Up to this point, this book has been mostly concerned with explaining the market microstructure of securitization, especially in the context of the Global Financial Crisis. But now we need to address the previous regime’s failings and propose a more robust environment for securitization ‘in the public interest’. In the aftermath of almost absolute collapse of the global financial system, ‘[s]upposedly “autonomous” regulatory agencies have been accused of being asleep at the wheel, being exposed to hyper-politicisation, and being used as political tools of blame shifting’. As theory predicts, regulatory changes have therefore come thick and fast since the GFC. However, a debate continues to rage between the post-GFC exhortation for more and more formal regulatory control over the financial industry and the growing fear of the effects on economic growth and national competitiveness, the latter publicized especially by the financial industry in an attempt to roll back regulation or prevent new restrictions.

Before we can address the problem in question, which is what regulation regime would be most suited to securitization markets, we need to put securitization as an industry in the context of what we know, or think we know, about regulation; its strengths and weaknesses. This chapter introduces and discusses the state of the art in regulatory theory and empirical study. An understanding of regulatory theory and empirical evidence may have helped avert the crisis. In the book Guardians of Finance, the authors ask, as do many others, ‘Why did – and do – the public and its elected officials allow regulators to behave in ways that are inconsistent with the public interest?’ Though to me this is only half the question, it turns out that regulatory theory could have provided these answers before 2007, and in the case of the question posed by the Guardian authors, the answer has been around since 1955. Indeed, modern commentators often show a lack of appreciation for the older work on the study of regulation.
Many of the issues we see debated in the press and argued in white papers and industry lobby releases have been well examined in other areas of financial regulation, but also and especially in the study of regulation in general. In this chapter, I explicitly apply both regulatory and financial theory to the problem of regulating securitization.

Financial experts seem both surprised and proud to ‘discover’ that regulation can be so flawed and that markets are not perfect. It is informative that many claim that the textbook theory of regulation is that it is solely intended to address market failures. That may be the accepted normative assessment, but there is a rich literature of regulation expanding on the difficulties with a public interest concept of regulation that is available to academics and practitioner specialists. The two main texts we used in the classroom at the LSE have ample coverage of the problems with the public interest theory of regulation. Chapter 4 of Understanding regulation, essentially the core text, originally published well before the GFC in 1999, devotes just over two pages to the public interest motivation, six pages on public choice/private interest/capture and sixteen and a half pages on alternatives. The chapter clearly points out the weaknesses in the public interest theory, and the difficulties in regulating in the public interest. In fact, it is my contention that one of the problems with pre-GFC financial regulation is that many financial specialists, market observers and financial regulators had not read this literature, or they purposely ignored it.

Financial markets ‘are at the intersection of many different fields of legal rules, including contract law, corporate governance, capital requirements, insolvency, taxation and consumer protection’. Equally, the study and administration of regulation has developed into its own social science emerging from a variety of different areas, including, especially, law, political science, economics and organizational behavior. I strongly suggest that we ignore this body of knowledge at our peril.

By the end of this chapter, we should have a good idea as to the normative approaches available in regulating securitization, and the strengths and weaknesses of the regulatory regimes that need to be considered when designing, implementing and administering rules for securitization markets in this post-GFC environment.

4.1 What is meant by ‘regulation’?

The first problem with using regulatory theory and practice in framing the problems inherent in securitization regulation is that there is far from one accepted definition of what regulation is. Regulation is not a term of art and has a seeming endless and often contested set of meanings. A traditional definition, according to LSE regulation expert Julia Black, assumes that regulation is ‘the activity of (A) controlling (B) by government (C) through a separate