Systemic Crises:

Why We Should Not Bank on Football in the Downturn

I'm trying to help football not go bankrupt. Look at the banks. If they don't stop they'll kill themselves.

UEFA President, Michel Platini (March 2011[1])

1. Introduction

An international wave of banking failures began in 2007, after a long debt-fuelled economic expansion. Aggressive policy response shifted the burden to the public sector, and what began with problems in the US mortgage market is still playing itself out four years later as a fully-fledged sovereign debt crisis. The US has lost its cherished AAA rating and many European governments have been subjected to the full force of market reaction. A new group of European banks has entered the market's crosshairs amidst concerns about sovereign debt exposure and liquidity problems. Although the impact of the crisis has been global, some of the biggest and earliest casualties were UK banks.

During the timeline relevant to discussion of UK bank failures, the sport of football enjoyed an unprecedented economic boom, especially in England. However, this surge in football's commercial fortune masked what Hamil and Walters (2009) termed "an inconvenient truth", using Al Gore's famous phrase. Football clubs in England are serially loss making and are on an unsustainable financial footing, with huge wage bills and crippling debts. Many key football stakeholders continue to ignore the unfolding solvency crisis and resist calls for

[1] "Platini reserved over support for bin Hammam", The Times, 23rd March 2011 (online subscription required)

preventative regulation. Lord Sugar, entrepreneur and ex-Chairman of Tottenham Hotspur, called this the “ostrich effect” in a recent television documentary[2]. To date, failures like those witnessed in the banking sector have been less public and less consequential in football, but have been no less frequent. Warnings on sustainability were also sounded to the banks but these were generally met with the historically familiar cry of “this time it’s different”. Even after numerous bailouts, calls for tougher regulation are being opposed.

Michel Platini set up the theme of this paper perfectly with the above quote. From the beginning of the 2011/12 football season UEFA’s “Financial Fair Play Regulations” requiring football clubs to break-even financially will take effect. UEFA’s intention is to reverse the chronic financial position of much of European football. Football in the UK is in a particularly weak financial condition. The Department of Culture, Media and Sport (DCMS) initiated a select committee inquiry (the “DCMS Inquiry”) into the governance of English football, following the Sports Minister’s assertion in January 2011[3] that “football is the worst governed sport in the country”.

In September 2011, the Independent Commission on Banking, chaired by Sir John Vickers, published its recommendations on the reform of UK banking. Its remit was to suggest measures to promote stability and increase competition. This public inquiry followed the Walker Review into the governance flaws that contributed to the UK banking failures of 2007 and 2008, and the publication of other reports such as the Financial Services Authority’s (FSA) response to the crisis, led by Lord Turner.

[2] “Lord Sugar Tackles Football”, broadcast on BBC2, 8th May, 2011
[3] “Hugh Robertson: Football is worst governed sport in UK”, The Guardian, 11th January, 2011 http://www.guardian.co.uk/football/2011/jan/20/hugh-robertson-football-worst-governed retrieved 30th August, 2011

This paper will tie the findings of these inquiries and reports into a single narrative highlighting the many similarities between the banking and football industries, and explaining why understanding these similarities is important. Although the main focus of this paper will be UK banking and English football, the financial crisis and football's solvency crisis are not confined to these territories, so international references, particularly to the United States, will also be used when appropriate.

1.1 Structure of this paper

This paper will begin by presenting the template of a typical systemic crisis, as described by theorists and economic historians. It will be shown later that the banking crisis and the origins of the football solvency crisis both fit this template.

The banking crisis will be analysed, beginning with the financial de-regulation of the 1980s and culminating in the bank failures of 2007 and 2008. Regulatory and governance failings will be highlighted. Labour market practices will be examined and shown to have contributed to the instability in the banking sector. The consequences of deregulation will be argued to have contributed to the crisis, especially the emergence of large integrated banks and the disappearance of traditional ownership structures in specialist sectors.

Next, the origins of football's solvency crisis will be assessed. The reader will be introduced to the conceptual framework of sport's "peculiar economics", and how it explains financial instability. The fierce debate surrounding the need for competitive balance will be described and it will be shown how this frames the arguments for and against intervention, and contextualises the design of sports leagues. The regulatory intervention of the late 1980s and the 1990s broadcasting revolution will be shown to have been the catalysts for football's "boom years". The impact of the famous Bosman case will be described. As in the analysis of the banking crisis, regulatory and governance weaknesses will be highlighted and labour market practices will be shown to have contributed to financial instability.

The paper will proceed to highlight the many similarities between the two industries. Common micro-economic factors predict instability. Both sectors exhibit a complex ecosystem based on a mix of mutual dependency and competition, within a pyramidal framework. Similar regulatory and governance failings allowed structural faults to stretch each system to breaking point. Theoretical perspectives on regulation will be added, and it will be shown that the DCMS Report and UEFA's new "Financial Fair Play Rules" are neither an overly interventionist response to the game's financial woes, nor a "lurch to the left" conflicting with desirable free market outcomes.

This will produce a final narrative opining that football's key stakeholders would be foolish not to address the game's financial woes and structural weaknesses. Football can learn from the banks' mistakes. Furthermore, the recession that many commentators thought had been weathered may not yet even have begun. The consequences for football could be very serious.

1.2 Aims of this paper

The paper has several aims. It will present the layman with a comprehensive understanding of the banking crisis and football's solvency crisis, each on a standalone basis. By extrapolating from existing research and commentary, a narrative will be constructed arguing that the lessons from the banking crisis highlight the risks associated with football's current financial position and the weakness of its regulatory and governance structures. Therefore, as the first paper to take this approach, it represents a valid and meaningful contribution to the existing literature on football's financial difficulties.

1.3 Research Method

Rather than collating primary data for quantitative analysis, this paper draws on existing literature relevant to the topics under discussion. Given the nature and scale of the issues being discussed this author believes that reference to reliable secondary data is the best method to deliver the paper’s aims.

Saunders *et al* (2009: 255-280) endorse the validity of using documentary secondary data such as books, articles or public records as a research method. For such an approach to be effective, the literature chosen must be reliable, and must be chosen for a particular purpose. Ideally such literature will contain no measurement bias. Furthermore, citing Kervin (1999), Saunders *et al* endorse this form of research if it represents a saving of time or financial resources over compiling and analysing primary data. Lee and Lings (2008: 231-259) concur with these views, and cite Scott’s (1990) requirements for the successful use of documentary sources of data, namely that such data must be authentic, credible, representative and meaningful.

The author selected documentary secondary data based on their prominence and on their relevance to the aims of this paper. For example, the submissions to the recent DCMS Inquiry into football's governance and the final report published in July 2011 (the "DCMS Report") were particularly useful sources of information. The DCMS Inquiry heard submissions from many informed witnesses, often representing conflicting opinions, and the select committee responsible for compiling the final report was drawn from members of different political parties. As such, its findings can be trusted as a comprehensive, independent and objective contribution to the literature. Likewise, academic research into football’s economic situation was selected based on its relevance and prominence. Again, this literature contains conflicting opinions and was not selected based on any bias towards a particular viewpoint.

The paper also relies on published research into the current financial crisis, and crises in general, as well as official publications following parliamentary and regulatory inquiries. The public inquiries are relevant because they represent high-level independent investigation based on expansive access to key stakeholders in the financial crisis. Books selected by the author as reference material were written by economists who had actually predicted the financial crisis to some degree, or by economic historians widely recognised as the key contributors to contemporary understanding of financial crises. A broad consensus has emerged from this literature, and it can be objectively considered to portray a reliable understanding of the key topics. Scholarly research was selected based on relevance and prominence. All research was selected objectively and not based on any natural bias towards this author’s opinions. In addition, the author draws on his experience as a financial professional and qualified investment analyst.

Therefore, this paper’s research method satisfies the Saunders *et al* criteria for effectiveness, and meets Scott’s requirements.

2. How micro-economic theory predicts crises and instability

Instability is an inherent and inescapable flaw of capitalism

Hyman Minsky, 1986

2.1 Financial crises are nothing new. Economists as far back as John Stuart Mill in 1848 have written about instability in the financial sector. The Great Depression of the 1930s followed a collapse in the US banking system. The US Savings and Loans sector suffered a crisis in the early 1980s, and many emerging market banking crises have been witnessed since then. Banking crises followed asset price bubbles in Scandinavia and Japan in the early 1990s. The title of a famous book by Reinhart and Rogoff (2009) is telling: "*This Time Is Different: Eight Centuries of Financial Folly*". Kindleberger's "*Manias, Panics and Crashes: A History of Financial Crises*", originally published in 1978, is similarly descriptive. Here the author describes financial crises as "a hardy perennial" (2009 : 1).

Kindleberger and Aliber (2009: 21-29) deconstructed previous crises into a generic sequential model. The first stage is when consumers become more optimistic about future economic success, and become more eager to borrow. Mill identified that such optimism may be encouraged by regulatory liberalisation or technological innovation. Minsky referred to such events as "displacements", macroeconomic events that transform the economic outlook. An expansion of credit begins as lenders' risk aversion declines and riskier loans are made. Investments previously deemed too risky are now financed. Economic optimism eventually declines after the top of the cycle is reached, and investors become more cautious. Loan losses rise, lenders also become more cautious and withdraw credit, and prices fall further. This describes how banks are "pro-cyclical". They lend too much in good times, and not enough in bad times – when borrowers arguably need credit most. This pro-cyclicality contributes to further rounds of price falls and loan losses.

Mill offered a similar explanation of financial crises in 1848, and observed that prices may overshoot reasonable value by as much on the way down as they did on the way up (Roubini and Mihm, 2010: 44). Kindleberger and Aliber (2009: 29-30) described many actual crises that fitted this template. Minsky believed that the greater the reliance on debt within the financial system, the more unstable it was (Roubini and Mihm, 2010: 82), and this is discussed in section 2.3.

2.2 Konzelmann *et al* (2010) describe John Maynard Keynes' view of the role played by psychology in financial market instability. Refuting the classical economic axiom of rational economic agents making decisions to maximise profit based on full information, Keynes cast doubts on man's ability to possess perfect economic foresight, or even to know enough about the range of possible outcomes to make rational decisions based on mathematical probability. This is echoed in Herbert Simon's concept of "administrative man" making "good enough" decisions rather than "economic man" making completely rational ones (Pugh and Hickson, 2007: 134). Man's rationality was "bounded". In Keynes' mind, there was a profound ignorance of the real economy's long-term trends and financial markets tended to take a short-term view accordingly. This unknowable future fosters "waves of irrational psychology" that lead to swings from wild exuberance to overwhelming gloom. The tendency is for individuals and organisations to believe that periods of prosperity will continue indefinitely, but sharp reversals occur when the system is shocked once this belief falters. Therefore, in Keynes' view, unregulated financial markets were inherently unstable.

2.3 Hyman Minsky gave further insight into the boom-to-bust progression with his *Financial Instability Hypothesis*. Citing his earlier works from 1975 and 1986, Minsky (1992) describes three forms of debt:

- Hedge finance, where the borrower can meet interest and scheduled principal from current income.
- Speculative finance, where the borrower can meet interest payments from current income but needs to refinance to redeem principal, or roll the debt over. Such debt is known as "interest only" debt in today's jargon.
- Ponzi finance, where the borrower cannot even meet scheduled interest payments and he requires asset disposal to service debt. Asset price gains are therefore relied upon.

Minky posited that prolonged stability ultimately breeds severe instability. When hedge finance is the predominant debt model an economy will be inherently stable. The longer that investment appears relatively riskless because of prolonged periods of prosperity, the greater the likelihood of further speculation. Human beings are not rational, value-driven investors; they are naturally momentum-driven investors. As speculation rises, debt units move from the hedge finance category towards speculative finance, and speculative finance units to Ponzi finance. Ponzi units are only viable as long as asset prices are rising. When they start to decline, the whole risk-taking process must reverse. Interest rate rises or a tightening of lending standards will shift borrowers in the speculative finance category into the Ponzi category. The more that speculative or Ponzi debt prevails, the more the economic system will be "deviation amplifying", where initial losses trigger a cascade of further losses. Banks' natural pro-cyclicality is important in Minsky's model.

Minsky also predicted increasing complexity of funding structures during a credit expansion. His analysis is interesting because it does not attribute the negative change in the business cycle to an exogenous event, but instead it is determined by internal dynamics, and a system of effective regulation is therefore required to keep activity within normal bounds.

By building on Keynes' contribution, Minsky is often described as post-Keynesian, perhaps explaining why he was marginalised by the mainstream economists of his time, dominated by the libertarian "Chicago School".

2.4 Much more could be written on the financial system's inherent instability in the face of human weakness, but the essential message is that most financial crises exhibit similar features during their life-cycles and that instability can be dampened by effective regulation. In the next section it will be shown that the current financial crisis can be described within this narrative, and in section 4 that much of the above can be identified in football's solvency crisis.

3. How the banking crisis arose

The enemy of the conventional wisdom is not ideas but the march of events

J. K. Galbraith, 1958

3.1.1 Deregulation

This paper starts its discussion of bank failures with the liberalisation of the financial services industry resulting from the Thatcher Government's "big bang" of 1986. Konzelmann *et al* (2010) describe how the "big bang" addressed perceived over-regulation, London's lack of international competitiveness as a financial centre, and the prevailing "old boys'" network that had perpetuated in the City. The effects of this liberalisation were profound. International institutions moved resources to London, and London's location between Tokyo and New York in an era of advancement in information and communication technology led to a huge rise in London's status. Many long-established British firms were acquired by international banks, and liberalisation of the financial markets led to banks moving away from their core retail and corporate banking models towards more fully integrated commercial and investment banks.

In the US, repeal of the Glass-Steagall act of 1933[4], under the Clinton administration also allowed for the emergence of large integrated international banks. The consequences of the deregulation of UK and US banks are discussed in more detail in section 3.2.6 and 5.3.3. In September 2011, the Independent Commission on Banking's final report (the "Vickers Report") recommended steps to reverse this integration of banks' core functions with their more speculative ones.

[4] In place to avoid a repeat of the banking crisis that led to the Great Depression.

3.1.2 Economic expansion

The early 1990s marked the start of the so-called "great moderation" internationally. The 1970s had witnessed an era of very damaging inflation. However, by the early 1990s the world's major economies had begun to control the problem of inflation and many central banks allowed interest rates to fall, fostering an era of economic growth. The Turner Review (2009) describes the macro-economic roots of the UK's crisis and begins with the fall in both nominal and real interest rates that began from the early 1990s. As borrowing costs fell, indebtedness rose. Household indebtedness rose from c.70% of UK GDP in 1991 to well over 100% by 2007. Credit was extended in increasing amounts to all sectors of the economy and the availability of credit drove up prices of both physical and financial assets. Real estate was one asset class that witnessed large price increases, but financial assets such as fixed-income securities also experienced large price gains. When yields on these securities fell, lenders and investors dropped their credit standards to earn higher returns. The Turner Review describes an ensuing "ferocious search for yield".

