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International capital markets: which have been the effects of the 2007 liquidity crisis on global financial regulation, supervision and compliance?

LLM 2011-2012
International Corporate Governance, Financial Regulation and Economic Law (ICGFREL)

- Candidate Number: F1020

- Course: LLM in International Corporate Governance, Financial Regulation and Economic Law (ICGFREL) – Dissertation

- Institution: Institute of Advanced Legal Studies (IALS) – School of Advanced Studies, University of London

- Date: 3rd September 2012.

List of Abbreviations

ABSs	Asset Backed Securities
BCBS	Basel Committee on Banking Supervision
Basel III	Basel III: A global regulatory framework for more resilient banks and banking systems
Basel III framework	Basel III: International framework for liquidity risk measurement, standards and monitoring
BIS	Bank for International Settlements
BoE	Bank of England
CDO	Collateralised Debt Obligation
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act 2010
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council of the European Union
EEA	European Economic Area
ESAs	European Supervisory Authorities
ESFS	European System of Financial Supervisors
ESRB	European Systemic Risk Board
EU	European Union
FCA	Financial Conduct Authority
FED	United States of America's Federal Reserve System
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSB	Financial Stability Board
FSF	Financial Stability Forum
FSMA 2000	Financial Services and Markets Act 2000
FSOC	Financial Stability Oversight Council
IMF	International Monetary Fund
IRB	Internal Ratings Based approach
PRA	Prudential Regulatory Authority
SEC	Securities and Exchange Commission
SPV	Standard purpose vehicle
UK	United Kingdom
US	United States of America
VaR	Value at Risk

Table of Legislation

EU

- Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board [2010] OJ L 331/1

- Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC [2010] OJ L 331/12

- Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC [2010] OJ L 331/48

- Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC [2010] OJ L 331/84

UK

- Financial Services Bill 2012

US

- Dodd-Frank Wall Street Reform and Consumer Protection Act 2010

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Dissertation Title

International capital markets: which have been the effects of the 2007 liquidity crisis on global financial regulation, supervision and compliance?

1. Introduction

The latest financial crisis that began in 2007[1] and the evaporation of liquidity within international financial markets (which led to a global a recession of unprecedented proportions since the Great Depression of the 1930s[2]), showed the need for the development of an effective regulatory and supervisory framework for the financial sector comprising both binding and non-binding regulatory measures, that is, laws and regulatory standards of good practice (soft law) that would adequately address and limit the creation of risks within markets, not only at company level (risk profile of individual banks—micro-prudential risk assessment), but also at the market level (the creation systemic risks by shifting individual firms' risks onto the global financial markets and the real economy—macro-prudential analysis).[3]

This failure to incorporate macro-prudential considerations within the regulatory framework when providing for minimum standards for the analysis of risk, catered for the excessive risk-taking on the part of financial institutions in the pursuit of higher profits and also for the creation of systemic risk[4] within financial markets:[5] risk was underpriced[6] and spread within the financial system, which combined with the lack of adequate capital buffers among financial institutions, severely affected the most developed economies and financial markets across the world via contagion—which, in turn, made its way through procyclicality. This was further exacerbated by the moral hazard derived from the practice of bankers who, in the pursuit of ever increasing target-related rewards (e.g., bonuses), took excessive risks and transferred them onto the market via

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[1] On 9th August according to the general consensus, kick-started by French bank BNP Paribas when it informed its investors that they would not 'be able to take money out of two of its funds because it cannot value the assets in them, owing to a 'complete evaporation of liquidity' in the market', evidencing the interruption of interbank lending and setting off a 'sharp rise in the cost of credit (...) [making] the financial world realise how serious the situation was'; BBC News Channel, 'Timeline: Credit Crunch to Downturn' *BBC News* (London, 7 August 2009) <news.bbc.co.uk/1/hi/7521250.stm> accessed 12 March 2012.

[2] Fred Yeager and others, 'US Legislation Designed to Improve Corporate Governance: an exploration' (2012) 33(1) Company Lawyer 25, 31.

[3] Kern Alexander, 'Rebuilding International Financial Regulation' (2011) 8 Journal of International Banking and Financial Law 489, 489 and fn 20 citing Jean C Trichet (2009) 'Macro-Prudential Supervision in Europe', Text of the 2nd City Lecture, www.ecb.int/press/key/date/2009/html/sp091211_2.en.html:

> Micro-prudential supervision focuses mainly on the solvency and risk management practices of individual financial institutions, depositor protection and protecting bank investors (…) macro-prudential supervision involves assessing the aggregate risks developing in the financial system, the financial system infrastructure, and the linkages between financial institutions and markets and the risks of common shocks in the financial system.

[4] Kern Alexander, Rahul Dhumale and John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (OUP 2006) 24, citing John Eatwell J and Lance Taylor, *Global Finance at Risk* (Free Press 2000): systemic risk is defined as 'a negative externality that imposes costs on the society at large because financial firms fail to price into their speculative activities the full costs associated with their risky behaviour'.

[5] Through financial product innovation, eg, securitisation that decomposed and transferred credit risk among wholesale institutional investors looking for higher returns. Alexander, 'Rebuilding International Financial Regulation' (n 3) 489. See also Brian McDonnell, 'Financial Regulation After the Storm: Heavy Hand After Light Touch' (2008) 10 Journal of International Banking and Financial Law 519 for an explanation of the securitisation process; BBC News Channel, 'Timeline' (n 1).

[6] Risk was underpriced because financial institutions accounted for only private estimations of risks (micro-prudential analysis) without any consideration given to the systemic risks created and shifted around markets (macro-prudential considerations). Alexander, Dhumale and Eatwell (n 4) 177.

securitisation and other engineered financial instruments—e.g., derivatives, collateralised debt obligations.

In this respect, I believe it has been correctly stated that:

> Basel II embodied some of the major weaknesses with the current international financial standard setting approach because the standards failed to protect the broader financial system against systemic risk (...) flawed methods of assessing and managing risk, combined with financial product innovation and structural changes in financial markets, provided the ingredients that allowed risk to be underpriced and shifted around the financial system.[7]

Having said that, and before getting into considering the legal aspects and regulatory consequences derived from the 2007 crisis, I am going to refer briefly to the recent financial crisis.

2. The 2007 financial crisis: origin and development

The chronology of the latest global financial (liquidity) crisis followed a path that began to be noticeable in early 2007.

To begin with, the origin of the crisis can be tracked down to the United States of America (US) and its housing market. US banks, in the quest for higher profits, granted high-risk loans to people with poor, or for that matter non-existent, credit records during the period before the crisis, in what it is known as the sub-prime mortgage business;[8] subsequently, banks would bundle up these high-risk loans and other bonds or assets into portfolios—called collateralised debt obligations (CDOs)—and sell them to wholesale institutional investors around the world—amongst other, insurance companies and investment funds—shifting the risk of default onto the financial system, thus creating and disseminating systemic risk and imposing negative externalities on the financial system, the economy[9] and society as a whole—let us remember that the US and UK governments at the time used taxpayers' money to bail out tumbling financial institutions.

As house prices went down at times when interest rates went up—between 2004-2006, a period during which interest rates rose five-fold—people with poor or non-existent credit records who found it difficult to honour the repayment of the original terms of their loans began to default on their more expensive obligations in great numbers; investors started to experience losses, credit markets started to feel the impact as banks were unwilling to lend to each other and liquidity started to dry up. In this context, one of the first indications of the approaching crisis appeared in early February 2007, when HSBC disclosed huge losses derived from sub-prime loans at its US mortgage business, Household Finance;[10] and a couple of months later, another warning sign worried the

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[7] Alexander, 'Rebuilding International Financial Regulation' (n 3) 489.

[8] BBC News Channel, 'Timeline' (n 1).

[9] ibid; Alexander, 'Rebuilding International Financial Regulation' (n 3) 489-90.

[10] BBC News Channel, 'US Housing Slowdown Knocks HSBC' *BBC News* (London, 8 February 2007) <http://news.bbc.co.uk/1/hi/business/6341205.stm> accessed 12 March 2012; BBC News Channel, 'Global Recession Timeline' *BBC News* (London) <http://news.bbc.co.uk/1/hi/8242825.stm> accessed 12 March 2012.

markets, when one of the largest US sub-prime mortgage lenders, New Century Financial, filed for bankruptcy protection.[11]

The markets and systemically important financial institutions being interconnected[12] and these engineered financial products being sold globally, the effects of the bursting of the US housing bubble were felt not only in the US but also in locations such as Australia, Belgium, China, France, Germany and the United Kingdom (UK), despite the efforts of Central Banks to add liquidity through money injections into the financial system and incentivise lending between banks by cutting interest rates—amongst others, these were the actions taken by the US Federal Reserve System (FED), the Bank of England (BoE) and the European Central Bank (ECB).[13]

This situation—absence of liquidity within financial markets; an eroded capital base; lack of liquidity buffers at company level; large off-balance sheet exposures within the shadow banking[14] system[15]—led financial institutions to search for additional capital via rights issues or even government bailouts, triggering bank runs due to the crisis of public confidence in the solvency and liquidity of many of these institutions[16] that forced some of these firms to either seek bankruptcy protection (such was the case for Lehman Brothers Bank in the US) or to be nationalised (like Northern Rock in the UK), and some other institutions even had to be taken over in order to avoid bankruptcy (like Bear Sterns in the US, acquired by JP Morgan Chase and Merrill Lynch in the UK, bought by Bank of America).[17] Additionally, insurance companies that guaranteed sub-prime loans also felt the impact of the crisis: AIG, for instance, had to be rescued in mid-September 2008 by the US Treasury.[18]

Additionally, a procyclical deleveraging process gave way to a rapid transmission of the crisis in the banking sector to the rest of the financial system and the real economy (i.e., contagion), resulting in a massive contraction of

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[11] BBC News Channel, ‘Top US Lender in Chapter 11 Move’ *BBC News* (London, 2 April 2007) <http://news.bbc.co.uk/1/hi/business/6519051.stm> accessed 12 March 2012; BBC News Channel, ‘Global Recession Timeline’ (n 10). See also McDonnell, ‘Financial Regulation After the Storm’ (n 5):

> In mid-2007 concerns over an increasing number of defaults in the US subprime mortgage market led to large-scale rating downgrades on subprime mortgage backed securities and the closure of a number of hedge funds with subprime exposure. This resulted in a lack of confidence in structured products more generally (...) Lack of transparency in the market for ABS and increasing concerns about the reliability of ratings for structured finance products led to withdrawal by much of the market from investment-structured assets (...) and originators were forced to draw down bank lines for financing. Many banks (...) were left with CDOs on their own balance sheets or in the specially created SPVs, which in order to preserve their reputations, they rescued when in trouble. Many banks were now either left with exposure to 'toxic' ABS or with debt obligations that could not be financed out of their own capital.

