Introduction to International Financial Law and Regulation

INTRODUCTION AND COURSE OVERVIEW - INTERNATIONAL FINANCIAL LAW AND REGULATION

1. FINANCIAL HISTORY

- (1) Barter and Exchange
- (2) Custody and Deposit Taking
- (3) International Finance
- (4) English Banking
- (5) Securities

2. FINANCIAL MARKETS

- (1) Money Markets
- (2) Banking Markets
- (3) Capital Markets
- (4) Financial Derivatives Markets
- (5) Insurance Markets

3. FINANCIAL SYSTEM AND ECONOMY

- (1) Money
- (2) Central Banking
- (3) Financial Sectors and Services
- (4) Financial System and Financial Policies
- (5) Financial Stability

4. FINANCIAL INTERMEDIATION

- (1) Financial Function
- (2) Financial Assets
- (3) Financial Distribution and Allocation
- (4) Financial Advantage
- (5) Financial Disadvantage

5. MARKET GROWTH

- (1) Market Size
- (2) Market Growth and Development
- (3) Market Change and Innovation
- (4) Market Transformation and Trends
- (5) Market Capability

6. FINANCIAL RISK AND INSTABILITY

- (1) Financial Risk
- (2) Financial Instability
- (3) Financial Theories or Objectives
- (4) Financial Market Contagion and Instability
  - (a) Banking Markets
  - (b) Securities Markets
  - (c) Insurance Markets
  - (d) Complex Groups and Financial Conglomerates
  - (e) Complex Regulatory Objectives
- (5) Financial Stability

7. FINANCIAL REGULATION AND CONTROL

- (1) Financial Regulation and Supervision
- (2) Regulatory Approach
  - (a) Functional
  - (b) Institutional

- (c) Objectives
- (d) Single Regulator
- (e) Macro-prudential

(3) Regulatory Structure

(4) Regulatory Design
- (a) Objectives
- (b) Structure
- (c) Scope or Tools
- (d) Source
- (e) Content
  - (i) Financial Rules
  - (ii) Conduct Rules
  - (iii) Market Rules
  - (iv) Market Resolution
  - (v) Market Oversight and Support

(5) Regulatory Reform

8. FINANCIAL CRISIS

(1) Financial Crises
(2) Financial Scandals
(3) Global Financial Crisis
(4) Global Crisis Response
(5) Regulatory Adjustment

9. INTERNATIONAL BANKING AND FINANCIAL REGULATION

(1) Bretton Woods and the Basel Committee on Banking Supervision
(2) Basel Committee Supervisory Programme
(3) Basel I, II and III
(4) Core Principles for Effective Banking Supervision
(5) International Financial Crisis Response

10. EUROPEAN BANKING AND FINANCIAL REGULATION

(1) European Union
(2) European Integration
(3) European Banking and Financial Markets
(4) European Mutual Recognition
(5) European Crisis Response

11. UK BANKING AND FINANCIAL REGULATION

(1) Bank of England
(2) UK Bank Supervision and Moral Suasion
(3) Banking Acts 1979 and 1987
(4) FSA and FSMA
(5) FPA, PRA and FCA

12. US BANKING AND FINANCIAL REFORM

(1) US Banking and Financial Regulation
(2) US Financial Reform
(3) US Financial Crisis Inquiry Commission (FCIC)
(4) US Senate (Carl Levin) and Valukas Examination Reports
(5) US Dodd Frank Act

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INTRODUCTION AND COURSE OVERVIEW – INTERNATIONAL FINANCIAL LAW AND REGULATION

Financial markets are of fundamental importance in modern economies. Financial markets provide a number of essential services without which modern business, commerce and government would be impossible. These include savings (or deposit), loan (or credit), payment, investment and insurance functions. All of this is necessary to allow government, business, commerce, households and individuals to operate on a daily basis.

National and international, financial markets have grown significantly in recent years. The size of the markets in a number of countries now far exceeds their real economies following decades of continuous innovation and expansion. Two separate global markets have been created with an older more traditional underlying trade or mercantile based economy and a new connected but separate and distinct overarching global financial economy. Massive amounts of investment funds are moved around the globe every day to realise the most profitable returns with financial regulation having a significant impact on the choice and structure of the transactions available.

Financial markets can produce substantial gains and profits although they are also susceptible to horrendous loss and collapse. Many of the largest markets, including specifically the banking markets, are inherently unstable and prone to crisis and closure. Properly designed and implemented financial regulation is necessary to ensure that risks are properly managed within financial institutions and that the stability of the markets protected more generally. Attention has also increasingly focused on the need to limit government and public costs in the event of market failure especially following the Global Financial Crisis beginning in summer 2007.

A number of different national regulatory models exist across countries. Many of these are based on local historical factors and traditions but also on common international standards in the banking, securities and insurance areas as well as in connection with such matters as payment and settlement systems and international financial crime. A number of important technical and other specialist committees have been set up at the international and European levels to take this work forward. Much of this has also had to be revised and strengthened, or abandoned and replaced, following the recent crises in markets. A number of important lessons continue to be learned following these events with many decisions only recently having been agreed. It is essential that all countries maintain effective supervisory and regulatory systems in all key financial sectors and markets and that domestic and cross-border contagion is avoided.

The purpose of this course is to examine the nature and operation of financial regulation in modern markets at the international, regional (principally European) and national levels. The main markets are identified and core elements within the financial system explained. The different types of financial risk that arise are noted with the meaning and

nature of the terms financial regulation, financial supervision and financial oversight reviewed. The causes behind the Global Financial Crisis are examined and key lessons and reforms necessary considered. The principal international standards that apply in the banking, securities and insurance areas are then reviewed, including, in particular, the work of the Basel Committee on Banking Supervision. The structure and content of the European financial programme are assessed. The nature of financial regulation within the UK and proposed future institutional changes are examined with other key domestic reforms, such as in the US, outlined. Provisional conclusions are drawn with regard to the effectiveness of the emerging international, European and national control frameworks being constructed at this time. The first Module of the course is only based on Sections 1-7 with Sections 8-12 providing a review and summary of the rest of the course.

1. FINANCIAL HISTORY

Financial history can be considered in terms of the origins of money, banking, international finance, the international financial system and capital markets more generally.

(1) Barter and Exchange

Some form of barter has always been available even in the most primitive of societies. The difficulty with barter is that it is dependent on a 'double coincidence of wants' which makes it inconvenient for trade with money having to be developed as a common payment medium. More complex forms of barter in the form of countertrade in international trade still exist. Chinese coinage dates from between the 12th and 10th centuries and European coinage from the 7th century BC. The Greek city-states had their own currencies until silver coinage was made obligatory in the 5th century. Agricultural produce including specifically grain was often used for exchange purposes such as in Egypt.

(2) Custody and Deposit Taking

Banking in the form of custody or the safekeeping of valuables can be considered to date from the Sumerians and Babylonians in the 2nd and 3rd centuries BC. Items of value including metals, livestock, tools or grain were kept in the temples or royal palaces with transferable receipts being used later. Wealthy families could also provide custody services using their strong rooms with standard terms and procedures being used by 1800 BC in Babylonia. Grain warehouses were in standard use in Egypt with sophisticated credit and accounts systems being developed to facilitate the transfer of value and payment. Early Greek moneychangers (*trapezitai*) developed exchange, deposit and credit facilities either on their own account or as brokers and using real and personal property as collateral. These practices were continued by the Roman *argentarii* until the collapse of the Roman Empire.

(3) International Finance

Early account and clearing systems date from the Great Fairs across Europe during the 12th and 13th centuries. Merchants kept their own accounts with settlement being effected at the close of their fair. Payment could either be made in cash in the form of gold, silver or copper or through early forms of bills of exchange or promissory notes. A bill of exchange operated with a merchant (the drawer) issuing written directions to another party who owed him money (the drawee) to pay their creditor (the beneficiary). Promissory notes are written undertakings to make payment either at a fixed time or on demand. Banking notes developed out of the promissory notes issued by private banks and then central banks under monopoly rights of issuance. Cheques would emerge later which are simply bills of exchange drawn on a bank.

Early double-entry bookkeeping was also used by the Knights Templar (Soldiers of Christ and of the Temple of Solomon) who developed cross-border money transfer mechanisms with receipts issued by any temple being capable of encashment at any other temple. The Order effectively created the first international banking network.

Certain trade merchants increasingly specialised in the provision of exchange, deposit and credit facilities for other counterparties with the growth of 'merchant banking' initially in the Italian towns of Siena, Lucca and Florence and then Venice and Genoa and later in The Netherlands, Germany and England. The term 'banca' referred to the bench on which the moneychangers or merchant bankers would sit. The first public clearing bank was the *Casa de San Giorgio* in Genoa in 1407 although public debt had been issued in Venice in the 1300s and Florence in the mid-1300s with the *Monte Commune*. The *Monte de Paschi* is reported to be the oldest surviving private bank in the world which was set up in Siena in 1472.

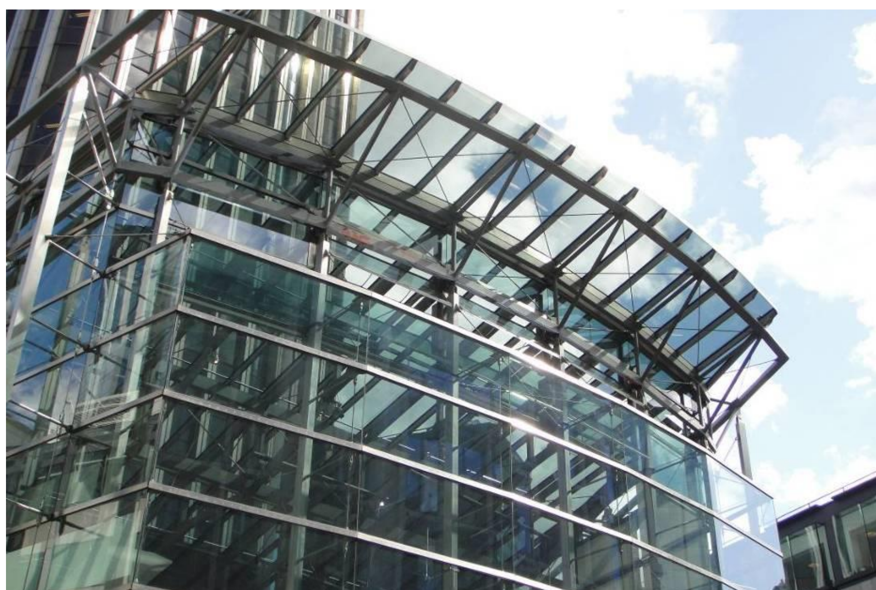
(4) English Banking

English banking is considered to have emerged out of the deposit and receipt facilities provided by goldsmiths or jewellers and lapidaries (who work with stone, minerals or gemstones) and scriveners (scribes) or notaries. Early paper money included the repayment orders or 'tallies' issued by the Treasury which became assignable in 1667 although all private bankers issued their own money until a monopoly on issuance was conferred on the Bank of England under the Bank Charter Act 1844. The Bank had been established in 1694 although the *Riksbank* had been opened in Sweden in 1656 and then closed and reopened as the National Bank in 1668.

Early English banks were partnerships or unincorporated associations. The right to incorporate by registration was introduced in 1844 under the Joint Stock Companies Act and limited liability under the Limited Liability Act 1855. The use of joint stock banking companies was initially restricted with joint stock banking not becoming common until the end of the 19th century and a wave of consolidation at the beginning of the 20th century and again after the Second World War.

(5) Securities

Trading in securities dates from the unregulated practices of merchants in coffee houses in the City of London from the 1700s. A number of the City of London's major financial institutions began in such coffee houses as *Garraway's, St Paul's, Jonathan's, The Jerusalem* and *The Baltic*. Intermediaries or brokers raising funds to invest in overseas trading expeditions and long-haul shipping voyages formed a club in *Jonathan's Coffeehouse* in 1760 which became the Stock Exchange in 1773 with an original Deed of Settlement in 1802. Merchants and insurers met in *Edward Lloyd's Coffeehouse* and then in *The New Lloyd's* from 1769. Offices were lent at the Royal Exchange and later in Leadenhall Street in 1928 and then Lime Street in 1958. The Baltic Shipping Exchange began with meetings of merchants and ships captains arranging freight and shipping in the *Jerusalem Coffeehouse* and the *Virginia and Maryland Coffeehouse* which became the *Virginia and Baltic* and then the *Baltic* in 1810 with the *Baltic Club* regulations being produced in 1823.



2. FINANCIAL MARKETS

The main financial markets are the money, banking, capital, insurance and gold, foreign exchange and commodity markets. The main participants in each market are referred to as financial institutions or financial intermediaries which assist allocate funds and capital within the financial system, moving it from areas of surplus or excess to deficit or need. The main institutions consist of the banks (including building societies), securities firms and traders or dealers, insurance companies and pension firms and other more specialist service providers such as gold or foreign exchange dealers, financial derivatives traders, finance houses, mutual funds and collective investment schemes. While more specialist markets exist for gold, foreign exchange and commodities, the most important larger sets of markets are as follows:

(1) Money Markets

The money markets consist of the Primary (or Discount) Market and the Secondary Money Markets for short-term money instruments. These are wholesale markets for short-term money market instruments (MMIs) of less than one year. These principally include government Treasury bills, Local authority or Corporate bills, Bankers' drafts (promissory notes issued by banks), Certificates of deposit (transferable securities representing underlying deposits) and Commercial paper (short-term marketable unsecured promissory notes), Bankers' acceptances (accepted bills of exchange) and bank deposits. The central bank uses the Primary Market to increase or decrease the amount of money in the economy by purchasing paper from them (which increases the funds available) or selling paper to them (which increases the funds). The Bank of England of the uses this to set the 'bank rate' at which it will deal with the discount houses. The Secondary Markets are specialist markets for money market instruments issued by particular counter parties. The main principal secondary markets are the Local Authority, Finance House, Inter-company, Sterling Inter-Bank and Sterling Certificate of Deposit and Commercial Paper markets.

(2) Banking Markets

The banking markets are longer term credit markets within which banks provide services to corporate and household customers. Banking services include deposit taking, wholesale lending, the provision of payment services, corporate and consumer finance and financial advice and trade finance services (including letters of credit, accepting or discounting bills of exchange and factoring (purchasing accounts receivable) or forfaiting (discounting instruments without recourse)). Investment banking functions including underwriting, broking, trading, asset management and the provision of corporate advice (below).

While banks are the main operators in the money markets, the banking markets refer to the separate sectors within which banks provide their services for corporate entities, households and individuals. These include deposit taking (savings), corporate lending, commercial and residential mortgage financing as well as credit card and consumer credit facilities. These are the main sectors through which companies and individuals borrow short and longer-term funds on either a secured or unsecured basis.

The banking markets may also be considered to include the trade finance markets which provide funds for national and international trade purposes. These were essentially based on bills of exchange, letters of credit and documentary credits (with payment being exchanged in return for bills representing underlying goods), forfaiting (purchasing notes or bills at discount) and other forms of receivables financing (funding or collecting company trade debts). British banks that provided deposit taking as well as trade financing services have traditionally been referred to as merchant banks.

