages. A tainted discourse exaggerated some values at the expense of others. True public reasoning, by contrast, inherently assumes that there is a plurality of reasons and not only one correct answer.

#### **b) Contrasting Example: Canada's Post-Deregulation Supervision**

The fatal effects of deregulation and other neoliberal politics for financial markets become all the more transparent if one takes a closer look at the contrasting example of Canada. Canada is by no means insignificant as a financial market. Rather, it is characterized by a relatively small number of relatively large financial institutions. Two of its banks are among the 50 largest banks of the world.<sup>163</sup> Nevertheless, its financial sector mastered the crisis comparatively well. None of Canada's banks required government assistance. This success can be attributed to a different attitude in regulation and supervision which was more critical of deregulation and some of its excesses even before the crisis. Canada had learned early from bad experience. In the late 1980s,

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<sup>160</sup> P. Krugman, *The Conscience of a Liberal* (2007), p. 101ff. For the theoretical underpinnings of neoliberalism, see Hayek (note 90).

<sup>161</sup> On the neoliberal underpinnings of GATS and investment arbitration see M. Krajewski, "Neoliberalismus und Konstitutionalismus im Weltwirtschaftsrecht: Entstehung, Krisen, Alternativen", 43 *Kritische Justiz* (2010) 387-396. For the neoliberalization of labour market policies, see N. Noaksson and K. Jacobsson, "The Production of Ideas and Expert Knowledge in OECD. The OECD Jobs Strategy in contrast with the EU employment strategy", *Score Rapportserie* (2003).

<sup>162</sup> See Noaksson and Jacobsson (note 161).

<sup>163</sup> Global Finance Magazine, [www.gfmag.com/tools/best-banks/10619-worlds-50-biggest-banks.html#axzz1QC5Y4ItD](http://www.gfmag.com/tools/best-banks/10619-worlds-50-biggest-banks.html#axzz1QC5Y4ItD) (24 June 2011).

Canada went through a period of deregulation that was substantially similar to deregulation in the US as well as in Europe in the subsequent decade. Pressured by a financial industry eager to meet both the demands of a globalizing real economy and emerging global financial markets, Canada adopted a series of deregulatory measures in 1987. For example, it abolished activity limits for commercial banks and set up the Office of the Superintendent of Financial Institutions (OSFI) as a single regulator, initially a weak and underfunded institution.<sup>164</sup> However, after several defaults in the trust sector as well as the failure of the Confederation Life Insurance Company in 1993-4, Minister of Finance Paul Martin as well as the OSFI opted for a policy change and began with a more prudential approach to financial regulation.<sup>165</sup> As a result, regulation, supervision, but also business strategies of banks differed from the US in a number of important ways.<sup>166</sup> It seems to me that the Canadian approach resulted in better public reasoning in prudential regulation.

First, Canada did not simply implement the minimum capital requirements required by Basel II. Rather, it second-guessed their wisdom in accordance with its regulatory philosophy. As a result, Canada imposed higher total capital ratios on banks (10% instead of 8%), and also a better quality of capital. Thus, even though some Canadian banks did not hold significantly more total capital than some of the banks which got into trouble during the crisis,<sup>167</sup> their capital was better. Canada requires a tier 1 capital ratio of 7%, 75% of which needs to be common equity, while Basel II imposes a 4% tier 1 requirement, half of which needs to be common equity.<sup>168</sup> Tier 1 capital and in particular common equity are the regulatory requirements on which prudential regulators should focus who want to keep their banks afloat in the first place (the so-called going-concern). Only tier 1 capital, i.e. common equity and instruments which can be converted into common equity, can permanently absorb losses, because it never needs to be repaid, can depreciate, and does not require interest payments. Thus, Canada's capital requirements did not yield to industry demands for unfettered expansion, but balanced it with the interests of the public.

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<sup>164</sup> R. A. Williams, "Exogenous Shocks in Subsystem Adjustment and Policy Change: The Credit Crunch and Canadian Banking Regulation", 29 *Journal of Public Policy* (2009) 29-53.

