The Foundations and Future of Financial Regulation

Financial regulation has entered into a new era, as many foundational economic theories and policies supporting the existing infrastructure have been questioned following the financial crisis. This book offers a timely exploration of financial regulation in the aftermath of the crisis in order to map out the future trajectory of regulation in an age where financial stability is being emphasised as a key regulatory objective.

The book is split into four sections: the objectives and regulatory landscape of financial regulation; the regulatory regime for investor protection; the regulatory regime for financial institutional safety and soundness; and macro-prudential supervision. The analysis ranges from theoretical and policy perspectives to comprehensive and critical consideration of financial regulation in the specifics. The book focuses on the substantive regulation of the UK and the EU, within a global context, making comparisons where relevant with the US. Running through the book is the consideration of the relationship between financial regulation, financial stability, institutional structures in the UK, EU and US, and the responsibility of various actors in governance.

This book offers an important contribution to the critical analysis of the role of financial regulation, market discipline and corporate responsibility in the financial sector, and on the roles of regulatory authorities. It will be of interest to academics and students of banking and finance law and comparative economics.

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This is an important work that explains the main theories and doctrines of financial regulation in light of the global credit and financial crisis and proposes new frameworks for analysing the evolving paradigms of financial regulation including macro-prudential regulation. A must read for the academic and policy specialist.

Kern Alexander, Chair for Law and Finance, University of Zurich

Written by two leading experts this book successfully combines cutting edge research in the field of financial regulation theory and practice with scholarly analysis that is quite unprecedented in terms of scope and breadth. It is bound to become one of the definitive works in the field of financial regulation and governance and an indispensable companion to students and practitioners of financial regulation and reform.

Emilios Avgouleas, Chair in International Banking Law and Finance, University of Edinburgh

The future of financial regulation, in the aftermath of the crisis, remains hotly contested. Andenas and Chiu bring an encyclopaedic knowledge of the literature, both economic and legal, to bear in discussing this topic in this book. Their concern is that such developments are likely to remain too much under the control of ‘experts’, especially from the self-interested industry, and continue along prior pathways, rather than be driven by wider, social considerations into more radical reforms.

Charles Goodhart, Professor of Economics, Director of the Financial Regulation Research Programme, London School of Economics

This is an important and timely book. This re-examines the global financial crisis from a governance perspective as well as many of the other core areas of significant regulatory reform including specifically improved micro-regulation and new macro-prudential supervision. The future success of the regulatory reform effects currently underway depend upon the extent to which the substantial residual challenges left in terms of governance and micro and macro financial regulation can be corrected. The overall objective must be to contain systemic risk.

The text is well written, well sourced and well informed. It is critical but constructive. It mixes theory with regulatory practice and need. The book identifies important continuing challenges in terms of regulatory debate and reform and the authors attempt to provide a new insightful and more effective correction agenda. This is an intelligent and subtle but still substantial and valuable addition to the post-crisis discussion and to any post-crisis regulatory library.

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The Foundations and Future of Financial Regulation
Governance for Responsibility

Mads Andenas and Iris H-Y Chiu
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Part 1

The objectives and governance landscape of financial regulation
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1 Introduction

The world of finance has undergone an upheaval since 2008–9 with the onset of the global financial crisis that has largely afflicted the major Western economies. These economies have developed structures of financial supervision and implemented leading standards in financial regulation. Much has been written about the diagnosis of the crisis and the book will not belabour this issue. Taking stock of the post-crisis reforms so far, this book critically analyses the aspects of post-crisis financial regulation that relate to the resurgence in the importance of financial stability. The resurgence in the importance of financial stability has led to an extension of the regulatory net over many hitherto unregulated areas in finance, reforms in micro-prudential and macro-prudential regulation and increasing levels of consumer protection. The surge in regulatory control over finance also allows us to question whether the fundamental premises of financial regulation are changing, to what extent financial regulation may be transformed and whether such transformative effects, if any, will endure.

The global financial crisis, often described as the worst episode since the Great Depression of the 1930s, has potentially brought about a Kuhnian paradigm shift in financial regulation. Although financial regulation serves a number of different objectives, the general character of financial regulation leading up to the global financial crisis was primarily facilitative of market-based governance.


3 Thomas Kuhn, The Structure of Scientific Revolutions (Chicago, IL: University of Chicago Press 1962) on the introduction of the concept of ‘paradigm shifts’.

4 To be explored in detail in Chapter 2.

5 Awrey argues that pre-crisis financial regulation is very much based on market fundamentalism, a belief that the role of regulation is to support markets. One lesson learnt from the crisis is that market fundamentalism causes regulators to ignore market developments that need to be governed,
The crisis has deeply questioned the market’s ability to address severe externalities, as state bailouts have become the norm for failed banks. The authors observe that a concern for financial stability has come to dominate post-crisis financial regulation rhetoric. We will examine to what extent the concept of governing for financial stability will change, ideologically and fundamentally, the character of financial regulation.

As the financial market is transactional in nature, the market itself has often been regarded as the first port of call for solving problems generated in the market. Against the backdrop of neo-liberalism and deregulation that supports financialisation, economic rationale for regulation have become the dominant justifications for regulation. Hence, the role of regulation in financial markets is framed in the economic language of ‘market failure’, such as in cases of regulation to overcome information asymmetry in securities and investment markets and the ‘agency’ problem between investment intermediaries and clients. The role of financial regulation is also to provide ‘public goods’ such as systemic stability, which underpins micro-prudential regulation and deposit guarantee schemes. Such a role may suggest that the regulatory stance adopted for the purposes of maintaining financial stability is more protective or paternalistic in nature. However, regulation purposed towards maintaining financial stability is also couched in the language of economic rationale, ‘public goods’ being defined as goods that are collectively enjoyed by society, but the provision of which is often subject to a collective action problem, and so the state is ultimately looked to in such as the adverse consequences of financial innovation and complexity. See Dan Awrey, ‘Complexity, Innovation and the Regulation of Modern Financial Markets’ (2012) Harvard Business Law Review (forthcoming) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1916649 accessed 7 May 2013.

Cioffi is of the view that the market is dysfunctional, replete with conflicts of interest and asymmetric information that reinforce and exacerbate each other, magnifying governance and market failures, see John W Cioffi, ‘After the Fall: Regulatory Lessons from the Global Financial Crisis’ in David Levi-Faur (ed), Handbook on the Politics of Regulation (Cheltenham: Edward Elgar 2011), 642.

Simon refers to this as a change in regulatory character from an economic ‘optimisation’ stance to a ‘managerialist’ stance where the regulator manages for safety and soundness, goals that are not market-oriented. William H Simon, ‘Optimization and its Discontents in Regulatory Design: Bank Regulation as an Example’ (2010) 4 Regulation & Governance 3.


Gerard A Epstein (ed), Financialisation and the World Economy (Cheltenham: Edward Elgar 2006), especially Chapter 1, ‘Introduction’. The growth of credit and different forms of financial intermediation with new markets has transformed investment and created new international interdependencies.


Such that each individual’s consumption of the good does not lead to a reduction in any other individual’s consumption of that good.
order to supply it.\textsuperscript{13} Regulatory interventions based on economic rationale tend towards being proportionate and favouring efficient solutions that the market can generate. The point of financial regulation is not to assume responsibility for or adversely affect the core intermediation and resource allocation functions of the financial sector.

Hence, the authors are of the view that financial regulation has been intensely pragmatic and is used mainly to resolve market failures generated by the financial services industry. In the UK, the overall framework of regulation up to the 1980s, providing for basic public goods such as enforcement against fraudulent sales of securities and collective investment products\textsuperscript{14} and deposit guarantee protection (which may be seen as a facilitative type of legislative instrument to encourage bank deposits), came into being without being too intrusive for the industry. A regulatory system for authorising and supervising all banking institutions was only established in the Banking Act 1987,\textsuperscript{15} and the conduct of the investment and securities industry was largely self-regulatory, with industry self-regulatory organisations providing rulebooks and discipline to members under a general umbrella of accountability to the Securities and Investments Board.\textsuperscript{16} Developing more general oversight and regulatory frameworks for the financial sector is a recent phenomenon. The major driving forces behind such developments are the functional approach to financial regulation culminating in the creation of the Financial Services Authority (FSA) after the election of the Labour government in 1997 and the increasing legal integration in financial services law in the


\textsuperscript{14} Prevention of Fraud (Investments) Act 1939, 1958. Both these legislative initiatives were in line with legislation adopted in most Western economies at the same time.

\textsuperscript{15} In the UK, banking regulation arguably only started in the late 1970s following the Banking Act 1979, which was in a large part precipitated by the secondary banking crisis from 1973 through to the late 1970s. See Margaret Reid, \textit{The Secondary Banking Crisis, 1973–5} (London: Macmillan 1982). This first Banking Act recognised a top tier of banks as being able to carry on a wide range of deposit and credit business and as enjoying ‘a high reputation and standing in the financial community’, and only subjected other credit institutions to licensing and oversight (Banking Act 1979, sch 2, para 1 and s 2). The reputational determinant of a ‘bank’ could not withstand the continued liberalisation of the financial sector, which would bring less reputable institutions and also foreign institutions such as the BCCI into the community. In 1984, Johnson Matthey, a recognised bank and member of the Gold Ring, failed and was bought by the Bank of England for £1 after sustaining severe losses on its loan book. See Marlene Havranek, ‘The Bank of England and Bank Failures’ (2000) 2 Insolvency Intelligence 73, which contains some discussion of the Johnson Matthey failure. This resulted in the enactment of the Banking Act 1987 that subjected all banks to an authorisation regime, under which the Bank of England had to formally approve a banking business and subjected it to continuing oversight in terms of reporting and prudential obligations. The Bank of England also acquired investigative and enforcement powers over banks, such as the power to revoke an authorisation. See Banking Act 1987, ss 3, 4 and sch 2.

European Union as a means of market integration under the Financial Services Action Plan (FSAP) of 1999.\(^\text{17}\)

One of the major regulatory reforms led by the Labour government after its successful election in 1997 was to introduce a consolidated and unified structure in financial regulation and supervision in the form of the FSA. The FSA had multiple objectives in its financial regulation remit,\(^\text{18}\) and positioned itself as appropriately structured to deal with the increasing consolidation of financial services firms into global financial supermarkets,\(^\text{19}\) offering banking, investment and even insurance services across group operations. Efficacy of oversight and economies of scale were strong supporting arguments for the establishment of the FSA,\(^\text{20}\) although the industry was wary of the growth in both substantive regulation and supervisory oversight that could ensue. Hence, the FSA undertook a risk-based approach to regulation,\(^\text{21}\) which emphasised the proportionality of regulatory interventions and cost-effectiveness in the deployment of regulatory resources. The risk-based approach to regulation since developed into a rather light-handed approach to enforcement,\(^\text{22}\) which was ultimately criticised as contributing to the global financial crisis of 2008–9.

The major push towards exponential growth in substantive financial services regulation has also come from the EU, which sees the legal integration movement...
as supporting market integration. Legal integration is driven by the FSAP 1999 and the fast-tracked legislative process recommended in the Lamfalussy Report 2001 at the EU level.\textsuperscript{23} Substantive laws in product regulation, such as securities\textsuperscript{24} and collective investment products,\textsuperscript{25} have undergone harmonisation. As for financial firms, regulatory harmonisation has taken place in prudential and consolidated supervision in the banking sector, the prudential,\textsuperscript{26} conduct of business and home country control principles in the investment firm sector,\textsuperscript{27} rules dealing with settlement, collateral and clearing,\textsuperscript{28} consumer-facing rules in

\textsuperscript{23} The ‘regulatory convergence’ process in the EU financial services sector prior to 2008 is discussed in Iris H-Y Chiu, \textit{Regulatory Convergence in EU Securities Regulation} (The Hague: Kluwer Law International 2008).


distance marketing of financial services, and rules dealing with the supervision and enforcement of market abuse and financial crime. Pre-crisis, it may be argued that financial regulation was already developing towards \textit{ex ante} safety and protection objectives in view of financialisation across the EU. However, it may also be argued that the main incentives for legal integration have been the pro-business need for legal certainty and legal integration has been rapid thanks to industry support.

The global financial crisis has brought about an opportunity to critically re-examine the character of financial regulation. The Turner Review is of the view that the crisis . . . raises important questions about the intellectual assumptions on which previous regulatory approaches have largely been built. At the core of these assumptions has been the theory of efficient and rational markets . . . these assumptions \textvisiblespace} are now subject to extensive challenge on both theoretical and empirical grounds, with potential implications for the appropriate design of regulation and for the role of regulatory authorities.

The tendency of financial regulation to support market-based governance is now deeply questioned as the crisis is regarded as a failure in market-based governance. There is now emphasis on the reassertion of public regulatory power in governing finance to provide the \textquoteleft public good\textquoteright of financial stability. Kaul on financial collateral arrangements as regards linked systems and credit claims \cite{2009OJL146/37} further support the protection of the actions taken by central counterparties in settlement and finality.


\cite{2005ECDirective2005/60/EC} European Parliament and Council Directive 2005/60/EC of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (Text with EEA relevance) \cite{2005OJL309/15} (Money Laundering Directive), and attendant Commission Directives and Regulations such as on wire transfers, cash controls and so on.


and others\(^{37}\) opine that modern public goods such as financial stability arise from the complexities and interconnections caused by liberalisation and the expansion of private transactional freedoms. Hence, financial stability is a ‘framework’-type public good that is enjoyed by all in order to further private aspirations and utility. De la Torre and Ize\(^{38}\) also argue that the crisis contains lessons that underline the importance of the role of regulation as the financial system could suffer from collective failures of cognition that undermine welfare for the system. However, what does the ‘public good’ of financial stability mean? We suggest that there are two possible interpretations. First, the ‘public good’ of financial stability refers to the economic concept of ‘public goods’ underpinning regulatory matters such as micro-prudential regulation, and the policy emphasis on the ‘public good’ of ‘financial stability’ therefore refers to the impetus on policymakers’ part to supply such public good that has been under-supplied in the pre-crisis years. Second, the ‘public good’ of financial stability may actually mean something different from the economic understanding of ‘public goods’ and refers more closely to the importing of sociopolitical dimensions in construing the needs of financial stability from citizens’ point of view. In which case, the term ‘public good’ would have been used loosely in policy rhetoric but it imports of a change in perspective as to what financial stability means and how such perspective should shape financial regulation.

Beck\(^{39}\) argues that global financial risks inevitably present ‘risk conflicts’ when the private sector engages in risky activities that put increasing numbers at risk of harm. Economists might call these externalities, although the risks may never materialise. Beck calls this ‘organised irresponsibility’, a shifting of risk through deliberate and rational organisation in private spheres. One of the consequences of ‘organised irresponsibility’ is the rise of Beck’s ‘cosmopolitan moment’, where the collective consciousness of society rises up to challenge the situation of ‘irresponsibility’ and frames the discourse not in economic, rational and efficiency terms, but in terms of justice and rights.

In the sphere of post-crisis financial regulation, we are witnessing ‘cosmopolitan moments’ in a number of Occupy movements around the world, in New York, London and Hong Kong. Although these have been forcibly put down after protracted legal proceedings in various places, such as London and Hong Kong, Occupy movements express the view that the social dimension of financial regulation has not gone far enough. It is this social dimension that may shape a new and emerging understanding of ‘public interest’ in regulating finance.


Post-crisis, policymakers have introduced legal reforms that address the immediate problems of the crisis, reasserting regulatory power to provide the public good of financial stability that has been under-supplied pre-crisis. Such legal reforms are underpinned by the meaning of public goods in the economic sense, as mentioned above. We also discern a number of legal reforms that are purposed to deal with more general and prospective issues in regulating finance, such as ‘too big to fail’ and the disconnect between finance and social utility in consumer products. These legal reforms hint of the importation of more fundamental changes in the underlying premises of regulation, and seem to be more based on seeking a realignment of the purposes of finance and public interest in the sociopolitical sense. The post-crisis reforms therefore reflect different strands of ideological underpinnings at work, some reforms continuing along the conventional economic rationale for regulation (although the importance of the public good of financial stability has become more pronounced), while some reforms suggest the potential for more dramatic shifts in the ideology of regulating finance. We will explore the different strands of ideological underpinning at work in three broad areas of substantive law reforms, in investor protection, institutional regulation for safety and soundness and macro-prudential regulation, and argue that it is important to encourage the rise of dialectical processes relating to the different ideological underpinnings in regulating finance. These dialectical processes could allow the ideological premises of regulating finance to be enriched by alternative visions other than economic rationale for regulation and introduce perspectives relating to social justice, rights and distributive welfare.

However, we are aware that several factors are at work that may continue to reinforce the dominance of economic rationale in regulating finance and frame the ‘public good’ of financial stability in the narrower but technically correct sense. First, the alacrity of the post-crisis reforms may have been necessary to bring the crisis under control, but adopting quick reforms may mean that such reforms are not necessarily the product of fundamental changes in normative thinking, but rather readjusted measures that are still based on the same economic rationales for regulation. O’Brien warns that regulatory adjustments post-crisis may tend excessively towards addressing the technical rather than the substantive aspects of risk relating to an area for regulation. See Fiona Haines, *The Paradox of Regulation: What Regulation Can Achieve and What It Cannot* (Cheltenham: Edward Elgar 2011) at chs 2, 3.

40 Conflicting objectives in regulation have been described by Haines as socio-cultural risk and political risk that could potentially be contending with more objective actuarial type assessments of risk relating to an area for regulation. See Fiona Haines, *The Paradox of Regulation: What Regulation Can Achieve and What It Cannot* (Cheltenham: Edward Elgar 2011) at chs 2, 3.


raised in the crisis, such as the wider notions of ‘governance, responsibility, integrity, and accountability’. An examination of the substantive legal reforms reveals approaches that hint of both the importation of fundamental ideological changes to regulating finance, as well as path-dependent approaches that continue in the same grain of pre-crisis financial regulation. Ideological changes need long periods of gestation, reflection and political will. Although a crisis sparks the will to develop new policies, quick responses are required and a number of post-crisis quick responses have taken path-dependent and uncontroversial directions, therefore hemming in the potential for more fundamental changes to take root at an ideological level.

Second, fundamental ideological changes may be better facilitated if international consensus can be achieved and, in this respect, international financial regulation and its premises are still emerging. Third, financial regulation is shaped by the preferences of dominant actors in the regulatory space at any given time. As regulators are inherently limited in terms of resources and national boundaries, a situation that has not fundamentally changed despite the expansion in regulatory remit, regulators continue to rely on the industry and other private sector actors to supply forms of governance. As will be discussed in Chapter 3, the industry remains a dominant actor in shaping financial regulation and has consistently preferred grounding financial regulation in economic rationale as the economic concerns for cost-effectiveness and efficiency provide a brake against over-regulation.

The emergence of a dialectical process in the fundamental premises of regulating finance can however be discerned. The authors observe in substantive law reforms relating to structural regulation (Chapter 11) and consumer protection (Chapter 8) elements of a new ideological premise revolving around the language of ‘financial stability’ in the reframing or reimagining financial regulation.

The authors argue these are encouraging signs and regulators should pave the way for further developing the dialectical process by wider participation in policymaking. We argue that policymakers and regulators should take the lead in developing the platform for such a dialectical process and the resurgence of regulatory power in the post-crisis era could be channelled towards that end.

In the alternative, we could adopt a cognitive interpretation of the global financial crisis, concluding that the same fundamental premises underlying financial regulation are not flawed, but there has merely been an under-supply of the public good of financial stability in micro- and macro-prudential regulation in the pre-crisis years. This is a limited and pragmatic approach to financial regulation and would point the way forward towards merely readjusting but not transforming financial regulation. We do not think that the post-crisis reforms have adopted such a minimalist approach. Ladeur suggests that there is a third way: the role of law is to provide broad procedural frameworks in which the cognitive developments of the financial sector can take place. However, this may mean that financial regulation stops short of embracing particular ideological premises but allows regulation to be shaped by the bottom-up dialectics in the financial sector and markets. We are of the view that although this view supports dialectical and learning processes in the shaping of financial regulation, which is important in the wake of the crisis, bottom-up dialectics may exclude the fundamentally under-represented stakeholders in the policymaking landscape. Such under-representation means that the development of financial regulation may inadequately benefit from diverse contesting narratives, resulting in serious gaps that may be exposed in the future. As such, there is a role for policymakers to be involved in the development of the dialectical process and in particular to facilitate wider participation in policymaking.

Part 1 of the book sets the scene and consists of four chapters. The first chapter is this introduction to the book. Chapter 2 will discuss the objectives in regulating finance and point out the renewed emphasis on financial stability as an important driver for shaping the future of financial regulation. However, this chapter will also point out the nebulous nature of ‘financial stability’ and the dark side of the ‘public good’ rhetoric, as the interface with wider economic goals and monetary policy may result in financial regulation being used as a means to achieve certain economic policies in different contexts. Chapter 3 will examine the decentred


53 To be discussed in detail in Chapter 3.
landscape for financial sector governance as dominated by the industry, and the industry’s influence upon the shape of financial regulation. This chapter will also explain how regulators are seeking to change the composition of the governance landscape through post-crisis reforms. Chapter 4 examines the limitations of regulators in governing finance and how gatekeepers, in particular auditors, may be enrolled in the financial sector governance landscape.

Parts 2, 3 and 4 deal with three broadly themed areas in financial regulation: the regulatory regime for investor protection, the regulation of institutional safety and soundness, and macro-prudential regulation. These parts will discuss key topics in substantive law reforms in these areas that are purportedly infused with the policy rhetoric of ‘financial stability’ in order to flesh out to what extent the substantive law reforms reflect changing fundamental premises.

Part 2 deals with the celebrated objective of ‘investor protection’ in financial regulation. ‘Investor protection’, once steeped in transactional and efficiency vocabulary, is also evolving as the axis of financial regulation turns increasingly on the objective of financial stability. Regulation in this area has always been premised on the economic rationale of market failures in information asymmetry between investors and issuers. Pre-crisis regulation of wholesale sector transactions was also minimal as it was regarded as economically unproductive to intervene in sophisticated parties’ transactions. Part 2 will deal with changed perspectives in relation to investor protection in both the wholesale and retail sectors and the ensuing legal reforms. Chapter 5 examines how the ideology surrounding ‘investor protection’ has evolved post-crisis, and questions whether greater investor protection might contribute to financial stability, and what this means for the economic rationale regarding regulating for investor protection. Chapters 6 and 7 deal with reforms in the wholesale sector. Chapter 6 deals with the reforms made to regulate the alternative investment management sector. The chapter suggests that the reforms have by and large taken a path-dependent approach, grounding prudential and investor protection regulation in relatively uncontroversial frameworks. In fact, in view of the increased burden on regulators to extend protection to wholesale investors, there still seems to be strong reliance upon wholesale market participants to provide the necessary governance in the wholesale sector.

Chapter 7 deals with the regulation of credit rating agencies, including discussion of how ratings as private credence goods are now regulated as quasi-public goods to protect wholesale sector investors. However, the nature of governance in this area is characterised by dilemmas and contesting objectives,


as the chapter will discuss. Chapter 8 then deals with retail investor protection. On the whole, a much more prescriptive and paternalistic stance towards investor protection may be detected, moving away from the days where ‘investor protection’ based on disclosure regulation was seen as sufficient. This chapter will critically discuss the nature of the enhanced paternalism in the retail sector and consider if this approach reflects changes in the fundamental premises of the ‘public good’ narrative surrounding financial stability.

Parts 3 and 4 deal with post-crisis reforms that target the mitigation of systemic risk. Part 3 focuses on the safety and soundness of financial institutions and reform measures targeted at ‘systemically important financial institutions’. Part 4 deals with macro-prudential supervision. Part 3 consists of five chapters. Chapter 9 deals with the fundamental premises for regulating institutional safety and soundness and whether such premises have been affected by post-crisis reforms. Chapter 10 discusses why and how ‘systemically important financial institutions’ (SIFIs) have arisen and what risks they pose to regulating for institutional safety and soundness. Chapter 11 then discusses the post-crisis regulatory reforms and proposals to address SIFIs including structural reforms, recovery plans and resolution regimes. Structural reforms in particular reflect changing fundamental premises in financial regulation towards the ‘public interest’ in the social utility of finance. Chapter 12 discusses the post-crisis reforms in micro-prudential regulation, which aim to ensure the \textit{ex ante} robustness of financial institutions at the individual level. This chapter shows the limits within which regulators can operate in governing institutional soundness and safety in regulatory frameworks broadly characterised as ‘meta-regulation’. Chapter 13 further examines the extension of micro-prudential regulation into issues relating to corporate governance, organisational soundness and risk management and critically questions the effectiveness of such ‘meta-regulatory’ models. Micro-prudential regulation seems to continue along path-dependent approaches and these chapters raise queries as to what the reforms may achieve.

Part 4 deals with macro-prudential supervision, a new regulatory resolve to monitor the financial sector in a system-wide manner and to deal pre-emptively with the build-up of systemic risk. The rise of macro-prudential regulation could be understood as a narrow adjustment in regulatory approach to complement micro-prudential regulation, a relatively path-dependent perspective, or as a new approach that embodies changing fundamental premises in financial regulation that imports of ‘public interest’ in the sociopolitical sense and supports greater and more pre-emptive forms of regulatory control. The emerging nature of macro-prudential regulation shows tendencies towards both trajectories and the potential for adopting the more transformative remains open. This part consists of three chapters. Chapter 14 discusses the uncertain contours in defining macro-prudential supervision. Chapter 15 then deals with the rise in information surveillance by regulators in the UK, and also in the EU, to support macro-prudential supervision, and the implications of such a rise in information surveillance. Macro-prudential supervision is vested in formal committee-type bodies set up in the UK and EU, which are actually networked structures of regulatory
agencies and central banks. Chapter 16 critically analyses how such networked structures may operate and work and Chapter 17 discusses the nature of pre-emptive regulation and ensuing issues of regulatory accountability. It also cautions against the development of regulatory insularity and elitism in the post-crisis regulatory approach that emphasises pre-emption, surveillance and technocracy. This chapter suggests that the transformative potential in developing macro-prudential based on wider considerations of public interest may only be harnessed if regulators actively encourage changes to the dynamics in the regulatory space and enrol more diverse stakeholder perspectives, moving away from regulatory insularity and the elitism of epistemic communities shaping financial regulation. Chapter 18 then turns to the international dimension and the challenges in the provision of global financial stability as a global public good.

The final chapter offers an overall conclusion, drawing together the main themes in the preceding sections of the book. The rise of the ‘financial stability’ rhetoric that punctuates post-crisis law reforms provides an opportunity to promote alternative narratives beyond the economic rationale for regulation. We observe the signs of changing fundamental premises in financial regulation in a number of substantive laws. However, we suggest that regulators should further encourage the dialectical processes relating to the fundamental premises of regulating finance.

2 The objectives of financial regulation

2.1 Identifying the objectives of financial regulation

Financial regulation serves a number of objectives,\(^1\) such as transactional protection for participants in financial markets,\(^2\) maintenance of the overall health, robustness and integrity of financial systems, and supranational objectives, such as market and legal integration in the European Union.\(^3\)

The objectives change over time and protecting the taxpayer against having to cover losses of the magnitude of the financial crisis of 2008–9 in order to prevent systemic risk is currently high on the list of objectives. Leading authors have set out the traditional goals of financial regulation in different ways. Goodhart and others state that the rationales for public regulation of the financial sector are: to protect the customer against monopolistic exploitation, to protect retail or less informed customers and to ensure systemic stability.\(^4\) Cranston, writing about banks, states that regulation serves the purposes of mitigating systemic risk, preventing fraud and financial crime, such as money laundering, and providing for consumer protection.\(^5\)

The different objectives of financial regulation are portrayed in the multiple narratives of financial regulation. Benjamin\(^6\) suggests that there are three narratives in financial law that sometimes overlap with and contradict each other. The first is the ‘arms-length narrative’, allowing the free market forces in the financial market to work via contractual bargaining. Under the second ‘fiduciary narrative’, those in a position to adversely affect another are prevented from opportunistically abusing that position. Finally, under the ‘consumer protection narrative’, regulatory intervention is used to introduce standards in order to address market failures in consumer protection. Although some of these narratives pull in opposing directions, they are broadly transaction-oriented. They are premised on a

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2 See further analysis of this concept below in Section ‘2.2 Transactional Protections’.
perception of the financial sector as a marketplace and are dominated by the theoretical paradigms of agency and market failure. Writing in the 1990s, Cerny argues that the trajectory of financial regulation is very much based on the neoliberal perspective of the role of markets and rational actors. This period in particular saw much financial liberalisation and deregulation, largely driven by more developed economies that believed in the link between financial liberalisation and economic development and wealth creation for all. Such support for financialisation dominated international organisations in trade and financial assistance, such as the GATS negotiations, the International Monetary Fund (IMF) and the World Bank (WB). The financial hegemony of the more developed Western economies also began to appear in international standard setting; for example, through the Basel Committee of the Bank for International Settlements (BIS). In securities regulation, the deep and liquid markets of the US attracted many cross listings and hence the SEC’s ‘gold standard’ of investor protection also became a brand that inspired emulation.