[12] Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (Bank for International Settlements rev edn June 2011) (BCBS, *Basel III*) paras 4 and 32.

[13] BBC News Channel, ‘Timeline’ (n 1).

[14] Investopedia, ‘Definition of Shadow Banking System’, <http://www.investopedia.com/terms/s/shadow-banking-system.asp#axzz246exLLFc> accessed 27 July 2012: the expression ‘shadow banking’ refers to ‘The financial intermediaries involved in facilitating the creation of credit across the global financial system, but whose members are not subject to regulatory oversight (...) [and] to unregulated activities by regulated institutions’.

[15] BCBS, *Basel III* (n 12) paras 4 and 16.

[16] ibid para 4.

[17] BBC News Channel, ‘Timeline’ (n 1).

[18] BBC News Channel, ‘Global Recession Timeline’ (n 10).

liquidity and credit availability, intensifying the crisis and forcing sovereigns to step in and inject enormous amounts of liquidity (i.e., cash), capital support and guarantees.[19]

For instance, the US and UK governments came up with plans for long-term recovery in October 2008, involving US$700 billion (bn) and £400bn facilities to be used to purchase 'toxic assets' (those derived from the sub-prime mortgages business) and recapitalise financial institutions in exchange for a stake in them, in order to curb the effects of the lack of liquidity and interbank lending and to shore up the global financial system.[20] Following this, the US Congress approved an additional US$787bn stimulus plan with the aim of preventing the US economy from falling into recession.[21]

3. Regulatory and supervisory considerations

It is clear at this point that banks and other financial institutions are meant to take risks, as it is the core of their business—they take risks by investing in order to make a profit.[22] But as mentioned, the financial regulatory framework failed to measure and address excessive risk taking by undercapitalised financial institutions and the creation of systemic risk within financial markets, all of which, within a downturn economy, proved to be disastrous for all major economies as financial institutions could not weather the storm they created or, to say the least, fuelled by their practices.

For instance, banks' methodologies for the calculation of regulatory capital were developed on a model-based approach: banks' value-at-risk (VaR) and enhanced VaR models (using its own probability of default, loss given default and exposure at default data) provided them with the opportunity to calculate lower regulatory capital than under previous regulatory capital rules (e.g., Basel I, according to which 'the target standard ratio of capital to weighted risk assets should be set at 8%'),[23] leading 'to significantly lower levels of regulatory capital across most banking institutions, especially for the most systemically important financial institutions'.[24]

In this respect, the 2007 crisis exposed the weaknesses of the regulatory framework of international financial standards, which allowed for the excessive creation of on- and off-balance sheet leverage in the banking sector of many countries; the erosion of the level and quality of the capital base; and the lack of liquidity buffers,[25] making it impossible for the banking system to absorb systemic trading and credit losses.[26]

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[19] BCBS, *Basel III* (n 12) para 4.

[20] BBC News Channel, 'Global Recession Timeline' (n 10); BBC News Channel, 'Timeline' (n 1).

[21] BBC News Channel, 'Global Recession Timeline' (n 10).

[22] Investing is a lucrative activity—financial institutions, in their role as investors, go to the capital and money markets to invest depositors' money with the expectation of making a profit after a certain period of time. Oxford University Press, *Oxford Advanced Learner's Dictionary* (Seventh edn, paperback, OUP 2005) 818. See also Alexander, Dhumale and Eatwell (n 4) 177.

[23] BCBS, 'International Convergence of Capital Measurement and Capital Standards' (Bank for International Settlements July 1988) <http://www.bis.org/publ/bcbs04a.pdf> accessed 18 July 2012, para 44.

[24] Alexander, 'Rebuilding International Financial Regulation' (n 3) 491.

[25] Committee of European Banking Supervisors, 'Guidelines on Liquidity Buffers' (Committee of European Banking Supervisors 2009) <http://www.eba.europa.eu/documents/Publications/Standards--Guidelines/2009/Liquidity-Buffers/Guidelines-on-Liquidity-Buffers.aspx> accessed 16 May 2012, guideline 1 and para 29: Liquidity buffers are core, highly liquid assets—eg cash—that cover the need

According to Brian McDonnell, the 2007 crisis was the result of several classic market failures, namely:

> [P]oor lending practices derived from moral hazard; asymmetry of information and the mispricing of risk; inadequately capitalised financial institutions funding long-term commitments out of short-term finance; lack of transparency to the market by banks, in particular, as to their exposure to toxic ABS; and driving it all, the pursuit of short-term profits.[27]

The 2007 crisis has also exposed major weaknesses in corporate governance practices within the financial sector,[28] such as lack of transparency,[29] lack of a stewardship role on the part of financial firms' executives, lack of ownership control, moral hazard, etc.

All these factors evidenced by the 2007 crisis prompted a review of the financial regulatory and supervisory framework by the relevant authorities and bodies of experts at all levels, including international financial standards of good practice such as the Basel Capital Accord; European Union (EU) supervisory structures; and local (country-specific) regulations and supervisory institutions as in the UK. In the words of Brian McDonnell, 'The usual response to market failure is government intervention in the form of "regulation"'.[30]

3.1. International financial standards of good practice: soft law

At the international level, financial regulation and supervision has been and is primarily the subject

> [O]f "international soft law" — meaning standards, guidelines, interpretations and other statements that are not legally binding or enforceable according to formal techniques of international law, but nevertheless are capable of exerting powerful influence over the behaviour of countries, public entities and private parties,[31]

produced by international standard-setting bodies informally constituted[32] and integrated by, e.g., public officials from different countries.[33]

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for additional capital that may arise in times of stress and when a financial institution needs 'to raise liquidity within a short timeframe and normal funding sources are no longer available or do not provide enough liquidity'.

[26] BCBS, *Basel III* (n 12) para 4.

[27] McDonnell, 'Financial Regulation After the Storm' (n 5).

[28] Kern Alexander, 'Reforming European Financial Supervision: Adapting EU Institutions to Market Structures' (2011) 12 ERA Forum 2 229, 231.

[29] Yeager and others, 'US Legislation' (n 2) 31.

[30] McDonnell, 'Financial Regulation After the Storm' (n 5).

[31] Alexander, 'Rebuilding International Financial Regulation' (n 3) 490.

[32] As opposed to formally constituted international financial institutions—eg, the International Monetary Fund (IMF)—, which are the product of formal international treaties and whose regulatory measures are enforceable through formal procedures. ibid.

These informal international standard-setting institutions and the regulatory and supervisory standards they produce are as important as formal law, in the sense that they are a powerful influence on the behaviour of not only the members of the organisation, but also of other countries and public and private entities who may apply those standards in order to show the market some degree of sophistication and for other related reasons—e.g., more benign terms for international credit lines, reputation, etc.—; sometimes, the application of such standards may come as an imposition from a formally constituted international institution—such as the IMF.[34]

Furthermore, these standards are much more flexible than formal law in respect of the way they are produced, and also the organisations that publish them are flexible in the sense that they can appraise and follow market and practice developments in the production of such standards, being thus able to adapt quickly to the changing conditions of the market; this quality, in addition to other benefits, makes soft law more appealing for countries and public and private institutions to adopt them.[35]

3.1.1. The New Basel Capital Accord: Basel III

Following from the above, and based on the idea that

> A strong and resilient banking system is the foundation for sustainable economic growth, as banks are at the centre of the credit intermediation process between savers and investors (...) [providing] critical services to consumers, small and medium-sized enterprises, large corporate firms and governments who rely on them to conduct their daily business, both at a domestic and international level,[36]

the BCBS (Bank for International Settlements—BIS)[37] has been developing since 1988 the Basel Capital Accord, that is, guidelines and voluntary international supervisory standards and rules of prudential regulation on capital adequacy and banking supervision intended to fulfil the Committee's mandate, which is:

> [T]o enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide (...) by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding.[38]

The latest edition of the Accord, known as Basel III,[39] was developed as a regulatory response to the 2007 financial crisis in order to improve risk

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[33] ibid.

[34] ibid.

[35] ibid 490-1.

[36] BCBS, *Basel III* (n 12) para 3.

[37] BIS, 'About the Basel Committee' <http://www.bis.org/about/index.htm> accessed 14 May 2012: broadly speaking, the BIS is the oldest international financial organisation in the world (established on 17 May 1930). Today it consists of Central Bank governors and senior financial advisers of countries represented on the Financial Stability Board (FSB), with the objective of fostering international monetary and financial cooperation to achieve monetary and financial stability. See also Alexander, 'Rebuilding International Financial Regulation' (n 3) 491.

[38] BIS, 'About the Basel Committee' (n 37).

[39] Comprising two separate documents: BCBS, *Basel III: International framework for liquidity risk measurement, standards and monitoring* (BIS December 2010) and BCBS, *Basel III: A global*

management, governance and transparency within the financial industry,[40] even though it has been built up on the basis of the previous edition of the Accord, Basel II and its 3-Pillar approach,[41] thus incorporating some of the features from the previous framework that contributed to the escalation of the 2007 crisis.[42]

The objective of the BCBS is to enhance the resilience of banks and the financial sector by strengthening the global capital framework; improving the quality and level of regulatory capital held by banks; improving market discipline and transparency of the capital base; and incorporating macro-prudential elements into the capital framework,[43] all of which should 'improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy'.[44]

Basel III, similarly to its predecessor, provides for a process-based regulatory framework or internal ratings based (IRB) approach—even though the BCBS has made some requirements more stringent in an attempt to make the regulatory system more risk-sensitive, incorporating some of the lessons learnt from the crisis in limited ways.[45] This IRB approach means that banks have the flexibility to estimate the amount of a potential loss from their own evaluation of a borrower's creditworthiness, thus forming the basis of minimum capital requirements, and that the regulatory authorities will assess and approve on a case-by-case basis the models for risk management and measurement developed by each individual bank employing its own methodology and set of data in order to determine its own regulatory capital structure, provided the regulator is satisfied with it.[46]

Thus, and like Basel II, it appears that this is an incentives-based system in the sense that banks should find in this regulatory system an incentive to improve their risk-assessment and management models and procedures because that would in turn lead them to a lower regulatory capital to be tied up by the institution—the less capital an institution is forced to hold the more such institution has available to reinvest in the hunt for additional profits.[47] And, also, being financial institutions in possession of the most relevant information and knowledge regarding their operations and the risks they are exposed to (as opposed to the regulator), they are in an exceptional position to provide the best inputs to assess such risks.[48]

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regulatory framework for more resilient banks and banking systems (BIS rev edn June 2011); see BCBS, *Basel III* (n 12) para 1.

