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The Evolution of Banking Regulation & Supervision: from isolated regulatory approach to regulation connected to macro-economic policies

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To the glory of God.

Many thanks to my supervisor, Dr M. Bagheri, as he inspired me to undertake a study of such an engaging topic.

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Abstract

The subject of this paper is a discussion of the banking financial crisis that surfaced from around 2008. The crisis is the most severe since the collapse of the US banking system between 1929 and 1933, but is unique due to its contagious effects on many countries, due to the interconnectedness of many economies in the 21st century. The main aim of banking regulation is to ensure a stable financial system and the protection of consumers. Banking regulation is the framework of rules and policies under which banks are required to operate. Supervision concerns the agents that are used on the delivery and effectiveness and enforceability of those rules and policies.

The subject matter of this paper is of interest to me due to the challenges that the pre-existing framework posed to regulators following the eruption of the crisis around the world. As is usually the case, banking regulators were unprepared, though the central banks were able to deliver on their function as a lender of last resort. This ensured that the crisis was abated to a good degree.

The academic challenge for me is an examination of the regulatory tools that had existed, an analysis of the adequacy of those tools, and the regulatory gap that now seems so obvious and whether even in-spite of what is now known, the current efforts to rebalance regulation are adequate. We are of course where we are, and current regulatory tools are usually a demonstration of past experience. The question now is, whether the issues that needs addressing are currently on the agenda of national governments.

I have restricted my discussion of this topic to the US and the UK, though I have on occasions referred to the EU and other countries. In my opinion, these two countries provide a good illustration of the causes of the crisis and what is being done to reduce the probability of future crisis.

ABBREVIATIONS

BBA	British Bankers Association
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BoE	Bank of England
CRA	Credit Rating Agency
CRD	Capital Markets Directive
CPI	Consumer Price Index
EBA	European Banking Authority
ECB	European Central Bank
ESA	European Supervisory Authorities
ESMA	European Securities Market Authority
ESRB	European Systemic Risk Board
EU	European Union
FATF	Financial Action Task Force
FCA	Financial Conduct Authority (UK)
FDIC	Federal Deposit Insurance Corporation
FPC	Financial Policy Committee
FRB	Federal Reserve Board (US)
FSA	Financial Services Authority
FPC	Financial Policy Committee (UK)
FSB	Financial Stability Board
FSAP	Financial Sector Assessment Programme
FSCS	Financial Services Compensation Scheme (UK)
FSF	Financial Stability Forum
FSOC	Financial Stability Oversight Council (US)
G-2-	Group of 20
IFI	International Financial Institutions

IMF	International Monetary Fund
IRB	Internal Ratings Based Approach
OECD	Organisation for Economic Co-operation and Development
PCBS	Parliamentary Commission on Banking Standards (UK)
PRA	Prudential Regulation Authority (UK)
SEC	Securities and Exchange Commission (US)
SPV	Special Purpose Vehicle
SIV	Structured Investment Vehicle
TBTF	Too Big to Fail
UN	United Nations

Chapter 1: Introduction: Financial markets failures and regulation

Banks have an intrinsic value to society, without which development and wealth creation in a society will be seriously impeded. Banks enable people to save, and facilitates the pooling of savings for the purpose of lending to whoever they might consider to be creditworthy[1]. They thereby facilitate economic interaction and development. Banks are commercial concerns and therefore serve the interests of their shareholders. Ordinarily, and without restrictions in place, they would behave like most businesses do, seeking profits at all costs, depending on their risk appetite.

If banks were not regulated, the protection of their depositors would hardly be of prime concern to them, in the order of priorities. Bank customers are, essentially, their creditors, who are consequently connected to the fortunes of their banks. Loss of confidence by depositors in banks would almost certainly result in a bank run. A bank run has serious implications for the economy. Depositor protection has therefore become one of the cornerstones of banking regulation across the world. A regime that does not undertake this function, risks jeopardizing the well being of its wider economy. If regulations were inexistent for the protection of consumers, banks would probably not be as transparent in their dealings with their depositors, in terms of the pricing of products, completion, provision of access to financial products and general transparency.

[1] Wood Philip, Regulation of International Finance, Chapter 1, Introduction

A liberal approach to banking regulation would mean that there is no systematic approach to the protection of bank deposits, and since only a proportion of bank deposit are available on demand at any one point, it may result into bank illiquidity, and consequently loss of confidence by depositors. There are therefore certain important requirements that are placed on banking institutions, including the protection of capital and the insurance of deposits with a premium levied to cover depositor claims[2].

1.1 The evolution of Financial Regulation

Banking regulation has evolved significantly in the UK and the USA as a response to various scandals and crisis. Financial crisis has therefore been a prime catalyst to banking regulation. Considered in another way, repetitive failures would be paramount in the banking industry, if lessons were not learnt from mistakes of the past. In the UK, Banking Regulation started with the passage of the Banking Act 1979. The Act set down the criteria that an institution had to satisfy in order to obtain a banking licence or accept deposits from customers, but it did not strictly define banking business. The most appropriate description of a Bank in the UK probably originated from case law[3], in the case of United Dominions Trust v Kirkwood (2).

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[2] Spong K., Banking Regulation: Its Purposes, Implementation, and Effects, Chapter 5
[3] McConnnachie Alistair, A History of Banking Regulation in the UK,Prosperity Magazine, July 2009.

The first comprehensive financial services regulatory framework was introduced to the UK following the Financial Services Act 1986. The Act introduced a number of Self Regulatory Organisations ("SRO's) with each given responsibility for a particular segment of the industry. Each SRO developed detailed rules that were tailored to its industry sector. Further down the years, the enactment of the Bank of England Act 1998 gave the BOE responsibility for setting interest rates and track the government's inflation target.

The Financial Services and Markets Act (2000) ("FSMA 2000"), underpinned the UK regulatory regime leading up to the 2008 crisis. Sir Andrew Large who had conducted a review of the regulatory regime, following the Maxwell pension scandal had misgivings on the then current state of financial regulation, which was anchored on the SIB. FSMA was therefore seen as having carried out the objective of the Large report. The Financial Services Authority ("FSA") was created from this legislation, with four main objectives: to maintain market confidence; for the reduction of financial crime; to encourage public awareness, and to ensure consumer protection. The FSA was the single regulator for the UK financial services industry; it was acknowledged by many as the appropriate structure for the twenty first century. It's stated goals were to "maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal". The FSA deployed considerable resource to firm-specific risks, the probability of their occurrence and their likely impact. It set out to achieve a more integrated supervision model, however, a common criticism of the FSA's approach, post-2008, was that its focus was consumer-driven[4], and that its assessment of risk and impact were rather firm-specific, in-spite of its objective of maintaining market confidence. It's interest in the UK being a major financial is also not lost on critics, who say that this was one of the reasons for its 'light touch' regulation. Perhaps if the UK government had undertaken a systematic review of the regulatory structure prior to the introduction of its 1997 reforms, and formally put forward its arguments for the creation of a single regulator, issues such as the combination of responsibility for monetary policy and banking supervision, would have been properly debated. It is notable that the re-balancing that occurred in 2013, now gives responsibility for the prudential supervision of banks back to the BOE. The Treasury was of the opinion back then that the BOE Governor would have been too powerful. In the view of Davies and Green, the main driver for the 1997 change was the Chancellor's interest in the reform of the monetary system, part of which resulted in the BOE gaining independence in interest rate policy, without as much attention paid to regulatory reform..

The US has historically had a more complex structure of prudential regulation of banking, due to the number of separate and independent regulators. The US has a dual-banking system of state and national bank authorization, which is stepped in history. The national government had introduced a national currency to support its war effort and had desired to put an end to states issuing their own banknotes. The result is that there are state banks that are

[4] this may have been due to the various mis-selling scandals, including , on mortgage endowments, pensions structured investment products, payment protection insurance.

regulated by the states and national banks that are chartered by the Office Comptroller of Currency. According to Dalvinder Singh, the primary regulatory bodies of the FRB, the OCC, the FDIC and the Office of Thrift Supervisors, were responsible for the supervision of approximately over 5 million institutions.

The FRB holds responsibility for the prudential regulation of state, national, foreign bank operations and financial holding companies. In addition, it holds responsibility for monetary policy and stability. The FDIC regulates state banks that are not regulated by the FRB.

The development of banking regulation has similarly responded to crisis or regulatory failure in the US. For instance, the establishment of the FDIC, followed the crisis of the 1930's and was established for the protection of bank deposits for national and state banks. Banking regulation in the US is disjointed, though there have been intermittent moves into regulatory consolidation. The Banking Act 1933 (also referred to as the Glass-Steagall Act) focused on the dismantling of universal banking and a separation of banking activities between retail and investment; this was in response to the Great Depression. This barrier was later dismantled by the Gramm-Leach-Bliley Act 1999, as the Glass-Steagall Act had been criticized for being the wrong anti-dote to the failures that resulted in the Great depression[5]. The aim of the Gramm-Leach-Bliley Act was to facilitate the efficiency of the US financial system, through, for instance, enabling the formation of financial holding companies that were supervised by the Federal Reserve, as the lead regulator. It

[5] Singh Davinder, Banking Regulation of UK and US Financial Markets, 2007, at page 37

nevertheless did not encourage a universal banking model and the US continued with the multi agency approach to supervision.

The US banking regulatory agencies are therefore comprised of Federal Reserve, Office of the Controller of the Currency, the Office of Thrift Supervision, or one of fifty sate regulators. The Federal Deposit Insurance Corporation is responsible for the protection of the fund. The state chartered regulates those state banks that are not part of the federal stem of regulation; some of the state regulatory agencies are powerful to the extent that their regulatory reach goes as far as international banks, like in the example of New York.

The complexity of the domestic banking regulation in the US may very well serve as a hindrance to a harmonious approach to multi-jurisdictional regulatory initiative, such as in the case of Basel II[6].

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[6] Davies H. and Green D., Global Financial Regulation, The Essential Guide, 2008, at page 161.

1.2 Shift of paradigm

Major changes in banking regulation, may be attributed to responses to banking crisis, the perceived anti-dotes to identified risks including the increased awareness of the need for consumer protection, national and international efforts to combat money laundering, the development of new banking products and services, and the growing competition amongst banks.

In his discourse of Future Trends in Banking Regulation, Kenneth Spong claims that "technological change, rising competition in banking, and the future financial and economic environment raise several issues for banking regulation and its objectives of depositor protection, monetary stability, an efficient and competitive banking system, and consumer protection[7]", though he also recognized that there is a need to continuously tune regulation to adapt to a changing environment. It is this writer's view, that Spong's prediction has almost certainly come true. It is also correct in my view, to say that this is an evolving paradigm, so perhaps an appropriate description of this particular section is not how the paradigm has shifted, but rather, the main determinants of the shift being those cited above from Spong.

The reasons for the shift in my view are two-fold. One is the natural phenomenon of new products coming into the market. The other is

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[7] Spong. K, Banking Regulation: Its Purposes, Implementation, and Effects, 1994, Chapter 8

the shift in the marketplace itself, that is partly driven by the increased competition amongst banks.

The development of innovative banking products has for instance led to new financial instruments, and therefore new risks. Banks have become managers of interest rates, exchange rates and market risks, for themselves and for their customers[8]. These include collateral debt obligations, residential mortgage backed securities including derivatives transactions[9]. According to *The Economist* magazine, the over-the-counter derivatives market was around $700 trillion in value and the derivatives market on exchanges $83 trillion, as of June 2011[10]. Derivatives typically carve out the risk and return elements of basic financial instruments, which enable those financial institutions to have the ability to manage their risk exposures. The increased competition amongst banks is driven by technological advancement i.e. electronic banking, in addition, by customer awareness and choice, the ability to penetrate more markets both inland and internationally, and the drive for increased shareholder value.

The identified changes mentioned above and others, have resulted

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[8] Spong. K, Banking Regulation: Its Purposes, Implementation, and Effects, 1994, Chapter 8

[9] (Report). Office of the Comptroller of the Currency, U.S. Department of Treasury. Retrieved July 2013. "A derivative is a financial contract whose value is derived from the performance of underlying market factors, such as interest rates, currency exchange rates, and commodity, credit, and equity prices. Derivative transactions include an assortment of financial contracts, including structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards, and various combinations thereof."

[10] Clear and Present Danger: Centrally cleared derivatives (clearing houses) *The Economist* (Economist Newspaper Ltd.(subscription required) 12-04-2012. Retrieved 06-05-2013.

into a response from the regulators, leading to regulations on the capital adequacy of banks, systems and control, risks management, deposit guarantees and consumer protection. Banks are now required to hold a certain amount of capital dependent on their risk exposures, the entrenchment of adequate systems and control, rules on transparency of bank products, and contribution to a deposit insurance guarantee scheme. According to Spong, this led in the USA, to a 1991 legislation on "limits on discount window borrowing by undercapitalized institutions, independent audits and accounting reforms, real estate lending guidelines and annual bank examinations"[11]. The government also responds in accordance to their remit, being mindful of such matters as the recognition of the opening up of the market through competition, and the establishment of an ombudsman scheme for customer complaints and redress[12].

Barth et al conclude that banking regulation and supervision are products of the political set-up of a country, which essentially derives from the degree of the government's involvement with banking. Also, that government restrictions and control of banking does not encourage effective bank performance, as much as private monitoring. In their view, an efficient and more stable banking sector is more likely from a market driven type of supervision, where

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[11] Spong. K, Banking Regulation: Its Purposes, Implementation, and Effects, 1994, Chapter 8

[12] In March 2000, in the UK, the Competition Commission was asked to investigate the supply of banking services by clearing banks to small and medium-sized enterprises. The UK has an ombudsman scheme – the Financial Ombudsman Scheme, for consumer complaints against financial institutions, including banks.

information is readily available, deposit insurance is less emphasized, and private sector participation is encouraged. They claim that deposit insurance discourages a true assessment of banks; that a lesser involvement of government with lending diversification and a more transparent system for the reliable disclosure of information, leads to the likelihood of bank stability. In their view, Basel II's third pillar of market discipline had a more positive contribution than the first two pillars of capital regulation and official supervision. They claim that their investigation did not reveal a correlation between stringency of capital regulation and the performance of banking systems. They say that capital regulation rules can be twisted and used to work for the government's advantage, by not calibrating it realistically, as in the example of Argentina which misapplied the credit risk weight of it's government debts as zero. As regards supervision, they say that unless the country is very well developed, the strengthening of supervisory powers impede bank development.

1.3 The 2008 financial crisis & response to the crisis

Bank "Crises are a manifestation of imperfect information, coupled with externalities".[13] According to Davies and Green, there were four main regulatory models, leading up to the financial crisis:[14]. In their analysis, the tripartite and the unified models were more common, the dual a little less common and the 'twin peaks' model, quite rare.

There have been numerous commentaries on the root cause of the crisis. It is perhaps useful to trace the cause and the unfolding of the crisis, in order that the responses to the crisis are properly understood, and commentaries on future regulatory models are critically appraised.

In an instructive report by the UK House of Lords, on Banking Supervision and Regulation[15], the history and causes of the crisis was traced from the imbalances that existed between the world economies; the overflow of excess money in the oil-producing and some Asian economies that fed consumption in the West, particularly in the US. The US was thereby presented with the double jeopardy of low interest rates resulting from the large capital inflows from these better-off economies and an imbalanced fixed exchange rates that

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[13] Barth J.R., Caprio C. Jr, Levine R., Rethinking Bank Regulation, 2006, at page 26

[14] Davies H. and Green D., Global Financial Regulation, The Essential Guide, 2008, at page 183

[15] House of Lords, Select Committee on Economic ~Affairs, 2nd Report of Session 2008-09, Volume 1 Report

resulted into cheap affordable imports. Inflation was low in the West and there was a high demand for credit. The report explains how the resulting asset prices led banks to competitively lend to households and businesses in a desperate attempt to achieve high returns on their investments. The standards of credit assessment were therefore lowered, resulting in sub-prime lending. Sub-prime lending in the US, was reported to have increased from 10% to 32% in a two-year period between 2003 and 2005.

Y. V. Reddy whilst commented on the re-regulating or rebalancing of the financial sector, noted, "excessive regulation was one of the causes of the global financial crisis"[16]. He claimed that excessive de-regulation of the sector took place mostly in the US, the UK and other European countries, but that this was not consistent with the practice in other developed economies like Australia or Canada. He argues that better supervision does not necessarily mean more regulation.

According to the PCBS, proprietary trading contributed to the financial crisis, though the commission was of the opinion that it was not a significant factor that led to the crisis[17]. The definition of proprietary trading varies within the financial industry, but perhaps a very clear description of this activity was provided by Lloyds as a situation where bank risks its own capital by taking positions in financial instruments in order to profit. Its view was that bank failure leading to the crisis was more a result of "highly leveraged

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[16] Reddy Y.V., Financial Sector Regulation and Macroeconomic policy, Bank for International Settlements Paper s No 62, year?????

[17] House of Lords (2013), Parliamentary Commission on Banking Standards, Third Report of Session 2012-13, 5 March 2013

structured credit, ineffective liquidity or risk management and/or poor corporate governance"

In its report the PCBS[18], cites a common interest in property prices as one of the causes of the crisis. Other reasons cited were over reliance on quantitative analysis, and the failure to learn the lessons of past failures,

[18] House of Lords, House of Commons, Parliamentary Commission on Banking Standards, Changing Banking for good, First Report of Session 2013-14, 12 June 2013, chapter 3

Chapter 2: Simple and isolated regulatory approach

2.1 Introduction: Banks and market failure: Systemic Risk and negative externalities

In this chapter, I have attempted to discuss the isolated approach to regulation that existed pre-2008 crisis, by examining the basic reasons for banking regulation, the risks that banks pose to the economy, and the infrastructure that existed to address those risks.

Some say that the crisis would have been avoided if not for the wider systemic risks and the negative externalities that effect the industry, however, it is apparent that banks have an inability to learn from the lessons of past crisis[19]. Banks have always been exposed to influences that are directly out of their control. Some noted that banks placed too much reliance on quantitative analysis, yet others cite the operation of regulatory silos.

The externalities included the combination of macro-imbalances and financialisation, rapid credit growth, the inadequacy of the regulation of cross-border banks, and issues surrounding market efficiency and market rationality,[20] as further explained in chapter 3 below.

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[19] Report of the Parliamentary Commission on Banking Standards, Changing Banking for Good, 2013, page 106

[20] The Turner Review, A regulatory response to the global financial crisis, 2009, page 13

2.2 Why do Banks have to be regulated?

The answer lies in an understanding of the functions of a bank. Banks are holders of depositors' funds and consequently, the supplier of credit into households and the wider economy. Availability of credit is important to the development of an economy, as it provides the means for personal attainments, and the provision of facility and infrastructure. Banks are the trusted guardians of depositors' money. For these reasons, the regulation of banks not only satisfies an economic function, but is also a subject of public policy. The first sniff of a bank's failure would spell trouble for the system, as depositors would demand the return of their money. Banks, typically do not have as much money in their coffers as they have received from their depositors. A bank run would therefore result into a systemic issue, affecting households and businesses. Some key objectives of national governments is economic development, maximization of economic output, and the promotion of access to capital. Banking crises will very likely lead to reduced economic output, economic volatility and worsen economic conditions[21]. Furthermore, as recent experience has shown, it also leads to unemployment, economic recession, sharp reduction in credit and other social problems. It is for these reasons that governments promulgate laws and regulations that govern what banks are allowed to do.

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[21] Barth J.R., Caprio C. Jr, Levine R., Rethinking Bank Regulation, 2006, Contrasting Approaches to Banking Regulation, pp26

2.3 What are the banking practices that have to be regulated?

Financial stability is a prerequisite of economic stability. Bank failure thereby results in loss of confidence in an economy. Regulators are the guardians of the banking industry and indirectly, of the economy. The importance of an efficient banking system should be given as much prominence but set against those of a competitive market economy, where inefficient banks are allowed to fail.

In view of the role of banks in the economy and their importance to economic growth and financial stability, what should be regulated becomes obvious. Some of these are covered in Chapter 2.6 below, but there are others that warrant mentioning here.

FSA's objectives, though that body is now defunct is instructive. Their stated objectives were to maintain market confidence; the reduction of financial crime; to encourage public awareness, and to ensure consumer protection. These translated into a rulebook that covered what was referred to as High Level Standards, Prudential Standards, Business Standards, and Redress arrangements. The detailed rules covered systems & controls, ensuring the probity of bank's senior management, the continued competency of those in key functions, including customer functions. Others covered capital adequacy, credit and operational risk management, conduct of business and the compensation arrangements for customers who had suffered loss[22].

The FRB says that its mandate is "to maintain a safe and competitive U.S. and global banking system." They do this by overseeing consumer protection, bank reserves provisioning, monitoring of inter-bank liabilities, and international banking operations. The FRB's rulebook also sets out the requirements for membership of state-chartered banks in the Federal Reserve System; sets limitations on certain investments and requirements for certain types of loans; establishes the minimum ratios of capital to assets that banks must maintain and the procedures for prompt corrective action when banks are not adequately capitalized; and, establishes rules governing banks' ownership or control of financial subsidiaries[23]

In summary, the banking practices that must be regulated are those that would ensure that the economic stability of a nation is not compromised, and it is these aims and objectives that translates into rules on systems and control, requirements on capital adequacy, and for banks conduct of business.

Capital adequacy is key to the survival of any business enterprise, and even moreso for banks. Banks should exist for the common good, the importance of capital adequacy cannot therefore be over-emphasised. Banking is one particular area in which national governments, prescribe rules on capital requirements for its

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[22] www.fsa.gov.uk, the old website is still accessible, but directs into the FCA website, accessed August 2013
[23] http://www.federalreserve.gov/bankinforeg/reglisting.htm#G, sourced 26/07/13

operations.[24]. As the focus of this paper is rebalancing of regulation, with a particular interest on the stability of the banking system, it is imperative that most of the discussion on banking practices that are or should be regulated, is to do with capital adequacy.