(3) Capital Markets

The capital markets are the market in which governments and corporate entities raise funds for longer-term investment or shorter working capital purposes. These are essentially securities markets including shares (equity), debentures (bond or debt instruments), warrants (certificates entitling the holder to subscribe for additional shares or debentures) and

convertible or other hybrid instruments. A primary securities market is for the initial issuance of such stock and the secondary market for its subsequent trading either on a formal exchange or over-the-counter (OTC) basis. OTC markets were essentially carried on over telephone lines but now most commonly use the internet or other digital devices. The capital markets include the Eurobond market (debt instruments in a currency other than the country of issuance) as well as other corporate equity or debt instruments listed on more than one exchange. Investment banking refers to US and international securities firms that provide capital market related services including underwriting (initial stock issuances), broking (buying and selling securities on behalf of clients), proprietary trading (on the firm's own account), asset management and providing corporate advice. Investment banks are not legally banks insofar as they cannot accept deposits. Deposit taking and securities activities were separated in the US under the Glass Steagall provisions of the Banking Act 1933 which was enacted after the Stock Market Crash in 1929.

(4) Financial Derivatives Markets

Financial derivatives are specialist financial contracts that derive their value from some other asset or index. These can either be used for risk management or trading (speculation) purposes. The three main forms are swaps (exchanges of currencies, interest rates or other commitments), futures (obligations to buy or sell at an agreed future time and price) and options (the right or election to purchase or sell at a specified future time and price). Derivatives now also include credit derivatives which provide protection against another party's payment default with the main instruments consisting of credit default swaps (CDSs), total return swaps (TRSs) and credit spreads swaps (CSSs). Derivatives are issued and traded both on formal exchanges as well as on an OTC basis. They may be considered to form part of the capital markets or to constitute distinct national and international markets.

(5) Insurance Markets

Insurance markets provide for the sale of protection cover in the event of defined events arising in return either for a single initial or continuing premium payment. These include both contingent liability (accident or non-life) insurance and non-contingent life insurance (or assurance). Assurance provides for payment on retirement or on death. Reinsurance involves the transfer or subcontracting of all or part of an insurable risk to another party. This provides a form of guaranteed payment. The largest single insurance reinsurance market in the world is Lloyds of London.

3. FINANCIAL SYSTEM AND ECONOMY

The financial system is a collective term for all financial markets and sectors in any particular country or defined regional or international area which includes all relevant financial institutions, contracts and services. The financial

system represents the total system for the creation, use, purchase and sale and extinction of financial assets within a larger economy. The real economy refers to that part of the economy involved with the manufacture and sale of goods and services. The full economy is then made up of the financial system, manufacturing and production system and total amount of net wealth, capital or assets held including land. The financial and manufacturing systems are both based on market mechanisms which allow for the sale and purchase of assets with wealth either being held in the form of real assets (such as land or property) or financial assets (including money and other financial instruments). Financial law can be considered to refer to all aspects of the law relating to the financial system, markets, institutions, rights and assets with the sale of goods and services being dealt with under commercial law.

(1) Money

Money is a form of legal tender which means that it has inherent value and is capable of being exchanged in settlement of a debt. Legal tender refers to any form of money that must be accepted in legal discharge of debts within a particular country. This is usually the currency of the country with the central bank having been given a monopoly (exclusive) rights of issuance. Financial assets consist of money, financial instruments, financial accounts, securities and other financial contracts incorporating payment obligations, such as insurance contracts. Securities include equities, bonds or debentures, convertibles, warrants and hybrid instruments. Financial contracts may include life assurance or contingent (accidental) cover, financial derivatives, credit derivatives and other structured finance instruments (such as collateralised debt obligations (CDOs) or credit linked notes (CLNs)).

The key function of money is to provide a common unit of measurement, account or pricing which is essential for the valuation of any asset or claim. Money represents its own assigned value and therefore acts as a store of value or wealth and as it is tender can be exchanged in settlement of any legal debt or payment obligation. Earlier commodity money systems were backed by defined amounts of gold, silver or other specie although all modern economies now operate on a largely fiat or fiduciary basis with money no longer be convertible into specie and only being backed by the credit standing of the sovereign, central bank or other state representative used.

Money is most commonly used for payment purposes. Payment can either be made through barter (an exchange of goods), money, paper-based funds transfer, electronic funds transfer or electronic or digital money. Money is also considered to act as a means of deferred payment although this only constitutes a form of delayed payment or credit. As legal tender, money is the only means of securing legal discharge of a payment obligation in the absence of contrary agreement between the parties.

The core functions of money in a modern economy can also be considered to include acting as a means of generating additional return or wealth through lending or investment.. In carrying out all of these functions, money provides a degree of convenience and security in managing government, corporate and individual operations and needs that would not otherwise be the possible, especially in modern complex economies with all of additional conflicts of interests and information management problems that arise.

(2) Central Banking

Central banking refers to the activities of the central bank which is the main public institution at the centre of the financial system. The central bank is principally responsible for managing the country's money (monetary policy). Monetary policy can most simply be understood in terms of controlling the volume or amount and cost of money in circulation at any time. This central bank will also usually hold the government accounts, manage the government's borrowing (or national debt), manage the country's foreign reserves and oversee the payment systems.

The central bank is generally also responsible for maintaining financial stability which may or may not include supervising the banks or other financial institutions directly. Banking supervision was, for example, transferred from the Bank of England to the Financial Services Authority (FSA) in the UK under the Banking Act 2008 and was dealt with on an integrated basis by the FSA under the Financial Services and Markets Act (FSMA) 2000. Prudential supervision of the most important systemic institutions is now be re-transferred back by the new Coalition Government elected in

the UK in May 2010 to a subsidiary of the Bank, the Prudential Regulatory Authority (PRA), with the FSA been replaced by a separate Financial Conduct Authority (FCA). A separate Financial Policy Committee (FPC) has also been set up within the Bank of England to carry out macro-prudential oversight which is concerned with monitoring the financial system and economy as a whole to identify any potential risks of exposures.

Central banks often emerged out of earlier large national banks. The Bank of Amsterdam Bank was originally set up in 1609 with the Swedish Stockholms Bank in 1656 which later became the Riksbanken in 1668 (Section 1(4) above). Modern central banking has nevertheless, generally been developed by the Bank of England which was set up by William Paterson in 1694. This has included acting as lender of last resort (LLR) to the banking system through the provision of emergency support credit either to the markets generally or to individual institutions in times of crisis. The LLR responsibilities of the Bank where eventually accepted with the first Barings crisis in 1890. Many aspects of bank and financial supervision and market support have had to be reconsidered following the Global Financial Crisis with the authorities having to develop a number of new mechanisms and tools on an ad hoc rather than pre-planned basis.

(3) Financial Sectors and Services

A number of essential services are carried out within the financial system. Five key functions can be identified in terms of providing deposit (or savings) facilities, providing loan (or credit) facilities, payment facilities, securities and investment facilities and insurance or other risk cover facilities (para 4(3) below). While payment involves the transfer of money or value held, credit involves the advancement of funds in return for a service (interest) payment and promise to repay or return (the underlying principal) at an agreed future date. The credit process constitutes a key component within any modern market economy as this allows governments to spend or companies to invest and individuals to consume in advance of income or earnings on the expectation that they will receive sufficient funds to repay the debt in due course. Credit forms an essential part of most government and corporate financing and provides additional choice in consumer and household financing.

Government or corporate borrowers can also use the capital markets in more complex economies for borrowing and investment purposes. This can principally be achieved through the issuance of bonds by governments and shares and debentures by companies. Financial intermediaries also provide a range of risk cover or protection services, principally through insurance or the purchase of other financial instruments including financial derivatives. In acting as financial intermediaries, banks and other financial institutions collect and redistribute surplus funds from public entities, companies or individuals across the economy which allows for their most efficient and productive use.

(4) Financial System and Financial Policies

The financial system consists of the total or aggregate set of markets and institutions within an economy and the inter-connections between them. This will include all of the separate markets referred to above as well as the relationships between all of the financial intermediaries either within markets or between markets and the use, transfer and extinction of all of the financial assets involved.

The economy refers to the larger structured system for the organisation of the production and sale of goods and services. Production is based on labour, capital and enterprise with goods and services being exchanged for money through payment. Adam Smith summarised the system in 1776 in *An Inquiry into the Nature and Causes of the Wealth of Nations* in terms of the division of labour, natural prices, private exchange, free trade and larger self interest which resulted in the most effective means of economic management through the 'invisible hand' of the markets. Smith specifically understood the economy in terms of household and government, income, expenditure and wealth. Wealth or capital can still be understood in terms of total net worth with assets less liabilities.

Policies involved in managing the financial system include Monetary policy as well as Regulatory policy, Fiscal policy, Economic policy and Macro-prudential policy most recently. Monetary policy, as has already been noted, refers to management of the volume and cost of money in circulation. The amount of money or credit in circulation is measured in terms of the money supply with different monetary aggregates being used (such as MO (notes and coins), M1 (bank reserves not in MO), M2 (money equivalents), M3 (M2 with large monetary deposits) and MB (total currency)). This is principally dealt with through open market operations by the Bank of England setting a base rate (referred to as the 'bank rate' in the UK) in its dealings with the major financial institutions in the primary money or Discount Market. Funds are then distributed or recycled through the rest of the economy at a margin above bank rate. Different objectives can be set for monetary policy (such as promoting price stability (inflation), growth and low unemployment) with different target regimes being available (including money supply growth over inflation or price level targeting).

Regulatory policy is concerned with the regulation and supervision of individual financial institutions with this to be re-transferred from the FSA to the PRA under the Coalition Government's reform proposals. (Regulatory design is discussed further in Section 7 available.) Fiscal policy refers to government expenditure, taxation and budget management including debt and deficit management. The government or national debt is the total amount of money owed by the government. The public sector deficit refers to the amount by which government spending exceeds income on an annual basis. Fiscal policies can either be neutral, expansionary of contractionary depending on whether total government expenditure is covered by total government receipts. Economic policy refers to the promotion of growth and employment through the larger management of the economy including labour markets, growth and development and innovation as well as related international trade policies.

Macro-prudential policy refers to the new initiatives being undertaken following the global financial crisis to ensure that authorities are able to manage all risks and exposures across the financial system and economy (Section 7(2)(e)). Other more specific policies may also have to be considered from time to time. Interest rate policy is concerned with the management of interest rates which forms part of larger monetary policy. Foreign exchange rate policy involves the management of the currency's exchange rate value as against other currencies. This may either be managed on a fixed, partially fixed or floating basis. Competition policy is concerned with the promotion of market competition through the removal of distorted practices or abusive dominant positions.

All of these policies have to be managed appropriately if the financial system and larger economy are to work effectively and produce the maximum benefits for governments, companies and households.

(5) Financial Stability

A stable financial system depends upon a number of factors being managed properly and effectively. These include maintaining:

(a) Price and asset price stability, specifically including low inflation and the avoidance of asset price bubbles such as in the areas of commercial real estate or residential property as a current before the recent crises;

(b) Continuing provision of core financial and payment services which carry out critical functions including safe savings, credit, payment, investment and insurance or risk cover;

(d) An effective system of supervision and regulation of financial institutions to ensure that they maintain necessary risk management systems and controls, adequate capital and liquidity, appropriate suitability and governance arrangements, effective accounts and regulatory reporting systems and reconstruction and resolution procedures (living wills) in the event of financial difficulties arising;

(c) Effective loss allocation through the purchase of insurance or other financial assets for investment or hedging purposes of private losses been borne by the private sector; and

(e) An effective system of macro-prudential oversight and effective crisis management and support in the event of major crisis arising to contain any potentially disruptive systemic threats materialising.

A number of benefits arise where the financial system and economy are managed effectively. These are considered further in section 5(4) below.

4. FINANCIAL INTERMEDIATION

Financial markets provide a number of key services including valuation, price agreement, payment, exchange and transaction validation. In so doing, a number of ancillary services are carried out in terms of price disclosure, contract or trading, clearing, settlement and regulatory and market reporting (for price disclosure and regulatory oversight purposes).

A market is any identifiable location, system (including electronic system) or formalised set of relations through which any product or commodity can be valued and bought or sold. A financial market is then any organised process through which financial assets, instruments or claims can be issued and traded. An exchange more specifically is any identifiable location through which instruments or claims can be issued and traded. A stock market is any organised or regulated marketplace for the trading of government or corporate stock and shares or other financial assets.

Introduction to International Financial Law and Regulation

(1) Financial Function

Financial instruments and financial markets carry out a number of essential functions without which only the most primitive of economies could operate. Money is necessary to act as a means of valuation and unit of account, store of value and medium of exchange. Other paper based instruments (including bills of exchange, promissory notes and checks) and other electronic systems are essential for payment purposes. Paper securities were used to evidence entitlement to a proportionate share in the aggregate assets of a corporate entity although much of this is now either issued or transferred in an electronic form.

The key functions of financial instruments and markets can be summarised as follows:

(a) **Deposit** (savings) or **safekeeping** (either for custody or safekeeping or income generation);
(b) **Loan** or **credit**;
(c) **Payment** (paper-based or electronic);
(d) **Investment** (combining return of principal and income either through dividend (on equity) or interest (on debt));
(e) **Risk cover** or **insurance**.

The structure and operation of modern economies would be impossible without these key core facilities and functions.

(2) Financial Assets

Financial claims are transferrable, enforceable obligations to transfer monetary value which can ultimately only be discharged in law through the payment of national currency in the form of legal tender in the absence of contrary agreement between the parties concerned.

Financial assets include any property with a monetary value. Under English property law, the following classes of asset may be distinguished:

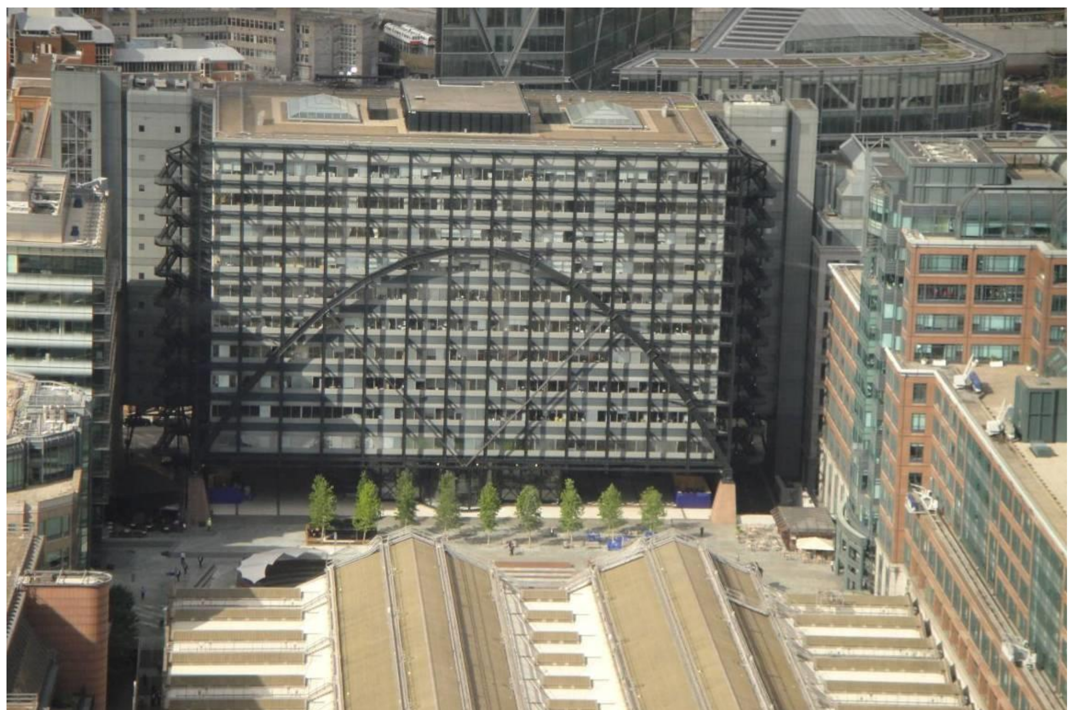
(a) Real property or land (heritable property in Scotland) including leasehold property under s1(1)(b) of the Law of Property Act 1925 although leaseholds are strictly personality (or chattels real);
(b) Personal property including:

(i) Tangible moveable property (corporeal personality);

(ii) Intangible moveables including (i) documentary intangibles (in which the right to payment is embodied in the document) and (ii) pure intangibles or 'choses in action' (claims). Documentary intangibles include document of title to payment (financial instruments), documents of title to negotiable securities (bonds and notes) and documents of title to goods (such as bills of lading).