3.1.3 Innovation

Accompanying this search for yield was a surge in financial innovation. *Securitisation*, or the creation of securities backed by large pools of assets such as residential and commercial mortgage loans, allowed yield-hungry investors to invest in pools of yield-generating assets, structured to meet investor risk-appetite. The well-known marketing concept of "segmentation" describes how both buyers and sellers can benefit from a product being tailored to meet different pockets of investor demand, over and above simply selling a "one size fits all" product. The securitisation market was simply engaging in a segmentation exercise.

Credit derivatives were developed in the mid-to late 1990s to isolate credit risk from the interest rate risk inherent in fixed interest securities. As foreign exchange risk diminished with the creation of the euro and the benign interest rate environment continued, credit risk acquired new status as an asset class in its own right. As use of credit derivatives became more common, the instruments were fused with securitisation technology to create increasingly complicated debt instruments that fed the huge demand for yield, but which also further increased leverage in the global financial system.

Innovation also occurred in risk management technology. One example was the emergence of the *Value-at-Risk* ("VaR") model, where statistical methods were used by banks to determine reserves against losses caused by market movements. If banks could be "certain" that losses would not exceed a particular amount, say 99% of the time, based on historic price movements, then that amount was required as a buffer against losses. Additional capital could be set aside to meet unexpected losses. However, the historic prices used by the banks as inputs into their models only reflected relatively recent history and ultimately failed to capture the real extent of the risks these banks were taking (Bootle, 2009: 11-12). The use of VaR and similar complicated models became widespread, leading to what the Turner Review describes as "a misplaced reliance on sophisticated maths". Sophisticated maths and models were now also required by investors to understand the complexity of many of the securities being created to meet their demand for yield. Most investors did not have the required infrastructure to assess these risks, so the credit rating agencies' assessment of risk was often relied upon.

3.1.4 Growth of credit and global macro-economic imbalances

As the “great moderation” continued apace, more credit expansion, yield-compression and financial innovation led to more complex forms of securitisation. Ultimately an over-reliance on structured finance as an asset class to provide investor returns, and also as a funding tool for financial institutions had become entrenched. An infiltration of poor quality credit assets into the financial system was underway. If banks were able to finance increasing quantities of poorly-underwitten loans by bundling and selling them to the range of different investors attracted to the yield of these assets, they would continue to originate such loans and continue the cycle. Leveraged loans were also bundled up and sold to investors, creating a leveraged finance boom (although subsequent performance of these loans has proven to be far better than many of the consumer assets that were securitised).

During this cycle various global macro-economic trends emerged, one of the most important being the global imbalances that occurred as China’s economy grew and as the western economies, most notably the US, continued to finance consumption with indebtedness. A huge trade surplus and corresponding savings surplus emerged in China which effectively financed the consumption behaviour of US consumers. A savings glut was also emerging in other dollar-bloc countries, oil exporting countries, and exporters such as Japan and Germany. The demand for US government bonds from this savings market kept US interest rates down, perpetuating the consumption/ indebtedness cycle, the growing leverage of financial institutions and the proliferation of risky and complex securities held by the investment community. Creating these securities generated huge fees for investment banks. The low labour costs prevailing in China fed low prices of tradable goods and international price pressures were low as a consequence. This lack of inflation also allowed for continued low interest rates, especially as it was typically outside central banks' remits to focus on the asset price inflation evident in many financial and real estate assets.

3.1.5 Regulatory arbitrage and the "shadow banks"

A largely unregulated sector had by now emerged as a key investor in credit assets – the so-called "shadow banking" system. The "shadow banking" system describes a network of bank-like entities, including some hedge funds, structured investment vehicles, conduits and other vehicles that tapped into the short-term savings market (mainly in the US, but by no means exclusively) that was awash with cash because of low interest rates and monetary expansion. The shadow banking system borrowed short-term money to invest in these complex longer-term credit assets and exploited the difference between the higher yield on the assets and the low short-term borrowing costs.[5] Bank capital adequacy regulations (discussed in more detail in section 3.2.1) meant that banks were not very efficient holders of these types of credit assets, or even the individual loans that were pooled to create these assets. However, by a quirk of the regulatory regime banks were able to either lend to these new investment vehicles, or provide a promise of liquidity to them if there was an unexpected drying up of the short-term funding market, without having to hold much (or even any) capital. The banks "arbitraged" the regulatory rules. This liquidity risk was perceived as being extremely remote, even non-existent. While "real" banks were subject to regulation, much of the shadow banking system operated outside the scope of the regulators.

The securitisation market was initially welcomed because it allowed banks to originate loans to households and companies, without having to continue holding these loans. Securitisation

[5] This "maturity transformation" is exactly how banks make a living, except banks were strictly (albeit inadequately) regulated. The shadow banks were essentially regulated only by the rating agencies, whose endorsement was required to achieve funding. The rating agencies, who investors and regulators relied upon, got paid to rate these liabilities, and also the securities the shadow banking system purchased. This represented a disproportionate degree of market influence, and a huge conflict of interest.

allowed for these loans to be bundled up and passed on to investors seeking the returns that these assets could pay. Banks' business models had seemingly changed from the traditional "*originate and hold*" to "*originate and distribute*". Likewise, credit derivatives allowed banks to hedge their credit risk with other parts of the financial community. Risk was spread all around the financial markets rather than being concentrated within banks. By retaining the so-called "first-loss" pieces of their portfolios, the originating banks could even retain a meaningful part of the income that these portfolios generated, but with the funding coming from other investors. Everybody was supposed to win. Borrowers got their loans, investors got their returns and banks got rewarded for originating loans.

Instead, the securitisation market eventually passed a tipping point beyond being a useful funding and diversification tool, to a point where it was now channelling bad-quality loans to investors with inadequate long-term funding. Credit derivatives, instead of being risk-mitigation tools, had become widely used to "synthetically" create securitised asset portfolios referencing the same bad-quality loans. This meant that one bad quality asset could be placed around the financial system many times over, with the credit rating agencies stamping their approval. Excessive leverage and huge quantities of bad loans proliferated as a result, and real and financial asset prices rose to unsustainable levels. This is precisely what Hyman Minsky predicted.

Lord Turner (2009) described the use of these instruments beyond their original purpose as "socially useless".[6] The Turner Review observed that this alternative use of credit derivatives sent a misleading price signal to the market. The yield on a credit derivative contract is supposed to reflect the creditworthiness of the borrower referenced in the contract. The demand for these contracts to create synthetic securitisations drove their yields down. As the

[6] Mansion House Speech, September 2009. Transcript of full speech available on http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0922_at.shtml retrieved 1st September, 2011.

growth of synthetic securitisation created more leverage in the financial system, the underlying contracts were signalling a decline in risk. This wrong-footed the watchdogs, who had allowed market signals a role in regulatory policy, and underpinned the mistaken belief that financial innovation had reduced risk.

3.1.6 The "Minsky moment"

By early-2007, rising interest rates had led to sub-prime borrowers in the US having difficulty financing their debts, beginning a cycle of house price declines and mortgage defaults. The performance of securities linked to these mortgage loans began to deteriorate as a consequence. US money-market funds[7], the main providers of short-term credit to the shadow banks, grew cautious and withdrew their funding. Other investors sought to sell their holdings of mortgage-backed bonds and other collateralised debt obligations. The shadow banks simultaneously needed to sell the complex securities they had invested in because their financing was running out, or to meet margin requirements. However, nobody wanted to buy these securities because of their complexity or because of the shift in perceived riskiness, or both. There was a "run on the shadow banks"[8] and prices fell precipitously as a result. The "Minsky moment" had arrived.

The banks that had pledged liquidity to the shadow banking system were suddenly faced with huge calls to advance loans that they had never in their darkest nightmares expected to have to make. Now it had become evident that the banks' real business model was "originate and *pretend to* distribute" (Goodhart, 2008). Depositors in the banks began to worry about the exposure to the assets that the banks were either forced to buy from the shadow banks, or to

[7] Money market funds are essentially deposits, but placed with asset managers rather than banks. As a consequence they are less regulated and do not benefit from an explicit public safety net

[8] A phrase coined by fund manager Paul McCulley at the annual central bankers' convention at Jackson Hole in 2007. For more read http://www.ft.com/cms/s/0/19db6e24-8fff-11dd-9890-0000779fd18c.html#axzz1WgyPOuoT retrieved 1st September 2011.

commit secured finance towards. Some banks were overly dependent on securitisation for funding and when investors in securitised assets withdrew, unmanageable funding gaps appeared. In extreme cases, such as Northern Rock, depositors queued to get their money out, prompting government intervention. Now there was a run on a real bank. Modern accounting rules meant that the falling prices of assets owned by the banking system had to be recognised as losses, and the vicious downward cycle continued.

3.1.7 Ostrich Effect?

Most economic agents were wrong-footed by the whole turn of events, but some notable commentators actually foresaw large elements of what would happen. Raghuram Rajan warned a 2005 gathering of central bankers and economists that the financial system was in danger. In 2006, Nouriel Roubini addressed his concerns in a speech to the International Monetary Fund, and warned of a major problem in the global financial system. Robert Shiller warned of a bubble in US housing. William White of the Bank of International Settlements warned about the systemic risks from asset price bubbles. Roger Bootle warned of a bubble in the UK housing market. Many economists actually predicted at least some part of the financial crisis, though perhaps Roubini and Rajan got the most right among the “Cassandras”. Most of these warnings were met with scepticism, especially by efficient-market protagonists and vested interests.

3.2 *What other factors contributed to the financial crisis?*

3.2.1 Regulatory Policy

It is worth starting with a brief explanation of the international framework of banking regulation. The Committee on Banking Regulations and Supervisory Practices was established in Basel in 1974 in the aftermath of serious disturbances in the currency and banking markets. The central banks (or appropriate banking supervisor, if different) of 27 countries from around the world were represented on this committee. The dominant global framework for banks' capital adequacy (the ability of banks' capital to provide a sufficient buffer against bad debts and other losses) was established by this committee's successor, the Basel Committee on Banking Supervision, in 1988.

Under the first Basel Accord ("Basel 1") the G10 banks bound by its rules agreed to hold capital equal to 8% of their total assets. However, Basel 1 recognised that some classes of loan were riskier than others, and allowed for "risk weightings" to be applied to the nominal amount of loan exposures to different borrower types. For example, a 0% risk weighting applied to credit extended to OECD sovereign governments (so 8% x 0% = 0% capital requirement), a 20% risk-weighting applied to loans to regulated banks in OECD countries (8% x 20% = 1.6%, or $1.60 for every $100 lent) and a 100% risk-weighting applied to corporate credit exposures (so, the full 8%). Although this rightly recognised that having a one-size-fits-all capital requirement was too blunt an instrument, it arbitrarily led to distortions in lending practice. If a bank could hold less capital against a 30-year loan to the weakest bank in the weakest OECD country than it needed to allocate against a 2-year loan to the safest corporate borrower in a stronger economy, there would be an incentive to lend to the riskier borrower, prudent judgment notwithstanding.

With anomalies such as this, and as the financial markets grew more complex on the back of financial innovation, Basel 1 became outdated. The move to a successor framework known as Basel 2 began in 1999, when a consultation process between the banking industry and the Basel Committee was initiated. In 2004 the successor regime's final terms were published and banks were given until 2008 to be fully compliant. Basel 2's guidelines were implemented in the EU by the Capital Requirement Directive, and national regulators were delegated responsibility for domestic regulation and supervision within this framework.

Basel 2 was founded on 3 pillars: minimum capital requirements, supervisory review and market discipline (i.e., allowing the market to send signals about institutions' behaviour and performance). Recognising the arbitrary nature of Basel 1's capital requirements, Basel 2 allowed banks to allocate capital not on the *type* of borrower, but based on its creditworthiness. A highly rated borrower should require less capital than a lower rated borrower. The risk assessment could take two forms. Less sophisticated banks could rely on external credit rating agencies, while more sophisticated banks could develop their own models. Banks could also use VaR methodology to determine the capital required against risks held in trading books. The "misplaced reliance" on rating agencies and "sophisticated maths" that the Turner Review described took hold within the financial markets, an unintended negative consequence of Basel 2.

Another weakness of this regime was that it was pro-cyclical. In good economic times banks held too little capital, increasing the propensity to lend. As borrower creditworthiness deteriorated more capital was required, reducing the incentive to lend. This exacerbated the credit-cycle, as was theorised in section 2. Basel 2 also contained some quirks that allowed for "regulatory arbitrage", where financial engineering enabled banks to reconfigure credit risk into a form that allowed for less capital to be required, without having improved the risk profile.

The Turner Review also criticised the supervisory pillar of Basel 2. More specifically, focus was on the supervision of individual institutions (*micro-prudential* regulation) at the expense of reviewing systemic inter-linkages and the health of the financial sector as a whole (*macro-*

prudential regulation). Absence of a macro-prudential approach was a critical factor in how the financial crisis unfolded.

It might appear harsh to place too much blame on Basel 2 for facilitating the growth in leverage of the banking sector, because it was only fully implemented in 2008. However, Lall (2009) is in no doubt about the regime's culpability. The publication of Basel 2's new rules in 2004, in advance of their 2008 implementation deadline, prompted banks to move towards this framework early.[9] This encouraged more leverage at a time when, in hindsight, it should have been reined in. Lall also identified significant capture of the regulatory process by the leading banks. "By hijacking the Basel process, large international banks effectively rewrote the rules of international capital regulation to give themselves free reign to set their own capital requirements" (Lall, 2009, p4).

In response to the crisis, further amendments have been introduced under “Basel 3” which takes full effect in 2019, recognising that moving from “here” to “there” will take time, especially in the face of strong lobbying by the banks. The key provisions include limiting absolute leverage allowed by banks, improving both the quality and quantity of banks’ capital, and addressing the mathematical and modelling assumptions that proved inadequate under the old regime. More forward looking regulation is encouraged and Basel 3 has taken steps towards a *macro-prudential* and *counter-cyclical* regulatory approach. However, Lall believes that the big banks have maintained a disproportionate influence in the establishment of the revised capital rules. Basel 3 has done little to address regulatory capture.[10]

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[9] Even if one was to absolve Basel 2 of blame, Basel 1 still played a huge role. For example, a committed but undrawn loan to the shadow banking sector could attract a 0% risk-weighting if structured in a particular way. This form of regulatory arbitrage was used on a massive scale by the banks (see sections 3.1.4 and 3.1.5) with disastrous consequences.

[10] In the weeks preceding publication of the Vickers Report, the UK banking sector lobbied hard against the expected recommendations, arguing that reform will hurt the real economy. Critics claim this is spurious and

Lall (2009, p13) adds that the Basel Committee itself lacks transparency and accountability. The Basel Committee is not subject to any mechanisms to hold it to public account. It is answerable only to the G10 central bank governors, many with no responsibility for banking supervision. A panel of supervisory heads was belatedly set up, but it only has advisory powers. Lall cites informed criticism of the Basel Committee as being more concerned with retaining control of the regulatory framework than actually monitoring its activity.