In the background, European integration and its impact on policy and legislative design for the financial sector is a major narrative too. The Financial Services Action Plan (FSAP) 1999 that called for a major push towards maximum market integration in the EU also encouraged major legal integration. During the years of financial liberalisation, regulatory focus was very much on transaction-

8 See introduction to this book in Chapter 1 and on the abolition of currency and credit controls in the 1980s, Mads Andenas, ‘Harmonising and Regulating Financial Markets’ in Mads Andenas and Camilla Andersen (eds), Theory and Practice of Harmonisation (Cheltenham: Edward Elgar 2012), 7–10.
10 Way also argues, however, that emerging economies’ leaders generally saw financial liberalisation as a quick fix in terms of wealth creation and an easy way of gaining popularity. Political support was thus not confined to developed economies. See Christopher R Way, ‘Political Insecurity and the Diffusion of Financial Market Regulation’ (2005) 598 Annals of the American Academy of Political and Social Science 125.
oriented matters, such as investor protection in securities regulation and investment firm conduct of business.\textsuperscript{14} In the age of financial liberalisation and financialisation, market-based concepts have dominated the discourse on public regulatory goals, such that regulatory goals were grounded in notions of efficiency and transaction facilitation.\textsuperscript{15}

Following the global financial crisis, the key narrative being asserted in financial regulation seems to be the \textit{public good} of financial stability.\textsuperscript{16} This is not to say that financial stability has never been viewed as important. For developed economies in the Western hemisphere, the banking disasters such as the failure of Herstatt in the 1970s have prompted coordinated action at the international level led by the Basel Committee of the BIS.\textsuperscript{17} The concerns for ‘financial stability’ have been framed in relation to institutional soundness and the templates developed under the Basel Capital Accords for institutional soundness provide the impression that the developed economies in the Western hemisphere have kept the issue under control. The comfort of relying upon such international standards may have resulted in growing complacency in the years leading up to the crisis, underexposing the underemphasis on the importance of ‘financial stability’ as an objective in financial regulation. The founding legislation for the single financial regulator, the Financial Services Authority (FSA) in the UK, did not feature ‘financial stability’ as a regulatory objective for the financial regulator,\textsuperscript{18} as policymakers assumed that it would be the central bank’s job to oversee financial stability,\textsuperscript{19} although the central bank was no longer responsible for micro-prudential supervision. ‘Financial stability’ was omitted as a regulatory


\textsuperscript{17} The rise of micro-prudential regulation under the Basel I and subsequent Capital Accords, see Chapter 12.

\textsuperscript{18} Section 2, UK Financial Services and Markets Act 2000.

objective for the UK FSA notwithstanding the FSA’s role as micro-prudential regulator and supervisor for banks. Only in the aftermath of the global financial crisis was the regulatory objective of ‘financial stability’ added to the list of legislative objectives for the FSA.\(^{20}\)

Rather, financial stability has always been seen to be a key issue for emerging economies undergoing financial liberalisation.\(^{21}\) Agreed wisdom\(^{22}\) on the issue is that emerging economies should be encouraged to adopt and implement internationally agreed standards on micro-prudential regulation, investor protection, regulation to maintain the integrity of markets (for example, by stamping out insider dealing and financial crime), and corporate governance, all standards that are relatively more developed in the US and the EU.

However, the global financial crisis of 2008–9 that imploded in the Western developed economies of the US and the EU brings into question how well-developed economies are managing financial stability. One of the consequences of the crisis is the shift in emphasis towards the financial stability objective in financial regulation in the UK and EU. Increasingly, the transaction-based narratives in financial regulation are being fused with these wider financial stability concerns beyond the issues of agency or market discipline.\(^{23}\)

‘Financial stability’ arguably exerts new ideological driving force for the future of financial regulation. There is now greater willingness to examine the wider effects of transactions taking place in the financial sector and pay less deference to market or contractual forces to work out what is best for the many participants in the sector, as these contractual or market forces may not necessarily show a healthy picture at the macro level.\(^{24}\) This may arguably portend a shift towards recognition and management of financial sector risk as a public and not merely as a private matter. Bieri opines that ‘Financial stability carries all the textbook hallmarks of a public good: first, it is nonrival, . . . [s]econd, financial stability is nonexcludable . . . [l]astly, individual agents cannot actively withdraw themselves

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from the influence of financial stability’. Although financial stability is framed in the economic language surrounding public goods, the renewed emphasis on financial stability could at least spur policymakers to recognise the under-provision of this public good in the pre-crisis years, if not lead to more fundamental shifts in ideological premises underlying the governance of finance. Enriques is of the view that policymakers and regulators implement sweeping reforms and fundamental changes in times of crisis mainly to be seen to be managing the crisis and keeping it under control. However, it remains uncertain how lasting the effects of reform will be and whether the reforms will fundamentally change the regulatory character of financial regulation. As the effectiveness of financial regulation may be undermined by globalisation and opportunities for regulatory arbitrage, national regulators face inherent limitations in being able to ‘control’ the externalities of finance. Commentators also wonder if reforms implemented for the purposes of crisis management will have a more persistent ideological impact, given the emphasis on problem-solving in the immediacy of a crisis and the backward-looking nature of such problem-solving. More fundamentally, is the rejuvenation of financial stability as a regulatory objective capable of bringing about an ideological revolution in financial regulation thinking?

Moran argues that financial regulation has always been driven by administrative theories, which focus on the use of technocracy and bureaucracy to solve

20 Financial regulation – objectives and governance

27 Saule T Omarova, ‘Wall Street as Community of Fate: Toward Financial Industry Self-Regulation’ (2011) 159 University of Pennsylvania Law Review 411 argues that given limitations on the part of national regulators, one should in fact encourage self-regulation by the industry towards the common good of financial stability.
30 Both authors have developed arguments against the suboptimal outcomes of crisis driven regulation. See, for example, Mads Andenas, ‘Who is Going to Supervise Europe’s Financial Markets’ in Mads Andenas and Yannis Averinos (eds), Financial Markets in Europe: Towards a Single Regulator? (The Hague: Kluwer Law International 2003), xv. The alternatives are, however, uncertain as only in the immediate post-crisis period will reactive measures be adopted: when the floodgates holding restrictive measures back burst, industry is no longer able to block reform effectively.
31 Moritz Renner, ‘Death by Complexity – The Financial Crisis and the Crisis of Law in World Society’ in Poul F Kjaer, Gunther Teubner and AlbertoFebbrajo (eds), The Financial Crisis in Constitutional Perspective (Oxford: Hart Publishing 2011), 93 argues that such normativisation is necessary to contain finance as the pre-crisis problem was the inability of the law to capture the normativisation of increasingly complex transactions, which later proved to be dysfunctional.
the problems at hand. The teleological paradigm of financial regulation, namely regulating finance for what it seeks to achieve, is arguably not a dominant driver. However, in the light of concerns such as social discontent expressed in the Occupy movements in New York and many cities around the world and the political issues surrounding the fiscal management and sovereign debt of many European countries, the point of regulating finance is not limited to transactional matters or individual institutional soundness. The scale of sociopolitical concerns may bear down upon the governance of finance so that policymakers may be forced to confront the shifting fundamental premises underlying the governance of finance.  

As financialisation begins to unravel in countries that have hitherto fervently believed in the freedom of the financial sector to allocate resources and create wealth, there is political and social appetite for a new narrative to control and manage the risks of the financial sector and to reassert order. The regulatory objective of ‘financial stability’ may no longer be confined to the economic understanding of a public good that is related to micro-prudential regulation. It is a potentially broad concept whose malleability may prove constructive in defining a new approach to financial regulation. On the other hand, policy articulation with regard to ‘financial stability’ may prove to be no more than a rhetorical tool, doing little to change the dominant neo-liberal foundations of financial markets. Will the rise of emphasis on ‘financial stability’ leave the neo-liberal foundations of financial markets undisturbed and merely tweak what are now recognised as ‘market failures’?

This chapter will now provide a critical overview of three key objectives in financial regulation, starting with the traditional tenet of transactional protections, and then addressing the resurgence of the financial stability objective and the ever-progressing need for European integration and its implications for the design of financial regulation objectives. This chapter will argue that financial stability concerns are exerting a fundamental influence over the other objectives of financial regulation. But it is by no means clear yet what the rise of the regulatory objective of ‘financial stability’ will achieve. Moreover, it appears that a more fundamental

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34 This is the idea in David Moss, When All Else Fails: Government as the Ultimate Risk Manager (Cambridge, MA: Harvard University Press 2002).

35 Aldo Mascareño, ‘The Ethics of the Financial Crisis’ in Poul F Kjaer, Gunther Teubner and Alberto Febbrajo (eds), The Financial Crisis in Constitutional Perspective (Oxford: Hart Publishing 2011), 333, however, argues that such readjustments should not be seen as weak, but rather a necessary cognitive learning from the mistakes of the past. He argues that finance occupies a cognitive and less normative sphere, that risk-taking should be experimented with and learnt from, and that social expectations should be less normative in nature.

rethink of financial regulation, in relation to issues such as social utility and distributive justice, has not been carried out.

2.2 Transactional protections

Transactional protections refer to interventions by public regulation in order to correct certain market failures such as information asymmetry or the agency problem. These failures are unlikely to be overcome by market discipline and regulatory intervention may be seen as providing a form of fairness by levelling the playing field, as well as enhancing efficiency for more optimal transactional outcomes. This section will discuss the two key tenets of financial regulation representative of the market failure tradition, in securities disclosure regulation and the principal-agent relationship between financial intermediaries and clients.

2.2.1 Mandatory disclosure in product regulation

Investment product regulation is based on mandatory disclosure as a means of transactional protection. Investors supply capital to entities under a situation of information asymmetry (i.e. the capital receivers have more knowledge about the prospects and health of the product than the investors, and are thus in a position to use this knowledge to their advantage). Coffee and Fox argue that voluntary disclosure is not likely to be sufficient for investors and hence there is market failure in the supply of optimal product information in the investment market warranting the imposition of mandatory disclosure. Investors are thus provided with an environment for investing in securities and collective investment products, which ensures that ‘material’ information is provided to facilitate decisions.

Disclosure is a regulatory mechanism that facilitates independent consumer judgement and is not as intrusive as ‘command and control’ types of regulation, which prescribe specific standards that are more paternalistic in nature. Mandatory disclosure does not warrant the safety or viability of an investment product, but provides a sufficiently transparent environment in order to allow users to make informed choices and to deal with false descriptions. Further, mandatory

disclosure regulation, by providing a uniform template for product disclosure, also assists in improving comparability of information for investors.\textsuperscript{42} The arguments supporting mandatory disclosure apply not only on the primary market where acquisitions of investment products are made directly from issuers or originators, but also on the secondary market for securities. Mandatory continuous disclosure regimes assist ongoing investment decisions on the secondary market by allowing investors to constantly evaluate buying and selling decisions,\textsuperscript{43} based on the efficient capital markets hypothesis.\textsuperscript{44} This hypothesis states that information will feed into price and price will be informationally efficient for investors on the markets. Empirical evidence\textsuperscript{45} also suggests that the correlation between securities disclosure and informationally efficient stock prices is still strong.

The development of mandatory disclosure has been most pronounced in securities and collective investment markets to which retail investors can gain access. This is because retail investors are unlikely to be in a position to overcome information asymmetries and hence market failure is most acute where retail investors are concerned. Where sophisticated or professional investors are concerned, such as investment banks, pension funds, insurance companies, large corporations and high-net-worth or experienced individuals, the assumption of market failure may not apply as these entities may be able to demand adequate disclosure to meet their needs and overcome information asymmetries. These entities are also often assisted by their own research capacity, as well as the work of information intermediaries such as credit rating agencies. Hence, the EU and UK securities regulation regime exempts certain issues from mandatory disclosure.\textsuperscript{46} The United States also has a similar ‘Regulation D’ regime. However, the global financial crisis arguably resulted from such weaknesses in the self-regulating wholesale end of the market.


\textsuperscript{45} Durnev and others developed a model to test the relationship between securities disclosure and price efficiency in the market, and concluded that disclosure improves efficient capital allocation, see Art Durnev and others, ‘Law, Share Price Accuracy, and Economic Performance: The New Evidence’ (2003) 102 \textit{Michigan Law Review} 331.

\textsuperscript{46} Prospectus Directive, arts 3(2) and 4, transposed in Prospectus Regulations 2005 (UK), inserting section 86 into the Financial Services and Markets Act 2000.
Mendales argues that sophisticated investment banks and institutions have failed to discern the quality of structured products, such as collateralised debt obligations based on residential mortgages. These are products that bundle a range of income-deriving assets, including a range of mortgages (from risky sub-prime mortgages to safer mortgages), but are generally regarded as robust and safe, as defaults are presumed to be rare and unlikely in times of asset price rises and cheap credit. Complex models and assumptions provided in disclosure documents baffle and are often not scrutinised by purchasers. Credit rating agencies, who were asked to provide a third-party rating for such issues, readily provided favourable ratings that were not thoroughly studied. Hence, the self-regulating discipline at the sophisticated/professional end of the market broke down as sophisticated and professional purchasers, their analysts and credit rating agencies failed to adequately question the risks and valuation of such complex structured products. The proliferation of complex untested products has ultimately proved to be toxic: mortgage defaults in the United States generated suspicion regarding the asset prices of these products, provoking a drop in market confidence and the collapse of the asset price. A large range of holders of such products were affected, precipitating the global financial crisis of 2008–9.

In Part 2, we will examine how regulatory reforms intend to restore the market discipline that can be exercised by sophisticated and professional investors. The EU Regulation on Credit Rating Agencies 2009 intends to address the quality

49 There is a general failure on the part of wholesale sector parties to appreciate risks that are disclosed. Behavioural tendencies, such as over-optimism and herding, play a part, as do the numbing effects of complexity. See Steven M Davidoff and Claire A Hill, ‘Securities Regulation vs Financial Regulation’ (Berle IV Symposium, London, 14–15 June 2012).
51 Including Lehman Brothers, whose position became so jeopardised by the asset price collapse in the CDO market that its insolvency became inevitable after it failed to secure a purchaser. The insolvency of Lehman Brothers, however, became the institutional failure that sparked off symptoms of contagion and loss of confidence in the global financial crisis. Stephen J Lubben, ‘Systemic Risk and Chapter 11’ (2009) 82 Temple Law Review 433, 439, arguing that Lehman’s failure severely accelerated the crisis.
of credit ratings by subjecting rating agencies to authorisation, supervision and monitoring of its methodologies, assumptions and models, as well as supervising conflicts of interest in its conduct of business. Further, the Alternative Investment Fund Managers Directive 2011 (AIFM Directive) will also provide for basic principles of minimum mandatory disclosure that hitherto unregulated collective investment schemes, such as hedge and private equity funds, must now adhere to, even if they are only exposed to sophisticated and professional investors. The fundamental belief in market discipline at this end of the market has been shaken and hence increased regulatory vetting and intervention is now accepted as necessary. Part 2 will argue that regulatory reforms in the wholesale sector have now connected investor protection and financial stability. Post-crisis, fundamental tenets of financial regulation based on market failures in transactions are being modified by considerations of financial stability. It is too early yet to predict the exact balance between these objectives, but the book will offer some observations and predictions in Part 2. We turn next to the other traditional paradigm in financial regulation based on the agency problem.

2.2.2 Principal-agent problem in intermediary regulation

Transactional protection in financial regulation also deals with mitigating the principal-agent problem in intermediary-client relationships. Most investors, whether retail or sophisticated, may access financial products and markets through a range of intermediaries. The rise of the financial intermediary has been characterised by Clark as representing an advanced stage of capitalism in the development of modern capitalist civilisation. As intermediaries provide a range of services including execution, investment advice and portfolio management for clients, they are in a principal-agent relationship vis-à-vis their clients and some aspects of such a relationship could be fiduciary in nature. Thus, legal intervention in prescribing intermediaries’ duties could prevent abuse of their superior knowledge and clients’ trust reposed in them, instead of leaving aggrieved clients to private enforcement after the fact. Legal intervention of this sort would also arguably achieve efficiency by reducing the transaction costs that would otherwise

be incurred by each investor having to design specific contracts for his or her own protection.57

The EU Markets in Financial Instruments Directive (MiFID) 200458 provides for a comprehensive regime regulating investment firm conduct of business. Investment firms are subject to proscriptive duties in managing conflicts of interest,59 communicating to clients the conflicts of interest policy firms need to maintain,60 accepting limited inducements,61 and in the production and labelling of investment research.62 Investment firms are also subject to protective duties, such as duties to segregate and handle client money and assets so that these may be identifiable and ring-fenced in the event of firm insolvency,63 the duty of suitability or appropriateness when giving a personal recommendation to clients in investment advice or other services,64 the duty of best execution when transacting orders for a client,65 and the duty to make fair and informative communications.66 As the global financial crisis of 2008–9 features largely product and institutional failure, rather than injury to investment firm customers through conduct of business, much of the MiFID regime pertaining to conduct of business is likely to be subject to little change.67

60 MiFID Commission Directive, art 18.
63 MiFID, art 13(7); MiFID Commission Directive, arts 16–19; FCA Handbook (as of 30 April 2013, formerly FSA Handbook) CASS 6.2, 7.3, 7.7.
64 MiFID, art 19; MiFID Commission Directive, arts 35–37; FCA Handbook (as of 30 April 2013, formerly FSA Handbook) COBS 9 and 10.
66 Articles 27–33 of the MiFID Commission Directive impose disclosure requirements where advice recommending products is given to retail clients. An adviser must also inform the client of the nature of risks in the financial instruments, the scope and nature of its intermediary services, costs and charges, and also, for professional clients, the conflict of interest policy, client money and assets handling policy, client categorisation, the receipt of inducements, the nature of investment research and execution policy.
Transactional protection, which has been the mainstay of financial regulation, has been reformed to allow for more regulatory prescription, intervention and enforcement. Part 2 will discuss these in detail. Such changes may improve investor protection as such, but as Part 2 will argue, they are also justified in the name of maintaining financial stability. Has ‘financial stability’ now infused traditional ideological paradigms in financial regulation and brought about fundamental changes to the regulatory approach to investor protection? Or is ‘financial stability’ a loose justification for reforms that are based on the same ideational grain? We turn now to examining what ‘financial stability’ means.

2.3 Financial stability

2.3.1 Meaning of financial stability

In its Charter, the Financial Stability Board refers to ‘addressing vulnerabilities affecting financial systems’ as being key to maintaining financial stability. How is ‘financial stability’ defined and what are the ‘vulnerabilities’ to be managed? Can the vulnerabilities be managed by the financial sector or do we need regulatory intervention?

Schinasi argues that the financial sector’s essential purpose is to manage risks and allocate resources in the real economy, hence, in taking on its intermediary role, the sector becomes itself a clearing house for risk and an essential facilitator for wealth creation in the real economy. All deposit-taking institutions take on much more debt than equity capital in financing their activities and carry out their intermediary functions in an inherently risky manner. Hence, it may be said that a continuum exists between financial stability and instability insofar as the financial sector serves the needs of economic activity and, in so doing, must tolerate a certain number of deficiencies, vulnerabilities and disturbances. The key issue in understanding financial stability or instability is when certain vulnerabilities or suboptimal situations should be regarded as no longer tolerable in the system and should be regarded as a form of ‘instability’. Schinasi opines that the measurability or objective quantification of stability or instability is difficult to achieve given the dynamics and the uncertainty of variables affecting the continuum.


In other words, the ‘financial stability’ desired is a balanced state of risks, but it is ‘difficult to decide . . . what is undesirable as compared to what is tolerable or desired’. Further, ‘stability’ or ‘instability’ may be regarded as occurring at different thresholds depending on whose perspective is adopted; the industry’s perspective would likely differ from the perspective of policymakers, stakeholders and the wider public. Drawing on sociologist Niklas Luhmann’s writings on risk in general, the ‘disaster threshold’ for different individuals or groups of constituents ‘will be located at very different positions, depending on whether one is involved in risk as a decision-maker or as someone affected by risky decisions. This makes it difficult to hope for consensus on [risk] calculations . . .’. The stabilising of the financial sector has caused national debt in deficit countries such as the UK to rise, leading to austerity measures and real economy effects in terms of unemployment, credit squeezes, enterprise failures and reduced consumption. In the alternative, however, the result of financial sector instability, had there not been state intervention, could also have been highly prejudicial to the real economy if the sector’s intermediary functions had become disrupted. In this regard, the nature of financial stability that is sought to be achieved is highly debatable.

Davies and Green opine that it is difficult to define stability or instability, particularly with forecasting purposes in mind, but with hindsight, one could refer to a state of ‘loss of normalcy’, ‘harm to bystanders’ or ‘lack of resilience to shocks’ as states of instability. These terms are not precise, however, and have to be understood within context. They are thus of the view that ‘financial stability . . . cannot be defined in terms other than broad and general ones that give little guidance on policy or action, and indeed that it could even be dangerous [to do so]’.

The understanding of financial stability/instability is thus made difficult, not because it is difficult to measure or evaluate financial flows and their potential ramifications, but because value judgements need to be made as to tolerance of levels of financial stability or instability.

76 For example, Xavier Friexas, ‘Crisis Management in Europe’ in Jeroen JM Kremers, Dirk Schoenmaker and Peter J Wierts (eds), Financial Supervision in Europe (Cheltenham: Edward Elgar 2003), 103ff.
The financial sector has had the pre-eminent role in risk allocation throughout the period of financialisation and deregulation. In other words, decisions and choices relating to tolerance for financial stability/instability have been made by individuals and institutions in the financial sector. Post-crisis, policymakers have realised that the management of risks in the financial sector, by the financial sector, may not be socially optimal given the incentives that drive the sector. There is now social demand for optimal management of financial risks, as the suboptimal situations apparent during the global financial crisis may be attributed to the lack of an organised framework to monitor risk allocation at a macro level. Post-crisis, the financial stability choices made by the financial sector will no longer go unchecked. Regulatory resurgence and governance will assume the role of making choices or interventions in the name of ‘financial stability’.

Moss points out that the basics of risk management lie in risk reduction and risk allocation. In terms of renewed regulatory emphasis on financial stability and the resurgence of regulatory power in the financial sector, the allocation of risk management has swung significantly towards public-led authorities, whether national governments or international organisations. This approach is manifest in the increased use of regulatory power, in investor protection measures discussed in Part 2, in increased regulatory intervention in prudential or safety regulation discussed in Part 3, and in the rise of macro-prudential supervision discussed in Part 4. Public-led strategies in managing financial sector risks are framed around rational technocratisation and increased use of regulatory power. However, will regulatory governance also mean ‘risk reduction’ in the financial sector? The post-crisis regulatory approach does not seem to wish to directly intervene in allocation functions undertaken by the financial sector, and hence, it may be inferred that regulatory governance will not involve itself in setting limits on risk and intervening in the financial sector’s allocation decisions. But as macro-prudential supervision may be widely defined (especially in the EU, although less so in the UK), there is scope for absolute risk reduction to be part of the regulatory governance strategies. Further, risk reduction may also be relevant to the debate regarding the social utility of the financial sector. However, this aspect is currently not a dominant narrative in the understanding of ‘financial stability’.

Zumbansen argues that financial regulation has evolved to support markets.

84 A symptom of government-led risk management, see David Moss, When All Else Fails: Government as the Ultimate Risk Manager (Cambridge, MA: Harvard University Press 2002).
85 See Part 4.
Can financial regulation be in a position to control the financial sector for interests that are a-market, such as the public interest in financial stability? In other words, even if there is a post-crisis embrace of the importance of financial stability as a regulatory objective, can this objective be framed in such a way as to address public interest? The path-dependent tendency of financial regulation has been to address market needs. Luhmann posits that although modern functional systems, such as financial systems, have become self-referential, the choices regarding how financial risk should be governed are still political or social in nature and may thus be made by constituents outside of the system.

Although ‘financial stability’ is a protean concept that could incorporate a sociopolitical dimension in relation to choices made in a democratic context, regulators have tended to and are likely to continue adopting a narrower perspective of financial stability in most of the post-crisis reforms in order to objectivise the concept and make it more manageable for regulatory administration. This approach produces more objective certainty in terms of regulatory responsibility but may delineate regulatory responsibility in such a way that ‘public interest’ is not actually served. Thus, on the one hand, there is a regulatory move towards judgment-led supervision (that will be discussed in Chapter 17), which seems to encourage greater pre-emptive regulatory control in order to protect public interest, reflecting perhaps bolder changing fundamental premises in financial regulation; on the other hand, the adoption of a narrow objectivised approach to regulating for financial stability is path-dependent, following in the economic frameworks for regulation and perhaps limiting regulatory responsibility rather than furthering bolder visions of public interest underlying regulation. The next section will argue that policymakers seem to be addressing the protean nature of financial stability by relying on technocratic and expert perspectives to understand the nature of systemic risk. This approach may be taken in order to provide a rational basis for regulatory design but may inherently inhibit the development of changing fundamental premises in the understanding of financial stability.

2.3.2 The perspectives of systemic risk

‘Systemic risk’ is a developing concept, which has not yet attained a textbook definition. However, it is undergoing systematic development tending towards the formulation of metrics and indicators so that there may be a rational and informed framework upon which to base regulation for ‘financial stability’. This section wishes to draw out the main concepts in understanding systemic risk, which is

88 Howard Davies and David Green, Banking on the Future: The Rise and Fall of Central Banking (Princeton, NJ: Princeton University Press 2010). The authors argue that developing measurable indicators is necessary for administering the objective of financial stability, generally under the function of ‘macro-prudential supervision’, as will be discussed in Part 4 of this book.
not yet a perfect science, and how each of these conceptualisations may affect the trajectories of financial regulation. It is also arguable that the uncertain nature of ‘systemic risk’ could itself exert ideological power to encourage a more conservative regulatory position (i.e. that because regulators are unsure what systemic risk means and how it may pan out, they may therefore take a more precautionary or pre-emptive position in dealing with what may be regarded as systemic risk). In the UK, the Bank of England and UK regulator have identified that systemic risk may be manifest in two distinct ways, viz:

(i) the amount of risk that the financial system takes at a point in time relative to its capital and liquidity resources (‘time-varying’ or ‘cyclical’ risk); and (ii) for a given amount of time-varying risk, structural features of the financial system, such as its connections and the distribution of risk across different participants, which create or exacerbate vulnerabilities (‘cross-sectional’ or ‘structural’ risk).89

Policymakers, as expressed above, as well as many international commentators,90 take the view that systemic risk monitoring would likely relate to mitigating time-varying risks in view of structural vulnerabilities, rather than ordering allocational decisions. In other words, the ‘amount of risk’ would remain market-driven. This section will, however, also discuss alternative and arguably minority views of systemic risk that are based on market misjudgements.

First, a rather widely accepted source of systemic risk is the contagious effect of institutional failure in the financial sector. This means that the failure or insolvency of one or a few financial institutions begins to jeopardise the viability of other institutions. This jeopardy may be the result of ‘real contagion’ or ‘information contagion’.91 ‘Real contagion’ refers to negative effects spreading to financial institutions, which are connected to the failing institution through counterparty default, or other transactional connections. A couple of commentators92 also opine that financial institutions could fail due to their fragility in being connected to one another (i.e. that connections among financial institutions

have become so vital that institutions are rendered fragile due to the necessary reliance upon the connections with one another). Such systemic fragility could give rise to a form of ‘collective welfare failure’. ‘Information contagion’\(^{93}\) refers to negative effects spreading to financial institutions due to perceptions of weakness, whether justified or otherwise, and such perceptions of weakness can result in asset price declines, seizure of activity, etc., which would then affect the real viability of those institutions. Some commentators regard systemic risk as the spread of failure confined to the financial sector,\(^{94}\) but others would regard systemic risk as the effects or potential effects that failures in the financial sector could have on the real economy causing impairment to economic activity generally.\(^{95}\) The key difference between these two perspectives is that the former focuses attention on the financial sector itself and may seek to govern systemic risk by concentrating on the soundness of financial institutions, but the latter perspective may introduce a wider economic and social outlook to the governance of systemic risk.

Taking the former perspective, policy emphasis could be placed on making institutions robust and resistant to failure in the first place, or alternatively, on containing and resolving failure so as to mitigate its impact.\(^{96}\) Post-crisis reforms in micro-prudential regulation\(^ {97}\) are arguably the result of the view that systemic risk originates from individual institutional risk.\(^ {98}\) Economists also suggest that

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93 Andrew Haldane also refers to information contagion as a complex adaptive network effect in spreading adaptive behaviour, fear and panic as responses to systemic risk. See Andrew Haldane, ‘Rethinking the Network Structure’ (Speech delivered at the Financial Student Association, Amsterdam, April 2009).


internal failure is key to systemic risk, and many proposals intended to redress systemic risk are derived from measures to combat internal failure.\textsuperscript{99} Further, the ‘contagion’ perspective of systemic risk encourages a significant amount of legal and economic research into what connections or factors exacerbate contagion and how contagion can be mitigated or contained.

In studying the weaknesses and vulnerabilities of a given financial system and where these are located,\textsuperscript{100} commentators have developed various indicators, such as a combination of liquidity, leverage, linkages and losses.\textsuperscript{101} Thus, illiquidity, linkages\textsuperscript{102} among financial institutions, leverage and business scope\textsuperscript{103} are considered most highly correlated with systemic risk, whereas the size of a financial institution as such does not matter as much.\textsuperscript{104} Such research has often concluded that regulatory attention should be given to ‘Systemically Important Financial Institutions’ (SIFIs),\textsuperscript{105} as they are financial groups that internalise complex and often opaque networks and linkages within the group. The Basel Committee has worked on identifying the features of a SIFI, by developing a set of five equally weighted indicators to be applied to banking institutions (size, linkages, global

\begin{itemize}
  \item \textsuperscript{102} Above and also supported by Gianni De Nicolo and Myron L Kwast, ‘Systemic Risk and Financial Consolidation: Are they Related?’ (2002) 26 Journal of Banking and Finance 861. See also Christopher Thorson, ‘Proposals To Reduce Systemic Risk Compared’ (2009) 28 Review of Banking and Financial Law 258, who proposes that contagion common denominators are liquidity access, leverage, credit relationships and maturity mismatches.
\end{itemize}
footprint, complexity and substitutability of services, and the Financial Stability Board has also recommended a list of SIFIs for regulatory attention. SIFIs may be monitored or subject to enhanced regimes of micro-prudential supervision, such as extra capital charges, stress testing, recovery plans, and perhaps even structural simplification that forces retail divisions to be separated. These measures will be further elaborated upon in Chapters 11, 12 and 13. Further, remuneration policies have also been said to affect risk fragility. With this in mind, the EU has taken the lead in prescribing certain remuneration structures to mitigate systemic risk and in requiring reporting of remuneration information by credit institutions (to be discussed in Chapter 13).