Money would constitute tangible moveable property although most financial assets exist in the form of financial instruments or pure claims. A financial instrument is a document of title to money in which the right to receive payment is held what constituted within the instrument and transferred with the instrument. Instruments may either involve an undertaking to pay a sum of money (including a bank note or promissory note, Treasury bill or bearer bond) or an order to pay another a sum of money (including a bill of exchange or a cheque which is legally a bill of exchange drawn on a bank). Financial instruments are further classified as either negotiable or non-negotiable with negotiability referring to the capacity of the transferee to acquire perfect title subject to having had no notice of any prior defect in title. Negotiability was historically conferred as a matter of practice on bills of exchange and cheques which was essential to their historical value and importance.

A security is a financial asset of claim representing either a debt obligation issued by a government or corporate body or an interest in the company concerned. Government debt instruments are generally referred to either as bills or gilts (UK only) and as debentures or bonds by corporate bodies. A security will also include shares or equity issued by companies which constitute a proportionate ownership entitlement in the assets of the company. A share is the interest of a shareholder in the company measured in money with shareholders entering into a series of mutual covenants between themselves (*Borland Trustee v Steel* [1901] 1 Ch 279, 288 Farwell J). The company is nevertheless a distinct legal entity from its shareholders (*Salomon v Salomon & Co Ltd* [1897] AC 22) with shareholders holding no equitable interest in the company's assets directly (*Macaura v Northern Assurance Co Ltd* [1925] AC 619).



(2) Financial Redistribution and Allocation

Banks, securities firms and other financial institutions are 'financial intermediaries' which carry out a number of core functions involving financial assets on financial markets. Financial intermediation refers to the matching or linking of excess with deficit capacity needs. Parties with excess assets (savings or investment) are brought together with those requiring funds (borrowers) to their mutual advantage. Financial intermediation adds value in a number of ways:

(a) Savers and investors receive a **secure** return on their funds;
(b) Borrowers are able to **pool** (increase) and **transform** (extend) maturities (the time for repayment);
(c) Ancillary **payment services** are provided;
(d) **Credit risk** is properly assessed and priced;
(e) Credit risk is subject to specialised **management** by banks and other financial institutions;
(f) **Transaction costs** are lowered;
(g) There is a consequent reduction in **counterparty credit** risk;
(h) Provision of general **information management** services;
(i) Overall increase in **credit volumes** (through credit multiplier effects) and investment within the economy and consequent increase in **welfare**.

(4) Financial Advantage

Apart from the core functions identified, a number of other advantages can be attributed to financial markets.

(a) They increase the total amount of **investment capital** available nationally and globally;
(b) Market **liquidity** is correspondingly improved;
(c) There is a better **allocation** of resources in all markets;
(d) Transaction **costs** are lowered;
(e) Consequent gains in **efficiency** arise;
(f) Market and corporate **discipline** is strengthened;
(g) Market **transparency** and information management is improved;
(h) Market **information** is better collected, distributed and assessed;
(i) Underlying trade and **commerce** expands;
(j) **Welfare** gains are realised more generally.

Financial markets also facilitate and support:

(a) Daily **consumer consumption**;
(b) Business and commercial **development** and **innovation**;
(c) The provision of **public services** and management of **public finance**;
(d) National and international **trade**;
(e) Public, corporate and household or individual **wealth**.

In so doing, financial markets more specifically provide the basis for:

(a) Individual consumption for the purposes of satisfying core needs in terms of food, water and housing as well as other consumption in the form of close and personal items;
(b) Employment or service provision by independent contractors;
(c) Mortgages and property purchase;
(d) Commercial property construction and development;
(e) Industrial and scientific investment and innovation.

Financial markets can accordingly be considered to add value in the following ways:

(a) They allow the core functions to be carried out referred to in terms of deposit (safekeeping), loan (credit), payment, investment (return) and risk cover (insurance);
(b) They support the real economy which could not operate without the functions referred to;
(c) They support government and public finance;
(d) They facilitate welfare provision and social protection through taxation and proportionate welfare redistribution;
(e) They provide a basis for commercial and larger social and public order based on the market system.

(5) Financial Disadvantage

Against these advantages, however, markets can also be considered to be:

(a) Inherently **unpredictable**;
(b) Consequently **unstable**;
(c) **Inefficient** and **ineffective** (in the absence of perfect information and no transaction costs);
(d) Involve high **maintenance costs** especially with the need for government and central bank support;
(e) Fundamentally **unfair** in terms of wealth accumulation and distribution.

Markets can work specifically be considered to be unfair in that:

(a) Benefits are **disproportionately** and unevenly enjoyed;
(b) Markets operate in a **remote** and distinct manner from the general public;
(c) People have no sense of **participation** or **control**;
(d) There is no consequent sense of **ownership** or **benefit**; and
(e) Markets operate without **personal**, **social** or **cultural responsibility** and can be considered to have no ethical content.

Other specific difficulties can also be identified at the national and international level:

(a) National fiscal collection, taxation and welfare distribution **systems** may not work effectively with many groups paying little or no tax;
(b) Cross-border **monetary management** and relations have to be managed more effectively;
(c) **Foreign exchange** and **payment** imbalance problems have to be removed;
(d) Increased **regulatory** co-operation and co-ordination of action has to be secured especially with continuing problems 'moral hazard' being removed through the reintroduction of some effective market exit (bankruptcy) threat for larger 'Too Big To Fail' (TBTF) firms;
(e) Emerging markets in developing countries require proper **sequencing** of investment and market reform.

Capital markets have been confused with capitalism which has often, in turn, been linked with earlier instances of historical abuse and exploitation. Capitalism and can be defined in a number of different ways and has been criticised historically by such writers as Karl Marx and Friedrich Engels and other more modern commentators, including many development and environmental writers. Capitalism has then been used to refer to or understood in terms of earlier

colonial exploitation and later industrial and post-industrial revolution abuses of workers and collective representation (including trades union) rights.

Capitalism simply represents one form of industrial and social organisation and can be understood in terms of a number of simple operational or component terms. Capitalism can be defined to include the following core elements:

(a) Private ownership of the principal factors of production, including capital and enterprise and of the produce of production principally in the form of earnings;
(b) Specialised production processes (based on Adam Smith's Division of Labour);
(c) A market economy operating mainly on the basis of private markets but with varying degrees of government involvement, support or regulation and some separate parallel public markets;
(d) Corporate entities and private and public companies with separate legal personality and limited liability as well as perpetual succession; and
(e) Cyclic investment in innovation and capital retention.

Private capital models can be considered to benefit from a number of advantages and values including:

(a) Individual incentives and rewards;
(b) Industrial and market expansion and growth;
(c) Consequent income generation and employment;
(d) Continuing investment and innovation; and
(e) Overall welfare benefit.

Private capital markets and capitalism can nevertheless suffer from a number of potential disadvantages or problems although these can be dealt with through the imposition of appropriate laws, regulations and other controls. These do not have to be understood in historical terms although elements of this correspond with earlier historical incidents.

(a) Market inefficiency and instability;
(b) Possible exploitation and abuse;
(c) Standards dilution and standards avoidance over time;
(d) Imposition of external costs (free riders) such as through environmental damage and financial instability; and
(e) Resource dependence and exhaustion longer term in the absence of sustainable production, extraction and replacement practices.

It is essential to ensure that markets operate effectively which includes dealing with all of these potential inefficiencies or defects. Appropriate laws and regulatory requirements have to be developed to contain any damage or potential loss in each of these areas. Much of this will necessarily involve government or public involvement although this should be limited where possible. A modern effective, managed, collaborative and sustainable market economy can be constructed which realises the full benefits of private financial markets but without the earlier instances of abuse and exploitation.

5. FINANCIAL GROWTH

Financial markets have been subject to significant change and expansion in recent years. This may be considered in terms of size, change, transformation, innovation and trends.

(1) Market Size

The substantial expansion in the size and scope of financial markets can be understood with reference to a number of key indicators:

(a) The total global stock of core **financial assets** reached US$140tn (£70.66tn and €104.49tn) by 2005 with the ratio of global financial assets to annual world output increasing from 109% in 1980 to 316% by 2000

(McKinsey Global Institute) – this subsequently rose to US$194tn just before the financial crisis beginning in summer 2007 following which it fell to US$172tn - it was predicted that the Chinese economy alone would grow to $123 trillion by 2040

(b) Over US$5.3tn moves round the world every day in **foreign exchange** markets ;

(c) The total global nominal value in over-the-counter (OTC) **financial derivatives** has expanded from US$3.45tn in 1990 to US$286tn by 2006 and subsequently to US$838.7tn by 2009 and then US$684 by 2010. It then rose to over $700 trillion by 2013 with total exchange and OTC derivatives possibly being in excess of £1 quadrillion or £1000 trillion;

(d) The ratio of **bank deposits** to financial securities has reduced from 42% to 27% between 1980 and 2005 as part of the larger process of securitisation of debt and growth in the importance of investment as opposed to commercial banking;

(e) In terms of **alternative investment**, the number of hedge funds had grown from 610 in 1990 to 9,575 by beginning 2007 with a total of US$1.6tn under management at the same time as private equity funds have grown to 684 vehicles with US$432bn of commitment – these numbers fell during the crisis but hedge funds recovered to manage US$1.82 trillion by 2009 with 6,300 funds and 22,350 separate funds under management in total;

(f) The amount of money placed in non-life insurance and life or pension assurance cover has also grown substantially with **Lloyd's of London** alone previously earning £10bn in profit a day.

One of the core difficulties that have arisen with this expansion in wealth is that it is not evenly held. Total financial assets owned by residents in higher income countries has increased from 50% of GDP to 100% between 1970 and 1985 and then again to 330% by 2004.

Earlier US dominance has since shifted although investment spreads remain uneven. US private equity investment fell from 68% in 2000 to 40% by 2005 with a corresponding drop in funds raised from 69% to 52%. Investments grew from 17% to 43% (17-38% of funds raised) in Europe with Asia Pacific growing from 6% to11% between 2000 and 2005.

Some of the US banks are still among the largest financial institutions in the world. The largest in terms of tier 1 capital in 2010 were Bank of America, after its acquisition of Merrill Lynch, and JP Morgan Chase, which had earlier acquired Bear Stearns and the operations of Washington Mutual. Over 50% of US investment bank income is nevertheless now generated abroad with 75% of global growth occurring outside the US. A number of large banks and financial groups have also increasing arisen in Asia and especially in China with its 'Big Four' of the Industrial and Commercial Bank of China, Bank of China, China Construction Bank and the Agricultural Bank of China.

(2) Market Growth and Development

Markets have been subject to substantial growth in recent decades. Markets benefited from the relatively stable conditions that arose after World War Two that allowed the substantial reconstruction of many European economies. International monetary stability was secured under the Bretton Woods system of managed exchange arrangements entered into in 1944 which fixed the value of the US dollar to gold and all other currencies to the dollar. Funding was made available through the US Marshall Plan and other assistance programmes.

Markets were disrupted with the move from fixed to floating currencies and the abandonment of the Bretton Woods exchange standard between 1971 and 1973 and again with the Third World debt crisis beginning in Mexico in 1982. The global economy was also rocked by the Asian financial crisis beginning in Thailand in July 1997 although it recovered substantially until the international credit crisis beginning in August 2007.

While it will take several years for the effects of the global financial crisis to be absorbed fully it, it is expected that financial markets will then continue to prosper and grow strongly again and hopefully at the same time support the real economy. A number of the responses adopted following the recent crises are intended to ensure that financial institutions and financial markets support the real economy. Financial functions and advantages are considered further in section 5 below.

(3) Market Change and Innovation

Financial markets have undergone significant change especially since the early 1970s and the collapse of the Bretton Woods system. The main changes can be summarised as follows:

(a) **Liberalisation** and **deregulation** of many market access, regulatory and capital or foreign exchange restrictions;

(b) **Technological** advances especially in computer software and hardware and telecommunications;

(c) Market **integration** (on a cross-border and then cross-sector basis) and globalisation more generally subsequently;

(d) Advances in **risk management** and financial innovation and engineering including, in particular, the construction of modern finance, portfolio and investment theory with the advances that that has permitted in terms of risk identification, measurement and management;

(e) The **stable financial** and monetary policy conditions that have generally applied since the exclusive reliance on fiat money with the collapse of Bretton Woods in 1973 (unsupported by gold) and the favourable credit conditions that have arisen since especially in the last 4-5 years.

(4) Market Transformation and Trends

These changes have permitted a restructuring of financial products and markets. This can be seen in the emergence of a number of key factors:

(a) There has been an **explosion** in the size of almost all financial market;

(b) Financial markets have become increasingly **trade and transaction** rather than bank and relationship based;

(c) There has been the emergence of a number of new **complex products** beginning with financial derivatives (in the mid-1970s following the collapse of Bretton Woods), the **dis-intermediation** of many products (especially with commercial paper), the **securitisation** of underlying receivables and loan-based products; subsequently **packaging** of outstanding debt and then the most recent expansion of new **structured** products including the linking and layering of exposures as well as '**privitisation'** of the main markets and market functions).

(d) A number of **new institutions** have emerged especially with the growth in the alternative investment market including, in particular, with **hedge funds** and **private equity** and with the corresponding expansion in the number and types of investors including pension funds, corporate treasuries, government agencies, specialist investment vehicles and individual investors more generally especially with the continued expansion of private income in a number of countries and with the growth in private pension provision.

A number of key trends can also be identified within financial markets more specifically:

(a) **Dis-intermediation** (with the issuance and trading in debt by institutions directly without financial institution support);
(b) **Securitisation** (with the move from inherently non-transferrable loan to transferable debt or security instruments);
(c) **Repackaging** and **structured financing** (with the restructuring of debt packages and linking of product profiles including, in particular, financial derivatives especially with the growth in credit derivatives (including total return swaps (TRS), credit spread swaps (CSS) and credit default swaps) as well as credit linked notes (CLNs) and collateralised debt obligations (CDOs);

(d) The **'privitisation'** of debt with the use of over the counter (OTC) markets, off-exchange transactions and in-house markets (internalisation); and
(e) The '**deconstruction'** of risk with the layering of exposure tranches and separate trading of differently rated or graded paper created and consequent creation of a considerably higher degree of **market complexity** financial marketplace involving the spread or diffusion (rather than dilution) of risk across many parts of the market and counter parties.