[24] Banking on Basle: The Future of International Financial Regulation, 2008

2.4 What are the international banking regulations?

The concept of international banking regulations is really non-existent. Countries define their own rules for the regulation of banks that operate within their borders. There are of course international efforts to achieve a coherent and common approach to the regulation of banks, especially where this concerns issues of capital adequacy and anti-money laundering. This is evidence of the changing nature of banking regulation from a simple to a more complex approach.

One particular initiative that has the semblance of international regulation is that which emanates from the BCBS. The BCBS describes its objective as the "understanding of key supervisory issues and to improve the quality of banking supervision worldwide"[25] and has been at the forefront of initiatives on the implementation of international standard for minimum capital regulation. Its committee's membership is representative of major developed and emerging market countries. In addition, it has formal channels for co-ordination with non-bank financial institutions and with non-member countries.

According to Tarullo, the rationale for banking capital requirements begins with the fact that, the central government is the deposit insurer or lender of last resort, or both, hence "the government is potentially the largest creditor of the bank"[26]. The bail-out of Lloyds

[25] www.bis.org/bcbs, sourced 30/07/13

[26] Tarullo D.K., Banking on Basel: The Future of International Financial Regulation, 2008, Chapter 2: Role of Capital Regulation

TSB and the Royal Bank of Scotland, has shown how the taxpayer through direct funding, economic or other social costs like unemployment and scarcity of credit take responsibility for the mismanagement of banks. Banks shareholders profit limitlessly from an upside but have a limited amount of loss in a downside. This results into costs on the society, well in excess of the losses incurred by the management and shareholders.[27] A classic moral hazard.

Basle's history is evident of the notion that regulations respond to economic developments. Its origin is traceable to developments in the aftermath of the Second World War, when the IMF Articles of Agreement allowed national governments to introduce controls on their domestic financial systems. The Committees' primary task was to co-ordinate the activities of national regulators[28].

Basle I and II were introduced before the 2008 crisis and attempted to stipulate risk and capital management requirements that were commensurate to their activities. Basle II was designed to be an improvement on Basle I and uses a 'three pillar' model. Basle III is currently being rolled out for adoption in 2015, though some countries are committed to its introduction before then.

Another piece of regulation that has gained international prominence concerns the fight against money laundering and terrorist finance.

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[27] Alexander Kern., Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, 2006, Summing Up and Conclusion, page 253

[28] Alexander Kern, Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, 2006, Summing Up and Conclusion, page 254

FATF, is an inter-governmental body with the aim of combating money laundering and terrorism financing. FATF currently comprises of thirty-six members and thirty one international and regional organisations that are Associate Members or Observers of the organisation[29]. Since the main focus of this paper is on core banking regulation, especially on the stability of banks and how this effect the wider economy, I have not discussed anti-money laundering controls in any detail.

[29] http://www.fatf-gafi.org

2.5 The role of the Basel Accords

My objective here is to further discuss the role of the Basle Accords, as regards supra-national regulation of capital adequacy including, general commentary and observations on its apparent inadequacies and limitations.

The collapse of three medium sized banks[30], with no obvious implications for systemic risks provided the G-10 central bank governors with sufficient reasons to consider that, due to floating exchange rates, banks would be at risk, if there were no co-ordinated cross-border supervision efforts. This resulted in central banks serious consideration of capital adequacy and cross-border supervision of banks, rather than the pre-existing practice of imposing on banks, minimum reserve deposits with the central bank[31]. The G-10 central bank governors also considered how to supervise branches of foreign international banks; and dealing with minimum capital requirements. According to W.P. Cooke, the first chair of the BCBS. "There is no objective basis for ex-cathedra statements about levels of capital. There can be no certainty, no dogma about capital adequacy". BCBS have since dealt with a variety of issues, starting with the first Basel Concordat of 1975 i.e. the first attempt to allocate international bank supervision between the host and home state regulators; a risk based 'capital Adequacy Accord' in 1988,

[30] the American Franklin National Bank; the Israeli-British Bank; the Bankhaus Herstatt.
[31] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, page 168

The Basel I Accord released in 1988, focused on credit risk, though it required banks to be mindful of other risks. The model prescribed a total minimum capital for a bank that was derived from the sum of the five risk categories, that were determined from the calculation of the capital required for each asset held by the bank. Its implementation was uneven and lacked uniformity in many countries; whilst implementation was effected in the EU through a directive, it was left to the other national governments to promulgate domestic laws for its introduction. Yet, the consensus is that the its implementation was fairly successful, with over 100 countries having adopted it, who were themselves not part of the negotiations

Tarullo D.K. expressed his view[32], on what he considered the apparent drawbacks of Basel 1, including the macroeconomic effects, regulatory arbitrage, and the divergence between risk and capital regulation.

The development of Basel II commenced less than a decade to Basel I and resulted from the perceived inadequacies of Basel I:, as a response to the sheer scale of securitization of mortgage activity[33] that was being undertaken by banks,. Secondly, it was discovered that the banking industry was progressively devising new methodologies of credit risk models for risk assessment purposes. , As new instruments were developed and bank activities more complex, Basle I started to lose credibility as a tool due regulatory

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[32] Tarullo Daniel K., Banking on Basel: The Future of International Financial Regulation, 2008, page 83

[33] note: securitization were undertaken primarily for other purposes, quirte separate from regulatory reasons, including e.g. the reduction of interest rate exposure.

arbitrage, as the new method "underscored the degree to which a risk weight assigned to an asset or asset equivalent could diverge from the bank's estimate of the actual risk created by that exposure"[34].

Comments were made on the limitations and inadequacies of Basle I, including no less than Alan Greenspan, the Feds Chairman. There were also comments that the Basle Committee had to strike a balance between maintaining a model that would remain relevant to the vast majority of banks, whilst being mindful of the need for an IRB model in the larger banks. Nevertheless and in-spite of this, meaningful progress through collaboration and debate led to Basel II, though the IRB model led to disagreements, some in the national interests but in the case of the US amongst its four national supervisory agencies.

Basel II was characterized by the reliance on CRA's, use of internal risk assessments, and lower capital requirements for residential mortgages.[35] Some have challenged whether the Basel policy of higher capital ratios has not led to societal trade-offs between banking system stability[36] and allocation of capital to productive uses. Others say that it is unproven to be the most efficient method for ensuring for banking stability. One must ask, whether in the light of the bank crisis, the Basle Committee were overly focused on

[34] Tarullo Daniel K., Banking on Basel: The Future of International Financial Regulation, 2008

[35] Tarullo Daniel K., Banking on Basel: The Future of International Financial Regulation, 2008, 4, 132

[36] One of the stated aims of Basle II is 'soundness and stability of the international banking system'

capital adequacy and capital rations as the main anti-dote to instability and systemic risk. The poor quality of mortgaged backed securities led to the spread of liquidity problems and was one of the main reasons for the unfolding of the 2008 crisis. Alexander, et al argue for other considerations for ensuring market discipline, in particular to make banks issue subordinated debts and that if this was properly designed, the market would almost end up policing itself, as risk based capital standards "are still no substitute for the discerning ability of the market to assess and price risk".[37] Tarullo supports this view as well whilst recommending the way forward from Basle II[38]. It is therefore apparent from recent experience that capital adequacy aside, BCBS needed to have taken a more intrusive stance on the primary activities of banks as part of their efforts to achieve bank stability, though there are some who argue, that if Basle II had been fully entrenched, rather than the debates that ensued, requirements for the setting aside of capital for off-balance sheet activities would have provided some measure of control on banks activities. In my view, the argument can only be won in one way, i.e. proven by the fact that the Basle Committee itself commenced in 2011, a revision of Basle II, by focusing on market risk framework, in the belief that the main cause of losses in the financial crisis and the increase in leverage in trading book was a result of market risk framework not capturing key risks.

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[37] Alexander Kern., Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, 9, 235

[38] Tarullo DK, Banking on Basel, 8,270

More generally, there are concerns that even the regulators do not have a sufficient understanding of how the A-IRB model might be deployed in regulated firms. A considerable amount of discretion is thereby ceded to banks during the evaluation process, a real potential hazard for the entire concept. Banks typically will not hold more capital than they need to, however, there is evidence that the largest banks hold capital in excess of regulatory requirements[39] It proves that banks to a certain extent are mindful of the risks of risking their survival. Even though they would play to the wire, if allowed, they must respond to other variables like market demands, by counterparties and debt investors, planning for the downsides of business activities.

Basle III was introduced in 2013 with the aim to "strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector". Its objective is to ensure that banks can absorb shocks arising from financial and economic stress, improve risk management and governance and strengthen banks' transparency and disclosure[40]. The reforms are targeted at micro-prudential regulation to help raise the resilience of banks to periods of stress; addressing macro-prudential system-wide risks and the pro-cyclical amplification of these risks. If there was one lesson that has been learnt by the Basle Committee from the 2008 crisis therefore, it is that macro-prudential issues has now entered its agenda, coupled with a consideration for systemic risks. There are also common sets

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[39] Tarullo Daniel K., Banking on Basel: The Future of International Financial Regulation, 2008, 5, 142

[40] British Bankers Association, Basle III workshop, 25/02/13

of monitoring metrics to assist supervisors to analyse liquidity risk trends.

The US is committed to implementing Basle III and has even gone further by extending it to other financial institutions with more than USD50 billion in assets. The FRB have also said that they will conduct annual tests on banks. In the EU, Basle III requirements have been adopted into Capital Requirements Directive 4, for implementation in EU countries.

In my view therefore, the BCBS appear to have made significant strides with Basle III, though it should then broaden out the wider agenda for the achievement of its goals. It has already recognized corporate governance and macroeconomic issues. Consideration should now be given to supervisory standards deployed by national regulators, and the framework for regulation within countries, even if these were only limited to recommendations. Macro-economic policies cannot be too prescriptive especially when they are intended for different countries at varying stages of development, however, the Basle committee can at least lead the debate. In addition, the BCBS clearly lack the necessary resources that it requires in certain aspects of its work; this was demonstrated by its reliance on banks to develop the A-IRB approach

2.6 Some other important aspects of banking regulation:

An effective system of banking regulation must deploy tools that ensure micro-prudential and systemic risks are curtailed effectively. Some of these tools are quite apparent, others are not so obvious, as for instance in the example of proprietary trading. This section examines other tools that are commonly utilized to ensure bank stability.

i. Capital adequacy restrictions on type and quality of securities holdings, loan quality.

Banks expose themselves to greater risks during buoyant periods of an economic cycle, due to competition for profitable business. Capital adequacy rules help to apply brakes to banks exposure to those risks. This is one of the reasons countries adopt the BCBS standards.

Capital adequacy standards must be transparent, have an effective institutional framework, and a viable methodology. Banks have short term liabilities and a mixture of short-term and longer-term assets. As is typical of most businesses, a bank would become insolvent if its liabilities exceed its assets. Banks utilize risk management techniques to mitigate credit risks and economic shock on their loan portfolio.

Alexander, et al identified some of the causes of banking sector crises as financial, macroeconomic and institutional.[41] Banks compete for savers funds on deposit rates; they are at risk of loss when the return they receive on assets is less than what they pay on liabilities[42]. A macroeconomic environment is a possible source of systemic risk. A good institutional framework that instills confidence in depositors is essential. In the UK, the FSCS are very keen to remain visible to the public, through advertisements.

The need for capital adequacy is paramount, especially in the mega banks, where a moral hazard of the too big to fail is easily created.

According to Avgouleas E, the neglect of liquidity in the Basle II requirements, enabled banks to rely excessively on short-term funding to finance their asset expansion[43]. Perhaps liquidity regulation coupled with the suggested use of subordinated debt, advanced by some could have arrested this practice. The subject of capital adequacy has attracted more attention from regulators across the world than ever before. In the UK, the FPC of the BOE has started work in behest, since it was set up in April 2013. According to reports[44], it has been reviewing capital adequacy across banks in the UK and referring its findings to the PRA who have insisted that banks

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[41] Alexander Kern., Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, 8,206

[42] Banks assets in the form of longer term loans would already have been fixed at a lower rate of interest.

[43] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, 3, 116

[44] Giles C, Britain's Banks are still a danger to the real economy, Financial Times, 20 June 2013

redress their capital shortfall where necessary. As a result, the Co-op was forced to raise capital to address its deficiency, a process described by Chris Giles as "banking recovery in action". He though, questions whether the bigger banks would have attracted such attention from the government and not a simple requirement for the bank to address its capital deficiency by itself. It raises the issue of whether some banks are still too big to fail, in-spite of capital adequacy rules.

In the US, the FRB have started implement Basel III, and will be subjecting banks to multiple capital requirements, including the application of a risk-based capital ratio, that will require the largest global banks to hold 7 percent equity to risk adjusted assets and the most risk loans requiring more than 100 percent capital. The FRB are proposing to impose a further charge to the leverage ratio, a measure that is said to "ignore riskiness of assets and measures equity against total assets"[45]. It is uncertain whether there would be a level playing field as regards foreign banks, within its shores.

Banks will always argue against requirements that they should hold more capital. It is debatable whether higher capital requirements should lead to a constraint in lending, after all banks can act more prudentially, by seeking other avenues for seeking capital, for instance, through the restriction of salaries, bonuses or dividends or by raising new capital. Co-op offers an example: it was forced by the PRA to plug a £1.5bn hole in its capital buffers by injecting money

[45] Foreign lenders await orders as Fed puts Basel III into practice, Financial Times, 3 July 2013

from other parts of its business[46]. The challenge for regulators in the new dispensation is to be able to stand their ground against the bigger banks that were perceived as TBTF.

ii. Financial Stability and the prevention of systemic risks, including limitation on the activities that banks can undertake

Financial stability has always been at the forefront of banking regulation. What appears to have escaped the regulators is the systemic risks that an individual bank's instability has the ability to unleash on others, especially if that individual bank is big. Avgouleas illustrates the example of where the rational actions of individual banks that are faced with the same challenging issues could translate into a systemic problem[47]. This particular issue escaped even the Basle Committee when setting capital adequacy rules, as their main focus was individual bank's capital provisioning. This deficiency has been recognized and addressed in the Basel III framework.

The 2008 banking crisis has led to a review of regulatory structures in major financial jurisdictions across the world. The UK has abolished the FSA and replaced it with two new bodies , the PRA, responsible for prudential supervision and the other, the FCA, with responsibility for investor protection. It has also established the FPC in the BOE that is responsible for macro-prudential supervision and for maintaining financial stability.

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[46] Financial Times, Britain's banks are still a danger to the economy, 20/06/13

[47] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, page 133

In the EU, the Larosiere report in February 2009, has led to the creation of an European Systemic Risk Board with responsibility for macro-prudential supervision, the replacement of regulations for minimum harmonization and mutual recognition by the maximum harmonization standards of a newly established European Supervisory Authorities. The EU has also legislated for CRA's and placed them under the supervision of the ESMA, the regulation of hedge funds and promotion of standardization of OTC derivatives.

The US response is even more fundamental. It enacted the Dodd-Frank Act in July 2010, which resulted in a wholesale expansion of the Feds supervisory function to include the supervision of insurance companies, certain non-bank financial institutions, commercial banks, the standardization of OTC derivatives and the establishment of the Financial System Oversight Council (FSOC).

The international community has come to realize that some form of international regulation is essential for the protection of banking stability.

iii. Proprietary trading

Proprietary trading has been cited as some as one of the main causes of the banking crisis[48]. It is considered as one of the riskiest forms of banking activity, due to the riskiness or opaqueness of the products that are traded. The FSA noted that "where a bank decides to engage in proprietary trading there is a potential for increased principal-

[48] Not everyone subscribes to this view, e.g. refer to the UK's Parliamentary Commission on Banking Standards report, March 2013

agent conflicts with its clients"[49]. According to the Volcker Rule, it is the act of 'engaging as a principal for the trading acccount' of a banking entity. In other words, it is recognizable as an activity where a bank trades for the benefit of itself, with a view to achieving short term gains. The activity may take place in other forms that are not easily recognizable. Bank's activity in this area may be encouraged by the notion of TBTF or the moral hazard that accompanies it, as bankers become comfortable that no matter how big its loss, it will not result in the bank's failure.

In the US, the Dodd-Frank Act introduced a new section to the Bank Holding Company Act, 1956, which is commonly known as the Volcker Rule[50]. It is claimed that Volcker was in favour of a return to the Glass-Steagall Act, referred to above in Chapter 1.1. The Act has ingeniously banned commercial banks from undertaking proprietary trading, whilst permitting other financial companies to continue to do so, with the proviso that such companies are required by their regulatory bodies to provision for additional capital requirements to take account of proprietary trading. Those requirements have of course been imposed on the other large financial institutions due to the recognition of the systemic risks that they themselves pose to the financial sector, but at least banks would be more protected from the risk of failure relating to proprietary trading. The US has confined the law to banking activities being undertaken within its territory or

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[49] UK's Parliamentary Commission on Banking Standards report, Proprietary Trading, Third Report of Session 2012-13, March 2013

[50] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012,
p 352

the activities of banks regulated within its territory, no matter where the activities are undertaken.

In the UK, the PCBS advised the government in December 2012, to erect a protective "ring-fence" around retail banking activities, with the threat of breaking recalcitrant banks up, if they fail to comply. They also demonstrated their support of the US Volcker rule, though they were prepared to compromise for banks to be allowed to sell "simple derivatives" to small businesses.[51] In its published report, in March 2013, it enumerated the issues surrounding proprietary trading as threefold:- prudential, cultural and the social utility and the implicit guarantee. The PCBS stated that it had found no evidence that proprietary trading was the primary cause of the banking crisis, however, it concluded that it "created prudential risks to the banking industry as the exposure to markets than is necessary for client servicing increases the potential for risks that may not be understood until the next crisis". PCBS's stance recognize the risks of proprietary trading on the one hand, but without the conviction that it was primarily of toxic effect to commercial banks.

In my view, the important issue is for the regulator to be aware of the types of risks that the system faces, and where those risks reside. One must remember that the Glass-Steagall rule was introduced in the US not for the purpose of controlling risks, but to address the potential problem of conflicts of interest. It is also unclear whether proprietary trading activities are more likely to fail than client servicing activities, as illustrated in Northern Rock, afterall, the

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[51] "Banks need 'electrified' ringfence, says review", Financal times 21/12/12

prominent risk in banking is credit risk. Bankers are very innovative and they must be allowed to respond to changes in economic activities, in order that they are able to fulfill their role. It therefore is my view that the most effective and long-term approach is to commence a review of banking activities especially where banks are involved in universal banking, for the purpose of understanding both the microprudential and macroprudential risks that those activities entail. One must consider that the risks that are presented by non-ringfenced banks cannot be ignored, as they continue to have an influence on the rest of the banking industry.

On the other hand, retail and commercial banks provide a valuable service, by selling derivatives to their customers, the challenge for regulators is to ensure that such banks do not stray into activities that are not captured in their risk profile. The risks presented by each activity should determine the imposition of appropriate measure of capital provisioning.

iv. Corporate Governance

The banking crisis occurred in spite of the existence of rules to ensure good corporate governance. Bank regulators are naturally interested in bank governance, as it is one of the tools that can be employed in ensuring the safe functioning of a bank. In the UK, for instance, the FSA put in place high level and detailed rules on systems and control and senior management accountability. The Feds had similar rules in place as did many other developed economies. The Working group on Corporate Governance of the Basel Committee recommended, following the 2008 crisis, that boards should actively deliver on its responsibility for the bank, whilst supported by robust and independent risk and control functions. Interestingly, it also noted that bank's senior management should recognize any structure that impede transparency and the risks that these may pose.

The Basel Committee had admittedly in the years leading up to the crisis, published papers on the need for an effective corporate governance in banks[52], it should make increased effort to promote a common standard corporate governance, due to the globalization of the banking industry, in order to enhance the control of risky activities and mutual trust. It is therefore my opinion that the Basel Committee needs to go a step further in pushing this agenda into national regulators for adoption and execution, no matter what the resistance might be due to cultural differences.

v. Cross-country co-operation and harmonization of rules

The inter-connectedness of markets across national borders raises different issues for domestic regulation. National governments are more interested in the stability of their economies, as opposed to that of other nations. However, in the modern world the degree of influence of externalities is more pronounced. Economic activities inter-connect and create externalities as much as banking activities. This is apparent from the manner in which cheap money combined with cheap exports from China and some far eastern economies contributed to the bubble in the US, that led to securitization in banking, and through the inter-connectedness of banks, bank liquidity problems in the

[52] Alexander, Dhumale, Eatwell, Global Governance of Financial Systems, 2006, page 244

western world. The realization by national regulators that they face a common challenge, therefore makes it incumbent on them to work together for the common good. National supervisors may have conflict of interest that prevent them from pursuing the common good, for instance when the taxpayers of a home country supervisor are responsible for the rescue costs of an international bank whose depositors are mostly located abroad. The IMF and the World Bank, the two most prominent international financial institutions, only operate in a standard setting role and do not have any compelling or enforcement powers. There is currently no global regulator that has the authority to supervise banks systemic risk on a global basis, though the ESRB fulfills this role as far as the EU is concerned, supervise cross-border banks, track national regulators enforcement and compliance with the regulatory provision of the BCBS or deal with crisis matters of international proportions[53]. It is therefore incumbent on national regulators to find a common ground for cooperation. It is obvious that the concept of international financial regulation does not exist, since there is no law that actually binds nation states to act in accordance to a certain code, in the regulation of its home market. It is therefore my view that the main determinant for a harmonious approach is the incentive that the desire for crisis-avoidance presents. There are of course others, for example, it will probably enhance the economy of a country if banks from that country are considered to be sufficiently capitalized and governed.

[53] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012,

There is also the issue of reputational constraints. Perhaps the way forward is for nations to enter into MoU's on particular issues.

There are some who hold the view that Transnational Regulatory Framework (TRN) is the solution to the regulatory challenge for a harmonized approach. Some have different views, including, that national regulators have their own national self-interests, that international regulatory cooperation results into conflicts of interests amongst the countries as some countries attempt to dominate, and that they are incapable of resolving amongst those countries.

vii The role of auditors

In order for the efforts and work of the government, regulators, shareholders, and bankers themselves to be efficiently delivered, there must be an overaching oversight on the process and delivery of the common objectives. Bank's auditors should ideally operate as another pair of eyes for regulatory objectives. It is worth noting that the factors leading to the collapse of Lehman Brothers was not identified by its auditors. There have been serious allegations about the roles that auditors played, giving banks clean bill of health even during the months leading up to the crisis.. There have also been comments about the concentration of audit practices through lack of competition and the need to broaden the scope of audit work, to include for instance, business risks, key performance indicators and internal controls.