3.2.2 Regulatory ethos

The attitude of the various national regulators entrusted with supervisory review was just as important as the substance of the regulatory framework. This was influenced by political and economic policy. Konzelmann *et al* (2010) posit that it was not the liberal-capitalism model that failed *per se*, but specifically the neo-liberal variety. The financial performance of the banks in the four main Anglo-Saxon economies (US, UK, Australia and Canada) were markedly different despite the pre-conditions to the crisis being shared among these countries. These economies were those categorised by the OECD as the most economically liberal in the world so the divergent performance can not be put down simply to "left versus right" philosophies. Konzelmann *et al* explain how these countries experienced similar economic liberalisation from the 1980s onwards but that it was only in the US and the UK that financial services growth was seen as an important contributor towards overall economic growth. Greenspan's now-famous quote before a committee investigating the crisis describes the US approach to regulation:

self-serving (for example, David Prosser http://www.independent.co.uk/news/business/comment/david-prosser-the-disproportionate-damage-banks-can-do-2346515.html retrieved 1st September, 2011).

"I made a mistake in presuming that the self-interest of organisations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in their firms." [11]

Alan Greenspan's regulatory doctrine placed total belief in the market's ability to provide optimal outcomes. Moreover, the UK and the US both adopted neo-liberal regulatory policies to support London and New York's respective roles as dominant global financial centres. Konzelmann *et al* criticise the Bank of England's role as being both a promoter of the City as well as its supervisor, an obvious conflict of interest that leads to accusations of regulatory capture. The UK's tri-partite regulatory framework was established in 1997 to reduce regulatory capture, but the weakness remained. There was "universal capture of the regulators and the political process by the financial sector" (Buiter, 2009).[12]

It was not liberalism that was the problem in the US and the UK, it was *the neo-liberal variety* of liberalism. In contrast, Australia and Canada implemented an *ordoliberal* regulatory approach, a regime where the state has a strong supervisory role to play by establishing legal and regulatory structures designed to create "order", rather than letting unfettered market forces do their work. This also contrasts to the Keynesian model of direct intervention by the state as an economic agent. Both Australia and Canada introduced a strong, single national regulator that restricted the ability of the dominant banks in each country to expand too quickly or to merge, curtailing the growth of financial services as a contributor to GDP, but providing an environment where a strong regulator could develop a more transparent and open relationship with the banks. In this environment the "clear conflict

[11] "Greenspan: I was wrong about the economy. Sort of." The Guardian, 24th October, 2008. http://www.guardian.co.uk/business/2008/oct/24/economics-creditcrunch-federal-reserve-greenspan retrieved on 24th August 2011.

[12] "Banking Crisis: regulation and supervision", a House of Commons Treasury Committee report, 2009, p11

of interest between light-touch regulation and exercising effective prudential regulation" was avoided.

Bootle (2009 : 16) also identified the policy of supporting London's competitive position as a financial centre and attributed this policy as a major cause of the regulatory ineffectiveness in the UK. Regulation was not so much "light touch" as "soft touch". Lack of regulation was not the problem as there was plenty of it. It just did not work.

3.2.3 Monetary policy regime

The prevailing era of low interest rates has already been discussed. Low inflation allowed for a prolonged spell of low interest rates in most major economies. However, Bootle (2009 : 13) describes how it was not so much monetary *policy* that laid the foundations for the crisis, it was the policy *regime*. Section 2 described how asset price bubbles are a major contributor to financial instability. Monetary policy globally, and specifically in the US, was seen as a tool with which to control financial inflation. In the US, monetary policy also had a remit to promote growth and employment. Containing asset prices was not a concern for monetary policy makers because they were not mandated to do so. Curiously, Alan Greenspan did act on occasion when asset price movements became extreme, but only downward movements. Greenspan warned of "irrational exuberance" in the stock market in 1996, but did nothing about it. Because of Greenspan's prominence and almost cult-like following, his doctrine became established across most of the western economies. Moreover, monetary policy was determined by lessons from the inflation problems of the 1970s. The financial instability of the 1930s was too distant a memory for many policy makers, who seemingly ignored the relatively recent financial crises in Scandinavia and Japan. Ignoring asset price inflation was a major failure of the monetary policy regime.

3.2.4 Moral Hazard

If there's one lesson of financial crises that does get remembered by everyone, it's that when the going gets rough, a lender of last resort will appear to save the day.

Roubini and Mihm (2009 : 71)

Moral hazard describes how the insurance of risk can lead to the unintended consequence of more risky behaviour. In banking there is ample evidence to illustrate how the perception of a safety net, both systemic and within institutions, allowed risk takers to adopt a 'win / win' or at least a 'win / don't lose' mentality. If risky trades worked, traders would get handsomely paid. If the trades failed the downside is minimised because the authorities will intervene. Traders call this a "free option". Following the collapse of the LTCM hedge fund in 1998, the bursting of the tech-bubble in 2000 and the terrorist attacks on September 11, 2001, Alan Greenspan's Fed injected the financial system with huge amounts of liquidity and provided systemic support where it was felt to be needed. As indicated above, it seemed that Greenspan was concerned with downward sharp price moves in asset markets, but not upward ones. Each of the above events had the capacity to cause severe asset price declines but financial instability was minimised by the Fed's intervention. Greenspan's unwillingness to see markets fall became known as the "Greenspan put", (a *put option* being the right to sell an asset at a certain price, a valuable right in a falling market).

Similarly, most western governments have some form of deposit protection insurance in place to support stability. Banks were allowed to grow until they became systemically 'too big to fail'. The unintended consequence was that a risk taking culture was fostered because someone else picks up the bill if all goes wrong. Gains are privatised but losses are socialised.

Discussion of moral hazard can be framed within Minsky's hypothesis, where prolonged stability leads to self-fulfilling instability. The "Greenspan put" encouraged a build up of speculative and Ponzi debt which left borrowers everywhere exposed to restricted credit and falling asset values. Although he was from Chicago, Minsky was thought of as an outlier by contemporaries belonging to the "Chicago School" of economists committed to the efficient-market hypothesis, of which Alan Greenspan was an adherent. Minsky died in 1996 so was unable to say "I told you so" when it all went wrong.

3.2.5 Governance failure

The UK banking crisis prompted a Treasury-sponsored review into perceived corporate governance failings, led by Sir David Walker. The Walker Review, published in November 2009, identified that UK institutions all faced the same regulatory environment, so the differing performances of these institutions was a strong indicator of variance in governance and management standards.

The Walker Review endorsed the current UK-wide governance framework established by the Financial Reporting Council's Combined Code, and the efficacy of its "comply or explain" requirement, but found fault in other areas. Inadequate financial industry experience among non-executive directors (NEDs) was identified as one failing. The importance of effective non-executive directors was highlighted and recommendations were made to ensure that in future NEDs are sufficiently experienced and continuously educated, and should spend more time engaged in their roles than had previously been the norm. NEDs' engagement in risk strategy was highlighted as being particularly important, as was the role of a NED to challenge opinion rather than simply conform.

The Walker Review also felt that some banks' chairmen were not devoting sufficient time to their roles, and identified that some chairmen lacked relevant experience and provided insufficient leadership. Separately, the Turner Review criticised the FSA's Fit and Proper Persons Test as "merely a box ticking exercise" which failed to ensure appropriate expertise in senior positions.

Walker identified the failing of institutional investors to engage sufficiently with their investee companies, particularly in the context of the principal/agent problem, where owners' and managers' interests are misaligned (discussed further in section 3.3.2). The role of remuneration committees and remuneration practices was criticised. Walker recommended better pay disclosure and retention incentives to align interests. Risk committees were also criticised and it was recommended that banks have separate board risk and audit committees. "Risk" should address future business and strategic risk, not just financial risk. Independence of the risk function from business units was urged. Much of the rest of the Walker Review addressed issues such as board evaluation and re-election procedures.

3.2.6 Ownership

Tied in with governance and the principal-agent problem is the issue of ownership. Financial journalist John Kay described how three types of ownership historically prevailed in the financial sector.[13] Commercial banks were typically listed public companies, owned by shareholders. The capital invested provided the security required by depositors to entrust their savings with these banks, and these shares offered the stable yields appropriate to utility companies.

[13] "How trust in finance was carried off by the carpetbaggers", Financial Times, 19th January, 2011 http://www.ft.com/cms/s/0/43552ab0-233c-11e0-b6a3-00144feab49a.html#axzz1Y8b7Icwa retrieved 1st September, 2011

Partnerships dominated the riskier activities such as investment banking and market making. This ensured tight internal control of competence and conduct. Managers' personal wealth was invested in the firm and there was no implicit safety net provided by the taxpayer or monetary authorities.

Mutual ownership was common in retail financial services, and a culture of trust was developed between the mutual society and its customers.

However, this important organisational variety was all but destroyed in the late 1980s onwards as public ownership structures were adopted post-"big bang". There was a belief that public ownership was the model best placed to achieve organisational progress by incentivising management through share option schemes. Any other form of ownership was a relic from another era. However, the consequences were that the benefits of the original ownership structures ceased. The previous utility-like commercial banks now engaged in the risk-taking that the old partnerships used to specialise in, but this time without the alignment of interest created by the partnership structure. The principal-agent problem was introduced and moral hazard infiltrated the system. The implicit taxpayer subsidy provided to retail banks was now extended to investment banking activities. The mutuals that used to provide retail banking services to their local clientele were now under pressure to compete with the new full-service publicly owned banks. As Kay concludes, "business behaviour is the product of the structure of organisation in which it takes place".

Andrew Hill, also of the Financial Times, offered an alternative view.[14] Good management is important, not the ownership structure. Dunfermline Building Society, a mutual, failed during the crisis. Spanish regional savings banks, also mutually owned, suffered severe stresses after the collapse of the southern property bubble. Political pressure was placed on these "cajas" to

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[14] "It's the managers, not the model", 10th May, 2011 http://www.ft.com/cms/s/0/6b8db826-7a80-11e0-8762-00144feabdc0.html#axzz1Y8b7Icwa retrieved 1st September, 2011

grow and lend aggressively. The better performing institutions in Spain were the larger national and international banks, which were publicly owned. However, this author believes that this was mainly due to the macro-prudential regulatory approach taken towards the big banks in Spain, and the corresponding requirement to behave "counter-cyclically". Kay's version holds far more water, but appropriate ownership is not by itself a sufficient condition for corporate success.

It is interesting that not one of the demutualised UK building societies survives in its own right today. Some were acquired by larger institutions before the crisis, some collapsed outright, while some were rescued by larger institutions, both in the mutual and private sector. Northern Rock and Bradford and Bingley, and to a lesser extent, Alliance and Leicester were all examples of the negative consequences of demutualisation.

3.3 Labour market practices

In addition to the above, it is generally agreed that labour market factors were a key contributor to the financial sector's difficulties. Much public energy has been directed towards "banker bashing" in the belief that banking remuneration practices caused the financial crisis, and as senior bankers continue to earn massive incomes while large parts of the country are suffering from the downturn. However, it would be wrong to isolate remuneration practices as the sole cause of the financial crisis. This author supports Rajan's view (2010 : 18) that excessive risk taking was simply a rational response to the many fault lines in the financial architecture, discussed above. It should also be noted that not all bankers are extremely well paid. Administrative employees are not paid like superstars. Even in some "front office" roles such as corporate lending, pay is good but certainly not spectacular. The best paid roles are those in and around lucrative advisory and trading functions. In each of these the role of talent is seen to be critical.

As a talent-driven industry, it can be expected that the ratio of remuneration to income is higher in the upper tiers of banking than in lower margin economic sectors. In order to attract talent, banks incentivise performance with large financial rewards. In good years many bankers get very well paid. In bad years, bankers may get fired in a worst case scenario, but they are not held liable for any share of their losses. Very often they get re-hired elsewhere anyway. Many bankers were retained after the financial crisis because they were the only ones who knew where the metaphorical bombs were buried, and how to diffuse them. If nationalised banks are to be returned to profitability prior to a return to private ownership, star bankers are perceived to be required. This is *moral hazard* again, this time manifested in employee behaviour rather than institutional behaviour. In traders' jargon, many employees are awarded a "free option", where the personal downside to their performance is zero, but the upside can be huge. This asymmetry of outcomes skews risk-taking behaviour.

Compensation information at the major investment banks can be quite opaque but it is generally accepted that a remuneration-to-revenue ratio of 45% to 65% was the range in the build up to the credit crisis. Payout ratios appear to have dropped in some institutions immediately after the crisis first hit, but the amounts were still be very large. Despite Goldman Sachs, for example, paying out a historically low 36% of revenues to employees in 2009, this still amounted to over $16 billion in salaries and bonuses. That figure represents an average of $500,000 for each of the bank's 30,000 employees, though obviously this would not have been evenly distributed.[15] Goldman Sachs, however, is to be commended as being one of the most transparent among its peers in disclosing compensation ratios.

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[15] "Compensation Ratios Become Latest Jargon", Financial Times, 12th February 2010 http://www.ft.com/cms/s/0/fbb017b2-1813-11df-91d2-00144feab49a.html#axzz1XkOqPWIX retrieved 13th September 2011

To curb regulatory restrictions on bonuses introduced since the onset of the financial crisis, investment banks have increased base salaries. However, the improved trading conditions following the dramatic cuts in interest rates, bank nationalisations and recapitalisations only proved to be temporary, and the banks are now lumbered with higher fixed costs while revenues are declining. A recent report estimates that compensation as a percentage of net income at the 20 largest investment banks will increase to 65% in 2011. It could be more than 80% at the investment banking units of UBS, Credit Suisse and Nomura.[16]

3.3.1 Why is bankers' pay so high?

Over and above the "talent-driven" explanation, Bootle (2009: 107-123) offers good insight into how market imperfections in the banking sector's labour market and the principal-agent problem explain high remuneration. Whilst acknowledging that in most cases bankers are generally hard working and clever, Bootle firmly refutes any notion that pay and talent are proportionate. Concentration within the financial services sector is very high. The top ten international banks accounted for 76% of international public share offerings in 1999 for example[17]. The financial crisis has seen some banks disappear and others retreat, further increasing the concentration in the industry today. Barriers to entry are high. With such huge revenues available to be earned it should be expected that new firms would enter the market, paying their employees less and undercutting the existing suppliers. Instead, the current dominant firms are rarely challenged by new arrivals. Reputation and track record are all-important, and to attract talent away from the existing market leaders would require more pay, not less.

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[16] "More Job Cuts Loom for EU Banks With Fixed Pay" Bloomberg, 13th September, 2011 http://www.bloomberg.com/news/2011-09-12/more-job-cuts-loom-for-european-banks-locked-into-higher-pay.html retrieved 13th September, 2011

[17] Group of Ten (1999). Report on Consolidation in the Financial Sector, Page 57. Financial consolidation has got even greater since this report was published.