<sup>165</sup> S. Konzelmann, M. Fovargue-Davies and G. Schnyder, "Varieties of Liberalism: Anglo-Saxon Capitalism in Crisis?" *Centre for Business Research Working Paper No. 403* (2010), p. 25.

<sup>166</sup> Overview in T. Porter, "Canadian banks in the financial and economic crisis", *Policy Responses to Unfettered Finance Workshop* (2010), p. 3ff.

<sup>167</sup> L. Ratnovski and R. Huang, "Why Are Canadian Banks More Resilient?" *IMF Working Paper WP/09/152* (2009), p. 7.

<sup>168</sup> *Ibid.*, p. 16.

Second, capital requirements worked better as a regulatory tool, because Canadian banks chose more traditional business strategies and avoided complex funding instruments and investments which mislead the indicators of risk under Basel II. In particular, their funding relied more heavily on deposits and less on wholesale funding,<sup>169</sup> and Canadian mortgage loans require higher creditworthiness, enjoy government guarantees, have shorter maturities, and therefore depend less on securitization.<sup>170</sup> This led to a more transparent market structure.

Third, and most importantly, the regulatory approach of OSFI could be characterized as a paragon of public reasoning. It created a culture of openness, where banks exchange information about their business strategies with their regulators in a timely and pro-active manner. The head of OSFI regularly attends board meetings, is usually well informed about potential problems the banks may face and may tackle them before it is too late. The difference with the light-touch regulation practiced elsewhere could not be greater.<sup>171</sup>

## **5. Intermediate Conclusion: The Intrinsic Relationship between Prudential Regulation and Public Reasoning**

One could easily add further examples which corroborate the view that deficits in public reasoning were an important root cause of the financial crisis. Much of the business of financial regulation was conducted in secrecy. For example, why were the interest rates of the Fed unusually low until about mid-2005?<sup>172</sup> Sometimes, it seems, the lack of transparency comes in handy in order to hide bad, or badly reasoned, decisions.<sup>173</sup> The examples mentioned are among those which have been identified as the principal causes of the financial crisis. It thus seems reasonable to conclude that the financial crisis results at least in part from a lack of public

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<sup>169</sup> Ibid., p. 9ff.

<sup>170</sup> J. Kiff, "Canadian Residential Mortgage Markets: Boring But Effective?" *IMF Working Paper WP/09/130* (2009).

<sup>171</sup> C. Freeland, "What Toronto Can Teach New York and London", *Financial Times*, 29 January 2010, <http://www.ft.com/cms/s/2/db2b340a-0a1b-11df-8b23-00144feabdc0.html#axzz1F6FYxtkO>; Konzelmann et al. (note 165), p. 24ff.

<sup>172</sup> E.g. J. B. Taylor, "The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong", in B. o. Canada (ed.), *A Festschrift in Honour of David Dodge's Contributions to Canadian Public Policy* (2008) 1-18.

<sup>173</sup> J. E. Stiglitz, *Freefall* (2010), p. 143.

reasoning, from supervisory and regulatory practices that did not meet the standard of public reasoning democracies should strive to reach. The financial crisis thus emerges less as the result of democratic choices than as the product of an absence of democratic practices.

On an epistemological level, this conclusion should not be very surprising. There is an intrinsic relationship between public reasoning and prudential supervision. In the end, both public reasoning and prudential supervision are about sound decision-making under conditions of uncertainty. In other words, public reasoning presents itself as the method which any prudential supervisor who is cognitively open to all reasonable views and not ideologically trapped in the belief to know it better than the rest of the world should follow. The more uncertain future events are, and the more serious the damage which might arise from it, the more public reasoning should be practiced.