It is possibly the deconstruction and separate trading of risk that creates the more significant challenges for regulators and central banks. The total amount of risk within the system is not diluted or diminished in any way. Total or aggregate exposures have increased significantly in recent years with risk simply having been broken up or parcelled and spread around with no individual financial institution or authority being able to assess or oversee the total risk created and the ability of the financial system to support that exposure.

This creates complex information problems especially in terms of data collection, aggregation and assessment. More fundamental problems also arise in terms of risk management with individual institutions simply purchasing and trading in risk products or exposures but with no underlying initial or original management function being undertaken. Credit tranches, where simply graded by rating agencies at the time of issuance and then sold on by financial institutions sequentially with no one party wishing to hold the debt at default.

The historic and original function of bank credit examination and associated personal credit relationship has been replaced by ratings and trading. As unregulated institutions, the role and function and capability of the rating agencies has also been questioned recently especially with the errors made with the pricing of debt in the US sub-prime market and the consequent global credit crisis that arose beginning in August 2007. A Regulation was adopted within the EU on Credit Rating Agencies which came into effect in December 2009 and established a registration system for agencies and harmonised approach to activity regulation. The Regulation was to be amended to include additional requirements in respect of structured products and to bring CRA within the oversight of the new European Securities and Markets Authority (ESMA) which began operations in January 2011.

(5) Market Capability

The ability of financial markets to with stand cyclic downturns and shocks has strengthened in recent decades. This has occurred as a result of a combination of factors:

(a) Increased market **transparency** within and across markets and market sectors;
(b) Increased market **information** with growth in support services examining and presenting data effectively;
(c) Increased **complexity** and **sophistication** of markets and market earnings with consequent improvement in liquidity and credit conditions;
(d) Substantial improvements in **model risk identification**, measurement and management techniques;
(e) The emergence of more sophisticated and specialist **central banking functions** which can more effectively manage monetary and credit conditions and provide liquidity or other emergency support as necessary.

6. FINANCIAL RISK AND INSTABILITY

While financial markets can generate substantial earnings and returns, they can also be subject to instability and collapse. Financial institutions must manage the direct financial risks that their activities create while the authorities must monitor the build-up of exposures within the financial system more generally and across the economy as a whole. Different assumptions have historically been made as to whether markets are inherently stable of unstable with other sets of theories arising with regard to the proper justification for financial regulation and official intervention in market processes.

(1) Financial Risk

Recent substantial increases in in the quality of risk management capability and market liquidity have to be considered against the nature of the underlying risks concerned and other aggravating risk factors. The principal financial risks that arise can be identified in terms of:

(a) **Credit** or counterparty default risk (involving the non-payment of interest during term and/or non-repayment of principal on maturity);
(b) **Market** or position risk with fluctuations in the value of debt or equity stock quoted on formal markets or sold secondarily;
(c) **Foreign exchange** or currency risk (including settlement or ‘Herstatt Risk’ with the non-completion of one side of a currency transaction);

(d) **Interest rate risk** (which may affect debt instruments specifically as well as create unfavourable conditions across markets more generally);

(e) More complex **financial derivatives** and **commodity** related risks (especially on options including ro, beta, delta, gamma and theta).

The two other principal forms of risk are operational and legal risks. Operational risk is principally concerned with the failure of internal systems and controls including human processes or through human error, fraud or theft. Legal risk is concerned with the validity and enforceability of transactions and contractual documentation and includes legal capacity, documentation validity and enforceability. Other business and management risks as well as external environmental risks have also to be considered.

Other market factors are also relevant in considering the current condition of national and global systems. These are monitored by national central banks and such international bodies as the International Monetary Fund (IMF) and Financial Stability Board (FSB). Relevant factors include:

(a) High levels of **sovereign debt** which have soared in many countries as a result of earlier ineffective management policies or fiscal stimulus or bank support costs incurred during one following the financial crisis;

(b) Continuing high levels of **household debt** (UK liabilities increased from 108% to 159% of GDP between 1994 and 2005 and with over £1tn still outstanding and with comparable increases from 92% to 135% in the US and in Europe);

(c) Significant **global payment imbalances** especially with the continuing US trade deficit and perceived high value of the Chinese Renminbi;

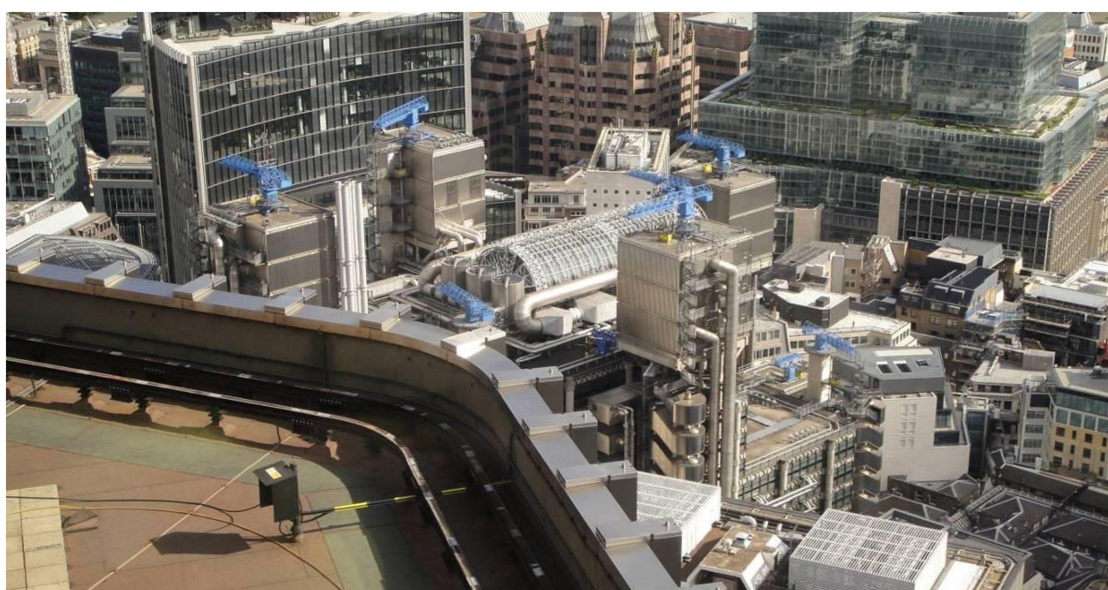
(d) Difficulties in **recycling** available funds as banks restructure their balance sheets and corporate and household borrowers limit commitments;

(e) Further potential **liquidity pressures** and **contagious effects** in the event of any sovereign debt difficulties such as in the Euro area and the pressure of this on larger international or national banks.

Other more specific continuing concerns within the financial sector include:

(a) Possible **foreign exchange** instability especially with the continuing low dollar and high Renminbi;

(b) Value of **commodity prices** as investors and speculators switched funds to perceived high return areas;



(c))Susceptibility to **hedge funds** and other investment vehicles to further downturns in markets;

(d) The ability of **equity finance** vehicles to continue in operation without favourable credit terms and the overall value and effectiveness of such a highly leveraged models despite some notable recent successes;

(e) The sustainability of the **'carry trade'** market (especially with the borrowing of funds in Japan and re-lending them elsewhere) with credit tightening and with the continued value of the **international remittances market** (with overseas residents transferring substantially large amounts of money back to their home countries for family or investment purposes).

A number of more general trends can then be identified. These include the emergence and dominance of new complex products. Markets have also generally moved from being loan to debt (producer to trader) based with a collapse in a traditional relations and personal banking. Finance and capital markets have assumed a new autonomy especially with the separation of the new global economy from the underlying trade or mercantile markets. Global finance has also become increasingly 'Anglo-US' based with the emergence of London and New York as the principal financial centres and, in particular, with the more recent pre-eminence of London following a number of reports on US markets.

(2) Financial Instability

The recent financial crises have forced a reconsideration as to whether financial markets are inherently efficiency and stable or inefficient and unstable. Approaches maintaining that markets are stable are based on such ideas as 'efficient markets theory' and 'rational expectations theory'. These assumes that markets are informationally efficient, and that asset prices are traded on all available information, with prices only varying from fundamental values where there has been some error. Other economic writers, such as Hyman Minsky and Charles Kindleberger, argued that markets are inherently cyclic and unstable and prone to collapse without correction.

(3) Financial Theories or Objectives

The traditional objectives of financial regulation have been to protect individual depositors and market or financial stability. The failure of an individual contract or transaction on the collapse of a particular financial institution may result in immediate loss to the relevant consumers (depositors, investors or policyholders) involved. Larger crisis may also threaten the stability of the specific market. The particular danger that arises in the banking area is that concerns with the stability of a particular bank may result in a withdrawal of funds from that bank (a run) which may threaten its stability. The closure of one bank may then threaten the stability of other institutions either through direct credit exposures or though parallel runs. Where a number of banks are involved, this process of contagion (or domino) may be sufficient to threaten the stability of banking market, which could result in a larger systems or systemic crisis or collapse.

Early writings on the need for financial regulation were based on more general public interest ideas such as in the US. The Supreme Court had to develop a number of specific and then general exceptions under the5th and 14th Amendment of the Constitution to allow the state and federal authorities to impose specific regulatory constraints. A substantial body of federal regulation was introduced in the US following the stock market collapse in 1929 and the Great Depression in the early 1930s. This included the Banking Act 1933, Securities Act 1933 and Securities and Exchange Act 1934 which created the basis for modern US financial regulation. The Banking Act specifically included the Glass Steagall provisions on the separation of commercial of investment banking. An enormous amount of regulation was imposed until the 1970s with writers then challenging the extent to which all of this acted against rather than in the public interest under more recent 'public choice' and 'regulatory capture' theory.

More theories justifying financial regulation tend to be based on ideas of specific market failure or default. The most commonly referred to arguments in terms of market failure are systemic collapse and externalities, natural monopolies and information asymmetries with consumer protection replacing any public interest. Officials have also focused on uncertainty and network effects, especially following the recent crises in the markets.

(4) Financial Market Contagion and Stability

Financial sectors can be affected by the build-up of risk in different ways with different potential levels of contagion or spread of crisis arising.

Introduction to International Financial Law and Regulation

(a) Banking Markets

This problem of contagion and systemic collapse is more prone in the banking market due to the underlying maturity mismatch or transformation problem referred to earlier with banks funding themselves through short deposit or wholesale borrowing and then lending this medium to long-term. In the event of a large withdrawal of funds, the bank will not be able to realise funds quickly as these will have been committed to medium to longer terms loans. As personal debt obligations, these cannot be transferred or sold easily. They can be assigned although an assignee may want some reduction in value due to their inability to carry out the same initial credit checks on the borrower. If a loan or funding book has to be sold quickly, this may result in a substantial reduction or 'fire sale'.

(b) Securities Markets

Securities markets have traditionally not been subject to the same danger of contagion and systemic collapse. This is due to the absence of the same underlying maturity mismatch or transformation as securities firms hold transferable security instruments. These can generally be easily sold on a formal or over-the-counter (OTC) market. As securities firms will also not have the same direct lending exposure to each other as with banks, the same risk of deposit withdrawals (runs) and contagion does not arise. Increased concerns have nevertheless arisen in recent years with the large volume of securities transactions taking place on the main exchanges and with operational or settlement ('plumbing') problems. The operation of major markets was threatened, for example, on Black Wednesday in 1987 and following the terrorist attacks in 9.11.2001. Difficulties also arose on the London Stock Exchange on 9.11.2008 with trading having to be suspended for a period.

(c) Insurance Markets

Insurance markets are also not subject to the same dangers of contagion and systemic collapse. Difficulties may nevertheless arise where firms fail to invest appropriately to ensure that they have sufficient income to cover their ongoing fixed (life cover) or contingent (fire and other risk insurance) contingent liabilities. Insurance firms operate by investing the premia received from clients in portfolios of assets to generate an adequate return to cover their liabilities.

(d) Complex Groups and Financial Conglomerates

The most recent significant concern that has arisen has been with regard to the emergence of large complex groups of financial conglomerates made up of banking, securities and insurance firms. The difficulty that arises in this case is that

losses suffered in any market and including specifically the more volatile securities, currency or derivatives markets can spread to the banking component of the group and possibly trigger a bank run, contagion and a systemic threat. This risk of 'inter-group' or 'cross-sector loss transfer' has to be managed carefully.

(e) Complex Objectives

More modern regulator systems have nevertheless tended to adopt more complex objectives. The new regulatory system set up in the UK under the FSMA, for example, imposes four specific statutory objectives on the Financial Services Authority (FSA). These consist of maintaining market confidence, promoting consumer protection and consumer education and reducing financial crime. The FSA has explained that it interprets maintaining market confidence to include ensuring market stability more generally. A number of additional more general but less formal 'supervisory principles' are also imposed under s2(2) FSMA based on proportionality, management responsibility, efficiency and competition. The core four statutory objectives were later revised under the Banking Act 2009 and, in particular, after the Northern Rock crisis, to include an express financial stability objective with consumer education been removed and transfer to another body.

The effect of this is that in practice, the FSA in the UK considers a large number of ly conflicting objectives in designing and implementing regulatory policy. The objectives of modern financial regulation have accordingly become considerably more complex. This may be considered to include each of the following which have to be effectively balanced and prioritised in practice:

- (a) Financial confidence;
- (b) Financial responsibility;
- (c) Proportionality
- (d) Financial awareness, education or capability;
- (e) Financial damage;
- (f) Financial efficiency;
- (g) Financial competition;
- (h) Financial innovation;
- (i) Reduced financial crime;
- (j) Financial conduct;
- (k) Promotion of good standards and financial ethics more generally;
- (l) Increased financial contribution and welfare more generally.

(5) Financial Stability

The overall objective must be to maintain financial stability more generally. Difficulties exist in defining financial stability specifically with many economic texts tending to use quantitative or numeric measures of all this removes judgment and discretion. Financial stability may be most clearly understood in terms of maintaining proper market function with financial instability arising where markets or the financial system as a whole are not able to carry out their proper functions.

Regulatory authorities across the world have tended to focus following the recent crises on the need to oversee the stability of the financial system and economy as a whole. This has been considered in terms of the development of new Macro-prudential regimes although again a number of difficulties arise in defining the precise functions involved and identifying and allocating the most appropriate tools. This work has been taken forward with the establishment in the UK of the Financial Policy Committee (FPC) with in the Bank of England, which replaces the earlier external tripartite Council for Financial Stability (CFS).

A European Systemic Risk Board (ESRB) has also been set up within the EU with a separate system of European System of Financial Supervisors (ESFS) and sector specific European Banking Authority (EBA), European Securities and Markets Authority (EMSA) and European Insurance and Occupational Pensions Authority (EIOPA). A similar

Financial Stability Oversight Council (FSOC) has also been set up in the US Dodd Frank Wall Street Reform and Consumer Protection Act 2010. It remains to be seen how of this will be developed over time.