In addition, the consumer of financial services is not wholly price sensitive. Inferior merger and acquisition advice, for example, is not worth half the price of better advice. The big corporations want the best advice only. There are echoes of Rosen's reasoning here, but in the context of the firm rather than the individual. The very tendency for pay in financial services to settle above the clearing price, and for employees to earn such a large share of revenues in the good times are deterrents to new firms entering the market. This lack of competition and market imperfection is also evident at the "retail" end of the banking market. Loss-leading behaviour, such as offering free current accounts or "buying league table" (see section 5.1.11) also discouraged competition in both retail and wholesale banking .

3.3.2 The principal-agent problem

Just because market imperfections skew the rewards towards a handful of firms does not by itself mean that employees should earn such a large share of these revenues. That this is allowed to occur comes from weak governance, and is a manifestation of the principal-agent problem.

Agency Theory describes where an organisation's shareholders (the owners, or principals) appoint managers (agents) to run the business. However, there is an inherent misalignment of interests. Managers tend to seek maximum personal gain over a short period and this can be at the expense of the longer term gains sought by the principals. A strong Board of Directors' should manage this conflict and shareholders should engage with investee companies (Walker Review, pp 68-90). However, Bootle (2009 : 90-92) describes where most of the shareholders of major financial services companies are institutional asset managers seeking short-term performance gains because they are staffed by portfolio managers on board the same "gravy train" as the bankers. Asset managers' fiduciary responsibilities towards their investors are also compromised by the principal-agent conflict. Roubini and Mihm (2010 : 185) call this the problem of "double agency", or as Bootle describes it, nobody is guarding the guards. Directors are also highly remunerated and are generally not incentivised to police this conflict as well as they should. (The comparison drawn in section 5.1.11 between football and banking with regard to short-term "win maximisation" and the importance of results can be seen in this context.)

Anthony Hilton of the Evening Standard, citing a research report by UBS, described where 231 key employees of Barclays received £554 million in 2010, an average pay of nearly £2 million each. [18] At the same time a comparable dividend of £653 million was paid to the shareholders who had invested £51 billion of equity capital. Hilton opined that

"*the Board, which is supposed to run the business in the interests of its owners, should hang its head in shame at that division of rewards. Those 231 employees could not operate without the shareholders' £51 billion, whereas the shareholders could most certainly find 231 others to run the bank, and for a lot less than the £2 million-plus this lot were paid*".

Citing Warren Buffet, Hilton added that employees like these were confusing their own value with the value of the seats in which they sit.

The Walker Review into banking governance (2009: 68-90) emphasises the importance of institutional investment managers' engagement with investee companies in the context of agency theory.

[18] Polarised incomes? I predict a riot", 31st March, 2011 http://www.thisislondon.co.uk/markets/article-23937154-polarised-incomes-i-predict-a-riot.do retrieved 1st September, 2011. In light of the civil unrest in London in August 2011, Hilton deserves some credit here!

3.3.3 Additional factors determining remuneration levels

Bootle also describes the "ratchet effect" where knowledge of others' salaries leads to a spiral of labour costs. This happens within firms, between firms and has spread across industries. For example, public sector salaries are driven up by the salaries that are earned by individuals of similar ability in the private sector. A further factor is the involvement of remuneration consultants in setting pay levels. Internal remuneration committees often refer to external consultants with better knowledge of remuneration across other firms and sectors. These consultants rarely cause a stir, Bootle observes. This was also highlighted in the Walker Review (pp 106-126).

There has been a recent trend towards the bonus component of bankers' pay to be paid in a higher proportion of company shares than pre-crisis. This has had the effect of driving up salaries in many banks, which was hardly the required outcome of those seeking better alignment. With the latest downturn in banking fortunes, this higher fixed cost is expected to lead to higher redundancy costs in the latest wave of job losses. Although it would appear to be intuitive that aligning employee interests with those of the owners by rewarding performance with stock, it must be recognised that both Lehman Brothers and Bear Stearns, both high profile banking failures, exhibited very high employee ownership. Interests *were* aligned, it was just that nobody fully understood how precarious each firm's position was becoming. It could even be argued that awarding company stock to employees may actually *misalign* employee and shareholder interests. Institutional shareholders hold bank stocks as part of large diversified portfolios so would like to see their banks taking some risks. Employee-shareholders will probably hold proportionally more of their wealth in their bank's shares, so should be more risk averse than the core owners.[19]

[19] "The corporate virtue of bankers", J. Whyte, 16th February, 2011. The Cobdon Centre. http://www.cobdencentre.org/2011/02/the-corporate-virtue-of-bankers/ retrieved 15th September, 2011.

4. How football's solvency crisis arose

4.1 *Football's "peculiar economics"*

Prior to any discussion of football's financial position and its governance, it is useful to include a short introduction to the economic theory of professional sports leagues.

Dobson and Goddard (2011: 1-8) provide a great summary of the classic contributions to the field of sports economics, which began with a paper by Rottenberg in 1956. At this time a major topic of discussion was the reserve clause in baseball employment contracts. When a baseball contract expired a player's team had the option to retain his services for another season, or in other words the player ceased to be a free agent. The effect was to limit players' movement and to create a monopsony in the players market: a player could only negotiate his contract with his existing employer. The reserve clause was defended by the teams because it helped maintain a healthy competitive balance among teams in a league. Without the reserve clause, rich teams would buy all the best players and the uncertainty of outcome deemed necessary for a sports league's commercial success would diminish. If only the rich, big city teams could win, spectator interest would fall. The league's revenues would fall and all teams would be worse off.

Rottenberg questioned this reasoning and argued that free agency would not necessarily lead to a concentration of talent among the richest teams. Professional teams sports differ from other industries where firms would ideally see their rivals eliminated. The "joint production" nature of sports leagues did indeed require competitive balance, but at some point diminishing returns set in when good players are accumulated. At some point, Rottenberg argued, a good player was worth more to poorer Team B than being just another good player at richer Team A. If teams are rational profit maximisers, the distribution of playing talent would be more or less equal, and this distribution would be the same under the reserve clause or under free agency. If a player's capitalised value was worth more to a rival team than his current team, it would make sense for both teams to trade the player's contract. Otherwise the current team would retain the player.

Rottenberg described the reserve clause's main impact as being that players received salaries lower than their capitalised worth to their team. Rents were directed towards teams, not players, in other words. Under free agency rents were directed to the players.

The next major contribution was from Neale (1964) who first articulated the term "peculiar economics". Neale used the example of boxer Joe Louis requiring a strong opponent to maximise his earnings from any given bout. This emphasises the joint production nature of a sports contest, and the requirement for competitive balance between opponents. Sporting competition would therefore appear to be peculiar in that monopoly was less profitable than competition. Neale explained this paradox by distinguishing between sporting and economic competition. In the strict economic sense it is the league, which establishes the framework within which teams jointly produce output, that is the "firm". It is quite common for a single league to supply the whole market because sports leagues have natural monopoly characteristics. An important consequence of Neale's analysis is that legislatures should recognise this distinction when scrutinising behaviour within sports leagues that would be considered anti-competitive in other industries, such as revenue sharing.

Sloane (1971) queried Neale's assertion that the league rather than the team is the "firm". In English football, for example, the governing bodies merely set the rules within which teams can freely operate. The teams, or clubs, retained discretion on all aspects of expenditure. Sloane felt that sports leagues were more akin to cartels which arrive at joint decisions regarding output, but this does not mean that the cartel should be elevated to the status of "firm" in economic analysis. Sloane proceeded to describe the motives of team owners.

Implicit in Neale and Rottenberg's analysis is that sports teams are profit maximisers. This may be a more accurate assumption in US team sports, but in England profit-making clubs had historically been rare exceptions. Team owners were usually already rich and were motivated by factors other than pecuniary gain. Prestige or simple sporting enthusiasm may better explain the motivation to own a football team. Sloane identified other plausible team objectives such as survival, attendance or revenue maximisation, playing success or communal health of the league, as well as profit, as potential motives. Therefore a club's objective could be seen as to maximise a utility function containing factors such as these, with varying weightings. An important consequence is that the case for regulation to override the free market outcome is enhanced if clubs are seen to be pursuing sporting rather than profit maximising objectives. For example, Rottenberg's defence of free agency would break down in this situation.

4.2 Competitive balance and contemporary economic discussion

Competitive balance is like wealth; everyone agrees it's good to have, but nobody agrees how much one needs.

Zimbalist, 2002

Optimum competitive balance remains an empirical question, but when competitive outcomes become virtually certain the beautiful game is dying.

Vrooman, 2007

The need for competitive balance is one of the most contentious issues in sports economics, not least because of its role in influencing league design, in justifying restrictive practices and because of its role in the financial instability debate. The competitive balance argument can be deconstructed into the following simple sequence (Szymanski, 2009 : 76-77):

1. A contest is more exciting the more uncertain the outcome is, and hence more attractive to fans / customers.
2. An uncertain outcome can only be produced if competitive resources are distributed evenly.
3. An even distribution of competitive resources can be produced by sharing resources or by restricting the labour market.

Szymanski argues that (1) above is not strongly supported empirically, except maybe in the long-term. Step (2) above assumes that success can be bought. The evidence of this will be stronger where labour is more frequently transferred (e.g., European football). Step (3) is the rationale invoked by team owners / league owners to justify labour market intervention and revenue redistribution, typically in the US where profit maximisation is a more common objective than in Europe. Szymanski's argument is that the importance of competitive balance to the commercial success of a sports league is overplayed by those agents with an interest in restricting labour.

The uncertainty of outcome hypothesis can take many forms: any given game is more attractive the less certain the expected outcome; a season-long league will be more interesting the more teams that can realistically win; and a league where over the longer term several teams can win the championship is assumed to be more interesting. The hypothesis is supported in the extreme sense of a live TV broadcast being more valuable than a broadcast when the result is known. The hypothesis is essentially intuitive but is it backed up by evidence in professional team sports?

In a classic paper from 2003, Szymanski cites several research pieces that seem to contradict the hypothesis. One example is where demand for tickets was plotted against pre-match betting odds. Demand was maximised when odds suggested that the home team's likelihood of winning were twice that of the away team. Szymanski lists 22 research studies into uncertainty of outcome, and showed that there was little unambiguous support for the hypothesis. Some studies actually contradicted it. However, Szymanski recognises that there may have been design weaknesses in the research and that it is difficult to control for other factors that might affect demand. Zimbalist (2002) says that the heterogeneity of sports environments must be reflected in the research.

Zimbalist draws attention to the multitude of ways of defining competitive balance, saying "there are as many ways of measuring it as there are to measure the money supply". For example, the Blue Ribbon report into professional baseball says that

"*proper competitive balance will not exist until every well-run club has a regularly occurring chance of reaching post-season play*" (Levin *et al*, 2000, p36).

Economists often use the standard deviation of winning percentages, but fans hardly experience the concept in this way. Humphreys' research (2002) reflected his view that the best measures are those which have predictive properties in respect of attendance, controlling for other factors.

Szymanski also uses the subjective example of the popularity of international team sports, which have no redistributive mechanisms and where big regularly plays small. He wrote this in 2003 however, saying that international football was more popular than the club game. This may not be wholly true in 2011. Furthermore, European football has historically exhibited low uncertainty yet has always been hugely popular, although perhaps this overlooks that there are often "leagues within leagues" creating sub-plots to keep customers interested. Szymanski adds that factors other than uncertainty can contribute to demand. For example, fans may even come to watch the visiting team play, the “absolute quality” argument. Whereas some fans turn up regardless, others prefer a strong likelihood of winning, which has led researchers and sports marketers to profile, or segment, potential customers by their motive for attending matches. Zimabalist contends that consumers might be less tolerant of dominance bought by financial strength than dominance achieved through strong management or youth development, the so called “legitimacy” argument.

Hoehn and Szymanski (1999) argue that if competitive balance is really important to fans in Europe then the current structure of European league competition must collapse. Vrooman (2007) adds that a European Super League of big city teams is the natural solution to a perceived problem of imbalance in European football, both inter- and intra-league. After the 1995 Bosman ruling, the invariance principle with respect to labour (i.e., competitive balance is unaltered by free agency) clearly did not hold. Bosman’s impact, combined with the *sportsmen* (win maximisation) and *champion* (financial benefits of playing in the Champions League) effects, has polarized competition throughout Europe and has driven clubs to the brink of insolvency. Dejonghe and Van Opstal (2008) describe how open labour markets combined with closed product markets (i.e., labour can cross borders but national leagues mean that clubs cannot) leads to competitive imbalance by distorting the distribution of labour, and hence either opening up the product market or some closing of the labour market is required to go some way to restoring balance.

The importance of the competitive balance debate, therefore, is its role in optimising league design, and in justifying intervention or regulation.

4.3 Labour market factors in football

We can assume that every healthy man can sing if he will. Perhaps half the individuals in an ethnically homogenous group have the capacity for it to an average degree, a quarter in a progressively diminishing measure, and let us say, a quarter in a measure above the average; and within this quarter, through a series of continually increasing singing ability and continually diminishing number of people who possess it, we come finally to the Carusos.

Joseph Schumpeter, 1949[20]

4.3.1 The economics of superstars

Schumpeter believed that there was an "aristocracy of talent" in every field (Heilbroner, 2000 : 309). In a classic article, Rosen (1981) also described how certain sectors are dominated by a relatively small number of individuals and asked why the distribution of rewards in many industries is highly skewed towards a small number of the most talented individuals. It should be no surprise that better shoemakers earn more than lesser ones, but there are several industries where "superstars" earn vastly more than the lesser performers, even those who are only marginally less talented. Technology is a major factor as it allows for the output of a movie star or musician to be watched or listened to by many without excluding others. The televised output of the world's leading football brands is no different. Rosen's analysis would also explain, for example, how Manchester United may only be a relatively small factor better than a mid-table club in the Premier League, but their popularity and commercial success are many times greater across the globe. Where technology allows for affordable consumption on a mass-scale and where imperfect substitution of preferences exists, an

[20] Quoted by Heilbroner (2000 : 306-307)

environment where star performers can dominate market share and command huge incomes arises.

4.3.2 Football's peculiar labour market: the transfer system explained

To help understand why wages have spiralled in UK and European football it is useful to trace the history of the labour market since the inception of the professional game and how the balance of bargaining power in today's game has shifted almost totally from the employer to the employee.

4.3.3 Feudal times

Professional contracts were established in England in 1885 and were structured around the "retain and transfer" system. At the end of a player's contract the club could decide whether to transfer or retain him. Contracts were of one year term so job security was minimal. Maximum wages were a feature of these contracts so the benefits of ownership lay well and truly with the clubs at this time. Magee (2006) discusses this balance of power in the context of the *structure v agency* conflict theorised in social sciences. The balance of power laid with the structure, rather than the agent, during this period. Magee described the labour / employer relationship at this time as being "essentially feudal". The system was left relatively unchanged until the 1960s when the PFA played a key role in reforming the system to alter this balance.