[40] BCBS, *Basel III* (n 12) para 2.

[41] ibid para 7.

[42] Alexander, 'Rebuilding International Financial Regulation' (n 3) 491-3.

[43] BCBS, *Basel III* (n 12) paras 7 and 9.

[44] ibid paras 1 and 3.

[45] Amongst other, the requirements for Tier 1 and Tier 2 capital have been strengthened in order to obtain a higher quality capital base; a stressed VaR capital requirement has been introduced; capital requirements for counterparty credit exposure to the shadow banking system and the capital buffers for such exposures have been strengthened; a capital charge for potential mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty will be applied to banks; and the Committee considered several measures to reduce the reliance on external ratings coming from the previous version of the Capital Accord. BCBS, *Basel III* (n 12) paras 9, 12, 13, 14(b), 15. See also Alexander, 'Rebuilding International Financial Regulation' (n 3) 492.

[46] Alexander, 'Rebuilding International Financial Regulation' (n 3) 491. See also Alexander, Dhumale & Eatwell (n 4) 231.

[47] Alexander, Dhumale & Eatwell (n 4) 231.

[48] ibid 177.

Regarding the issue of procyclicality,[49] Basel III has introduced a series of countercyclical capital requirements, such as a regulatory framework furnishing supervisory authorities with 'stronger tools to promote capital conservation in the banking sector (...) [which] will help increase sector resilience (...) and will provide the mechanism for rebuilding capital during the economic recovery';[50] and the imposition on banks of the need to build up additional capital defences 'in periods where the risks of system-wide stress are growing markedly'[51] through a countercyclical capital buffer aimed at achieving 'the broader macro-prudential goal of protecting the banking sector in periods of excess aggregate credit growth';[52] strong capital buffers above the minimum requirement are very important in order to mitigate procyclicality—by addressing excess credit growth—and help raise the resilience of the banking sector.[53] With these measures, the new Capital Accord addresses both micro- and macro-prudential concerns, as it ensures 'that banking sector capital requirements take account of the macro-financial environment in which banks operate'.[54]

3.1.2. Concerns over the extent of the change within the New Basel Capital Accord

Even though the Basel Committee has acknowledged that the 2007 crisis was due to systemic factors,[55] which derived from the lack of consideration given to systemic risks (macro-prudential regulatory measures), the new and updated version of the Basel Capital Accord still relies on the enhanced IRB approach for the measurement of regulatory capital[56] on which Basel II was built upon, furthering homogeneity within the banking sector—the problem is that homogeneity was one of the causal factors that allowed the crisis to get to such a destructive extent:

> If markets are to be liquid and reasonably stable they should have a wide range of participants with heterogeneous objectives and methods. Markets become illiquid when actions become homogeneous (...) The liberalisation of financial markets has reduced heterogeneity in financial markets. Financial sector regulators are reinforcing the homogenising process by encouraging firms to use the same risk management techniques.[57]

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[49] Which was one of the main factors that deepened the effects of the liquidity crisis via the acceleration of the contagion effect through the quick transmission of financial shocks from the banking and financial sectors to the real economy; BCBS, *Basel III* (n 12) paras 4, 18, 26.

[50] ibid para 28. See also ibid paras 26 and 27.

[51] ibid para 136.

[52] ibid paras 30, 29 and 31, 136-150; Avinash Persaud, 'A Critique of Current Proposals to Reform Bank Regulation' (2010) 3 Journal of International Banking and Financial Law 147, 148.

[53] BCBS, *Basel III* (n 12) paras 19, 31, 136-7; Avinash Persaud, 'A critique' (n 52) 148.

[54] BCBS, *Basel III* (n 12) para 137.

[55] ibid para 4.

[56] ibid paras 12, 14(a).

[57] European Parliament: Policy Department, Economic and Scientific Policy, 'Financial Supervision and Crisis Management in the EU' (European Parliament 2007) <http://www.europarl.europa.eu/document/activities/cont/201108/20110818ATT25070/20110818ATT25070EN.pdf> accessed 4 May 2012, v.

The stressed VaR models remain the essential basis for the calculation of the risk and the determination of the regulatory capital by banking institutions under Basel III and the problem is that these models have proved very wrong during the last crisis, because they 'massively underestimated the likelihood of significant fall in asset prices based on external shocks and failed to take into account the likelihood of numerous aftershocks'[58] since they do not incorporate macro-prudential factors and systemic risk in the equation, such as measuring and limiting 'leverage levels in the financial system as a whole, requiring financial institutions to have enhanced liquidity reserves against short-term wholesale funding exposures'.[59]

Along the same lines, the BCBS has built a regulatory framework based on the same 'light-touch' approach to prudential regulation that informed Basel II (with a few modifications in order to strengthen the estimation of risks and the determination of the minimum regulatory capital base) in the sense that it still assumes that 'bankers, investors and other market participants (...) [have] the expertise and incentives to control excessive financial risk-taking',[60] which the crisis has proved completely wrong, showing how those market participants increased systemic risks inspired by the pursuit of personal benefits—e.g., target-related compensations or the exponential increase of profits for the banking institution.

Thus, it looks like the BCBS has not been able to develop a regulatory and supervisory framework that properly addresses both individual firms' and systemic risks by linking micro- and macro-prudential regulatory and supervisory aspects into one system, despite the efforts to incorporate more risk-sensitive regulation[61] in order to tighten the requirements for the calculation of regulatory capital and the increase in the Tier 1 capital base in order to improve its quality and the liquidity of financial institutions.[62]

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[58] Alexander, 'Rebuilding International Financial Regulation' (n 3) 492.

[59] ibid:

> This market-based approach to measuring and managing risk disproportionately focused on the risks facing the individual firm, and not the risks facing the firm in a malfunctioning financial system. The economic capital models (...) failed to anticipate macro-prudential risks (...) and utilised risk sensitive techniques that, in the face of extreme events, could exacerbate systemic risks, with the potential to precipitate a crisis (...) Basel II embodied the failure of policymakers and regulators to incorporate systemic risks in the design of regulatory institutions and of risk management.

[60] ibid 489.

[61] Avinash Persaud, 'A Critique' (n 52) 148, argues that incorporating more risk-sensitive bank regulation would lead to the fallacy of the 'risk-sensitive' approach: '[I]f booms are fuelled by an underestimation of risks, and regulation is more sensitive to the estimation of risks, then the booms will be bigger and the busts deeper'. Based on the idea that this fallacy is correlated to the boom-bust cycle and that boom cycles share similar characteristics, he suggests as an alternative making the financial system less sensitive to the estimation of risks in two possible ways: the first, by allowing regulatory authorities to adopt counter-cyclical regulatory measures—such as to raise minimum capital requirements—when they recognise that a boom cycle is increasing because that means bankers are underestimating risks; the second option would be 'to limit the flow of risks to institutions with a structural capacity for holding that risk' based on the type of risk—that is, market risk, credit risk or liquidity risk—being 'The capacity for risk (...) related to the maturity of funding' of the individual firm. See also Basel Committee, Basel III (n 12) paras 29-31, 136-37; text to note 59.

[62] Alexander, 'Rebuilding International Financial Regulation' (n 3) 492.

3.1.3. A word on the Financial Stability Board

The FSB, an international institution that replaced the Financial Stability Forum (FSF) ten years after the latter was established,[63] has been entrusted by G20 countries with coordinating

> [A]t the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies[64]

in order to achieve and maintain financial stability. Membership obligations for countries comprise the need to maintain financial stability; maintain open and transparent financial sectors; implement international financial standards and agree to undergo periodic peer reviews.[65]

The FSB 'has been given responsibility (...) to approve and oversee the development of international financial standards that control systemic risk and provide more effective oversight of the global financial system',[66] including amongst its duties the assessment of vulnerabilities of the financial system and recognition of an adequate course of action to address them; the promotion of coordination and information-sharing between financial authorities; monitoring and advising on developments in the market and their implications for regulatory policy, and on best practice in meeting regulatory standards; undertaking joint strategic reviews of the policy development work of the international standard setting bodies; setting guidelines for supervisory colleges and supporting their establishment; managing contingency planning for cross-border crisis management; and collaborating with the IMF to conduct early warning exercises.[67]

In this connection, the FSB has adopted—and periodically reviews and updates—a set of key standards for sound financial systems[68] grouped under 12 policy areas considered of importance 'and deserving priority implementation depending on country circumstances'.[69] These key standards are soft law, in the sense that they are not formally enforceable and have varied degrees of endorsement, but are nevertheless 'accepted as representing minimum requirements for good practice that countries are encouraged to meet or exceed'.[70]

Thus, the FSB is another expression of the 'new drive to devise more effective international regulatory frameworks that durably link micro-prudential

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[63] FSB website, 'History' <http://www.financialstabilityboard.org/about/history.htm> accessed 13 July 2012: the FSF was an international financial institution founded by G7 Finance Ministers and Central Bank Governors in April 1999 in order to promote stability in the international financial system by enhancing cooperation among national and international supervisory bodies and international financial institutions.

[64] FSB website, 'Overview' <http://www.financialstabilityboard.org/about/overview.htm> accessed 13 July 2012.

[65] FSB website, 'Mandate' <http://www.financialstabilityboard.org/about/mandate.htm> (FSB, 'Mandate') accessed 13 July 2012.

[66] Alexander, 'Rebuilding International Financial Regulation' (n 3) 492.

[67] FSB, 'Mandate' (65).

[68] ibid. See also Financial Stability Board, 'Key Standards for Sound Financial Systems' <http://www.financialstabilityboard.org/cos/key_standards.htm> (FSB, 'Key Standards') accessed 13 July 2012.

[69] FSB, 'Key Standards' (n 68).

[70] ibid.

supervision with broader macro-prudential systemic concerns',[71] even though it is more of a coordinator in the sense that it is aimed at facilitating the work of national financial supervisors in coordination with other national and international financial standard-setting and supervisory institutions—e.g., the IMF, the Basel Committee, the International Organisation of Securities Commissions, the Financial Action Task Force, etc.