#### **IV. After the Crisis: Strengthening Public Reasoning in the Regulatory Framework and Supervisory Practice**

The remaining part of this paper is devoted to a more forward-looking analysis of the reforms put into place in the aftermath of the crisis. The story of the absence of public reasoning during the crisis compels a look at the new regulation enacted and the institutional framework set up in the aftermath of the crisis, and also at its normative implications for the practice of legal interpretation. It is certainly both practically impossible and also premature to try to answer these questions exhaustively. I will therefore cursorily discuss some salient aspects of the new regulation (1.) and of the supervisory structure (2.), and then discuss a few respects in which the idea of public reasoning can be operationalized in legal practice (3.).

##### **1. Public Reasoning in Post-Crisis Regulation: Beyond Crude Indicators?**

Given the preceding analysis, it would be desirable if the problems of simplifying indicators and privatized reasoning were mitigated in post-crisis regulation. A cursory analysis of the regulatory

reforms undertaken in the US, Europe, and on the international level renders a mixed picture. While post-crisis regulation is definitely more sensitive to risks that used to be neglected and based on additional, more granular information, and also more transparent, especially with respect to the derivatives trade,<sup>174</sup> sometimes it seems to be limited to the addition of further simplifying indicators instead of switching to more case-sensitive decision-making which is commensurate to the complexity of financial markets. Also, it does not apply the axe to the privatization of public reasoning through the use of internal models.

On the positive side, under Basel III, additional risks will have to be factored into the calculation of minimum capital requirements, in particular counterparty credit risks.<sup>175</sup> Also, an overall leverage ratio provides some safeguard against the shortcomings of risk-weighted capital requirements (even though one might doubt the effectivity of this instrument given that it existed already in the US before the crisis).<sup>176</sup> Off-balance sheet items are included in the calculation of the leverage ratio.<sup>177</sup> In addition, some aspects of Basel III bridge the gap between microprudential and macroprudential regulation which proved to be fatal during the crisis. One of these tools is the new liquidity requirement which might mitigate the spread of distress from one institution to another as a consequence of the rollover risks inherent in wholesale funding.<sup>178</sup> Another microprudential tool is the new countercyclical capital buffer which might dampen the effects of an economic downturn on the availability of credit: Downturns normally cause asset depreciations, which diminish banks' regulatory capital and make it harder for them to extend credit, or even makes them try to deleverage. If regulation imposes lower capital requirements during downturns, one might defeat this procyclical effect.<sup>179</sup> The regulatory framework has thus become considerably more risk-sensitive, allowing for better reasoning in supervision, at least as long as the number of unintended consequences remains low.

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<sup>174</sup> V. V. Acharya, O. Shachar and M. G. Subrahmanyam, "Regulating OTC Derivatives", in V. V. Acharya and M. Richardson (ed.), *Regulating Wall Street* (2011) 367-425, 380.

<sup>175</sup> Basel III, para. 97ff.

<sup>176</sup> Basel III, para. 151ff.; for the US leverage ratio see 12 CFR § 325.3.

<sup>177</sup> Basel III, para. 162ff.

<sup>178</sup> On liquidity requirements see Basel III, para. 34ff. On their macroprudential function see Financial Stability Board, "Macroprudential policy tools and frameworks. Update to G20 Finance Ministers and Central Bank Governors", 14 February 2011, <http://www.bis.org/publ/othp13.pdf>, p. 7f.

<sup>179</sup> On countercyclical capital buffers see Basel III, para. 136ff.; Basel Committee, "Guidance for national authorities operating the countercyclical capital buffer", December 2010.

But in spite of these refinements to capital requirements, they still suffer from the limitations intrinsic to the indicators used for their calculation. Indicators are always an abstraction from a reality which is necessarily more complex than the indicator suggests. Otherwise there would be no need to use the indicator. To counter-balance this effect, Basel III puts much weight on internal stress tests.<sup>180</sup> But again, stress tests are based on models, on assumptions about extreme scenarios, and are therefore only as good as the properties of these models. True public reasoning would require second-guessing these properties. It remains to be seen whether regulators will take stress tests more seriously as a safeguard against the shortcomings of indicators and the detrimental potential of the use of internal models for regulatory purposes.