Besides looking for systemic risk signals in financial institutions or in the financial sector, a broader perspective may also allow us to look for systemic risk signals in the vulnerabilities and stresses in the general economy. These could be in

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relation to the real economy such as GDP figures, the corporate sector such as leverage and expenses ratio, the market economy such as any precursors to a stock market crash, short selling signs that may entail a currency price collapse such as in the Asian financial crisis of 1997, financial sector in specific, such as sustained asset bubbles, credit crunches, ratings downgrades, and the household economy in terms of net assets and disposable income. Commentators taking this perspective study signs of systemic risk not within the institution or in linkages between institutions, but more broadly in patterns and trends in finance, whether consumer or wholesale, and in the economy at large. Hollo and others provide a macro-aggregate indicator of systemic risk by studying the levels of stress across bank and non-bank financial intermediaries, money markets, securities (equities and bonds) markets and foreign exchange markets. A number of commentators are of the view that general broad-based trends – such as asset price rises and bubbles, the build-up of credit, patterns and occurrences of default, declines in liquidity or rises in inter-bank interest rates – could all point the way to indicating the build-up of systemic risk in the financial sector. Tymoigne proposes to measure financial fragility using a composite indicator looking at ponzi finance patterns, hedge and speculative finance across

household, corporate and real sectors. Schwaab and others also propose a macroeconomic measure of systemic risk that takes into account the effect of predicting risk from macroeconomic trends such as those highlighted above.\textsuperscript{126} This perspective of systemic risk therefore requires intelligent monitoring and a bird’s-eye view of not only the financial sector’s activities, but also the activities in the economy in general. This view of systemic risk would also imply a necessity of coordination between systemic risk management and economic and monetary policies.\textsuperscript{127}

Finally, an alternative view of systemic risk could be defined as ensuring that essential financial services for the real economy remain as undisrupted as possible. Under this view, the regulation of finance amounts to ensuring that finance serves social needs and does not jeopardise them. Smith and Walter predict that ‘[i]t is easy to forget that financial markets are in the end a tool for social welfare and must earn and maintain their legitimacy in that context’.\textsuperscript{128} A socially grounded view of systemic risk requires an examination of the purposes served by finance and that such purposes be socially useful. Nells and Semmler argue that we must determine whether financial transactions are really connected to productive purposes for the real economy and that wealth creation should not be limited to financial sector participants.\textsuperscript{129} Lothian\textsuperscript{130} also supports an ‘institutional reconstructionist’ view of financial regulation, calling for an examination of financial sector activity that has become decoupled from wealth creation and production in the real economy. She argues that the decoupling represents the beginning of a chain of behaviour and events that ultimately led to the global financial crisis of 2008–9. Hence, the seeds for systemic risk may be sown in financial activity that has become disconnected from the social utility purpose of finance.\textsuperscript{131} One commentator even suggests social reconstruction in finance, moving away from


\textsuperscript{127} Which perhaps explains why central banks have a dominant position in administering systemic risk surveillance, to be discussed shortly. This position seems to be supported by Andrew Haldane, see ‘Tail of the Unexpected’ (‘The Credit Crisis Five Years On: Unpacking the Crisis’ conference, University of Edinburgh Business School, 8 June 2012) www.bankofengland.co.uk/publications/Documents/speeches/2012/speech582.pdf accessed 14 December 2012.

\textsuperscript{128} Roy C Smith and Ingo Walter, Governing the Modern Corporation (Oxford: Oxford University Press 2006), 281.


\textsuperscript{130} Tamara Lothian, ‘Beyond Macroprudential Regulation: Three Ways of Thinking about Financial Crisis, Regulation and Reform’ (2012) 3 Global Policy 410.

\textsuperscript{131} This is discussed at great length in several books that detail how the financial sector has become self-serving, generating large profits in order to grow empires and justify huge remuneration packages; see Suzanne McGee, Chasing Goldman Sachs (New York: Crown Business 2010); Gillian Tett, Fool’s Gold: How Unrestrained Greed Corrupted a Dream, Shattered Global Markets and Unleashed a Catastrophe (London: Abacus 2010).
relying on private sector finance for financial needs and developing public sector finance as a public good.\textsuperscript{132} Such a perspective may require fundamental rethinking of the role of finance in the private sector. The post-crisis regulatory reforms so far are arguably based on the assumption that the financial sector should retain primacy in its functions relating to resource allocation. O’Brien views this approach as ‘privileging innovation over security’.\textsuperscript{133} In the wake of the crisis, although policymakers are now valuing ‘security’ in terms of their emphasis on maintaining financial stability, policymakers have not become sufficiently unconvinced by or disillusioned with ‘innovation’. Although Moloney\textsuperscript{134} observes that there is greater distrust of financial innovation and financialisation, as evidenced in EU policymakers’ preference to subject financial innovation to scrutiny, an overhaul of regulatory ideology towards recalibrating finance for social utility or welfare is still remote. The post-crisis regulatory reforms do not suggest a fundamental move towards regulating the allocational role the financial sector should serve. Luhmann’s thesis on functional systemic differentiation may be very much at work here in sustaining the self-referential nature of the financial sector as a system, such that notions of social utility, justice and values are relatively unsuccessful in pervading its sphere.\textsuperscript{135} However, as the system has almost suffered an implosion, the opportunity should perhaps be seized to question the normative purposes that are served by the financial sector and its systemic boundaries. It may, however, be difficult to justify why ‘social utility’ should feature in financial regulation. After all, financial sector participants are in the best position to judge their own private utility from financial sector transactions. Can policymakers better allocate risk and capital, given that the tide has already turned against centrally planned economies?\textsuperscript{136}

Further, it could be argued that the ‘social utility’ sought consists in maintaining essential financial services, such as deposit, payment, clearing and settlement, and thus regulatory intervention should be limited to such issues, so as not to encourage unnecessary and possibly inefficient regulatory creep.

In sum, since the global financial crisis, there has been no radical overhaul of the role of private sector finance. Policymakers and regulators continue their

\textsuperscript{135} See Tatjana Schönwälder-Kuntze, “Corporate Citizenship” from a Systems-Theoretical Point of View’ in Jesús Conill, Christoph Luetge and Tatjana Schönwälder-Kuntze (eds), Corporate Citizenship, Contractarianism and Ethical Theory (Surrey: Ashgate 2008).
efforts to repair the existing system of finance, suggesting that ‘social utility’ is best understood as preserving the private utility hitherto derived from financial sector products and transactions. Regulators are cautiously developing tools to enable them to intervene for the purposes of ‘financial stability’. However, regulators are keen to base their expanded powers upon technocratic and rational frameworks so that the impressions of unlimited discretionary power are limited. This also means that the ideological power of ‘financial stability’ remains limited in changing the fundamental premises of financial regulation. Gray and Bholat, however, wonder whether quantitative measures of systemic risk currently being developed should not be tweaked to include qualitative input, such as social tolerance for the levels of financial stability/instability in the economy at any given point in time, rather than leaving the measures entirely to technocratic and expert communities. The drawbacks of a rationalised and strongly quantitative approach to understanding systemic risk are that real social concerns may become depersonalised. Indeed, a technical and narrow-minded approach to addressing systemic risk could lead to errors of regulatory judgement being magnified throughout the financial sector.

The renewed vigour in the pursuit of financial stability as a regulatory objective is unlikely to give rise to unlimited discretionary expansions in regulatory power, as new regulatory powers are very much based on technocratic and precise criteria. The resurgence in regulatory powers and governance to address ‘financial stability’ is not intended to result in a reordering in the role of private sector finance. The predominantly technocratic manner in which ‘financial stability’ is likely to be pursued as a regulatory objective may indeed prevent a more fundamental ideological revolution from taking place. In other words, the post-crisis resurgence of financial regulation in the name of ‘financial stability’ does not seem to light the way towards a radical overhaul of the nature of financial regulation. Financial regulation is being readjusted based on cognitive learning from the crisis and epistemological developments in the understanding of systemic risk and how it works. However, as indicated by the Occupy movements in Wall Street, London and elsewhere in late 2011, there is social appetite for financial regulation objectives to take into account the social utility, values and justice behind private sector finance. It remains to be seen to what extent these will feed into the shaping of regulatory objectives. The drive to incorporate social utility into regulatory objectives may end up influencing the as yet imprecise definition of ‘systemic risk’.

However, the protean nature of ‘financial stability’ may also be subject to political objectives. The resurgence of regulatory power in managing ‘financial stability’

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stability’ could also be used to further national economic policy.\textsuperscript{139} This potential trajectory in financial regulation could be pertinent to states desperately managing their levels of sovereign debt, which have become a source of financial instability in a number of euro area countries. For example, micro-prudential regulation that ties capital adequacy and liquidity regulation to holdings of sovereign debt regarded as ‘safe’ or ‘liquid’ may be a tool for maintaining the market in sovereign debt. The perceived safety of euro area banks bolstered by regulation may also contribute to a friendlier climate for sovereign debt auctions. The next section turns to whether the financial stability objective may be coupled with monetary policy and central bank functions in the UK and the EU.

\subsection*{2.4 Financial regulation as a tool for domestic economic policy and its relationship to monetary policy}

Loose monetary policy in the United States in the decades leading up to the global financial crisis has been argued to be relevant to excessive levels of risk-taking by banks, contributing to the scale of the crisis in 2008–9.\textsuperscript{140} Although it has been the trend to separate banking/financial regulation from central banking, the connections between financial regulation and monetary policy are being revisited in order to ascertain how they may work together to deliver financial stability. In the UK, financial regulation has been separate from central banking since 1997, when banking supervision moved from the Bank of England to the FSA. In the EU, the European Central Bank (ECB) has been established as an independent body with a distinct mandate and this has not included financial regulation. However, important synergies have been lost in the removal of financial regulation from central banking and, in both the UK and EU, there are now reforms to re-establish the central bank’s role in preserving financial stability alongside its role in monetary policy.\textsuperscript{141} Both the Bank of England and the ECB will assume responsibility in micro-prudential supervision. The Prudential Regulation

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Authority (PRA), a subsidiary of the Bank of England, has been created to carry out micro-prudential oversight in the UK from mid-2013. The ECB will assume the role of micro-prudential supervisor for euro area banks and banks in non-euro area countries that are willing to subject themselves to its oversight (the Single Supervisory Mechanism, to be in force from 2014). The role of macro-prudential supervision (discussed in detail in Part 4) will also be assumed under the umbrella of the central bank in both the UK and EU.

The earlier arguments for the separation of central banks from financial regulators are based largely on the fear that conflicts of objectives from the perspective of ‘financial stability’ would hamper effective monetary policy.\(^{142}\) Di Noia and Di Giorgio use empirical evidence to show that countries with central banks whose role includes banking supervision have not managed to keep inflation lower (perhaps because they have too much on their plate) than in countries where the functions of central banking and banking supervision are separate.\(^{143}\) However, Davies and Green argue that the emphasis on monetary policy, though not wrong, has led central banks in developed countries to adopt a narrow focus on price stability at the expense of a wider contribution to financial stability.\(^{144}\) The separation of banking supervision from central banking also means that useful supervisory information regarding banking activities, asset profiles and so on is not readily available to central banks, and this could in turn hamper effective monetary policy.\(^{145}\) Seater argues that not only is bank supervision useful to monetary policy – in the sense that central bankers are better able to set policies on the supply of money in the economy if they know what allocational trends are taking place in the financial sector – but that the control over monetary policy is itself beneficial for adjustments in bank regulation.\(^{146}\)

In the field of capital adequacy requirements, for example, the supply of money can be positioned at a level taking into account of the risk profiles of banks and their activities. It has also been argued that central banks have an integral role in preserving financial stability as they provide liquidity assistance of the last resort.\(^{147}\) In sum, the role of the central bank as being central to financial

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stability.\textsuperscript{148} is being strongly reaffirmed although it may be argued that central banks never really abandoned the objective of ‘financial stability’.\textsuperscript{149} Post-crisis, commentators have begun to converge on the view that the separation of monetary policy from bank supervision is appropriate for times of perceived ‘financial stability’ when the probability of crises is low,\textsuperscript{150} but perhaps not when times are more volatile. The connections between financial regulation and monetary policy have now been re-established within the regulatory frameworks for micro- and macro-prudential supervision, as mentioned above. It is noted that macro-prudential supervision does not regard banking supervision as servant to monetary policy or vice versa, but is based on the idea that signs of instability will be dealt with pre-emptively, using a range of instruments including financial regulation (especially micro-prudential regulation) and monetary policy.\textsuperscript{151} Further, in the UK, the Bank of England’s subsidiary, the Prudential Regulation Authority (to be discussed in Part 4) will be responsible for overseeing special resolution regimes (SRRs) for banks. This may be synergistic with the Bank of England’s role as lender of last resort,\textsuperscript{152} both roles being particularly relevant in a financial crisis as a means of preserving financial stability.

However, if the reinvigoration of financial regulation merely entails subsuming financial regulation under general economic management, financial regulation may become a mere servant to policy. If this were to happen, financial regulation might end up highly contextualised and even less driven by ideology than during the time when the economic rationale dominated the character of financial regulation. If such policymaking is to be undertaken largely under central bank leadership in the UK and EU, the technocratic and removed nature of central banking may influence the nature of financial regulation, entailing an elitist culture. Part 4 critically discusses this issue. Indeed, it is a recurring theme in this book that one of the unintended consequences of the resurgence of financial

\textsuperscript{149} Davies and Green argue that the pursuit of ‘financial stability’ on the books in the pre-crisis years was superficial, as evidenced by the less than insightful Bank of England’s Financial Stability Reviews which exclude many key issues, such as bank liquidity positions and asset price trends. See Howard Davies and David Green, Banking on the Future: The Rise and Fall of Central Banking (Princeton, NJ: Princeton University Press 2010), 66.
regulation and regulatory power in the post-crisis era is a movement towards elitism in financial regulation, led by regulators who seek technocratic and rational bases for regulation and the partnership of sophisticated epistemic communities and stakeholders. This movement could result in the development of narrow-minded financial regulation rationales and techniques that are alienated from wider social demands and needs. This issue will be taken up in the last section of this chapter.

The next section will discuss European market integration as a key driving force shaping the character of financial regulation in the EU and how it now grapples with the language of financial stability, in which national governments and regulators may have great but diverging interests.

2.5 European market integration and legal convergence

2.5.1 Market integration and regulatory convergence

One of the major objectives in financial regulation at the EU level is the achievement of an integrated financial services market in the EU. The integration of the EU financial services markets should be considered against the backdrop of EU economic integration as a whole, based on the four freedoms in the Treaty of Rome and, later, the Single European Act 1987. One of the ideological foundations for economic integration lies in ordoliberalism, which supports the creation of an economic ‘state’ or polity. It has also been envisaged that integration may be carried out at a technocratic level towards economic ends. Positive integration was introduced by creating minimum harmonised legal standards in the 1980s and 1990s, such as in prudential regulation for banks and securities regulation.
It is generally agreed that the internal market for capital fundraising and investment activity was still far from being complete by the end of the 1990s. In 1999, a detailed report was finally issued by the Financial Services Policy Group (comprised of Ecofin Council ministers, the ECB and the European Commission) proposing action in order to facilitate the completion of the internal market in capital fundraising (the FSAP). These measures were endorsed in the Lamfalussy Report of 2001. The reform proposals recommended that the internal market for capital be completed by introducing incentives for freedom of movement of capital in the form of ‘passports’ based on the platform of harmonised legal standards. Such harmonisation was to provide a level playing field and prevent a race to the bottom. Extensive legal harmonisation has also taken place in investment regulation (e.g. securities and UCITS product regulation) and comprehensive regulatory frameworks have been introduced for investment services and investment markets (whether physical or via electronic platforms), allowing these to flourish and to become more competitive and robust. International developments in capital adequacy harmonisation and combating financial crime have also found their way into legal harmonisation in the EU.

**Objectives**


162 UCITS recast Directive.

163 MiFID.

164 MiFID.

165 Market Abuse Directive.


‘Level Three’ Committees such as the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) were formed pursuant to the Lamfalussy recommendation to foster supervisory and regulatory convergence in the implementation of harmonised legal standards.\textsuperscript{168} Level Three Committees forged technical guidelines to assist in the consistent implementation of harmonised legal standards and to achieve consistency in supervisory techniques and styles. Although the technical guidelines were not binding, the Committees represented a soft framework for regulatory convergence on the books, as well as in practice.\textsuperscript{169} Respect for comity and peer pressure in the Committees,\textsuperscript{170} mechanisms such as the CESR’s consolidated ‘Questions and Answers’\textsuperscript{171} and informal mediation processes facilitated by CESR for disputing national regulators, all gently nudge Member States towards convergence in the transposition and implementation of the Directives.

Market integration in the financial sector has been pursued with almost religious fervour and regulatory convergence is believed to facilitate such integration. Has the inexorable pace of legal harmonisation been affected by the global financial crisis of 2008–9?

\subsection*{2.5.2 De Larosière Report 2009\textsuperscript{172}}

At the onset of the global financial crisis, in 2008, the European Commission established a high-level group of experts chaired by Jacques de Larosière to recommend a blueprint for financial supervision in the EU.


\textsuperscript{171} Majone has also argued that the platform for technical standards and developing technocracy finds less resistance to network cooperation and consensus. See Giandomenico Majone, Regulating Europe (London: Routledge 1996).

The de Larosière Report provides a comprehensive analysis of the weaknesses in the financial sector in the EU and recommends stronger regulatory governance in many areas including micro-prudential capital adequacy, oversight of credit rating agencies, and oversight of the parallel banking system (such as unregulated hedge and private equity funds). The Report also suggests reforms to conduct of business rules applicable to investment firms (such as the separation of depositary institutions from hedge funds in response to the Madoff scandal), to remuneration policies, to corporate governance and to the trading of derivative instruments (in order to improve centralised trading and transparency). In terms of improving crisis management in the EU financial sector, the Report recommends instituting macro-prudential supervision at the EU level so as to have a bird’s-eye view of trends and patterns in the financial sector and to develop an effective early warning system enabling Member State regulators to take coordinated preventive action.173

The Report supports expansion in legal harmonisation as:

(a) a single financial market – which is one of the key-features of the Union – cannot function properly if national rules and regulations are significantly different from one country to the other;
(b) such a diversity is bound to lead to competitive distortions among financial institutions and encourage regulatory arbitrage;
(c) for cross-border groups, regulatory diversity goes against efficiency and the normal group approaches to risk management and capital allocation;
(d) in cases of institutional failures, the management of crises in case of cross-border institutions is made all the more difficult.174

Expanded legal harmonisation is regarded in the Report to be essential to the market integration project, as well as improving coordinated supervision and cross border crisis management in the public interest.

2.5.3 The implementation of the de Larosière Report

The Report considers legal integration to be an important driver in EU financial regulation, but it is now infused with the need to preserve financial stability. The Report supports ‘regulatory consistency’ as being essential to the single market, and the European Commission continues to assert that there is ‘clear complementarity between financial stability and integration. Economic and financial integration is not an obstacle to stability, and integration can deliver strong

benefits for the broader economies’.\textsuperscript{175} Policymakers at the EU level seem to be anxious to align the needs of financial stability with indefatigable legal integration.\textsuperscript{176} Gestures, such as changing the title of the annual ‘European Financial Integration Monitor’ to the ‘European Financial Stability and Integration Monitor’ since 2010, are indicative of this concern to persist with market and legal integration.

Regulatory reforms to EU-level financial regulation have taken place and the European System of Financial Supervision (ESFS) has now been established as the European institutional architecture for financial regulation. These measures endeavour to ensure that regulatory convergence is aligned with the needs of financial stability.

Where substantive legal reform is concerned, the Regulation for Credit Rating Agencies 2009\textsuperscript{177} has been swiftly enacted, creating a system of EU-wide authorisation for credit rating agencies, subject to ongoing supervision at Member State level. The Capital Requirements Directives 2009 and 2010 have also amended the 2006 Directive. They now provide for enhanced credit risk recognition of structured finance products,\textsuperscript{178} retention of risk\textsuperscript{179} as a form of risk management and supervision of remuneration policies\textsuperscript{180} at financial institutions to be aligned with risk management and micro-prudential measures, such as the possible imposition of leverage controls.\textsuperscript{181} The Regulation on short selling and certain aspects of credit default swaps also provides for a disclosure regime for short sales beyond a particular level and the discretionary imposition of regulatory bans and controls in times of ‘exceptional circumstances’.\textsuperscript{182} The Directive on

181 Capital Requirements Directive 2010, art 156.
Alternative Investment Fund Managers 2011 also finally passed both Council and Parliament in mid-2011 allowing for the expansion of supervisory oversight of prudential and conduct of business matters and disclosure regulation to assist regulatory surveillance. Further amendments to the initial Lamfalussy procedure Directives have also been passed in respect of the Prospectus Directive 2003, and will be passed for the Markets in Financial Instruments and Transparency Directives.

2.5.4 Institutional reforms – European system of financial supervision

The institutional reforms proposed in the de Larosière Report have also been implemented, resulting in the creation of the ESFS. The ESFS comprises three pan-European financial regulators (the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), a Joint Committee


of the European Supervisory Authorities and national regulators, and a pan-European macro-prudential supervisor (the European Systemic Risk Board (ESRB)) formed under the auspices of the ECB.

The EBA, ESMA and EIOPA are tasked with the continuing mandate of market integration and legal convergence but also protective objectives, such as systemic stability and consumer protection. The Regulations establishing the EBA, ESMA and EIOPA have mirror provisions on the roles, functions and powers of these bodies. In terms of furthering the market integration objective, these bodies have the power to recommend technical standards for uniform implementation of EU Directives in financial regulation and to issue binding guidelines on supervisory practices and standards. Further, by mid-2014, the ECB will institute a Single Supervisory Mechanism to set standards for and engage in micro-prudential supervision for all euro area banks and banks in non-euro area countries that choose to be subject to the ECB’s oversight, as ‘[t]he single market and the banking union are . . . mutually reinforcing processes’. The three European authorities are also responsible for achieving market integration through supervisory convergence, based on common guidelines, and the monitoring of coherence in supervisory action. The three authorities, in forging supervisory convergence, have the power to facilitate the settling of disagreements between national regulators, or where conciliation fails, to impose a decision to resolve the disagreement. They are also responsible for establishing colleges of supervisors for joint supervision and stress testing of financial institutions, forging a common supervisory culture and conducting peer reviews of national regulators for convergence in supervisory measures.

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193 EBA, ESMA and EIOPA Regulations, arts 8, 10, 15–16. However, the power to make such delegated legislation is revocable by the European Council and Parliament (see arts 12 and 13) and is subject to review by the Commission (art 11). The substantive technical standards may also be vetted and objected to by the Commission (art 14), providing layers of checks and balances to the exercise of such legislative power. The status of successfully passed standards and guidelines are, however, binding on Member States and non-compliance would amount to a breach of Union law (art 17).
195 EBA, ESMA and EIOPA Regulations, art 16.
196 EBA, ESMA and EIOPA Regulations, arts 18, 19.
197 EBA, ESMA and EIOPA Regulations, art 21.
198 EBA, ESMA and EIOPA Regulations, art 29.
199 EBA, ESMA and EIOPA Regulations, art 30.
The three authorities also have the mandate to take the lead on setting policies and standards in consumer financial protection\(^{200}\) and ensuring the consistent application of financial guarantee schemes.\(^{201}\)

The three authorities’ final major mandate is in relation to crisis management and systemic risk. Article 18 of the EBA, ESMA and EIOPA Regulations provides for the three authorities to facilitate coordinated crisis management by national regulators. In exceptional circumstances, supported by a Council resolution, the three authorities have the power to address decisions directly to national regulators and, where there is non-compliance by regulators, to address a decision directly to financial institutions. In dealing with systemic risk mitigation, the three authorities are tasked with developing quantitative and qualitative systemic risk indicators,\(^{202}\) in conjunction with the ESRB. The three authorities are also to develop a permanent capacity to deal with systemic risk policies and governance,\(^{203}\) by continuing to monitor and assess market developments\(^{204}\) and by collecting information from national regulators and conducting analyses.\(^{205}\) The three authorities may for the purposes of discharging their systemic risk mandate put in place plans for resolution or recovery of financial institutions.\(^{206}\) The authorities are required to provide assessments to the European Parliament, the Council, the Commission and the ESRB of trends, potential risks and vulnerabilities at least once a year.\(^{207}\)

The ESRB\(^ {208}\) is the pan-European body that is tasked with macro-prudential oversight. It is responsible for collecting and analysing information in order to identify systemic risk signals, determine the priorities of these risks and issue appropriate warnings and recommendations in view of these risks.\(^{209}\) The Board is directed by a General Board\(^ {210}\) comprised of the President and Vice-President of the ECB, governors of national central banks, the Chairpersons of the three European authorities mentioned above, a Member of the European Commission, the Chairs and Vice-Chairs of the ESRB’s Advisory Scientific Committee and the Chair of the ESRB’s Advisory Technical Committee. The General Board will be assisted by a Steering Committee\(^ {211}\) made up of an even spread of representatives from the ESRB itself, the General Board, the ECB, EBA, ESMA and EIOPA Regulations, art 9.

\(^{201}\) EBA, ESMA and EIOPA Regulations, art 26.

\(^{202}\) EBA, ESMA and EIOPA Regulations, arts 22, 23.

\(^{203}\) EBA, ESMA and EIOPA Regulations, art 24.

\(^{204}\) EBA, ESMA and EIOPA Regulations, art 32.

\(^{205}\) EBA, ESMA and EIOPA Regulations, art 35.

\(^{206}\) EBA, ESMA and EIOPA Regulations, art 25.

\(^{207}\) EBA, ESMA and EIOPA Regulations, art 32.


\(^{209}\) ESRB Regulation, art 3.

\(^{210}\) ESRB Regulation, art 6.

\(^{211}\) ESRB Regulation, art 11.
the ESMA, EBA and EIOPA, the European Commission, the Economic and Financial Committee of the European Council, and the two advisory committees of the ESRB. The ESRB’s work will be assisted by an Advisory Scientific Committee,212 which comprises of experts from across a wide range of fields and skills, and the Advisory Technical Committee,213 which consists of representatives from national central banks and EU-level representation.

The ESRB has the power to collect and request information from the three European authorities mentioned above, from national central banks and from regulators.214 It is also tasked with provision of information to the three European authorities where appropriate.215 The collection of information by the ESRB, however, must be in aggregate form and may not identify any particular financial institution.216 Although this may be understandable in terms of protecting financial institutions from premature reputational risk, it may also hinder the ESRB in making a judgement on whether an individual institution is particularly exacerbating systemic risk. The ESRB may also consult private sector stakeholders for advice, contributing to its analysis capacity.217

The ESRB’s role is to issue warnings and/or recommendations to the EU as a whole or to individual Member States or national regulators.218 These warnings and recommendations are to be contemporaneously transmitted to the addressees and the Council and Commission. The ESRB may follow up with the addressees as to what action is taken in respect of the warnings or recommendations, but the general enforcement procedure for breach of Union law under the Treaty does not apply.219 Where appropriate, the General Board may make its warnings or recommendations public, once the Council and addressees have been informed and a two-thirds majority vote obtained in the meeting of the General Board.220 A number of commentators221 have noted that although the power of the ESRB is limited to such ‘soft law’ warnings, these measures are unlikely to be ignored. Indeed, they are likely to facilitate a form of economic governance that may be adapted to suit both boom and crisis times.

Does the discussion above allow us to conclude that legal convergence is not in the least undermined by the onset of the global financial crisis and the needs of financial stability, that on the contrary legal convergence is in fact on the rise?

212 ESRB Regulation, art 12.
213 ESRB Regulation, art 13.
214 ESRB Regulation, art 15.
215 ESRB Regulation, art 15.
216 ESRB Regulation, art 15(3).
217 ESRB Regulation, art 14.
218 ESRB Regulation, art 16.
219 ESRB Regulation, art 17.
220 ESRB Regulation, art 18.
EU policymakers see legal integration as being reinforced by financial stability concerns and that financial stability concerns should not undermine legal integration. However, it will be argued that the needs of financial stability are not so aligned with those of European market integration. This friction may produce governance and ideological challenges to the development of European financial regulation. The legal integration in EU financial regulation achieved so far does not in itself support the continuing assumption that the needs of regulatory governance and economic policy are completely aligned.

Commentators have backed legal convergence in EU financial regulation on the basis of the high actual level of market integration in the wholesale financial and banking sectors. Market integration has resulted in increasing levels of cross-border activities, which may give rise to issues of supervisory efficacy and crisis management in case of cross-border spillover effects. Policy integration has been slow in the much-needed areas of cross-border supervision, deposit-guarantee schemes, lender of last resort policy, crisis management and resolution schemes, such as special bankruptcy regimes and state bailout. Warnings were sounded before the onset of the global financial crisis but, as Pisani-Ferry and others have pointed out, market integration has outpaced policy integration. We suggest that the areas in which policy integration has been achieved reflect industry and producer interests, and that these interests gave a tremendous boost to policy resolve. But the areas of policy where integration is lacking, though closely tied

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222 Ferran gives an in-depth account of the ‘battles’ at the EU level between Member States, Member States and the European Commission and the European Commission and Parliament in the shaping of various financial services legislation reforms post-crisis. These ‘battles’ highlight the different interests and ideologies at play and an ‘integrated’ front is often the result of protracted wrangling. She warns that integration is not to be assumed for the future given challenges ahead such as the euro area sovereign debt crisis. See Eilis Ferran, ‘Crisis-driven Regulatory Reform: Where in the World is the EU Going?’ in Eilis Ferran, Niamh Moloney, Jennifer G Hill and John C Coffee Jr., The Regulatory Aftermath of the Global Financial Crisis (Cambridge: Cambridge University Press, 2012), 1.


to the risks of market integration, are fraught with difficult political differences as they all involve some fiscal cost. Further, there is also no incentive for the industry to push for legal integration in these areas, as the needs of overall economic governance are not of immediate commercial concern. Market integration has provided a friendly climate for the rise of SIFIs that undermine the patchwork of home-host country supervision in the pan-EU arrangements and increase the risk of losses exceeding what one Member State can bear.