3.2. European Financial Supervision: the European System of Financial Supervisors

European financial regulation was originally built on a functionalist approach, meaning that legislation required that the same activities were regulated by the same laws regardless of the institution that carried out such activities, and prudential supervision was conducted at the local—country—level via either a single regulator, a two-body regulator or a three-pillar institutional model;[72] financial supervision of individual institutions was carried out by each Member State based on the principle of home country supervision, that is, supervision was within the remit of the supervisory authority of the jurisdiction where the institution was incorporated or had its headquarters, and in the case of a group's subsidiary, supervision of the latter was carried out by the host country's supervisory authority.[73] This approach to financial regulation and supervision was useful as long as banking and financial activities remained within the same jurisdiction and when groups had a fragmented management structure.[74]

In 1999, the EU Commission initiated the Financial Services Action Plan aimed at eliminating the fragmentation of the old system, harmonising the legal and regulatory framework for capital markets and creating an integrated European market in financial services and securities trading to be implemented by 2004, and to this end, the Commission set up in July 2000 an expert advisory committee of 'wise men' chaired by Baron Alexander Lamfalussy.[75] This committee recommended in its final report a four-level procedure for the passing and approval of new securities legislation, and introduced two new expert consultative bodies: the European Securities Committee and the Committee of European Securities Regulators. By late 2003 two other expert committees were introduced: the Committee of European Banking Supervisors and the European Insurance and Occupational Pensions Committee—improving the effectiveness and efficiency of the regulatory standard-setting process.[76]

However, a growing interconnectedness of financial EU markets due to a process of increasing integration following the adoption of the single EU currency (via, for instance, the liberalisation of capital restrictions and increased cross-border operations of banking and financial institutions), combined with increasing developments in technology (e.g., electronic exchanges and trading platforms),[77]

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[71] Alexander, 'Rebuilding International Financial Regulation' (n 3) 492.

[72] Alexander, 'Reforming European Financial Supervision' (n 28) 233.

[73] ibid 233-34.

[74] ibid 234.

[75] Peter O Mülbert and Alexander Wilhelm, 'Reforms of EU Banking and Securities Regulation after the Financial Crisis' [2011] Banking and Finance Law Review 188; Alexander, 'Reforming European Financial Supervision' (n 28) 235.

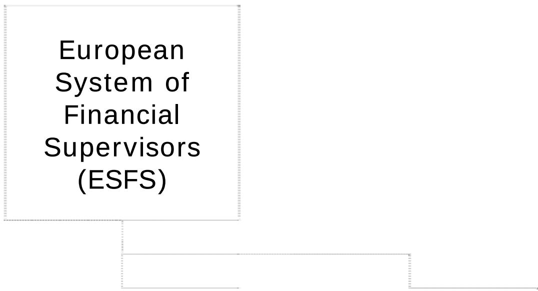
[76] ibid.

[77] Alexander (n 27) 231-32 and 234. See also Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority

in addition to the 2007 crisis' negative externalities and the consequential exposure of the weaknesses in the regulatory and supervisory framework,[78] prompted a review process of EU financial regulation and of EU regulatory and supervisory authorities, their functions, performance and structure,[79] in much the way it happened both at the international level (e.g., reforms to the Basel III framework and the creation of the FSB) and locally (e.g., in the UK and the new tripartite regulatory authority that will replace the Financial Services Authority—FSA).

As a consequence, the European Commission, in September 2009, came up with plans for a change to the financial supervisory structure in place at the time. According to the proposal, the new supervisory authority would be a structured as a system—the European System of Financial Supervisors (ESFS)—and consist of; a) three European Supervisory Authorities (ESAs) entrusted with providing help to restore confidence in the market; contributing to the development of a harmonised EU rulebook for the implementation of EU financial sector regulation; and solving cross-border firms-related problems; and b) a European Systemic Risk Board (ESRB) assigned the task of monitoring and preventing the accumulation of systemic risks that 'threaten the stability of the overall financial system',[80] linking both micro- and macro-prudential supervision.[81] A year later, on 22 September 2010, the European Parliament voted for the proposal—later confirmed by the EU Economic and Financial Affairs Council (ECOFIN) on 17 November 2010—creating the ESFS and confirming its structure and composition (graphic 1),[82] operative since January 2011 in replacement of the old supervisory framework.[83]

Graphic 1



(European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC [2010] OJ L 331/12 (EBA Regulation) para 8.

[78] Regulation (EU) No 1093/2010 p 1.

[79] Alexander, 'Reforming European Financial Supervision' (n 28) 229-31.

[80] European Commission, 'The EU Single Market: Financial Supervision' [28 June 2012] <http://ec.europa.eu/internal_market/finances/committees/index_en.htm> accessed 15 August 2012.

[81] Alexander, 'Reforming European Financial Supervision' (n 28) 230-1: 'The ESA's main function involve coordinating the micro-prudential supervision of Member States… while the ESRB will perform macro-prudential oversight and surveillance of systemic risk in EU and global financial markets'.

[82] European Commission, 'The EU Single Market' (n 80); Alexander, 'Reforming European Financial Supervision' (n 28) 239.

[83] ibid

Source: Kern Alexander, 'Reforming European Financial Supervision: adapting EU institutions to market structures' [2011] 12 ERA Forum 2 229, 231

In general terms, to achieve their objectives and fulfil their tasks, the Agencies have been vested with authority to make decisions on the drafting and proposing 'regulatory technical standards, adopting non-binding recommendations and guidelines, and facilitating member authorities' implementation of a common EU regulatory code' approved by the EU Commission, Parliament and Council.[84]

This does not mean that supervision of financial markets will be taken from the remit of individual EU countries and transferred to the ESFS; instead, this is a decentralised system according to which EU Member States will still be responsible for the micro- and macro-prudential supervision of their financial institutions and internal markets—through their supervisory authorities—even though they have to coordinate their supervisory practices with each other and provide supervisory information to the relevant ESAs, and will be accountable to the respective ESA for such supervisory practices.[85] In turn, the ESRB and each ESA will be accountable to the European Parliament and the Council.[86]

3.2.1. The European Systemic Risk Board

The ESRB has been created as part of the ESFS[87] and based on the recognition that 'financial stability is a precondition for the real economy to provide jobs, credit and growth';[88] the EU Commission expressed at the time that

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[84] Alexander, 'Reforming European Financial Supervision' (n 28) 245-6.

[85] ibid 243-46.

[86] Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board [2010] OJ L 331/1 (ESRB Regulation) Article 19; EBA Regulation Article 3; Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC [2010] OJ L 331/48 (EIOPA Regulation) Article 3; Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC [2010] OJ L 331/84 (ESMA Regulation) Article 3.

[87] ESRB Regulation Article 1(1) and (2).

[88] ibid para 1.

'Given the integration of international financial markets and the contagion risk of financial crises, there is a need for strong commitment on the part of the Union at the global level'[89] and, based on the De Larosière report,[90] there was a 'need to improve the regulation and supervision of financial institutions within the Union'.[91]

The ESRB has been given the objective of monitoring the European financial system in order to prevent or mitigate the creation and accumulation of systemic risks[92] arising from developments in the financial system that can threaten financial stability within the EU (considering macro-economic developments) with the aim of avoiding 'periods of widespread financial distress... contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth'.[93]

To this end, the ESRB will determine, collect and analyse relevant and necessary information from, among others, the ESAs, the European System of Central Banks and the Commission; identify and prioritise risks; issue warnings and recommendations in response to systemic risks identified, making them public if it is appropriate to do so and monitor the follow-up of such warnings and recommendations, reporting on all recommendations and warnings to the Council of Ministers and to the European Parliament; collaborate with the ESAs by furnishing them with necessary information and helping in the development of a common set of qualitative and quantitative indicators to identify and measure risks (colour-coded system); work in coordination with International Financial Institutions—such as the IMF and the FSB—and relevant bodies from European and third countries in relation to macro-prudential oversight; and any other related tasks as specified by EU legislation.[94]

The creation of the ESRB as a complement to the ESAs within the ESFS is intended to contribute to the creation of a level playing-field across European markets through the development of a more integrated and efficient EU supervisory structure that will provide the necessary macro-prudential assessment of the European markets and of systemic risks therein, improving supervisory and regulatory practices across the EU to control cross-border systemic risks.[95] For instance, if we consider the activities carried out by internationally active institutions, a need appears for an increased coordination and cooperation among supervisors from home and host countries regarding information exchange in order to prudentially regulate and supervise them;[96] the ESRB, it is expected, will provide such coordination within an integrated EU financial market by creating enhanced channels for the exchange of information (thus tackling the issue of confidentiality of certain sensitive information) based on a common set of supervisory standards.[97]

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[89] ibid para 7.

[90] High-Level Group (chaired by Jacques de Larosière) Report of 25 February 2009.

[91] ESRB Regulation para 2.

[92] Defined as '[A] risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree'. ibid Article 2(c).

[93] ibid Article 3(1).

[94] ibid Article 3(2), 15-18. See also Alexander, 'Reforming European Financial Supervision' (n 28) 240-1.

[95] Alexander, 'Reforming European Financial Supervision' (n 28) 241.

[96] Alexander, Dhumale & Eatwell (n 4) 50.

[97] ibid 51-52.

3.2.2. ESAs: The European Banking Authority

The EBA has been established as part of the ESFS[98] with the objective of protecting the public interest through its contribution to financial stability and effectiveness by the improvement of the functioning of the internal market; ensuring that financial markets are transparent, efficient and operate with integrity and in an orderly manner; strengthening international supervisory coordination; preventing regulatory arbitrage; promoting equal conditions of competition; ensuring the appropriate regulation and supervision of credit and other risks; and enhancing customer protection.[99] In this connection, it will have to be responsible for settling disagreements between competent authorities (colleges of supervisors included) from different Member States in cross-border situations.[100]

The scope of supervisory powers conferred to the EBA include the supervision of activities developed by credit institutions in the pursuit of their business; the capital adequacy of investment firms and credit institutions; the prevention of money laundering and terrorist financing; deposit-guarantee schemes; distance marketing of consumer financial services; payment services in internal markets; the business of electronic money institutions; the activities developed by financial institutions, financial conglomerates (to the extent that they develop the activities covered), investment firms, payments and money institutions; and any other activities and institutions as determined by future, legally binding Union acts.[101]

The EBA will work in cooperation with the other two ESAs as well as with the ESRB and relevant supervisory authorities from Member States in the pursuit of its objective and the fulfilment of its tasks[102] and, according to Regulation (EU) No 1093/2010 Article 21(1), it will contribute to promoting and monitoring the efficient, effective and consistent functioning of colleges of supervisors, which are institutions integrated by European Economic Area (EEA) supervisors of subsidiaries and branches considered significant; supervisory authorities from third countries with equivalent confidentiality provisions; and central banks as appropriate, and whose functions include the coordination of communication and exchange of information between supervisors; to decide on, and validate the model adopted by the financial group for risk-measurement and capital adequacy purposes; sharing and/or delegation of tasks between supervisors on a voluntary basis; planning and coordination of supervisory activities for the financial group; collaboration in the development of joint risk assessments and decisions on the risk-based capital requirements of the financial group; etc.[103]

3.2.3. ESAs: The European Insurance and Occupational Pensions Authority

The EIOPA is the second of the ESAs created within the ESFS[104] and sharing the same objective as the EBA: to protect the public interest by

[98] EBA Regulation Articles 1(1) and 2(1).