A promising example in this respect is the Comprehensive Capital Analysis and Review (CCAR) by the Fed.<sup>181</sup> It is a stress test like examination destined to look more closely at the specific risk profile of each institution than the cross-institutional supervisory stress tests required by Dodd Frank.<sup>182</sup> CCAR is a confidential examination. The Fed does not want to publish the results as this might make the test less demanding in order to prevent runs on institutions that fail the test. Nevertheless, CCAR should not be executed in complete secrecy. The fundamentals of the test design should be subject to public scrutiny, just because there are only few standards for stress testing so far. They still need to be discussed. Transparency and open public reasoning are likely to enhance their credibility and quality of CCAR. It will ensure that no relevant position is missing or excluded in the exercise.

## **2. Public Reasoning and Institutions: Will Communication Trump over Fragmentation?**

Like substantive regulation, the institutional structures set up in the aftermath of the crisis render a mixed picture measured by the standard of public reasoning, although the positive aspects seem to prevail. That standard requires some explanation to begin with. Since Sen is not very explicit on institutional questions, I argued that I would complement his approach with Habermas' theory

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<sup>180</sup> E.g. Basel III para. 19 (new stress test requirement for liquidity risk); Basel III, para. 98 (amended stress test requirement for counterparty credit risk); Basel Committee, "Revisions to the Basel II market risk framework", February 2011, para. 718(lxxvii)ff. (enhanced stress test requirements for market risk).

<sup>181</sup> Board of Governors of the Federal Reserve System, "Comprehensive Capital Analysis and Review: Objectives and Overview", 18 March 2011.

<sup>182</sup> Cf. Dodd Frank Act, Section 165(i).



of deliberative democracy. One important element of Habermas' theory is the idea that legislative institutions should have universal competence. He sees this as a requirement of fair and balanced bargaining. The exclusion of certain issues in specific, fragmented fora might lead to power imbalances.<sup>183</sup> On the other hand, I would be less concerned about accurate representation than Habermas, since the aggregate preferences of the members of elected bodies might significantly differ from those of the electorate.<sup>184</sup> Therefore, one should not go as far as to demand a world parliament. Rather, it should be considered sufficient that all relevant stakeholders have a realistic chance that their concerns will be taken seriously in the deliberations and that the body remains cognitively open for new insights. Also, institutional structures should have remedies against national egotisms like non-compliance and externalities through free-riding.

Applying this standard, it seems that the risk of fragmentation has been reduced through the global coordination in the G20 and the Financial Stability Board. These bodies have a broader competence than the more specialized bodies like the Basel Committee. In particular, they complement microprudential regulation with much-needed macroprudential oversight.<sup>185</sup> Also, the fact that the FSB works under the supervision of the G20, which ultimately meets at the level of the Heads of State and Government, ensures that financial regulation does not happen in isolation from other issues, such as the environment, human rights, and trade. Nevertheless, in fact, the focus of the G20 and the FSB has remained limited. Thus far, sovereign debt issues do not figure prominently on their agenda,<sup>186</sup> even though there is a strong relationship between banking and sovereign debt crises. While this problem could be cured in the short run, it seems problematic that the G20 and the FSB only include developed and emerging economies. Certainly, developing states usually do not have equally developed financial markets and therefore are not directly affected by much of the regulation under debate. Nor will they have the expertise and resource to contribute to all meetings. However, worldwide financial conditions also affect their economic and social conditions. For example, financial and monetary stability is an important precondition for foreign investment, low sovereign debts both in the donor and the recipient states are a precondition for successful official development assistance, and financial

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<sup>183</sup> Habermas (note 18), Chapter 4, in particular at p. 222.

<sup>184</sup> See supra note 28 and accompanying text.

<sup>185</sup> Financial Stability Board (note 178), p. 8.