The de Larosière Report is right in acknowledging that EU financial regulation has been inappropriate and inadequate in many areas. Although the gamut of regulatory and institutional reforms discussed above implement the Report, a number of key reforms closely related to financial stability have yet to be realised. This is because the collective action problems on the part of EU Member States have still not been overcome by the recent round of institutional reforms. First, a number of commentators argue that macro-prudential supervision undertaken by the ESRB should be supported by greater force of law and the ability to issue corrective mechanisms. Second, given that there are a significant number of SIFIs in the pan-EU market, it is argued that a common strategy should be developed for governing these SIFIs. SIFIs may engage in unique behaviour, as shown in the empirical research by Navaretti and others relating to the funnelling and transferring of resources across the banking group in times of crises. Further, the asset positions of SIFIs can be opaque, complex and difficult to disentangle as shown in the Lehman Brothers bankruptcy fallout. SIFIs may also adopt concentrated positions such as AIG’s credit default swaps exposure during the global financial crisis. SIFIs pose a key challenge to the management of systemic risk and a coordinated pan-European strategy is needed to monitor SIFI behaviour and information on SIFIs. Although the Liikanen Report proposes to deal with them by implementing mandatory structural separation, this proposal is not yet received with consensus by policymakers in the EU. There remains no coordinated EU-level strategy to deal with SIFIs as such.

Financial Management 443, arguing that market integration has allowed universal banking institutions to become large concentrated behemoths capturing ever larger market shares.

228 Discussed above under ‘The Perspectives of Systemic Risk’.
Third, it is also argued that coordinated blueprints for crisis resolution\textsuperscript{235} remain elusive, as Member States are not prepared to commit to \textit{ex ante} fiscal burden-sharing arrangements. Although the Commission has drafted a proposed Recovery and Resolution Directive,\textsuperscript{236} the discussion in the next section will highlight the challenges that remain for the finalisation of this Directive. Finally, the financial stability of the EU as a whole is closely connected with the financial stability of the euro area, which is being threatened due to the fiscal imprudence\textsuperscript{237} of several countries triggering sovereign debt crises in those countries. Work in this area is still in progress, although some semblance of a new fiscal and growth pact\textsuperscript{238} seems to have been agreed upon.

The regulatory and institutional reforms achieved so far have addressed some of the concerns in the de Larosière Report relating to financial stability at the EU level. But there remain gaps in the EU regulatory regime in relation to financial stability needs. The Commission has also identified setbacks and pauses in market integration in the financial sector since 2010.\textsuperscript{239} The next section will argue that the needs of financial stability at the national level could legitimately challenge the assumed bias in favour of market integration.

### 2.5.5 Financial stability as justifying legal divergences

As argued earlier, ‘financial stability’ essentially relates to a relative tolerance level for risk-taking. It may be argued that it is easier to find consensus on acceptable levels of tolerance within smaller communities than within larger communities. This would suggest that tolerance levels are more likely to be readily determined at a national level than a pan-European or international level.\textsuperscript{240} Hence, ‘financial


\textsuperscript{240} Although Beck argues that global risks faced by citizens worldwide may provoke a common response in the form of a ‘cosmopolitan’ moment, where the collective consciousness of society rises up to challenge the situation of ‘irresponsibility’ and frames the discourse not in economic, rational and efficiency terms, but in terms of justice and rights. See Ulrich Beck, \textit{World At Risk} (Giaran Cronin tr, Cambridge: Polity Press 2009).
stability’ is a malleable concept that can operate on national, pan-European and international levels, and may justify different policy choices at different levels. This also explains why, in the name of ‘financial stability’, Member States have responded differently to the global financial crisis. The global financial crisis has affected the financial institutions and sectors of Member States differently and to different extents, and the choices made reflect the need to maintain national interests in ‘financial stability’. There are three types of divergences that have taken place in the name of reflecting national interests in ‘financial stability’.

The first type of divergence refers to actions taken by Member States that are not subject to maximum legal harmonisation in EU financial regulation. It may be said that such divergences are therefore to be expected, as maximum legal harmonisation has not been envisaged. However, a number of these actions have been clear expressions of national interest without consultation at the EU level and with little consideration of spillover effects upon other Member States. The second type of divergence actions refers to ‘super-equivalent’ regimes that have been legislated in order to reflect and protect national interests, despite maximum legal harmonisation measures already in place in EU financial regulation. The third type of divergence concerns exceptional regimes that likely deviate from the Treaty freedoms in that they erect obstacles to the freedom of establishment or to provide services but nevertheless may arguably be justified in the public interest.

2.5.6 Divergences where no maximum legal harmonisation exists

In the pre-crisis years, one area in financial regulation that was not subject to any legal integration was financial institution crisis management and resolution regimes. Although market and legal integration promoted more cross-border financial activity and the establishment of financial institutions with an EU-wide footprint, financial institutions were ‘global in life and national in death’. National authorities realised that it was up to them to take the best courses of action to protect national financial stability after the fall of Lehman Brothers in the US in September 2008, which was a key trigger point for bank crises in various parts of the EU.

Faced with the threat of banking collapses, national governments in the EU have taken a number of actions that principally reflect domestic interests and policy, although ad hoc forms of coordination have been observed. The UK, which needed to bail out the Royal Bank of Scotland and Halifax Bank of Scotland, 241

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developed a plan to provide liquidity to the financial system. The plan involved a special liquidity scheme operated by the Bank of England, recapitalisation of the banks whereby the government would buy bank shares, and government guarantees of new debt issued by the banks.\(^{244}\) Quaglia argues that this was essentially a British plan,\(^{245}\) which was later ‘transferred’ to other Member States as they designed their own banking bailouts. The European Commission exerted its influence much later, with a Communication on bank recapitalisation and another on impaired bank assets in December 2008 and February 2009, respectively.\(^{246}\) The subsequent bailout of cross-border bank Fortis was also carried out through loose coordination of the concerned Benelux national governments. The three governments injected capital into the national parts of Fortis within their respective territories, but when the injection proved to be insufficient for Fortis, the Netherlands nationalised its part of Fortis, Belgium nationalised its part of Fortis too but quickly disposed of its share in BNP Paribas and Luxembourg sold its part of Fortis to La Baloise, a non-life insurance group. The flurry of bank bailouts in 2008 was therefore characterised by ad hoc coordination, if necessary among Member States, and by bilateral rather than multilateral forms of policy coordination. Although the bailout of Dexia by France, Belgium and Luxembourg in late 2011 was more of a joint effort, such coordination was still relatively bilateral and ad hoc in nature.\(^{247}\) The bank bailout patterns in the EU have shown a tendency to exert strong national preferences in the absence of a multilateral strategy for pan-European crisis resolution. Further, the most heavily criticised government in the global financial crisis was that of Iceland. Iceland took unilateral action to freeze depositor accounts and assets when its three largest banks, Landsbanki, Glitnir and Kaupthing, got into trouble, affecting depositors in the EU, especially in the UK and the Netherlands. The UK’s retaliatory action against Iceland – using national terror laws to freeze Icelandic bank assets located in the UK – was also an expression of national divergence in order to protect national depositors’ interests. Although the European Commission took Iceland to task at the European Court of Justice,\(^{248}\) the Court ruled that Iceland did not breach any Directive or the principle of non-discrimination in its actions as the failure of its deposit guarantee scheme to cope with the magnitude of the crisis did not entail state liability. The restructuring of failed banks in Iceland to preserve


\(^{248}\) EFTA Surveillance Authority with the European Commission v Iceland Case E-16/11 (28 January 2013).
its financial stability could not per se offend the principle of non-discrimination against foreign EU depositors of Icelandic bank Icesave (although the resulting effect was the non-protection of foreign depositors in the EU).

The Commission’s proposed Directive now provides for legal integration in the SRRs to be established in Member States. SRRs are legal frameworks allowing national authorities to take over a financial institution in crisis in order to stem panic and decide how the institution may be recovered or resolved. The resolution tools are: the outright sale of business, the creation of a bridge institution to temporarily own and run the failing institution until a purchaser may be found, and the separation of good from bad assets and mandatory bail in for creditors and equity holders so that the private sector will absorb as much losses as possible. The global financial crisis has, however, shown that nationalisation is a key tool and is perhaps the tool most resorted to, but the Proposal is silent on this issue, leaving cross-border resolution problems that involve nationalisation to Member State negotiations. Perhaps the omission is due to concerns for moral hazard in case banks and financial institutions are given the impression that state bailouts are on the cards. But this omission is a serious gap in the purportedly EU-wide strategy in crisis management to preserve financial stability. Commentators have argued that the public interest in the banking sector is such that state bailouts necessarily need to be considered. With cross-border banking in the EU, a coordinated strategy in state bailout is required to prevent protectionist and beggar-thy-neighbour approaches, and assist in distributing the fiscal burden in a more predictable way. Fiscal burden sharing is mentioned as the possible subject of Member States’ bilateral agreements. But is not EU-level legal integration supposed to overcome some of the differences and difficulties in Member States’ approaches that could be subject to protracted wrangling and negotiation? It is queried if the proposed Directive is leaving the most difficult issues that relate to financial stability – the role of government assistance and fiscal cost sharing to one side and merely putting together what it can for the


purposes of legal integration? Draghi\textsuperscript{253} suggests that an EU-wide resolution authority may be required to deal with cross-border resolutions. This issue is likely to be subject to intense negotiations among Member States, and between Member States and the European institutions.\textsuperscript{234} The limits of the proposed Directive show that legal integration should perhaps not be prematurely rushed into and that national financial stability needs do pose challenges to legal integration.

Further, fiscal cost may also be incurred for the Directive’s other proposed resolution options such as the bridge bank and the separation of assets as bad assets may have to be underwritten or absorbed by the taxpayer. Although the Directive provides that Member States should establish group resolution schemes for cross-border banks in the EU on an \textit{ex ante} basis,\textsuperscript{255} such \textit{ex ante} schemes would be tested when a real situation arises. \textit{Ex ante} financing arrangements\textsuperscript{256} would also be tested when \textit{ex ante} arrangements are insufficient.\textsuperscript{257} The proposal to borrow from deposit guarantee schemes\textsuperscript{258} in Member States may also meet with resistance from Member States.

The Commission also encourages a policy of early intervention\textsuperscript{259} in institutions that may show signs of imminent failure. In cross-border groups, the decision whether or not to intervene early may be contested between joint supervisors. The Commission’s proposed Directive will not rule out actual implementational differences between Member States and problems that may occur at the level of coordination.

Although legal integration is afoot in the key area of financial institution crisis management and resolution, this is an area that will arguably expose the limits of legal integration as national interests are varied and the achievement of common ground may be limited. For example, the UK’s banking sector features many internationally active global banks, many of which have originated from the US. The UK’s shared interests with the US in terms of crisis management and resolution are more pronounced than with many other Member States. The UK and US have now entered into an agreement to entrust leadership of resolution operations to the Federal Deposit Insurance Corporation if a systemically

\begin{thebibliography}{99}
\bibitem{255} Commission Proposal above, art 83ff.
\bibitem{256} Commission Proposal above, art 91ff.
\bibitem{257} Commission Proposal above, article 95.
\bibitem{258} Commission Proposal above, article 99.
\end{thebibliography}
important financial institution that originates from the US should fail. This is a form of divergence adopted by the UK in relation to how resolution would apply to bank subsidiaries in the UK whose parent companies are based in the US. Resolution in such situations would be led by the US authorities who would apply different legal frameworks to those that may be harmonised at the EU level.

The proposed Directive also deals with harmonising more aspects of deposit guarantee schemes including how they are funded. Although this aspect was pointed out in the Iceland case as being unharmonised previously and perhaps its harmonisation could have made national deposit guarantee schemes more robust, the Iceland case is very instructive for what it has decided upon. The upshot of the case is arguably that however much harmonisation is achieved with regard to the structure and framework of national deposit guarantee schemes, there could be no assurance that Member States would be taken to task for the failure of a scheme, and divergent national actions taken to preserve the Member State’s financial stability could be regarded as not infringing the principle of non-discrimination.

One must not forget the divergent actions taken by Member States in the global financial crisis concerning policy choices made in respect of national deposit guarantee schemes. The EU established minimum legal harmonisation for deposits at 20,000 euros per defined deposit account in 1994. However, the UK exceeded that level even before the crisis, providing for 100 per cent of the first £2,000 plus up to 90 per cent of the next £33,000. After the UK suffered the Northern Rock bank run in October 2007, the deposit guarantee in the UK was raised to £50,000 per defined deposit account. In the wake of the Icelandic banking crisis in June 2008, the UK government then guaranteed 100 per cent of the defined deposits placed with the failed Icelandic banks for UK depositors. In September 2008, when a number of Irish banks, including Anglo-Irish banks, were on the brink of collapse, the Irish government announced a 100 per cent guarantee for deposits in six banks, causing deposit outflows to take place from other Member States. Though criticised by some commentators as a ‘beggaring-thy-neighbour’ approach, the policy remains in place. The EU has, however, taken the decision to increase its minimum deposit guarantee to 100,000 euros per defined account. The unilateral Irish decision remains the poster child for...
questioning whether legal convergence in deposit guarantee schemes will actually bring about conforming action in all Member States. The Commission’s Proposal to allow deposit guarantee schemes as a form of backup funding for resolution arrangements will also directly threaten the ability of Member States to make a commitment like Ireland has done. The Irish choice shows the stark contest between national interest and European approaches.

2.5.7 Super-equivalent legal regimes

The second type of divergence observed relates to the institution of regulatory regimes that add to the regulatory frameworks imposed by maximum legal harmonisation measures at the EU level. Such ‘gold-plating’ or introduction of more stringent ‘super-equivalent’ regimes may be justified on the basis of national interests, such as consumer protection. In the UK, a key ‘super-equivalent regime’ is the Retail Distribution Review (RDR), which will be discussed in Chapter 8.

The UK may be regarded as having a unique reputation for challenging regulatory convergence in EU financial regulation by introducing super-equivalent regimes, one example of which is the client money protection reform instituted in the UK after a string of post-Lehman litigation, as will be discussed in Chapter 4. EU-level convergence in consumer protection regulation has achieved much in terms of frameworks and principles to be applied, such as suitability and appropriateness obligations. However, the actual application and enforcement of such standards depends heavily on the local conditions facing each national regulator, who may be better able to articulate how the standards are to be worked out and supervised.\textsuperscript{265} Further, the perceived inadequacy of consumer protection in financial services in the UK despite the existence of EU-level regulation raises questions of national interest, and could pose a future problem for financial stability. It may be argued that the UK is quite right to see super-equivalent regimes such as the RDR as a necessary reform. After all, the UK has a vibrant financial products market for consumers and has suffered persistent episodes of mis-selling, from endowment mortgages\textsuperscript{266} in the 1990s to payment protection insurance.\textsuperscript{267} Gerding argues that the underlying layer of consumer activity in the

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US sub-prime mortgage market precipitated the overflow of the financial crisis into the wholesale sector in late 2007.\textsuperscript{268} Hence, the impetus for taking national approaches in governing the retail financial services sector flows from supporting the regulatory objective of financial stability and mitigation of systemic risk. Moloney also critically queries whether increased levels of rule-making (particularly by ESMA) and the pursuit of supervisory convergence actually meet the needs of consumer protection.\textsuperscript{269}

\textbf{2.5.8 Deviations from Treaty freedoms – structural reforms to the banking sector}

The third type of divergence discussed is that of regulatory reforms, which impose additional barriers to entry for foreign establishments or providers of services coming from other EU Member States. The example given here is the potential implementation of structural reforms to the UK banking sector as proposed in the Independent Banking Commission Report (or Vickers Report),\textsuperscript{270} which will be dealt with in detail in Chapter 11. Although this example is again taken from the UK, the UK’s position on the matter shows how an international financial centre plans to deal with the issue of national financial stability.

The structural reforms in the Vickers Report would mean that cross-border entities that wish to engage in retail banking sector business in the UK would be subject to the new regulatory regime of structural separation. This would be the case if the legislation supporting the Vickers Report comes into effect in 2015.\textsuperscript{271} The European Commission has instituted the Liikanen review\textsuperscript{272} to see if structural reforms may be required in the EU as a whole. Although the Liikanen review\textsuperscript{273} favours structural separation of trading activities for banks that hold trading assets beyond 15 per cent of their total assets, the Liikanen proposals differ from the UK Vickers’ proposals in some respects, and it is more remote that the Liikanen proposals may be implemented soon. The EBA,\textsuperscript{274} for instance, does not support an immediate implementation of the Liikanen review’s structural reform proposals, preferring to focus on legal integration in resolution regimes in the EU. Even if the Liikanen proposals may be adopted in the EU, any differences between the


\textsuperscript{271} See the analysis in Eilis Ferran, ‘The New Mandate for the Supervision of Financial Services Conduct’ (2012) \textit{Current Legal Problems} 1–43, discussing the consequences of a heavily regulated regime for competition in the market.

\textsuperscript{272} ‘EU Banks Face Ring-fencing on Trading Assets’, \textit{Financial Times} (London, 10 Sep 2012).

\textsuperscript{273} Erkki Liikanen, High-level Expert Group on Reforming the Structure of the EU Banking Sector (Final Report, October 2012).

\textsuperscript{274} EBA, Opinion on the Recommendations of the High-Level Expert Group on Reforming the Structure of the EU Banking Sector (14 December 2012).
Liikanen proposals and the Vickers proposals (much of which have been endorsed by the UK coalition government) would still raise the question of whether the divergences may be tolerated within the accepted legal principles for deviation.

Can the structural reforms proposed in the UK be justified as being acceptable exceptions to the Treaty freedoms in view of the general good of financial stability in the UK? On the one hand, such structural reforms would directly address the problems raised by the unilateral action taken by Iceland in relation to the Icelandic banks’ retail business in the UK. On the other hand, these reforms could be viewed as protectionist and as infringing the Treaty freedoms in relation to establishment and provision of services. Mervyn King, the Governor of the Bank of England, has admitted that the Vickers Report reforms could be challenged by the EU.  

The Vickers Report has been accepted by the UK government and will be implemented by 2015. It may be argued that the Vickers Report reforms were well publicised in the UK and in the international press, and therefore the Council or Commission could have worked through dialogue and diplomacy to water down the restrictive implications of the Report for cross-border banking and financial services. However, in the absence of a judicial challenge, the EU’s silence may not be taken as acquiescence. Next, if we turn to the jurisprudence of the European Court allowing public interest-based restrictions upon the freedom to provide services or establishment, it is arguable that the Vickers Report reforms could fall within the public interest of the UK’s need to preserve financial stability.

In Alpine Investments BV v Minister van Financiën, Alpine took the Minister of Finance in the Netherlands to the European Court to complain against the Minister’s rule prohibiting cold-calling in commodity-linked investment transactions. Such cold-calling took place in relation to Dutch customers, as well as customers in the UK, Belgium and Luxembourg. Alpine argued that the Minister’s rule has infringed Alpine’s right to provide cross-border financial services to customers. The Court agreed to characterise the Minister’s rule as a restrictive measure that could be regarded as infringing the freedom to provide services. However, the Court held that the restrictive measure was justified as it was in the public interest of the Netherlands to provide regulatory controls in order to maintain the reputation of its financial markets. As the Minister had a valid concern with respect to customer treatment and possible complaints, he had a justified basis for imposing the restrictive measure. In other non-financial services cases, the European Court has held, in the context of restrictive rules imposed by Health authorities in respect of citizens seeking medical treatment abroad and then claiming reimbursement from their domestic health authorities, that restrictive rules such as prior notification and assessment by the domestic health authorities are justified as being necessary for the public interest.


276 HM Treasury, Banking Reform: Delivering Stability and Supporting a Sustainable Economy (White Paper, Cm 8356, June 2012).

outfits are justified as a matter of public interest in balancing the fiscal position of the social security systems responsible for public health in Member States.\footnote{278} It may be argued that in view of the increased national deficit, caused in part by the decision to spend trillions of pounds on bank bailouts in the UK, the public interest in limiting the fiscal cost to the real economy is a palpable one. The UK has a large international banking and finance sector and is exposed to fiscal burdens in relation to cross-border spillovers, hence the intention of the Vickers Report to limit such future fiscal burdens\footnote{279} is very much based on the unique vulnerabilities of the UK. A restrictive measure such as the Vickers Report’s structural reforms could arguably be justified as in the public interest of the UK taxpaying public.

This section has examined three types of divergences between Member States and the EU in protecting financial stability at the national level as opposed to the EU level. These differences are due to the essentially different levels of risk tolerance in financial activities, the relative economic and social importance of the financial sector in Member States’ economies, and the different needs of consumers and the domestic corporate sector in each Member State.\footnote{280}

As the rhetoric of financial stability may be adapted to different contexts, what challenges do the needs of financial stability pose to the dogged and cherished goal of market and legal integration in the EU? Do financial stability needs undermine market and legal integration and should we rethink the market integration project?\footnote{281}

### 2.5.9 The refinement of market integration as a regulatory objective

There is a point in supporting supranationally coordinated frameworks for regulating finance in the EU given the relatively high levels of integration in the wholesale finance and banking sectors. Such supranational frameworks will \textit{prima facie} be in a position to address individual Member States’ collective action problems.\footnote{282} However, Moloney warns that if regulatory power is concentrated

\footnotesize{281} See Mads Andenas, ‘Harmonising and Regulating Financial Markets’ in Mads Andenas and Camilla Andersen (eds), \textit{Theory and Practice of Harmonisation} (Cheltenham: Edward Elgar 2012).
at the pan-European level, then a systemic error of judgement made at that level could be magnified many times across the EU. In this respect, policymakers at the EU level should, for example, consider carefully whether legislation that focuses on pan-European access to markets (such as the AIFM Directive) is too path-dependent, and how granting access and pursuing market integration might work with the financial stability rationale for regulating hedge and private equity funds.

Post-crisis, it is questioned whether we should take it for granted that European, and indeed international, finance should be regulated at a level beyond the nation state when the fiscal cost of crisis management is not shared, but is borne entirely by the nation state. Pressing on with legal integration, particularly in finance, in the EU could backfire if Member States are of the view that the one-size-fits-all rules do not reflect local needs in financial stability. If legal integration proceeds doggedly at the level of broader principles in order to ‘fit all’, then implementation is likely to be adapted to local conditions, resulting in a reality of divergent action in Member States even if emanating from a common legal source.

It is commented that the governance of finance at the EU level and internationally should be subject to ideational re-examination. This means that the EU should accept that market integration – encouraging and facilitating market access – should not be doggedly pursued without considering national financial stability needs. A number of commentators in fact suggest that more decentralisation should take place so that different financial stability needs, reflecting local socio-economic and developmental profiles, are better taken care of. In other words, post-crisis governance of finance should perhaps use supranational levels of governance to deal with issues subject to collective action problems, such as crisis management, fiscal burden-sharing, and supervisory coordination and intelligence sharing in relation to multinational banks. But there is room for allowing decentralised governance to monitor and adjust rules in relation to preemptive and ex ante safety mechanisms, such as micro-prudential and risk management regulation. Helleiner and Pagliari use the term ‘cooperative decentralisation’

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284 Discussed in Chapter 6.


to designate this form of governance, \(^{288}\) and their work reflects contemporary EU governance literature in general. \(^{289}\)

Sabel and Zeitlin’s ‘direct deliberative polyarchy’ model posits a multi-level approach, in which non-hierarchical participation in EU policymaking is networked yet orderly. The key characteristic of the model is its deliberative mode: policymaking is considered to be forged through discussion and negotiation at every level. Policies are deliberated and negotiated between EU-level institutions and Member State politicians; lower-level agencies, epistemic communities and stakeholder groups deliberate over the details of policy implementation. This model allows for experimentation at different levels of governance in order to respond to the variety of issues raised in any particular area of governance. Arguably, financial regulation in the EU has also reached the stage where the assumption that integration is beneficial and benefits everyone equally no longer holds. Deliberative and experimentalist forms of governance should instead encourage the pooling of information and ideas in order to re-examine the question as to which issues may best be dealt with at the collective level and which should be considered locally. The state of socio-economic convergence between Member States and the costs/benefits of legal convergence should also be factored into such deliberations. \(^{290}\)

In terms of considering what may be appropriately addressed at the EU level in the interests of financial stability, a supranational level of governance is arguably appropriate for issues that are subject to collective action problems. For example, there is a case for saying that micro-prudential measures that may affect the competitiveness of financial institutions or subject to regulatory arbitrage should be considered as appropriate candidates for legal integration. Further, legal integration that is in the interests of transaction cost efficiency may also be warranted. If all Member States have a common concern, then a regulatory framework harmonised at the EU level may be an efficient and effective way of ensuring that an adequate framework is put in place for all Member States. However, even where the overwhelming case may be justified for legal integration in financial regulation, such integration should be sensitive to national needs. Decentralised governance should be allowed where relevant to adjust rules to meet national needs.

The definition of ‘financial stability’ as discussed earlier includes notions of tolerance for risk-taking and disaster thresholds measured by local as well as


supranational needs. EU policymakers should engage in dialogue with Member States in respect of the ‘financial stability’ profiles regarded as optimum at the EU level and at Member State levels. Such ‘financial stability’ profiles include Member States’ desired levels of risk tolerance given the structure and profile of their economy, corporate and financial sectors, and thresholds of resilience that are regarded as essential to protect services that are in the public interest. Differences in such risk/resilience profiles should be subject to dialogic and ideational negotiations at the EU level in order to ascertain the extent of integration that is optimal.

We envisage that Member States’ needs could differ in relation to the risk and growth needs of an economy, the profile of the financial sector in the domestic and international economy, and key local needs pertaining to certain financial services. There should be more room for dialogue and deliberation in terms of how national regulatory regimes may meet those particular needs, which may not be shared with others. For example, a Member State that has a large, small and medium enterprise sector may need to ensure adequate amounts of lending to such a sector although such loans are risky. Another Member State that has a large state-owned corporate sector may not have the same needs. Hence, the financial regulation framework developed at the EU level should be able to take into account such local needs and avoid causing unnecessary stress to the economic fabric of Member States. A one-size-fits-all approach should be avoided where such an approach cuts across different financial sector profiles, ignoring local consequences. In the proposed Commission Directive on recovery and resolution, bail-in by creditors is seen as a key resolution tool regarded as appropriate to be the subject of legal integration to be applied across all Member States. However, one must consider the profile of creditors to determine if the legal integration of bail-in mechanisms is ideal. In Germany, bank creditors may be other banks, and in the UK, bank creditors may be institutional investors, both UK and foreign. How would bail-in impact banks as creditors if systemic stress is affecting the entire financial sector? Further, would bail-in by institutional investors necessarily be ideal as there is a social dimension to the obligations they owe to savers? If the EU were to pause and rethink the indefatigable legal integration machinery, perhaps more nuanced and efficient common frameworks can be achieved to address largely common concerns, while leaving room for more experimental and decentralised approaches to deal with local needs. This would also address Moloney’s earlier mentioned critique that ‘more Europe’ could impose more risks and magnify systemic impacts of wrong decisions taken at the policy level.

One development is that the financial stability needs of euro area Member States may be different from other non-euro area Member States. Being tied to one currency and one monetary policy in the face of sovereign debt trouble in Greece, Italy, Portugal, Ireland and Spain generates unique financial stability

concerns for sovereigns and banks. In late December 2012, political agreement has been secured to make the ECB the single micro-prudential banking supervisor for major euro area banks, as well as banks from participating non-euro area Member States, in order to decouple banks from sovereigns, and to allow euro area banks to regain stability and credibility. This development is arguably necessary to meet the unique financial stability needs of euro area Member States. However, in order to ensure that non-euro area and non-participating Member States would not be sidelined in respect of policymaking, these Member States have bargained for double majority voting powers at the EBA so that legal integration would proceed in a way adequately taking into account their interests. The euro area banking union may be regarded as an approach that attempts to strike a balance between the legal integration that has already occurred in financial regulation, on the one hand, and developing policies to meet differentiated financial stability needs, on the other hand. This approach seems to recognise that legal integration needs to be subject to discussion, and does not rule out that policy divergences may follow when the euro area banking union comes into place in 2014. However, the extent and scope of future policy and legal divergences may be determined by the relational dynamics between the ECB and the EBA. We are of the view that any differentiated approach that will be allowed to be taken by the ECB would lead the way for opening up opportunities for dialogic processes to take place at both the ECB and EBA levels so that Member States’ interests can be represented, and challenging legal integration would not be taboo. The euro area banking union negotiations also show that where divergences such as meeting the euro area Member States’ needs occur, such divergences are managed within an inclusive dialogic framework that includes non-euro area Member States.

The rise of ‘financial stability’ as an important rationale for financial regulation has provided an opportunity in the EU to consider refining its persistent pursuit of market and legal integration. The euro area banking union seems to embrace early signs of adjusting the pursuit of market and legal integration in the face of financial stability needs in the euro area Member States.