That a club could retain an out of contract player and prevent him from playing for another club was challenged famously by Eastham in 1963. The Football League argued that without this system the biggest clubs would buy all the best players, distorting competitive balance. The PFA's response was that clubs should offer longer term contracts. Judge Wilberforce ruled that “retain and transfer” was a restraint of trade, and players became free agents at the end of their contracts, although a transfer fee was still required to effect a change of registration. The power still remained with the club therefore, although the *structure-agency* pendulum had swung more to the centre.

In the 1990s, as the game grew from its position as a marginal economic activity into big business, increased regulatory scrutiny was applied to football with regard to competition and labour market legislation. Prior to this, football authorities even felt they were exempt from normal labour laws. In the 1970s, for example, the *Dona v Mantero* case resulted in a European Court of Justice ruling that sporting considerations were a justification for restricting labour mobility, and as a consequence football authorities operated in the belief that quotas and the transfer system were outside serious EU scrutiny.

4.3.4 The Bosman case and its impact on wage expenditure

The Bosman case was the first high profile case of EU intervention to challenge this belief. Out of contract at his Belgian club (FC Liege), Bosman sought a move to a French club (Dunkerque) but Liege refused to allow the move because of concerns about Dunkerque’s ability to pay the transfer fee.

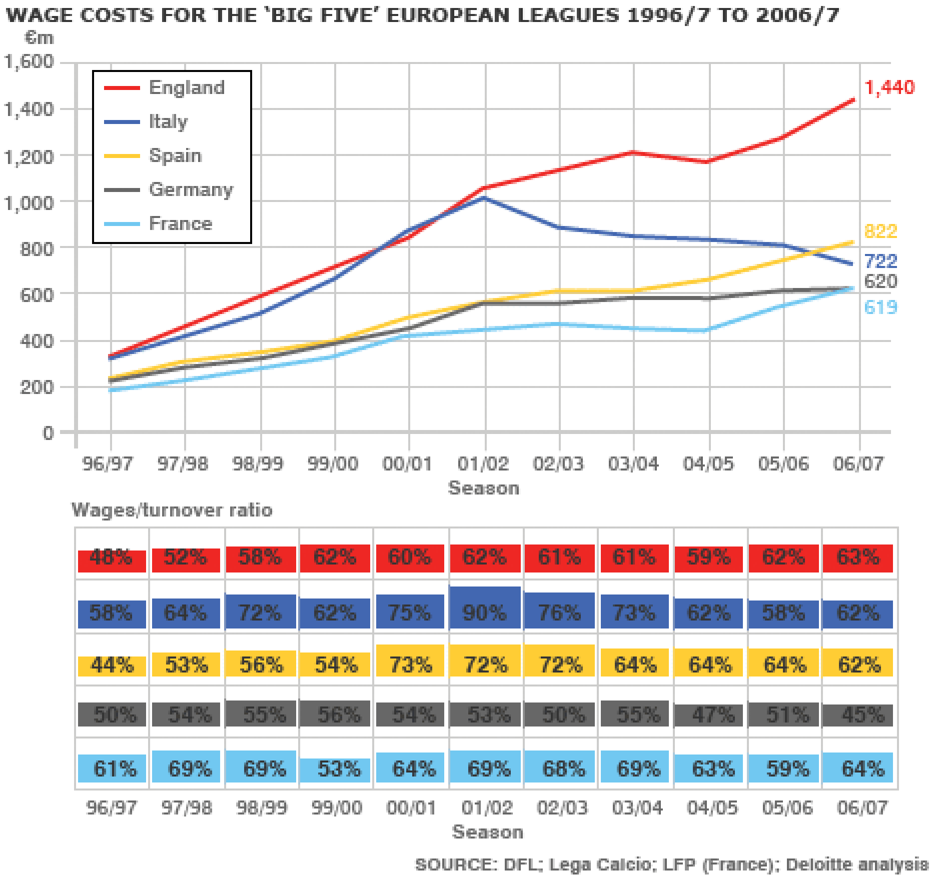
The issues were two-fold: restriction of a player’s right to change club and restriction of cross-border mobility (the transfer mechanism had no specific cross-border restrictions, but was deemed to deter labour mobility). The European Court of Justice ruled that, despite the EC’s tolerance of certain restrictive practices due to sport’s “specificity”, the labour mobility enshrined in the Treaty of Rome was absolute and warranted no exception in the case of sport. Players were now free to move at the end of their contracts and UEFA’s “3+2” rule in place since 1991 was deemed illegal. The *structure-agency* pendulum had now swung to the player, and as revenues were growing rapidly at football clubs, so too did their wage bills.

The direct results were wage inflation, longer-term contracts, a huge rise in prominence of players' agents, and far more labour market mobility. The effects of *Bosman* were predicted by Rottenberg in 1956. Rottenburg, in a precursor to the famous Coase Theorem, argued that labour ownership rights would have no impact on competitive balance. If clubs held the power, the richest clubs would buy the best players. If players held the power, they would play for whoever paid the highest wages. The outcome would be the same, only the recipient of the economic rent would differ. He was right in one respect: rent now accrued to labour rather than capital, and rich clubs bought the best players – and regardless of nationality.[21]

The large increase in revenues in the 1990s went largely now to elite footballers and the classic football pyramid was destabilised. Clubs in the major leagues, especially England's, tended to buy labour from abroad rather than develop talent at home. Furthermore, clubs poached young players and the clubs that trained them received little compensation.[22]

The chart below illustrates both the absolute rise in wage levels across European football, and the rising wage bill relative to turnover since the Bosman ruling in 1995.

[21] Although the "win-maximisation" objective common in European football weakens his contention with regard to the invariance of competitive balance.
[22] Compromises on training compensation and other matters relating to young players were eventually reached between the football authorities, the players' union and the EC.



Source: Deloitte, cited by BBC[23]

Since the above data were collated, Premier League wages have risen further to 68% of revenues in 2009/10, substantially above the 60% level recommended by financial specialists Deloitte.[24] Whilst Manchester United's wage bill was 46% of revenues, many clubs' ratios were higher than the 68% average. Below the Premier League this percentage is even higher still, nearly 90%, although new Football League regulations are addressed towards reducing this.[25]

[23]" 'Record' Premier League wage bill', BBC, 28th May, 2008 http://news.bbc.co.uk/1/hi/7423254.stm retrieved 1st September, 2011

[24] "Premier League wages keep on rising", BBC, 9th June, 2011 http://www.bbc.co.uk/news/business-13679632 retrieved on 1st September, 2011

[25] "Warning over Premier League wages", BBC, 8th June, 2010 http://www.bbc.co.uk/news/10249101 retrieved on 1st September, 2011

4.4 How English football changed since the 1980s

If the seeds of the banking crisis were sewn by the 1986 “big bang”, it is also around this time that this discussion of football’s solvency crisis begins. Conn (2005: 45-54) describes how the structure of the game changed in England from this time. Many parts of English football were in a pitiful state in the 1980s, with declining attendances, dilapidated stadia, hooliganism and other anti-social behaviour dominating the headlines. Disaster had struck in 1985 when a fire at Bradford City’s ground claimed the lives of 56 supporters and this tragedy was followed only days later by crowd disturbances involving Liverpool supporters at the European Cup Final in Brussels. 39 Juventus fans died in a stampede which caused a wall to collapse. This prompted a ban on English clubs entering European club competition. The fact that Liverpool had reached the final and Everton won the European Cup Winners Cup in that season showed that English club football was still competitive and capable of achieving results against top continental opposition, however, so at least some aspects of the game were still capable of meeting high standards. Nevertheless, Conn referred to the 1980s as the “desperate decade” which reached its tragic conclusion with the death of 96 Liverpool supporters at Hillsborough. Government intervention was prompted by the Taylor Report in 1990 which called for dramatic improvements in safety standards by introducing all-seater stadia requirements and other strict safety controls. The Taylor Report advocated government funding to contribute to the cost of the overhaul of football’s physical structures, and also advocated an overhaul of the sport’s governance structures.

Conn adds that the Football League was facing a financial crisis in the late 1980s. Middlesbrough went into receivership while many others were on the brink. Charlton, which had to leave its ground, and Wolves were both within minutes of going bust. Amidst all these problems it was clear that change was required, but as Conn described, there were many interested parties looking to gain in any shake-up. The Football League fired the first shots, by producing a document calling for greater harmony between themselves and the Football Association (FA). The League and the FA often clashed on issues such as the release of players for international duty and, more importantly, distribution of money. Conn corrects the popular misperception that some elite club chairmen, in a visionary manner, identified the commercial potential of televised football. The Football League's document actually identified the changing broadcast landscape as representing "an era of unprecedented opportunity".

The FA saw the Football's League's proposals as a threat, and in an effort to stamp its authority it embraced the idea of a breakaway from the Football League of several of England's most commercially attractive clubs. Conn believes that this was a misjudgment on the FA's part. The Football League was certainly representing its clubs' financial interests, led by the larger clubs' demands for more distributions from the FA's FA Cup and international match revenues. However, it was these same large clubs that were threatening to breakaway and which the FA supported in its 1991 *Blueprint for the Future of Football*. Most of the *Blueprint* was never implemented, except for the creation in 1992 of the Premier League. The rationale for endorsing the breakaway was purely for footballing reasons according to the *Blueprint*. A smaller elite league would place less demands on England's international footballers. However, Conn identified the desire to "smash the Football League" as the real motivation. As it turned out, the Premier League was never reduced to its intended 18 clubs and the Premier League was never held to account for this by the FA. The anticipated flow of TV revenues materialised from the broadcast deal with BSKYB, and the vast majority of the revenues were now no longer shared with clubs outside the top flight, a break with one of the Football League's founding principles. The club versus country conflict was never resolved – it arguably got worse.

The real extent of the impact of the broadcast revolution is highlighted in the DCMS Report. The Premier League's first season in 1992 attracted television revenues of £42 million. This had risen to over £1 billion by 2010, and total turnover had risen from £170 million in 1992 to over £2 billion today. The DCMS Report cites Sean Hamil's description of the seeds of football's turnaround as a "perfect storm": stadium modernisation prompted by the Taylor Report and funded by a 25% subsidy from a levy on pools betting duty, the re-introduction of English clubs into European club competition in 1990, the pay TV revolution that had started to generate more lucrative TV deals, and all at a time when a 15-year economic expansion had just begun. As growth rises, leisure expenditure as a proportion of income rises. The birth of the Premier League allowed the elite clubs to make the most of the circumstances. Three years later came the Bosman ruling which further changed football's financial profile with dramatic consequences. Wage inflation increased and clubs' debts rose to cover the expense.

Therefore, it can be shown that a cocktail of regulatory and technological change and supportive economic conditions were fuelling a boom in English football, accompanied by rising debt levels. At this point, students of Mill, Minsky, Keynes and Kindleberger might have seen enough to identify the ingredients of a financial crisis in the making. These were football's "displacement" events.

4.5 Is football really in a financial crisis?

There is said to be a commercial crisis when a great number of merchants and traders at once have, or apprehend that they shall have, a difficulty in meeting their obligations.

John Stuart Mill, 1848[26]

Lago *et al* (2006) have previously cautioned against use of the word "crisis" to describe the European club football financial landscape but nevertheless recognised that the frequency and

[26] Quoted in Syke's Banking and Currency, 1949.

scale of football's operating losses were a significant issue. In 2008, a UEFA report[27] revealed that

"*just under half of European top division clubs (47%) reported net losses in 2008. 37% of larger clubs and 55% of smaller clubs reported net losses. Nearly half of the clubs that reported losses, 22% of all clubs, reported losses that were significant, equivalent to more than 20% of income. Smaller clubs were more than twice as likely to report significant losses as larger clubs.*"

Those with a relaxed view on football's finances take the view that it should not matter if a club runs into financial difficulty if its owners continue to plug any financial holes, or if rich buyers can be found, although banker and senior football figure Keith Harris has cautioned that the universe of potential mega-rich buyers is finite. "We have been through a time when clubs have been overspending, with ordinary players commanding huge transfer fees and wages. The climate has changed, and takeovers are not going to be the solution to the woes that they may have been two years ago."[28]

One needs to look no further than the recent DCMS Report for a summary of the current debate on English football's financial welfare. The DCMS Inquiry heard many interested parties offer their views on football's financial situation. Greg Clarke, the Chairman of the Football League, was in no doubt about the risk posed to football's future by the levels of debt in the game. Clarke told the inquiry that "debt is the biggest problem. If I had to list the ten things about football that keep me awake at night, it would be debt one to ten. The level

[27] The European Club Footballing Landscape: Club Licensing Benchmark Report Financial Year 2008. UEFA. Page 64

[28] "Era of billionaire bail-outs is over warns dealmaker", David Conn, Guardian 7th January, 2009 http://www.guardian.co.uk/football/2009/jan/07/premier-league-money-keith-harris retrieved 1st September, 2011.

of debt is absolutely unsustainable. We are heading for the precipice and we will get there quicker than people think."

50 clubs have gone into administration since the Premier League began, although only one was in the top flight. Specialist law firm Olswang told the DCMS Inquiry that debt was the problem in every case of insolvency that they had been engaged in, and that debt was an inappropriate financing tool for football clubs.

Professor Richard Giulianotti observed that “there is clear evidence that there is too much debt. A UEFA report last year indicated that, for the 2007/08 season, English Premier League clubs accounted for 56% (£3.5 billion) of the net debt of all European clubs - a grossly disproportionate figure".

Maintaining his sanguine stance on football's indebtedness, Szymanski observed that while English football debts were far higher than any other in Europe, so were the assets. Furthermore, Deloitte estimated the net debt of Premier League clubs at £3.3 billion in 2008/09, against income of £2 billion. By the standard of most businesses this level of debt is not excessive and does not endanger the clubs' collective long term future, in Szymanski's view.

A number of witnesses highlighted the extent to which the financial benefits associated with membership of the Premier League had the effect of encouraging reckless financial speculation. The key issue here is not simply the amount of revenue that a Premier League club can generate, but the growing gap between what a Premier League club and a Championship side can generate. This rising inequality tempts lesser clubs to engage in higher spending to achieve the goal of securing the higher income that promotion to the Premier League can generate. The link between wages and performance is well documented, as is the income gap between the Premier League and the lower leagues. The DCMS Inquiry heard several submissions stating that the gap between the richer clubs and the less rich clubs was aggravating the crisis. The super-rich-benefactor-funded clubs are placing unsustainable burdens on less rich clubs, and this effect flows all the way down the professional pyramid. In the Premier League, Deloitte suggested that this impacts particularly on clubs in the middle - those aiming either to close the gap on the clubs above them or to retain their Premier League status. Hence Portsmouth, despite turnover of over £50 million, was spending over 100% of its revenue on wages when it went into insolvency. In the Championship, the overall ratio was 88% in 2009/10. Approximately one-third of clubs in the Championship reported a wages/revenue ratio of 100% or more. Deloitte, meanwhile, suggested that a 60% ratio is prudent.