<sup>186</sup> C. Tietje, *Architektur der Weltfinanzordnung* (2011), p. 27.

instruments such as commodities futures might lead to asset bubbles which gravely affect food prices.<sup>187</sup>

On the domestic and supranational level, bodies like the Financial Stability Oversight Council (FSOC) and the European Systemic Risk Board (ESRB) engage in macroprudential regulation. They do not do so in isolation, but have strong links with microprudential regulators, like the ESRB through the European Supervisory Authorities (ESA) in the frame of the European System of Financial Supervision (ESFS),<sup>188</sup> or are directly involved in microprudential regulation like the FSOC which determines which institution is of systemic importance.<sup>189</sup> In light of the idea of public reasoning, their lack of decision-making competencies is set off by their function as hubs for the gathering of information and coordinated deliberation.

One might ask whether the plethora of new agencies and fora does not increase the risk of fragmentation. Indeed, those bodies might disagree and end up blocking each other or sending out contradictory signs. However, the ESFS framework provides for some mechanisms which might reduce such risks. Thus, in case the colleges of (domestic) supervisors cannot agree on a measure regarding the supervision of a particular financial conglomerate with subsidiaries in several member states, the ESAs may first try to mediate the conflict. Ultimately, it has the power to take a binding decision.<sup>190</sup> Besides that, the fact that the colleges of supervisors were not replaced by a single European agency might be advantageous from the perspective of public reasoning – provided that domestic supervisors cooperate in a spirit of fairness and do not simply strive for turf protection. In the optimal case, the colleges might lead to a more pluralistic supervision which is less prone to capture by specific domestic interests, or the interests of a

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<sup>187</sup> For an analysis of the impact of the financial crisis on developing states based on data from the IMF, ILO and FAO, see WEED, *Towards a Global Finance System at the Service of Sustainable Development. Assessing the Development Impact of European and Global Financial Reforms* (2011), p. 7-10.

<sup>188</sup> EU Regulation 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, OJ L 331 of 15 December 2010, p. 1ff.

<sup>189</sup> Dodd Frank Act, Section 113(a)(1).

<sup>190</sup> EU Regulation 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), OJ L 331 of 14 December 2010, p. 12ff., Art. 19(2) and (3) in conjunction with Art. 22(4).

European agency.<sup>191</sup> The interests of states at the (economic) periphery of the European Union which do not participate in many colleges must, however, be adequately reflected in the guidelines and recommendations to be adopted by the ESAs.<sup>192</sup>

By contrast, from the viewpoint of public reasoning one should not be overly concerned about some of the objections to the ESFS which are being raised in scholarly circles. Certainly, certain decisions of the ESA might bind national supervisors and therefore be at odds with the German concept of ministerial responsibility.<sup>193</sup> This is a constitutional principle which concretizes the idea of parliamentary democracy. Accordingly, each administrative decision (with some exceptions like for monetary policy) needs to be answerable to, and subject to the orders of, a minister who is accountable to parliament.<sup>194</sup> However, the idea of public reasoning de-emphasizes the idea of representation and of transmission-belt like relationships of authorization which obviously underly the concept of ministerial responsibility. Thus, deficits in ministerial responsibility could be counter-balanced by advances in public reasoning. Decisions of ESAs which bind national supervisors have to be preceded by deliberations and negotiations within the ESA concerned (except in case of emergencies). It seems difficult to complain about a lack of democratic legitimacy in this respect.<sup>195</sup>

In contrast to Europe, the supervisory structure in the United States has not been changed dramatically. Except for the OTS, all supervisors by and large retain their competencies. It is unclear how harmful competition among them might be prevented in the future.

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<sup>191</sup> Particularly promising from the perspective of public reasoning is the idea that the European Banking Authority may request further deliberations by colleges of supervisors if it considers their decisions inappropriate, cf. EU Regulation 1093/2010 (note 190), Art. 21(2)(3).

<sup>192</sup> E.g. EU Regulation 1093/2010 (note 190), Art. 16.