The issue of auditing of CRA's and of ring-fenced banks in the UK is of particular interest. One industry stakeholder, Mazars, submits in one of its reports on the PCBS, that "auditors of ring-fenced banks should be a different firm from the banking group auditors; that no audit firm should audit more than one ring-fenced bank, that ring-fenced bank's auditors should be voted on by shareholders and separately from the group's auditors and that auditors of the ring-fenced bank should not provide non-audit services to other parts of the group and should be restricted in any non-audit services within the ring-fenced bank"[54]. These comments are quite sensible and are ones that should be considered not only within the context of ring fenced banks and CRA's , but also more widely in the banking industry.

[54] Mazars, 2013, Mazar's Insight: PCBS Final Report, Too important to fail, but too big to succeed?

2.7 The Role of Credit rating agencies

Credit rating agencies have played a prominent role assessing the risks of default of credit securities. They support the analysis of institutional investors, mainly investment banks in their decision making. According to Philip Turner, the activities of CRA's contributed to the banking crisis in three ways, even though he then concluded that regulatory responses would not completely resolve the identified problems[55]. Firstly, he cited the increased importance of securitized credit as an offshoot of structured credit and the resulting problem that procyclicality would add to a self-reinforcing downturn. He explained that the growth of the credit derivatives market resulted in the use of credit ratings in counterparty collateral transactions and hence the possibility of a strong procyclical effect, and gave the example of AIG where in 2008, a threatened rating agency downgrade resulted into serious liquidity strain. A great majority of the securitized credit were held by investing vehicles that were solely interested in maturity transformations and not by end investors that were prepared to hold to maturity. The other investors had assumed, and interpreted a good rating as a stamp of approval for not only credit risk, but also liquidity and market price stability. In the second place, he claimed that there was a development of ratings ineffectiveness, due to a number of factors,

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[55] The Turner Review, A regulatory response to the global financial crisis, 2009, page 76

including the extension of ratings to products where there was limited historical information, the complexity of structured credit instruments, and over-reliance on mathematical modeling. The third reason he gave related to the independence and therefore effectiveness of the work of CRA's.

He therefore advocated for the compulsory registration and regulation of CRA's to ensure transparent governance and management of the conflicts of interest that may arise in the activities of CRA's. He also pushed for CRA's to be transparent on the basis of their assessments to investors, in order that those investors are not misled that those assessments are for credit purposes only and not for liquidity or market price. Furthermore, he proposed that there should be a fundamental review of the use of structured financing ratings in the Basel II framework[56].

There was much reliance on credit agencies in the Basel II framework, for the assessment of credit risk, leading to possible conflicts of interest. CRA's were involved with the ratings of mortgage securities backed assets, one of the dysfunctional products in the market that led to the crisis. It appears to me therefore that the Basel Committee could only have been behind the curve.

Yet another criticism that is levied on the banking industry was that there was sheer over-reliance on the assessments of CDO's by CRA's even when it was apparent that those assessments were unreliable.

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[56] The Turner Review, A regulatory response to the global financial crisis, 2009, page 8

Avgouleas E expressed the view that this amounted to 'availability and representativeness heuristics' or put in other words, working from a known practice/rule of thumb, that were derived from market participants conclusion that it was unnecessary to undertake their own vigorous analysis of such complex products[57]. This is really surprising, given that there was little evidence that the market had a proper understanding of the products.

The EU has proceeded to legislate for the supervision of credit ratings agencies, by introducing a harmonized approach and establishing a registration and supervisory oversight of the new European Securities and Markets Authority (ESMA). CRA's are now required in the EU to comply with stringent requirements, including transparency, avoidance of conflict of interest and the submission of their process and methodology to historical validation. There exists a string of other controls, including a ban on CRA's provision of advisory services and a requirement for an internal audit of their work.

In the US, the Enron and Worldcom failures had already begun congressional focus in the activities of CRA's. The Sarbanes-Oxley Act of 2002 therefore required the SEC to undertake a study of the role and function of CRA's in the operation of the security market. Provisions of the Dodd-Frank Act which eventually expanded the SEC's oversight of CRA's policies. The US have therefore introduced similar provisions to those that have been implemented in the EU.

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[57] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, page 125

A number of issues were debated by the European parliament, leading up to the legislation on CRA's. Some of these, should naturally address some of the problems that were inherent in the manner these bodies influenced the financial markets. For instance, the ownership of CRA's and better transparency on their investment holdings should serve the market better. In addition, the introduction of a civil liability system should ensure that CRA's are made to redress investors where they have been negatively affected by abuse or gross negligence by the CRA.

Avgouleas argues for the establishment of a global financial regulator, and adds that it should be given the role of regulating CRA's in much the same manner as is currently provided in the EU[58].

It is my view that these initiatives could only help to address the inadequacies of the pre-crisis system, though it is also recognized that there must be commitment to regularly review the activities of CRA's in order to assess whether the desired objectives are achievable despite the changes that have been made. This is also important from the view of assessing whether there should be a change of course in the manner of approach to the problem.

[58] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, page 450

2.8 The need for a rebalance of regulation

The global financial crisis has proven that there was something dysfunctional about the pre-existing practice of the regulation of banks. Banks are meant to facilitate and service the economy and not the other way round.. Financial markets exists to underscore an efficient allocation of resources, but it appeared that bankers started to regard themselves rather differently.

Banking regulation has of course developed over many years, mostly on the back of failures and crisis, this is therefore not new. This particular crisis presents both developed and emerging economies with an opportunity to conduct a review of what went wrong, and to commence on the establishment of a better framework for the future.

Banking regulation is fast assuming a different culture post-crisis. We now find that regulators, in particular, Central Banks are now more open and transparent in their policy decisions, to the extent that they create the perception that they view, not only the banks that they regulate but the wider participants in the national economy as their stakeholders. For instance, there have been public pronouncements of the detailed workings of central bank's policy on interest rates. The BOE says that one of it's aims in this respect, is to enable people and businesses to forward plan. I am not suggesting that the regulators have not previously been open, but only that there is a noticeable wind of change in the manner of their openness.

It is widely accepted that the banking crisis was caused by a combination and interconnected of a number of issues that affected banking domestically and internationally, some of which are discussed in chapter 1 above, and the rest of this paper. It is also apparent that the regulators risk radar was ignorant of some contributors to the crisis, to the extent that they were totally caught unprepared for dealing with them. History teaches us that the development of regulation is usually directly connected to need; need that are themselves borne out of a crisis or failure. Regulators recognize the world over that they have to respond to the current challenges by having a radical re-think of their approach. This is evident in the US, UK and in the EU. Regulatory structures are being re-modelled, regulatory issues are being reviewed and re-casted following a wider review of the causes of the crisis and a viable plan for the future. The response to the challenge requires far more than the creation of a low interest rate environment, a mere restructure of the regulatory agencies, and the adoption of more stringent capital adequacy standards. There should in my opinion, as others have suggested also be a root and branch review of the social utility of banks, a polarisaton of certain aspects of banking activities, a review of the role and potential risks of shadow banking, a better coordinated efforts of regulation at the international level, that extends the on the work of the Basle Committee, and a review of the role and effects of rating agencies. Some of these restructures have already commenced, but there is still a lot to do, in terms of pulling in the other identified useful variables. For instance, the importance of macro-economic considerations and how this joins up with macro-prudential policy making cannot be over-emphasized.

Chapter 3: The new regulatory challenge and failure of the old regime of regulation

3.1 Introduction

One of the lessons of the banking crisis, is the appreciation of the potential impact of the 'too big to fail' banks. These institutions are considered TBTF due to their inter-connectedness with other banks the economy at large, and also the cyclical effects of their failure. The success of re-balancing banking regulation, and addressing systemic risks is to a large extent dependable on how well risks are mitigated at the TBTF banks. The FSB has recommended a policy framework for addressing this problem as follows: a process which ensures that banks can be wound down without the risk of destabilization to the financial system and at no cost to the taxpayer; a requirement that such banks have a higher provisioning for loss; a more intrusive oversight of TBTF banks; an infrastructure that will reduce the possibility of contagion that may arise from the failure of particular institutions; and, tailored prudential rules national regulators.[59]. Others have suggested the separation of retail banking from investment banking, and requirements that banks have viable recovery and resolution plans, otherwise referred to as 'living wills'. Yet, others have questioned the lack of connectedness of prudential regulation with macro-economic policies.

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[59] 'Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, p 348

In reality, with all the best will behind the initiatives being pushed by the FSB and the BCBS, they amount to soft law that requires the support of national regulators. Nevertheless, a lot of progress has been made in the US, the EU and the UK, which provides some encouragement.

3.2 Problems with the above simple approach to banking regulation

The debate around the framework for banking regulation was predominantly focused on issues, such as structure, independence, the combination of bank supervision with monetary responsibility, and the probable conflict of the lender of last resort duties with supervisory duties. Until the financial crisis, bank stability and its relationship with macro-economic policy was hardly on the radar.

The Turner Review[60], provides a useful insight on the limitations of the pre-existing regulatory landscape in the UK. In his analysis of "What Went Wrong?", Turner categorized these under four main sections: (i) that macro-imbalances met with financial innovation; (ii) that in the experience of the UK, there was rapid credit growth, significant wholesale and overseas funding; (iii) that there was global finance without global government and (iv) that there were fundamental theoretical issues related to market efficiency and market rationality. An analysis of this imbalance has already been covered in Chapter 1. He said that the industry, and regulators had a misplaced reliance on sophisticated analysis, using observations of past patterns of price movement to determine forward-looking risks i.e. the concept of Value-at-Risk (VAR).

The increasing leverage of banking institutions, combined with the increased activities at trading financial instruments, the inadequate

[60] The Turner review, A regulatory response to the global banking crisis, March 2009, at page 11

provision of capital against trading books, and the widespread use of sophisticated analysis posed a systemic risk to the industry. It is probably fair to say that banks existed for themselves (i.e. their shareholders) to the detriment of the wider economy.

Turner concludes that regulatory reform must focus on the factors that led to the "over-extension of credit" and promoted the severity of the crisis, including[61], the growth of sophisticated credit models, combined with inadequate capital provisioning against trading books and the competition for borrowing customers; the over-exposure to trading activities; and, inadequate capital provisioning.

In one of its Staff Reports[62], Hirtle B. et al claim that the 2008 financial instability arose from the isolation of the supervision and regulation of financial firms from macro-prudential issues. Lord George commented that "economic and financial stability go hand in hand".[63] In its 2009 report,[64] the House of Lords commented that, a clear lesson to be learned from the crisis was that the tripartite regulatory structure in the UK (between, the Treasury, the Bank of England and the FSA) had failed to "recognize the affinity between responsibility for financial stability and for macro-prudential supervision of the banking and shadow banking sectors". It concluded that the BoE should assume responsibility for macro-

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[61] Turner Review, page 28

[62] Hirtle B, Schuermann T, Stiroh K, Macroprudential Supervision of Financial Institutions: Lessons from the SCAP, Federal Reserve Bank of New York Staff Reports, no 409, November 2009, at the Introduction.

[63] Lord George, The approach to economic management,: How it has evolved, Bank for International Settlements, Per Jacobson Foundation, 2008, at page 8

[64] Banking Supervision and Regulation, Volume 1 Report, House of Lords , Select Committee on Economic Affairs, 2nd Report of Session 2008-09, at page 31

prudential supervision, though it recognized that those responsibilities would overlap with those of the FSA (the FSA has now been replaced by the FCA and the PRA). These views are further examined below in Chapters 3 and 4.

IFI's have had limited influence on national financial regulations. There have been two notable initiatives in this area. One relates to the role of the Financial Stability Forum (FSF). The IMF and the World Bank were not set up to oversee the standards of financial regulations, their focus being more on monetary and fiscal policy issues. The existing regulatory groups of Basel; and IOSCO could hardly promulgate regulatory policies and this state of play led to debates on a need for a multi-jurisdictional financial regulator.

According to Kern Alexander, supervisory practices were too focused on individual firms and consumers, and not enough attention to macroprudential or macro-economic issues. It placed reliance on the premise that if individual firms were managing their risks well, that the financial system would be safe. In his view, the new focus on macro-prudential supervision should require that regulators interrogate the possibility of systemic risks., and the impact of monetary policy on the financial markets[65].

Anthony Hotson's[66], the economic historian says that problems could be abated if bankers and regulators pay more attention to history, as there are no new principles governing the stability of the monetary

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[65] Alexander Kern, Reforming European Financial Institutions and the role of EU institutions, Amicus Curiae, Issue 82, Summer 2010
[66] Hilton A., Evening Standard, "Bank Stability depends on the assets",23 July 2013

system. He says that bank's over-exposure to the property market, is a risk to financial stability. [67] This suggests that serious consideration must be given to the one key element that drives property acquisition through bank lending i.e. interest rate, a macro-economic tool! According to Hilton, banks were borrowing to lend to the extent that a parlous 2.5% of this activity was supported by equity capital. He argues that banks should have a provisioning higher than the prescribed Basel III 3% of their balance sheet as capital, a view that appears to be increasingly favoured by a number of European countries.

This writer sees the point of Hotson's view. The UK has embarked on a fiscal policy of 'Help for Home Buyers' that is intended to provide £3.5billion of additional investment to assist people to buy their own homes. This is in a climate of historically low interest rates. Some commentators are anxious that this fiscal step might lead to a housing bubble. In my view, the regulator's monetary policy must be joined up with government's fiscal policy, though I note that the BoE governor has largely dismissed the risk of a bubble. There must be established pull-backs to ensure that such policies do not result into destabilization.

In summary therefore, in my view, certain wider issues must be given serious consideration as part of the regulatory framework for the future.

[67] Hilton A., Evening Standard, "Bank Stability depends on the assets",23 July 2013

3.3 National regulation while there international banking activity

In Europe the economic and political dynamics are dis-jointed; monetary union exists without a true fiscal co-operation, hence countries within the EU locked their exchange rates into one through the single currency, but did not in a similar fashion impose a significant level of fiscal union in relation to fiscal and budgetary targets – i.e. inflation rates, productivity and some other economic indicators were divergent. This disparity is indicative of banking regulation within the EU. Regulators relied on home state regulators and the passporting of financial activity across the EU, without a joined-up approach to tackle contagious negative externalities. The second banking Directive enables the branch bank to be supervised by regulators in its home country. This arrangement naturally leads to cross-border risks as failure of a bank in its home state exposes the host nation to potential loss and possible systemic risks.

The BCBS was established by the Central Bank Governors of the G10 countries in 1974 and its members now drawn from 13 countries. It is a forum for the exchange of information between national supervisors and develops supervisory standards, the most prominent of which is on capital regulation. Its recommendations have no legal force, though some are adopted into law and regulations by some countries, as for instance the CRD in the EU.

Kern Alexander et al argue that 'international financial regulation' requires a treaty regime that is backed up by legally binding agreements on capital adequacy and consolidated supervision[68]. They argue that it would require an international institution to facilitate its development and oversee its implementation. They propose that a Global Financial Governance Council, is authorised by treaty to delegate the authority to develop international standards to existing international supervisory bodies.

Cross-border banks must be supervised in an appropriate manner and there is a need for a serious debate. The politics and difficulty involved in achieving a coherent voice would make it difficult for the functioning of a supranational supervisor, this is apparent from the difficulties that were faced by the BCBS, where they were unable to agree on simple matters such as the definition of capital. The idea postulated by Kern et al warrants serious consideration, but is not in my view promising. The politics and delay surrounding the adoption of the Basel II framework, is a good indicator of how protracted ,negotiations and agreement for a treaty regime might be.

[68] Alexander Kern., Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, Chap 5

3.4 The role of macro prudential policy

The function of macroprudential regulation is to ensure that the aggregate effects of individual firm's actions do not have a negative result on the banking system as a whole, resulting into systemic risks. Microprudential regulation is concerned with the supervision of individual firm's behavior, and its focus is quite narrow, and has a bottom up approach.

If banks were allowed to grow TBTF, which results into interconnected with other financial institutions, it creates a self-fulfilling moral hazard that results into taxpayers being held to ransom. It is probably true that the single major contributor to the crisis, was the lack of an effective macroprudential supervision process. This is apparent from how the crisis unfolded. Securitisation enabled banks to have a lower capital capital adequacy charge. Banks were exposed to the market for various reasons, including, for the funding of their lending activities, some of the banks had significant holdings of risky securitized assets, and thirdly, some banks supported conduits and SIV's[69]. The conduits and SIV's invests in a pool of long-term assets. Subprime investors started to report losses in 2007, which escalated and CRA's started to downgrade some of the securitization tranches.

The case for macroprudential regulation is made out. Leading economies have recognized its role, in the US. UK and in the EU. I

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[69] House of Lords, Select Committee on Economic Affairs, 2nd Report of Session 2008-2009, Banking Supervision and Regulation, 02/06/09, p.13

therefore highlight here some of the gaps that were identifiable from the lack of macroprudential considerations, and therefore justifies its introduction.

Firstly, there were minimal reporting requirements for securitized assets and there was an inadequate understanding in the industry of the risks that they posed to the sector. Furthermore, regulators were over reliant on risk assessments that were provided by CRA's .

I have mentioned above in 2.7, how the work of CRA's were found to be dubious. Their ratings assessments were often incorrect and the basis of their assessments misunderstood by investors, who failed to appreciate the basis of those assessments were limited to the risk of credit defaults only. The industry simply buried its head in the sand and enjoyed the ride whilst it was good.

The increased complexity in financial services and the interconnectedness of banks poses a challenge. Banks have become increasingly innovative, and the skills required to manage the risks have lagged behind. There is a need for enhancement of skills both at the senior management level of banks and at the regulators. It is not enough to ringfence banks, the focus should rather lie in an understanding of where risks lie. In addition, there should be counter-cyclical capital measures to stem the tide of procyclicality, and ensure good housekeeping and readiness for inevitable downturns.

As I argue below in 3.6, economic activities have the ability to singularly cause systemic risks. The property market is one such activity. Central banks' monitoring of inflation is insufficient, it needs to measure house price inflation as well. In addition, loan-to-value ratios and debt-to-income ratio should be of interest to the regulator, especially during period of historically low interest rates or when fiscal measures such as the UK's Help to Buy scheme may potentially cause a housing market bubble. This is particularly significant as house price inflation does not feed into the CPI, both in the US and the UK. Perhaps a macroprudential regulator would have identified this issue as an indicator of a possible systemic risk. The level at which banks are relying on wholesale funding, the availability of credit in the economy, level of borrowers exposure and the implications of all these to the economy should be all kept under review.

The BoE has gained statutory responsibility for overseeing the financial system as a whole. In the US, the FRB has a 'dual mandate' focus on inflation and the "real economy", and the management of systemic risk is mandated to the FSOC, whose members include the FRB. Primarily this change should ensure that the central banks are able to exploit the synergies between microprudential supervision on the one hand and their expertise as monetary regulators. This entrenchment of macroprudential regulation can only encourage rigour in the approach regulators adopt to preventing bank failure and systemic risks.

3.5 Banking regulation and overall economic conditions.

Banking regulation does not exist by itself. It is desired for an "economic purpose". Banks serve an important economic function, it is therefore in the national interest to ensure that they continue to deliver on this function. In view of this, banks have become a matter of public interest and banking regulation, a matter of public policy.

Apart from their primary functions, banks are regulated to ensure that certain economic conditions are preserved. Those conditions include the protection of depositors' funds to ensure confidence in the system, monetary and financial stability to ensure transaction flows, an efficient financial system for the provision of good customer service, and a competitive environment in which to ensure fairness and innovation,

Macroeconomic policies are normally the preserve of governments; the government deal with issues such as tax policies and are concerned about the general well-being of the economy, including the employment rate and impact of its overall policies on its people.

As the subject matter of this chapter is the new regulatory challenge, and since it is apparent from recent experience that macroeconomic issues are increasingly becoming of interest to regulators, I have explored below some of the fiscal economic issues that may impact on banking regulation under the new dispensation.

i. Interest rate and banking regulation

The control of short term interest rates is a demand management tool, that is used to keep overall aggregate demand growing consistently in line with underlying supply capacity[70]. It is primarily a monetary tool, though it has started to assume a new role. Central Banks are starting to integrate monetary policies with fiscal considerations, through for instance linking interest rates to unemployment rather than solely on inflation data. The main focus of monetary policy is price stability, hence the control of inflation. The UK and US are committed to keeping interest rates on hold until the unemployment level improves. Interest rates of course drive many economic activities, and very significantly property purchases. Activities in the property market was a major contributor to the crisis, as it was this activity that led to securitization of sub-prime mortgage assets, a main contributor to bank's liquidity problems that started in the US.

ii. Tax policy and bank regulation

The main source of government expenditure is taxation. By implication, the level of taxation on personal or business resources influences economic activity and consumer behavior. There is probably a case for future regulatory policies to include taxation. For instance, the UK government is committed to the Help to Buy scheme, within a low interest rate environment. This will naturally stoke up demand and lead to house price inflation. There is perhaps a case for

[70] Per Jacobson Lecture, 2008, George Eddie, The Approach to Macroeconomic Management: How it Has Evolved.

introducing additional taxation measures, to help address the problem of house price inflation.

iii. Currency exchange rate and Bank Regulation

A currency exchange rate are used to affect the relative price of exports and imports with the result that it effects a nations balance of payments, hence its domestic output and its level of employment. Certain oil-exporting countries, China and some far eastern countries accumulated large current account surpluses during a period in which leading western economies had large deficits. Since China's exchange rate is managed and widely believed to be undervalued, it makes its products cheaper, making its growth partly reliant on its cheap money. Conversely, cheaper products swamp the West. Regulators need to be on top of the implications of such policies. Perhaps a lesson can be learnt from China, which following the decline in world trade, after the onset of the banking crisis, decided to 're-peg' its exchange rate, in order to protect its exporters.

iv. Competition policy and bank regulation

A healthy competition policy within the banking industry, will no doubt result into positive outcomes. In the first place, it would help reduce the rate of growth of banks and therefore the propensity of TBTF; secondly, it would lead to consumer choice, innovation, and product efficiency. The existence of banks that are perceived TBTF encourages inappropriate risk taking at the expense of the taxpayers.

v. Social policies and banking regulation

The new BoE Governor has set a new agenda never seen in the UK, but quite similar to the strategy that is being pursued by the FRB and the ECB. He has announced that the BOE base rate will not increase above its current level, unless UK's unemployment rate falls below 7%[71],[72]. Despite these caveats, there is an apparent symbolic shift in the approach of the BoE. For instance, the BOE had since the crisis surfaced largely ignored the inflation target of 2%. A new phrase has now thereby entered the financial vocabulary, referred to as "forward guidance". Regulators now appear to appreciate that monetary policy is very much linked to fiscal measures, and ultimately to regulation.. Carney has gone on to criticize bank's culture and said banks should focus on creating jobs rather than just making profits. On 8 August 2013, he said, "banks could absolutely play a socially useful and an economically useful function". He said that the cultural issue was very important.