4.6 Other issues addressed by the DCMS Inquiry

4.6.1 Governance failure

The DCMS Inquiry heard submissions from key former FA insiders that the FA lacked authority. Decision making was often impossible because of the diverse range of interests represented on the FA's board, and also because of the disproportionate strength of some vested interests. Accusations were made that the Premier League bullied the FA, though the Premier League denied this. Lord Burns remarked that "the present board, is as if with the Financial Services Authority, we had a controlling interest by the banks whom they are regulating". A lack of independent directors was cited as a major failing in the FA's governance. The DCMS Report urged reform of the FA's Board and wider Council.

4.6.2 Possible interventions to restore financial rationality

The DCMS Inquiry heard UEFA describe the rationale for its Financial Fair Play Regulations ("FFPR"), primarily the need to restore rationality to football's finances. In addition to having to meet certain minimum infrastructural, sporting and human resource criteria, clubs seeking to enter UEFA competitions must now comply with financial rules requiring clubs to live within their means. Over a rolling three-year period, the first monitoring period beginning in season 2011/12, clubs must break-even financially, although certain youth development, infrastructure development and community outreach costs are exempted from the overall expenditure calculation. Commercial transactions must be recorded at fair market value to avoid wealthy owners manipulating revenue figures. Early warning triggers such as wages rising above 70% of revenues prompt deeper scrutiny by UEFA of business plans. Overdue football-related or tax liabilities will represent a breach of the rules. Possible sanctions range from closer UEFA scrutiny and influence over a club's financial affairs to an outright ban on entering UEFA competitions. Recognising that few clubs would currently satisfy these new rules UEFA will allow leeway for contractual costs relating to legacy commitments, and has carved out acceptable deficits in the early years. The DCMS Report welcomed the UEFA FFPR and felt that they would have every chance of improving English football's finances. The Football League recently voted to introduce similar rules.

The inquiry also heard German stakeholders describe how their system works. A strict licensing system in Germany has meant that no insolvencies have been witnessed since 1963. The cornerstone of the German system is a process where the clubs are continuously subjected to financial monitoring and must comply with a range of financial measures. The result is profitability, community linkages and competitive parity. Ownership rules requiring members to own at least 50% plus one share prevent mega-rich benefactors purchasing clubs as they have done in England. Many supporters groups backed this rule in their submissions to the inquiry. However, Szymanski pointed to research querying the success of the German model. Szymanski also highlighted German clubs' lack of success in Europe, and lower levels of public transparency than exist in England. A DCMS Select Committee visit to Germany and interviews with stakeholders revealed that the German system has weaknesses. It was felt that some big German clubs received preferential treatment. Despite the scrutiny applied to clubs' affairs, many are not well-run and are in financial difficulty. However, the DCMS Report accepted that debt levels are lower and cases of financial stress are fewer. The Report was appreciative of the manner in which clubs and the licensing authorities work with each other, rather than against each other.

The Premier League argued that changes to its rule book effectively represented a licensing system, but UEFA disputed this, claiming that the Premier League's self-regulatory model only amounted to an incomplete or "divided" system. The inquiry heard that implementing German rules would be practically harder in England because of the separate powers of the Premier League and Football League, whereas there is only one league body in Germany. The DCMS Report concluded that the FA should administer any national licensing system, with the leagues left to concentrate on other matters.

4.6.3 Ownership issues

Many witnesses to the DCMS Inquiry offered the view that football clubs should be seen as community-rooted assets and not regular businesses that seek to maximise profits, echoing Sloane's famous observation. Historically, club ownership in England reflected this. The inquiry drew on Conn's account of the changing ownership landscape to put the current situation in context. Conn (2005: 110-113) described how the FA's long-standing Rule 34 ensured that football clubs were not owned purely for financial gain. Rule 34 restricted director pay and dividend distribution, and disallowed personal gain from asset disposal upon insolvency. This led to certain benefits but also discouraged commercial enterprise. Stadia were dilapidated and the problems discussed in section 4.3 were at least partially rooted in the lack of commercial foresight resulting from Rule 34. The dividend limit was relaxed from 5% to 15% in 1981 but Tottenham Hotspur was the first club to circumvent Rule 34 when it listed on the stock exchange in 1983. A holding company was formed to own the football club and Rule 34 was blatantly flaunted, as the holding company was not a football club subject to the FA's jurisdiction. Many clubs followed suit and similarly avoided Rule 34's restrictions. The FA never objected and there was now no limit on what football club directors could pay themselves and take home as a dividend, other than having to answer to their shareholders. When Southampton FC "reversed" into a local property company, one of its board members was Chairman of the FA (Conn, 2005: 111), illustrating the FA's casual disregard.

Hamil and Walters (2010 : 17-36) detail the history of football clubs' conversion to plc status, and in most cases their subsequent reversion to private ownership. 22 clubs listed on various exchanges, but only 8 remain on the stock market. Only Arsenal and Watford have seen price rises since flotation (as at 2010). In hindsight, it appears obvious that football clubs were just not suitable to dispersed stockholder ownership, not least because of the absence of the profit-maximisation motive. Revenues and intellectual property values may have been rising, but losses were also mounting. Anticipated profits never materialised. Disclosure details, relating to planned transfer activity for example, eroded competitive advantage and compliance costs were material. The only gainers from listing on the stock exchange were the legacy owners who profited handsomely. [29]

More recently a clear trend towards foreign ownership has emerged. The DCMS Report observes that over half of the Premier League's clubs are now owned by foreigners. Witnesses offered several weaknesses associated with this trend. There was no natural alignment of interest with the development of the broader national game. Foreign owners were unfamiliar with the complexities and nuances of English football. The traditions and

[29] On 16th August 2011 Manchester United announced plans for a part-IPO on the Singapore Stock Exchange.

community roots of clubs might not be appreciated by foreign owners. There were reputational issues, an extreme example being Thaksin Shinawatra's politically-motivated ownership of Manchester City and his reckless financial management. Foreign ownership also made the task of judging whether an owner was "fit and proper" more difficult. Manchester United and Liverpool were examples of inappropriate leveraged buy-out structures being used to assist foreign owners in acquiring their targets.

The inquiry heard that domestic owners were also causing problems, with witnesses offering examples of unscrupulous asset-stripping. Portsmouth FC's ownership changed four times in the year preceding the club's collapse into administration. This prompted criticism of the scrutiny applied to these owners as it appeared that passport checks were about as far as the vetting process went. Special ire was reserved for Leeds United, whose ownership until recently was not even known.

Christian Muller described how German rules ensured that members owned at least “50% plus one share” of their clubs, whilst acknowledging that clubs were moving towards more commercial ownership. This, along with the strict licensing and business appraisal process imposed by the German regulator, meant that the long-term interests of the clubs were protected better, and stronger community links were maintained. The system works well because it has popular backing. This theme was continued by representatives of various English supporters trusts who gave examples to the inquiry of clubs being managed for the benefit of their communities and being managed for the long-term. Some clubs were rescued from insolvency by supporters’ trusts and new finance was raised. The key to the success of supporter involvement is strong governance, which may not be guaranteed by supporter representation on a club's board. If supporters only hold a minority stake it is harder for any major influence to be exerted. Supporters may not have sufficient financial acumen or business skills to ensure successful management, although this view was dismissed as "patronising" by one witness. Some specialist law firms suggested appropriate legal models of ownership, such as Community Interest Companies, which provide transparency and prevent asset stripping.

The DCMS Report was generally supportive of the case for supporter ownership and urged the football authorities and government to make it easier for supporter-led initiatives such as Supporters Direct to influence the governance of football clubs. The DCMS Report was also heavily critical of the scrutiny historically applied to ownership issues by the football authorities.

This author believes there is an interesting parallel with academic research into corruption at organisations such as the International Olympic Committee. Applying an agency-theory perspective to governance failure at the IOC, Mason *et al* (2006) cited the lack of a strong principal with a claim on the IOC's residual revenues as a root cause of the self-interest and opportunism that prevailed in the 1990s. It has often been asked "who owns football?". The "agents" that run the elite tip of the football pyramid for their own purpose are not accountable to many of the game's diverse and important stakeholders. The lack of a strong and indentifiable stakeholder in football allows for opportunism and poor financial management, and in football's case, the destabilisation of the rest of the pyramid. The need for a strong regulator in this regard was identified in 1997 by Hamil (1999: 23-39) yet the problem has not been addressed, and has become more deeply entrenched.

4.6.4 Football Creditors Rule

THE DCMS Inquiry was particularly alarmed by the controversial Football Creditors Rule. This longstanding rule requires that insolvent clubs must discharge all football-related creditors in order to re-enter competition. This effectively subordinates the tax authorities and local service providers to football clubs and footballers. The rationale was to ensure that footballers got paid and that other football clubs did not suffer systemic consequences of another's failure. However justifiable in principle these aims might have been historically, the modern commercial environment renders the rule morally and economically indefensible. Supporters Direct observed that the Football Creditors Rule effectively provided a public sector subsidy to insolvent football clubs. This was exemplified by Gary Pettit, a licensed insolvency practitioner, who argued that the rule was anti-competitive, and should be amended if not removed. He observed that, in the case of Portsmouth "the football creditors are in the region of £30 million (to be paid in full) with other creditors receiving approximately 16 pence in the pound". Olswang similarly opposed the Football Creditors Rule, as did a number of supporters' trusts.

The DCMS Report concluded that the Football Creditors Rule should be abolished. It represents a "post facto" preferential treatment of creditors that would be illegal in the run-up to the insolvency of any other business, and there was a compelling systemic argument against it because it provides a "safety net" in the event of failure. In other words it introduces moral hazard. If the football authorities do not take the initiative themselves, and HMRC loses its legal challenge to the Football Creditors Rule, it was recommended that the Government considers introducing legislation to abolish it.

4.6.5 The Role of Agents

Whilst recognising the benefits of player representation, the DCMS Report urged tighter regulation of agents due to their capacity to create conflicts of interest and their ability to inflate transfer values. In 2009/10 agents earned fees of over £67 million relating to Premier

League transfers alone, a drain on the game's resources.[30] The DCMS urged the FA to lead the move for tighter agent regulation and expressed disappointment of FIFA's abdication of responsibility in this regard.

[30] Source: http://soccerlens.com/premier-league-teams-fluff-67m-on-agents-fees/62370/ retrieved on 1st September, 2011.

5. Further discussion

Previous sections have examined the financial instability and structural weaknesses in both banking and football. This section will tie the most important points together to enable comparison. These will be discussed under the following headings:

- Economics
- Governance and Regulation
- Labour markets

5.1 Economics

5.1.1 Both industries enjoyed a prolonged economic tailwind and growth was catalysed by the classic "displacement" events of regulatory change and technological innovation. This fitted the typical build up to a financial crisis described by writers such as Mill, Minsky, Kindleberger, Reinhart and Rogoff, and John Maynard Keynes. The subsequent irrationality and increased indebtedness also fitted the classic template of a financial crisis.

5.1.2 In light of Greg Clarke's concerns about unsustainable debt, this author believes that few UK professional football clubs would exhibit a financial condition fitting Hyman Minsky's definition of "hedge finance" described in section 2.3, a sustainable debt model followed by clubs like Arsenal. Most would, at best, exhibit a "speculative" financial structure and, at worst, be in Minsky's "Ponzi" category, leaving clubs vulnerable to tightening credit, falling revenue or a weaker transfer market. Selling footballers to service debt is not a sustainable business strategy, and there are limits to how much ticket prices can rise in a low-growth or recessionary environment.

Vested interests would argue that football has always weathered recessions well. However, this might be making the same mistake as *value-at-risk* models led banks to make. To predict the severity of possible losses, these models made forward projections based on historical data. However, these data were not extracted from periods when the financial system was in as Ponzi-like a condition as it was pre-crisis, so they under-estimated potential losses. If football is in a similarly overstretched condition it may be far more vulnerable to recession than ever before.

Mapping football clubs' financial health to Minsky's debt models would be an interesting research topic in its own right.

5.1.3 Both industries boast “peculiar economics”, not least their common tendency towards instability. There is an elegant parallel between the co-dependency of football clubs with each other, and banks with each other. Although banks aim to maximise market share, they also need each other. Banks lend to and borrow from each other on a daily basis in the inter-bank market; they hedge their foreign exchange and interest rate risks with each other; they form syndicates together to lend large amounts to companies. Bigger banks need smaller banks to share in the risk, and smaller banks need bigger banks to originate loans that they could never source by themselves; prior to the financial crisis it was common for banks to provide medium term funding to each other and, to a limited extent, invest in each others’ hybrid-capital instruments. Some bankers even get rewarded based on “league table”.

Although this paper aims to highlight the systemic similarities of each sector, it is clear that one football club's failure is unlikely to cause the whole system to come crashing down, as the failure of a large universal bank could (and also with huge wider economic consequences). Banking dwarfs football in its importance to the economy, but the joint-production similarity remains valid. One bank could not efficiently supply the whole market, but one "league" of dominant firms could, to a large extent.

The analogy holds up in other contexts too; for example, where excessive risk taking at the top of the system is likely to cause similar behaviour further down the system (see section 5.1.4), which clearly happens in both industries.

There is even a quasi-*lender of last resort* in football in the sense that clubs are protected against unpaid transfer instalments from clubs in financial trouble. The Premier League can re-allocate broadcasting distributions from the debtor to the creditor, mitigating counterparty or systemic risk.

5.1.4 Both industries exhibit a similar pyramid structure. Banking in the UK consists of dominant banks with national and international reach, banks of national reach, and banks that serve mainly their local communities. English football boasts clubs that are dominant domestically and competitive internationally, clubs that compete at the top level nationally, and clubs that mainly serve only their local region.

Out-of-control banks at the top of the banking pyramid can induce instability further down the pyramid. If HBOS and RBS were earning substantial returns on equity that the market believed were sustainable, others had to keep up (see section 5.1.11).

Because of open-leagues with promotion and relegation, the financial excess of those at the top of the football pyramid also tempt those below to engage in unsustainable financial practices. This lack of sustainability is particularly evident in the Football League. There is also a cross-border element to this effect. Overspending in European football's larger leagues also affected smaller leagues like Scotland's where the Old Firm needed to spend to compete in European competition, and arguably also for UK television viewers. This further polarised an already unequal domestic competition.

It may be argued that that the high returns on equity earned by over-exuberant banks in the big markets put pressure on banks in smaller financial centres like Ireland and Iceland (bad regulation and political cronyism notwithstanding). In an international market for capital these smaller banks could not have been seen to be underperformers.

5.1.5 Football operates in a “closed-product market” (clubs can only compete in their own country except for certain internationally structured competitions) and an open labour-market. The financial rewards for clubs that qualify for Champions League football make qualification for other clubs harder, raising the barrier to entry for others, and increasing competitive and financial disparity. International labour is drawn to those clubs paying the highest wages. Limited access to qualification and high labour costs in football allow for only an elite few to be genuinely competitive outside their home markets.