2.6 The rise of public regulatory power and preemptive governance in the financial sector

The renewed importance of the regulatory objective of financial stability and the role of regulators in providing, or at least ensuring an adequate supply of, this public good has generally led to a resurgence in regulatory power,292 at both the

292 Pagliari, for instance, agrees with the characterisation of post-crisis financial regulation reforms as a resurgence of public regulatory power but opines that the substance of the reforms continues to leave much reflexive implementation to the ‘private’ realm (i.e. the financial sector and markets). See Stefano Pagliari, ‘Who Governs Finance? The Shifting Public-Private Divide in the Regulation of Derivatives, Rating Agencies and Hedge Funds’ (2012) 18 European Law Journal 44.
UK and EU levels, characterised by the introduction of more *ex ante* pre-emptive regulatory measures. Luhmann\textsuperscript{293} is of the view that the political and social preference is increasingly for a form of regulation of risk that is preventive in nature.\textsuperscript{294} New pre-emptive approaches have been introduced in investor protection, micro-prudential and macro-prudential regulation, as will be discussed in Parts 2, 3 and 4, respectively. Although the reforms do not fundamentally change the financial sector’s intermediary role, the reforms would arguably make some intrusive judgements on risk, especially in the retail sector.

Walklate and Mythen\textsuperscript{295} posit that the materialisation of disasters on a large social scale often triggers pre-emptive forms of governance that are motivated by fear of the effects of disaster and the desire to prevent the onset of those effects. Andenas describes this as a response to a form of ‘Pascal’s wager’: even if we cannot know whether terrible consequences exist, as long as we are not sure that they do not exist, we should act to prevent the possible terrible consequences from materialising.\textsuperscript{296}

Within the financial sector, risks may need to be collectively recognised and managed, but individual financial institutions are unlikely to engage in collective governance. This may be akin to ‘erosion’ or failure of the concept of responsibility, argued by Nunner-Winkler\textsuperscript{297} to be characteristic of contemporary life. Contemporary life is beset with complexity, chains of causal factors and interacting forces. Hence, even disasters that affect many may not be traced back to a single individual. Further, as the concept of ‘responsibility’ was developed in individualistic action-based situations, it cannot be adapted to more complex situations. Luhmann also writes, along similar lines, that modern-day risks arise from decisions made, but that the effects are generally felt externally, in perhaps unexpected ways, and through indirect connections of causation. Thus, it has become increasingly difficult to pin down those responsible\textsuperscript{298} for generating risk and harm. Responsibility has become a diffuse concept, and the private sector, suffering from collective action problems, is perhaps rightly perceived as unable to take into account considerations of financial stability from a more public good or collective perspective.

Governments are often seen as the most apt agents to introduce such pre-emptive governance to manage risks that affect collective interests. The crisis provides an opportunity for rise in regulatory governance of the financial sector to be perceived as reflecting sociopolitical dimensions of public interest. However, the implications for regulatory responsibility may be more than regulators could or wish to bear.299 We observe that shifts towards resurgence in regulatory power and pre-emptive forms of governance in a number of post-crisis reforms are often balanced with path-dependent approaches that are based on well-established premises in financial regulation. In view of regulators’ limited resources and hesitation to assume excessive responsibility in governing finance, Pagliari writes: ‘The invisible hand of market discipline remains . . . an important ally in the attempt to re-regulate . . .’.300 But it may be too quick to accept that in the post-crisis landscape, the same actors in governance should conduct business as usual. Smith and Tombs301 caution against placing too much trust in self-regulatory oversight by the regulated industry. As Chapter 3 will discuss, the financial services industry has wielded excessive influence in shaping regulation in the pre-crisis era and regulators are anxious to move away from the old model of governance.

This book will argue that regulators are trying to overcome the difficulties of their newly expanded and pre-emptive mandates by enrolling supplementary governance capacity. This may be due to an inherent limitation in resources but may also be reflective of an anxiety to delineate responsibility and keep responsibility within manageable limits. Regulators are now keen to rely on experts and other governance actors outside of the finance industry. But this approach may lead to a form of governance that is technocratic and elitist (as will be discussed in Part 4). Moreover, these outsourced experts would still have to contend with the industry’s powerful influence over how it should be regulated.

Chapter 3 will provide a contextual discussion with respect to the governance landscape in financial regulation and how regulators have traditionally relied on the financial services industry to supply a significant amount of self-governance and co-governance. However, the post-crisis resurgence of public regulatory power is accompanied by regulators’ endeavours to enrol the help of other financial sector participants not directly involved in the financial services industry. Regulators are looking to central counterparties in derivatives markets, auditors and institutional shareholders, among others. The role of auditors will be discussed

299 For example, in Judge’s model of taking pre-emptive regulatory actions to manage systemic risk, regulators would need to understand the complexity in transactions constructed by the industry and target certain transactional ‘nodes’ in order to disincentivise complexity or mandatorily de-complexify or simplify transactions in order to mitigate systemic risk. Such pre-emptive actions not only require precise judgment, but also an appreciation of how private parties’ rights may be affected. See Kathryn Judge, ‘Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk’ (2012) 64 Stanford Law Review 657.


in Chapter 4, and the role of institutions will be discussed in Chapters 6, 7 and 13. The concern with this trend, however, is that financial governance may become dominated by elitist views. Further, it is questionable to what extent professionals or experts can be relied on to provide a form of governance. Cowton argues that professionals, traditionally perceived as experts tied to ethical codes and values and committed to public service, should no longer be perceived as such. Cowton’s empirical observations lead him to conclude that professional commitment to public service or governance is contingent and not necessary. Coffee has also written at length about how professionals have been compromised by profit motives and conflicts of interest. Further, commentators have observed that experts working together in comfortable familiarity may become subject to consensus views and groupthink. Solomon argues that expert groupthink has the effect of filtering out information so that the information basis upon which decisions are made may be thinner than is ideal. In this respect, allowing diverse stakeholders to contribute to the discussion without requiring consensus may produce a better matrix of information and ideas for decision-making.

Drawing on Luhmann’s writings, if modern-day risk is generated by decision-makers who ‘externally’ affect others and do not take *ex ante* steps to mitigate or claim responsibility for the materialisation of risks, then risk discourse should arguably not be confined to narrow clusters of experts. Further, if *ex post* responsibility is difficult to pin down – and given the lack of successful criminal or civil actions concerning the disclosure or sale of structured products that failed during the global financial crisis, this seems true – then would not *ex ante* participation of the widest range of possible ‘affected groups’ be socially welcome? In the pre-crisis years, it was commented that certain stakeholders were poorly

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307 John C Monica Jr, Michael E Heintz and Patrick T Lewis, ‘The Perils of Pre-Empitive Regulation’ (2007) 2 *Nature Nanotechnology* 68, writing on the pre-emptive regulation of nanotechnology. The similarities between this discussion and pre-emptive regulation in the financial sector is that both areas involve many unknowns, especially in the understanding of the dynamics of systemic risk, and hence early assumptions and parameters may prove to be stifling or mistaken.

represented in this regulatory space. The post-crisis reforms will facilitate ex post actions for liability against investment funds, depositaries of alternative investment funds and even credit rating agencies, as Part 2 will show, but there are many challenges to these new post-crisis regimes. In support of ex ante enrolment of stakeholders, Williams and others also argue that experts may seem to be objective and neutral but that there is a serious democratic deficit in allowing experts a lion’s share of governance in areas that affect the general economy and ordinary citizens’ lives. They argue that there is a need for social input into governance processes in financial regulation.

The resurgence of regulatory power does not of itself achieve a dramatic shift in the fundamental premises of financial regulation, and we argue that enduring transformative effects in financial regulation can be better achieved by stimulating greater stakeholder participation in financial sector governance. Abraham and Sheppard in their empirical survey of experts and non-experts in a highly technocratic area, report that the concerns, opinions and views vary significantly between non-experts and experts, and that there is a need to address the gap of accountability in areas of technocratic regulation. In light of the above observations that expert-led governance may also suffer from various weaknesses, there is a plausible argument for facilitating greater stakeholder input in policymaking processes. Further, as regulatory pre-emptive strategies may themselves produce new risk factors in the financial landscape, feedback from a wide stakeholder base regarding the implications of regulation would be invaluable. Given the tendency of the regulated to engage in rule avoidance, arbitrage measures and lobbying, the regulator should perhaps rely less on the regulated for feedback on the implications of new rules.

Walklate and Mythen suggest that the citizenry is generally socially interested in being informed, responsibilised and included in governance measures to pre-empt disasters. Hence, contemporary pre-emptive governance need not succumb to being paternalistic and narrow-minded, but could instead be balanced, with diversity and reflexivity in a decentralised landscape increasing its effectiveness. A number of credible stakeholder groups have arisen in the form of non-governmental organisations and they introduce valuable perspectives from moral

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and social justice points of view vis-à-vis mainstream views on economic governance.\textsuperscript{313}

Further, one of the limitations of regulatory control lies in informational empowerment that is crucial for pre-emptive forms of regulation,\textsuperscript{314} especially over the long term and in a context of unpredictability. As information comes from diverse sources and analytical capacity is dispersed, pre-emptive governance led by public forms of governance could be enhanced by widening participation to include stakeholders outside the industry. Assmuth and others argue that diverse stakeholder participation to enrich information production and understanding may contribute to greater ‘risk integration’ (i.e. towards an integrated understanding of all risks involved).\textsuperscript{315} But will the widening of an already decentred landscape of governance in the financial sector entail complex dynamics and appropriation of governance power in diverse locations?\textsuperscript{316} From a pessimistic view, chaotic power plays may become dominant and governance could be reduced to procedural management of the complex and diverse dynamics.\textsuperscript{317} Diverse participation does not overcome the dispersal of interests. Each group of stakeholders may be interested in advancing its interests or preventing painful change and adaptation.\textsuperscript{318} For the purposes of achieving a sense of coherence and steering towards sustainable and long-term financial regulation objectives, public-led governance is indispensable to navigating and coordinating how ideologies driving regulatory objectives may be shaped and delivered.

\subsection*{2.7 Concluding remarks}

The authors view the resurgence of regulatory power as a welcome phenomenon, but argue that regulators should take the lead in developing more platforms for the dialectical processes regarding the fundamental premises of financial regulation. This would also address the concerns regarding excessive regulatory responsibility and limited regulatory resources. Financial regulation should not become elitist and removed from the diversity and richness of social concerns regarding finance. Indeed, the protean nature of ‘financial stability’ is likely to be better framed and shaped by wider participation and pooling of information. Narrow approaches to financial stability may even adversely affect the quality of

\begin{thebibliography}{9}
\bibitem{313} See, for example, Boris Holzer, \textit{Moralising the Corporation} (Cheltenham: Edward Elgar 2010).
\bibitem{316} Omarova addresses the risk that stakeholder enrolment may provide opportunities for interest-based lobbying, see Saule T Omarova, ‘Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation’ (2011) 37 \textit{Journal of Corporation Law} 621.
\bibitem{318} Jan-Peter Voll, Adrian Smith and John Grin, ‘Designing Long-Term Policy: Rethinking Transition Management’ (2009) 42 \textit{Political Scientist} 275.
\end{thebibliography}
governance. There is a role for enrolling wider dialogue, debate and participation in shaping the fundamental ideologies that should drive financial regulation.

The next chapter will examine the decentred governance landscape in financial regulation, how the regulator-regulated relationship has influenced and will shape developments in financial regulation, and the potential for changes in the composition of the governance landscape.
3 The decentred regulatory space in financial sector governance and the essential partnership of public and private-led governance

3.1 The nature of the decentred regulatory space in financial regulation

With globalisation and financial liberalisation, the growth of the global investment economy has led to financialisation, often explained as the dominance of financial services and products in global wealth creation and the empowerment of private entities involved in this economy. By the beginning of the twenty-first century, ‘financial markets [had become] vast, innovative, aggressive and highly competitive’. Financialisation is characterised by deregulation in financial services and markets and the rise in the power of non-public entities involved in standard setting, supervision and securing compliance. This phenomenon is set against the backdrop of the ideological movement from liberal political economy to neo-liberalism and the predominance of economic theories of regulation.

1 An account of financial liberalisation may be found in John Williamson and Molly Mahar, A Review of Financial Liberalization (Washington, DC: World Bank 1996).

2 Gerard A Epstein (ed), Financialisation and the World Economy (Cheltenham: Edward Elgar 2006), esp Chapter 1 by Epstein. See the further analysis of this concept in Section B of Chapter 2, Costs and Benefits of Neoliberalism: A Class Analysis by Gérard Duménil and Dominique Lévy.

3 Roy C Smith and Ingo Walter, Governing the Modern Corporation (Oxford: Oxford University Press 2006), 44.


The financial sector is situated in a ‘decentred’ regulatory space. Black argues that decentred regulation is premised on five preconditions, namely complexity, fragmentation, interdependencies, ungovernability and the rejection of a clear private-public distinction. ‘Complexity’ refers to the nature of problems that may need to be dealt with. ‘Fragmentation’ refers to the fragmentation of knowledge, resources and capacity for control in the regulatory space. ‘Interdependencies’ refers to the dynamics between the participants in the regulatory space, co-producing and co-enforcing norms of governance. ‘Ungovernability’ refers to the autonomy and unpredictability of actor behaviour in the regulatory space, which will pose challenges to assumptions made by regulatory authorities. In a decentred landscape, there is, some argue, no public-private distinction as all participants contribute to and influence governance. The decentred analysis has frequently been applied to financial regulation, as the financial services industry is a powerful and innovative industry that has been able to exert self-governance over many of its activities and the language of efficiency and market discipline often suffices accepted trust and reliance in market-based solutions and governance, now commonly questioned, see Justin Fox, *The Myth of the Rational Market* (New York: HarperCollins 2009), but warned of earlier in Joseph Stiglitz, *The Roaring Nineties* (London: Penguin 2003); Amartya Sen, *On Ethics and Economics* (Oxford: Blackwell 1987). See also Anthony Ogus, *Regulation: Legal Form and Economic Theory* (Oxford: Clarendon 1994). See also critical discussion in David M Driesen, ‘Regulatory Reform: The New Lochnerism’ (2006) 36 *Environmental Law* 1. A more moderate Harvard school also considers that most forms of regulation are not distortive or ineffective. See an extension of this latter school in the balanced and insightful analysis by Steven P Croley, *Regulation and Public Interests: The Possibility of Good Regulatory Government* (Princeton, NJ: Princeton University Press 2008).

10 Prior to the global financial crisis, OTC derivatives, hedge and private equity funds were unregulated parts of the financial sector. Other than credit rating agencies, which were regulated, other ‘rating services’, such as corporate governance and social responsibility ratings, remained unregulated.
to keep regulatory governance at arm’s length. Pagliari argues that regulators have in fact been actively encouraging the financial sector to take leadership to develop forms of reflexive regulation to govern the sector’s activity, emphasising recourse to market-based solutions instead of the sometimes inappropriate hand of regulation.

On the other hand, it is not entirely true that public regulatory governance as a distinct form of governance has become irrelevant in the financial services landscape. Regulators arguably remain unique in the regulatory space, and are representations of perspectives of ‘public interest’ or ‘public good’ (in the economic sense of public goods that are not supplied for failure of collective action on the part of the market). The ‘public’ character of regulators in the regulatory space is arguably distinct and this is conceptually sustainable even if the regulatory space is decentred.

Donahue asks: ‘[g]overnance and markets . . . tend to be tangled with each other’, but ‘does engaging the market offer the most promising blueprint for accountability in the pursuit of particular public goals?’ Goodhart and others have also argued that there is a place for ‘regulation’ in governing the activities of the financial services industry where market failures and public goods such as systemic stability are concerned. There is an acknowledgement that concerns such as ‘public goods’ are likely to be best addressed by the type of governance that is characterised by public interest and capable of articulating values and objectives of a communitarian character. Such ‘public’ governance, as argued by Donahue, is based on a form of ‘extensive accountability’ to a variety of stake-

holders and furthering a variety of different ‘mandates’. This is different from ‘intensive accountability’, represented by market-based governance, which seeks rather single-mindedly market efficiency and individual wealth creation. Hence, there is a unique role for ‘regulation’ as a form of public governance.

Levi-Faur argues that the economic society rests on a bedrock of regulation, a phenomenon known as ‘regulatory capitalism’. Regulatory capitalism refers to the existence of governance frameworks that shape economic functioning and protect certain political or social values, representing a landscape where economic functions and needs are facilitated, and distributive or social goals are also pursued. Braithwaite supports this by arguing that it is a myth that the laissez-faire nature of markets has been allowed to flourish as such in the ideology of neo-liberalism and deregulation. In fact, he argues that the public character of governance continues to exist extensively and has evolved into a form of regulatory capitalism. Regulators continue to define governance over businesses in competition policy and laws, and in laws relating to health, safety and product quality. Empirical research has also pointed out that citizens’ acceptance of the level of risk associated with any economic or social activity is directly correlated with the level of institutional trust, and hence, the presence of the ‘public character’ of regulatory governance as an institution underpinning the investment economy is necessary to facilitate acceptance of private investment risks and participation in the investment economy.

Although the global financial crisis of 2008–9 has led to a resurgence of public regulatory power, the financial sector is still a decentred governance landscape post-crisis, as no amount of re-regulation can elevate the state to a position of substitute for the variety of actors in governance that have arisen, nor is that an ideal position whether from a practical or normative point of view.

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20 ‘Regulation’ may be defined as a phenomenon that seeks to provide a sustained and focused approach to modify the behaviour of the subjects of regulation, so that compliance may be secured according to the standards and goals in such regulation; see Philip Selznick, ‘Focusing Organizational Research on Regulation’ in Roger G Noll (ed), Regulatory Policy and the Social Sciences (Berkeley, CA: University of California Press 1985), 363–7. See also Giandomenico Majone (ed), Deregulation or Re-regulation? Regulatory Reform in Europe and the United States (New York: Pinter 1990), 1–6; Anthony Ogus, On Regulation: Legal Form and Economic Theory (Oxford: Clarendon 1994); Karen Yeung, Securing Compliance (Oxford: Hart Publishing 2004), 5, 11. Margot Priest further discusses regulatory control in seven parts in Margot Priest, ‘The Privatisation of Regulation: Five Models of Self-Regulation’ (1997–8) 29 Ottawa Law Review 233, closely correlating to the three main tenets of standards, supervision and compliance as referred to above.
24 Helmut Wilke, Governance in a Disenchanted World (Cheltenham: Edward Elgar 2009).
The decentred landscape is populated and dominated by resourceful, competent and powerful financial services industry participants alongside state-based regulators, regional authorities (such as the EU) and international bodies\(^{25}\) (such as IOSCO).\(^{26}\) Meyer and Drori\(^{27}\) argue that contemporary areas of governance are dominated by knowledge-based individuals and communities whose collective role provides a form of governance that is perceived as legitimate and credible because of the knowledge base, professionalism and rationality in operation and action. Hence, ‘knowledge-based’ actors are likely to have the authority to lead or participate in governance. The regulated industry, leading in innovation and standardisation has maintained, and is likely to maintain, this position of ‘authority’ in governance even in the post-crisis landscape. The composition of the regulatory space has a fundamental impact upon the underlying narratives of financial regulation, and may inhibit changes in fundamental premises of financial regulation towards sociopolitical dimensions of public interest that conflict with the industry’s interests.

In 1998, Goodhart and others published the important book *Financial Regulation: Why, How and Where Now?*,\(^{28}\) taking stock of the realities of financial regulation up to the 1990s and consolidated a vision of the workings and mechanics of financial regulation. By that time, the regulatory space in financial regulation was recognised as a relational paradigm – an open-ended relational contract between the regulator and regulated. The authors argued that it is practically impossible to intrude in an extensive regulatory manner into the highly innovative workings of the financial sector, but it remains important that the regulator is able to address market failures and pursue and provide certain necessary public goods such as systemic stability. Hence, the authors also contended that the nature of financial regulation will become a relational outworking between regulator and industry in terms of specific ‘bonding’ commitments by the industry to conduct itself and to achieve certain outcomes acceptable to the regulator. The relational paradigm between the regulator and regulated dominates the decentred regulatory space of financial regulation. In other words, the most prominent influence in the form of private sector-led governance in the regulatory space is the financial services industry itself.

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\(^{26}\) Arup refers to this as the matrix of state and corporate power in co-governing the financial sector, see Christopher Arup, ‘The Global Financial Crisis: Learning from Regulatory and Governance Studies’ (2010) 32 Law and Policy 363.


We are of the view that the relational paradigm in pre-crisis financial regulation has been fostered by two key factors: the rise of the risk-based approach to regulation on the part of regulators, and the growth in political and economic power of financial institutions in empire-building that has convinced regulators to rely on many forms of self-regulatory and shared governance with the regulated industry. These will now be discussed.

3.2 Risk-based approach to regulation

Prior to the global financial crisis, the UK regulator’s approach to regulating the financial services industry was a risk-based approach. The risk-based approach to financial regulation has also been accepted in many other countries, such as Australia and parts of Canada. Although the risk-based approach is technically a regulatory strategy that seeks to maximise efficiency in the use of regulatory resources, this chapter will argue that the risk-based approach may result in an unintended consequence in respect of the relational paradigm between the regulator and regulated, allowing the regulated to play a perhaps too-significant role in governance and to exert significant influence over the regulator’s actions.

Risk-based regulation is a modern compromise between the acknowledgement of the realities of the decentred regulatory space and the limitations of the regulators in providing public goods. Risk-based regulation seeks to define the regulator’s responsibility within the parameters of economic resources, efficiency and cost-benefit analyses.

Risk-based regulation is often interpreted as a preventive or pre-emptive regulatory approach, whereby the private and social risks of financial activities

are measured, adjusted and assessed so as to inform the regulator of the appropriate regulatory approach to take with respect to a firm or the industry in general, having regard to the regulator’s resources. The UK regulator has been committed to risk-based regulation since its establishment in 2000. Although the intention of risk-based regulation is to ensure that regulatory attention and resources are prioritised in an efficient manner to address the riskiest issues that may affect the delivery of regulatory goals, Black has also critically commented that risk-based regulation could be used to redefine blame and the parameters of accountability. A risk-based approach in regulation could allow regulators to carry out variable levels of supervision depending on the risk profiles of firms and hence allocate resources according to those priorities. In this way, any supervisory ‘shortfall’ involving firms that are regarded as ‘safer’ by regulators could be perceived as a legitimate approach. However, if the risk profiles of firms are in any way mistaken, at any given time, then the regulator may run the risk of allocating insufficient resources to manage unperceived risks. It is arguable that the global financial crisis that hit two of the UK’s largest high-street banks, namely Halifax Bank of Scotland and the Royal Bank of Scotland in late 2008 and early 2009, could be due to the misperception of each banks’ health under

32 A detailed examination of what risks are identified, how risks are adjusted to ‘net’ levels after considering firms’ mitigation approaches, how regulators decide if particular risks ought to be addressed in regulation or supervision and the impact of regulation on firm activities is presented in Julia Black, ‘The Development of Risk-based Regulation in Financial Services: Canada, the UK and Australia – A Research Report’ (London: ECRC Centre for the Analysis of Risk and Regulation, LSE 2004) www.lse.ac.uk/collections/law/staff%20publications%20full%20text/black/risk%20based%20regulation%20in%20financial%20services.pdf accessed 18 October 2012.


35 The risk profile of a firm may take between one and three years to be constructed and it is uncertain how periodic reviews will be carried out by the regulator, see Stuart Bazley and Andrew Haynes, Financial Services Authority Regulation and Risk-based Compliance (London: Tottel Publishing 2006), 4.30.

36 In relation to the Royal Bank of Scotland, the FSA’s self-critical report attributes its inadequate supervision to inadequate data, due to which a more intelligent risk profile of the bank could not be put together for regulators, and the lack of liquidity supervision, which was not subject to
the risk-based regulatory framework. In 2006, the then-Chairman of the UK Financial Services Authority (FSA), Callum McCarthy, identified about 1,500 firms that were subject to medium-to-high risk-based supervision, which entailed regular visits and continuous monitoring by the FSA. The remaining 28,349 firms were subject to low risk supervision, which meant compliance with reporting requirements established under FSA rules. Much of the financial sector leading up to the global financial crisis was arguably subject to a form of self-certifying discipline.

In a risk-based regulatory approach, the regulator constructs the risk profile of the regulated and that provides the blueprint for how the regulator supervises the regulated. The spectrum below shows the varying degrees of closeness in a regulator-regulated relationship in a risk-based approach to regulation.

If the risk profile of a regulated entity is ‘low-risk’, towards the left end of the spectrum above, greater reliance may be placed upon the regulated’s submission of data and reporting, amounting to a form of self-certification by the regulated. The relationship is characterised by trust and, paradoxically, distance. Further down the spectrum would be more intensive regulator monitoring or supervision.
to steer aberrant conduct into line (i.e. greater distrust and scrutiny but closeness in intensity). The main challenges for the regulator in the risk-based approach are that:

(a) The relational distance between the regulator and regulated in low-risk firms could amount to a longer term ‘delegation’ to the regulated to monitor itself and such delegation may entail agency problems in due course. If the construction of the risk profile of a firm is based on faulty assumptions, then such an agency problem may become augmented over time.\footnote{See general discussions in Sally Lloyd-Bostock and Bridget M Hutter, ‘Reforming Regulation of the Medical Profession: The Risks of Risk-Based Approaches’ (2008) 10 Health and Risk Society 69; Allen L Camp, ‘Treatment of Uncertainties in Risk-Based Regulation’ (December 1994) www.osti.gov/bridge/servlets/purl/46555-dl5dVd/webviewable/46555.pdf accessed 1 January 2013.}

(b) The relational closeness between the regulator and regulated in more intensive monitoring may actually result in a bias towards decreased enforcement over time.

In an earlier article, one of the authors\footnote{As is the case with Northern Rock, where risk profiles became sticky and not suitable for supervisory purposes; see, for example, FSA, ‘The Supervision of Northern Rock: A Lessons Learned Review’ (March 2008) www.fsa.gov.uk/pubs/other/nr_report.pdf accessed 1 January 2013, 49, 51.} discussed how the relational paradigm of risk-based regulation may affect the discharge of legal duties by regulated financial investment intermediaries. Attention has been drawn to the possibility that the relational paradigm in risk-based supervision may allow room for investment intermediaries to adjust and change suboptimal practices through dialogue and negotiation with the regulator. Further, this process would render it inappropriate for bright-line pronouncements (especially judicial ones) to be made, suggesting that the regulated has fallen below a particular standard of care or breached a rule. Risk-based regulation allows issues with the regulated to be first pursued within a relational paradigm, perhaps by moving from a medium supervisory level to a high-medium or high level and, hence, this relational paradigm may indirectly encourage less resort to enforcement, leaving governance issues internalised in the relational paradigm. Although the relational outworking could encourage more effective changes in behaviour,\footnote{Iris H-Y Chin, ‘The Nature of a Financial Investment Intermediary’s Duty to His Client’ (2008) 28 Legal Studies 254.} it could also mask shirking by firms and create opacity as to how firms are monitored. Although policymakers are keen to distinguish between risk-based regulation and the now-discredited light-touch regulation carried out by the FSA,\footnote{Karen Yeung, Securing Compliance (Oxford: Hart Publishing 2004).} it is arguable that the nature of risk-based regulation lends itself to an atmosphere of relational outworking between

\footnote{Regulatory Reform Select Committee, Themes and Trends in Regulatory Reform (HC 2008–9, 329-I).}
regulator and regulated, leading to an enforcement deficit. Further, Weber argues that the regulated, armed with information and sophisticated innovation, could easily exert disproportionate influence over their own regulation and supervision, while nevertheless creating an impression of accountability and responsibility to the regulator. In sum, risk-based regulation may fail to take into account its relational side risks, the risks of being too far or too close to the regulated. Further, the relational paradigm of financial regulation in this area has gradually eclipsed jurisprudence in civil actions as being an important source of governance.

Post-crisis, the UK regulator continued to affirm its risk-based approach. It remains to be seen how far its successor regulatory bodies, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA), will pursue a risk-based approach to supervision.

The influence of the risk-based approach lies in its purported cost-effectiveness, proportionality and flexibility in assessing risk and determining appropriate regulatory action, reflecting the limitations of regulatory resources in the decentred regulatory space. How might supervisory convergence, championed by the three European authorities discussed in Chapter 2, affect the risk-based approach at national level? The three European authorities do not, by and large, have a direct relationship with the industry and are responsible for monitoring the convergence of national regulators’ supervisory practices. Risk-based monitoring by the three European authorities would likely mean more intensive reviews and audits of national regulators who are perceived to be deviating from the supervisory convergence envisaged. Would this result in a form of ‘regulatory competition’ between Member States seeking to influence the form of convergent supervisory practices? If so, the UK regulator may be incentivised to move away from the internalised relational dynamics of supervision mentioned above to a more

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44 FSA, ‘The Turner Review: A Regulatory Response to the Global Banking Crisis’ (March 2009) www.fsa.gov.uk/pubs/other/turner_review.pdf accessed 3 January 2013, 88, which acknowledged that the FSA’s approach in relational outworking with firms was not aggressive enough and a more intrusive and systemic approach was needed.


pronounced form of supervision that leads to enforcement, so that its supervisory practices may be seen as visible and robust. Post-crisis, the UK regulator has indeed adopted a more pronounced enforcement approach, stepping up enforcement in a wide variety of areas relating to investment firm conduct of business, client money and asset handling, systems and controls, and insider dealing. In this way, supervisory monitoring at the pan-EU level may exert a countervailing force upon the relational paradigm of the regulator-regulated relationship.

However, the growth of economic and political power in the financial services industry suggests that the sector may continue to wield significant influence over the nature of financial regulation, whether at the national or EU levels. The next section briefly discusses this.

### 3.3 The growth in economic and political power in the financial sector

The 1990s saw an increase in financial sector liberalisation and competition and, in Smith and Walter’s words, ‘By the end of the 1990s, financial markets were vast, innovative, aggressive and highly competitive’. McGee argues that each financial institution desires to build its own empire, ‘chasing Goldman Sachs’, the leading eminent investment firm, engaging in activities regardless of social utility.