[71] though there are three certain 'knock outs', mainly, if the Bank's Financial Policy Committee determines that the stance poses a significant threat to financial stability; the CPI inflation is judged more likely than not to be at or above 2.5% over an 18-month to two-year horizon; and, inflation looks like it could get out of control in the medium term

[72] www.bbc.co.uk/nes/business-23588958, date: 08/08/13

3.6 Combining macroeconomic policy and regulatory policy

According to Reddy Y.V., "the regulation of the financial sector should serve the broader goals of human endeavor, namely growth, stability and equity" and that "public policy in general and macroeconomic policy in particular share similar objectives"[73]. The global crisis has shown that there are valid reasons why financial regulation should be joined up with macro-economic policies.

Financial stability is connected to both macro-economic and micro-economic factors. For instance, interest rate, currency exchange rate and inflation can effect the fortunes of an economy in much the same way as inefficient prudential supervision of banks. According to Singh D., macro-economic and micro-economic factors are independent in an economy but not mutually exclusive. He claims that financial stability in an economy can "only be ensured through cooperation between the central bank, other safety-net players and bank and financial regulators[74]". He cites Andrew Crockett's reference to this as the micro- and macro-prudential aspects of financial stability[75]. Banks should facilitate an efficient allocation of resources to their most productive use, as they are agents of economic exchange and engage in the management of risk and risk

[73] Reddy Y.V. Financial sector regulation and macroeconomic policy, BIS Papers No 62

[74] Singh Davinder, Banking Regulation of UK and US Financial Markets, 2007, Chapter 1, page 3.

[75] Singh Davinder, Banking Regulation of UK and US Financial Markets, 2007, Chapter 1, page 3.

diversification through trading. However, they are unlikely to survive if they are not properly managed, and one of the ways in which banks can be efficiently run, and bank supervisors perform an effective role. On the other hand, national governments are interested in sustained economic growth, low inflation, a high level of employment, sound government finance, a healthy balance of payments and good living standards for their people. The government has two macroeconomic tools at its disposal for this. It uses fiscal policies in the form of tax revenue and spending, and monetary policy, which is the control of money supply and interest rates. In that sense, banking regulation policy and macroeconomic policy have similar objectives.

Banking regulation is now more than simple micro-prudential regulation. For instance, the BoE following the transfer of microprudential responsibilities from the FSA, has been allocated the mandate for macroprudential regulation. In essence, part of the FPC's remit is that it would assume leadership during periods of boom or busts, by imposing the appropriate level of capital ratios on banks. If these were left disjointed, the situation could arise where the micro-prudential and the macroprudential supervisor's work run counter each other.[76].

As mentioned above, the importance of macroeconomic polices to regulation has been recognized in the UK, where the FPC has been given the objectives of the "identification, monitoring of, and taking action to remove or reduce systemic risks with a view to protecting

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[76] Blanchard O. Rethinking macroeconomic policy, one of the series of "Seoul Papers" on current macro and financial issues. 09/05/13

and enhancing the resilience of the UK financial system"[77]. Most notably, it also has the additional responsibility of supporting the economic policies of the government, including those for growth and employment.

Some people have argued that core inflation is not the right measure of inflation but that increase in oil prices or housing prices are the real key[78]. They say that a single index does not give the entire picture. There is some truth in this argument for instance, in the UK, the BoE was making a good effort keeping to the inflation target, interest rates appeared to be at as sensible level, and the economy was expanding it seemed quite healthily. Nevertheless, housing inflation and consumer consumption was racing ahead of the rest of the economy. House prices are not included in the calculation of the CPI, only the cost of housing, in the form of rent or rent equivalents. A joined-up approach would perhaps have identified some of the issues that led to the crisis much earlier i.e. credit expansion caused by a race to the bottom by lenders, that were competing to offer credit and cheap money to consumers.

Some commentators have suggested that a culture of low inflation/low interest rate impedes the scope for achieving a correction, in the event of a collapse in demand, as happened in the immediate aftermath of the 2008 crisis. The lack of scope resulted into reliance on fiscal policy to help stoke up demand. Governments

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[77] BoE, Financial Stability Paper No. 21, How could macroprudential policy affect financial system resilience and credit, Lessons from the literature, May 2013

[78] Blanchard O. Rethinking macroeconomic policy, one of the series of "Seoul Papers" on current macro and financial issues. 09/05/13

have therefore resorted to fiscal measures such as increased spending, in order to drive the economy forward.

There is also a need for more fiscal space for governments, in order that they are able to run larger fiscal deficits when required. In addition, individual fiscal polices should be considered particularly for certain areas of the economy, in order that they do not create unwanted risks or problems in other sectors of the economy. For instance, the UK government is fiscally trying to drive investment into the housing market and help the economic recovery. It has therefore introduced a 'Help to Buy" scheme for first time property purchases, where it facilitates this through a shared equity scheme and and a mortgage guarantee scheme, both costing in the region of £15bn. The scheme has led to a 19% quarterly increase in Buy-to-let lending, 56% increase in annual High loan-to-value lending, 2.6% annual increase in house prices and 4% quarterly change in mortgage repossessions[79]. Graeme Leach, the chief economist at the Institute of Directors has referred to the scheme as very dangerous, whilst other have expressed their concern that it could lead to another bubble. It is obvious that there is a shortage of housing supply in the UK, especially in the In my view, an anti-bubble mechanism clearly needs to be built into this particular government policy, through monetary or other fiscal measures.

One of the criticism of giving both responsibilities to the central bank is that the central bank would have a softer stance against inflation, as in higher interest rates have a detrimental effect on bank balance

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[79] Financial Times,: "Carney rate vow set to fuel buy-to-let mortgage boom" , 09/08/13

sheets. The other criticism is that it concentrates a lot of power in one body.

Chapter 4: The multifaceted market, financial regulation and UK Bank Regulation and Supervision Development

4.1 Introduction:

London has the pre-eminence of being considered a major financial centre of the world, due to various obvious factors. The City of London is home to several international banks. Some of the banks are licensed and regulated by the UK regulators, and some including the EU banks are passported into the UK, as they are regulated by their home nations. The UK therefore has domestic banks, EU banks, and other international banks. They may be categorized into retail banks, commercial banks and investment banks. They operate differently, but serve one unique function: to facilitate economic activity; they therefore pose similar risks to the economy. The discussion that follows is focused on the UK banks alone, this being my area of primary interest although I recognize that there are several other financial activities that takes place in the UK, in addition, that the UK financial services industry is influenced by a host of global activities.

4.2 Shift from simple connection between regulated and regulator

The UK regulatory landscape is indeed evolving. The UK government has responded swiftly to the major banking crisis by recognising the need for change. As early as October 2008, with the onset of the crisis, it's Chancellor of the Exchequer ordered that the then FSA Chairman, Lord Turner undertake a review of the causes of the crisis and to make recommendations on the changes to regulation and supervision for the future. In addition, there were a number of parliamentary reviews on various aspects of banking, in an attempt to learn how best to prepare for the future.

The government's commitment to making the UK's financial system and its infrastructure more robust, has led to a new regulatory architecture, increasing the focus of regulation to macroprudential issues and expanding the role of the BoE, with the mandate, to "contribute to protecting and enhancing the stability of the financial systems of the United Kingdom"[80]. The regulatory changes are intended to make banks and other financial institutions more resilient and are underpinned by stronger requirements on capital buffers, the strengthening of governance and risk management, recovery and resolution plans and a new overaching regulatory structure. The new regulatory structure has resulted into the dismantling of the FSA and the formation of the PRA, FCA and the FPC. The PRA and FPC are responsible for microprudential

[80] www.bankofengland.co.uk/financial_risk_reduction, sourced on 27/08/13

regulation and macroprudential regulation, respectively, whilst there is a Special Resolution Unit ("SRU") alongside it for the delivery of an orderly wind-down, as part of resolution planning of distressed banks. The FCA is responsible for ensuring that markets function well and the conduct of business of regulated institutions.

Another significant change, is the efforts that are being made to change the culture of banking and expectations of banks, especially the big ones. The PRA has said that it is not its role to ensure that firms do not fail, rather it will ensure that firms fail in an orderly and efficient manner. In addition, it has said that it's supervisory approach will be judgement-based, forward-looking, and focused.

A lot of what the BoE/PRA have said are not new, however, the new framework suggests that there will be significant supervisory changes. The relationship between the regulators and the banking industry is being transformed from that of a simple and direct connection, into a more sophisticated one. For instance, the PRA has said that its use of judgment will be based on 'evidence and analysis". This in my view will allow the regulator with a lot of latitude and discretion, but within the confines of evidence, of which only they determine what is relevant and useful. Furthermore, it suggests that the regulator will more actively seek information on which to base its decisions, which will be on potential risks of failure of the firm, noting that it has said that it will use its judgment where "necessary in the context of a complex financial system where compliance with detailed rules is, on its own, unlikely to secure acceptable outcomes"[81]. Previously, compliance with the letter of the rules was adequate, and evidence of such compliance was enough proof that all was well with the firm. It was part of the "close and continuos" culture of the past, where, supervision was more light touch. This judgement based approach is therefore a radical departure, and it uncertain whether banks currently do appreciate the implications of this change.

The PRA's 'forward looking' approach suggests that it will become more proactive, and analytical in the identification and treatment of issues. It will assess banks against current risks but will not only assess these risks against its own objectives, but consider the risks against the probability and impact of occurrence in that bank, the probability of certain occurrences flowing from those risks in the future, and also against other plausible risks that could arise in the future. It has emphasized the importance for firms to be open and straightforward in their dealings with the regulator.

It is also committed to a focused approach to regulation, tailoring its supervisory approach to the risks that a firm presents. A key part of the PRA's function is its primary focus on the harm that firms might cause to the stability of the UK. Another major departure from the past is that it will duly allow a firm to fail.

These changes imply that the regulator is keen to have a more robust approach to regulation. It appears to have abandoned tunnel-

[81] The BoE, Prudential Regulation Authority, The PRA's Approach to Banking Supervision, October 2012

visioning to that of achieving a wider view of issues, and prepared to perform its role within “the external context in which a firm operates”. This is obviously a bold move, as it would mean that its judgement may be more open to challenge, in a world where externalities that are outside the control of a firm would become relevant in assessing whether or not a firm poses a risk to the regulators objectives.

Lastly, the fact that the PRA will become part of the BoE, the lender of last resort, itself implies a deep cultural change,that exceeds that of a relationship based on simple rules. At the forefront of its supervisory approach is its relationship with the FPC, and its efforts to capture macroprudential issues not only by itself but also through other regulatory agencies, including the FCA.

4.3 The relationship between regulatory laws (measures) and Macroeconomic policies

Alexander et al provide a very useful analysis on how macroeconomic policies might join up with prudential regulation[82]. Banks behave in a predictable manner in time of boom or downturn and their behaviour is generally accepted as procyclical. For instance, banks increase their lending in a buoyant economy and behave differently when there is a downturn. They provide a further illustration of how the resulting procyclicality of regulation, is exacerbated by what they have referred to as "the contagion-inducing techniques of risk management", and gave the example of the Asian crisis where banks reduced their exposure to emerging markets, leading to a further fuelling of the problem and macroeconomic consequences. At the time, the Asian crisis and the widespread action of most US banks had caused the Latin American assets to be almost worthless. US regulators, allowed their regulated banks assets to be revaluated in the banks balance sheets at their maturity value, rather than marked to market. The US regulators did not require an immediate write down. The reaction of the US regulators resulted in the avoidance of a systemic and macroeconomic problem in the US, as it prevented a collapse in lending, liquidity and confidence in the banking system.

[82] Alexander Kern., Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, p. 257

Adverse economic conditions such as unemployment or high interest rates may lead to underperforming loans and ultimately pose a systemic risk to banks. Some of these conditions are the results of wrong fiscal policies or policies that were driven by political motivations. For example, successive UK governments have championed the cause of the City of London, de to the spin-off of the employment it creates and the earnings into the government coffers. There is a school of thought, that believes that Gordon Brown's government was responsible for the FSA's light touch approach. The BoE is autonomous and has a good degree of independence in carrying out its monetary functions. This autonomous culture will probably grow on the PRA and the FPC in the manner in which they deliver on their objectives, and away from government influence.

Credit expansion was used by the government to stimulate the economy and for job creation. Successive UK governments have also encouraged home ownership, even when they were well aware of escalating house price inflation, and the ramifications of a downturn in the employment market, or a general downturn in the economy. It is of course always desirable for an economy to grow, and the regulator would readily share this view, what would be important to a macroprudential regulator is that the growth is healthy. The healtiness of the growth is based on a continuos analysis of the reasons for the growth and the identification of the risks and mitigating measure for any fallouts that may arise from such growth. One should reasonably expect that a macroprudential regulator in the dispensation, would devise certain tools to use as levers in restraing unheath growth or industry practices. One such tool for the housing market might be an imposition of loan to value ratios, on certain types of mortgage lending. We have started to see this demosntarted in the framework for the future. The PRA will work closely with the FCA and the FPC in ensuring financial stability of the UK. It will. The PRA will be expected to implement FCA's recommendations on a 'comply or explain' basis and for complying with the FPC's directions in the use of macroprudential tools. These measures will hopefully ensure a capture of macroprudential matters.

4.4 Possible leakages and arbitrage

I have covered above in Chapter 3.3, the need for international co-operation on financial regulation. This naturally has its challenges, as previous experience has shown. In view of this, perhaps the next best alternative, is for national regulators to follow the example of others, though with a very important caveat, that a rigorous analysis is conducted on such initiatives on relevance and applicability. One such initiative is the Dodd-Frank Act, 2010 in the US, especially its provisions that all firms identified as having significant influence on the system are regulated in one shape or form, whether or not they hold a banking licence.

The make up of the EU raises a significant risk, to its member countries. The banking crisis, exposed the inadequacy of the framework which focused on national supervisors and passporting arrangements. The national supervisors broke ranks and dealt with distressed cross-border institutions in a national way, as in the example of the Icelandic banks. It exposed the lack of macro-prudential oversight, the failure of reliance on home country controls, again in the example of the Icelandic banks, and thirdly, the the lack of cross-border structures for crisis management and bank resolution[83]. Efforts have been made to address some of these deficiencies, which includes the establishment of the ERRB, the enhancement of the maximum harmonization by having the

[83] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012,

authority to draft new EU standards for a common rulebook, and by the introduction of a new framework for cross-border institutions, resulting in a change from home country control to supervisory colleges. It is still early days yet to assess whether the new initiatives will be reasonably fit for purpose, going forward. It is therefore an area that requires close and regular scrutiny.

Regulators policies are susceptible to fierce lobbying by the industry and other stakeholders, either through the government or directly. There was a fierce debate on the manner of the ringfencing of banks, in relation to the plans to separate proprietary trading by banks from retail banking. The BBA were opposed to it as were a number of large banks. In the end, there are claims that the final plans have been watered down, and a particular MP, Andrew Tyrie, the chair of the banking commission, referred to it as "virtually useless". He noted that the regulator would have to issue three preliminary notices and a warning notice to a bank that is suspected of attempting to breach the barrier. In addition, the Treasury's consent must be sought on up to three separate occasions before a bank that has fallen foul of the rules could be broken up[84]. This shows how the government and through them, the regulators could be susceptible to pressure from bodies who have separate interests.

The regulator is almost always behind the curve. The industry has vast resources at its disposal that are used deliberately for regulatory arbitrage. Banks may do this for instance through the restructuring transactions or even relocating transactions to less burdensome

[84] Financial Times, MP's cast doubt on Treasury's resolve, 09/07/13

jurisdictions. Mike Carneys, the BoE's Governor "forward looking' pledge[85] to hold rates until the employment figure falls to 7% has already resulted in the market digesting the policy decision and coming up with their analysis and view as to when rates would actually go up. The BoE had calculated that the first rate rise will not happen until mid 2016 whilst the market has priced in rate rise before that date, on the back of unemployment falling quicker or as a response to inflationary pressure, one of the 'three knockouts'[86].

The growth of shadow banking has been cited as one of the causes of the crisis. These institutions face similar risks to traditional banks, but are not regulated in the same manner, nor do their investors have similar deposit insurance protection as do bank customers. T is notable that the 2008 crisis, started with liquidity problems within the shadow banking sector, and the lack of confidence in the sector transformed into a major banking crisis. The main problem with shadow banking has been suggested as maturity transformation[87] and the large scale at which it was undertaken, for instance 'the large-scale maturity transformation between short-term promises to note-holders and much longer term instruments held on the asset side'[88]. The whole industry was driven by the quest for excessive profit makings. The regulators will need to improve their level of awareness of market activity and develop the appropriate skills for dealing with them. It is notable that the UK regulators have already

[85] in August 2013
[86] Financial Times, Carney's rates pledge aims to boost nascent recovery", 08/08/13
[87] The Turner Review, 2009, A regulatory response to the global financial crisis, p. 21

[88] The Turner Review, A regulatory response to the global financial crisis, 2009, p. 21

given consideration to the introduction of a process that would make it possible for such transactions to be recordable and detailed information on quality and quantity readily available[89].

[89] House of Commons, 2008-2009, Treasury Committee, Banking Crisis: dealing with the failures of the UK banks: Government, UK Financial Investments Ltd and the Financial Services Authority Responses to the Seventh Report from the Commitee

4.5 Emergence of new regulatory paradigms where market disciplines as well as macroeconomic policies are taken into account:

The crisis has driven changes into the regulatory system. Regulators in the leading world economies, including the US, EU and the UK now recognize the interconnectedness of financial institutions, especially when they undertake cross-border activities. The consideration of macroprudential issues is therefore quickly becoming a familiar practice for regulators. The relevance of macroeconomic issues has not escaped the attention of regulators and national governments will now be made to share their fiscal responsibilities with government agencies that are naturally less-politicised than their treasury departments. It will be an in interesting new way of doing things and no doubt, there will be tensions along the way.

In the minutes of the FPC meeting of June 2013, it noted that the Chancellor had sent to the Committee, a document whish set out the Governments economic policy and recommendations. Of particular interest is that the FPC committed to making note of the Governments "economic policy, including its objectives for growth and employment"[90]. The FPC also noted the Financial Stability Report, and ordered the FCA and PRA to provide it with an assessment of the vulnerability of borrowers and financial institutions to sharp upward movements in long term interest rates. An arm of the central bank looking at interest rates not as a lever for the control of inflation, but for its macroeconomic implications. This

[90] Bank of England, Record of the FPC meeting, 18/06/13, www.bankofengland.co.uk, searched on 30/08/13.

is indeed a true demonstration of a departure from the past, and a new horizon in the making.

It is clear that central banks must pay as much attention to the resilience of the economy and corporate governance within the regulated firms, as much as they have been concerned with inflation, and utilize a wider set of tools, beyond capital adequacy and regulatory rules, to deliver on their wider responsibility of ensuring a stable financial system.

Chapter 5: Conclusion

A lot has happened in the financial services regulatory arena since the onset of the global crisis in 2007/2008. The regulatory approach of major economies has changed and efforts are continuing to make the evolving system to be fit for purpose. Academics, practitioners and those in government appear to be agreed on one thing: that the pre-crisis approach to the regulation and supervision of the banking industry was narrow in scope and delivery. This has led to a major change of culture within the US, the EU and also the international bodies of the BCBS and the IMF who have a stake in the financial stability of the global financial system. Financial stability has therefore very quickly become the by-word rather than bank stability, and regulators are now more receptive to the idea of a bank's failure, as long as the failure does not lead to an imbalance of financial stability. The new tools are macroprudential regulation, and macroeconomic considerations. These are the logical tools to add to the pre-existing toolkit, in order that a wider more robust approach can be achieved, and those with responsibility for financial supervision have not shoed away from using them.

There are some challenges. There is a dire need for the cross-border supervision of banks, the orderly resolution of those banks to ensure that the risk of contagion is contained, including an understanding and allocation of responsibilities amongst national supervisors. Furthermore, it is apparent that regulators appear are generally behind the curve. Serious thought therefore needs to be given to the allocation of valuable resource to enable bank supervisors to perform their roles more effectively.

Some have advocated the idea of supra national regulators and one of the prominent arguments are those made by Avgolueas. He says that this should be based on four pillars of: macroprudential; microprudential; financial policy, regulation, and knowledge supervisor, and a global resolution authority

The banking regulation world in my view is surely in a better place, afterall, our knowledge is limited by our own experiences. Stakeholders continue to discuss and argue the other additional measures that should be explored, to ensure global financial stability. It appears that the crisis has made it easier to acknowledge the inadequacies of the old system and to be more receptive to a whole new approach, without totally discarding of the old system.

In conclusion therefore, my observations are that there is a definite shift in the paradigm of regulation, banks will no longer be supervised in silos, but with the objective of 'helicopter viewing', output-focused regulation will hopefully mean exactly what it says as regulators do away with a tick-box supervisory approach. Furthermore, the primary concern of supervisors will increasingly shift into the wider systemic risks that financial institution present to their economies. Macroeconomic policies will be joined up with microprudential and macroprudential considerations and no doubt, discussions will continue on how all of these can be better dealt with on a supranational level.