[99] ibid Article 1(5)(a)-(f). See also ibid Articles 8 and 9 for tasks and powers of the EBA.

[100] ibid paras 31, 32 and 36 and Article 8(b).

[101] ibid Article 1(2) and (3).

[102] ibid Article 2(1), (3) and (4).

[103] Alexander, 'Reforming European Financial Supervision' (n 28) 244. See also, amongst other, EBA Regulation paras 32 and 35 and Articles 8(1)(b) and (i) and 21.

[104] EIOPA Regulation Article 1(1) and 2(1).

contributing to financial stability and effectiveness through the improvement of the functioning of the internal market; ensuring that financial markets are transparent, efficient and operate with integrity and in an orderly manner; strengthening international supervisory coordination; preventing regulatory arbitrage; promoting equal conditions of competition; ensuring the appropriate regulation and supervision of risks related to insurance, reinsurance and occupational pensions activities; and enhancing customer protection.[105]

The EIOPA has the power to act in the fields of insurance; co-insurance; reinsurance; life insurance; reinsurance mediation; the prevention of money laundering and terrorist financing; distance marketing of consumer financial services; insurance undertakings, insurance groups, financial conglomerates (to the extent that they develop the activities covered), institutions for occupational retirement provision (in respect of which the EIOPA will act without prejudice to national social and labour law) and insurance intermediaries (including matters of corporate governance, auditing and financial reporting, provided that such actions are necessary to ensure the effective and consistent application of EU legislation); as well as any other activities and institutions as determined by future, legally binding EU regulation.[106]

The EIOPA has also been established to work in cooperation with the ESRB, fellow ESAs and the relevant supervisory authorities and colleges of supervisors from EU Member Countries, being responsible for the settlement of disputes between competent authorities (colleges of supervisors included) from different EU Member States in cross-border situations.[107]

3.2.4. ESAs: The European Securities and Markets Authority

Finally, the ESMA is the third of the ESAs established to work under the umbrella of the ESFS.[108] Its objective has been set to be the same as for the other two ESAs, that is, the protection of the public interest through its contribution to the financial stability and effectiveness of the internal market; ensuring that financial markets are transparent, efficient and operate with integrity and in an orderly manner; strengthening international supervisory coordination; preventing regulatory arbitrage; promoting equal conditions of competition; ensuring the appropriate regulation and supervision of risks; and enhancing customer protection.[109]

The scope of action given to the ESMA comprises the supervision of investor-compensation schemes; securities settlement; publication of prospectuses on initial public offerings, securities listings and transparency of information when securities are admitted to trading on regulated markets; financial collateral arrangements; insider dealing and market manipulation; markets in financial instruments; undertakings for collective investment in transferable securities; capital adequacy of investment and credit institutions (without prejudice to the competence of the EBA in terms of prudential supervision); credit rating agencies; financial conglomerates (to the extent that

[105] ibid Article 1(2), (3), (4) and (6)(a)-(f). See also ibid Articles 8 and 9 for tasks and powers of the EIOPA.

[106] ibid Articles 2(1), (3) and (4).

[107] See, amongst other, ibid paras 30, 31 and 35, Articles 8(1)(b) and (i)and 21.

[108] ESMA Regulation Article 1(1) and 2(1).

[109] ibid Article 1(2), (3) and (5)(a)-(f). See also ibid Articles 8 and 9 for tasks and powers of the ESMA.

they develop the activities covered); the prevention of money laundering and terrorist financing; distance marketing of consumer financial services; activities of market participants in relation to issues not directly covered (including matters of corporate governance, auditing and financial reporting, provided that such actions are necessary to ensure the effective and consistent application of EU legislation); take-over bids; clearing and settlement and derivative issues; and any further activities and institutions as conferred by future EU legislation.[110]

As with the other two ESAs, the ESMA has been established to work in cooperation with the ESRB, EBA and EIOPA and with the relevant supervisory authorities and colleges of supervisors of EU Member Countries, being responsible for the settlement of disputes between competent authorities (colleges of supervisors included) from different EU Member States in cross-border situations.[111]

3.2.5. Concerns over the future effectiveness of the new European supervisory architecture

One of the concerns raised by the current system is that the ESFS does not contemplate crisis management mechanisms that would allow executive action to be adopted by the relevant ESA or by the ESRB to address adverse developments that would threat financial and/or economic stability and an orderly functioning—in part or in total—of the EU financial system;[112] even though the ESAs have been given powers to intervene in case of adverse developments that may jeopardise an orderly functioning and the integrity of financial markets or the stability of the EU financial system, the actions must be undertaken by the relevant national authority of the relevant EU Member State and not by the ESA whose role is limited to that of a facilitator or, eventually, coordinator of such actions or even issuing decisions or recommendations addressing the relevant national authority to take action.[113]

Another issue of concern is that, due to the interconnectedness of European financial markets, it would have been more convenient to establish a single EU supervisory authority centralising the supervision of around 50 of the largest financial institutions with cross-border operations throughout Europe which would mean supervisory jurisdiction of a single authority over the headquarter and foreign branches and subsidiaries of these institutions operating across Europe.[114] In this way, the single supervisor would be able to supervise cross-border operations and EU-wide financial markets in a more efficient way than Member States' authorities acting independently and identify cross-border externalities and systemic risks building up in EU financial markets, thus promoting 'a level playing field in supervisory practices, coordinating and overseeing the activities of Member State authorities, and conducting cross-border surveillance and enforcement';[115] additionally, a single EU regulator 'could also play an important role in supervising the growing inter-connected infrastructure of EU capital markets, in particular clearing houses and certain

[110] ibid Article 1(2) and (3).

[111] See, amongst other, ibid paras 31, 32 and 36 and Articles Articles 2(1), (3) and (4), 8(1)(b) and (i) and 21.

[112] Alexander, 'Reforming European Financial Supervision' (n 28) 252.

[113] EBA Regulation Article 18; EIOPA Regulation Article 18; ESMA Regulation Article 18.

[114] Alexander, 'Reforming European Financial Supervision' (n 28) 248.

[115] ibid.

settlement systems that operate at EU level'.[116] Regardless of any considerations on whether it would be better to establish a single EU regulatory authority, this is not possible because of legal limitations crystallised on the Treaty for European Union.[117]

3.3. Financial regulatory framework in the UK: The Financial Services Bill and the New Approach to Financial Regulation

The 2007 financial crisis triggered a review of the regulatory and supervisory architecture at the global, regional and national levels, and the UK has been no exception to this trend.

Since 1997 and up until now,[118] the responsibility for financial regulation and supervision, and consequently for financial stability, was within the remit of three institutions: HM Treasury, the BoE and the FSA.[119] As a consequence of the turmoil that engulfed the financial system, this Tripartite System was heavily criticised for failing to anticipate the crisis and to provide decisive leadership in order to resolve it, apparently due to a lack of definition of the role that each of those entities would play, leading to a recession that imposed huge costs on society and forced the government to step in and inject liquidity to save financial institutions from their certain collapse.[120]

In addition, the FSA was criticised for implementing a 'light-touch' approach to prudential regulation that was based on the assumption that market participants (e.g., bankers and investors) had knowledge of the risks they were assuming and an incentive to control excessive risk-taking (this approach was clearly wrong),[121] and for relying too much on 'tick-box' compliance, leading to a lack of consideration given to the build-up of systemic risks, instead of adopting a judgement-based approach that would implicate an in-depth, strategic risk analysis.[122]

Having said that, after the crisis the FSA adopted a more stringent approach to prudential regulation and supervision by, for instance, introducing

> [A] new enforcement strategy of credible deterrence, resulting in a number of successful prosecutions for insider dealing. On the retail side (...) adopted a new consumer protection strategy, which incorporates earlier identification of risks, sector-wide interventions, and greater scrutiny of products and their governance, among other elements.[123]

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[116] ibid.

[117] ibid.

[118] Late August 2012.

[119] James Perry and others, 'The new UK regulatory landscape' (2011) 83 Compliance Officer Bulletin 1, 1.

[120] ibid 1-2.

[121] Alexander, 'Reforming European Financial Supervision' (n 28) 489.

[122] Perry and others, 'The new UK regulatory landscape' (n 119) 9-10.

[123] HM Treasury, *A New Approach to Financial Regulation: Building a Stronger System* (The Stationary Office Ltd February 2011) para 4.4.

Furthermore, the FSA also obtained a criminal conviction in March 2009 in a case of insider dealing[124] amongst other successful prosecutions;[125] resorted to civil proceedings were it has obtained injunctive actions to, for instance, freeze assets; imposed significant high profile financial penalties (fines) in the exercise of disciplinary measures; and showed an increased readiness to act, even though it has been argued that the impetus with which the FSA has been prosecuting (in criminal, civil and regulatory—disciplinary—cases) has been selective and directed to easier targets 'for investigation and prosecution in order to secure high profile victories rather than (...) tackling problems which may be occurring within larger institutions.'[126]

As a consequence, the coalition government decided to introduce a proposal[127] to reform the UK's financial regulatory and supervisory architecture: it proposed the abolition of the current system and the creation of three new bodies that would take on the responsibility for regulation and supervision of the financial sector, namely the Financial Policy Committee (FPC), the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA); the new system would be introduced through primary legislation (the Financial Services Bill 2012)[128] which will make changes to the Financial Services and Markets Act 2000 (FSMA 2000).[129]

The Financial Services Bill 'will implement the Government's commitment to strengthen the financial regulatory structure in the UK'[130] and, amongst the above mentioned and other changes, this bill will amend the Bank of England Act 1998, the FSMA 2000, the Banking Act 2009 and section 785 of the Companies Act 2006; it will also make other provisions about financial services and markets; and on the exercise of certain statutory functions relating to building societies, friendly societies and other mutual societies.[131]

3.3.1. The Financial Policy Committee

As part of the amendments of the Bank of England Act 1988,[132] the FPC will be established as a committee of the BoE's Court of Directors[133] and will be

[124] FSA website, 'Solicitor and his father-in-law found guilty in FSA insider dealing case' (London, 27 March 2009) <http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/042.shtml> accessed 25 August 2012.