Financial intermediaries have become more and more self-serving at the expense of their social utility purposes. Concerned principally about the wealth and growth of their institutions, they are becoming giant behemoths and fearsome...
competitors in the industry. The industry has also developed formidable interest
groups to influence regulation so that regulation takes more of a facilitative stance
for the economic growth and political importance of the industry.58 It is argued
that the pre-crisis regulatory regimes in important financial jurisdictions, such as
the US and UK, have been shaped extensively by industry interest.59 Further, as
the growth of large financial groups spans international boundaries, national
regulators may find it more difficult to impose regulatory standards without
leakage by arbitrage. The tendency may thus be to settle for minimum standards
or standards represented by international convergence.60 International standards
are often shaped by epistemic communities championed by the powerful financial
services industry and hence market power has come to be a significant political
power on an international scale.61 The next section will discuss how regulators
have become captured by the industry’s sophistication and innovations62 as they
rely increasingly on co-governance models co-opting the industry to govern itself.63

Moreover, intellectual movements in regulation theory have also provided
support for regulatory reliance on the self-regulatory and shared governance roles
of the financial services industry. The next section will provide a review of
contemporary perspectives on governance, which have been developed in order
to overcome the limitations to top-down, traditional command-and-control forms
of regulation. These novel models of governance have been favoured by regulators
as being in line with the risk-based approach that prevents overstretching of
regulatory resources.64 Further, these novel models of governance have possibly
also been welcomed by the financial services industry as they allow the industry

58 Richard W Painter, Getting the Government America Deserves: How Ethics Reform Can Make a Difference
(New York: Oxford University Press 2009), on the US; Robert F Weber, ‘New Governance,
Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models
Approach to Capital Adequacy Regulation’ (2010) 62 Administrative Law Review 783; and for the
Journal of Financial Crime 356 on the regulatory capture of the FSA.
Research 743.
and Society 351.
61 Geoffrey RD Underhill, ‘Markets beyond Politics? The State and the Internationalisation of
Example of the Internal Models Approach to Capital Adequacy Regulation’ (2010) 62 Administrative
Law Review 783.
63 Ford argues that the political context of power is an important backdrop to regulatory perspectives
and implementation, see Cristie Ford, ‘Macro- and Micro-Level Effects on Responsive Financial
64 The inevitable interaction between the risk-based regulatory approach and shared governance
models such as meta-regulation is discussed in Julia Black, ‘Paradoxes and Failures: “New
to play a dominant part in the regulatory space in shaping its own governance.\(^{65}\) It is to be noted that Morgan\(^ {66}\) has earlier warned that such novel forms of governance also tend towards favouring economic rationale and language surrounding regulation and eclipses the language and representation of social rights and distributive justice in regulation.

### 3.4 Models of contemporary governance in the financial sector

#### 3.4.1 Self-regulatory forms of governance

Regulators trusted the financial services industry in various areas of self-regulatory governance in the pre-crisis years. The Better Regulation Task Force suggested that often ‘no intervention’, leaving to the good sense of personal self-regulation, is a better alternative to regulation even where risks may be perceived.\(^ {67}\) Williamson maintains that bilateral private ordering could involve parties in providing ‘good order and workable arrangements’,\(^ {68}\) thereby obviating the need for externally imposed regulation. De Minico describes the private transactional paradigm as an autopoietic and self-referential system of self-regulation.\(^ {69}\) This means that participants to the transactional paradigm actively make the rules by which they bind themselves as they navigate the dynamics of bargaining and negotiation with their counterparties. The transactional paradigm emerges from the bottom-up and many commentators opine that transactional rules in finance, particularly in international finance, have become standardised, creating a body of transactional private law that governs international financial transactions.\(^ {70}\)

An extended form of self-regulatory governance may lie in ‘smart regulation’. Gunningham and Sinclair propose that smart regulation involves using the

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\(^{65}\) Dorn, for example, argues that the participation of the industry in making market-based forms of governance credible and legitimate have captured regulators to the point of rapture, a state where regulators support industry goals and celebrate industry achievements instead of taking a sceptical monitoring role; see Nicholas Dorn, ‘Policy Stances in Financial Market Regulation: Regulator Rapture, Club Rules or Democracy?’ in Kern Alexander and Niamh Moloney (eds), *Law Reform and Financial Markets* (Cheltenham: Edward Elgar 2011), 35.


expertise, interests and resources of second and third parties in the regulatory space as ‘surrogate’ regulators, and thus providing a range of policy instruments and instrument mixes for addressing any governance issue.\textsuperscript{71} The incentives of these second and third parties in governing the issues at hand would provide a form of ‘smart’ governance that does not require the imposition of direct regulation.

An example of regulatory trust in self-regulatory governance in the pre-crisis years is the unregulated private placement market.

In Chapter 2, we discussed how private placement regimes for complex structured products are exempt from mandatory disclosure, leaving sophisticated investors to determine pre-contractual and contractual protections that suit their interests. Sophisticated investors generally have access to investments that may be riskier in nature. The wholesale financial sector has autonomy in taking on investment risks, even if the risk and liquidity profiles of products such as complex collateralised debt obligations have been considered unfavourable since 1997.\textsuperscript{72}

However, self-regulatory governance focuses on facilitating transactions, but may not provide a blueprint for dealing with failures and externalities.\textsuperscript{73} Partnoy argues that transacting parties will each look after their selfish interests, even if they perceive problems that could arise for other participants. Opportunistic behaviour may appear, participants in the market may pass risk on to the next available participant and, when trouble occurs, collective action is unlikely.\textsuperscript{74} In financial markets where participants are heterogeneous, diffuse and international, the externalities may be dispersed and borderless. The relational connection is arguably too weak for bilateral forms of governance to arise. Hence, there would be a gap in addressing externalities that arise in such a context.

In the wake of the global financial crisis, regulators have begun to doubt the wisdom of leaving areas of the financial sector to self-regulatory forms of governance. For example, the EU\textsuperscript{75} and the US\textsuperscript{76} have both introduced legislation

\begin{itemize}
\item \textsuperscript{74} Frank Partnoy, ‘Financial Derivatives and the Costs of Regulatory Arbitrage’ (1996–7) 22 \textit{Journal of Corporation Law} 211.
\item \textsuperscript{75} Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, also known as European Markets and Infrastructure Regulation 2012 (EMIR).
\item \textsuperscript{76} Title VII, Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173), commonly known as the Dodd-Frank Act 2010.
\end{itemize}
to compel central clearing of a large number of derivative contracts, bringing the
hitherto unregulated area of bilateral derivative contracts under regulatory purview.
The London Interbank Offered Rate (LIBOR) fixing scandal that came to light in late 2012 has further resulted in the UK regulator taking away a hitherto self-regulatory area in banking (i.e. the establishment of the London Inter-bank Offering Rate upon which the price of many private contracts are based). Upon uncovering that a number of banks including Barclays Plc and the Royal Bank of Scotland have been involved in making submissions for LIBOR based on their trading interests and therefore making such submissions heavily conflicted, the UK regulator has decided to regulate and supervise the LIBOR submissions to preserve the integrity of LIBOR. The scope for self-regulation is becoming more limited as a result of the loss of trust and confidence in the integrity of the banking and financial sector.

Nevertheless, regulators are still contemplating using ‘smart regulation’ models where the incentives of private sector participants could be used for monitoring purposes. In the wholesale sector, regulatory reforms have been introduced to compel investors to better monitor the risks related to their investment activities, as will be discussed in Chapters 6 and 7. Commentators have suggested that large equity or bond holders in financial institutions and subordinated debt holders may be well-disposed to enforce market discipline. This also seems to find consensus with policymakers, especially in the UK. There is also discussion about encouraging banks to use contingent convertible capital instruments (CoCos) to absorb potential losses, so that debtholders, whose instruments will be converted into loss-absorbing equity upon certain triggers, could act as risk monitors.

77 Martin Wheatley, *The Wheatley Review of LIBOR* (FSA, September 2012). The regulation of benchmarks that have hitherto been self-regulatory is also underway in the EU, see European Commission, *Consultation on a Possible Framework for the Regulation of the Production and Use of Indices serving as Benchmarks in Financial and other Contracts* (December 2012) http://ec.europa.eu/internal_market/consultations/2012/benchmarks_en.htm accessed 7 May 2013.


81 This will be further discussed in Chapter 11.
Minority institutional shareholders could also potentially encourage market discipline. In the UK, much criticism has been levied against shareholders of failed banks acting as ‘absentee landlords’. 82 The corporate sector is replete with ‘ownerless corporations’. 83 Hence, reforms 84 have been ushered in to bolster the market-based discipline that can be exercised by shareholders, in particular institutional investors who have a long investment horizon and are seen to be in an apt position to monitor the long-term well-being and performance of their investee companies, including financial institutions. 85

Given that institutional holdings in any investee company may be small, would there be incentives to monitor? Commentators have suggested that shareholders are likely to act as monitors only if the equity stake is sufficiently large. 86 On the other hand, empirical literature suggests that shareholders with large stakes in financial institutions are more likely to encourage management to engage in excessive risk-taking activity, in order to drive earnings up for shareholders’ short-term interests. 87 Chapter 13 will explore in greater detail the potential of minority institutional shareholder monitoring as part of corporate governance and risk management.

Nevertheless, Donahue argues that the incentives of private participants are often geared towards the maximising of private interests or profit-seeking behaviour. This is fundamentally different from the nature of regulatory governance, which is characterised by multiple objectives and yardsticks in evaluation of progress and achievement. Hence, the reliance on market participants’ behaviour as a form of governance may not always be aligned with achievement of the collective good or regulatory objectives. 88


84 The UK Stewardship Code 2010. More discussion of this will follow in Chapter 13.


The scope for self-regulation has become somewhat reduced post-crisis. However, as Part 2 will discuss in relation to reforms to the wholesale investment sector, the regulatory approach has been to move along the self-regulation spectrum slightly, to prefer ‘smart regulation’ where the financial services industry may be monitored by other private sector actors. But a vulnerability of the smart regulation model is that too much trust may be placed in ‘surrogate regulators’ to provide the entire rubric of regulation or governance.\textsuperscript{89}

Next, we will examine to what extent regulators have resorted to market-based solutions in the financial sector and the future of such market-based solutions in the post-crisis era.

\subsection*{3.4.2 Market-based governance}

The ‘Market’ is classically understood to be based on the freedom of participation and exercise of will by individuals in their own self-interest, but it has developed into an institution, a model\textsuperscript{90} and even a collective entity, which today may arguably be providing a form of ‘governance’, a collective good over and above individual private goods exchanged in a market context. Market-based governance may be described as ‘[the motivation] of private interests to further public good’,\textsuperscript{91} relying on the invisible hand of the market to meet not only private interests, but the collective interests of participants in the market. The activities of participants in the market are relied upon to provide solutions to problems that may be generated by the market itself. For example, market-based solutions could arise in the following situations:

(a) the development of standardised terms in frequently occurring transactions, saving transaction costs for participants and promoting efficiency;\textsuperscript{92}


\textsuperscript{91}Rahul Dhumale, ‘An Incentive-Based Regulatory System: A Bridge Too Far’ (June 2000), ESRC Centre for Business Research Working Paper No 170 www.chr.cam.ac.uk/pdf/wp170.pdf accessed 4 January 2013. This could be regarded as contained in the traditional market economy models and as just providing another aspect of Adam Smith’s ‘invisible hand’.

market discipline provided by market participants vis-à-vis each other, such as the demand side over the supply side;\(^93\)

c) the development of consolidated private sector institutions, such as stock exchanges, that provide a platform for standard-setting and provision of discipline;\(^94\)

d) the provision of ‘governance’ goods, such as certification goods, by market-based providers;\(^95\)

e) using market concepts to refashion the supply of public goods or services;\(^96\)

f) outsourcing to the market functions that may have been carried out by the government,\(^97\) such as seeking private investment into partnerships with the government in providing quasi-public services such as health care or education.\(^98\)

Shamir argues that market-based governance allows information to be discovered from the market and innovations to take place, providing a reflexive form of governance that is derived from and feeds back into the open and porous nature of the market itself and into society in general.\(^99\) The following examines how regulatory actors have come to rely on the different forms of market-based governance mentioned above and discusses the future of market-based governance given the issues that have arisen in the global financial crisis.

\section{3.4.3 The different forms of market-based governance}

First, regulators have allowed much of market-based governance in terms of transactional standardisation to provide the governing frameworks for financial transactions. Supply side and demand side factors are played out to determine


\(^{94}\) In much the same way as credit rating agencies have been used to provide information regarding issuers’ credit-worthiness and stock exchange membership is used to discipline members. See also the role of trade associations for the financial industry and the role of the corporate governance industry.

\(^{95}\) Such as credit, corporate governance and social responsibility ratings.


the evolution of standards or a market for standards. Supply side factors may include the perception by industry participants that self-regulatory standards will stave off more costly regulatory intervention,¹⁰⁰ industry participants’ interest in developing technocratic standards appropriate to industry needs,¹⁰¹ and competitive pressures among market participants in producing standards of credible self-regulation where there are also demand side pressures for such generation.¹⁰²

On the demand side, it may be argued that self-regulatory standards generated by the market are well-regarded, given the technocratic issues at hand, and are perceived to be more persuasive, inspiring greater compliance than externally imposed regulatory standards.¹⁰³ In financial regulation, many self-regulatory standards have been generated as a form of standardisation and this is largely due to the leadership of organisations such as trade and industry associations or international organisations, associations and networks.¹⁰⁴ Faerman and others also argue that regulators seek out the industry to come up with industry standards or solutions as they are generally recognised to have more expertise and resources, providing more convincing leadership in complex technocratic issues.¹⁰⁵

The International Chamber of Commerce’s UCP60⁰⁶ is the leading standardised template for much of documentary trade finance issued by banks. Another


⁰² Peer pressure racing to the top may be seen as an effective market force that compels financial institutions to adopt best behaviour, see Michael D Pfarrer and others, ‘Coming Forward: Institutional Influences on Voluntary Disclosure’ (November 2005) http://mba.tuck.dartmouth.edu/mechanisms/pages/Articles/Pfarrer.pdf accessed 4 January 2013, an empirical study that shows that mimicking practices in the industry is often an important driver for changes in the behaviour of financial institutions, in this case, concerning restatement of earnings.


area of market-based governance is the role of the International Swaps and Derivatives Association (ISDA) in providing standardised templates for derivatives transactions. Derivatives transactions are not subject to product regulation in the leading jurisdictions of financial regulation, such as the US and the UK. Although exchange-traded derivatives have developed standard forms and counterparty risk in these transactions is mitigated by having the exchange stand as central counterparty, bilateral OTC derivatives are generally tailor-made to suit the purposes of counterparties and are therefore less standardised. They are settled bilaterally, which means that counterparties have to bear the credit risk of each other and this risk is augmented if the settlement time frames of derivatives are long, varied and have many periodic runs. In order to mitigate the risk of bilateral OTC derivatives, ISDA has developed a Master Agreement to standardise certain terms such as collateral policies, netting of open positions and how counterparty credit risk should be evaluated. Many OTC derivatives are based on the ISDA Master Agreement, but parties may add and adapt the terms of the agreement to suit their needs.

Market-based governance in standardised templates may obscure the need for regulation without addressing market failures. Market-based governance led by the industry may advance the common interests of industry association members and may be inherently disadvantageous to other stakeholders who are subject to them. The key case in point is the Banking Code that used to offer a standard template for key customer terms in retail banking. The Code provided many requirements of responsibility on the part of banks but such provisions of responsibility tended to be bank-friendly and exacting for customers. For example, customers could be placed in a position of loss if unauthorised payments, traced to their less-than-perfect vigilance, were made out of their account. The FSA has, since late 2009, introduced the Banking Conduct of Business Sourcebook (BCOBS) that supersedes the self-regulatory nature of the Banking Code. The BCOBS now provides a more favourable regime for customers as it reverses the burden of proof for recklessness or gross negligence when the customers’ irresponsibility is at issue. It also requires banks to treat customers in financial difficulty with fairness. More discussion on the move towards more protective and paternalistic consumer protection will be provided in Chapter 8.


109 Established by the Jack Committee 1987, the Banking Code has been in use since 1992.

110 The last Banking Code was the Banking Code 2008.

111 FCA Handbook (previously FSA Handbook) (as of 30 April 2013) BCOBS 5.1.11.

Further, the generation of standardised templates may assist the industry in taking a minimal cost approach to addressing issues of concern, warding off costlier approaches that could be required under regulation. The effectiveness of such forms of market-based governance would need to be carefully examined in terms of the outcomes achieved. An example in point is the Equator Principles, developed by leading banks to ensure that their project finance decisions are in line with the social responsibility concerns of the project. The development of such Principles may be important in preventing intrusive regulations concerning the social aspects of project finance. The Principles oblige banks to monitor the borrower’s assessment of the social responsibility impact and the borrower’s management of such impact in consultation with stakeholders. However, the quality of monitoring undertaken by each bank, especially in the post-contractual phases, depends on the bank’s own processes, which are not subject to further independent review. It is noted that the actual outcomes achieved for stakeholders affected by project finance are not subject to independent evaluation and accountability.

Finally, transactional standardisation, which is likely to be based on a market-leader position, may create systemic risks. Such standardisation may provide certainty and efficiency, but reduces diversity in the forms of market-based governance and may contribute to snowballing of risks (perhaps systemic risk) if it is subsequently realised that certain transactional rules are flawed.

In relation to the over-the-counter (OTC) derivatives markets, regulatory reforms have been carried out as regulators realise that positions held by heavily exposed counterparties (such as AIG) in bilateral OTC derivative trading could pose systemic risks. OTC derivatives have come under scrutiny following the risk of default by American insurance giant AIG in the credit default swaps market during the global financial crisis. The looming default was ultimately prevented by a bailout granted by the US Treasury. Schwarcz points out that without regulation, the externalities caused by systemic risk would not be prevented or internalised because the motivation of market participants ‘is to protect themselves but not the system as a whole . . . No firm . . . has an incentive to limit its risk taking in order to reduce the danger of contagion for other firms’.

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In the EU, a Regulation\textsuperscript{118} has been enacted to compel significant standardisation of OTC derivative transactions, clearing by central counterparties, and reporting by central counterparties and trade repositories. The key feature of the Regulation is to provide for derivative transactions with certain features to be centrally cleared; national regulators may also designate specific classes of derivative transactions that need to be centrally cleared.\textsuperscript{119} This measure allows the management of risk in the derivatives market to be scrutinised by central counterparties.\textsuperscript{120} Under this approach, counterparties are co-opted to occupy a leading governance function in the regulatory space, albeit overseen by regulators in a framework of prudential and risk management rules. Although the Regulation is not a radical shift to top-down command-and-control forms of governance, it is nevertheless a pre-emptive regulatory regime. Central counterparties are required to report\textsuperscript{121} all transaction information to trade repositories, which are authorised and supervised by ESMA.\textsuperscript{122} ESMA thus undertakes a surveillance function,\textsuperscript{123} over and above the ‘smart regulation’ framework, in order to maintain a position of pre-emptive control.

One concern that could emerge would be whether central counterparties could become such concentrated repositories of credit risk that systemic risk might be aggravated if their failure occurs. Would reliance on central counterparties have to be backed by government support, as a form of lender of last resort?\textsuperscript{124}

Second, market-based governance can be provided by self-regulatory organisations that may exist in the form of trade and voluntary associations, either domestic or international. The governance provided by self-regulatory organisations may be in the form of standardisation, as discussed above. Self-regulatory organisations may also provide discipline or enforcement through membership. Discipline or enforcement could be levied by way of membership denial, exclusions, withdrawals, suspensions, limitations of privileges or access, reputational discipline or even punitive gestures.\textsuperscript{125}

In the US, stock exchanges such as the NYSE and NASDAQ are providers of market-based governance in terms of listing requirements and discipline for brokers and broker-dealers. This model has, however, been abandoned in much

\textsuperscript{118} Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, also known as European Markets and Infrastructure Regulation 2012 (EMIR).

\textsuperscript{119} Arts 4–6.

\textsuperscript{120} Mandatory risk mitigation techniques set out in Article 11 will be imposed on derivative instruments not centrally cleared.

\textsuperscript{121} Art 9.

\textsuperscript{122} Art 55ff.

\textsuperscript{123} Art 61ff.


Commentators are of the view that as all European listed markets have been demutualised and have become for-profit entities, competitive forces compel stock markets to seek private interests such as profit maximisation over public interest and this interest is likely to align with the private interest maximisation of its members. Hence, stock exchanges are no longer in an appropriate position to provide credible governance. Bradley argues that markets are a platform for the freedom of transactions to arise and that it is antagonistic to the ‘market’ concept to intervene in planning or curtailing transactions as such. Hence, it takes regulatory governance to impose controls, as in short sales, in the name of maintaining market stability. In the wake of the global financial crisis, the EU has introduced reforms directly intervening in the securities markets in view of maintaining financial stability. A key example is the regime controlling short selling. The EU Regulation on Short Selling allows regulators to impose controls and bans on short selling where there are ‘exceptional circumstances’ that threaten to adversely affect market stability and confidence or where the price of a security falls dramatically. Further, a pre-emptive governance position is taken to require all short sales above 0.2 per cent of the issued capital of a company to be reported to national regulators. The discretionary regime therefore seems to recognise the ‘efficiency’ function of short sales as an information signalling mechanism. However, in view of suboptimal behavioural tendencies to dump and to intensify short selling in times of stress, considered use of direct interventionist controls is deemed in the interests of preserving financial stability.

Third, market-based governance may be found in certifier and information mediation goods, such as ratings and gatekeeping services that meet market participants’ needs. Market demand for third-party verification and reputational

133 Loss aversion and herd-like behaviour are much discussed behavioural suboptimalities affecting investor heuristics, see Thomas Gilovich, Dale Griffin and Daniel Kahneman (eds), Heuristics and Biases: The Psychology of Intuitive Judgment (Cambridge: Cambridge University Press 2002); Daniel Kahneman and Amos Tversky (eds), Choices, Values and Frames (Cambridge: Cambridge University Press 2003).
certification is found in relation to the evaluation of issuer products, such as an underwriter’s reputational involvement, credit ratings and analyst recommendations. Increasingly, where socially responsible investment is important, the corporate governance and social responsibility ratings of the issuer may be crucial to the marketability of an investment product. Such third-party verification or reputational certification is thus a commodity demanded and supplied by the marketplace, but could also provide a form of quality assurance to investors. Gatekeepers such as auditors and lawyers, however, perform a different function, as their involvement is generally demanded by issuers and financial institutions for compliance purposes and, as such, the market in these services may arguably have arisen as a result of regulatory imposition.

Jessop opines that the capitalistic notion of commodification refers to putting a quantifiable value on all goods and services. 134 Thus, reputational verification and quality assurance type services in the financial sector are commodities that appeal to the demand for reputational output in an informationally asymmetric market. These reputational commodities could perform a role in securing the public good of investor protection as well and hence we have a situation where market-based governance may indeed contribute to public interest governance. In the pre-crisis approach, reputational commodities were left untouched, as exemplified in the self-regulating sector of credit rating agencies.

Although a ‘non-value’-based consequence, such as investor protection, may result from the market-based nature of the supply of reputational commodities, the history of corporate failures seems to show that credit ratings agencies have put profit before the social utility of their ratings. 135 If certifier output is not reliable, then instead of adding to information efficiency in the market, the reputational output performs the opposite function. 136 Jessop also argues that the commodification of reputational market-based services encourages a ‘value perception’ of these services, distracting attention from their ‘non-value’ purposes or effects. 137 The hope that such certification products may also serve the purposes of investor protection may thus be misplaced.

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Post-crisis, the EU has enacted a Regulation for Credit Rating Agencies 2009 to regulate the incentives affecting credit rating agencies in order to bolster investor protection in the wholesale sector. However, this move may be very much due to the importance of credit ratings to regulatory requirements in prudential regulation and the investment markets. There is no general trend to regulate all forms of reputational commodities, such as corporate governance and social responsibility ratings.

Reputational gatekeepers, such as auditors, underwriters and lawyers, are also regarded as an important group of providers of market-based governance. Their proximity and access to firm and industry information often allows regulators to treat them as having the capacity for monitoring and acting as surrogate regulators. The governance role of reputational gatekeepers necessitates a thorough evaluation of the nature of the gatekeeping service, as a business, a professional body and a regulatory service. However, the ‘business’ interest of auditors has been heavily criticised since the fall of Enron in the US in 2000 as having contributed to and connived in corporate fraud. Post-crisis, there is considerable regulatory interest in enrolling gatekeepers in the regulatory space, but no discernible increase in regulatory control over them. Chapter 4 will discuss the role of auditors, in particular as the EU and UK explore the expansion of their governance capacity.

Finally, market-based governance may occur in the use of market concepts to fashion the provision of regulatory or public goods. Risk-based regulation, as discussed above, is very much a manifestation of market-based perspectives being infused into the provision of regulatory or public goods. However, Donahue explains that regulatory governance is ‘extensive’ in nature, serving multiple goals.

140 For example, the Standards established by the Accounting Practices Board in the UK that deal with the standard of care and diligence expected of auditors in a financial audit. But see Adam C Pritchard and Poonam Puri, ‘The Regulation of Public Auditing in Canada and the United States: Self-Regulation or Government Regulation?’ (February 2006) Fraser Institute Digital Publication at http://ssrn.com/abstract=1427641 accessed 5 January 2013, who argue that a self-regulatory professional body for auditors may not provide credible discipline for maintaining high standards in the profession.
the attainment of which may be measured in different ways. The market, on the other hand, is ‘intensive’ in nature, as there is usually a single-minded focus on the part of market participants to seek profit and minimise costs. Hence, some forms of market-based governance may be a way of ‘engineering into public undertakings a greater degree of intensive accountability that typifies markets’. There is, however, a fundamental tension between the extensive nature of governance and the intensive nature of the market. Since regulatory governance is ‘extensive’ in nature, how far should it be curtailed or affected by market-based concepts of cost and efficiency? Post-crisis, although the UK is still committed to the risk-based approach, risk-based language is not as dominant in EU policy documents. Hence, it remains to be seen to what extent the post-crisis resurgence of regulatory power aimed at providing the public good of financial stability will affect the market-based efficiency language so embedded in risk-based regulation. Existing literature on outsourcing and public-private financing projects may also provide evidence of such tension between the extensive and intensive purposes of market-based governance, although this book will not discuss these in detail.

Various forms of market-based governance flourished in the pre-crisis years, as they seemed to provide an efficient and effective means of governing private transactions. Further, no evaluation was made of their adequacy and appropriateness in terms of financial stability and systemic risk. Post-crisis, a thorough re-evaluation of market-based governance has been undertaken, especially at the EU-level, in light of the de Larosière Report. Inroads have been made to market-based governance, such as in the EU Regulations dealing with Short Selling and Market Infrastructure and the Alternative Investment Fund Managers Directive. Where credit rating agencies are concerned, significant regulatory control now exists in the sector. Such regulatory reforms have addressed a number of market failures, which had been identified but not addressed due to a lack of political will. The regulatory reforms have also introduced the perspective of systemic risk mitigation and financial stability into the regulatory fabric. The distrust for

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145 One of the authors has discussed in an earlier article how ‘outsourcing’ may work in providing the public good of consolidated stock market information under the EU Markets in Financial Instruments Directive 2006; see Iris H-Y Chiu, ‘Delegated Regulatory Administration in EU Securities Regulation’ (2006) 40 International Lawyer 737 and citations therein.

146 The chapter will not discuss Private Finance Initiatives (PFIs) in detail. See generally Darrin Grimsey and Mervyn K Lewis, Public Private Partnerships: The Worldwide Revolution in Infrastructure Provision and Project Finance (Cheltenham: Edward Elgar 2007).
market-based solutions\textsuperscript{147} and firm-based solutions\textsuperscript{148} will affect the relational paradigm of the regulator and regulated in the post-crisis regulatory space, but there may be limits to reducing the governance influence of the financial services industry, as the discussion below will show.

Next, we turn to how the relational paradigm between the regulator and regulated has fostered shared forms of governance and how these models of governance may fare in the post-crisis era.