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Abstract

The subject of this paper is a discussion of the banking financial crisis that surfaced from around 2008. The crisis is the most severe since the collapse of the US banking system between 1929 and 1933, but is unique due to its contagious effects on many countries, due to the interconnectedness of many economies in the 21st century. The main aim of banking regulation is to ensure a stable financial system and the protection of consumers. Banking regulation is the framework of rules and policies under which banks are required to operate. Supervision concerns the agents that are used on the delivery and effectiveness and enforceability of those rules and policies.

The subject matter of this paper is of interest to me due to the challenges that the pre-existing framework posed to regulators following the eruption of the crisis around the world. As is usually the case, banking regulators were unprepared, though the central banks were able to deliver on their function as a lender of last resort. This ensured that the crisis was abated to a good degree.

The academic challenge for me is an examination of the regulatory tools that had existed, an analysis of the adequacy of those tools, and the regulatory gap that now seems so obvious and whether even in-spite of what is now known, the current efforts to rebalance regulation are adequate. We are of course where we are, and current regulatory tools are usually a demonstration of past experience. The question now is, whether the issues that needs addressing are currently on the agenda of national governments.

I have restricted my discussion of this topic to the US and the UK, though I have on occasions referred to the EU and other countries. In my opinion, these two countries provide a good illustration of the causes of the crisis and what is being done to reduce the probability of future crisis.

ABBREVIATIONS

BBA	British Bankers Association
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BoE	Bank of England
CRA	Credit Rating Agency
CRD	Capital Markets Directive
CPI	Consumer Price Index
EBA	European Banking Authority
ECB	European Central Bank
ESA	European Supervisory Authorities
ESMA	European Securities Market Authority
ESRB	European Systemic Risk Board
EU	European Union
FATF	Financial Action Task Force
FCA	Financial Conduct Authority (UK)
FDIC	Federal Deposit Insurance Corporation
FPC	Financial Policy Committee
FRB	Federal Reserve Board (US)
FSA	Financial Services Authority
FPC	Financial Policy Committee (UK)
FSB	Financial Stability Board
FSAP	Financial Sector Assessment Programme
FSCS	Financial Services Compensation Scheme (UK)
FSF	Financial Stability Forum
FSOC	Financial Stability Oversight Council (US)
G-2-	Group of 20
IFI	International Financial Institutions

IMF	International Monetary Fund
IRB	Internal Ratings Based Approach
OECD	Organisation for Economic Co-operation and Development
PCBS	Parliamentary Commission on Banking Standards (UK)
PRA	Prudential Regulation Authority (UK)
SEC	Securities and Exchange Commission (US)
SPV	Special Purpose Vehicle
SIV	Structured Investment Vehicle
TBTF	Too Big to Fail
UN	United Nations

Chapter 1: Introduction: Financial markets failures and regulation

Banks have an intrinsic value to society, without which development and wealth creation in a society will be seriously impeded. Banks enable people to save, and facilitates the pooling of savings for the purpose of lending to whoever they might consider to be creditworthy[1]. They thereby facilitate economic interaction and development. Banks are commercial concerns and therefore serve the interests of their shareholders. Ordinarily, and without restrictions in place, they would behave like most businesses do, seeking profits at all costs, depending on their risk appetite.

If banks were not regulated, the protection of their depositors would hardly be of prime concern to them, in the order of priorities. Bank customers are, essentially, their creditors, who are consequently connected to the fortunes of their banks. Loss of confidence by depositors in banks would almost certainly result in a bank run. A bank run has serious implications for the economy. Depositor protection has therefore become one of the cornerstones of banking regulation across the world. A regime that does not undertake this function, risks jeopardizing the well being of its wider economy. If regulations were inexistent for the protection of consumers, banks would probably not be as transparent in their dealings with their depositors, in terms of the pricing of products, completion, provision of access to financial products and general transparency.

[1] Wood Philip, Regulation of International Finance, Chapter 1, Introduction

A liberal approach to banking regulation would mean that there is no systematic approach to the protection of bank deposits, and since only a proportion of bank deposit are available on demand at any one point, it may result into bank illiquidity, and consequently loss of confidence by depositors. There are therefore certain important requirements that are placed on banking institutions, including the protection of capital and the insurance of deposits with a premium levied to cover depositor claims[2].

1.1 The evolution of Financial Regulation

Banking regulation has evolved significantly in the UK and the USA as a response to various scandals and crisis. Financial crisis has therefore been a prime catalyst to banking regulation. Considered in another way, repetitive failures would be paramount in the banking industry, if lessons were not learnt from mistakes of the past. In the UK, Banking Regulation started with the passage of the Banking Act 1979. The Act set down the criteria that an institution had to satisfy in order to obtain a banking licence or accept deposits from customers, but it did not strictly define banking business. The most appropriate description of a Bank in the UK probably originated from case law[3], in the case of United Dominions Trust v Kirkwood (2).

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[2] Spong K., Banking Regulation: Its Purposes, Implementation, and Effects, Chapter 5

[3] McConnnachie Alistair, A History of Banking Regulation in the UK,Prosperity Magazine, July 2009.

The first comprehensive financial services regulatory framework was introduced to the UK following the Financial Services Act 1986. The Act introduced a number of Self Regulatory Organisations ("SRO's) with each given responsibility for a particular segment of the industry. Each SRO developed detailed rules that were tailored to its industry sector. Further down the years, the enactment of the Bank of England Act 1998 gave the BOE responsibility for setting interest rates and track the government's inflation target.

The Financial Services and Markets Act (2000) ("FSMA 2000"), underpinned the UK regulatory regime leading up to the 2008 crisis. Sir Andrew Large who had conducted a review of the regulatory regime, following the Maxwell pension scandal had misgivings on the then current state of financial regulation, which was anchored on the SIB. FSMA was therefore seen as having carried out the objective of the Large report. The Financial Services Authority ("FSA") was created from this legislation, with four main objectives: to maintain market confidence; for the reduction of financial crime; to encourage public awareness, and to ensure consumer protection. The FSA was the single regulator for the UK financial services industry; it was acknowledged by many as the appropriate structure for the twenty first century. It's stated goals were to "maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal". The FSA deployed considerable resource to firm-specific risks, the probability of their occurrence and their likely impact. It set out to achieve a more integrated supervision model, however, a common criticism of the FSA's approach, post-2008, was that its focus was consumer-driven[4], and that its assessment of risk and impact were rather firm-specific, in-spite of its objective of maintaining market confidence. It's interest in the UK being a major financial is also not lost on critics, who say that this was one of the reasons for its 'light touch' regulation. Perhaps if the UK government had undertaken a systematic review of the regulatory structure prior to the introduction of its 1997 reforms, and formally put forward its arguments for the creation of a single regulator, issues such as the combination of responsibility for monetary policy and banking supervision, would have been properly debated. It is notable that the re-balancing that occurred in 2013, now gives responsibility for the prudential supervision of banks back to the BOE. The Treasury was of the opinion back then that the BOE Governor would have been too powerful. In the view of Davies and Green, the main driver for the 1997 change was the Chancellor's interest in the reform of the monetary system, part of which resulted in the BOE gaining independence in interest rate policy, without as much attention paid to regulatory reform..

The US has historically had a more complex structure of prudential regulation of banking, due to the number of separate and independent regulators. The US has a dual-banking system of state and national bank authorization, which is stepped in history. The national government had introduced a national currency to support its war effort and had desired to put an end to states issuing their own banknotes. The result is that there are state banks that are

[4] this may have been due to the various mis-selling scandals, including , on mortgage endowments, pensions structured investment products, payment protection insurance.

regulated by the states and national banks that are chartered by the Office Comptroller of Currency. According to Dalvinder Singh, the primary regulatory bodies of the FRB, the OCC, the FDIC and the Office of Thrift Supervisors, were responsible for the supervision of approximately over 5 million institutions.

The FRB holds responsibility for the prudential regulation of state, national, foreign bank operations and financial holding companies. In addition, it holds responsibility for monetary policy and stability. The FDIC regulates state banks that are not regulated by the FRB.

The development of banking regulation has similarly responded to crisis or regulatory failure in the US. For instance, the establishment of the FDIC, followed the crisis of the 1930's and was established for the protection of bank deposits for national and state banks. Banking regulation in the US is disjointed, though there have been intermittent moves into regulatory consolidation. The Banking Act 1933 (also referred to as the Glass-Steagall Act) focused on the dismantling of universal banking and a separation of banking activities between retail and investment; this was in response to the Great Depression. This barrier was later dismantled by the Gramm-Leach-Bliley Act 1999, as the Glass-Steagall Act had been criticized for being the wrong anti-dote to the failures that resulted in the Great depression[5]. The aim of the Gramm-Leach-Bliley Act was to facilitate the efficiency of the US financial system, through, for instance, enabling the formation of financial holding companies that were supervised by the Federal Reserve, as the lead regulator. It

[5] Singh Davinder, Banking Regulation of UK and US Financial Markets, 2007, at page 37

nevertheless did not encourage a universal banking model and the US continued with the multi agency approach to supervision.

The US banking regulatory agencies are therefore comprised of Federal Reserve, Office of the Controller of the Currency, the Office of Thrift Supervision, or one of fifty sate regulators. The Federal Deposit Insurance Corporation is responsible for the protection of the fund. The state chartered regulates those state banks that are not part of the federal stem of regulation; some of the state regulatory agencies are powerful to the extent that their regulatory reach goes as far as international banks, like in the example of New York.

The complexity of the domestic banking regulation in the US may very well serve as a hindrance to a harmonious approach to multi-jurisdictional regulatory initiative, such as in the case of Basel II[6].

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[6] Davies H. and Green D., Global Financial Regulation, The Essential Guide, 2008, at page 161.

1.2 Shift of paradigm

Major changes in banking regulation, may be attributed to responses to banking crisis, the perceived anti-dotes to identified risks including the increased awareness of the need for consumer protection, national and international efforts to combat money laundering, the development of new banking products and services, and the growing competition amongst banks.

In his discourse of Future Trends in Banking Regulation, Kenneth Spong claims that "technological change, rising competition in banking, and the future financial and economic environment raise several issues for banking regulation and its objectives of depositor protection, monetary stability, an efficient and competitive banking system, and consumer protection[7]", though he also recognized that there is a need to continuously tune regulation to adapt to a changing environment. It is this writer's view, that Spong's prediction has almost certainly come true. It is also correct in my view, to say that this is an evolving paradigm, so perhaps an appropriate description of this particular section is not how the paradigm has shifted, but rather, the main determinants of the shift being those cited above from Spong.

The reasons for the shift in my view are two-fold. One is the natural phenomenon of new products coming into the market. The other is

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[7] Spong. K, Banking Regulation: Its Purposes, Implementation, and Effects, 1994, Chapter 8

the shift in the marketplace itself, that is partly driven by the increased competition amongst banks.

The development of innovative banking products has for instance led to new financial instruments, and therefore new risks. Banks have become managers of interest rates, exchange rates and market risks, for themselves and for their customers[8]. These include collateral debt obligations, residential mortgage backed securities including derivatives transactions[9]. According to *The Economist* magazine, the over-the-counter derivatives market was around $700 trillion in value and the derivatives market on exchanges $83 trillion, as of June 2011[10]. Derivatives typically carve out the risk and return elements of basic financial instruments, which enable those financial institutions to have the ability to manage their risk exposures. The increased competition amongst banks is driven by technological advancement i.e. electronic banking, in addition, by customer awareness and choice, the ability to penetrate more markets both inland and internationally, and the drive for increased shareholder value.

The identified changes mentioned above and others, have resulted

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[8] Spong. K, Banking Regulation: Its Purposes, Implementation, and Effects, 1994, Chapter 8

[9] (Report). Office of the Comptroller of the Currency, U.S. Department of Treasury. Retrieved July 2013. "A derivative is a financial contract whose value is derived from the performance of underlying market factors, such as interest rates, currency exchange rates, and commodity, credit, and equity prices. Derivative transactions include an assortment of financial contracts, including structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards, and various combinations thereof."

[10] Clear and Present Danger: Centrally cleared derivatives (clearing houses) *The Economist* (Economist Newspaper Ltd.(subscription required) 12-04-2012. Retrieved 06-05-2013.

into a response from the regulators, leading to regulations on the capital adequacy of banks, systems and control, risks management, deposit guarantees and consumer protection. Banks are now required to hold a certain amount of capital dependent on their risk exposures, the entrenchment of adequate systems and control, rules on transparency of bank products, and contribution to a deposit insurance guarantee scheme. According to Spong, this led in the USA, to a 1991 legislation on "limits on discount window borrowing by undercapitalized institutions, independent audits and accounting reforms, real estate lending guidelines and annual bank examinations"[11]. The government also responds in accordance to their remit, being mindful of such matters as the recognition of the opening up of the market through competition, and the establishment of an ombudsman scheme for customer complaints and redress[12].

Barth et al conclude that banking regulation and supervision are products of the political set-up of a country, which essentially derives from the degree of the government's involvement with banking. Also, that government restrictions and control of banking does not encourage effective bank performance, as much as private monitoring. In their view, an efficient and more stable banking sector is more likely from a market driven type of supervision, where

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[11] Spong. K, Banking Regulation: Its Purposes, Implementation, and Effects, 1994, Chapter 8

[12] In March 2000, in the UK, the Competition Commission was asked to investigate the supply of banking services by clearing banks to small and medium-sized enterprises. The UK has an ombudsman scheme – the Financial Ombudsman Scheme, for consumer complaints against financial institutions, including banks.

information is readily available, deposit insurance is less emphasized, and private sector participation is encouraged. They claim that deposit insurance discourages a true assessment of banks; that a lesser involvement of government with lending diversification and a more transparent system for the reliable disclosure of information, leads to the likelihood of bank stability. In their view, Basel II's third pillar of market discipline had a more positive contribution than the first two pillars of capital regulation and official supervision. They claim that their investigation did not reveal a correlation between stringency of capital regulation and the performance of banking systems. They say that capital regulation rules can be twisted and used to work for the government's advantage, by not calibrating it realistically, as in the example of Argentina which misapplied the credit risk weight of it's government debts as zero. As regards supervision, they say that unless the country is very well developed, the strengthening of supervisory powers impede bank development.

1.3 The 2008 financial crisis & response to the crisis

Bank "Crises are a manifestation of imperfect information, coupled with externalities".[13] According to Davies and Green, there were four main regulatory models, leading up to the financial crisis:[14]. In their analysis, the tripartite and the unified models were more common, the dual a little less common and the 'twin peaks' model, quite rare.

There have been numerous commentaries on the root cause of the crisis. It is perhaps useful to trace the cause and the unfolding of the crisis, in order that the responses to the crisis are properly understood, and commentaries on future regulatory models are critically appraised.

In an instructive report by the UK House of Lords, on Banking Supervision and Regulation[15], the history and causes of the crisis was traced from the imbalances that existed between the world economies; the overflow of excess money in the oil-producing and some Asian economies that fed consumption in the West, particularly in the US. The US was thereby presented with the double jeopardy of low interest rates resulting from the large capital inflows from these better-off economies and an imbalanced fixed exchange rates that

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[13] Barth J.R., Caprio C. Jr, Levine R., Rethinking Bank Regulation, 2006, at page 26

[14] Davies H. and Green D., Global Financial Regulation, The Essential Guide, 2008, at page 183

[15] House of Lords, Select Committee on Economic ~Affairs, 2nd Report of Session 2008-09, Volume 1 Report

resulted into cheap affordable imports. Inflation was low in the West and there was a high demand for credit. The report explains how the resulting asset prices led banks to competitively lend to households and businesses in a desperate attempt to achieve high returns on their investments. The standards of credit assessment were therefore lowered, resulting in sub-prime lending. Sub-prime lending in the US, was reported to have increased from 10% to 32% in a two-year period between 2003 and 2005.

Y. V. Reddy whilst commented on the re-regulating or rebalancing of the financial sector, noted, "excessive regulation was one of the causes of the global financial crisis"[16]. He claimed that excessive de-regulation of the sector took place mostly in the US, the UK and other European countries, but that this was not consistent with the practice in other developed economies like Australia or Canada. He argues that better supervision does not necessarily mean more regulation.

According to the PCBS, proprietary trading contributed to the financial crisis, though the commission was of the opinion that it was not a significant factor that led to the crisis[17]. The definition of proprietary trading varies within the financial industry, but perhaps a very clear description of this activity was provided by Lloyds as a situation where bank risks its own capital by taking positions in financial instruments in order to profit. Its view was that bank failure leading to the crisis was more a result of "highly leveraged

[16] Reddy Y.V., Financial Sector Regulation and Macroeconomic policy, Bank for International Settlements Paper s No 62, year?????

[17] House of Lords (2013), Parliamentary Commission on Banking Standards, Third Report of Session 2012-13, 5 March 2013

structured credit, ineffective liquidity or risk management and/or poor corporate governance"

In its report the PCBS[18], cites a common interest in property prices as one of the causes of the crisis. Other reasons cited were over reliance on quantitative analysis, and the failure to learn the lessons of past failures,

[18] House of Lords, House of Commons, Parliamentary Commission on Banking Standards, Changing Banking for good, First Report of Session 2013-14, 12 June 2013, chapter 3

Chapter 2: Simple and isolated regulatory approach

2.1 Introduction: Banks and market failure: Systemic Risk and negative externalities

In this chapter, I have attempted to discuss the isolated approach to regulation that existed pre-2008 crisis, by examining the basic reasons for banking regulation, the risks that banks pose to the economy, and the infrastructure that existed to address those risks.

Some say that the crisis would have been avoided if not for the wider systemic risks and the negative externalities that effect the industry, however, it is apparent that banks have an inability to learn from the lessons of past crisis[19]. Banks have always been exposed to influences that are directly out of their control. Some noted that banks placed too much reliance on quantitative analysis, yet others cite the operation of regulatory silos.

The externalities included the combination of macro-imbalances and financialisation, rapid credit growth, the inadequacy of the regulation of cross-border banks, and issues surrounding market efficiency and market rationality,[20] as further explained in chapter 3 below.

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[19] Report of the Parliamentary Commission on Banking Standards, Changing Banking for Good, 2013, page 106

[20] The Turner Review, A regulatory response to the global financial crisis, 2009, page 13

2.2 Why do Banks have to be regulated?

The answer lies in an understanding of the functions of a bank. Banks are holders of depositors' funds and consequently, the supplier of credit into households and the wider economy. Availability of credit is important to the development of an economy, as it provides the means for personal attainments, and the provision of facility and infrastructure. Banks are the trusted guardians of depositors' money. For these reasons, the regulation of banks not only satisfies an economic function, but is also a subject of public policy. The first sniff of a bank's failure would spell trouble for the system, as depositors would demand the return of their money. Banks, typically do not have as much money in their coffers as they have received from their depositors. A bank run would therefore result into a systemic issue, affecting households and businesses. Some key objectives of national governments is economic development, maximization of economic output, and the promotion of access to capital. Banking crises will very likely lead to reduced economic output, economic volatility and worsen economic conditions[21]. Furthermore, as recent experience has shown, it also leads to unemployment, economic recession, sharp reduction in credit and other social problems. It is for these reasons that governments promulgate laws and regulations that govern what banks are allowed to do.

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[21] Barth J.R., Caprio C. Jr, Levine R., Rethinking Bank Regulation, 2006, Contrasting Approaches to Banking Regulation, pp26

2.3 What are the banking practices that have to be regulated?

Financial stability is a prerequisite of economic stability. Bank failure thereby results in loss of confidence in an economy. Regulators are the guardians of the banking industry and indirectly, of the economy. The importance of an efficient banking system should be given as much prominence but set against those of a competitive market economy, where inefficient banks are allowed to fail.

In view of the role of banks in the economy and their importance to economic growth and financial stability, what should be regulated becomes obvious. Some of these are covered in Chapter 2.6 below, but there are others that warrant mentioning here.

FSA's objectives, though that body is now defunct is instructive. Their stated objectives were to maintain market confidence; the reduction of financial crime; to encourage public awareness, and to ensure consumer protection. These translated into a rulebook that covered what was referred to as High Level Standards, Prudential Standards, Business Standards, and Redress arrangements. The detailed rules covered systems & controls, ensuring the probity of bank's senior management, the continued competency of those in key functions, including customer functions. Others covered capital adequacy, credit and operational risk management, conduct of business and the compensation arrangements for customers who had suffered loss[22].

The FRB says that its mandate is "to maintain a safe and competitive U.S. and global banking system." They do this by overseeing consumer protection, bank reserves provisioning, monitoring of inter-bank liabilities, and international banking operations. The FRB's rulebook also sets out the requirements for membership of state-chartered banks in the Federal Reserve System; sets limitations on certain investments and requirements for certain types of loans; establishes the minimum ratios of capital to assets that banks must maintain and the procedures for prompt corrective action when banks are not adequately capitalized; and, establishes rules governing banks' ownership or control of financial subsidiaries[23]

In summary, the banking practices that must be regulated are those that would ensure that the economic stability of a nation is not compromised, and it is these aims and objectives that translates into rules on systems and control, requirements on capital adequacy, and for banks conduct of business.

Capital adequacy is key to the survival of any business enterprise, and even moreso for banks. Banks should exist for the common good, the importance of capital adequacy cannot therefore be over-emphasised. Banking is one particular area in which national governments, prescribe rules on capital requirements for its

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[22] www.fsa.gov.uk, the old website is still accessible, but directs into the FCA website, accessed August 2013

[23] http://www.federalreserve.gov/bankinforeg/reglisting.htm#G, sourced 26/07/13

operations.[24]. As the focus of this paper is rebalancing of regulation, with a particular interest on the stability of the banking system, it is imperative that most of the discussion on banking practices that are or should be regulated, is to do with capital adequacy.

[24] Banking on Basle: The Future of International Financial Regulation, 2008

2.4 What are the international banking regulations?

The concept of international banking regulations is really non-existent. Countries define their own rules for the regulation of banks that operate within their borders. There are of course international efforts to achieve a coherent and common approach to the regulation of banks, especially where this concerns issues of capital adequacy and anti-money laundering. This is evidence of the changing nature of banking regulation from a simple to a more complex approach.