7. FINANCIAL REGULATION AND CONTROL

Financial markets provide a number of core functions and services without which modern economies could not have been constructed nor operate. In so doing, a large number of specific advantages arise especially through the process of financial intermediation and with the overall consequent increase in the total stock of financial assets and wealth within society. Markets are nevertheless unstable and vulnerable to failure or collapse. Banking markets, in particular, are inherently unstable in light of the separation or dislocation of the deposit and lending function with a 'maturity' gap (pr mismatch or transformation gap) arising between the bank's ability to receive short-term funds (through deposits or inter-bank borrowing) and the pooling and on-lending of these funds on a medium to long-term (5, 10 or 15 year) basis. Crises can then arise where banks fail to manage this maturity transformation effectively or where financial institutions failure to manage the other risks that arise with their particular type of business activity creates or possibly through other human error or abuse.

(1) Financial Regulation and Supervision

Financial regulation is concerned with the imposition of a series of obligations on financial institutions to limit the risks they create. These can be imposed under law, secondary legislative provisions, rules, administrative actions or individual regulatory decisions. Supervision is concerned with the monitoring of compliance by institutions with the regulatory obligations imposed or with more general standards of the market conduct.

The purpose of financial regulation is to protect the stable and efficient operation of the markets and ultimately limit potential market support and government costs. For this purpose, all relevant risks have to be identified and managed. Financial regulation is principally based on effective internal risk management with a number of core requirements being imposed on firms to ensure that they manage all of the exposures that their activities created.

Regulatory systems are generally based on a series of parallel Authorisation (or licensing), ongoing Supervision and Enforcement (sanction) measures. All financial laws are based on and incorporate each of these sets of provisions. Almost all financial laws impose a 'general prohibition' which prohibits the carrying out of the specific activity covered (such as banking, securities and insurance) without an appropriate licence or authorisation. The license or authorisation is then only available through compliance with the authorisation, supervision and enforcement measures imposed. (This is imposed under s19(1) FSMA in the UK.)

Authorisation is conditional on compliance with a number of regulatory obligations with regard to such matters as the suitability of directors, senior managers and staff (fit and properness), effective systems and controls and governance arrangements and minimum solvency or reserves requirements (capital adequacy and liquidity).

Supervision is based on regular returns, possible special reports (asked for by the authorities into such matters as the effectiveness of internal control systems) and relations (supervising meetings on a bilateral basis between the banking and authority or on a trilateral basis also including the internal accountants or external auditors).

Enforcement can be carried out through the imposition of fines, censure (pubic or private) or withdrawal of individual approval or firm permission and ultimately winding-up or bankruptcy with the authorities having other interim remedies such as power to apply for disclosure, injunctions or restitution orders.

(2) Regulatory Approach

A number of different general approaches can be adopted with regard to the type of regulatory system adopted in any particular country. These have generally been distinguished in terms of either a 'Functional' or 'Institutional' approach with writers more recently referring to more sophisticated 'Objectives' based approach. A number of countries have also adopted a unitary or 'Single Regulation' based system with much regulatory attention following the recent crises focusing on the need to adopt a more general 'Macro-prudential' based regime.

(a) Functional

Under a functional system, the authorities focus on the types of particular financial activities (such as banking, securities trading or insurance) carried on with a separate agency been set up for each. This was the general approach adopted in the UK and US and other systems following an Angl American model.

(b) Institutional

With an institutional regime, the authorities focus primarily on the key institutions involved with a wider range of authorised activities being permitted. This is, for example, the approach adopted on the European Continent which had specifically adopted a 'Universal Bank' model, which allows banks to carry on a wide range of financial activities (including banking, securities, corporate finance, asset management and financial derivatives) under a single license. This would generally only exclude insurance services which had to be carried out by separate institution although a number of more complex *Bancassurance* or *Bankaffianz* groups were developed in the 1990s which combined all of these activities.

(c) Objectives

An objectives based system identifies a number of core separate regulatory purposes with a separate agency being established for each. The increasing extended list of possible regulatory objectives to be imposed on authorities has already been referred to Section 6(4)(e) above. This clearly has to be narrowed with a decision taken as to the most important core functions involved. This may, for example, include Prudential regulation, Conduct or consumer protection, Markets, Payment systems, Financial crime and Competition. A narrower model is also sometimes proposed, which would only involve creating a Prudential (or financial regulatory) authority and then a separate Consumer (or conduct) authority. This has been referred to as the 'Twin Peaks' approach and followed as part of the most recent restructuring of the regulatory system within the UK.

(d) Single Regulator

With the increasing high degree of integration of financial sectors and markets, the decision was taken in a number of countries, including specifically the UK under the previous Labour Administration, to establish a single unitary system

with a single financial authority for all services and markets. This has been referred to as the 'Single Regulator' debate. The effect is to create a single authority to oversee all financial markets and services, such as with the FSA in the UK. This is examined in further detail in Section 7(3) below.

(e) Macro-prudential

More recent regulatory systems revisions, especially following the recent crises in the markets, have focused on developing a corer central 'Macro-prudential' function either within a separate agency or within the central bank. The new system proposed by the Coalition Government in the UK creates a central bank based macro-prudential model with the Financial Policy Committee (FPC) within the Bank. Financial regulation of all systemically important institutions is to be transferred to the Prudential Regulatory Authority (PRA), which would be set up as a subsidiary of the Bank, and with consumer protection and market supervision been dealt with by the separate Financial Conduct Authority (FCA). This then combines aspects of single prudential regulation (of all different sectors within the PRA) within a larger new central bank based macro-prudential model.

(3) Regulatory Structure

The integration of financial markets and operation of large complex groups of financial conglomerates has led to the establishment of single integrated regulators in a number of countries. This has been referred to as 'the Single Regulator' debate. This is nevertheless not a single debate with three separate sets of issues being involved each of which have to be distinguished:

(a) initial agency or institutional integration (establishing a '**Single Regulator'**);
(b) corresponding statutory or regulatory harmonisation (with '**Single Regulation'**); and
(c) the degree of underlying cross-sector financial integration to be permitted ('**Single Markets'**).

A number of arguments can be developed for and against either a single or multiple regulatory model. These are generally based on such matters as policy grounds (integration, consistency, simplicity, review and development), institutional issues (administrative control, contact and communication, better allocation and use of resources, improved training and enhanced internal and external accountability) and operational matters (efficiency, responsiveness, flexibility, cost and competitiveness). A number of corresponding arguments can nevertheless be developed against each of these arguments generally based on administrative concentration, loss of regulatory (inter-agency) oversight and competition, potential increased regulatory burden and cost and lack of transparency and accountability and abuse more generally.

Appropriate corrective mechanisms have then to be adopted in each case. The issue is accordingly not one of whether any specific single or multiple regulator solution is better on a theoretical basis but on the effectiveness of subsequent corrective adjustments adopted after the decision is taken either to adopt a single or multiple model. The single or multiple regulator choice must initially be taken having regard to the local market, economic, legal, regulatory and to some extent political considerations with an appropriate set of corresponding corrective measures or adjustments then being put in place to deal with the corresponding disadvantages that arise depending upon which option is selected.

With the more recent changes that have taken place in markets, a general presumption in favour of regulatory integration has arisen rather than the continued use of a multiple regulatory model. A number of factors have tended to favour the move towards an integrated solution. These include:

(a) Increased **market complexity** and high degree of underlying market integration that has taken place in recent years;
(b) The **multiple objectives** adopted by regulators and new complexity of regulatory models;
(c) Massive demands of **complex information collection**, **processing** and **exchange** in modern markets;
(d) The need for co-ordinated regulatory **action** and **enforcement**; and
(e) The need for co-ordinated and extended **market support** mechanisms in the event of a major crisis.

The Coalition Government in the UK has nevertheless decided to adopt a partial 'Twin Peaks' with a separate PRA and FCA. This is necessary due to the decision to create a centralised Macro-prudential function with the FCA within the Bank. The Bank will then be responsible for the conduct of monetary, regulatory and macro-prudential policy. It was then necessary to separate supervision of non-systemic institutions and other markets as otherwise the Bank would have been overloaded. This can then be justified on the basis of non-systemic regulatory delegation of function.

(4) Regulatory Design

A number of common or general issues arise in setting up or designing a regulatory system within all countries. Each of these has to be considered either expressly or implied impliedly in drafting national regulatory laws. The overall effectiveness of any national, regional or international regulatory system will depend upon the extent to which an appropriate set of decisions has been taken with to regard each issue and how well they operate together in practice.

(a) Objectives

The authority or authorities must be assigned clear objectives with these being appropriately prioritised or the authority being given necessary discretion to determine how they should be balanced in practice. The principal possible objectives have already been referred to in Section 6(4)(e) and section 7(2)(c) above.

(b) Structure

The system must either operate on the basis of a single or multiple agency basis with an appropriate degree of division of function been specified where more than one agency is involved. Whichever model is selected, an appropriate set of oversight and accountability mechanisms must be adopted as discussed in Section 7(3) above. Where a multiple agency system is to be used for other necessary contact, consultation, co-operation, exchange of information and coordination of action procedures must also be set up.

(c) Scope or Tools

Regulatory systems can operate at a number of different levels, depending on the degree of active oversight and supervision desired. Five general options or degrees of intervention can be distinguished with an appropriate mix been selected in any particular case:

(i) Full **Authorisation** or **Licensing** for all regulated firms or businesses operating on an individual basis;
(ii) A **Permission** requirement for each of the particular financial activities to be carried out;
(iii) Individuals may be separately **Approved** such as with the UK Approved persons regime imposed under s59 FSMA;
(iv) Stock market and exchanges can be separately **Recognised** such as under Part UK FSMA;
(iv) Less formal **Registration** or simple **Notification** systems without onerous conditions may also be used in areas where a full regulatory system is not considered necessary.

A dual Authorisation and Permission regime was set up in the UK under ss19 and 20 FSMA partly as this is a single regulatory system and partly as firms from other EU countries are already pre-authorised under relevant European financial directives. All firms are required authorised under s19 FSMA but with the specific activities that they are entitled to carry on been set out in their separate permission listing under s20 FSMA. European firms are authorised under Schedules 3 and 4 provided that they comply with certain notification requirements and only otherwise have to confirm that they have the necessary permission from their home country failing which they would have to apply to the FSA to have this extended.

(d) Source

Regulatory obligations can be imposed through a number of different sources as has already been referred to. A number of overlapping masures are generally adopted in practice in most countries depending upon local practices and traditions. The principal options are:

(i) A financial **Law** or **statute**;
(ii) **Secondary legislation** (referred to as the Statutory Instruments in the UK);
(iii) Financial **rules** under a delegated power to the regulatory agency usually supported by a separate power to issue guidance;
(iv) Financial **principles** to impose more general standards of good conduct;
(v) Individual regulatory **decisions** or **administrative** actions.

The UK regulatory system operates through the statutory FSMA with a large number of separate Statutory Instruments being issued under the FSMA. The core agencies, roles and functions, powers and authority and offences and remedies are dealt with under FSMA. Some important provisions are defined (such as the full list of ‘regulated activities’ and exemptions) with its of coming into force (commencement) and repeals been dealt with through separate statutory instruments. The FSA has issued a separate integrated Handbook of Rules and Guidance under ss138 and 157 FSMA which also includes certain general principles or high level standards such as the 11 Principles for Businesses included within the PRIN section of the Handbook (available http://www.fsa.gov.uk/pages/handbook/). The 11 Principles in PRIN impose basic standards of financial institutions with regard to Integrity; Skill, care and diligence; Management and control; Financial prudence; Market conduct; Customers' interests; Communications with clients; Conflicts of interest; Customers: relationships of trust; Clients' assets; Relations with regulators.

(e) Content

A number of basic regulatory obligations have to be imposed under the mix of laws, instruments, rules and guidance and principles adopted. These provisions can generally be considered to be made up of a mixture of Financial rules, Conduct rules and Market rules, as well as supplementary Resolution and Support or Oversight rules.

(i) Financial Rules

Financial entry rules are concerned with controlling the quality of the institutions like to operate in a particular marketplace. As discussed, market entry requirements are essentially based on initial Authorisation (licensing or entry conditions), continuing Supervision (based on the filing and submission of continuing returns, reports and relations (through management and regulatory meetings) as well as special visits and inspections) and Enforcement in the event

of breach (including sanction in the form of fine or censure as well as restriction or cancellation of authorisations or other protective measures such as injunctions or freezing orders).

The most important initial authorisation and continuing supervisory obligations are based on minimum capital and liquidity requirements the purpose of which is to protect the solvency of the institution from trading losses. Capital adequacy creates a reserve on the liability side of the balance sheet principally made up of paid-up share capital and retained earnings, as well as other items such as disclosed and underscores reserves, revaluation reserves (property of foreign exchange), general provisions, hybrid capital instruments and minimum five-year subordinated debt. Core tier 1 capital consists of paid-up share capital and retained earnings with tier 1 also including disclosed reserves and all other items falling within tier 2. Banks must maintain under the Basel Committee on Banking Supervision's Basel I rules a minimum capital to risk adjusted assets ratio of 8% with 4% tier 1 and 4% tier 2 including 2% core tier 1 capital. The Basel Committee had also created three separate Pillars of Standardised charges, Supervisory review and enhanced Market discipline under its Basel II rules in July 2004 which were further strengthened under Basel III in December 2010. The work of the Basel Committee is considered further in Section 9 below.

Liquidity rules require banks to hold a certain proportion of items on the asset side of the balance sheet in a highly liquid form generally either consisting of cash or government securities that can be disposed of quickly. While banks generally kept liquid reserves of around 30% historically, this fell to between 1-3% just before the financial crisis, mainly due to the ability of banks to borrow short-term funds on the interbank markets. Liquidity rules have been tightened substantially since with the Basel Committee specifically introducing a new minimum Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) as part of its Basel III package of measures agreed in December 2010.

(ii) Conduct Rules

Conduct rules are concerned with ensuring that market participants (firms and individuals) operate in accordance with relevant accepted standards. These consist of basic criminal laws (including prohibitions on theft, fraud and insider trading) as well as supporting civil law remedies (such as penalties for market abuse, misrepresentation and statutory damages). More specific 'conduct of business' (COB) rules will also be imposed in more complex sectors such as in the securities area where firms have to manage difficult firm/client and inter-client conflicts of interest. The current main UK conduct of business rules are set out in the revised Conduct of Business Sourcebook (COBS) contained in the Financial Services Authority's (FSA) Handbook of Rules and Guidance as amended by relevant European provision. A separate insurance conduct of business (ICOB) has also been adopted recently.

(iii) Market Rules

Market rules deal with the structure and operation of specific formal markets. These include provisions in connection with primary debt or share listing, subsequent secondary trading or dealing and the clearing and settlement of trades. Clearing refers to the netting or offsetting of multiple sales and purchases in the same stock during the trading period to produce a net final amount due. Settlement refers to the actual exchange of cash and security on the agreed settlement date which generally takes place within three days of the trade (T+3) under best global practice.