\subsection*{3.4.4 Shared governance}

A number of contemporary governance paradigms have been developed in which leadership is provided through regulation, but the regulated are co-opted to provide governance within discretionary parameters. Regulatory provisions may be ‘open-textured’,\textsuperscript{149} as they may not be able to capture all of the situations that require governance. Some regulatory provisions may be more ‘open-textured’ than others, giving a degree of discretion to the regulated to implement or interpret the regulatory requirement. In this section, we will deal with the open-textured forms of regulatory governance, which in reality produce forms of delegated governance to the regulated, ideally overseen by the regulator at a meta-level.\textsuperscript{150}

Ford terms such regulatory techniques as ‘flexible regulation’,\textsuperscript{151} while Gilad uses the term ‘process-oriented’ regulation to describe this family of regulatory techniques.\textsuperscript{152} The family of flexible regulation techniques includes principles-based regulation, which, according to Black,\textsuperscript{153} features the following key elements: a purposive approach to interpretation of regulatory norms, a reliance on the internal management of firms, a focus on ensuring regulatees attain the purposes or outcomes of the regulation rather than technical compliance with detailed rules, a targeted approach to enforcement, and a redistribution of responsibilities within the regulatory regime for ensuring and demonstrating compliance.

\begin{footnotesize}
\begin{itemize}
\item[148] See, for example, general distrust in corporate culture in the wake of the Barclays LIBOR scandal in June 2012: Editorial, ‘Culture Shocks’ Financial Times (London, 17 July 2012).
\item[150] Bamberger likens such shared governance to ‘delegated governance’ meaning that regulators delegate the implementation of governance to firms and oversee them at a meta-level. Kenneth A Bamberger, ‘Regulation as Delegation: Private Firms, Decisionmaking, and Accountability in the Administrative State’ (2006) 56 Duke Law Journal 377.
\end{itemize}
\end{footnotesize}
Principles-based regulation is similar to outcomes-based regulation where certain known outcomes are prescribed in regulation while leaving a certain amount of discretion and responsibility to firms to take actions to ensure the attainment of those outcomes. However, outcomes-based regulation may be inappropriate where the certainty of outcomes cannot be defined, and process-based regulation may be more apt. Process-based regulation focuses more on systems and internal procedures that approximate to soundness of control and governance even if the outcomes are not entirely known. The regulated, however, may be delegated the discretion to design the exact technologies and implementation of the systems and procedures. For example, ‘management-based regulation’ as a form of process-based regulation emphasises organisational innovation and procedures to meet public regulatory goals. ‘New governance’, which is another form of process-based regulation, refers to the regulated being empowered to design compliance strategies and procedures accountable to an engaged regulator who constantly scrutinises at a meta-level. Where knowledge regarding ‘good’ outcomes or ‘good’ processes may both be limited, then flexible regulation could take on a form of ‘meta-regulation’, which may encompass both the setting out of broad goals and objectives, as well as the broad contours of systems and procedures, but emphasising on the experimental nature of such frameworks and the need to feed back and learn from the implementation and review of such frameworks. Shared governance in financial regulation has embraced a fair amount of principles-based regulation, especially in the UK.

likely to be rebranded as outcomes-based regulation, Shared governance essentially allows flexibility in compliance and co-opts the regulated in co-designing their compliance. It will be suggested that the post-crisis resurgence of public regulatory power will not fundamentally change the importance and the characteristics of such ‘shared’ governance. In particular, meta-regulation is of particular importance in financial regulation as it inherently accepts that regulators are dealing with uncertainty whether in regulatory outcomes or processes and therefore emphasises the value of experimental and learning-based implementation by firms.

3.4.5 Meta-regulation

‘Meta-regulation’ refers to a regulatory approach that empowers and enhances the capacity of corporations to self-regulate, but connects ‘the private justice of the internal management system’ to the ‘public justice of accountability.’ Parker proposes that such capacity to self-regulate may be enhanced by value orientation, management commitment, the acquisition of skills and knowledge, and the design of internal processes and systems. The ‘self-regulation’ of each microcosm should then be accountable to regulators and stakeholders in order to achieve not just ‘compliance’, but responsibility towards the democratic polity. Parker envisages that ‘meta-regulation’ would improve the permeability of the corporation to public accountability.

In the decentred regulatory space, financial institutions themselves have been regarded as key in producing internal governance and controls to connect the private justice of the internal system to the public justice of accountability. Hence, meta-regulation permeates micro-prudential regulation and risk management. In the EU, the Markets in Financial Instruments Directive 2004 (MiFID) provides for broad principles of organisational soundness, the establishment of internal controls such as a compliance function, risk management systems, internal audits and the responsibility of senior management for internal control generally.

161 Due to the unfortunate but almost inevitable association with the discredited ‘light-touch’ approach to regulation that characterised the UK regulator in the pre-crisis years, see Iain MacNeil, ‘The Trajectory of Regulatory Reform in the UK in the Wake of the Financial Crisis’ (2010) 11 European Business Organization Law Review 484 at 498.


166 Christine Parker, The Open Corporation (Cambridge: Cambridge University Press 2000).

These broad frameworks are proxies for achieving the outcomes of prudential soundness and robust conduct of business. Firms have the responsibility and discretion to implement the broad frameworks into firm-based systems and procedures. On the one hand, organisational structures and arrangements cannot be excessively prescribed as regulators are not in a position to micromanage firms, but on the other hand, financial institutions are relied upon to design a proportionate and appropriate form of compliance that meets regulatory objectives. Firm-centric organisational and governance structures are therefore seen as facilitating the achievement of public regulatory needs in maintaining the safety and soundness of financial institutions. The MiFID has adopted a meta-regulatory approach: regulators expect certain internal measures to be in place in firms and the regulators’ role is to provide overall supervision. In fact, risk management – and in particular enterprise risk management (ERM)\textsuperscript{168} – is being developed in the private sector as a professional discipline. The role of regulatory governance in this area is therefore very broad-based and principles-led, providing a framework rather than prescriptive rules as such.

Although regulators are encouraged to be dynamic and responsive under such meta-regulatory regimes, can regulators make any meaningful assessment of ‘compliance’ in supervision and enforcement? Baldwin and Black\textsuperscript{169} argue that regulators need to adopt an approach of ‘really responsive regulation’ that considers a variety of contextual and attitudinal factors in selecting for appropriate forms of supervision and enforcement in complex regulatory regimes. However, one concern is that meta-regulation requires more costly and sophisticated work on the part of regulators to critically scrutinise and constantly consider adjustments.\textsuperscript{170} Would regulators take the path of the least cost and least resistance and just ‘delegate’ the details of such meta-regulatory governance to be implemented by firms?

The micro-prudential regulation developed for the most sophisticated banks and financial institutions is meta-regulatory in nature. As will be fleshed out in greater detail in Chapter 12, the Basel II Accord’s capital adequacy standards feature discretionary and ‘delegated’ approaches that allow banks to develop sophisticated proprietary internal systems to comply with capital adequacy requirements. Banks have taken advantage of their discretionary part in designing self-governance and have opted for proprietary systems that favour selfish and excessive risk-taking.\textsuperscript{171} Commentators have criticised Basel II as being too open-ended and imprecise, pandering to the needs of flexibility and the self-interest of


\textsuperscript{170} Cary Coglianese and Evan Mendelson, ‘Meta-Regulation and Self-Regulation’ in R Baldwin, M Cave and M Lodge (eds), \textit{The Oxford Handbook of Regulation} (Oxford: Oxford University Press) , 146–68.

\textsuperscript{171} This is a rational decision based on the corporate finance position discussed in Chapter 2 relating to the Modigliani-Miller theorem.
financial institutions. Roubini has pointed out how the open-endedness of the standards served the interests of risk-taking executives in financial institutions, instead of the public interest. These open-ended standards have arguably succumbed to the ‘gaming efforts of corporations’, becoming standards of a cosmetic and minimal character, entailing the least cost to corporations. Gerding suggests that this is a race to the bottom. Each financial institution has developed its own proprietary risk management system, preventing open competition among alternative systems. The risk management systems developed by each financial institution have been technologically and scientifically limited and have tolerated suboptimalities and faults, yet remaining safe in their opacity.

However, in the wake of the global financial crisis, the meta-regulatory character of micro-prudential regulation is unlikely to change radically, as risk management is essentially an area that regulators cannot micromanage. More regulatory supervision is purported to be the way forward, but as Chapters 12 and 13 will discuss, meta-regulation continues to pose challenges to regulators in the decentred regulatory space.

Meta-regulation allows firms to become microcosmic centres of self-control, identifying the risks and opportunities to which the firm is subject and pooling resources to develop strategies. ERM, for instance, is described by Power as a tool for self-governance for the entire organisation of the firm. However, he


questions whether ERM’s engagement in dealing with the risks facing the
corporation runs any deeper than systems and processes designed to provide
compliance and box-ticking comfort. Further, risk management may be
excessively concerned about capturing data and providing audit trails, as it is
based on an extension of the audit framework and its practice is closely linked to
auditing and accounting practices.

Although meta-regulation can be reflexive and cost-effective, as well as co-opting
firms into designing solutions that may be more appropriate for them, the key
drawbacks in meta-regulation lie in firms’ conflicting objectives in designing risk
management systems and the inability of regulators to critically evaluate these
systems. Coglianese and others term this difficulty as one of ‘complemen-
tarity’ between firm goals and regulatory goals, and the lack of complementarity
may affect the effectiveness of the meta-regulatory regime in achieving public
regulatory goals. Firms are drawn towards making risk management and internal
control systems support business objectives rather than hinder them. Regulators
would need to evaluate firm-designed solutions against social, and not just private,
optimums, but it is not easy to make the connection between what is observed at
the micro-level and what such micro-level behaviour may portend at the macro-
level. Chapters 12 and 13 will discuss regulatory endeavours, post-crisis, to be more
prescriptive in risk management and corporate governance matters, reducing
the open-endedness of meta-regulation. The chapters will discuss whether these
new measures reflect adequately lessons learnt from the vulnerabilities of meta-
regulation or whether the vulnerabilities of meta-regulation are inherent in such

181 Rene M Stultz, ‘Rethinking Risk Management’ in Donald H Chew (ed), Corporate Risk Management (New York: Columbia Business School 2008), 119, where it is said that ‘the primary goal of risk management is to eliminate the possibilities of costly lower-tail outcomes’.
a shared governance model and that regulators and civil society should learn to become cognisant of its risks and adapt to the limitations of such governance.\textsuperscript{187} Black argues that open-ended forms of regulation, such as ‘principles-based regulation’, are susceptible to seven paradoxes, the foremost of which is that:

[Such governance models] can lead to the development of the type of relationship invoked by the Utopian vision, of responsibility, mutuality and trust, but these are the very elements of the regulatory relationships that have to be present for it to operate at all.\textsuperscript{188}

If meta-regulation may only work optimally in a utopian relational paradigm between regulator and regulated that can meet both the institutional and public interest needs, it must be questioned whether meta-regulation could work in the real world. Post-crisis, we are caught in a position where meta-regulation still seems to be an appropriate model to adopt in regulation but regulators remain challenged by the agency problems that abound in such a relational paradigm, as well as broader issues that relate to power and values.\textsuperscript{189}

Finally, we turn to examine areas in the financial services sector where there may be public interest, but which will not respond to and are not governable by regulation, even under the governance models discussed above. These are the areas of business ethics, social responsibility and corporate culture, which are contextual settings for the outworking of regulatory governance in the financial sector. Hector Sants, speaking in 2010, argued that regulators should focus on their role of facilitating culture and ethics, as these shape the behaviour and judgement of financial institutions.\textsuperscript{190} The incentives for regulatory compliance are shaped by these contextual factors and will affect the ultimate outworking of regulatory compliance.

\textbf{3.4.6 Ungovernable areas of business ethics, corporate culture and corporate social responsibility}

‘Business ethics’ has become a staple discipline in business management education\textsuperscript{191} and is arguably crystallising into a body of values and standards for

\textsuperscript{187} Seeking new consensus, such as discussed in Nick J Fox and Katie J Ward, ‘What Governs Governance, and How Does it Evolve? The Sociology of Governance-In-Action’ (2008) 59 The British Journal of Sociology 519.


\textsuperscript{191} Timothy L Fort, \textit{Ethics and Governance: Business as Mediating Institution} (Oxford: Oxford University Press 2001); Michael Segon and Christopher Booth, ‘Business Ethics and CSR as part of MBA
behaviour within for-profit organisations. Ethics and values shape the attitudinal context of regulatory governance and may foster environments that deter deviant, fraudulent and other antisocial behaviour. Ethics may also relate to ‘proactively’ increasing the social good, through community participation and volunteering for example, thus distinguishing the corporation as a socially responsible and accountable institution.

Ethics could be understood as an internal regulatory map (i.e. that individuals or organisations have a coherent moral awareness, make moral judgements, may be driven to act on moral motivations and hence may produce moral behaviour). However, the motivation for ethical behaviour may also be rational, linked to the management of reputation or image, for example, if reputation or image is an important asset. Hendry argues that we live in a bi-moral society where both the pursuit of individual wealth and social good are equally lauded; when choices must be made between the two, individuals and institutions are often placed in a difficult dilemma. Internal dispositions towards moral behaviour are often challenged by countervailing forces, such as rational calculations in game scenarios, organisational indifference or market perceptions of the value of such behaviour. The understanding of ‘ethics’ may morph according to the social, political and economic contexts and hence it may become a meaningless


200 Boatright argues that rather than championing individual business ethics or even organisational business ethics, the model of a moral market should be championed to define rules on transactions and engagement so that communitarian values and good can be achieved. See John R Boatright, ‘Does Business Ethics Rest on a Mistake?’ (1999) 9 Business Ethics Quarterly 583, and critical review in Jeffrey D Smith, ‘Moral Markets and Moral Managers Revisited’ (2005) 61 Journal of Business Ethics 129.
It is also arguable that ethical questions are often asked only with the benefit of hindsight (i.e. that pointing to the lack of ethical behaviour as an important factor leading to crisis usually takes place after the fact). Ex ante, however, it is difficult to ascertain what role ‘ethical behaviour’ might play in preventing or mitigating a crisis. Further, certain behaviour may not necessarily be regarded as ‘unethical’ from an ex ante viewpoint. However, the UK is considering introducing a form of professional governance for bankers. In the wake of the scandals involving LIBOR manipulation and customer mis-selling, the lack of ethics in the financial sector has become an issue of public concern. The UK instituted a Parliamentary Commission on Banking Standards led by MP Andrew Tyrie to look into whether banking ethics and culture should be subject to forms of governance. The Commission moots the possibility of the establishment of an independent Banking Standards Review Council to establish a Code of ethical standards of conduct for all bank employees and to be able to exercise powers of discipline over bank employees who fail to comply.

It has also been opined that regulatory governance needs to work within healthy corporate cultures at banks and financial institutions. The European Banking Authority’s (EBA’s) admonition to banks to develop a culture of internal control emphasises that there is a need to commit to a concept of ‘culture’ that goes beyond mechanistic and superficial ‘compliance’. Organisational culture refers to the social or normative glue that holds an organisation together. It expresses the values or social ideals and the beliefs that organisation members come to share, and which in turn affect their behaviour, values and beliefs. Regulatory attention has been turned to the influence of corporate culture on regulatory governance in the wake of the LIBOR manipulation scandal that was uncovered since June 2012. In June 2012, the UK regulator fined Barclays for engaging in unacceptable market conduct but has been unable to proceed.

Jean-Pierre Galavielle, ‘Business Ethics is a Matter of Good Conduct and of Good Conscience?’ (2004) 53 Journal of Business Ethics 9, arguing that the rise of the importance of ethics must be contextualised and that what is regarded as important by the public is often not reflected in corporate practice.


FSA Enforcement Notice against Barclays Plc (27 June 2012).
with precise criminal prosecutions for non-compliance or breach of law. The fine is a result of Barclays’ earlier settlement with the regulator following investigations into manipulation of the LIBOR, which has hitherto been set jointly by banks under the premises of the British Bankers’ Association. In January 2013, another bank implicated in LIBOR manipulation, the Royal Bank of Scotland, was fined.\(^\text{209}\) The United States regulator, the SEC, and the Swiss and UK regulators also took the Swiss bank UBS to task for its involvement in LIBOR manipulation.\(^\text{210}\) The investigations into the episodes of manipulation, which took place over a number of years, revealed an unhealthy corporate culture of indifference and contempt for the integrity of the processes for setting the LIBOR, prompting discussions at the policy\(^\text{211}\) and popular\(^\text{212}\) levels as to whether the corporate culture of banking and financial institutions required closer examination.

Regulatory governance has essentially become a relational paradigm between the regulator and regulated, but are corporate cultures fostering various forms of agency problems, such as box-ticking and superficial compliance, gaming and regulatory avoidance, and downright contempt for regulation? Schein\(^\text{213}\) argues that organisational culture is fostered by many interacting factors. Among these, he highlights critical incidents, leadership, evolutionary forces that compel organisations towards isomorphism or differentiation, corporate restructurings (e.g. mergers and acquisitions) and the perpetuation of certain values or norms through the recruitment of individuals that have an affinity for those norms and values. Can regulatory governance affect these factors or are these areas ungovernable by law?

Finally, the contemporary movement of ‘corporate social responsibility’ (‘CSR’) may also provide a contextual setting for banks and financial institutions in terms of general behaviour and accountability. CSR is generated by the private sector\(^\text{214}\) to compel financial institutions to reflect upon\(^\text{215}\) and voluntarily report\(^\text{216}\) ‘socially responsible’ behaviour, providing a form of bottom-up

\(^{209}\) ‘RBS Eyes Bonus Pot to Recoup Libor Losses’, Financial Times (11 January 2013).


\(^{211}\) George Parker, ‘Political mood tips against bankers’ Financial Times (London, 28 June 2012).

\(^{212}\) Andrew Hill, ‘Corporate Culture: Lofty Aspirations’ Financial Times (London, 15 July 2012).


\(^{214}\) Shamir provides an interesting discussion of how CSR was framed in critical language employed by NGOs and stakeholders against corporations and now has become adopted in corporate ideology and language as a voluntary self-regulatory movement; see Ronen Shamir, ‘Capitalism, Governance, and Authority: The Case of Corporate Social Responsibility’ (2010) 6 Annual Review of Law and Social Sciences 531.

\(^{215}\) For example, voluntary initiatives in corporate social responsibility include subscribing to accountability principles, which compel firms to design policies, act and reflect upon actions within the framework of social responsibility principles, the Plan-Do-Check-Act cycle. See the AA1000 Accountability Principles Standard 2008 (London: AccountAbility 2008) www.accountability.org/images/content/0/7/074/AA1000APS%202008.pdf accessed 5 January 2013.

\(^{216}\) Much of CSR lies in voluntary reporting of Environmental, Social and Governance (ESG) matters or the triple bottom line in People, Planet and Profit. See Iris H-Y Chiu ‘Standardization
governance. Might CSR compliment regulatory governance in motivating banks and financial institutions to behave in a manner consistent with the public interest? Or, on the contrary, is CSR confined to environmental, social and corporate governance issues, with banks and financial institutions narrowly engaged in one or more of these sectors simply appearing ‘socially responsible’? Will the concept of CSR affect the core business conduct of banks and financial institutions, such as in more sensitive and responsive treatment of customers in financial difficulty, the protection of retail customers from predatory credit, and perhaps even the design and distribution of sound investment products? Given the significant support for CSR as being aligned with the financial objectives of corporations, CSR may be interpreted as being subservient to the profit-making needs of corporations. Further, CSR may also be used as a form of reputational management and public relations exercise to stave off serious scrutiny. Commentators also warn that CSR may be used as a means to allow the already powerful financial sector to engage in greater political influence. If corporations are asked to play a part in developing the social good, they could argue that

in Corporate Social Responsibility Reporting and a Universalist Concept of CSR?: A Path Paved with Good Intentions’ (2011) 22 Florida Journal of International Law 361 for a general overview of the developments in CSR reporting.


219 Jordi Xifra and Enric Ordeix, ‘Managing Reputational Risk in an Economic Downturn: The Case of Banco Santander’ (2009) 35 Public Relations Review 353, for example, argues that the bank’s voluntary initiative to exchange assets for customers whose investments were placed in funds managed by Bernard Madoff is an example of social responsibility going beyond legal compliance.


223 Joseph Corkin, ‘Misappropriating Citizenship: The Limits of Corporate Social Responsibility’ in Nina Boeger, Rachel Murray and Charlotte Villiers (eds), Perspectives on Corporate Social Responsibility (Cheltenham: Edward Elgar 2008); Charlotte Villiers, ‘Corporate Law, Corporate Power and Corporate Social Responsibility’ in Nina Boeger, Rachel Murray and Charlotte Villiers (eds), Perspectives on Corporate Social Responsibility (Cheltenham: Edward Elgar 2008); Subhabrata Bobby
corporate interests should be factored into the social good equation. CSR may thus become a legitimate platform for greater corporate influence upon social life.

As CSR is a concept that is constantly adapted to the corporation’s strategic purposes, it is more likely that CSR would itself be subject to corporate culture than be in a position to lead cultural or ethical changes in an organisation.

3.5 Conclusion

This chapter has focused on the decentred nature of the regulatory space in financial regulation and how financial regulation has been shaped or limited by it. We argue that the financial services industry has acquired significant influence over regulatory governance in the sector. The shape of regulatory governance in the financial sector reflects the relational paradigm between the regulator and regulated. Post-crisis, this relational paradigm is not radically changed. Although the scope for self-regulation and market-based governance has contracted, regulators continue to rely on meta-regulation in many key areas of financial regulation, as Part 3 will discuss, and general issues such as banking ethics and corporate culture may remain ungovernable. Regulators continue to face limitations in regulatory resources and are likely to rely on the financial sector to supply governance in areas where regulators are unable to overprescribe or micromanage. The importance of the financial sector in the decentred governance landscape will continue to influence and shape the future of financial regulation.

Wilke argues that expert-led governance is likely to continue to dominate policymaking and that the financial services industry is likely to continue being an important actor in the regulatory space. One countervailing trend that has been observed post-crisis, and which will be discussed in detail in Part 2, is the enrolment of ‘other’ experts (e.g. institutional investors, supranational organisations and professions, such as auditors) to assist in mitigating the influence from the industry. However, the selective bias towards these other experts in the financial sector may lead to elitism in financial regulation; the citizenry thus becomes even more removed and excluded from the opaque influence exerted by these experts over the developments in financial regulation. Part 4 will return to this point with critical observations.

Banerjee, Corporate Social Responsibility: The Good, the Bad and the Ugly (Cheltenham: Edward Elgar 2007), 146.


225 Helmut Wilke, Governance in a Disenchanted World (Cheltenham: Edward Elgar 2009).

The governance role of auditors in financial regulation

As Chapter 3 demonstrates, contemporary regulation theories are open to governance models that involve regulatory partnership with the regulated and other market participants. In the pre-crisis years, one group of experts were already enrolled in a role that assists regulators. Auditors are engaged by firms although their work serves the wider purpose of regulatory compliance or accountability. However, they are not regarded as guardians of the public interest in securing regulatory compliance or accountability as auditors are engaged by clients and it is the clients that have direct responsibility for regulatory compliance and accountability.1 As auditors have access to firm information and technical expertise in understanding the financial profiles of the firms they audit, what auditors know and do could be of relevance to regulators in the supervisory process.2 Auditors have always been regarded as being in a position to assist regulatory supervision as ‘gatekeepers’3 despite the fact that the levels of regulatory accountability imposed on them are much lower than those imposed on the financial institutions themselves.

The authors devote this chapter to discussing auditors in their governance role as post-crisis reforms are being proposed in the EU and UK to make auditors more effective gatekeepers. However, what auditors do and what is expected of them by regulators may be the subject of an ‘expectations gap’. This chapter will discuss the ‘expectations gap’ as being a key theme in discussing the governance role of auditors. Section 4.1 will discuss the role of auditors in relation to financial sector firms and the ‘expectations gap’ between auditors and regulators. Section 4.2 discusses the failings in the audits of compliance with regard to client money and asset-handling rules in financial regulation, which have given rise to proposals

1 Unless auditors are commissioned directly by regulators to prepare reports under section 166, Financial Services and Markets Act 2000.
to reform auditors’ roles and the auditing industry. Section 4.3 discusses the UK’s\(^4\) and EU’s\(^5\) proposals and will examine whether and to what extent such proposals affect the roles and liability of auditors. Section 4.4 concludes.

**4.1 The evolution of the role of auditors in corporate sector governance**

In the financial sector, auditors perform the traditional role of vetting corporate reporting and vetting compliance with rules in financial regulation relating to client money and asset handling.

The Companies Act 2006 in the UK provides for a mandatory yearly audit of all companies, private and public,\(^6\) unless the private company falls within the special ‘small business’ regime in the Act.\(^7\) The audit may be viewed as a way to bridge the information asymmetry between the company and its investors as the audit is a process allowing independent, professional third parties to verify disclosure by management of the company’s financial health, which could be subject to the agency problem. An auditor’s remit consists of verifying that the financial statements have been prepared using the mandatory IFRS accounting standards and that the statements present a true and fair view of the company’s condition.\(^8\) The audit of financial statements produced by the company’s management is arguably a basic layer of gatekeeping for the corporate sector as part of compliance with general company law. Although the company laws of EU Member States are largely left to national legal frameworks, the EU has harmonised the mandatory use of the International Financial Reporting Standards (IFRS)\(^9\) for financial reporting and auditing, so as to improve the comparability of financial reporting across the EU.

**4.1.1 Fraud detection**

One of the expectations linked to the audit is that auditors may be able to detect fraud in corporate reporting. Fraud detection serves as a platform for facilitating market discipline of management. It is argued that there is a public perception of the auditor’s role as a fraud detector,\(^10\) although auditors do not see this as

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7. Companies Act 2006, s 477, exempts companies with a turnover not exceeding £6.5 million, balance sheet not exceeding £3.26 million and employees not exceeding 50.
their primary role. Power refers to the audit as a ritual of verification, akin to a label, that confirms the integrity of corporate disclosure so that those affected by the information asymmetry may have the comfort of safety in investment.\(^{11}\) There is arguably an ‘expectations gap’ between how auditors and the public see the auditors’ role. An ‘expectations gap’ is a gap between what the auditor does and what users expect the auditors to have done, such as in fraud detection or insolvency predictions. This section will provide a literature review of the ‘expectations gap’ in the auditor’s traditional role in corporate reporting. This section will also argue that the legal framework relating to the civil liability of auditors shows that the law does not put the onus on auditors to address such an ‘expectations gap’. Section 4.2 will then argue that in relation to financial regulation, there is also an ‘expectations gap’ between auditors and regulators and that this has culminated in audit failures exemplified in the post-Lehman litigation. Section 4.2 sets the context for the reforms that will be discussed in Section 4.3.

The ‘expectations gap’ arises as auditors may have less capacity and competence to detect irregularities and fraud in corporate reporting than is assumed by the public.\(^{12}\) Some of the empirical literature argues that fraud detection is not technically easy given that auditors sample the financial records kept by the company and have only an overview of the internal systems and controls, rather than intimate knowledge.\(^{13}\) It has been shown that auditors need to spend considerable time and effort in pursuing many false alarms in order to hit on real incidences of concern and the auditing process may not be able to accommodate this.\(^{14}\) Further, auditors also have to develop models incorporating many variables in order to detect possible fraud. One study concludes that the combination of 62 variables in both financial and non-financial information, such as corporate

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12 Paul E Johnson, R Glen Berryman and Karim Jamal, ‘Detecting Framing Effects in Financial Statements’ (1996) 12 *Contemporary Accounting Research* 85, argues that the auditors’ approach is also important to detecting fraud. Auditors who accept management’s framing of certain financial statements and see from the management’s point of view are more likely to be misled. This study is based on an empirical experiment.


governance information, could significantly improve audit detection of management fraud.  

Corona and Randhawa further argue that auditors may not report fraud, even if detected, particularly in a continuing tenure where previous fraud has gone undetected. This is because auditors may fear a reputational backlash for delayed discovery. Indeed, in a context where it may be difficult to detect if an auditor could have detected fraud, the behavioural tendency to continue along a slippery slope is likely. There is also a body of opinion that is resistant to turning the audit into a systematic fraud detection or policing exercise, as this may damage auditor-client relationships and entail issues of auditor liability due to unmet expectations. Markham in particular argues that auditors should not be policing possible wrongdoing on the part of clients. It is also questionable whether the cost of such detective work bears a proportionate relationship to the purposes of the audit and its role in facilitating market-based governance.

So to what extent can an auditor’s work mitigate fraud and irregularities? Empirical research provides a few examples. The phenomenon of earnings restatements show that the audit may flex its muscles to force corrective disclosure to be made, which is empirically shown to affect investor decisions and share prices. Although it may take time for auditors to detect irregularities, earnings management is likely to become more apparent with patterns of balance sheet bloating, which can be detected by auditors. Fraud detection certainly requires effort and a more sceptical and critical mindset on the part of auditors, but it is


17 Fairchild, however, presents a more nuanced game theoretic model where the auditor is likely to increase fraud detection with increased tenure. But beyond a certain point, managerial fraud may reduce and hence qualified reports become unnecessary. It could equally be possible that auditors develop sympathies for management beyond a certain point in time explaining why the number of qualified reports decrease. Richard Fairchild, ‘Does Audit Tenure Lead to More Fraud? A Game-theoretic Approach’ (June 2007) http://ssrn.com/abstract=993400 accessed 5 January 2013.


not such a forbidding task, and auditors may be able to find such trails and leads. Hence, the Financial Reporting Council\(^{21}\) in the UK responsible for setting standards for auditors states in International Standard on Auditing (ISA) 240 that:

The objectives of the auditor are:

(a) To identify and assess the risks of material misstatement of the financial statements due to fraud;
(b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
(c) To respond appropriately to fraud or suspected fraud identified during the audit.\(^{22}\)

The professional standard therefore sets the expectations of what an audit can deliver, as being the possible uncovering of material misstatements due to fraud. The profession therefore expects that material misstatements may be uncovered, not necessarily that all forms of fraud, however minor, must be detected. The primary responsibility for fraud detection and prevention lies with company management and there is an inevitable risk that auditors may not be able to detect material misstatements, whether made in error or as a result of carefully organised and concealed fraud.\(^{23}\)

The ‘expectations gap’ between what is expected of fraud detection and what the audit delivers is further reinforced by civil law jurisprudence.

### 4.1.2 Professional accountability in civil law

It is arguable that the limited regime of auditors’ civil liability reinforces the legitimacy of the ‘expectations gap’. Kraakman argued, in an early classic, that gatekeepers’ liability is a form of alternative or secondary liability that is only engaged if the enterprise and the officers subject to liability cannot fully meet the demands for compensation.\(^{24}\) The limitation of gatekeeper liability is seen as sound as gatekeepers are not directly involved with causing the loss. The EU’s position

\(^{21}\) The Auditing Practices Board until July 2012 was responsible for setting auditing standards. In July 2012, as part of a reform of the Financial Reporting Council (FRC), the Auditing Practices Board (APB) was replaced by the Audit & Assurance Council. Responsibility for setting auditing standards was assumed by the FRC Board, with the Audit and Assurance Council acting in an advisory role to the FRC Board and its Codes and Standards Committee.