Banks *can* establish globally, subject to permission from national regulators. However, the cost of being competitive internationally, especially the high labour costs required in international investment banking, create a high-barrier to entry to all but a few dominant firms. Brand and reputation also impede competition, and international talent is drawn to the major financial centres. Therefore, an open labour market and a semi-closed product market exist in banking. Bootle’s industry concentration and its consequences (section 3.3.1) can be seen in this context.

5.1.5 Brand equity also creates a high-barrier to entry in each industry. A new football club cannot just establish and become successful in a big UK city; nor can a new bank. “Fan equity” and “brand equity” mean customers are sticky in each industry. Customers are also sticky in banking because of the complicated procedures involved in moving accounts.

5.1.6 Competitive balance is considered an essential theoretical ingredient in a sports league's success, although there is considerable debate as to how strongly this hypothesis holds in real life. The quality of research design has been queried in this area. It would appear that competitive balance may not exist to a great extent in many quarters of European football.

The Vickers Inquiry addressed the perceived lack of competition in UK retail banking, although some of the evidence questioned the strength of the empirical link between customer outcomes and concentration.[31] One paper reviewed by the inquiry queried the quality of the research design. Some believe that that retail banking is more than adequately competitive and no regulatory intervention is warranted [32]. This debate seems to mirror the competitive balance debate in football.

Vrooman (2007) explains how lack of competition is causing instability in European football. Bootle (2009: 111-112) describes how lack of competition in banking contributes to systemic instability, via the labour market. This theme (inequality as a cause of instability) is continued in section 5.1.13.

5.1.8 Confidence is an essential ingredient in each industry. Confidence in the integrity of results is essential for a football league's commercial success. Confidence in the health of a bank and its system is essential for it to operate. The same can obviously be said of other industries, e.g., air travel.

5.1.9 Failure in each industry is often subsidised by the taxpayer, albeit in a vastly different quantum. Taxpayers bail out banks because of the systemic and social consequences of failure. The Football Creditors Rule subordinates the tax authorities. This rule is in place in

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[31] Interim Report, April 20112, Annex D, pp 167-171

[32] For example, Andrew Hagger, "Changing banks is not like switching energy providers", The Independent, 9th April 2011 (http://www.independent.co.uk/money/spend-save/money-insider-changing-banks-is-not-like-switching-energy-providers-2265498.html retrieved 1st September, 2011).

recognition of the systemic risk among football clubs. As a junior creditor HMRC only gets paid a fraction of its dues upon a club's insolvency. Football clubs regularly run arrears in settling their tax bills so the State unwittingly provides an overdraft facility to football clubs.

This is a clear example of *moral hazard*. The cost of failure is an insufficient deterrent in each industry: in banking because of taxpayer bailouts and other interventions of last resort, and also because of remuneration practices; in football because key stakeholders ignore financial peril in the belief that a rich buyer is always out there, and because the taxpayer can foot the bill in administration. The DCMS Report's description of the Football Creditors Rule as a "safety net" identifies this.

To correct this, Lord Sugar believes football clubs should have to reconstitute and start again in the junior leagues in the event of administration;[33] Lord Turner wants an environment where big banks can be allowed to fail in an orderly manner (Turner Review, p7).

In his submission to the DCMS Inquiry, Stefan Szymanski opined that there was no obvious sign of market failure in football, and hence no case to justify intervention. This author believes that the presence of moral hazard is at least one example where this claim is wrong. The taxpayer-provided overdraft which gets written down in administration is a clear case of costs being externalised, a classic market failure.[34]

5.1.10 The principal-agent problem manifested itself in each industry. Banking even suffered from the "double-agency" problem where its nominal principals were compromised in fulfilling their fiduciary obligations to the real owners. As a consequence nobody policed the principal-agent conflict effectively, and a culture of focusing on short-term results was

[33] Opinion voiced in "Lord Sugar Tackles Football", broadcast on BBC2, 8th May, 2011.

[34] Market failure is an economic term describing where the market fails to provide an efficient allocation of resources. The Treasury Green Book 2003 (pp 51-54) sets out the possible case for government intervention if certain examples of market failure occur. Moral hazard and externalities are among two of these examples.

fostered. The quarterly banking reporting seasons almost resembled a sporting contest where it was important to beat a rival.

In football, the lack of a strong “residual claimant” also allows short-term results to dominate financial stability as an objective.

It could also be argued that stakeholders ignored over-heating because in both industries the *customers* were enjoying themselves too much. Football fans were getting a better product and consumers were given copious amounts of credit by the banks to finance their spending, and house price rises made homeowners feel good.

5.1.11 With such a focus on results, banking publications publish weekly league tables across the many business categories (M&A, syndicated loans, international bond and equity underwriting etc.). Being high up in the league tables was an important marketing tool to attract new business and talented staff. Many managers were rewarded on league table position so banks often engaged in loss-making transactions to “buy league table”. This is similar to Sloane’s famous “win maximisation” observation in football.

A long-serving Lloyds Bank employee told this paper's author that they were lambasted by shareholders for not being as adventurous as HBOS (which collapsed, and was rescued by Lloyds and the State) and how his senior management struggled to reconcile risk standards with league table ranking. For "Lloyds shareholders" one could easily substitute "Arsenal supporters", although Arsenal is unlikely to ever enter into a shotgun marriage with a failed rival.

5.1.12 Both industries witnessed a rush towards stock market ownership by previously individually or mutually owned entities. This seems to have been a big mistake. Anticipated returns never materialised and many of these privatisations were either reversed or ended in tears. The only winners were the legacy owners of football clubs, who retained control of their businesses while cashing in on false expectations of return, or the “carpetbaggers” who cashed in on mutuals’ reserves whilst unleashing unreasonable market expectations on their companies. Pressure on regional players to expand and compete with national or even international players proved too much for some.

5.1.13 Rajan (2010: 21-45) identified income inequality in the US as one of the most important factors fuelling the housing bubble which caused so much damage to the international financial system. In a chapter titled "Let Them Eat Credit", Rajan pointed to the role played by political pressure to increase home ownership among lower earners in creating a flawed financial architecture. Lower earners subsequently borrowed more than was sustainable to keep in touch with the higher earners in society. Much of this debt was financed by foreign capital flows from trade surplus countries.

There is a broad parallel here with the financial problems in English football. An inflow of foreign capital (for example Roman Abramovic) that fuelled expenditure placed pressure on less wealthy clubs to overspend to keep up. In football the foreign capital mainly financed the rich, not the poor, but that is just a detail. Rising inequality was singled out as a major cause of instability in football by observers such as Ian Watmore at the DCMS Inquiry.

5.1.14 The first major financial crisis came to a head in English football when ITV Digital collapsed in 2001. Many Football League clubs had already spent their contractual future revenues and collapsed into administration when they failed to materialise. These clubs suffered the consequences of depending on a single trade buyer for a large part of their output.

There are some parallels with Northern Rock here. “The Rock” had developed a huge over-reliance on the wholesale funding market, and in particular the securitisation market - in essence a single trade buyer. When this market suddenly dried up, Northern Rock was left high and dry.

This prompts the question of whether English football has made any contingency against BSKYB's insolvency or regulatory change prompted by, for example, the Karen Murphy case or a corporate scandal, however remote they may seem. The Lloyds insurance market might be worth exploring to hedge these risks. The DCMS Report recognises one of these risks and has urged the UK government to lobby to maintain territorial sale of broadcasting rights.

5.1.15 Since the inception of the Premier League, top flight football clubs have collectively failed to break-even (Hamil and Walters, 2009). It would be interesting to determine if certain banks have collectively broken even over the same period.

5.1.16 It is argued (e.g., Hoehn and Szymanski (1999) and Vrooman (2007)) that the current structure of European football does not represent a natural equilibrium, and that a form of European Superleague might be the optimum free market approach. Separately, in his submission to the DCMS Inquiry, Szymanski argued that it is important not to confuse insolvent football clubs with an insolvent system.

In a recent Leading Article, the Financial Times claimed that it is important not

"to confuse the banking system with the viability of extant banks. That is a recipe for disaster - nowhere more than in the absurd combination of monetary union with banking systems that remain national".[35]

[35] Misdiagnosing the eurozone's banks", Financial Times, 23rd August 2011 http://www.ft.com/cms/s/7592ca60-ccc3-11e0-b923-00144feabdc0,Authorised=false.html?_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2F7592ca60-ccc3-11e0-b923-00144feabdc0.html&_i_referer=http%3A%2F%2Frereferyned#axzz1Y8b7Icwa (subscription required).

Is the Financial Times calling for a Superleague of European banks? Is Professor Szymanski contributing to financial editorials?

5.1.17 So far discussion has presented two parallel industries. In fact high-finance and football have actually also met head-on. Man United's LBO and hedge-fund financed "PIK notes", and subsequent high-yield bond offering was one example. Another was Liverpool's LBO, where a long-term asset was financed on a short-term basis by two banks no longer solvent at the first point of refinancing (RBS and Wachovia). Liverpool could be argued to have been engaging in a "maturity transformation" exercise of its own in this respect – exactly what banks do to earn a living.[36]

Arsenal's financing structure was far more sensible, a long-term mortgage loan "wrapped" by Ambac, a specialist US insurer that collapsed because of its exposure to CDOs. Arsenal was still reliant on the London housing market avoiding a slump, so can be considered lucky that the monetary response to the crisis underpinned property prices. Hedge funds have been established to own footballers' transfer rights. Securitisation played a part in Leeds United's downfall, as did Leeds' conversion to plc status. In fact, both were also contributors to Bradford & Bingley's downfall. Securitisation and stock market flotation obviously do not mix well in Yorkshire.

5.1.18 Barclays accepted investment from Qatar's sovereign wealth to avoid part-nationalisation. Qatar was also rumoured as a buyer of Manchester United. Not everyone can rely on a Sovereign Wealth Fund to solve their debt problems.

5.1.19 Manchester United recently signed a commercial deal where DHL paid to have its name on the club's training kit, a far less visible association than sponsoring the club's main

[36] Maturity transformation is the term used to describe where banks convert short-term liabilities into long term assets, i.e., they borrow short but lend long. This leaves the borrower heavily exposed to refinancing risk, and is why valuable assets such as houses are financed by long-term mortgage loans.

jerseys. Whilst the club's commercial department undoubtedly deserves plaudits for such a deal, it reminds this author of the latter stages of the credit boom. With bankers seeking new sources of fee income and new products to satisfy investors' quest for yield (or value), complex products such as CPDOs made a brief experience.[37] At this point the credit market was being squeezed to its pips by the bankers, and the endgame was coming into sight. Are sports marketers now starting to squeeze the commercial market to its pips, or is there plenty of juice left? The match day consumer might now be close to "demand destruction" point at many clubs.

5.20 Hamil believes that virtue should bring its own reward in football.[38] A banker friend of this author criticises neo-liberal economists for encouraging a system where "reward is its own virtue". Excessive spending on success in football supports this humorous twist on a well-known expression.

5.2 Governance and Regulation

5.2.1 The international regulatory framework was at least superficially similar in each industry. In banking, the global framework is set by the Basel Committee, the Capital Requirement Directive implements the Basel rules across the European Union, and national supervision is entrusted to one or more domestic supervisors. In the years preceding the financial crisis, a tri-partite regulatory regime operated in the UK, with the Bank of England, the FSA and the Treasury each playing a role.

[37] No description of a CPDO will be offered here, but these were extremely complicated and esotheric instruments.

[38] Verbal submission to the DCMS Inquiry, 8th February 2011. http://www.publications.parliament.uk/pa/cm201011/cmselect/cmcumeds/c792-i/c79201.htm retrieved 15th September, 2011

In football, FIFA establishes certain global rules, such as those governing the transfer system; UEFA organises European team competitions and co-ordinates its member organisations. Domestic regulation is the responsibility of national associations; the FA, the Premier League and the Football League operate a tri-partite regulatory regime in England. There may be no great consequence in this, but it is an elegant similarity.

Lall's criticism of the Basel Committee's lack of transparency and accountability, and its pre-occupation with maintaining control rather than monitoring effectiveness could just as easily be directed at FIFA, or the Premier League. Some might level this criticism at UEFA, although this author is among those who believe that UEFA is well-intentioned in its efforts to restore rationality to football's finances (see section 5.2.3).

5.2.2 In those countries where a neo-liberal or "light-touch" financial regulatory philosophy prevailed, banking failures were most prevalent. The objective of maintaining London's position as Europe's dominant financial centre was achieved at the expense of better regulation to protect its banks. The US and the UK were among the worst hit in the financial crisis, whereas other English speaking, economically liberal countries like Canada and Australia escaped the worst of the crisis because of sounder regulation, of the ordoliberal variety. This arguably came at the cost to their banks of international market share.

The Premier League applied a light-touch (did it apply any touch?) to its member clubs in pursuit of being Europe's dominant league. Germany and France's leagues exhibit sounder finances but at the expense of regular European success.

While the FA has allegedly been bullied by the Premier League, the FSA was toothless in standing up to the dominant banks.

Lord Turner's ideal model where a pro-active regulator "leans into the wind of irrational exuberance" stands little chance when the regulator is also the industry's cheerleader.[39] In each industry the regulatory process was captured by the leading UK / English participants. The Basel Committee was also captured by the industry.

5.2.3 Banking problems were rooted in favouring micro-prudential regulation over macro-prudential regulation. English football certainly is not regulated on a macro-prudential basis; it is arguable if it is even regulated on a micro-prudential basis.

In response to the financial crisis a series of national and international measures have been proposed. UEFA has introduced a credible response to the financial instability at the top level of football. However, the onus is on national regulators to implement something similar to cover those clubs not competing in Europe. To date, the Premier League's response has been to require tax payments to be up-to-date and to take a closer role in supervising clubs' finances. It has also tightened its Fit and Proper Persons test and has prohibited third party player ownership. The Football League recently announced it will adopt the UEFA FFPR model. If the Premier League does not follow suit it will become a virtual closed league.

This paper was tempted to describe UEFA's FFPR as Keynesian in approach, by prescribing intervention. However, the FFPR are better described as representing an ordoliberal approach, because they are simply an attempt by a prudent regulator to impose order into an otherwise free market. This is an important distinction. Free market protagonists might balk at overly interventionist measures, but the ordoliberal nature of the FFPR does not represent a "lurch to the left".

The FFPR certainly address regulation on a macro-prudential basis, and with the break-even assessment being applied on a 3 year rolling basis, they could be argued to dampen pro-

[39] House of Commons Treasury Committee (2009). "Banking Crisis: regulation and supervision." p16.

cyclicality (by reducing the immediate need to sell players upon relegation, for example). In a business with international systemic linkages this is an important step. To completely avoid the pitfalls of pro-cyclicality this paper would like to see consideration given to a form of performance-related pay being made mandatory in players' contracts. A basic salary with bonus linked to central distributions from broadcasting and league position, and certain commercial revenues would automatically stabilise clubs' finances upon relegation.