<sup>193</sup> N. Sonder, "Die verwaltungsrechtliche Kontrolle von Ratingagenturen im neuen System der Finanzaufsicht", in A. Debus et al. (ed.), *Verwaltungsrechtsraum Europa* (2011), forthcoming.

<sup>194</sup> W. Loschelder, "Weisungshierarchie und persönliche Verantwortung in der Exekutive", in J. Isensee and P. Kirchhof (ed.), *Handbuch des Staatsrechts*, vol. V, 3rd edn. (2007) 409-455, marginal notes 37ff. (general principle) and 52ff. (exceptions).

<sup>195</sup> In my view, deliberations and negotiations within the ESFS would be at least as good a means for overcoming deficits in ministerial responsibility as the ratification of the regulations setting up the ESAs by domestic parliaments. The latter option has been proposed by U. Häde, "Jenseits der Effizienz: Wer kontrolliert die Kontrolleure? Demokratische Verantwortlichkeit und rechtsstaatliche Kontrolle der europäischen Finanzaufsichtsbehörden" (2011), manuscript, who argues that the EU should have adopted the regulations under Article 352 TFEU.

### 3. Public Reasoning as a Guiding Principle for Legal Interpretation

The concept of public reasoning may also serve as a guiding principle for the interpretation of legal norms in the practice of prudential supervision. One could think of many potential uses for such a guiding principle in the application of legal norms. Public reasoning could be particularly insightful for the interpretation of broadly drafted, little determined legal concepts, or for the exercise of discretion by supervisors. In the following I look at a few examples from domestic, European and international law.

Although a large part of the German laws and regulations on banking supervision and capital requirements implements European law,<sup>196</sup> they charge the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) as well as the Bundesbank, the competent supervisors, with the application of vague and indetermined general provisions and with the exercise of discretion.<sup>197</sup> Thus, Section 2(5) of the Solvability Regulation<sup>198</sup> allows financial institutions to dispense with the daily calculation of regulatory capital requirements if it puts in place “appropriate” internal risk management tools. Similarly, Section 25a(1) of the same regulation require that financial institutions put in place “appropriate and effective” risk management commensurate to its business strategy. The supervisors need to put flesh on these rather open notions and concretize them in a reasonable way. Public reasoning might guide this effort. For example, supervisors should engage in a process of open deliberation with stakeholders and experts, such as industry representatives, associations for consumer protection, and scientists, in order to determine a general standard of appropriateness for internal risk management. In doing so, they should put an eye on the reliability of indicators and the reductionisms inherent in them. Of course, applications of this standard will have to respect confidentiality concerns of the financial firms concerned.

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<sup>196</sup> See note 154; see also Directive 2006/49 of the European Parliament and of the Council on the capital adequacy of investment firms and credit institutions, OJ L 177 of 30 June 2006, p. 201ff.

<sup>197</sup> The distinction between the interpretation of vague norms and the exercise of discretion is a (epistemologically questionable) peculiarity of German administrative law; see W. Hoffmann-Riem, “Eigenständigkeit der Verwaltung”, in W. Hoffmann-Riem et al. (ed.), *Grundlagen des Verwaltungsrechts*, vol. 1 (2006) 623-714, margin notes 83ff.; H.-J. Koch, *Unbestimmte Rechtsbegriffe und Ermessensermächtigung im Verwaltungsrecht* (1979).

<sup>198</sup> Verordnung über die angemessene Eigenmittelausstattung von Instituten, Institutsgruppen und Finanzholding-Gruppen – Solvabilitätsverordnung, BGBl. I-2006, p. 2926, with amendments, available at [www.juris.de](http://www.juris.de).