(iv) Market Resolution

While financial laws initially govern market entry through authorisation, supervision and enforcement (above), they must also deal with the exit of financial institutions from the markets. Market exit rules are concerned with the realisation of assets within a failed institution (generally based on winding up and insolvency laws) and other liabilities or claims resolution (through appropriate complaints, compensation (deposit protection or insurance) and other corrective action powers on behalf of the relevant recovery agent in the event of the firm's closure and insolvency).

A considerable degree of attention has focused on the resolution of banks and other financial institutions following the financial crisis. Special procedures must be in place to deal with financial banks and institutions in difficulty. This can either be achieved through internal Reconstruction and Recovery Plans (RRPS or 'Living Wills' in the UK or 'Funeral Plans' in the US) or formal resolution powers available to the regulatory authority or separate public entity (referred to as the Special Resolution Regime in the UK or SRR). RRPs can be designed to include capital on liquidity support, additional funds through asset, business or subsidiary disposals or the larger restructuring of an institution including ultimate winding down and closure.

Equivalent statutory powers are conferred on the authorities under an SRR which allows them to restructure the institution in the event that the RRP fails. While special powers were available to the Federal Deposit Insurance Corporation (FDIC), few countries maintained necessary formal resolution powers before the global financial crisis and only relied on more general corporate administration or bankruptcy laws. A number of statutes have since been adopted to create effective SRR procedures such as under the Banking Act 2009 UK, which includes a special Bank Administration Procedure (BAP) and amended Bank Insolvency Procedure (BIP) with three SRR options of private acquisition, temporary 'bridge bank' transfer or public acquisition (nationalisation).

(v) Market Support and Oversight

While all of these financial, conduct, market and resolution rules are designed to ensure that markets operate in an effective and stable manner on a continuing basis, additional reserve, support or corrective mechanisms must also be maintained. Financial regulation can be considered to be involved with limiting risk and exposure within a market with external support also being required when the stability of the market as a whole may be threatened. Compensation for specific financial consumers (bank depositors, security investors and insurance policyholders) is dealt with through some form of deposit protection or insurance which guarantees minimum payments in the event of the collapse of the institution involved. Where the stability of the banking system more generally is threatened, the central bank will provide separate emergency assistance to banks in need of funds. The central bank will then act as a form of 'lender of last resort' (LLR) to the banking system. A 'moral hazard' danger nevertheless arises in that banks may then take excessive risk in reliance on the emergency funds being available.

A series of LLR rules were developed during the 19th century to attempt to deal with this. These were clarified and restated in the writings of the famous economist Walter Bagehot in a collective series of papers published as *Lombard Street* in 1873 (reissued in 1999 by Wiley Investment Classics). Under Bagehot's 'rules', emergency funding should only be made available where a bank is experiencing liquidity rather than solvency difficulties with funds only being provided on a penal basis either at high interest rates or on substantial collateral to act as a disincentive to reliance and

risk taking (moral hazard). Funding can only be made available to insolvent banks where the collapse of the particular institution may otherwise threaten the stability of financial system through contagion.

These traditional LLR rules also generally only apply with regard to banks with emergency funding not officially being made available to securities firms, insurance undertakings or other financial institutions. A reserve facility was nevertheless provided for in the US under the Federal Reserve Act 1913. The authorities have rarely considered using this until the most recent credit crisis during which it was accepted that funds may have to be made available to securities firms. The effect of the integration of financial markets and construction of more complex financial groups has required that traditional LLR rules have had to be reconsidered. It may be that funds are still only made available through banking markets although these can then be redistributed within larger groups and across financial sectors. A number of more specific but still significant extensions to traditional UK LLR practice also occurred following the emergency support provided to Northern Rock by the Bank of England beginning on 14 September 2007.

Authorities have also since the global financial crisis developed new Macro-prudential oversight systems to allow them to monitor the financial system and economy as a whole to identify any emerging risks of exposures. Through the specific new institutions have been created with the Financial Services Oversight Council (FSOC) in the US, the European Systemic Risk Board (ESRB) in the EU and Financial Policy Committee (FPC) within the Bank of England in the UK, which replaced the earlier Council for Financial Stability (CFS) set out immediately after the crisis. Each of these bodies is developing new procedures for the collection and examination of market information and data and appropriate tools to deal with emerging threats to the stability of the financial system.

(5) Regulatory Adjustment

Modern financial regulation has become considerably more complex in recent years, especially as a result of all of the changes that have taken place in markets and supporting computer and telecommunications technology. This has affected regulatory practice in countries in different ways although a number of more general changes and trends can be identified. These are clearly visible in the UK which has constructed a particularly sophisticated and integrated regulatory model. The following trends can be identified within the new UK regulatory system:

(a) The regulatory system has become increasingly '**risk based'** as regulatory objectives are targeted to secure a large number of key risks or exposures;

(b) The system has become increasingly **rules** (rather than law or statute) based and then more **principles** based with consequent improvements in terms of flexibility, speed of adaptation and the promotion of a more generally compliance culture although this has to be balanced against concerns of increased uncertainty, enforceability abuse and consequent legality issues;

(c) The regime has become more clearly **objectives** based with a number of parallel purposes or targets being pursued at the same time (including financial stability, capability, efficiency, competition, innovation, effectiveness, conduct, crime, ethics and contribution);

(d) The adoption of rules and principles are based on a new '**Better Regulation'** procedure which includes:

   (i) Full consultation;
   (ii) Maximum transparency;
   (iii) Conduct of a full cost benefit analysis;
   (iv) Completion of a proper competition analysis; and
   (v) Respect for necessity and proportionality.

(e) Modern financial regulation had become increasingly **market based** with a reliance on market solutions as regulators had moved from more traditional regulatory intervention to firm self-assessment and compliance although this has then been tightened again following the global financial crisis as part of the larger **re-regulation** of financial markets .

We are beginning to see the emergence of a new national, regional and international regulatory agenda based on these new trends. There is a new complexity and sophistication in modern financial relations, policy and control which reflects concerns with the need to protect the continuing stability of financial markets within an increasingly single integrated and interdependent global marketplace and limit the costs of crisis and collapse.

8. FINANCIAL CRISIS

Financial crises may arise where firms fail to manage their risk effectively or some other source of external instability arises and the stability of a particular sector or market are threatened. A financial crisis may be considered to arise where there has been a major interference or disruption with the operation of a particular market or system. This is distinct from more general market volatility or specific scandals which affect a particular firm. A financial crisis generally only arises where one or more markets or systems are threatened more generally.

(1) Financial Crises

Markets are inherently cyclic and unstable. They have been a number of significant crises historically going back to. Tulip Mania in the 1600s, the South Sea Bubble and Mississippi Bubble in the 1700s and Railway Mania in the 1800s. More recent examples include the Mexican and Russian defaults in the early 1990s.International markets sustained significant losses following the 1997 Asian crisis beginning with the collapse in the value of the Thai bhat in July 1997 and then with the crisis in the Long-Term Capital-Management (LTCM) in 1998 which had to be supported by a number of other institutions. There was also a fall in stock market prices following the end of the technological ‘bubble’ in 2000 and then after the terrorist attacks on 9.11.2001 although no major continuing damage was sustained.

Significant examples of over financial crisis include:

(a) The 1929 stock market crash in New York which led to the Great Depression during the early 1930s;

(b) The collapse of the Bretton Woods system of managed exchange rates beginning in August 1971 with the announcement of the closure of the Gold Window by President Richard Nixon and the move to floating currencies after the failure of the major countries to agree any alternative replacement system (above);

(c) The Third World Debt Crisis during the early 1980s beginning with the declaration of the Mexican moratorium in August 1982 which triggered a number of forced restructurings and reschedulings as well as the later

'Mexican Peso' crisis in 1994 with the G7 having to provide a US$40bn support package through the IMF (above);

(d) The Asian Financial Crisis beginning on 2 July 1997 with the collapse of the Thai baht which spread to Malaysia, Indonesia and The Philippines as well as South Korea and Japan and with the IMF having to arrange a total support package of over US$100bn (above); and

(e) The Russian debt crisis beginning in May 1998 with a collapse in the value of the rouble and short-term interest rates being raised to 150% and US$40bn of outstanding treasury securities being restructured (above).

(2) Financial Scandals

The reputation and credibility of financial markets has also suffered in recent times following a number of high profile scandals and crises. Although few created larger systemic threats, damage was sustained to the credibility and viability of specific firms and to the attractiveness of investment for smaller corporate or individual investors. Specific instances of more recent scandal include the following:

(a) The provision of a support package by 14 of the largest US financial institutions to the hedge fund Long-Term Capital Management (LCTM) in summer 1998 which had leveraged its US$4.8bn equity to US$125bn;

(b) The closure of the Bank of Credit and Commerce International (BCCI) in July 1991 following confirmation that BCCI had been involved in money laundering in Florida and had committed fraud in the UK with its founder Agha Hassan Abedi dying in 1995 before he could be extradited and with his co-founder Suraleh Naquvi and with 13 other executives being convicted of fraud in Abu Dhabi;

(c) Orange County, California lost US$1.7bn in 1994 through speculative investment by its Treasurer Robert Citron using the County's US$7.4bn investment pool and US$13bn in borrowing with Merrill Lynch later agreeing to pay US$400m;

(d) Barings Bank was sold to the Dutch bank ING for £1 in February 1995 after its derivatives trader Nick Leeson lost £830m (US$1.3bn) in arbitraging Nikkei 225 Index contracts between Osaka and Singapore and after the Bank of England and other banks refused to provide any support;

(e) Daiwa Bank lost US$1.1bn in unauthorised trading in US Treasury bonds by Toshihide Iguchi in its New York branch;

(f) Sumitomo Corporation lost US$3bn after its corporate trader Yasuo Hamanaka had tried to manipulate the world copper market in 1996;

(g) Morgan Grenfell Asset Management (MGAM) made substantial losses in 1996 through its fund manager Peter Young who had been investing in unquoted high technology stock with its parent Deutsche Bank having to pay £230m (US$380bn) in compensation;

(h) Leading Japanese securities houses were found to have made payments in response to blackmail threats (*sokayia*) to *Yakusa* gangs with Nomura being implicated in 1991 which forced the resignation of the Finance Minister Ryutaro Hashimoto and with Nomura, Dai-Ichi Kangyo Bank, Daiwa Securities and Nikko Securities being implicated again in 1997 (with 58 senior executives resigning) and with Yamaichi Securities collapsing in November 1997.

(3) Global Financial Crisis

Markets have again been rocked with the global financial crisis beginning in summer 2007. Markets had enjoyed substantial growth and sustained increase in earnings during the 'bull' conditions between 2003 and 2007. This was only halted with the tightening in credit conditions that arose during summer 2007 following the tightening of conditions on international inter-bank markets after the losses sustained by a number of smaller specialist vehicles in the US sub-prime mortgage market. The stability of the larger banks was never threatened although a number of more specialist 'conduits' or specialist investment vehicles (SIVs) had to be closed or supported at the same time as losses were suffered by a number of hedge funds which either had to be re-capitalised or folded.

The crisis became significantly more serious during summer 2008 following the difficulties experienced at the Government Sponsored Entities (GSEs) Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation), with both GSEs being put into conservatorship on 6 September 2008 and the government been forced to provide US$100 of billions of support for each. The US authorities also decided to support American International Group (AIG) with $85billion later on 16 September but decided to force Lehman Brothers on 15 September 2008. While JP Morgan Chase had purchased the Bear Stearns on 14 March 2008 with a $25 facility from the Federal Reserve and Bank of America acquired Merrill Lynch on 14 September, a number of other institutions had to close including Washington Mutual (WaMu) on 25 September 2008. The failure of Lehman's, in particular, led to massive instability in global stock markets, which persisted until early October, with the UK government announcing a three .support plan based on market liquidity, wholesale market guarantees and recapitalisation on Wednesday 8 October 2008. The significant dislocation in the market nevertheless resulted in a Global Recession which persisted until 2010/2011.

A large number of papers have been issued on the causes of the crisis. This can be considered in a number of different ways. Five key general factors may nevertheless be identified:

(a) Massive accumulation of **credit** and **debt** by governments, companies and households with financial institutions becoming over-leverage;
(b) Excessive innovation leading to overly complex financial products and opaque wholesale markets which undermined **transparency** before and during the crisis;
(c) Failure of **risk management** and **governance** within financial institutions and overdependence on external counter parties including Credit Ratings Agencies (CRAs) which mispriced risk;
(d) **Mixing** of low with high risk products with contagion and collapse in confidence undermining whole asset classes including specifically CDOs and structured finance;
(e) Authorities lacked the necessary **resolution tools** to deal with individual institutions and **support mechanisms** for larger markets.

These can be summarised in terms of monetary policy or central bank failure, innovation or product failure, firm management and governance failure, market failure and regulatory and central bank support failure.

(4) Global Crisis Response

A large number of papers were issued by various official and private bodies following the crisis to attempt to understand what had happened and to draw necessary lessons. These include by the Financial Stability Forum (which was renamed the Financial Stability Board (FSB)), the G20, the G30, an EU High Level Group (under Jacques de Larosiere) and Lord Adair Turner in the UK.

A series of significant corrective actions have also been taken at the national level in many countries to attempt to contain the damage caused and prevent similar crises in future. This included developing a number of new liquidity support facilities within the US, agreeing a $700 billion Troubled Asset Recovery Programme, the bail-out initiatives under the Emergency Economic Stabilization Act of 2008 and monetary stimulus Quantitative Easing (QE) beging in November 2008 and again in August 2010. This was followed by the adoption of the 638 page Dodd Frank Act in 2010 with 1,601 sections and 243 new rules, 61 studies and 22 periodic reports to follow.

A number of papers were issued by the Tripartite Authorities in the UK (made up of the Bank of England, Treasury and FSA) and with the government having to nationalise Northern Rock on 17 February 2008 after attempting to secure a private market solution with bids having been submitted by Virgin, Olivant and an internal management group. This led directly to the adoption of a range of new resolution mechanisms under the Special Resolution Regime (SRR) set up under the Banking Act 2009. The FSA was also forced to put in place a Supervisory Enhancement Programme (SEP) following its supervisory failure of Northern Rock and the strong criticism he received. A number of other Parliamentary papers commenting on regulatory matters, were issued and, in particular, by the Treasury Select Committee under John McFall and then Andrew Tyrie following the General Election in May 2010.

A series of measures will have to be adopted in each of the areas of monetary policy, risk management and governance, pricing and credit ratings, resolution and market support and larger macro-prudential oversight. This was not simply a bank or banking sector issue with the whole of the financial system having been affected and with consequent necessary action having to be taken by central banks, regulatory authorities, governments, corporate bodies and households as well as financial institutions. The underlying objective should be to ensure that markets operate in a stable and effective manner and provide maximum advantage. In so doing, regulatory reform should be targeted, proportionate and constructive rather than simplistic, excessive and destructive.

(5) Regulatory Adjustment

The effect of the Global Financial Crisis has been to create a powerful new degree of political and public impetus and pressure to re-examine and reconsider the nature of modern financial markets financial risk, and financial regulation. Earlier assumptions regard to the efficiency of markets, ability of firms to consider and protect their own interests and the effectiveness of regulatory regimes and capacity of authorities to oversee firms and limit contagion where it arises have had to be wholly reassessed. We are now at the beginning of a new era in financial market oversight and control. It has also taken several years since the crisis to examine and consult on possible new regulatory measures and tools with the new capital requirements and Basel III only been agreed in December 2010 and with a number of for other important matters still to be finalised in 2011 (such as on Systemically Important Financial Institutions (SIFIs) and Globally Systemically Important Financial Institutions (G-SIFIs). All of this will be considered in further detail at international, European and national levels in later Modules.