One particular initiative that has the semblance of international regulation is that which emanates from the BCBS. The BCBS describes its objective as the "understanding of key supervisory issues and to improve the quality of banking supervision worldwide"[25] and has been at the forefront of initiatives on the implementation of international standard for minimum capital regulation. Its committee's membership is representative of major developed and emerging market countries. In addition, it has formal channels for co-ordination with non-bank financial institutions and with non-member countries.

According to Tarullo, the rationale for banking capital requirements begins with the fact that, the central government is the deposit insurer or lender of last resort, or both, hence "the government is potentially the largest creditor of the bank"[26]. The bail-out of Lloyds

[25] www.bis.org/bcbs, sourced 30/07/13

[26] Tarullo D.K., Banking on Basel: The Future of International Financial Regulation, 2008, Chapter 2: Role of Capital Regulation

TSB and the Royal Bank of Scotland, has shown how the taxpayer through direct funding, economic or other social costs like unemployment and scarcity of credit take responsibility for the mismanagement of banks. Banks shareholders profit limitlessly from an upside but have a limited amount of loss in a downside. This results into costs on the society, well in excess of the losses incurred by the management and shareholders.[27] A classic moral hazard.

Basle's history is evident of the notion that regulations respond to economic developments. Its origin is traceable to developments in the aftermath of the Second World War, when the IMF Articles of Agreement allowed national governments to introduce controls on their domestic financial systems. The Committees' primary task was to co-ordinate the activities of national regulators[28].

Basle I and II were introduced before the 2008 crisis and attempted to stipulate risk and capital management requirements that were commensurate to their activities. Basle II was designed to be an improvement on Basle I and uses a 'three pillar' model. Basle III is currently being rolled out for adoption in 2015, though some countries are committed to its introduction before then.

Another piece of regulation that has gained international prominence concerns the fight against money laundering and terrorist finance.

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[27] Alexander Kern., Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, 2006, Summing Up and Conclusion, page 253

[28] Alexander Kern, Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, 2006, Summing Up and Conclusion, page 254

FATF, is an inter-governmental body with the aim of combating money laundering and terrorism financing. FATF currently comprises of thirty-six members and thirty one international and regional organisations that are Associate Members or Observers of the organisation[29]. Since the main focus of this paper is on core banking regulation, especially on the stability of banks and how this effect the wider economy, I have not discussed anti-money laundering controls in any detail.

[29] http://www.fatf-gafi.org

2.5 The role of the Basel Accords

My objective here is to further discuss the role of the Basle Accords, as regards supra-national regulation of capital adequacy including, general commentary and observations on its apparent inadequacies and limitations.

The collapse of three medium sized banks[30], with no obvious implications for systemic risks provided the G-10 central bank governors with sufficient reasons to consider that, due to floating exchange rates, banks would be at risk, if there were no co-ordinated cross-border supervision efforts. This resulted in central banks serious consideration of capital adequacy and cross-border supervision of banks, rather than the pre-existing practice of imposing on banks, minimum reserve deposits with the central bank[31]. The G-10 central bank governors also considered how to supervise branches of foreign international banks; and dealing with minimum capital requirements. According to W.P. Cooke, the first chair of the BCBS. "There is no objective basis for ex-cathedra statements about levels of capital. There can be no certainty, no dogma about capital adequacy". BCBS have since dealt with a variety of issues, starting with the first Basel Concordat of 1975 i.e. the first attempt to allocate international bank supervision between the host and home state regulators; a risk based 'capital Adequacy Accord' in 1988,

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[30] the American Franklin National Bank; the Israeli-British Bank; the Bankhaus Herstatt.
[31] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, page 168

The Basel I Accord released in 1988, focused on credit risk, though it required banks to be mindful of other risks. The model prescribed a total minimum capital for a bank that was derived from the sum of the five risk categories, that were determined from the calculation of the capital required for each asset held by the bank.   Its implementation was uneven and lacked uniformity in many countries; whilst implementation was effected in the EU through a directive, it was left to the other national governments to promulgate domestic laws for its introduction. Yet, the consensus is that the its implementation was fairly successful, with over 100 countries having adopted it, who were themselves not part of the negotiations

Tarullo D.K. expressed his view[32], on what he considered the apparent drawbacks of Basel 1, including the macroeconomic effects, regulatory arbitrage, and the divergence between risk and capital regulation.

The development of Basel II commenced less than a decade to Basel I and resulted from the perceived inadequacies of Basel I:, as a response to the sheer scale of securitization of mortgage activity[33] that was being undertaken by banks,. Secondly, it was discovered that the banking industry was progressively devising new methodologies of credit risk models for risk assessment purposes. , As new instruments were developed and bank activities more complex, Basle I started to lose credibility as a tool due regulatory

32 Tarullo Daniel K., Banking on Basel: The Future of International Financial Regulation, 2008, page 83

33 note: securitization were undertaken primarily for other purposes, quirte separate from regulatory reasons, including e.g. the reduction of interest rate exposure.

arbitrage, as the new method "underscored the degree to which a risk weight assigned to an asset or asset equivalent could diverge from the bank's estimate of the actual risk created by that exposure"[34].

Comments were made on the limitations and inadequacies of Basle I, including no less than Alan Greenspan, the Feds Chairman. There were also comments that the Basle Committee had to strike a balance between maintaining a model that would remain relevant to the vast majority of banks, whilst being mindful of the need for an IRB model in the larger banks. Nevertheless and in-spite of this, meaningful progress through collaboration and debate led to Basel II, though the IRB model led to disagreements, some in the national interests but in the case of the US amongst its four national supervisory agencies.

Basel II was characterized by the reliance on CRA's, use of internal risk assessments, and lower capital requirements for residential mortgages.[35] Some have challenged whether the Basel policy of higher capital ratios has not led to societal trade-offs between banking system stability[36] and allocation of capital to productive uses. Others say that it is unproven to be the most efficient method for ensuring for banking stability. One must ask, whether in the light of the bank crisis, the Basle Committee were overly focused on

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[34] Tarullo Daniel K., Banking on Basel: The Future of International Financial Regulation, 2008

[35] Tarullo Daniel K., Banking on Basel: The Future of International Financial Regulation, 2008, 4, 132

[36] One of the stated aims of Basle II is 'soundness and stability of the international banking system'

capital adequacy and capital rations as the main anti-dote to instability and systemic risk. The poor quality of mortgaged backed securities led to the spread of liquidity problems and was one of the main reasons for the unfolding of the 2008 crisis. Alexander, et al argue for other considerations for ensuring market discipline, in particular to make banks issue subordinated debts and that if this was properly designed, the market would almost end up policing itself, as risk based capital standards "are still no substitute for the discerning ability of the market to assess and price risk".[37] Tarullo supports this view as well whilst recommending the way forward from Basle II[38]. It is therefore apparent from recent experience that capital adequacy aside, BCBS needed to have taken a more intrusive stance on the primary activities of banks as part of their efforts to achieve bank stability, though there are some who argue, that if Basle II had been fully entrenched, rather than the debates that ensued, requirements for the setting aside of capital for off-balance sheet activities would have provided some measure of control on banks activities. In my view, the argument can only be won in one way, i.e. proven by the fact that the Basle Committee itself commenced in 2011, a revision of Basle II, by focusing on market risk framework, in the belief that the main cause of losses in the financial crisis and the increase in leverage in trading book was a result of market risk framework not capturing key risks.

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[37] Alexander Kern., Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, 9, 235

[38] Tarullo DK, Banking on Basel, 8,270

More generally, there are concerns that even the regulators do not have a sufficient understanding of how the A-IRB model might be deployed in regulated firms. A considerable amount of discretion is thereby ceded to banks during the evaluation process, a real potential hazard for the entire concept. Banks typically will not hold more capital than they need to, however, there is evidence that the largest banks hold capital in excess of regulatory requirements[39] It proves that banks to a certain extent are mindful of the risks of risking their survival. Even though they would play to the wire, if allowed, they must respond to other variables like market demands, by counterparties and debt investors, planning for the downsides of business activities.

Basle III was introduced in 2013 with the aim to "strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector". Its objective is to ensure that banks can absorb shocks arising from financial and economic stress, improve risk management and governance and strengthen banks' transparency and disclosure[40]. The reforms are targeted at micro-prudential regulation to help raise the resilience of banks to periods of stress; addressing macro-prudential system-wide risks and the pro-cyclical amplification of these risks. If there was one lesson that has been learnt by the Basle Committee from the 2008 crisis therefore, it is that macro-prudential issues has now entered its agenda, coupled with a consideration for systemic risks. There are also common sets

[39] Tarullo Daniel K., Banking on Basel: The Future of International Financial Regulation, 2008, 5, 142

[40] British Bankers Association, Basle III workshop, 25/02/13

of monitoring metrics to assist supervisors to analyse liquidity risk trends.

The US is committed to implementing Basle III and has even gone further by extending it to other financial institutions with more than USD50 billion in assets. The FRB have also said that they will conduct annual tests on banks. In the EU, Basle III requirements have been adopted into Capital Requirements Directive 4, for implementation in EU countries.

In my view therefore, the BCBS appear to have made significant strides with Basle III, though it should then broaden out the wider agenda for the achievement of its goals. It has already recognized corporate governance and macroeconomic issues. Consideration should now be given to supervisory standards deployed by national regulators, and the framework for regulation within countries, even if these were only limited to recommendations. Macro-economic policies cannot be too prescriptive especially when they are intended for different countries at varying stages of development, however, the Basle committee can at least lead the debate. In addition, the BCBS clearly lack the necessary resources that it requires in certain aspects of its work; this was demonstrated by its reliance on banks to develop the A-IRB approach

2.6 Some other important aspects of banking regulation:

An effective system of banking regulation must deploy tools that ensure micro-prudential and systemic risks are curtailed effectively. Some of these tools are quite apparent, others are not so obvious, as for instance in the example of proprietary trading. This section examines other tools that are commonly utilized to ensure bank stability.

i. Capital adequacy restrictions on type and quality of securities holdings, loan quality.

Banks expose themselves to greater risks during buoyant periods of an economic cycle, due to competition for profitable business. Capital adequacy rules help to apply brakes to banks exposure to those risks. This is one of the reasons countries adopt the BCBS standards.

Capital adequacy standards must be transparent, have an effective institutional framework, and a viable methodology. Banks have short term liabilities and a mixture of short-term and longer-term assets. As is typical of most businesses, a bank would become insolvent if its liabilities exceed its assets. Banks utilize risk management techniques to mitigate credit risks and economic shock on their loan portfolio.

Alexander, et al identified some of the causes of banking sector crises as financial, macroeconomic and institutional.[41] Banks compete for savers funds on deposit rates; they are at risk of loss when the return they receive on assets is less than what they pay on liabilities[42]. A macroeconomic environment is a possible source of systemic risk. A good institutional framework that instills confidence in depositors is essential. In the UK, the FSCS are very keen to remain visible to the public, through advertisements.

The need for capital adequacy is paramount, especially in the mega banks, where a moral hazard of the too big to fail is easily created.

According to Avgouleas E, the neglect of liquidity in the Basle II requirements, enabled banks to rely excessively on short-term funding to finance their asset expansion[43]. Perhaps liquidity regulation coupled with the suggested use of subordinated debt, advanced by some could have arrested this practice. The subject of capital adequacy has attracted more attention from regulators across the world than ever before. In the UK, the FPC of the BOE has started work in behest, since it was set up in April 2013. According to reports[44], it has been reviewing capital adequacy across banks in the UK and referring its findings to the PRA who have insisted that banks

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[41] Alexander Kern., Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, 8,206

[42] Banks assets in the form of longer term loans would already have been fixed at a lower rate of interest.

[43] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, 3, 116

[44] Giles C, Britain's Banks are still a danger to the real economy, Financial Times, 20 June 2013

redress their capital shortfall where necessary. As a result, the Co-op was forced to raise capital to address its deficiency, a process described by Chris Giles as "banking recovery in action". He though, questions whether the bigger banks would have attracted such attention from the government and not a simple requirement for the bank to address its capital deficiency by itself. It raises the issue of whether some banks are still too big to fail, in-spite of capital adequacy rules.

In the US, the FRB have started implement Basel III, and will be subjecting banks to multiple capital requirements, including the application of a risk-based capital ratio, that will require the largest global banks to hold 7 percent equity to risk adjusted assets and the most risk loans requiring more than 100 percent capital. The FRB are proposing to impose a further charge to the leverage ratio, a measure that is said to "ignore riskiness of assets and measures equity against total assets"[45]. It is uncertain whether there would be a level playing field as regards foreign banks, within its shores.

Banks will always argue against requirements that they should hold more capital. It is debatable whether higher capital requirements should lead to a constraint in lending, after all banks can act more prudentially, by seeking other avenues for seeking capital, for instance, through the restriction of salaries, bonuses or dividends or by raising new capital. Co-op offers an example: it was forced by the PRA to plug a £1.5bn hole in its capital buffers by injecting money

[45] Foreign lenders await orders as Fed puts Basel III into practice, Financial Times, 3 July 2013

from other parts of its business[46]. The challenge for regulators in the new dispensation is to be able to stand their ground against the bigger banks that were perceived as TBTF.

ii. Financial Stability and the prevention of systemic risks, including limitation on the activities that banks can undertake

Financial stability has always been at the forefront of banking regulation. What appears to have escaped the regulators is the systemic risks that an individual bank's instability has the ability to unleash on others, especially if that individual bank is big. Avgouleas illustrates the example of where the rational actions of individual banks that are faced with the same challenging issues could translate into a systemic problem[47]. This particular issue escaped even the Basle Committee when setting capital adequacy rules, as their main focus was individual bank's capital provisioning. This deficiency has been recognized and addressed in the Basel III framework.

The 2008 banking crisis has led to a review of regulatory structures in major financial jurisdictions across the world. The UK has abolished the FSA and replaced it with two new bodies , the PRA, responsible for prudential supervision and the other, the FCA, with responsibility for investor protection. It has also established the FPC in the BOE that is responsible for macro-prudential supervision and for maintaining financial stability.

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[46] Financial Times, Britain's banks are still a danger to the economy, 20/06/13

[47] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, page 133

In the EU, the Larosiere report in February 2009, has led to the creation of an European Systemic Risk Board with responsibility for macro-prudential supervision, the replacement of regulations for minimum harmonization and mutual recognition by the maximum harmonization standards of a newly established European Supervisory Authorities. The EU has also legislated for CRA's and placed them under the supervision of the ESMA, the regulation of hedge funds and promotion of standardization of OTC derivatives.

The US response is even more fundamental. It enacted the Dodd-Frank Act in July 2010, which resulted in a wholesale expansion of the Feds supervisory function to include the supervision of insurance companies, certain non-bank financial institutions, commercial banks, the standardization of OTC derivatives and the establishment of the Financial System Oversight Council (FSOC).

The international community has come to realize that some form of international regulation is essential for the protection of banking stability.

iii. Proprietary trading

Proprietary trading has been cited as some as one of the main causes of the banking crisis[48]. It is considered as one of the riskiest forms of banking activity, due to the riskiness or opaqueness of the products that are traded. The FSA noted that "where a bank decides to engage in proprietary trading there is a potential for increased principal-

[48] Not everyone subscribes to this view, e.g. refer to the UK's Parliamentary Commission on Banking Standards report, March 2013

agent conflicts with its clients"[49]. According to the Volcker Rule, it is the act of 'engaging as a principal for the trading acccount' of a banking entity. In other words, it is recognizable as an activity where a bank trades for the benefit of itself, with a view to achieving short term gains. The activity may take place in other forms that are not easily recognizable. Bank's activity in this area may be encouraged by the notion of TBTF or the moral hazard that accompanies it, as bankers become comfortable that no matter how big its loss, it will not result in the bank's failure.

In the US, the Dodd-Frank Act introduced a new section to the Bank Holding Company Act, 1956, which is commonly known as the Volcker Rule[50]. It is claimed that Volcker was in favour of a return to the Glass-Steagall Act, referred to above in Chapter 1.1. The Act has ingeniously banned commercial banks from undertaking proprietary trading, whilst permitting other financial companies to continue to do so, with the proviso that such companies are required by their regulatory bodies to provision for additional capital requirements to take account of proprietary trading. Those requirements have of course been imposed on the other large financial institutions due to the recognition of the systemic risks that they themselves pose to the financial sector, but at least banks would be more protected from the risk of failure relating to proprietary trading. The US has confined the law to banking activities being undertaken within its territory or

[49] UK's Parliamentary Commission on Banking Standards report, Proprietary Trading, Third Report of Session 2012-13, March 2013

[50] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012,
p 352

the activities of banks regulated within its territory, no matter where the activities are undertaken.

In the UK, the PCBS advised the government in December 2012, to erect a protective "ring-fence" around retail banking activities, with the threat of breaking recalcitrant banks up, if they fail to comply. They also demonstrated their support of the US Volcker rule, though they were prepared to compromise for banks to be allowed to sell "simple derivatives" to small businesses.[51] In its published report, in March 2013, it enumerated the issues surrounding proprietary trading as threefold:- prudential, cultural and the social utility and the implicit guarantee. The PCBS stated that it had found no evidence that proprietary trading was the primary cause of the banking crisis, however, it concluded that it "created prudential risks to the banking industry as the exposure to markets than is necessary for client servicing increases the potential for risks that may not be understood until the next crisis". PCBS's stance recognize the risks of proprietary trading on the one hand, but without the conviction that it was primarily of toxic effect to commercial banks.

In my view, the important issue is for the regulator to be aware of the types of risks that the system faces, and where those risks reside. One must remember that the Glass-Steagall rule was introduced in the US not for the purpose of controlling risks, but to address the potential problem of conflicts of interest. It is also unclear whether proprietary trading activities are more likely to fail than client servicing activities, as illustrated in Northern Rock, afterall, the

[51] "Banks need 'electrified' ringfence, says review", Financal times 21/12/12

prominent risk in banking is credit risk. Bankers are very innovative and they must be allowed to respond to changes in economic activities, in order that they are able to fulfill their role. It therefore is my view that the most effective and long-term approach is to commence a review of banking activities especially where banks are involved in universal banking, for the purpose of understanding both the microprudential and macroprudential risks that those activities entail. One must consider that the risks that are presented by non-ringfenced banks cannot be ignored, as they continue to have an influence on the rest of the banking industry.

On the other hand, retail and commercial banks provide a valuable service, by selling derivatives to their customers, the challenge for regulators is to ensure that such banks do not stray into activities that are not captured in their risk profile. The risks presented by each activity should determine the imposition of appropriate measure of capital provisioning.

iv. Corporate Governance

The banking crisis occurred in spite of the existence of rules to ensure good corporate governance. Bank regulators are naturally interested in bank governance, as it is one of the tools that can be employed in ensuring the safe functioning of a bank. In the UK, for instance, the FSA put in place high level and detailed rules on systems and control and senior management accountability. The Feds had similar rules in place as did many other developed economies. The Working group on Corporate Governance of the Basel Committee recommended, following the 2008 crisis, that boards should actively deliver on its responsibility for the bank, whilst supported by robust and independent risk and control functions. Interestingly, it also noted that bank's senior management should recognize any structure that impede transparency and the risks that these may pose.

The Basel Committee had admittedly in the years leading up to the crisis, published papers on the need for an effective corporate governance in banks[52], it should make increased effort to promote a common standard corporate governance, due to the globalization of the banking industry, in order to enhance the control of risky activities and mutual trust. It is therefore my opinion that the Basel Committee needs to go a step further in pushing this agenda into national regulators for adoption and execution, no matter what the resistance might be due to cultural differences.

v. Cross-country co-operation and harmonization of rules

The inter-connectedness of markets across national borders raises different issues for domestic regulation. National governments are more interested in the stability of their economies, as opposed to that of other nations. However, in the modern world the degree of influence of externalities is more pronounced. Economic activities inter-connect and create externalities as much as banking activities. This is apparent from the manner in which cheap money combined with cheap exports from China and some far eastern economies contributed to the bubble in the US, that led to securitization in banking, and through the inter-connectedness of banks, bank liquidity problems in the

[52] Alexander, Dhumale, Eatwell, Global Governance of Financial Systems, 2006, page 244

western world. The realization by national regulators that they face a common challenge, therefore makes it incumbent on them to work together for the common good. National supervisors may have conflict of interest that prevent them from pursuing the common good, for instance when the taxpayers of a home country supervisor are responsible for the rescue costs of an international bank whose depositors are mostly located abroad. The IMF and the World Bank, the two most prominent international financial institutions, only operate in a standard setting role and do not have any compelling or enforcement powers. There is currently no global regulator that has the authority to supervise banks systemic risk on a global basis, though the ESRB fulfills this role as far as the EU is concerned, supervise cross-border banks, track national regulators enforcement and compliance with the regulatory provision of the BCBS or deal with crisis matters of international proportions[53]. It is therefore incumbent on national regulators to find a common ground for cooperation. It is obvious that the concept of international financial regulation does not exist, since there is no law that actually binds nation states to act in accordance to a certain code, in the regulation of its home market. It is therefore my view that the main determinant for a harmonious approach is the incentive that the desire for crisis-avoidance presents. There are of course others, for example, it will probably enhance the economy of a country if banks from that country are considered to be sufficiently capitalized and governed.

[53] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012,

There is also the issue of reputational constraints. Perhaps the way forward is for nations to enter into MoU's on particular issues.

There are some who hold the view that Transnational Regulatory Framework (TRN) is the solution to the regulatory challenge for a harmonized approach. Some have different views, including, that national regulators have their own national self-interests, that international regulatory cooperation results into conflicts of interests amongst the countries as some countries attempt to dominate, and that they are incapable of resolving amongst those countries.

vii The role of auditors

In order for the efforts and work of the government, regulators, shareholders, and bankers themselves to be efficiently delivered, there must be an overaching oversight on the process and delivery of the common objectives. Bank's auditors should ideally operate as another pair of eyes for regulatory objectives. It is worth noting that the factors leading to the collapse of Lehman Brothers was not identified by its auditors. There have been serious allegations about the roles that auditors played, giving banks clean bill of health even during the months leading up to the crisis.. There have also been comments about the concentration of audit practices through lack of competition and the need to broaden the scope of audit work, to include for instance, business risks, key performance indicators and internal controls.