[125] Jill Treanor, 'Bankers Beware – FSA enforcer is ready to take on the City's chancers' *The Guardian* (London, 14 August 2012) 23: the FSA has secured ten criminal convictions in the last 18 months, as it has adopted a more active role in prosecuting crime and rule-breaking in the City.

[126] Sara Teasdale, 'FSA to FCA: Recent Trends in UK Financial Conduct Regulation' (2011) 26(12) Journal of International Banking Law and Regulation 583.

[127] HM Treasury, *A New Approach* (n 123).

[128] Currently with the House of Lords for enactment and intended by the Government for it to be implemented by early 2013 if it receives Royal Assent by the end of the current year. See also Graeme Barber, 'Legislative comment: The Financial Services Bill 2012' (2012) 33(8) Company Lawyer 245; HM Treasury, 'Financial Services: The Financial Services Bill' <http://www.hm-treasury.gov.uk/fin_financial_services_bill.htm> accessed 29 August 2012.

[129] Perry and others, 'The new UK regulatory landscape' (n 119) 3-4.

[130] HM Treasury, 'Financial Services' (n 128).

[131] UK Parliament Website, 'Parliamentary Business: Summary of the Bill' <http://services.parliament.uk/bills/2012-13/financialservices.html> accessed 29 August 2012.

[132] UK Parliament, 'Financial Services Bill' <http://www.publications.parliament.uk/pa/bills/lbill/2012-2013/0025/2013025.pdf> accessed 25 August 2012 s 3(1).

[133] UK Parliament, 'Financial Services Bill' (n 132) s 3(1).

responsible for macro-prudential regulation and supervision,[134] monitoring the financial system as a whole and addressing systemic risks and vulnerabilities that may arise within it and may threaten the UK's financial stability (thereby improving its resilience) and the wider economy (thus enhancing macroeconomic stability) in order to realize its objective of protecting and enhancing financial stability by focusing on systemic stability.[135] It will be accountable to the BoE, Parliament and HM Treasury, and its activities will be funded by the industry via a statutory levy in relation to the functions that it will get from the FSA and by a statutory cash ratio deposit scheme in respect of the responsibilities that it will inherit from the BoE.[136]

Amongst its functions, the FPC will be responsible for:

- [M]onitoring the financial stability of the United Kingdom's financial system, identifying emerging risks and vulnerabilities, and cyclical imbalances;
- monitoring and assessing the activities of the PRA and the FCA, in order to identify any financial stability implications that may derive from these authorities' actions;
- monitoring the regulatory perimeter, both to ensure that the split in responsibilities between the PRA and the FCA remains appropriate and to ensure that activities being undertaken on or outside the boundary of prudential regulation with potentially systemic consequences are understood;
- showing a close interest in the other aspects of the Bank of England's work that are relevant to financial stability, such as infrastructure regulation, resolution arrangements for failing firms and the provision of liquidity insurance to the financial sector; and
- assessing the effectiveness of the FPC's macro-prudential tools and considering any potential additions or adjustments to the toolkit.[137]

In case the FPC considers it necessary to bring forward taking action in relation to identified risks and/or vulnerabilities, it has been empowered to give recommendations within the Bank, to the Treasury and to the PRA and the FCA which the latter bodies have to comply with, or explain the reasons for non-compliance, and it additionally has the power to direct them in relation to the implementation of macro-prudential measures;[138] complementarily, the FPC will be able to make public announcements and warnings to raise awareness; influence EU and international macro-prudential policy; and make recommendations on action to be taken by the Treasury on necessary changes to the FPC.[139]

The commitment has been stressed in the proposal to bring transparency to the new system in order to create an 'open, accountable and effective FPC'.[140]

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[134] HM Treasury, *A New Approach* (n 123) para 2.1.

[135] ibid paras 2.9-11.

[136] Perry and others, 'The new UK regulatory landscape' (n 119) 9.

[137] ibid 7.

[138] HM Treasury, *A New Approach* (n 123) paras 2.24-25, 2.36-45.

[139] ibid paras 2.26, 2.32-35. See also Perry and others, 'The new UK regulatory landscape' (n 119) 8.

[140] HM Treasury, *A New Approach* (n 123) paras 2.81 and 2.88.

In this respect, the Government will enact legislation requiring the FPC to publish:[141]

- financial stability reports every six months with an assessment of the stability and resilience of the financial sector and a description and assessment of the activities developed by the FPC between reports and their effectiveness; and
- minutes of meetings within six weeks of the date of each meeting, describing the deliberations, decisions taken and the reasoning behind those decisions, unless some of the issues discussed are highly confidential and market sensitive, in which case they will be excluded from the minutes.

3.3.2. The Prudential Regulatory Authority

As part of the modifications to be made to the FSMA 2000,[142] the PRA will be created as a subsidiary to the BoE to be responsible for micro-prudential regulation, authorisation and supervision of prudentially significant firms—i.e., banks, investment banks, building societies, credit unions, insurers, etc.[143]—in its pursuit of its strategic objective of contributing to the promotion of financial stability; and of its operational objective of promoting safety and soundness of authorised entities including the minimisation of the possible negative externalities emanating from failure of any of them.[144]

In order to achieve its objectives, the PRA will have regard to a common set of regulatory principles in order 'to ensure that the regulators have a clear mandate and focus';[145] these principles are as follows:[146]

1. The need to use resources in the most efficient and economical way;
2. A burden or restriction should be proportionate to its expected benefits;
3. Consumers should take responsibility for their decisions;
4. The responsibilities of senior management of an authorised entity to comply with imposed requirements;
5. The desirability of availability of information on authorised entities or recognised investment exchanges in order to contribute the achievement of its strategic and operational objectives by the Authority; finally,
6. Transparency in the regulators' exercise of their functions.

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[141] ibid paras 2.82-87. See also Perry and others, 'The new UK regulatory landscape' (n 119) 9.

[142] UK Parliament, 'Financial Services Bill' (n 132) s 5(1).

[143] ibid 4 and 10.

[144] HM Treasury, *A New Approach* (n 123) para 3.6 and box 3.A. See also Perry and others, 'The new UK regulatory landscape' (n 119) 10.

[145] HM Treasury, *A New Approach* (n 123) para 3.8.

[146] ibid box 3B.

Additionally, the PRA—and, for that matter, the FCA—will be subject to certain specific requirements emanating from EU legislation.[147]

In this context, the PRA will be empowered to assess the safety and soundness of firms, taking action to address any issues as appropriate; make prudential regulatory rules for regulated firms; authorise firms when it is satisfied that they will be prudentially managed and have a viable business model, and then supervise them (either on its own or in coordination with the FCA where both Authorities have interests); approve individuals to perform controlled functions within regulated firms; raise levies to fund itself (as it will inherit functions from the FSA, it is intended that the PRA will obtain funding from a statutory levy imposed on regulated firm and collected by the FCA).[148]

Finally, the PRA will be accountable (as a subsidiarity of the BoE) to the BoE's Court of Directors, in relation to administrative matters (e.g., budget, remuneration policy, value for money, etc.);[149] to Parliament, in respect of the achievement of its objectives and regarding the common set of regulatory principles (this will be channelled through an annual report presented to the Treasury, who will ultimately lay it before Parliament);[150] and, finally, the National Audit Office, who will 'produce reports on the economy, efficiency and effectiveness of the PRA's performance, which may be scrutinised by the House of Commons public accounts committee'.[151]

3.3.3. The Financial Conduct Authority

Finally, the FCA will be established as 'a separate and focused conduct regulator wit tailored objectives, functions and powers'.[152] As the successor of the FSA,[153] it will be responsible for the protection of consumers, for maintaining competition within the market and will also supervise the conduct of financial service providers in the wholesale and retail markets;[154] adopt the legal corporate entity of the FSA, operating independently as a non-departmental body and its funding, as with the FSA, will be sourced out of fees paid by the industry.[155]

Additionally, as with the PRA, the FCA will have a strategic objective—the protection and enhancement of confidence in the financial system; and it will additionally have not one but three operational objectives providing the foundation for an integrated conduct regulatory authority, namely:[156]

1. Facilitating efficiency and choice in the market for financial services, e.g., by removing barriers;

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[147] ibid para 3.14.

[148] Perry and others, 'The new UK regulatory landscape' (n 119) 11-13.

[149] HM Treasury, *A New Approach* (n 123) para 3.53. See also Perry and others, 'The new UK regulatory landscape' (n 119) 13.

[150] HM Treasury, *A New Approach* (n 123) paras 3.54 and 3.72. See also Perry and others, 'The new UK regulatory landscape' (n 119) 13.

[151] Perry and others, 'The new UK regulatory landscape' (n 119) 13.

[152] HM Treasury, *A New Approach* (n 123) para 4.5.

[153] UK Parliament, 'Financial Services Bill' (n 132) s 5(1).

[154] Graeme Barber, 'The New Approach to Financial Regulation: a Step Into the Unknown' (2011) 32 Company Lawyer 276.

[155] HM Treasury, *A New Approach* (n 123) para 4.35.

[156] ibid paras 3.6 and 3.8, 4.13-19 and box 4.A.

2. Securing an appropriate degree of protection for consumers on a case-by-case basis—that is, considering, among other factors, the type of consumer, the product it is buying, the channel used for purchasing the product; and
3. Protecting and enhancing the integrity and soundness of the financial system by, for instance, tackling market abuse and the use of the system for financial crime purposes.