9. INTERNATIONAL BANKING AND FINANCIAL REGULATION

Many national banking and financial laws are based on international standards agreed at the international level through various technical committees. The main body in the banking area is the Basel Committee on Banking Supervision which was set up in 1974 and is based at the offices of the Bank for International Settlements (BIS) in Basel, Switzerland. The technical committees in other key financial sectors are considered separately subsequently The significance of the measures adopted is that they are have been prepared by technical committees made up of representatives from the national authorities in the largest financial centres in cooperation with officials from emerging markets. They have then able to produce expert and technically relevant papers although only in the form of informal standards (sometimes referred to as ‘soft law’) rather than formal international laws, treaties or conventions which would have been highly difficult to agree in light of the sensitivity of the matters covered and differences in underlying national laws and practices. These standards are then dependent on national adoption and implementation or transplantation through such regional systems as the EU.

(a) Bretton Woods

The Basel Committee was set up in September 1974 following the collapse of the Bretton Woods system of managed exchange rates which had stabilised international currencies since the end of the Second World War. All of the currencies had been fixed to the dollar with the dollar being fixed to gold at US$35 per ounce. President Richard Nixon announced the closure of the ‘Gold Window’ in a radio address on 15 August 1971 which led to the abandonment of the fixed exchange rate mechanism and move to floating currencies. This resulted in substantial losses to many international banks with market instability arising in the US especially with the closure of the Franklin National in summer 1974 and Bankhaus Herstatt in Cologne, Germany on 26 June 1974. This led to a crisis in the international

financial system with the G10 having to issue a support Communiqué in September 1974 and with the Basel Committee being set up to attempt to develop international standards and practices to prevent similar crises arising in future.

(b) Basel Committee Supervisory Programme

The Committee initially prepared a series of general standards to improve the cross-border supervision of major banking groups. These were based on an allocation of supervisory responsibility between the parent and host authorities and for the exchange of information and co-operation and co-ordination of action. A *First Concordat* was issued in 1974 following the Bankhaus Herstatt crisis. A *Revised Concordat* was produced in 1983 after the collapse of Banco Ambrosiano in Italy with a further *Information Supplement* being released in 1990. A set of absolute minimum provisions was then created under the 1992 *Statement of Minimum Standards* following the closure of BCCI in July 1991 with a further *Report on the Implementation of Minimum Standards* in 1996.

(c) Basel I, II and III

While the Committee had not originally been set up to produce regulatory standards rather than supervisory principles, it began to consider the issue during the early 1980s following the Third World Debt Crisis beginning in Mexico in 1982. The Committee recognised that the capital standards of international banks had fallen to dangerously low levels with the US and UK authorities agreeing a separate *Bilateral Capital* Accord in 1986. This was presented to the Committee with the threat of applying this to all banks in New York and London unless the Committee produced its own global standards. The Committee released a first *Basel I* Capital Accord in July 1988 which established the 8% minimum capital to risk adjusted assets ratio calculated on the basis of government and corporate borrowers from OECD or non-OECD countries. (Cash is generally given a 0% weighting, OECD debt in the local currency 10%, non-OECD debt 20%, secured lending 50% and all other borrowing 100% with all items on a bank's balance sheet being multiplied by these ratios to create a lower 'risk-adjusted figure' and with separate rules applying with regard to the conversion of off-balance sheet items into on-balance sheet equivalent values.)

Despite its non-legally binding nature, these provisions were accepted as the de facto global standards for a decade despite their simplicity and only crude approximation of actual risk. The Basel Committee agreed separate international standards for capital for securities activities under its 1986 Market Risk Amendment which were generally based on the EU Capital Adequacy Directive 1993 (93/6/EEC of 15 March 1993).

A revised set of Basel II standards was subsequently agreed in July 2004 after five years of negotiation to create a more sophisticated and risk sensitive measurement framework. This was based on three Pillars with minimum capital requirements in Pillar 1 (for credit risk, market risk and a new operational risk charge), Minimum supervisory review standards in Pillar 2 and Market discipline (based on market disclosure) in Pillar 3. The 8% minimum figure was retained within Pillar 1 although this was made more risk sensitive using the ratings produced by approved Credit Rating Agencies (CRAs) and with alternative Foundation and Advanced Internal Ratings Base (IRB) methods being provided for more sophisticated institutions using banks' internal rather than external CRA ratings. Basel II was much more risk sensitive although problems remained with regard to the low capital levels permitted under the market risk trading book sections for securities activities and for specific operations, such as securitisation. Basel II was implemented in the EU under the Capital Requirements Directive in 2006 (2006/48/EC of 14 June 2006) although it had not been implemented fully in many countries before the global financial crisis beginning in summer 2007.

The most recent Basel III requirements were agreed after the global financial crisis by the Committee in December 2010. This generally provides for the core tier 1 (CET1) capital figure of 2% to be increased to 4.5% with a separate Conservation Buffer of 2.5% which increases this to 7% (section 9(1)(e) below). A discretionary counter-cyclical buffer of between 0-2.5% is to be applied with a further systemic buffer of around 2-3% to follow after final agreement by the Financial Stability Board in 2011. A separate leverage ratio (of 3% tier 1 capital) is also to be imposed with two new liquidity ratios for the first time (the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)).

(d) Core Principles for Effective Banking Supervision

While the Basel Committee's work had generally either focused on supervisory or regulatory matters until the mid-1990s, the Committee was directed by the G7/8 governments to prepare a fully integrated set of *Core Principles for Effective Banking* following the Asian Financial Crisis beginning in Thailand in July 1997. 25 Core Principles were subsequently produced in September 1997 and then revised in October 2006. A separate implementation of the *Core Principles Methodology* was produced in October 1999 and then reissued in October 2006. The Core Principles were significant in that they combined supervisory and regulatory matters, were designed to apply at the national and cross-border levels and applied to G10 and non-G10 country banks. They also became the model for other similar sets of core principles in other sectors including securities, insurance and payment and settlement.

(e) International Financial Crisis Response

The Basel Committee standards were criticised following the global financial crisis for allowing banks to maintain inadequately low levels of capital and with no international liquidity standards having been agreed. The Committee produced over 30 documents following the crisis in a number of core areas (Section 9(1)(c) above). The most important result was the Basel III capital amendments agreed in December 2010 with supporting new global liquidity standards with a minimum Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). The main difficulty was the delayed eight year implementation period until 2018. The Basel III capital rules consist of:

(a) Core tier 1 capital (essentially paid up share capital and retained earnings) is increased from 2% to 4.5%;
(b) Supplemented by a protective Conservation Buffer of 2.5% which increases the core tier 1 ratio to 7%:
(c) A discretionary 0-2.5% counter-cyclical buffer (to be applied during 'boom' periods when markets were rising to create additional capital reserves);
(d) A further Systemic Risk buffer of approximately 2-3% for larger banks and financial groups which create additional systemic risks (referred to as 'Systemically Important Financial Institutions' (SIFIs) or 'Global SIFIs' (G-SIFIs)); and
(e) A new 3% tier 1 leverage ratio.

The Committee has also developed a number of other sets of basic principles in key areas related to the global financial crisis as part of its larger crisis response. The most important other documents include:

(a) Nineteen principles on bank governance and supervisory oversight under the *Principles for Enhancing Corporate Governance* (March 2010);

(b) Nine principles on remuneration under *Compensation Principles and Standards Assessment Methodology* (January 2010) with a further *Range of Methodologies for Risk and Performance Alignment of Remuneration* (May 2011);

(c) Ten recommendations on *Cross-border Bank Resolution* (March 2010);

(d) Eight principles on the operation of *Good Practice Principles on Supervisory Colleges* (October 2010); and

(e) The Committee has also attempted to include a macro-prudential oversight component within its Basel III framework under *The Basel Committee's Response to the Financial Crisis: Report to the G20* (October 2010).

The Committee has been criticised for the length of the time that it has taken to produce its crisis response documents and for succumbing both to industry lobbying and to government pressure, such as with the delayed implementation period until 2019. The Committee has nevertheless had to conduct a full and proper consultation process and take into account all relevant opinions. The Committee has consequently produced a targeted, informed, balanced and proportionate as well as inclusive and co-operative new agenda which includes measures in all key post- crisis reform areas within the scope of the Committee's competence and mandate.

10. EUROPEAN BANKING AND FINANCIAL REGULATION

The European Union represents the most developed and sophisticated system of regional integration attempted in the world at this time. This is based on a Single Market in goods and services which includes a specific banking and financial services programme. This is principally founded on the recast Banking Consolidation Directive (BCD) 2006/48/EC and Markets in Financial Instruments Directive (MiFID) 2004/13/EC. The BCD will be further amended to give effect to Basel III (CRDIV) with the MiFID being replaced by a MiFID II. European integration is based on the idea of economic functionalism with the directives in the banking and financial area being based on the three core concepts of Mutual Recognition (MR), Minimum Harmonisation (MH) and Home Country Control (HCC). The objective of all of these directives is to create a common or single passport system for all financial institutions which allows them to provide services in all Member States of the EU. The EU programme is being further amended and extended as part of the EU's post-crisis response and economic recovery policy.

(a) European Union

The EU has been constructed incrementally through a series of international treaties beginning with the European Coal and Steel Community (ECSC) in 1951 and European Economic Community (EEC) Treaty and EURATOM Treaty in 1958. These were integrated under the Treaty on European Union Treaty 1993 in Maastricht which created the three pillars consisting of the European Community (the EEC, ECSC and EURATOM) and a new Common Foreign and Security Policy (CFSP) and Justice and Home Affairs Policy (JHAP). This was subsequently revised and extended under the Treaty of Amsterdam 1999, Treaty of Nice 2000 and Treaty of Lisbon 2007.

The Treaties provided for the establishment of a number of European institutions including the European Council, European Commission, European Parliament (with direct elections from June 2004) and the European Court of Justice. Banking and insurance were included within the original General Programmes produced under the EEC (and later EC)

Treaty which were intended to remove all obstacles to do free movement of services and establishment through implementing directives.

The free movement of capital was also provided for under the EEC Treaty although a series of 'standstill' provisions were agreed and incorporated into the implementing directives which delayed this coming into effect the late 1980s as part of the 'Single Market' or '1992 Programme' which was provided for under a 1985 White Paper prepared by Commission President, Jacques Delors, and the UK Commissioner Lord Cockfield.

(b) European Integration

European integration policy is based on economic functionalism. This involves the pursuit of a narrow target objective the successful completion of which allows wider cooperation to be secured in other areas. European functional integration was initially achieved through the creation of the European Coal and Steel Community under the ECSC Treaty which was later extended to include nuclear energy and a Common Market under the EURATOM and EEC Treaties. This was further extended under the Maastricht Treaty which provided for European Monetary Union (EMU) with the additional pillars on CFSP and JHAP and then later treaties.

The European institutions initially attempted to agree necessary directives under a policy of full harmonisation during the 1960s and 1970s although this was unsuccessful principally due to differences in underlying laws. A more limited 'Minimum Harmonisation' (MH) approach was developed during the early 1980s following the famous decision in *Cassis de Dijon* in 1979 and a Commission Communication on the importance of the decision in securing mutual recognition in 1980. This policy was incorporated into the Commission's White Paper in 1985 on *Completing the Internal Market* with supporting Treaty amendments been effected under a Single European Act 1986. Mutual recognition operates on the basis of each European Member State respecting the validity of the laws of each other provided that they comply with certain agreed minimum harmonisation (MH) standards and with supervision and compliance being secured on a home country control (HCC) basis.

(c) European Banking and Financial Markets

A First Banking Directive (FBD) was agreed in 1975 which came into effect in 1977. This followed rejection of an earlier full draft harmonisation directive on a German-Dutch model which the other Member States could not agree to at that time. Following the decision to move from a full harmonisation to a mutual recognition (MR) approach, three major directives were adopted in the banking area in 1989 with the Second Banking Directive (SBD), Solvency Ratio Directive (SRD) and Own Funds Directive (OFD). The SRD and OFD implemented the Basel 1988 Capital Accord within Europe, with the SBD expanding the convergence of European bank regulations begun under the FBD.

A number of other more specific directives were adopted in such areas as consolidated (group) supervision and large (borrower) exposures with other amendments being later agreed. All of these measures were drawn together in a Banking Consolidated Directive (BCD) in 2000 which was amended and reissued as a Recast Banking Consolidated Directive in 2006 to implement Basel II within the EU. This will be amended again under a further Capital Requirements Directive (CRD IV) to give effect to Basel III. Capital requirements for banks and securities firms had already been amended under a CRD II (on large exposures, hybrid capital instruments, securitisation, crisis management and college supervision) and CRD III (dealing with trading book re-securitisation (structured finance) and remuneration).

The list of activities covered by the SBD included all banking and securities functions on a Continental European bank model with the sole exclusion of insurance services. A separate securities directive had to be agreed for such countries as the UK and the Netherlands which had more specialist non-bank securities firms. This led to the adoption of the Investment Services Directive (ISD) in 1993 with a supporting Capital Adequacy Directive (CAD). The ISD was substantially amended subsequently under the Markets in Financial Instruments Directive (MiFID) in 2004 and with a consultation document on a new MiFID II being issued in 2010. A series of 'Three Generations' of directives had also been adopted in the life (assurance) and non-life (contingent liability) insurance areas with a further Solvency II Directive to come into effect by 2013 to create a Basel II equivalent capital regime for insurance companies.

(d) European Consolidation, Revision and Completion

The European banking and financial directives have since been amended on a number of occasions and then consolidated, especially with the BCD 2000 and recast BCD 2006. The European Commission has also undertaken a number of other steps to attempt to ensure the effective operation of the single markets in each of the banking, securities and insurance areas. An original Action Plan was adopted in 1977 with a Financial Services Action Plan (FSAP) in 1998. The Lamfalussy Committee examined the delays that arose in securing securities and capital market integration in 2001 with a four level approach being recommended to correct these. This was based on a series of framework principles, technical implementing measures, strengthened co-operation and effective compliance. The Lamfalussy Committee had identified the micro and macro benefits of a single financial market with five core barriers and eight overarching principles to direct reform. The Commission issued a subsequent series of Progress Reports on its completion work before the financial crisis beginning in September 2007.

(e) European Crisis Response

The EU response to the financial crisis was initially slow and hesitant. A number of Member States, beginning with Ireland and then Germany, had adopted protective measures through increasing domestic deposit protection ceilings to assist national depositors and banks. The European institutions have since adopted a more complete response based on a general Recovery Plan in October and November 2008 (*From Financial Crisis to Recovery: A European Framework for Action* Com (2008) 706 final and *A European Economic Recovery Plan* Com (2008) 800 final). These are generally based on promoting growth and stimulating confidence in the short term and reinforcing competitiveness in the long term.