The issue of auditing of CRA’s and of ring-fenced banks in the UK is of particular interest. One industry stakeholder, Mazars, submits in one of its reports on the PCBS, that “auditors of ring-fenced banks should be a different firm from the banking group auditors; that no audit firm should audit more than one ring-fenced bank, that ring-fenced bank’s auditors should be voted on by shareholders and separately from the group’s auditors and that auditors of the ring-fenced bank should not provide non-audit services to other parts of the group and should be restricted in any non-audit services within the ring-fenced bank”[54]. These comments are quite sensible and are ones that should be considered not only within the context of ring fenced banks and CRA’s , but also more widely in the banking industry.

[54] Mazars, 2013, Mazar’s Insight: PCBS Final Report, Too important to fail, but too big to succeed?

2.7 The Role of Credit rating agencies

Credit rating agencies have played a prominent role assessing the risks of default of credit securities. They support the analysis of institutional investors, mainly investment banks in their decision making. According to Philip Turner, the activities of CRA's contributed to the banking crisis in three ways, even though he then concluded that regulatory responses would not completely resolve the identified problems[55]. Firstly, he cited the increased importance of securitized credit as an offshoot of structured credit and the resulting problem that procyclicality would add to a self-reinforcing downturn. He explained that the growth of the credit derivatives market resulted in the use of credit ratings in counterparty collateral transactions and hence the possibility of a strong procyclical effect, and gave the example of AIG where in 2008, a threatened rating agency downgrade resulted into serious liquidity strain. A great majority of the securitized credit were held by investing vehicles that were solely interested in maturity transformations and not by end investors that were prepared to hold to maturity. The other investors had assumed, and interpreted a good rating as a stamp of approval for not only credit risk, but also liquidity and market price stability. In the second place, he claimed that there was a development of ratings ineffectiveness, due to a number of factors,

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[55] The Turner Review, A regulatory response to the global financial crisis, 2009, page 76

including the extension of ratings to products where there was limited historical information, the complexity of structured credit instruments, and over-reliance on mathematical modeling. The third reason he gave related to the independence and therefore effectiveness of the work of CRA's.

He therefore advocated for the compulsory registration and regulation of CRA's to ensure transparent governance and management of the conflicts of interest that may arise in the activities of CRA's. He also pushed for CRA's to be transparent on the basis of their assessments to investors, in order that those investors are not misled that those assessments are for credit purposes only and not for liquidity or market price. Furthermore, he proposed that there should be a fundamental review of the use of structured financing ratings in the Basel II framework[56].

There was much reliance on credit agencies in the Basel II framework, for the assessment of credit risk, leading to possible conflicts of interest. CRA's were involved with the ratings of mortgage securities backed assets, one of the dysfunctional products in the market that led to the crisis. It appears to me therefore that the Basel Committee could only have been behind the curve.

Yet another criticism that is levied on the banking industry was that there was sheer over-reliance on the assessments of CDO's by CRA's even when it was apparent that those assessments were unreliable.

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[56] The Turner Review, A regulatory response to the global financial crisis, 2009, page 8

Avgouleas E expressed the view that this amounted to 'availability and representativeness heuristics' or put in other words, working from a known practice/rule of thumb, that were derived from market participants conclusion that it was unnecessary to undertake their own vigorous analysis of such complex products[57]. This is really surprising, given that there was little evidence that the market had a proper understanding of the products.

The EU has proceeded to legislate for the supervision of credit ratings agencies, by introducing a harmonized approach and establishing a registration and supervisory oversight of the new European Securities and Markets Authority (ESMA). CRA's are now required in the EU to comply with stringent requirements, including transparency, avoidance of conflict of interest and the submission of their process and methodology to historical validation. There exists a string of other controls, including a ban on CRA's provision of advisory services and a requirement for an internal audit of their work.

In the US, the Enron and Worldcom failures had already begun congressional focus in the activities of CRA's. The Sarbanes-Oxley Act of 2002 therefore required the SEC to undertake a study of the role and function of CRA's in the operation of the security market. Provisions of the Dodd-Frank Act which eventually expanded the SEC's oversight of CRA's policies. The US have therefore introduced similar provisions to those that have been implemented in the EU.

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[57] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, page 125

A number of issues were debated by the European parliament, leading up to the legislation on CRA's. Some of these, should naturally address some of the problems that were inherent in the manner these bodies influenced the financial markets. For instance, the ownership of CRA's and better transparency on their investment holdings should serve the market better. In addition, the introduction of a civil liability system should ensure that CRA's are made to redress investors where they have been negatively affected by abuse or gross negligence by the CRA.

Avgouleas argues for the establishment of a global financial regulator, and adds that it should be given the role of regulating CRA's in much the same manner as is currently provided in the EU[58].

It is my view that these initiatives could only help to address the inadequacies of the pre-crisis system, though it is also recognized that there must be commitment to regularly review the activities of CRA's in order to assess whether the desired objectives are achievable despite the changes that have been made. This is also important from the view of assessing whether there should be a change of course in the manner of approach to the problem.

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[58] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, page 450

2.8 The need for a rebalance of regulation

The global financial crisis has proven that there was something dysfunctional about the pre-existing practice of the regulation of banks. Banks are meant to facilitate and service the economy and not the other way round.. Financial markets exists to underscore an efficient allocation of resources, but it appeared that bankers started to regard themselves rather differently.

Banking regulation has of course developed over many years, mostly on the back of failures and crisis, this is therefore not new. This particular crisis presents both developed and emerging economies with an opportunity to conduct a review of what went wrong, and to commence on the establishment of a better framework for the future.

Banking regulation is fast assuming a different culture post-crisis. We now find that regulators, in particular, Central Banks are now more open and transparent in their policy decisions, to the extent that they create the perception that they view, not only the banks that they regulate but the wider participants in the national economy as their stakeholders. For instance, there have been public pronouncements of the detailed workings of central bank's policy on interest rates. The BOE says that one of it's aims in this respect, is to enable people and businesses to forward plan. I am not suggesting that the regulators have not previously been open, but only that there is a noticeable wind of change in the manner of their openness.

It is widely accepted that the banking crisis was caused by a combination and interconnected of a number of issues that affected banking domestically and internationally, some of which are discussed in chapter 1 above, and the rest of this paper. It is also apparent that the regulators risk radar was ignorant of some contributors to the crisis, to the extent that they were totally caught unprepared for dealing with them. History teaches us that the development of regulation is usually directly connected to need; need that are themselves borne out of a crisis or failure. Regulators recognize the world over that they have to respond to the current challenges by having a radical re-think of their approach. This is evident in the US, UK and in the EU. Regulatory structures are being re-modelled, regulatory issues are being reviewed and re-casted following a wider review of the causes of the crisis and a viable plan for the future. The response to the challenge requires far more than the creation of a low interest rate environment, a mere restructure of the regulatory agencies, and the adoption of more stringent capital adequacy standards. There should in my opinion, as others have suggested also be a root and branch review of the social utility of banks, a polarisaton of certain aspects of banking activities, a review of the role and potential risks of shadow banking, a better coordinated efforts of regulation at the international level, that extends the on the work of the Basle Committee, and a review of the role and effects of rating agencies. Some of these restructures have already commenced, but there is still a lot to do, in terms of pulling in the other identified useful variables. For instance, the importance of macro-economic considerations and how this joins up with macro-prudential policy making cannot be over-emphasized.

Chapter 3: The new regulatory challenge and failure of the old regime of regulation

3.1 Introduction

One of the lessons of the banking crisis, is the appreciation of the potential impact of the 'too big to fail' banks. These institutions are considered TBTF due to their inter-connectedness with other banks the economy at large, and also the cyclical effects of their failure. The success of re-balancing banking regulation, and addressing systemic risks is to a large extent dependable on how well risks are mitigated at the TBTF banks. The FSB has recommended a policy framework for addressing this problem as follows: a process which ensures that banks can be wound down without the risk of destabilization to the financial system and at no cost to the taxpayer; a requirement that such banks have a higher provisioning for loss; a more intrusive oversight of TBTF banks; an infrastructure that will reduce the possibility of contagion that may arise from the failure of particular institutions; and, tailored prudential rules national regulators.[59]. Others have suggested the separation of retail banking from investment banking, and requirements that banks have viable recovery and resolution plans, otherwise referred to as 'living wills'. Yet, others have questioned the lack of connectedness of prudential regulation with macro-economic policies.

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[59] 'Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012, p 348

In reality, with all the best will behind the initiatives being pushed by the FSB and the BCBS, they amount to soft law that requires the support of national regulators. Nevertheless, a lot of progress has been made in the US, the EU and the UK, which provides some encouragement.

3.2 Problems with the above simple approach to banking regulation

The debate around the framework for banking regulation was predominantly focused on issues, such as structure, independence, the combination of bank supervision with monetary responsibility, and the probable conflict of the lender of last resort duties with supervisory duties. Until the financial crisis, bank stability and its relationship with macro-economic policy was hardly on the radar.

The Turner Review[60], provides a useful insight on the limitations of the pre-existing regulatory landscape in the UK. In his analysis of "What Went Wrong?", Turner categorized these under four main sections: (i) that macro-imbalances met with financial innovation; (ii) that in the experience of the UK, there was rapid credit growth, significant wholesale and overseas funding; (iii) that there was global finance without global government and (iv) that there were fundamental theoretical issues related to market efficiency and market rationality. An analysis of this imbalance has already been covered in Chapter 1. He said that the industry, and regulators had a misplaced reliance on sophisticated analysis, using observations of past patterns of price movement to determine forward-looking risks i.e. the concept of Value-at-Risk (VAR).

The increasing leverage of banking institutions, combined with the increased activities at trading financial instruments, the inadequate

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[60] The Turner review, A regulatory response to the global banking crisis, March 2009, at page 11

provision of capital against trading books, and the widespread use of sophisticated analysis posed a systemic risk to the industry. It is probably fair to say that banks existed for themselves (i.e. their shareholders) to the detriment of the wider economy.

Turner concludes that regulatory reform must focus on the factors that led to the "over-extension of credit" and promoted the severity of the crisis, including[61], the growth of sophisticated credit models, combined with inadequate capital provisioning against trading books and the competition for borrowing customers; the over-exposure to trading activities; and, inadequate capital provisioning.

In one of its Staff Reports[62], Hirtle B. et al claim that the 2008 financial instability arose from the isolation of the supervision and regulation of financial firms from macro-prudential issues. Lord George commented that "economic and financial stability go hand in hand".[63] In its 2009 report,[64] the House of Lords commented that, a clear lesson to be learned from the crisis was that the tripartite regulatory structure in the UK (between, the Treasury, the Bank of England and the FSA) had failed to "recognize the affinity between responsibility for financial stability and for macro-prudential supervision of the banking and shadow banking sectors". It concluded that the BoE should assume responsibility for macro-

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[61] Turner Review, page 28

[62] Hirtle B, Schuermann T, Stiroh K, Macroprudential Supervision of Financial Institutions: Lessons from the SCAP, Federal Reserve Bank of New York Staff Reports, no 409, November 2009, at the Introduction.

[63] Lord George, The approach to economic management,: How it has evolved, Bank for International Settlements, Per Jacobson Foundation, 2008, at page 8

[64] Banking Supervision and Regulation, Volume 1 Report, House of Lords , Select Committee on Economic Affairs, 2nd Report of Session 2008-09, at page 31

prudential supervision, though it recognized that those responsibilities would overlap with those of the FSA (the FSA has now been replaced by the FCA and the PRA). These views are further examined below in Chapters 3 and 4.

IFI's have had limited influence on national financial regulations. There have been two notable initiatives in this area. One relates to the role of the Financial Stability Forum (FSF). The IMF and the World Bank were not set up to oversee the standards of financial regulations, their focus being more on monetary and fiscal policy issues. The existing regulatory groups of Basel; and IOSCO could hardly promulgate regulatory policies and this state of play led to debates on a need for a multi-jurisdictional financial regulator.

According to Kern Alexander, supervisory practices were too focused on individual firms and consumers, and not enough attention to macroprudential or macro-economic issues. It placed reliance on the premise that if individual firms were managing their risks well, that the financial system would be safe. In his view, the new focus on macro-prudential supervision should require that regulators interrogate the possibility of systemic risks., and the impact of monetary policy on the financial markets[65].

Anthony Hotson's[66], the economic historian says that problems could be abated if bankers and regulators pay more attention to history, as there are no new principles governing the stability of the monetary

[65] Alexander Kern, Reforming European Financial Institutions and the role of EU institutions, Amicus Curiae, Issue 82, Summer 2010
[66] Hilton A., Evening Standard, "Bank Stability depends on the assets",23 July 2013

system. He says that bank's over-exposure to the property market, is a risk to financial stability. [67] This suggests that serious consideration must be given to the one key element that drives property acquisition through bank lending i.e. interest rate, a macro-economic tool! According to Hilton, banks were borrowing to lend to the extent that a parlous 2.5% of this activity was supported by equity capital. He argues that banks should have a provisioning higher than the prescribed Basel III 3% of their balance sheet as capital, a view that appears to be increasingly favoured by a number of European countries.

This writer sees the point of Hotson's view. The UK has embarked on a fiscal policy of 'Help for Home Buyers' that is intended to provide £3.5billion of additional investment to assist people to buy their own homes. This is in a climate of historically low interest rates. Some commentators are anxious that this fiscal step might lead to a housing bubble. In my view, the regulator's monetary policy must be joined up with government's fiscal policy, though I note that the BoE governor has largely dismissed the risk of a bubble. There must be established pull-backs to ensure that such policies do not result into destabilization.

In summary therefore, in my view, certain wider issues must be given serious consideration as part of the regulatory framework for the future.

[67] Hilton A., Evening Standard, "Bank Stability depends on the assets",23 July 2013

3.3 National regulation while there international banking activity

In Europe the economic and political dynamics are dis-jointed; monetary union exists without a true fiscal co-operation, hence countries within the EU locked their exchange rates into one through the single currency, but did not in a similar fashion impose a significant level of fiscal union in relation to fiscal and budgetary targets – i.e. inflation rates, productivity and some other economic indicators were divergent. This disparity is indicative of banking regulation within the EU. Regulators relied on home state regulators and the passporting of financial activity across the EU, without a joined-up approach to tackle contagious negative externalities. The second banking Directive enables the branch bank to be supervised by regulators in its home country. This arrangement naturally leads to cross-border risks as failure of a bank in its home state exposes the host nation to potential loss and possible systemic risks.

The BCBS was established by the Central Bank Governors of the G10 countries in 1974 and its members now drawn from 13 countries. It is a forum for the exchange of information between national supervisors and develops supervisory standards, the most prominent of which is on capital regulation. Its recommendations have no legal force, though some are adopted into law and regulations by some countries, as for instance the CRD in the EU.

Kern Alexander et al argue that 'international financial regulation' requires a treaty regime that is backed up by legally binding agreements on capital adequacy and consolidated supervision[68]. They argue that it would require an international institution to facilitate its development and oversee its implementation. They propose that a Global Financial Governance Council, is authorised by treaty to delegate the authority to develop international standards to existing international supervisory bodies.

Cross-border banks must be supervised in an appropriate manner and there is a need for a serious debate. The politics and difficulty involved in achieving a coherent voice would make it difficult for the functioning of a supranational supervisor, this is apparent from the difficulties that were faced by the BCBS, where they were unable to agree on simple matters such as the definition of capital. The idea postulated by Kern et al warrants serious consideration, but is not in my view promising. The politics and delay surrounding the adoption of the Basel II framework, is a good indicator of how protracted ,negotiations and agreement for a treaty regime might be.

[68] Alexander Kern., Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, Chap 5

3.4 The role of macro prudential policy

The function of macroprudential regulation is to ensure that the aggregate effects of individual firm's actions do not have a negative result on the banking system as a whole, resulting into systemic risks. Microprudential regulation is concerned with the supervision of individual firm's behavior, and its focus is quite narrow, and has a bottom up approach.

If banks were allowed to grow TBTF, which results into interconnected with other financial institutions, it creates a self-fulfilling moral hazard that results into taxpayers being held to ransom. It is probably true that the single major contributor to the crisis, was the lack of an effective macroprudential supervision process. This is apparent from how the crisis unfolded. Securitisation enabled banks to have a lower capital capital adequacy charge. Banks were exposed to the market for various reasons, including, for the funding of their lending activities, some of the banks had significant holdings of risky securitized assets, and thirdly, some banks supported conduits and SIV's[69]. The conduits and SIV's invests in a pool of long-term assets. Subprime investors started to report losses in 2007, which escalated and CRA's started to downgrade some of the securitization tranches.

The case for macroprudential regulation is made out. Leading economies have recognized its role, in the US. UK and in the EU. I

[69] House of Lords, Select Committee on Economic Affairs, 2nd Report of Session 2008-2009, Banking Supervision and Regulation, 02/06/09, p.13

therefore highlight here some of the gaps that were identifiable from the lack of macroprudential considerations, and therefore justifies its introduction.

Firstly, there were minimal reporting requirements for securitized assets and there was an inadequate understanding in the industry of the risks that they posed to the sector. Furthermore, regulators were over reliant on risk assessments that were provided by CRA's .

I have mentioned above in 2.7, how the work of CRA's were found to be dubious. Their ratings assessments were often incorrect and the basis of their assessments misunderstood by investors, who failed to appreciate the basis of those assessments were limited to the risk of credit defaults only. The industry simply buried its head in the sand and enjoyed the ride whilst it was good.

The increased complexity in financial services and the interconnectedness of banks poses a challenge. Banks have become increasingly innovative, and the skills required to manage the risks have lagged behind. There is a need for enhancement of skills both at the senior management level of banks and at the regulators. It is not enough to ringfence banks, the focus should rather lie in an understanding of where risks lie. In addition, there should be counter-cyclical capital measures to stem the tide of procyclicality, and ensure good housekeeping and readiness for inevitable downturns.

As I argue below in 3.6, economic activities have the ability to singularly cause systemic risks. The property market is one such activity. Central banks' monitoring of inflation is insufficient, it needs to measure house price inflation as well. In addition, loan-to-value ratios and debt-to-income ratio should be of interest to the regulator, especially during period of historically low interest rates or when fiscal measures such as the UK's Help to Buy scheme may potentially cause a housing market bubble. This is particularly significant as house price inflation does not feed into the CPI, both in the US and the UK. Perhaps a macroprudential regulator would have identified this issue as an indicator of a possible systemic risk. The level at which banks are relying on wholesale funding, the availability of credit in the economy, level of borrowers exposure and the implications of all these to the economy should be all kept under review.

The BoE has gained statutory responsibility for overseeing the financial system as a whole. In the US, the FRB has a 'dual mandate' focus on inflation and the "real economy", and the management of systemic risk is mandated to the FSOC, whose members include the FRB. Primarily this change should ensure that the central banks are able to exploit the synergies between microprudential supervision on the one hand and their expertise as monetary regulators. This entrenchment of macroprudential regulation can only encourage rigour in the approach regulators adopt to preventing bank failure and systemic risks.

3.5 Banking regulation and overall economic conditions.

Banking regulation does not exist by itself. It is desired for an "economic purpose". Banks serve an important economic function, it is therefore in the national interest to ensure that they continue to deliver on this function. In view of this, banks have become a matter of public interest and banking regulation, a matter of public policy.

Apart from their primary functions, banks are regulated to ensure that certain economic conditions are preserved. Those conditions include the protection of depositors' funds to ensure confidence in the system, monetary and financial stability to ensure transaction flows, an efficient financial system for the provision of good customer service, and a competitive environment in which to ensure fairness and innovation,

Macroeconomic policies are normally the preserve of governments; the government deal with issues such as tax policies and are concerned about the general well-being of the economy, including the employment rate and impact of its overall policies on its people.

As the subject matter of this chapter is the new regulatory challenge, and since it is apparent from recent experience that macroeconomic issues are increasingly becoming of interest to regulators, I have explored below some of the fiscal economic issues that may impact on banking regulation under the new dispensation.

i. Interest rate and banking regulation

The control of short term interest rates is a demand management tool, that is used to keep overall aggregate demand growing consistently in line with underlying supply capacity[70]. It is primarily a monetary tool, though it has started to assume a new role. Central Banks are starting to integrate monetary policies with fiscal considerations, through for instance linking interest rates to unemployment rather than solely on inflation data. The main focus of monetary policy is price stability, hence the control of inflation. The UK and US are committed to keeping interest rates on hold until the unemployment level improves. Interest rates of course drive many economic activities, and very significantly property purchases. Activities in the property market was a major contributor to the crisis, as it was this activity that led to securitization of sub-prime mortgage assets, a main contributor to bank's liquidity problems that started in the US.

ii. Tax policy and bank regulation

The main source of government expenditure is taxation. By implication, the level of taxation on personal or business resources influences economic activity and consumer behavior. There is probably a case for future regulatory policies to include taxation. For instance, the UK government is committed to the Help to Buy scheme, within a low interest rate environment. This will naturally stoke up demand and lead to house price inflation. There is perhaps a case for

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[70] Per Jacobson Lecture, 2008, George Eddie, The Approach to Macroeconomic Management: How it Has Evolved.

introducing additional taxation measures, to help address the problem of house price inflation.

iii. Currency exchange rate and Bank Regulation

A currency exchange rate are used to affect the relative price of exports and imports with the result that it effects a nations balance of payments, hence its domestic output and its level of employment. Certain oil-exporting countries, China and some far eastern countries accumulated large current account surpluses during a period in which leading western economies had large deficits. Since China's exchange rate is managed and widely believed to be undervalued, it makes its products cheaper, making its growth partly reliant on its cheap money. Conversely, cheaper products swamp the West. Regulators need to be on top of the implications of such policies. Perhaps a lesson can be learnt from China, which following the decline in world trade, after the onset of the banking crisis, decided to 're-peg' its exchange rate, in order to protect its exporters.

iv. Competition policy and bank regulation

A healthy competition policy within the banking industry, will no doubt result into positive outcomes. In the first place, it would help reduce the rate of growth of banks and therefore the propensity of TBTF; secondly, it would lead to consumer choice, innovation, and product efficiency. The existence of banks that are perceived TBTF encourages inappropriate risk taking at the expense of the taxpayers.

v. Social policies and banking regulation

The new BoE Governor has set a new agenda never seen in the UK, but quite similar to the strategy that is being pursued by the FRB and the ECB. He has announced that the BOE base rate will not increase above its current level, unless UK's unemployment rate falls below 7%[71],[72]. Despite these caveats, there is an apparent symbolic shift in the approach of the BoE. For instance, the BOE had since the crisis surfaced largely ignored the inflation target of 2%. A new phrase has now thereby entered the financial vocabulary, referred to as "forward guidance". Regulators now appear to appreciate that monetary policy is very much linked to fiscal measures, and ultimately to regulation.. Carney has gone on to criticize bank's culture and said banks should focus on creating jobs rather than just making profits. On 8 August 2013, he said, "banks could absolutely play a socially useful and an economically useful function". He said that the cultural issue was very important.