Further to these operational objectives, the FCA must discharge its functions in a way that promotes competition in the market, provided that it can do so in a manner compatible with both its strategic and operational objectives.[157] And also, the FCA will conduct its regulatory and supervisory activities based on the set of common regulatory principles that it will share with the PRA, that is: efficiency and economy in the use of resources; proportionality between burden or restriction imposed and the expected benefit; consumer responsibility; senior management responsibility; availability of information on entities and recognised investment exchanges; and transparency in the regulators' exercise of their functions.[158]

The FCA will be entrusted with the supervision of all financial institutions established and operating—in relation to both retail customers and dealings between wholesale market participants—in the UK, including those authorised and thus 'regulated prudentially by the PRA and those passporting in to the UK'.[159] Furthermore, it will be responsible for regulating the wholesale market conduct of market participants dealing or trading in markets and wholesale firms internally and in relation to their customers and clients.[160] Finally, the FCA will be responsible for both the authorisation and supervision of financial firms that do not fall within the remit of the PRA, being additionally responsible in respect of them for the provision of a prudential regulatory framework.[161]

On the other hand, the FCA will be empowered to enforce conduct and prudential rules, being able to impose high fines in order to encourage compliance across the financial sector, and it will even be able to use redress to 'secure better outcomes for retail customers who have not been treated fairly'.[162]

3.4. The US response to the financial crisis: the Dodd-Frank Act and the Financial Stability Oversight Council

As a consequence of the Great Depression of the 1930s, the US Congress adopted in 1933 the Glass-Steagall Act in order to limit excessive risk taking by banks because this was one of the main factors contributing to the Great Depression, and created 'a firewall between commercial and investment banking by forbidding the former from underwriting securities'.[163] This Act, later complemented by the Bank Holding Company Act 1956, lead to 'a period of

[157] ibid paras 4.13, 4.20-22 and box 4.A.
[158] ibid paras 4.23-29.
[159] ibid para 4.45.
[160] ibid paras 4.46.
[161] ibid paras 4.47. See also Perry and others, 'The new UK regulatory landscape' (n 119) 15.
[162] HM Treasury, *A New Approach* (n 123) paras 4.70-71.
[163] Yeager and others, 'US Legislation' (n 2) 30.

almost 50 years of stability in the financial sector',[164] until lobbyists' pressures started to gain ground and obtained the slow but increasing relaxation of the limitations imposed by the above mentioned statutes, until the repeal of the Glass-Steagall Act and the deregulation of the financial services industry achieved with the passage of the Financial Services Modernization Act 1999.[165]

Such a change in the legal framework lead to the exponential growth of the sub-prime mortgage business that fuelled a housing market bubble: banks were able to provide funding to the sub-prime mortgage business because they were able to securitise those toxic assets, take them out of their balance sheets and transfer those individual risks to the market, thereby creating, piling up and spreading systemic risk; however, increasing interest rates during 2004-2006 forced growing amounts of sub-prime mortgage holders to default on their payments; eventually, this caused the housing market bubble to burst, leading to the collapse of the financial system, bringing the US economy and the country to its knees, and forcing the US Government to intervene twice with the injection of colossal levels of liquidity (ultimately funded by the taxpayer) to keep the economy—and the country—afloat through the recapitalisation of 'too big to fail', systemically important financial institutions.

3.4.1. The Dodd-Frank Act 2010

With that situation as the background, the US Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank Act 2010), according to the Preamble:

> To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ''too big to fail'', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.

The Act thus intends to restore confidence in financial institutions and the financial system through the generation of a systemic change,[166] meaning a modification of the conditions and practices that lead to the crisis by changing the approach to regulation and supervision from 'light-touch'[167] to a more invasive one: amongst other things, the Act provides for the imposition of limits to the acceptable levels of risk to be assumed by an institution; the implementation of risk-reduction mechanisms within the financial system; the creation of a Financial Stability Oversight Council (FSOC), entrusted with the prudential supervision of the US financial system in order to identify and limit excessive risk creation and

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[164] ibid.

[165] ibid.

[166] ibid 29.

[167] Alexander, 'Rebuilding International Financial Regulation' (n 3) 489:

> Both US and UK policymakers and financial supervisors adhered to a "light-touch" approach to prudential regulation that was premised on the assumption that (...) market participants had the expertise and incentives to control excessive financial risk-taking. As it turned out, they had neither the expertise not incentives to do so

empowering it with the necessary tools to achieve this objective; and the requirement for large and complex companies to 'periodically submit plans for their orderly shutdown should the company'[168] defaults and goes bankrupt.[169]

3.4.2. Financial Stability Oversight Council

The establishment of the FSOC[170] is another representation of the commitment of the US authorities to change the financial supervisory landscape. The FSOC is a collaborative body responsible for the macro-prudential supervision of the US financial system and the institutions operating within it to identify and limit excessive risk creation, and as such, is responsible for the monitoring of the financial system in order to identify potential threats to its stability and to respond accordingly.[171]

According to section 112(a)(1) of the Dodd-Frank Act, the objective assigned to the FSOC comprises:

1. To identify risks to the financial stability of the US that could arise from financial distress, failure or ongoing operations of systemically important financial institutions, or that could arise outside the financial services industry;
2. To promote market discipline; and
3. To respond to emerging threats to the stability of the US financial system.

To achieve this, the FSOC has been granted powers to, amongst other, collect information; monitor the financial services industry; monitor domestic and international proposals and developments and provide advice and recommendations to the Congress to enhance the integrity, efficiency, competitiveness and stability of the financial system; facilitate regulatory coordination and information sharing between Federal and State relevant agencies; advise member agencies on general supervisory priorities and principles; identify systemically important financial market utilities and payment settlement activities; and advise primary financial regulatory agencies on the application of new or heightened (stricter) financial standards.[172]

In the discharge of its duties, the FSOC can make recommendations to the FED for the provision of tougher rules on, e.g., capital, liquidity and risk management in order to limit the growth in size and complexity of companies and to limit companies that can pose systemic risks; it can also require the FED to regulate a nonbank financial institution if the latter could pose a threat to financial stability (section 113); it can impose a 15-1 leverage requirement if a company poses a threat to financial stability (section 165(j)(1)); and as a

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[168] Yeager and others, 'US Legislation' (n 2) 30.

[169] ibid 29-30.

[170] Dodd-Frank Act, s 111(a).

[171] FSOC website, 'Financial Stability Oversight Council: Created Under the Dodd-Frank Wall Street Reform and Consumer Protection Act: Frequently Asked Questions' <http://www.treasury.gov/initiatives/Documents/FAQ%20-%20FinancialStabilityOversightCouncilOctober2010FINALv2.pdf> accessed 26 August 2012.

[172] Dodd-Frank Act, s 112(a)(2)(A)-(N).

measure of last resort, it can approve a FED decision to require a large and complex financial institution to divest some of its holdings if such an entity would pose a grave threat to the functioning of the US financial system (section 121(a)(5) Dodd-Frank Act).[173]

4. A word on the problem of Moral Hazard and its role in furthering the crisis

Moral hazard has played an important, and even crucial role in the development of the 2007 crisis as financial and banking institutions resorted to poor lending practices in the search for increasing short-term profits in the period before the crisis hit the markets: they provided funding to risky borrowers (e.g., sub-prime mortgage business) because securitisation allowed banks to remove those assets (sub-prime debt) from their balance sheets by selling them to a standard purpose vehicle (SPV) which would subsequently issue asset backed securities (ABS) and sell them on the market, shifting such risks around the market and increasing systemic risks, with the additional problem that wholesale investors purchasing those ABS did not fully comprehend the risks incorporated in them due to a lack of transparency and disclosure by banking institutions of the real nature behind those ABS at the time of the sale (asymmetry of information).[174]

By securitising, banking institutions would not only find an alternative source of funding after exhausting traditional ones (e.g., deposits),[175] but would also remove debt from their balance sheets, which had the obvious benefit of reducing their risk profile, thus reducing the minimum capital requirement, which, in turn, provided these institutions with more available capital to reinvest, for the lower the risk profile of the individual institution the less capital it needs to hold in order to guarantee possible expected and unexpected losses.

Furthermore, within this process of securitisation credit rating agencies would play a significant part as well due to the above mentioned lack of information—instead of rating the ABS issued by the SPV as based on the nature of the ABS and the assets that backed those ABS (as they should have done in order to counter the lack of transparency in these instruments), they would rate them as based on the characteristics of the SPV in terms of its capacity to repay principal and interest to the holder of the ABS on redemption; by doing this, ABS would achieve higher ratings, making them more appealing to potential buyers;[176] if credit rating agencies rated ABS as based on the quality of the sub-prime loans backing those securities, the latter would probably have been rated very poorly (due to the riskiness of the holder of the sub-prime loan) and consequently would not have sold on the markets.

Brian McDonnell goes further and argues that:

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[173] US Senate Committee on Housing, Banking and Urban Affairs, 'Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act' <http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf> accessed 28 August 2012. See also Yeager and others, 'US Legislation' (n 2) 30.

[174] McDonnell, 'Financial Regulation After the Storm' (n 5): 'Although theoretically possible for an investor to analyse the value of the securities themselves, their complexity and the need for information on the underlying assets often made this impracticable'.

[175] ibid.

[176] ibid.

> Usually the securities needed to be AAA rated to sell and would be structured to achieve this increasingly with the help of the credit rating agencies who would suggest improvements and credit enhancements based on their models; clearly a conflict of interest.[177]

This reliance on third party credit ratings has shown the emergence of two problems related to private credit rating agencies: firstly, and in accordance with McDonnell's statement, the risk that these agencies act in their own interest or the borrower's in order to maximise their gains by issuing favourable ratings; and second the quality of each rating agency's assessment and of the standards they applied to rate companies and securities.[178]

These agencies should have acted to reduce the asymmetric information problem when rating those ABS as they should have had the necessary expertise and adequate incentives to perform their assessments and ratings knowledgeably and faithfully,[179] not only of the creditworthiness of the SPV issuing the securities, but also of the securities and the particular issues throughout their life[180] to provide additional reassurance to potential purchasers who did not usually have access to complete information on the ABS.

If we bear in mind that credit ratings agencies charged fees (incentives) to produce their ratings and that those fees are paid by the institutions selling the ABS being rated, this is a clear case of manipulation of information and misrepresentation to the investment community and general public derived from the expectation of maximising their own gains[181]—also, a clear case of moral hazard.

Another source of moral hazard-related market failures derive from the fact that governments granted huge bailouts to ailing banking and financial institutions in order to keep them afloat due, amongst other reasons, to their systemic importance (they were 'too big to fail'), signalling to the market that, no matter how risky some transactions are and the number of them, no matter how indebted a financial institution has got after failing to price correctly the risks it has taken (putting itself in the position of being unable to afford the consequences of excessive risk taking), the government will pick up the bill and pay for those market failures (regardless of the source of the funds—e.g., taxpayers' money or proceedings from a sale of government bonds).[182] The too-big-to-fail doctrine can induce moral hazard because large financial institutions will take on excessive risks knowing that there is a lender of last resort (in this case, the government) providing the funding needed to avoid bankruptcy.[183]

Hence, it is possible to appreciate the extent to which moral hazard contributed to the under-pricing of individual financial and banking institutions' risks and to the shifting of such risks around the market, and how these market failures were encouraged by the expectation of exponentially growing profits and

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[177] ibid. See also Alexander, Dhumale and Eatwell (n 4) 232.