A number of other more specific measures have been adopted or proposed in the banking and financial areas with new directives in the areas of hedge funds and Alternative Investment Managers and Credit Rating Agencies (CRAs) as well as CRD IV (to implement Basel III) and Solvency II in the insuarance area. Deposit insurance levels have been increased and restrictions imposed on bankers' bonuses. The Commission has been working on strengthening the supervision of cross-border groups through colleges and on ensuring effective bank resolution through the establishment of resolution funds. Communications and cross-border crisis management for banks were issued in November 2009 and on bank resolution funds in May 2010. A bank levy has been proposed and further possible transaction taxes considered.

The opportunity has also been taken to replace the earlier European technical committees in each of the banking, securities and insurance areas with new authorities from January 2011. This has involved establishing a European Banking Authority (EBA), a European Securities and Markets Authority (ESMA) and a European Insurance and Occupational Pensions Authority (EIOPA). These were set up as part of a larger initiative to create a European System of Financial Supervisors (ESFS) with a separate European Systemic Risk Board (ESRB) being set up to conduct macro-prudential oversight of all European markets.

Commissioner Barnier issued ‘Twelve levers to boost growth and strengthen confidence’ in April 2011. The Competition Directorate General (DG) has also issued a number of decisions on state aids and merger control especially in light of the emergency assistance provided by governments to national banks and subsequent consolidation within the financial sector.

11. UK BANKING AND FINANCIAL REGULATION

UK banking markets have historically been supervised by the Bank of England on an informal non-legal basis for centuries. This was referred to as ‘moral suasion’ and reflected the authority and reputation of the Bank in the markets and the relatively tight and closed nature of the British financial system within which all of the major firms and senior individuals were familiar with each other. Statutory regulation was not introduced in the UK until under the Banking Act 1979, which implemented the requirement to create an authorisation system under article 3(1) of the European First Banking Directive (FBD) in1977. The 1979 Act was replaced by the Banking Act 1987 with a single integrated regulatory system then being set up by the Labour Government under the Financial Services and Markets Act (FSMA) 2000 although this is to be dismantled by a Conservative and Liberal Democrat Coalition in 2012/13.

(1) Bank of England

The Bank of England was originally set up following a proposal by the Scottish merchant William Patterson in 1694to raise funds to cover the cost of continuing European wars. The Bank initially competed with the other private and public banks within the UK and only assumed its larger public and government functions over time. The Bank was not formally nationalised until 1944. The Bank carries out the general functions of a central bank in managing monetary policy, holding the government accounts, managing government borrowing and the national debt as well as foreign reserves, providing financial advice to the government and overseeing the payment systems (Section 3(3) above). The Bank only assumed formal responsibility in providing lender of last resort (LLR) support to the banking system after the first Barings crisis in 1890 having earlier allowed banks to fail.

(2) UK Bank Supervision and Moral Suasion

The Bank historically conducted its oversight of the banking and financial system on an informal basis. The Bank obtained information from the banking sector as part of its conduct of monetary policy and developed close relations with all of the key personnel within the main banks. The traditional method of bank supervision of moral suasion relies on the market authority and reputation of the Bank to ensure that banks comply with its directions. This was nevertheless supported by an implied non-legal threat of withdrawal of daily liquidity and emergency financial support. The system of moral suasion was considered to benefit from its judgement, discretionary and personal style of operation in contrast with the much more fixed and formal approached adopted in such other countries as the US with official bank examiners and mandatory supervisory rules.

(3) Banking Acts 1979 and 1987

The system of moral suasion began to break down during the early 1970s following the large influx of overseas banks into the UK which prevented the continued operation of the earlier closed or club style supervision previously used. The adoption of a formal licensing or authorisation system was also required under the FBD with the Bank realising that the creation of a formal system may assist deal with the large number of new overseas banks in London. A first Banking Act was enacted in 1979 which created a two tier system of 'authorised banks' and 'licensed deposit-takers' although this was later abolished under the Banking Act 1987. The 1987 Act was adopted following further crises in the UK including with the £150m rescue of Johnson Matthey which threatened the stability of the London gold market in 1984. Internal supervisory practices were later strengthened again following the closure of BCCI in July 1991 which included dividing the Bank up into separate Monetary Stability and Financial Stability Wings.

Responsibility for bank supervision was transferred from the Bank to the Financial Services Authority (FSA) under the Bank of England Act 1998 in summer 1998 (referred to as N1) in anticipation of the creation of a fully integrated single regulatory system within the UK under the Financial Services and Markets Act (FSMA) 2000, which came into effect in December 2001 (N2). Since then, all UK financial markets and services have been overseen by the single FSA subject to the regulatory requirements set out in its integrated Handbook of Rules and Guidance issued under ss138 and 157 FSMA. The new Coalition Government, which came into power in May 2010, has announced that it will re-transfer financial supervision from the FSA to a new subsidiary of the Bank, the Prudential Regulatory Authority (PRA), with the FSA being replaced by a separate Financial Conduct Authority (FCA). A new Financial Policy Committee (FPC) has also been set up within the Bank which will be responsible for overall financial stability and the conduct of macro-prudential oversight within the UK.

(4) FSA and FSMA

The regulatory system set up under the FSMA operates on a delegated rules basis. Detailed requirements are not set out in the statue but in the Handbook of Rules and Guidance issued by the FSA under ss 138 and 157 FSMA. The objective is to create a system which is so far as possible based on common provisions applicable to all financial firms subject to separate special rules, sourcebooks or guides applicable to particular activities.

All financial institutions have to comply with the High Level Standards in Block One and the common provisions on Authorisation, Supervision and Enforcement which were dealt with under three separate sourcebooks under the Regulatory Processes Block of the Handbook. These included Authorisation (AUTH), Supervision (SUP) and Enforcement (ENF) with a Decision Procedure and Penalties Manual (DEPP). Enforcement was subsequently moved to a separate Enforcement Guide (EG) in the Regulatory Guides Block of the Handbook with Authorisation being covered by separate guides and fact sheets. Firms also have to comply with the three Redress Block manuals governing Dispute Resolution: Complaints (DISP), Compensation (COMP) and Complaints against the FSA (COAF).

Banks are specifically subject to the general provisions set out in the High Level Standards in Block One including the eleven Principles for Businesses (PRIN), Threshold Conditions (COND), Senior Management Arrangements, Systems and Controls (SYSC), Fit and Proper tests for Approved Persons (FIT), Statements of Principle and Code of Practice for Approved Persons (APER) and General Provisions (GEN) as well as new provisions on Financial Stability and Market Confidence (FIN MAR). The main capital, liquidity and prudential requirements are set out in the General Prudential Sourcebook (GENPRU) and Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU) with a separate Prudential sourcebook for Insurers (INSPRU) and UCITS firms (UPRU). The earlier provisions contained in the Banking Codes governing relations between banks and their customers have since been moved to the Banking: Conduct of Business Sourcebook (BCOBS). Conduct of business requirements for banks and securities firms carrying on investment services for clients are set out in the COBS sourcebook with separate sourcebooks on Client Assets (CASS) and Market Conduct (MAR including market conduct, stabilisation and multilateral trading facilities ETFs).
Banks may have to comply with other additional provisions, for example on Electronic Money (ELM) if relevant while firms carrying our securities activities are subject to the Listing Rules (LR), Prospectus Rules (PR) and Disclosure Rules and Transparency Rules (DTR) in the Listing, Prospectus and Disclosure block.

(5) FPA, PRA and FCA

The earlier integrated system set up under the FSMA is being replaced in the 2012 with the new structure based on the Bank of England with its Financial Policy Committee (FPC) and subsidiary Prudential Regulatory Authority (PRA) and a separate Financial Conduct Authority (FCA). Single integrated supervision will still be retained under the new regime insofar as the prudential regulation of all larger systemic firms is dealt with by the PRA but with the supervision of smaller firms being dealt by the FCA. The FCA will also be responsible for market oversight while the Bank will continue to oversee the money payment systems. While this may create some overlap in function and rules, it is hoped that the new system will benefit overall from the improved focus on the financial and systemic stability conducted through the Bank and the FPC.

12. US BANKING AND FINANCIAL REFORM

The course also examines the background and basic structure of the banking and financial system in the US and the responses adopted following the global financial crisis and the emerging shape of the new US regulatory environment. The US regulatory system was principally constructed during the early 1930s as part of the New Deal ('100 Days') programme under President F D Roosevelt after the Stock Market Crash in 1929. The Supreme Court had earlier restricted state and federal regulation as being contrary to the 'Free Commerce' Clause under the Constitution although this had been relaxed through a number of individual decisions during the 1920s. The volume of federal utility regulation expanded substantially after World War II until a more deregulatory approach was followed during the late 1970s and 1980s. This culminated with the Financial Competitiveness (Gramm Leach Bliley) Act 1999 and the Commodity Futures Modernisation Act (CFMA) in 2000 which deregulated the banking and financial and derivatives markets. A substantial programme of re-regulation has since been adopted, or proposed, following the more recent financial crisis in the US and elsewhere. The implications of all of these initiatives are reviewed as part of the course.

(1) US Banking and Financial Regulation

The US system essentially adopts a functional approach to financial regulation with separate agencies being maintained for each principal type of financial activity, including banking, securities and insurance, at both the federal and state levels. This includes the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the, the Office of the Comptroller of the Currency (OCC), National Credit Union Administration (NCUA), the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA) as well as state banking super-intendancies, insurance authorities and Attorneys General, which enforce local 'blue sky' securities laws. Even with deregulatory policies under the Gramm Leach Bliley Act, which allowed the establishment of Financial Holding Companies (FHCs), an essential sector separation policy has been adopted with agencies encouraged to oversee and compete with each other to ensure high standards.

A number of the main statutes were adopted during the 1930s, including the Securities Act 1933 and Securities and Exchange Act 1934 as well as the Banking Act 1935. The Securities Act provided for the establishment of the SEC and principally regulated the market for initial issuance of securities while the 1934 Act governed secondary trading. The Banking Act included the Glass Steagall restrictions on commercial banking and securities activities and provided for the establishment of the Federal Deposit Insurance Corporation (FDIC). A number of other statues were adopted subsequently, including the Federal Deposit Insurance Act of 1950 and the Bank Holding Company Act 1956, as well as a series of re-regulatory and consumer protection measures during the 1970s and 1980s. These were followed by a series of deregulatory statutes in the 1990s, including Gramm Leach Bliley and the CFMA. All of this has since been substantially reformed and strengthened under the most recent Dodd Frank Wall Street and Consumer Protection Act 2010.

(2) US Banking and Financial Reform

The US government published two main reports on agency restructuring following the crisis. Treasury Secretary Hank Paulson published a reform paper under the Bush Administration in 2008 with his *Blueprint for a Modernized Financial Regulatory Structure* which was followed by the report by Timothy Geithner under the Obama Administration on *Financial Regulatory Reform* in June 2009. The 2009 paper accepts that the crisis had many causes and went back decades with five principal sets of recommendations being issued on improved oversight and control of financial firms and markets, consumer protection, financial crisis management and international co-operation with a new Financial Services Oversight Council (FSOC) and Consumer Financial Protection Agency (CFPA) to be established.

The Troubled Asset Relief Program (TARP), which provided for the creation of a US$700bn facility to purchase distressed mortgage backed securities and preferred stock from banks, was set up under the Emergency Economic Stabilisation Act (EESA) 2008. A US$787bn package of measures to promote jobs and investment and consumer spending was also provided under the American Recovery and Reinvestment Act (ARRA) 2009.

(3) US Financial Crisis Inquiry Commission (FCIC)

The independent Financial Crisis Inquiry Commission (FCIC) produced its report on the *Causes of the Financial and Economic Crisis in the United States* in January 2011. This examines the circumstances behind the collapse and losses suffered by the key financial institutions involved as well as the policies adopted by each of the key regulatory authorities. The Report divides the events behind the crisis up into a number of separate stages and summaries its key findings in terms of avoidability, supervisory and regulatory failure, risk management and corporate governance defect, leverage, official fall and ethical failure.

(4) US Senate (Carl Levin) and Valukas Examination Reports

The Permanent Subcommittee on Investigations (PSI) of the US Senate, under Chairman Karl Levin and Ranking Minority Member Tom Coburn, produced its report on *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* in April 2011. This followed two years of investigations beginning in November 2008 into the causes of the crisis. The Report concluded that the crisis was not a natural disaster but the result of high risk complex financial products, credit rating agency error, regulatory failure and undisclosed conflicts of interest within investment firms. After examining the development of US financial markets over the 15 years prior to the crisis and the emergence of large 'too big to fail' (TBTF) institutions, the Report conducted four case studies into the collapse of Washington Mutual Bank (WaMu), the failure of the Office of Thrift Supervision (OTS), the inflated ratings produced by Moody's and Standard & Poor's and perceived failures and conflicts of interest within Deutsche Bank and Goldman Sachs.

A separate report was published by independent Examiner, Anton R Valukas, into the collapse Lehman Brothers Holdings Inc in 11 March 2010. This includes an 'Executive Summary and Procedural Background' (Volume 1) and examination of business and risk management. It also examines issues surrounding valuation and survival (Volume 2), the disputed 'Repo 105' transaction (Volume 3), potential claims against Lehman's secured lenders (including specifically JP Morgan Chase, Citibank and HSBC and others) with Government involvement (Volume 4) and preferences or voidable transfers (Volume 5). The legal issues involved are reviewed in Volume 6 with other ancillary matters in Volume 7 and additional factual information in Volumes 8 and 9.

(5) US Dodd Frank Act Wall Street and Consumer Protection Act 2010

The principal legislative reform enacted in the US was the Dodd Frank Wall Street Reform and Consumer Protection Act which was signed into law by the President on 21 July 2010. This followed a Congressional Conference Report with discussions having been led by Congressman Barney Frank and Christopher Dodd. The Act contains 1,601 sections and 16 separate laws (titles) and extends to over 2,300 pages. It was expected to require 243 new federal rules, 67 studies and 22 periodic reports. The stated objectives of the Act were to promote financial stability, end 'TBTF' and avoid 'bailouts'. The Act provided for the establishment of the FSOC and independent Consumer Financial Protection Bureau (CFPB) (Titles II and X) with the OTS being merged with the OCC and a new Federal Insurance Office (FIO) created (Titles III and V). Large hedge funds would become subject to SEC oversight with restrictions imposed on proprietary trading under the 'Volcker Rule' named after former Federal Reserve Chairman Paul Volker (Titles IV and VII). The Federal Reserve would be able to impose on standards on payment, clearing and settlement systems with a number of amendments being adopted to improve investor protection (Titles VIII and IX).

All of this is examined in further detail subsequently.

12. MODULE REVIEW AND CLOSE

The purpose of this paper has been to review the background, structure, nature, size and function of financial markets. The key financial risks involved have been identified and the design and content of financial regulatory systems which manage these exposures examined. The nature of financial instability has also been discussed and a number of earlier crises and scandals referred to with the most recent global financial crisis being referred to in outline.

The nature and content of international, European UK and US banking financial regulation has also been referred to be fully. Subsequent classes will examine the nature and response to the global financial crisis and then International, EU, UK and US financial regulation in further detail.

We very much hope that you have found this introduction useful and instructive. Additional online reading and external reading lists are provided on QMplus although these are strictly voluntary.

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INTRODUCTION AND COURSE OVERVIEW

BANKING AND FINANCIAL LAW AND REGULATION

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