[71] though there are three certain 'knock outs', mainly, if the Bank's Financial Policy Committee determines that the stance poses a significant threat to financial stability; the CPI inflation is judged more likely than not to be at or above 2.5% over an 18-month to two-year horizon; and, inflation looks like it could get out of control in the medium term

[72] www.bbc.co.uk/nes/business-23588958, date: 08/08/13

3.6 Combining macroeconomic policy and regulatory policy

According to Reddy Y.V., “the regulation of the financial sector should serve the broader goals of human endeavor, namely growth, stability and equity” and that “public policy in general and macroeconomic policy in particular share similar objectives”[73]. The global crisis has shown that there are valid reasons why financial regulation should be joined up with macro-economic policies.

Financial stability is connected to both macro-economic and micro-economic factors. For instance, interest rate, currency exchange rate and inflation can effect the fortunes of an economy in much the same way as inefficient prudential supervision of banks. According to Singh D., macro-economic and micro-economic factors are independent in an economy but not mutually exclusive. He claims that financial stability in an economy can “only be ensured through cooperation between the central bank, other safety-net players and bank and financial regulators[74]”. He cites Andrew Crockett’s reference to this as the micro- and macro-prudential aspects of financial stability[75]. Banks should facilitate an efficient allocation of resources to their most productive use, as they are agents of economic exchange and engage in the management of risk and risk

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[73] Reddy Y.V. Financial sector regulation and macroeconomic policy, BIS Papers No 62

[74] Singh Davinder, Banking Regulation of UK and US Financial Markets, 2007, Chapter 1, page 3.

[75] Singh Davinder, Banking Regulation of UK and US Financial Markets, 2007, Chapter 1, page 3.

diversification through trading. However, they are unlikely to survive if they are not properly managed, and one of the ways in which banks can be efficiently run, and bank supervisors perform an effective role. On the other hand, national governments are interested in sustained economic growth, low inflation, a high level of employment, sound government finance, a healthy balance of payments and good living standards for their people. The government has two macroeconomic tools at its disposal for this. It uses fiscal policies in the form of tax revenue and spending, and monetary policy, which is the control of money supply and interest rates. In that sense, banking regulation policy and macroeconomic policy have similar objectives.

Banking regulation is now more than simple micro-prudential regulation. For instance, the BoE following the transfer of microprudential responsibilities from the FSA, has been allocated the mandate for macroprudential regulation. In essence, part of the FPC's remit is that it would assume leadership during periods of boom or busts, by imposing the appropriate level of capital ratios on banks. If these were left disjointed, the situation could arise where the micro-prudential and the macroprudential supervisor's work run counter each other.[76].

As mentioned above, the importance of macroeconomic polices to regulation has been recognized in the UK, where the FPC has been given the objectives of the "identification, monitoring of, and taking action to remove or reduce systemic risks with a view to protecting

[76] Blanchard O. Rethinking macroeconomic policy, one of the series of "Seoul Papers" on current macro and financial issues. 09/05/13

and enhancing the resilience of the UK financial system"[77]. Most notably, it also has the additional responsibility of supporting the economic policies of the government, including those for growth and employment.

Some people have argued that core inflation is not the right measure of inflation but that increase in oil prices or housing prices are the real key[78]. They say that a single index does not give the entire picture. There is some truth in this argument for instance, in the UK, the BoE was making a good effort keeping to the inflation target, interest rates appeared to be at as sensible level, and the economy was expanding it seemed quite healthily. Nevertheless, housing inflation and consumer consumption was racing ahead of the rest of the economy. House prices are not included in the calculation of the CPI, only the cost of housing, in the form of rent or rent equivalents. A joined-up approach would perhaps have identified some of the issues that led to the crisis much earlier i.e. credit expansion caused by a race to the bottom by lenders, that were competing to offer credit and cheap money to consumers.

Some commentators have suggested that a culture of low inflation/low interest rate impedes the scope for achieving a correction, in the event of a collapse in demand, as happened in the immediate aftermath of the 2008 crisis. The lack of scope resulted into reliance on fiscal policy to help stoke up demand. Governments

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[77] BoE, Financial Stability Paper No. 21, How could macroprudential policy affect financial system resilience and credit, Lessons from the literature, May 2013

[78] Blanchard O. Rethinking macroeconomic policy, one of the series of "Seoul Papers" on current macro and financial issues. 09/05/13

have therefore resorted to fiscal measures such as increased spending, in order to drive the economy forward.

There is also a need for more fiscal space for governments, in order that they are able to run larger fiscal deficits when required. In addition, individual fiscal polices should be considered particularly for certain areas of the economy, in order that they do not create unwanted risks or problems in other sectors of the economy. For instance, the UK government is fiscally trying to drive investment into the housing market and help the economic recovery. It has therefore introduced a 'Help to Buy" scheme for first time property purchases, where it facilitates this through a shared equity scheme and and a mortgage guarantee scheme, both costing in the region of £15bn. The scheme has led to a 19% quarterly increase in Buy-to-let lending, 56% increase in annual High loan-to-value lending, 2.6% annual increase in house prices and 4% quarterly change in mortgage repossessions[79]. Graeme Leach, the chief economist at the Institute of Directors has referred to the scheme as very dangerous, whilst other have expressed their concern that it could lead to another bubble. It is obvious that there is a shortage of housing supply in the UK, especially in the In my view, an anti-bubble mechanism clearly needs to be built into this particular government policy, through monetary or other fiscal measures.

One of the criticism of giving both responsibilities to the central bank is that the central bank would have a softer stance against inflation, as in higher interest rates have a detrimental effect on bank balance

[79] Financial Times,: "Carney rate vow set to fuel buy-to-let mortgage boom" , 09/08/13

sheets. The other criticism is that it concentrates a lot of power in one body.

Chapter 4: The multifaceted market, financial regulation and UK Bank Regulation and Supervision Development

4.1 Introduction:

London has the pre-eminence of being considered a major financial centre of the world, due to various obvious factors. The City of London is home to several international banks. Some of the banks are licensed and regulated by the UK regulators, and some including the EU banks are passported into the UK, as they are regulated by their home nations. The UK therefore has domestic banks, EU banks, and other international banks. They may be categorized into retail banks, commercial banks and investment banks. They operate differently, but serve one unique function: to facilitate economic activity; they therefore pose similar risks to the economy. The discussion that follows is focused on the UK banks alone, this being my area of primary interest although I recognize that there are several other financial activities that takes place in the UK, in addition, that the UK financial services industry is influenced by a host of global activities.

4.2 Shift from simple connection between regulated and regulator

The UK regulatory landscape is indeed evolving. The UK government has responded swiftly to the major banking crisis by recognising the need for change. As early as October 2008, with the onset of the crisis, it's Chancellor of the Exchequer ordered that the then FSA Chairman, Lord Turner undertake a review of the causes of the crisis and to make recommendations on the changes to regulation and supervision for the future. In addition, there were a number of parliamentary reviews on various aspects of banking, in an attempt to learn how best to prepare for the future.

The government's commitment to making the UK's financial system and its infrastructure more robust, has led to a new regulatory architecture, increasing the focus of regulation to macroprudential issues and expanding the role of the BoE, with the mandate, to "contribute to protecting and enhancing the stability of the financial systems of the United Kingdom"[80]. The regulatory changes are intended to make banks and other financial institutions more resilient and are underpinned by stronger requirements on capital buffers, the strengthening of governance and risk management, recovery and resolution plans and a new overaching regulatory structure. The new regulatory structure has resulted into the dismantling of the FSA and the formation of the PRA, FCA and the FPC. The PRA and FPC are responsible for microprudential

[80] www.bankofengland.co.uk/financial_risk_reduction, sourced on 27/08/13

regulation and macroprudential regulation, respectively, whilst there is a Special Resolution Unit ("SRU") alongside it for the delivery of an orderly wind-down, as part of resolution planning of distressed banks. The FCA is responsible for ensuring that markets function well and the conduct of business of regulated institutions.

Another significant change, is the efforts that are being made to change the culture of banking and expectations of banks, especially the big ones. The PRA has said that it is not its role to ensure that firms do not fail, rather it will ensure that firms fail in an orderly and efficient manner. In addition, it has said that it's supervisory approach will be judgement-based, forward-looking, and focused.

A lot of what the BoE/PRA have said are not new, however, the new framework suggests that there will be significant supervisory changes. The relationship between the regulators and the banking industry is being transformed from that of a simple and direct connection, into a more sophisticated one. For instance, the PRA has said that its use of judgment will be based on 'evidence and analysis". This in my view will allow the regulator with a lot of latitude and discretion, but within the confines of evidence, of which only they determine what is relevant and useful. Furthermore, it suggests that the regulator will more actively seek information on which to base its decisions, which will be on potential risks of failure of the firm, noting that it has said that it will use its judgment where "necessary in the context of a complex financial system where compliance with detailed rules is, on its own, unlikely to secure acceptable outcomes"[81]. Previously, compliance with the letter of the rules was adequate, and evidence of such compliance was enough proof that all was well with the firm. It was part of the "close and continuos" culture of the past, where, supervision was more light touch. This judgement based approach is therefore a radical departure, and it uncertain whether banks currently do appreciate the implications of this change.

The PRA's 'forward looking' approach suggests that it will become more proactive, and analytical in the identification and treatment of issues. It will assess banks against current risks but will not only assess these risks against its own objectives, but consider the risks against the probability and impact of occurrence in that bank, the probability of certain occurrences flowing from those risks in the future, and also against other plausible risks that could arise in the future. It has emphasized the importance for firms to be open and straightforward in their dealings with the regulator.

It is also committed to a focused approach to regulation, tailoring its supervisory approach to the risks that a firm presents. A key part of the PRA's function is its primary focus on the harm that firms might cause to the stability of the UK. Another major departure from the past is that it will duly allow a firm to fail.

These changes imply that the regulator is keen to have a more robust approach to regulation. It appears to have abandoned tunnel-

[81] The BoE, Prudential Regulation Authority, The PRA's Approach to Banking Supervision, October 2012

visioning to that of achieving a wider view of issues, and prepared to perform its role within "the external context in which a firm operates". This is obviously a bold move, as it would mean that its judgement may be more open to challenge, in a world where externalities that are outside the control of a firm would become relevant in assessing whether or not a firm poses a risk to the regulators objectives.

Lastly, the fact that the PRA will become part of the BoE, the lender of last resort, itself implies a deep cultural change,that exceeds that of a relationship based on simple rules. At the forefront of its supervisory approach is its relationship with the FPC, and its efforts to capture macroprudential issues not only by itself but also through other regulatory agencies, including the FCA.

4.3 The relationship between regulatory laws (measures) and Macroeconomic policies

Alexander et al provide a very useful analysis on how macroeconomic policies might join up with prudential regulation[82]. Banks behave in a predictable manner in time of boom or downturn and their behaviour is generally accepted as procyclical. For instance, banks increase their lending in a buoyant economy and behave differently when there is a downturn. They provide a further illustration of how the resulting procyclicality of regulation, is exacerbated by what they have referred to as "the contagion-inducing techniques of risk management", and gave the example of the Asian crisis where banks reduced their exposure to emerging markets, leading to a further fuelling of the problem and macroeconomic consequences. At the time, the Asian crisis and the widespread action of most US banks had caused the Latin American assets to be almost worthless. US regulators, allowed their regulated banks assets to be revaluated in the banks balance sheets at their maturity value, rather than marked to market. The US regulators did not require an immediate write down. The reaction of the US regulators resulted in the avoidance of a systemic and macroeconomic problem in the US, as it prevented a collapse in lending, liquidity and confidence in the banking system.

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[82] Alexander Kern., Dhumale R., Eatwell J., Global Governance of Financial Systems: The International Regulation of Systemic Risk, p. 257

Adverse economic conditions such as unemployment or high interest rates may lead to underperforming loans and ultimately pose a systemic risk to banks. Some of these conditions are the results of wrong fiscal policies or policies that were driven by political motivations. For example, successive UK governments have championed the cause of the City of London, de to the spin-off of the employment it creates and the earnings into the government coffers. There is a school of thought, that believes that Gordon Brown's government was responsible for the FSA's light touch approach. The BoE is autonomous and has a good degree of independence in carrying out its monetary functions. This autonomous culture will probably grow on the PRA and the FPC in the manner in which they deliver on their objectives, and away from government influence.

Credit expansion was used by the government to stimulate the economy and for job creation. Successive UK governments have also encouraged home ownership, even when they were well aware of escalating house price inflation, and the ramifications of a downturn in the employment market, or a general downturn in the economy. It is of course always desirable for an economy to grow, and the regulator would readily share this view, what would be important to a macroprudential regulator is that the growth is healthy. The healtiness of the growth is based on a continuos analysis of the reasons for the growth and the identification of the risks and mitigating measure for any fallouts that may arise from such growth. One should reasonably expect that a macroprudential regulator in the dispensation, would devise certain tools to use as levers in restraing unheath growth or industry practices. One such tool for the housing market might be an imposition of loan to value ratios, on certain types of mortgage lending. We have started to see this demosntarted in the framework for the future. The PRA will work closely with the FCA and the FPC in ensuring financial stability of the UK. It will. The PRA will be expected to implement FCA's recommendations on a 'comply or explain' basis and for complying with the FPC's directions in the use of macroprudential tools. These measures will hopefully ensure a capture of macroprudential matters.

4.4 Possible leakages and arbitrage

I have covered above in Chapter 3.3, the need for international co-operation on financial regulation. This naturally has its challenges, as previous experience has shown. In view of this, perhaps the next best alternative, is for national regulators to follow the example of others, though with a very important caveat, that a rigorous analysis is conducted on such initiatives on relevance and applicability. One such initiative is the Dodd-Frank Act, 2010 in the US, especially its provisions that all firms identified as having significant influence on the system are regulated in one shape or form, whether or not they hold a banking licence.

The make up of the EU raises a significant risk, to its member countries. The banking crisis, exposed the inadequacy of the framework which focused on national supervisors and passporting arrangements. The national supervisors broke ranks and dealt with distressed cross-border institutions in a national way, as in the example of the Icelandic banks. It exposed the lack of macro-prudential oversight, the failure of reliance on home country controls, again in the example of the Icelandic banks, and thirdly, the the lack of cross-border structures for crisis management and bank resolution[83]. Efforts have been made to address some of these deficiencies, which includes the establishment of the ERRB, the enhancement of the maximum harmonization by having the

[83] Avgouleas E.: Governance of Global Financial Markets: The Law, the Economics, the Politics, 2012,

authority to draft new EU standards for a common rulebook, and by the introduction of a new framework for cross-border institutions, resulting in a change from home country control to supervisory colleges. It is still early days yet to assess whether the new initiatives will be reasonably fit for purpose, going forward. It is therefore an area that requires close and regular scrutiny.

Regulators policies are susceptible to fierce lobbying by the industry and other stakeholders, either through the government or directly. There was a fierce debate on the manner of the ringfencing of banks, in relation to the plans to separate proprietary trading by banks from retail banking. The BBA were opposed to it as were a number of large banks. In the end, there are claims that the final plans have been watered down, and a particular MP, Andrew Tyrie, the chair of the banking commission, referred to it as "virtually useless". He noted that the regulator would have to issue three preliminary notices and a warning notice to a bank that is suspected of attempting to breach the barrier. In addition, the Treasury's consent must be sought on up to three separate occasions before a bank that has fallen foul of the rules could be broken up[84]. This shows how the government and through them, the regulators could be susceptible to pressure from bodies who have separate interests.

The regulator is almost always behind the curve. The industry has vast resources at its disposal that are used deliberately for regulatory arbitrage. Banks may do this for instance through the restructuring transactions or even relocating transactions to less burdensome

[84] Financial Times, MP's cast doubt on Treasury's resolve, 09/07/13

jurisdictions. Mike Carneys, the BoE's Governor "forward looking' pledge[85] to hold rates until the employment figure falls to 7% has already resulted in the market digesting the policy decision and coming up with their analysis and view as to when rates would actually go up. The BoE had calculated that the first rate rise will not happen until mid 2016 whilst the market has priced in rate rise before that date, on the back of unemployment falling quicker or as a response to inflationary pressure, one of the 'three knockouts'[86].

The growth of shadow banking has been cited as one of the causes of the crisis. These institutions face similar risks to traditional banks, but are not regulated in the same manner, nor do their investors have similar deposit insurance protection as do bank customers. T is notable that the 2008 crisis, started with liquidity problems within the shadow banking sector, and the lack of confidence in the sector transformed into a major banking crisis. The main problem with shadow banking has been suggested as maturity transformation[87] and the large scale at which it was undertaken, for instance 'the large-scale maturity transformation between short-term promises to note-holders and much longer term instruments held on the asset side'[88]. The whole industry was driven by the quest for excessive profit makings. The regulators will need to improve their level of awareness of market activity and develop the appropriate skills for dealing with them. It is notable that the UK regulators have already

[85] in August 2013
[86] Financial Times, Carney's rates pledge aims to boost nascent recovery", 08/08/13
[87] The Turner Review, 2009, A regulatory response to the global financial crisis, p. 21

[88] The Turner Review, A regulatory response to the global financial crisis, 2009, p. 21

given consideration to the introduction of a process that would make it possible for such transactions to be recordable and detailed information on quality and quantity readily available[89].

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[89] House of Commons, 2008-2009, Treasury Committee, Banking Crisis: dealing with the failures of the UK banks: Government, UK Financial Investments Ltd and the Financial Services Authority Responses to the Seventh Report from the Commitee

4.5 Emergence of new regulatory paradigms where market disciplines as well as macroeconomic policies are taken into account:

The crisis has driven changes into the regulatory system. Regulators in the leading world economies, including the US, EU and the UK now recognize the interconnectedness of financial institutions, especially when they undertake cross-border activities. The consideration of macroprudential issues is therefore quickly becoming a familiar practice for regulators. The relevance of macroeconomic issues has not escaped the attention of regulators and national governments will now be made to share their fiscal responsibilities with government agencies that are naturally less-politicised than their treasury departments. It will be an in interesting new way of doing things and no doubt, there will be tensions along the way.

In the minutes of the FPC meeting of June 2013, it noted that the Chancellor had sent to the Committee, a document whish set out the Governments economic policy and recommendations. Of particular interest is that the FPC committed to making note of the Governments "economic policy, including its objectives for growth and employment"[90]. The FPC also noted the Financial Stability Report, and ordered the FCA and PRA to provide it with an assessment of the vulnerability of borrowers and financial institutions to sharp upward movements in long term interest rates. An arm of the central bank looking at interest rates not as a lever for the control of inflation, but for its macroeconomic implications. This

[90] Bank of England, Record of the FPC meeting, 18/06/13, www.bankofengland.co.uk, searched on 30/08/13.

is indeed a true demonstration of a departure from the past, and a new horizon in the making.

It is clear that central banks must pay as much attention to the resilience of the economy and corporate governance within the regulated firms, as much as they have been concerned with inflation, and utilize a wider set of tools, beyond capital adequacy and regulatory rules, to deliver on their wider responsibility of ensuring a stable financial system.

Chapter 5: Conclusion

A lot has happened in the financial services regulatory arena since the onset of the global crisis in 2007/2008. The regulatory approach of major economies has changed and efforts are continuing to make the evolving system to be fit for purpose. Academics, practitioners and those in government appear to be agreed on one thing: that the pre-crisis approach to the regulation and supervision of the banking industry was narrow in scope and delivery. This has led to a major change of culture within the US, the EU and also the international bodies of the BCBS and the IMF who have a stake in the financial stability of the global financial system. Financial stability has therefore very quickly become the by-word rather than bank stability, and regulators are now more receptive to the idea of a bank's failure, as long as the failure does not lead to an imbalance of financial stability. The new tools are macroprudential regulation, and macroeconomic considerations. These are the logical tools to add to the pre-existing toolkit, in order that a wider more robust approach can be achieved, and those with responsibility for financial supervision have not shoed away from using them.

There are some challenges. There is a dire need for the cross-border supervision of banks, the orderly resolution of those banks to ensure that the risk of contagion is contained, including an understanding and allocation of responsibilities amongst national supervisors. Furthermore, it is apparent that regulators appear are generally behind the curve. Serious thought therefore needs to be given to the allocation of valuable resource to enable bank supervisors to perform their roles more effectively.

Some have advocated the idea of supra national regulators and one of the prominent arguments are those made by Avgolueas. He says that this should be based on four pillars of: macroprudential; microprudential; financial policy, regulation, and knowledge supervisor, and a global resolution authority

The banking regulation world in my view is surely in a better place, afterall, our knowledge is limited by our own experiences. Stakeholders continue to discuss and argue the other additional measures that should be explored, to ensure global financial stability. It appears that the crisis has made it easier to acknowledge the inadequacies of the old system and to be more receptive to a whole new approach, without totally discarding of the old system.

In conclusion therefore, my observations are that there is a definite shift in the paradigm of regulation, banks will no longer be supervised in silos, but with the objective of 'helicopter viewing', output-focused regulation will hopefully mean exactly what it says as regulators do away with a tick-box supervisory approach. Furthermore, the primary concern of supervisors will increasingly shift into the wider systemic risks that financial institution present to their economies. Macroeconomic policies will be joined up with microprudential and macroprudential considerations and no doubt, discussions will continue on how all of these can be better dealt with on a supranational level.

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