[178] Alexander, Dhumale & Eatwell (n 4) 232.

[179] Stephen J Choi and Andrew T Guzman, 'National Laws, International Money: Regulating in a Global Capital Market' (1996-1997) 65 Fordham Law Review 1855, 1901.

[180] Geoffrey Fuller, *The Law and Practice of International Capital Markets* (LexisNexis Butterworths 2007) paras 1.175, 1.179 and 1.190.

[181] Alexander, Dhumale and Eatwell (n 4) 232.

[182] A good starting point is the Dodd-Frank Act in the US, which states in its Peamble that it will protect the taxpayer 'by ending bailouts', showing explicitly to the market and to financial institutions that it will not recapitalise them should they go bust.

[183] Alexander, Dhumale & Eatwell (n 4) 30.

target-related rewards (e.g., bonuses),[184] driving bank executives and other staff to take excessive risks and transfer them onto the market, and credit rating agencies to advise banking and financial institutions on how to structure securities issues in order to grant them the highest ratings for the instruments to be more marketable, without taking into consideration the full extent of the implications of their ratings for overall systemic risk, contributing significantly to the development of the crisis.[185]

5. Too-Big-to-Fail doctrine: a comment on competition issues during the height of the crisis

From the liquidity crisis and subsequent recession that engulfed international financial markets flowed the idea of 'too big to fail' financial institutions: in fact, some these 'too big to fail' banking and financial institutions justified governmental intervention in the US and the UK with huge amounts of liquidity to keep them afloat, due to its systemic importance.

Additionally, for instance, the UK Government allowed and even pushed forward a merger of two very big financial institutions, Lloyds TSB and HBOS, even though this meant that the first of them took over the latter in a £12bn deal, giving birth to a banking giant that held almost one third of the UK's savings and mortgage market based on the assumption that any failure of HBOS would damage the UK—a transaction considered to be

> [T]ruly exceptional in its scale and would not usually be allowed. 'It's the kind of the deal that ministers would normally expect the competition watchdogs to block' (...) But on this occasion they are using a national interest clause in competition law to override any objections the watchdogs would have'.[186]

These examples show that regulators not only allowed financial institutions to grow in size and (systemic) importance, but at some point made it happen (forced by circumstances some might say) for if the governments of the US and the UK had to recapitalise these institutions because they were 'too big to fail', it was due to letting them grow and get such systemic importance in the first place.

According to the too-big-to-fail doctrine, the fact that there is a lender of last resort (whether a central bank or the government for that matter) can induce moral hazard: management and owners of large financial institutions will take on excessive risks and will manage their risk exposure less diligently in the knowledge that there is an institution that will provide the necessary liquidity to stay afloat and prevent a possible 'domino effect' that could affect other financial institutions.[187]

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[184] McDonnell, 'Financial Regulation After the Storm' (n 5). See also Alexander, 'Rebuilding International Financial Regulation' (n 3) 489: 'Executive compensation contributed to excessive risk-taking at banks and other financial institutions, while institutional shareholders failed to exercise an effective stewardship role to curb the excessive risk-taking of senior management'.

[185] Alexander, Dhumale & Eatwell (n 4) 233.

[186] BBC News Channel, 'Lloyds TSB seals £12bn HBOS deal' *BBC News* (London, 17 September 2008) <http://news.bbc.co.uk/1/hi/business/7622180.stm> accessed 22 July 2012.

[187] Alexander, Dhumale & Eatwell (n 4) 30.

Having said that, according to Avinash Persaud it is not a matter of financial institutions 'being too big to fail' in a context of lack of liquidity, because banks are 'intrinsically illiquid institutions. It does not take a large failure to lead to panic (...) we can have a large boom and subsequent crash, with the same economic misery, in a world of only small banks as in a world of large banks'.[188]

The response to this problem has been to impose limits to the growth of financial institutions through the imposition of tighter capital requirements and even by empowering the regulator to adopt highly intrusive measures, such as the imposition of divestments in extreme circumstances contemplated under section 121(a)(5) of the Dodd-Frank Act 2010.

On the other hand, the European Commission forced Lloyds to divest, ordering the sale of 632 branches but did not allow any of the UK's big banks to bid for it precisely in order to promote competition.[189] And on top of that, the UK's Competition Commission intended to force Lloyds to dispose of additional branches in an attempt to improve competition in the financial market,[190] as there were concerns over the position of Lloyds after the takeover of HBOS—a report of the Treasury Select Committee concluded in April 2011 that the bank was in a 'powerful position (...) [that] could be damaging competition in the UK'.[191]

Finally, let us remember now that the FCA will have to discharge its functions, once established, in a way that promotes competition in the market if it can do so in a manner compatible with both its strategic and operational objectives.[192]

6. Conclusion

It has been stated that:

> The primary role of international banking regulation (...) should be to promote the efficient pricing of financial risk in all financial systems and to ensure that regulators focus not only on the amount of risk created by individual financial institutions but also on the aggregate amount of risk created by all financial institutions in global financial markets.[193]

In this respect, the regulatory and supervisory infrastructures of the EU, the UK and the US have been modified and updated as a consequence of the

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188 Avinash Persaud, 'A Critique' (n 52) 147-8.

189 Robert Preston, 'Lloyds sale of Verde hits huge obstacle' *BBC News* (London, 14 June 2011) <http://www.bbc.co.uk/news/business-13761449> accessed 22 July 2012. See also Phillip Inman, 'Lloyds agrees branch deal with Co-op' *The* Guardian (London, 27 June 2011) <http://www.guardian.co.uk/business/2012/jun/27/lloyds-branches-co-op-nbnk> accessed 14 August 2012: The deal was finally closed with The Co-ooperative Bank.

190 Harry Wilson, 'Competition Commission investigation into UK banking "inevitable" *The Telegraph* (London, 25 May 2011) <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8534251/Competition-Commission-investigation-into-UK-banking-inevitable.html> accessed 28 September 2011.

191 Press Association, 'Lloyds Banking Group Blocks Competition in the Sector, Warn MPs' *The Guardian* (London, 2 April 2011) <http://www.guardian.co.uk/business/2011/apr/02/lloyds-banking-industry-competition> accessed 28 September 2011.

192 HM Treasury, *A New Approach* (n 123) paras 4.13, 4.20-2 and box 4.A.

193 Alexander, Dhumale & Eatwell (n 4) 15.

2007 liquidity crisis that also prompted a revision of international financial standards (e.g., the Basel Capital Accord), all this with the aim of promoting the efficient pricing of risks—i.e., both individual firms' and systemic risks.

Basel III has been built upon the principles and structure of its previous edition and has adopted the same approach to financial regulation and supervision, therefore still bringing homogeneity to the market and still relying in IRB models; and it does not adequately address both individual firms' and systemic risks by linking micro- and macro-prudential regulatory and supervisory aspects into one system, even though it has incorporated new, more stringent risk-sensitive requirements for the calculation of regulatory capital and the increase in the Tier 1 capital base to improve its quality and the liquidity of banks.

On the bright side, the BCBS has publicly said that 'banks must reveal 'all the components' of their capital from 30 June next year, as their progress in building up buffers is monitored by authorities (...) [for it] wants to ensure that lenders are falling in line with new Basel III rules',[194] signalling its intention to bring more transparency to the market by enhancing the quality and level disclosure on the part of financial institutions; this, in turn, will allow supervisors to assess in detail the capital position of banks. It remains to be seen whether Basel III will be able to achieve its objective and address both micro- and macro-prudential concerns and make the system more resilient.

The EU, on the other hand, has developed a regulatory and supervisory system that links both macro-prudential supervision of the EU financial system (ESRB) with micro-prudential supervision of financial institutions (ESAs) and coordinates the supervisory activities of EU Member States, standardising such practices and creating a level playing-field all across the EU, even though it has not been provided with centralised powers for crisis management to allow the new bodies to take executive action to address adverse developments that may threat financial and/or economic stability and the orderly functioning of the European financial system.

At the national level, the new regulatory and supervisory architecture in the UK incorporates a more macro-prudential and invasive approach to regulation and supervision: the FPC will be responsible for supervising the financial system in the UK in order to identify and address the creation of systemic risks, and the other two bodies, the PRA and the FCA, will work in coordination with the FPC and with each other while supervising individual institutions, thus linking micro- and macro-prudential supervisory activities. There are concerns, however, as to the Bank of England's powerful role after the Financial Services Bill gets Royal Assent: Kate Barker, a long-standing member of the Monetary Policy Committee, said that 'the steady erosion of democratic control over regulation of the financial system would accelerate under proposals by the coalition government to create a super-watchdog in Threadneedle Street' (i.e., the Bank of England).[195] Again, it remains to be seen whether the new system will be able to achieve its objectives.

Finally, these and other initiatives (e.g., the Dodd-Frank Act 2010 and the creation of the FSOC in the US) intend to address corporate governance concerns by bringing more transparency to the market and also aim at addressing competition concerns by limiting the growth of financial institutions up to the point of being 'too big to fail'. Finally, these initiatives, through the tightening of capital requirements (both the amount and quality of capital to be held by banks)

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[194] Julian Harris, 'New reporting template to hit banks next year' *City AM* (London, 27 Junew 2012) 8.

[195] Phillip Inman, 'Governor too powerful, says Bank insider' The Guardian (London, 23 August 2012) 28.

in relation to the risk profile of the institution, aim at addressing moral hazard concerns.

All these changes and the adoption of the above mentioned and other measures will directly impact compliance by financial institutions, as they will be scrutinised more intensely: no more ‘light-touch’ and ‘tick-box’ supervision means that supervisors will now get more involved and thus financial institutions will have to show and convince the authorities that they are holding enough capital in relation to their risk profile and that they are not irresponsibly creating and spreading systemic risks, and also that they are not growing and getting such a systemic importance that may threaten the stability of the financial system. But only future will tell whether these changes in regulation and supervisory practices are enough to recognise and address threats to financial stability and to provide for the orderly functioning of the market.

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