As regards the exercise of discretion, supervisors should engage in public reasoning in particular insofar as their decision has far-reaching consequences for the industry as a whole. For example, Section 36(4) of the German Solvability Regulation gives supervisors discretion to attribute a risk weight of more than 150% for shares and certificates of investment funds which involve particularly high risks. Again, the determination of this exceptional level of risk should not be left to grossly simplifying indicators, but might require deliberations involving various stakeholders and experts. Of course, general principles of German administrative law require supervisors to base their discretionary decisions on accurate assumptions.<sup>199</sup> But apart from the right to be heard in case of decisions which infringe the rights of an individual (Section 28 of the German Administrative Procedure Act),<sup>200</sup> it does not provide for a methodology for establishing what the supervisor considers as “accurate”. This is where public reasoning might come in. Also, the idea of public reasoning might incline supervisors to set up meetings with external auditors and the audited firms.<sup>201</sup>

Mutual recognition regimes are a further field of where the idea of public reasoning could be applied in legal interpretation. Whether on the level of the European Union or on the international level, for example under the Annex on Financial Services under GATS, mutual recognition regimes usually require some minimum standard of prudential regulation.<sup>202</sup> Otherwise, supervisors would be unwilling to rely on the decisions of other supervisors. One could argue that a supervisor meets the minimum standard required if it uses public reasoning in the design and application of this standard. On the other hand, public reasoning would require all supervisors which are part of a mutual recognition regime to freely share information among them. In addition, disclosures pursuant to pillar 3 of Basel III should be required to be specific enough in order to allow for meaningful reasoning.

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<sup>199</sup> R. Schenke, *Verwaltungsgerichtsordnung* (16th edn., 2009), Section 114, marginal note 12.

<sup>200</sup> *Verwaltungsverfahrensgesetz* of 25 May 1976, latest version promulgated on 23 January 2003, BGBl. 2003-I, p. 102ff, with amendments, English version available at [www.iuscomp.org/gla/statutes/VwVfG.htm](http://www.iuscomp.org/gla/statutes/VwVfG.htm).

<sup>201</sup> This is proposed by the European Commission in its Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies, COM(2010) 284, 2 June 2010, p. 14.

<sup>202</sup> E.g. the Basel Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishment, cf. Scott (note 153), p. 224.

## Conclusion

It should be clear from the preceding reflections that the idea of public reasoning is different from a simple anti-neoliberal recipe. It is also different from a simple argument for more disclosure. Rather, it leads to a plea for better, more granular information, and for more deliberative decision-making involving market participants, consumers, and government representatives. Its main thrust is procedural, methodological, and not substantive. It might therefore give rise to proposals which cannot uniformly be assigned to either the pro-market or the pro-government side of the great ideological divide in economic policy of the last decades. For example, from the perspective of public reasoning, it would not necessarily be advisable to set up public credit rating agencies, and it would be absolutely contrary to the idea of public reasoning to interfere in rating methodologies. Instead, what is desirable is probably a truly competitive market for transparent credit ratings untainted by special interests. Also, the idea of public reasoning could be invoked against prohibitions on normal (non-naked) short sales because they only delay price adjustments and falsify important market information.<sup>203</sup> Free markets do not only need good information, they also produce it.

On another level, it is my hope that this article corroborates the view that economic development must go hand in hand with democratic reforms (here understood as an increase in public reasoning). Whether on the domestic level or on the international level, new, dynamic markets need institutions and procedures for public reasoning in order to contain the risks arising from them. And even if something goes wrong, like in the crisis of 2007-2010, democratic societies might have the ability to feed the lessons learned into decision-making through public reasoning and to do better next time. True, financial market regulation is not a great example for learning from experience. To the contrary, it rather seems like an eternal repetition of the same mistakes. However, in the run-up to the last crisis, this might have been at least in part the result of the fact that democratic development did not keep up with market integration. We cannot look into the seeds of time, but I do not see any reason that less public reasoning and more authoritarian

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<sup>203</sup> M. Brenner and M. G. Subrahmanyam, "Short selling", in V. V. Acharya and M. Richardson (ed.), *Restoring Financial Stability* (2009) 269-275.

market regulation would do a better job next time. It's not worth doing a control test. Democratic government might not be perfect – but it is probably as good as it gets.

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