By insisting on clubs not having overdue liabilities to other football clubs and, especially, to tax authorities, the FFPR recognise systemic risks and address moral hazard.

5.2.4 Manchester City's recent lucrative stadium naming rights deal with a company closely associated with the club's owners prompts accusations of the "regulatory arbitrage" activities engaged in by the banking sector when trying to sidestep regulatory rules. Regulatory arbitrage was a major cause of the growth in shadow banking activities that created instability in the global financial system. UEFA needs to be vigilant and strong in the face of similar attempts by the football industry.

5.2.5 Both the Walker Review into banking governance and the DCMS inquiry into football's governance identified failings relating to insufficient input from independent non-executive directors. Boards of Directors in both industries failed to meet their responsibilities with regard to risk management, financial trusteeship and stakeholder representation.

5.2.6 Much of the discussion on reform of the banking sector has focused on the distinction between "utility" banking, where banks provide the money transmission, deposit taking and lending functions essential to the smooth running of a capitalist economy, and riskier banking such as securities trading and underwriting, derivative trading and investing capital on a proprietary basis. Prior to the financial crisis, some banks were posting returns-on-equity close to 30% p.a. (Alesandri and Haldane, 2009). This can only be achieved by taking too much risk, being too highly leveraged or by overcharging customers (or all three). If banks were thought of as utilities alarm bells would have been ringing aloud.

Many, including this author, believe that banks should be made to focus on utility-like financial services, as they did pre-“big bang”, and be capitalised by investors seeking the stable returns offered by traditional utilities. The riskier activities should be separately capitalised, with asset managers and hedge funds deploying private capital to generate returns for investors with a different risk appetite. This may be difficult to achieve, and it may be difficult to determine where "utility banking" ends and "casino banking" begins, but it sets up the following comparison: football clubs also exhibit strong utility-like features. This is a more nuanced expression of the view of football clubs as community assets that many submissions to the DCMS Inquiry articulated. Like utilities, football clubs are natural monopolies. Should Newcastle United fold, supporters would not simply substitute consumption by attending Sunderland’s games. They are also an essential public service in many towns and cities. Traditional utilities are regulated so that the consumer is protected against unscrupulous pricing behaviour, continuity of service is ensured[40], and that safety standards are maintained. Of course, football is not as important as water or electricity so this argument requires a liberal definition of “utility”.

In Germany, football ticket prices are affordable, clubs must prove that their business plans are viable, and ownership is controlled to mitigate excessive risk taking and to maintain community roots. Whilst English football grounds are now undoubtedly safe, on every other measure football would appear to fail the utility-regulation test. If the nuclear power industry was regulated like English football or UK banking, you would leave the country.

[40] Water consumers in Northern Ireland might have something to say on this point.

Acclaimed author and financial commentator, Nassim Nicholas Taleb, furthers the utility argument to scathing effect by claiming that opportunists were allowed to “hijack” a public utility, and calls for banking regulation to address this.[41] It does not require a great leap of the imagination to apply Taleb’s criticism to the football industry.

5.2.7 In each industry “Fit and Proper Persons” tests were insufficient, and were merely box-ticking exercises. Only criminals were prevented from holding key jobs in banks. Football apparently had no such scruples.

5.2.8 Rewarding failure or overlooking unethical behaviour links both industries. Conn (2004: 115-123) described how Sir Dave Richards landed the role of Premier League Chairman, one of football’s most senior administrative roles, after leading Sheffield Wednesday to substantial losses, and engaging in share trading practices that would be illegal in a public company. Peter Ridsdale landed key executive and advisory roles after leading Leeds United to financial disaster. The City and Wall Street are awash with examples of traders or managers who landed attractive roles or received massive payouts after overseeing large losses. Whole banks were given massive injections of public capital after woeful corporate performance. Goldman Sachs recently won a lucrative mandate from Greece to advise on its debt restructuring, despite having earlier assisted Greece in concealing the true scale of its borrowings.

5.2.9 Good management and governance can steer a firm through bad regulation. The flipside is that good regulation is a necessary but insufficient ingredient for stability. The Walker Review emphasised the need for independent thinking, experience, risk assessment in relation to strategy, and strong leadership. Arsenal and HSBC are held as examples of UK

[41] "How bank bonuses let us all down", Financial Times, 24th February, 2009
http://www.ft.com/cms/s/0/fa89be08-02aa-11de-b58b-000077b07658.html#axzz1WWI7R4pJ
retrieved 30th August, 2011

businesses that can still be well run when peers were being reckless.[42] Nevertheless, when the boom years were underway HSBC lost billions on its investment in Household Finance Corporation in the US. Arsenal bought Francis Jeffers!

5.3 Labour markets

5.3.1 There are not many industries where key employees earn such a large share of revenues as the football and banking industries. Key employees in each industry often earn more than the most senior managers, which is also relatively unusual. Talent-driven industries will usually exhibit higher pay-to-turnover ratios than, say, manufacturing or retail, but the systemic consequences of remuneration practices in banking and football are what set these industries apart.

The same quest for talent is obviously evident in both football and banking. Football's "win maximisation" objective and post-Bosman economic rent distribution have led to rapid wage inflation, and many clubs spend more on wages than their revenues can sustain. When one club overspends, it tempts others to do the same in order to remain competitive.

As in banking, many footballers' pay-outs are asymmetric to the pay-out to owners. When football clubs in the UK go into administration, players continue to get paid in full ahead of other creditors because of the Football Creditors Rule. In most cases, footballers at relegated clubs continue to earn the incomes fixed when the club was playing at a higher level, and earning more revenues. This exacerbates financial instability. Bootle's description of market

[42] Arsenal's model has come under recent scrutiny, with accusations that it has failed to react to the emergence of Manchester City and Liverpool's re-emergence, both following external investment. Governance processes have also drawn the criticism that too much power is placed in the hands of one man, whose opinions go unchallenged. For example, Alex Fynn, http://www.cityam.com/sport/what-s-gone-wrong-arsenal-and-wenger-insider-gives-his-view retrieved on 31st August 2011.

imperfections and the "free option" concept explain the causes and dangers of remuneration practices in banking.

5.3.2 This paper is hardly pioneering in comparing the labour markets in the two industries. Gillian Tett of The Financial Times described how financial services salaries rise due to fears of key staff defecting to a rival.[43] Tett acknowledges the benefit of football's transfer system in this context, as fixed-term contracts contribute to contractual stability. That said, "pay me more or I'll quit for a rival" demands are also common in football as evidenced by Wayne Rooney's successful stand-off with his club in early 2011. The case for the football industry's defence of the transfer system has been described above, despite its inherent restrictive nature. Tett argues that the goal of achieving systemic stability in banking would justify some degree of restriction in the banking industry, as contractual stability could dampen pressure on remuneration increases. This resembles Dejonghe and Van Opstal's argument for partial closure of the labour market as a solution to financial instability in football (see section 4.2).

Bootle's "ratchet effect" is also clearly evident in football.

5.3.3 Tony Jackson of the Financial Times suggests that banking employees are only acting rationally by treating their employers opportunistically.[44] Before the "big bang" in the late 1980s many of the dominant firms in the City were private-partnership stockbrokers who paid as little as possible by way of fixed salaries and rewarded staff with a share of profits.

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[43] "Banks can learn from football", September 10, 2009. http://www.ft.com/cms/s/0/489b60fe-9e2a-11de-b0aa-00144feabdc0.html#axzz1YmRt9ssL retrieved 1st September, 2011.
[44] "Investment banks are victims of their own footloose culture", 17th January, 2011 http://www.ft.com/cms/s/35491124-2194-11e0-9e3b-00144feab49a,Authorised=false.html?_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2F35491124-2194-11e0-9e3b-00144feab49a.html&_i_referer=http%3A%2F%2Frereferyned#axzz1Y8b7Icwa (subscription required)

Low profits meant low remuneration but high profits meant higher bonuses. Now that these firms have been subsumed within larger stock market listed enterprises, such fluctuations in the distribution of residual income are no longer palatable to their principals. Banks make wholesale redundancies in bad times and are re-hired by other firms during the next upturn. This practice has turned bankers into mercenaries, hardwiring opportunistic culture into the employment market.

Jackson also echoes the Hilton / Buffet question (section 3.3.2), by asking whether the business that a star banker brings in is attributable to that individual's talent, or whether the brand of his employer is the critical factor. The employee may not have built his client relationships if he or she was employed at a lesser institution. This also poses an obvious question in the football business: to what extent are star footballers worth their rewards on the basis of their talent, and how much is attributable to their clubs' status? Does labour earn more than its fair share of the revenues at the expense of another key factor of production, capital, which owns the brand or platform that employs them?

5.3.4 The "Wimbledon effect" is clearly evident in both industries. Although the main event takes place in the UK, many of the key players (both firms and individuals in the financial services sector) are foreign. Figures relating to the nationality of investment bankers would be hard to come by, but any walk around a City trading floor would yield a convincing confirmation of this phenomenon. Konzelmann *et al* (2010) explicitly refer to this effect.

5.3.5 It was pointed out in section 4.3.4 that one of the results of the Bosman ruling was the marked increase in prominence of agents, incentivised to encourage their clients to move in search of better pay. There is also a proliferation of head-hunters and recruitment consultants (of varying degrees of repute) in the finance industry, with lucrative fees available to those who can encourage employees to move to another institution. Although there is no transfer system in conventional industries, the structure of bankers' pay, with an annual bonus paid shortly after the publication of full year results, leads to a *de facto* transfer window. As most banks report results during the same few weeks of the year with bonuses paid out afterwards, March and April are the most common months for bankers to switch jobs. It is more difficult and more expensive for the "acquiring" institution to poach staff outside of this window, so such moves are much rarer.

5.3.6 A further feature shared by both industries is the dominance of male employees in senior posts. According to a report by Financial News, cited by City A.M. newspaper, only 17 out of the 220 most senior executives in London's investment banks are women, and 8 of these are in "softer" roles such as human resource management.[45] Excluding these, only 9 of the 212 executive positions surveyed by the report (4.2%) are held by women. The report cites 11 banks as having no female board representation. FTSE 100 listed banks' boards are only 9% female, versus 12.2% across the whole FTSE 100, and only 2% of the senior executives at these firms are female, according to a Treasury Committee report "Women in the City", published in March 2010. The Davies Report (February 2011) recommends that women should account for 25% of directorships in the UK by 2015, so female under-representation is clearly a general corporate phenomenon, but just worse in finance than in broader industry. It must be acknowledged that testimony to the Treasury Committee highlighted that many women were not seeking board roles in financial services because of other lifestyle choices, so it is not fair to portray the situation as wholly "demand driven". Supply factors are also important.

[45] "Only 4.2pc of top bankers are women", City A.AM, 29th March, 2011 http://www.cityam.com/news-and-analysis/only-42pc-top-bankers-are-women retrieved on 25th August, 2011

Among the drawbacks of female under-representation is a tendency towards "groupthink" because there are fewer challenges to board decisions provided by those with a different perspective. Sir Charles Goodhart, formerly of the Bank of England, claimed in his evidence to the Committee that higher female board representation could have made the whole crisis less likely. The final report believes that this is going too far, but opines that something is wrong when over half of the population is under-represented by such a degree. One verbal representation to the committee described a male dominated and testosterone-driven culture.[46]

Without digging too deeply into football's governance, it seems apparent that similar issues prevail. At a Football Against Racism in Europe (FARE) conference in Amsterdam in early 2011, William Gaillard of UEFA declared that "the absence of women as high-level administrators and leaders in the game is inexplicable".[47] UEFA President Michel Platini added that "we must a find a way to break the glass ceiling preventing women from reaching positions of responsibility within our organisations".[48] The conference discussed the lack of minority ethnic groups and women in administrative and coaching roles. A research paper by Loughborough University set the agenda for discussion. The Loughborough report identified a culture of "institutional discrimination", and documented the "under-representation" of women in executive positions. It found that "more than 99 per cent" of European football's senior administrators, at clubs and football associations, are middle-aged to elderly white men. The report concluded there is a "deeply masculine culture, and overt and casual sexism

46 "The City needs to put more women in senior jobs, says MPs' report", The Guardian, 3rd April, 2010 http://www.guardian.co.uk/business/2010/apr/03/city-needs-senior-women retrieved 1st September, 2011.

47 "Seminar spotlights institutional discrimination", UEFA, 2011. http://www.uefa.com/uefa/socialresponsibility/antiracism/news/newsid=1586623.html retrieved 4th September, 2011

48 "UEFA Appoint Woman to Executive Committee", CAFE, 2011. http://www.cafefootball.eu/2011/06/17/news/UEFA-appoint-woman-to-Executive-Committee.aspx retrieved 4th September, 2011.

inherent within the men's game".[49] In June 2011 UEFA began to address this weakness within its own ranks by appointing the respected Karen Espelund to its Executive Committee.

[49] "Sky bench 'pre-historic' Keys and Gray", Irish Times, 25th January, 2011. http://www.irishtimes.com/newspaper/sport/2011/0125/1224288248867.html retrieved 4th September, 2011.

6. Conclusions

The summer of 2011 showed that the financial markets take no prisoners when sentiment turns. There is no hiding place for those with too much debt, and lack of decisive leadership is punished. There is a consensus building that the UK is facing many years of sub-trend growth, and the near-term prospects for a further recession are rising. The “sugar rush”[50] provided by the bank bail-outs and the slashing of interest rates is over. The football sector needs to wake-up to the new economic reality. It may have survived the first stage of the financial crisis, but it is unlikely to be immune to any pending and prolonged period of economic weakness.

We saw that the banking industry

- is inherently unstable
- met all of the classic signs of a financial crisis, including an unsustainable rise in leverage preceded by technological and regulatory innovation
- captured its weak and ineffective regulators
- operated within a flawed regulatory framework established by an international body lacking accountability and transparency, and which was pre-occupied with retaining control over global regulation
- is pyramidal in structure, with intricate systemic linkages and interdependencies
- was infected by moral hazard
- leads to losses being regularly socialised
- exhibits utility-like properties that regulators failed to appreciate
- pays vast amounts and a very high share of turnover to its key labour providers, to destabilising effect

[50] A term regularly used by economist and Sunday Telegraph columnist, Liam Halligan.

- rewarded failure and unethical behaviour
- has low levels of employer/employee loyalty (and vice versa) and is influenced by parties which benefit from encouraging labour movement
- imports key employees from abroad on a widespread basis
- failed to adequately police the principal/agent conflict
- exhibits high barriers-to-entry which distort competitive balance
- adopted inappropriate ownership structures on a widespread scale
- was placed under strain by unequal income distribution
- encouraged local players to take large financial risks to compete with national players, and national players to do the same to compete with the global players
- placed an undue focus on short-term results
- had weak standards governing fitness for office
- had notably low female representation at senior-management and board level, creating a tendency towards "groupthink", and
- ignored many warning calls from knowledgeable quarters.

Football in England exhibits all of the above. Football might be lucky when the economic tide goes out, but this author would not bank on it.

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