\(^{23}\) ISA (UK and Ireland) 240, paras 4–8.

in the 2008 Commission Recommendation\textsuperscript{25} is also to limit auditors’ civil liability in order not to impede the discharge of auditing functions.\textsuperscript{26}

There are several variables to take into account. One is the form of civil liability that would apply. In most countries, this is a joint and several liability, and the standard of care is a high one, commensurate with the professional stature one would expect of an auditor-accountant. Another is the way in which accountants organise themselves. Joint and several liability will be limited in its effect if auditors are allowed to incorporate as limited liability companies or organise themselves as limited liability partnerships.

In the UK, civil law imposes severe limitations on the persons who may call auditors to account in respect of a financial audit. In the classic case of \textit{Caparo Industries v Dickman},\textsuperscript{27} a potential takeover bidder who had built up a shareholding large enough to launch a takeover bid in Fidelity Plc sued the auditors Dickman when it was subsequently discovered that a negligent audit had allowed the financial statements to paint a rosier picture of Fidelity’s financial health than thought. The House of Lords dismissed the action on the basis that the auditors did not owe a duty of care to the shareholders at large, and that such a duty would only be owed in a situation of sufficient proximity between the auditors and the shareholder whose purpose for consulting the financial statements was made known to the auditors in advance. Hence, even if existing and potential investors are reasonably likely to consult and rely on audited financial statements, the civil liability of auditors is not engaged unless a special relationship causes a duty of care to arise.

There are several points to be made here. The first is that the House of Lords in \textit{Caparo} overturned a strong and clear judgment from the Court of Appeal.\textsuperscript{28} Lord Justices Bingham and Taylor were in the majority in the Court of Appeal, with Bingham LJ giving the lead majority judgment. They held that ‘the degree of closeness between the parties’ established a duty of care. They emphasised that there had been a sufficient assumption of responsibility by the auditors.\textsuperscript{29} Bingham LJ concluded that the auditors had voluntarily assumed direct responsibility to individual shareholders to whom they owed a duty to exercise reasonable care in carrying out their audit. He further concluded that such duty was owed to a shareholder in respect of any loss sustained by him in selling, retaining, or buying


\textsuperscript{26} There was very strong lobbying and pressure from the accountancy industry after accountancy firms had settled liability claims resulting from the successive major financial scandals in the late 1980s onwards. The accountancy industry wanted statutory limitations in liability, in the form of caps, proportionate liability (not joint and several) or the possibility to limit liability in the forms of organisation.

\textsuperscript{27} [1990] UKHL 2, [1990] 2 AC 605.

\textsuperscript{28} [1989] Q.B. 653.

\textsuperscript{29} The focus on assumption of liability continued in the Court of Appeal until the overturning in the Lords in \textit{Caparo}, see \textit{Reid v Rush and Tompkins Group Plc} [1989] EWCA Civ 10, [1990] 1 WLR 212.
shares in the company. 30 Taylor LJ supported this, and stated: ‘once proximity to the shareholder is established the auditor ought prima facie to be liable for any loss suffered in foreseeable reliance upon the report’.

Bingham LJ also referred to 31 the approval by Cardozo CJ in Ultramares Corporation v Touche of an earlier statement that:

... negligent words are not actionable unless they are uttered directly, with knowledge or notice that they will be acted on, to one to whom the speaker is bound by some relation of duty, arising out of public calling, contract or otherwise, to act with care if he acts at all. 32

Bingham LJ then said: ‘This formulation would not exclude the finding of a sufficiently proximate relationship in the present case if the words “will be acted upon” are replaced, as in English law I think they should be, by “may be acted upon”’.

Bingham LJ relied on Denning LJ’s dissenting judgment in Candler v Crane 33 and its approval in Hedley Byrne. 34 After setting out the facts in Candler, Lord Reid said in Hedley Byrne:

This seems to me to be a typical case of agreeing to assume a responsibility; the [accountants] knew why the plaintiff wanted to see the accounts and why their employers, the company, wanted them to be shown to him, and agreed to show them to him without even a suggestion that he should not rely on them. 35

Bingham LJ then relied on the statutory scheme: the provision of guidance for the making of investment decisions was one of the purposes to be discerned in the statutory provisions. He observed:

I think these provisions also reflect a wider and more commercial intention. The growth and development of limited liability companies over a relatively very short period have been phenomenal. Their proliferation and expansion have depended on their acceptance by the investing public as an advantageous and (on the whole) reliable medium of investment. The statutory requirements that companies account to their members and that auditors express an independent opinion to shareholders on the truth and accuracy of company accounts are in my view designed (in part at least) to fortify confidence in the

30 [1989] Q.B. 653, 685D-690F.
32 Ultramares Corporation v Touche, 174 N.E. 441, 447.
35 At 487.
holding of shares as a medium of investment by enabling shareholders to make informed investment decisions. There are obvious reasons, both economic and social, why this end should be regarded as desirable.

This ground did allow for liability towards the investors/shareholders in tort. The Court, however, rejected a submission by Caparo that an auditor owed a duty to a potential investor who held no shares. The relationship of the unwelcome bidder in a potential takeover situation will today be regarded as equally proximate to the auditor as the relationship of a shareholder to whom the report was directed. Here, account must be taken of the fact that the duties to inform the market was less developed at that time, and this part of the judgment must be seen in its historical context. The facts of the case took place before the regulatory reforms of the late 1980s had taken effect, or before the consequences in the common law could have been fully worked out. In this context, the subsequent House of Lords judgment may be regarded as positively retrograde in not taking account of regulatory duties and the functioning of the market.

Although the Court of Appeal supported the framing of a duty of care to shareholders, the issues of causation and quantum would have provided the next line of defence for auditors. Both Denning and Bingham LJ discussed the much-quoted observation of Cardozo CJ in *Ultramares*. Lord Bridge cited Cardozo CJ’s concern about ‘liability in an indeterminate amount for an indeterminate time to an indeterminate class’ and did not go into how Denning and Bingham LJ had applied Cardozo CJ’s analysis.

The House of Lords rejected the Court of Appeal’s conclusion on duty of care in *Caparo*. The House, however, did not provide much analysis for its opposite conclusion that no sufficient proximity existed between the auditors and the shareholder, and that the civil liability of auditors is not engaged unless a special relationship causes a duty of care to arise. There was no discussion of the statutory scheme except a rejection of Bingham LJ’s analysis. *Caparo* was a policy decision, creating a restriction of liability that otherwise would have followed from the principles of tort law as they stood at the time.

The limitations the House of Lords in *Caparo* placed in 1990 on the parameters of auditors’ civil liability have continued in *Stone & Rolls v Moore Stephens*. In that case, the controlling shareholder, S, of a company, Stone & Rolls Ltd, sued the auditors, Moore Stephens, for failing to detect fraud in sham transactions the company had carried out, ultimately causing the company to enter into liquidation. The auditors proceeded to strike out the claim and this was ultimately upheld by the House of Lords. The House of Lords reasoned that auditors owed a duty of care to the company and the body of shareholders as a whole. However, S was the only shareholder and controlling mind of the company and knew that fraud was being carried out. S therefore could not rely on an action against the auditors.

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36 *Ultramares Corporation v Touche*, 174 N.E. 441 (1931), 444.
to benefit from his own fraud. The auditors were entitled to the defence of *ex turpi causa* against S. The majority decision in the House of Lords also suggested that the fraudulent acts of persons in the course of business could be imputed to the company itself, such that the company was also precluded from suing its auditors for failure to detect fraud. Watts has criticised this part of the judgment as going too far; companies are an abstraction that act through natural persons and, hence, an imputation of fraud should not easily be made to undermine the separate legal personality of the company.\(^3^8\) This would prevent liquidators from suing for the company. However, where there may be other innocent shareholders, there is still a possibility for calling auditors to account, subject to the test of proximity above.\(^3^9\) The judgment, however, rejected that a wider remit of care was owed to creditors.

The tenor of private law jurisprudence has placed many limitations on the characterisation and enforcement of auditors’ duties of care. This reinforces the position that auditors are not to be regarded as surrogates for the performance of primary obligations that firms should perform.

Is this position the same in contexts where auditors are regarded as assisting with regulatory supervision? The next section will discuss the ‘expectations gap’ between auditors and regulators in the context of auditing compliance with client money and asset handling rules in financial regulation.

### 4.2 Auditing compliance with client asset and money handling rules in financial institutions

In addition to the general verification of financial statements, the auditor of a financial institution in the EU and UK is required to verify compliance with certain rules. Under the EU Markets in Financial Instruments Directive 2004\(^4^0\) (MiFID), auditors are required to verify the compliance of an investment firm with rules requiring the handling of client assets and money in such a way as to protect client rights in the event of firm failure or insolvency.\(^4^1\)

The UK Financial Services Authority (FSA) has enacted these rules in its Handbook: CASS 6 and 7, and auditors’ duties in SUP 3. However, it is specified

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\(^3^9\) Roach acknowledges that the *ex turpi causa* defence is not likely to work for large firms with dispersed shareholding, see Lee Roach, ‘Auditor Liability: The Case for Limitation: Part 1’ [2010] *Company Lawyer* 136.


in SUP 3.10 that the auditor’s report not only pertains to compliance, but should also assess the adequacy of internal controls (including the internal controls of outsourcees) that enable compliance with the client asset and money handling rules. Auditors must also be ‘independent’ and free from conflicts of interests.\textsuperscript{42} In the years before the global financial crisis, auditors readily signed off their investment firm client’s compliance as satisfactory and adequate, until the Lehman Brothers bankruptcy revealed the suboptimality of auditors’ practices in this area. Auditors have largely seen their role in vetting CASS compliance as assisting their financial sector clients to overcome regulatory hurdles.\textsuperscript{43}

An ‘expectations gap’ exists between regulators and the audit profession in relation to vetting compliance with rules in financial regulation relating to client money and asset handling. Although auditors’ roles are generally fashioned by regulation, their primary accountability has been to the firms that appoint them, and not to regulators. Auditors’ incentives do not necessarily converge with regulators’ expectations of their governance role. This is illustrated with reference to the Lehman saga, as will be discussed below. Further, the regulatory framework does not address the ‘expectations gap’ by calling auditors to account.

The main regulatory body that ensures discipline in the auditing industry is the Financial Reporting Council (FRC). The FRC monitors the development of accounting standards and the quality of audits. It carries out inspections and audits of major auditors.\textsuperscript{44} The Professional Discipline Board under the Council may discipline auditors. In light of the UK regulator’s revelation of severe weaknesses in auditors’ work relating to CASS compliance vetting, the Board took action against Pricewaterhouse Coopers,\textsuperscript{15} the CASS compliance vetter for JP Morgan, who was fined by the UK regulator. However, a small fine of £1.4 million was levied on Pricewaterhouse Coopers at the conclusion of the proceedings. It has been commented\textsuperscript{46} that the small fine shows general unwillingness to take enforcement action against auditors, as too much deference is paid to their role. Further, it is difficult to discern whether auditors have actually discharged diligence. Auditors can adduce evidence of processes and data trails to insist that they have taken due care, and it is difficult to prove otherwise.\textsuperscript{47}

It could be argued that the UK regulator may also call auditors to account as the Financial Services and Markets Act allows the regulator to impose regulatory

\textsuperscript{42} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SUP 3.5.
\textsuperscript{43} Roman A Tomasic, ‘Corporate Governance Failure: The Role of Internal and External Gatekeepers in UK Banks and Financial Institutions’ (2010) 10 Corporate Governance 8, 8–11, 26–27.
\textsuperscript{44} Professional Oversight Board, part of the Financial Reporting Council.
\textsuperscript{45} Jonathan Guthrie, ‘PwC fine underplays auditors’ responsibilities’ Financial Times (London, 6 January 2012).
\textsuperscript{46} The fine was thought by the FT to be meagre, see Jonathan Guthrie, ‘PwC fine underplays auditors’ responsibilities’ Financial Times (London, 6 January 2012).
duties on auditors. Further, the duties surrounding auditors’ CASS compliance vetting is framed as ‘regulatory rights and duties’. The main enforcement measure that may be taken is the power of disqualification under section 345 of the Act. The FSA Handbook SUP 3.8 and SUP 3.10 set out the few express duties imposed on auditors: auditors have a duty to submit a report on CASS compliance and to gain access to information in the firm in order to discharge their vetting function. Auditors have clearly been trusted to provide the regulator with assurance but there were no regulatory enforcement decisions against financial institutions in respect of CASS infringements in the pre-crisis years.

The Lehman Brothers bankruptcy litigation has revealed the extent of non-compliance with CASS that has prevailed in the industry and has gone undiscovered by the regulator due to its trust in auditors’ CASS compliance vetting. The UK regulator has realised that the ‘expectations gap’ matters. CASS compliance vetting has become a form of surrogate regulatory supervision and misplaced trust in auditors has affected the achievement of the regulatory goal of client protection intended under CASS.

4.2.1 The Lehman saga

With the onset of the Lehman Brothers bankruptcy in the US, the Lehman subsidiary in Europe, Lehman Brothers International, was subject to numerous legal actions taken by clients seeking to recover money and assets still held by the firm when the abrupt bankruptcy proceedings started in the US. A key question that arose in many of these proceedings is the issue of whether clients’ claims to money and assets were based on proprietary rights, which would have been safeguarded if the firm had complied with CASS. The first case heard in the High Court was Lehman Bros International v CRC Credit Fund. In that case, a hedge fund brought an action to claim the return of moneys and assets held on its behalf by Lehman Brothers. The court was asked to decide if the fund had a proprietary claim to client assets and moneys even though such assets and moneys were not appropriately segregated into client accounts by Lehman. The unravelling of Lehman’s internal controls showed a lack of care in ensuring segregation of client moneys, much of which remained in house accounts, with poor reconciliation and record keeping. These practices were in place in spite of the rules in MiFID, and CASS and auditors’ vetting imposed by MiFID and SUP. The High Court decided that although the regulatory rules required segregation of client moneys, these rules did not create proprietary rights for clients as such. Rather, clients had to establish their claims in the common law of trust. It was decided that although

48 Financial Services and Markets Act 2000, s 342.
49 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SUP 3.8.
50 FCA Handbook (as of 30 April 2013, formerly FSA Handbook) EG 15 further provides circumstances where such power may be exercised.
a statutory trust over the client’s money arose at receipt, when the moneys were deposited into the house account and mixed with other funds, it could no longer be said that the moneys could be identified as client property. In effect, then, the lack of care in Lehman’s handling of the client moneys caused the client to ‘lose’ the initial proprietary claim to moneys handed over in trust. This case caused considerable furore in the investment community and, upon appeal, the UK Court of Appeal reversed the judgment deciding that the initial trust could not be extinguished even in cases of poor handling of client moneys and assets. The statutory protections were to be read as intending to provide client protection in the manner of a proprietary claim however non-compliant Lehman turned out to be.52 The case does not, however, resolve the practical issue of how to identify the amount the client is entitled to be returned. The UK regulator has now enacted pooling rules in CASS 7A to return pro-rated amounts of client money and assets where moneys have been pooled together in the firm’s own account (‘primary pooling’) or in the account of an outsourcee that fails (‘secondary pooling’). Further reforms have also been introduced to improve firm processes in record keeping, daily reconciliations and reporting to clients in order to facilitate the orderly distribution of client moneys and assets upon insolvency.53

In the wake of discovering the unsatisfactory state of CASS compliance manifested in the string of post-Lehman litigation, the UK regulator carried out an extensive audit of investment firm practices with respect to their compliance with CASS and found shortfalls in compliance from the most eminent firms to their smaller counterparts. The most high profile enforcement measure was a fine on JP Morgan Securities for the sum of £33.3 million for failures in internal controls and processes relating to client money and asset handling.54 Between 1 November 2002 and 8 July 2009, JP Morgan Securities failed to segregate the client money held by its futures and options business with JP Morgan Chase Bank NA. The error occurred following the merger of JP Morgan and Chase. Instead of being held overnight in a segregated money market account, client money was held in an unsegregated account. This error remained undetected for nearly seven years. During this period, the client money balance held by JP Morgan Securities varied between $1.9 billion (in December 2002) and $23 billion (in October 2008). Had the firm become insolvent at any time during this period, client money would have been at risk of loss. Barclays Capital was fined in the region of £1.12 million, and BlackRock was also fined a substantial sum55 for similar failings.

Finally, enforcement notices with fines were issued for a number of smaller firms across the financial sector, where failure to adequately segregate client money or assets had been found.\textsuperscript{56}

It may have been conceivable that auditors be treated as surrogate supervisors for compliance matters such as client asset and handling, as a natural extension of expertise in book keeping. However, given that auditors’ processes rely on sampling and internal audit information, it is questionable whether auditor vetting is effective for irregularity detection. Irregularity detection, like fraud detection, may be missed where a myriad of information and accounts are not intimately examined but only sampled. Auditors’ work in vetting CASS compliance is carried out based on each auditing firm’s standards of judgement and there is a lack of industry harmonisation.\textsuperscript{57} This lack of substantive industry harmonisation also exists in other services, such as assurance work for risk management, corporate governance and corporate responsibility. However, the lack of standardisation in the discharge of such work may not necessarily mean that the work is substandard. Audit firms are free to compete over how they use their expertise in a range of verification and assurance work.

Auditors’ lacklustre performance in relation to CASS compliance vetting has arguably been substandard; auditors lack incentives to monitor their clients and do not incur liability for their clients’ breaches or customers’ losses. Although enforcement actions have been taken against the firms that have breached CASS rules, auditors who have signed off erroneous clean bills of health for financial institutions in CASS compliance have not faced consequences of note.\textsuperscript{58}


\textsuperscript{57} IAASB, International Standard on Assurance Engagements (ISAE) 3000, Assurance Engagements Other than Audits or Reviews of Historical Financial Information (2005) provides guidelines on how an assurance provider should determine the scope of the engagement and the level of assurance provided, the relevance of expertise and skill and extent of information access to carry out the assurance. These are high-level guidelines that attempt to make clear the scope, purpose and limitations of each assurance but do not provide for harmonised industry standards. The meaningfulness of assurance engagements would largely be determined by the recipients of corporate reports who could be motivated to make sense of the assurance provider’s delimitation of the scope and purpose of the assurance. Further, the Auditing Practices Board’s guidelines for non-audit work centre on the ethical aspects of how an engagement should be framed and the processes auditors should undertake, hence any standardisation in these areas is framework-based rather than substantive in nature. See APB Ethical Standards for Auditors, www.frc.org.uk/Our-Work/Codes-Standards/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/Ethical-standards-for-auditors.aspx accessed 6 January 2013.

\textsuperscript{58} The Accounting and Actuarial Discipline Board of the Financial Reporting Council disciplined the auditors of JP Morgan (i.e. Pricewaterhouse Coopers, and levied a fine of £1.4m, which was
4.2.2 Would auditors be liable under civil law?

Judicial limitations in relation to auditors’ duties of care in the context of corporate reporting may also affect the shape of auditor civil liability in respect of other assurance services. In the context of CASS compliance vetting, to whom is a duty owed? Could the clients of a firm sue the auditors for verifying compliance where such compliance is shoddy and patchy? Could Lehman’s clients, whose proprietary rights to money placed with the firm are jeopardised by the firm’s shoddy handling practices, sue auditors for having signed off clean bills of health for Lehman? Would not the Caparo argument apply, such that duties of care cannot be owed by auditors to large and unidentified groups of persons? Could the liquidators of Lehman sue its auditors or would the negligence imputed to the firm bar it from suing? Developments in civil law jurisprudence are arguably antagonistic towards developing a wider base of potential claimants and may thus reinforce the legitimacy of the ‘expectations gap’. Neither tort law nor contractual liability have been developed in European jurisdictions to create duties or make enforcement more effective. To some extent, courts have regarded regulatory rules as public interference in private law relationships and have been reluctant to develop remedies. Auditors also have access to a range of contractual mechanisms to try to limit whatever liability would otherwise apply. The duties owed in the contractual relationship may be formulated in such ways that tort liability too is limited.

4.2.3 Should the expectations gap be addressed?

The audit of CASS compliance is a form of delegated governance that regulators devolve to auditors, as their access to firm information and their capacity to apply a critical mind are attributes useful to their governance capacity as gatekeepers. Auditors may reach where regulatory supervision may not. However, the audit is a market-based service rendered to the client firm. Although the audit can also assist regulatory supervision in CASS compliance, auditors are not compelled to consider this aspect of their work. The audit and assurance are revenue-generating services for accounting firms. Coffee and others have argued that auditors have gradually lost sight of the public interest aspect of their audit work, using the auditing opportunities as channels for non-audit business and so commodifying the audit. In Smith and Walter’s view, auditors’ private commercial interests considered by the FT to be meagre); see Jonathan Guthrie, ‘PwC fine underplays auditors’ responsibilities’ Financial Times (London, 6 January 2012).


have greatly compromised their objectivity, making questionable the quality of any ‘governance’ perceived to be supplied by the audit. Donahue asks ‘[g]overnance and markets . . . tend to be tangled with each other’, but ‘does engaging the market offer the most promising blueprint for accountability in the pursuit of particular public goals?’ He rightly notes that public goods tend to entail ‘extensive accountability’ to a wide range of public constituents, while market-based concepts are intensive in nature, limited to transactional and contractual forms of accountability. Although the audit and CASS compliance vetting are regulatory requirements, auditors’ relationships with their clients remain in the private realm of contract.

Is it imperative to address the ‘expectations gap’ in order to enhance the role that auditing may play in assisting regulatory supervision? One can argue that as the role of the audit was created by regulation, whether in relation to corporate reporting or CASS compliance vetting, auditors should not be able to ignore the public interest aspect of their work and should become more accountable to regulators. This may mean that imposing regulatory duties and liabilities should be considered an important means to address the ‘expectations gap’. On the other hand, auditors have a private commercial relationship with their clients and so their work should be seen as assisting the client in meeting regulatory requirements. Where clients breach regulatory requirements, clients should be primarily responsible for such infringements. Auditors should not be called to liability or held responsible for clients’ infringements. This argument would support not addressing the ‘expectations gap’, since such a gap is not suboptimal, but merely reflects the limits on what auditors can legitimately do. The legal framework in private law jurisprudence and the lack of regulatory enforcement against auditors seem to support the latter view.

The Lehman saga has arguably made it clear to the UK regulator that the ‘expectations gap’ needs to be addressed or a gaping hole may be left in the regulatory supervision of CASS compliance. The UK and EU have proposed rather different approaches to deal with this issue.

4.3 Different visions of the auditors’ governance role in the UK and EU

4.3.1 The UK’s vision

Post-crisis, the UK regulator requires auditors to state if CASS compliance vetting has been performed under the terms of a ‘reasonable assurance engagement’ or


Roy C Smith and Ingo Walter, Governing the Modern Corporation (Oxford: Oxford University Press 2006), 159, 277.

a ‘limited assurance engagement’, depending on whether the auditor can fully verify the state of record keeping maintained by the financial institution concerned. Auditors are required to report on specified matters of compliance, and to report on a standard form, within four months of each reporting period. SUP 3.10 now forces auditors to take certain steps in their vetting work, such steps being designated as duties. It may be argued that precise mandatory action that auditors need to take could be interpreted as legal duties, such as the duty to submit reports on the standard form and in time. The enhancement of legal duties could be a way to address the ‘expectations gap’, compelling auditors to prioritise their role in assisting regulatory supervision.

However, it remains to be seen whether regulators will actually take enforcement action against auditors for poor reporting. First, a ‘limited assurance engagement’ could possibly protect auditors where compliance vetting may not be satisfactory. Second, how will the regulator’s role in enforcement exist alongside the FRC’s role in professional discipline? Given that the regulator left it to the FRC to discipline Pricewaterhouse Coopers, it may be inferred that the regulator considers itself to be the primary supervisor of financial institutions and its role with respect to auditors remains ambivalent. The regulator may not wish to exercise its draconian power of disqualification without submitting to the expert oversight of the FRC.

Further, this chapter argues that the UK regulator is addressing the ‘expectations gap’ by limiting the expectations attached to CASS compliance vetting. This means that the ‘expectations gap’ is being managed by reducing the gap instead of putting pressure on auditors to close the gap. The regulator has articulated a new policy regarding the role of auditors as intelligence assistants to regulators. This may arguably redefine the auditor’s role as being limited to precise assistance to the primary supervisor, the regulator, rather than being surrogate supervisors in terms of CASS compliance (as seemed to be the case pre-crisis). The regulator’s move therefore shifts responsibility for supervising CASS compliance back to itself and addresses the ‘expectations gap’ by limiting the size of the gap. If so, then the effect could be that auditors need not fear an expansion of regulatory enforcement in their direction as regulators have not sought to address the ‘expectations gap’ by enhancing auditor responsibility for securing compliance.

64 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SUP 3.10.4.
65 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SUP 3.10.5, 3.10.5A, 3.10.5B, 3.10.5C, 3.10.6, 3.10.7.
66 FCA Handbook (as of 30 April 2013, formerly FSA Handbook) EG 15.6.4 provides that the FCA will consider the adequacy of any disciplinary action which has been or may be taken by professional bodies over auditors before exercising its own powers of disqualification.
67 Also reflected in feedback received by the then FSA and FRC from auditors, see FSA and Financial Reporting Council, ‘Enhancing the Auditor’s Contribution to Prudential Regulation: Feedback on DP10/3’ (March 2011) FS11/1 www.fsa.gov.uk/pubs/discussion/fs11_01.pdf accessed 6 January 2013, para 1.20.
The UK is actively seeking assistance from the auditing industry in terms of intelligence provision. SUP 3.2 in the FSA Handbook states that auditors are most valued for their intelligence assistance to regulators and SUP 3.10.9 expressly requires auditors to state if any requirement in CASS compliance has not been met by the firm and whether, in the auditor’s opinion, there is a breach of CASS rules. Hence, these requirements may enrol auditors in a role that specifically assists regulatory detection of CASS breaches. It may be argued that SUP 3.10.9 can be read as a duty to assist regulators and, if so, the question is open as to whether the regulator could directly disqualify auditors who fail to detect a breach. However, SUP 3.10.9 is worded as supplying an opinion and so the provision itself may already be limiting the scope for auditor liability insofar as the Financial Services and Markets Act provides that an auditor is not to be regarded as contravening any duty by way of providing an opinion on a matter.

Further, SUP 3.8 grants auditors rights to access firm information and secure firm cooperation in accessing information. One of the duties imposed on auditors is the passing of information to regulators, particularly in periodic meetings that the UK regulator schedules with auditors of financial institutions. It has also been established as a rule that auditors should cooperate with the UK regulator in the discharge of their functions. Such cooperation has been defined as regular bilateral or trilateral meetings (at least annually) between auditors of ‘high impact’ financial institutions and regulators. The bilateral meeting would involve the leader of the supervisory team on the side of the regulators and the lead audit partner; the trilateral meeting would also involve one independent non-executive director of the audit firm, such as the chair of the audit committee. Such meetings are to be open and cooperative and are designed to assist the regulator in supervisory intelligence. The UK regulator, under the powers of the Financial Services and Markets Act, can engage any skilled person to perform a skilled person’s assessment of whatever matter the regulator requires, also known as a section 166 engagement. The UK regulator intends to more actively engage auditors in section 166 appointments.

The new dialogic relationship between the regulator and auditors is the hallmark of post-crisis reforms relating to auditors’ roles. This is supported by the Basel Committee, which expressly recommends that there should be regular communication between external auditors and financial regulators in order to exchange mutually useful information. Supervisors may provide external auditors with sectoral intelligence.

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68 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SUP 3.10.9.
69 Financial Services and Markets Act 2000, s 342(3)(b).
70 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SUP 3.8.1, 3.8.8.
71 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SUP 3.8.2.
73 Financial Services and Markets Act 2000, s 166.
74 Basel Committee on Banking Supervision, External Audits of Banks (March 2013) at paras 144–173.
with information that is useful for the preparation of the audit while auditors may provide information useful to the supervisor for purposes of supervisory monitoring. This chapter argues that such a mutually beneficial intelligence relationship may, however, give rise to a perhaps excessively cooperative culture between regulators and auditors, and this may result in the unwillingness of regulators to take enforcement action against auditors in respect of the duties imposed on them, given their interests in preserving a long-term relationship with their informers. It is predicted that there is not likely be much regulatory enforcement against auditors in respect of the new provisions in SUP that may amount to regulatory duties. Further, the FRC has signed a Memorandum of Understanding with the UK regulator to meet at least four times a year to exchange information and provide intelligence and has begun to provide information regarding bank audits in particular. It is suggested in this chapter that the regulator’s concerns regarding auditors’ regulatory duties in respect of CASS are likely to be addressed by passing on such concerns to the FRC.

The UK’s approach is likely to have the practical effect of limiting the ‘expectations gap’ surrounding the CASS compliance vetting role of auditors by emphasising their intelligence role and not the imposition of regulatory duties as such. However, there are a couple of concerns with this approach. First, although auditors have technical expertise and access to firm information, it is uncertain how their intelligence role would sit with their loyalty to clients as championed by professional standards. Regulators need to consider how to treat the intelligence emanating from auditors. They should be aware that over-reliance could allow the auditing industry to influence regulators with its views, which may represent the financial services industry’s views. Second, the regulator needs to be strategically clear as to what the auditors’ role is in their increased dialogic relationship. There may still be a tendency to allow auditors to become surrogate supervisors in view of their expertise and the limitations on regulatory resources. Even if the regulator regards auditors largely as intelligence providers, and not...

75 Including information useful for prudential supervision, detection of illegalities and breaches and information that may have an impact upon systemic risk generally.
78 Such as has been the case with the FSA’s over-reliance on a skilled person’s s166 report on HBOS in the face of doubts regarding HBOS’ risk controls, see House of Commons and House of Lords, Parliamentary Commission on Banking Standards, An Accident Waiting to Happen: The Failure of HBOS (4 April 2013), paras 67–71.
necessarily as assistant or surrogate supervisors, the auditors’ relationship with
regulators may result in an enforcement deficit with regard to financial institutions.
Auditors’ intelligence may provide opportunities for early intervention in
supervision and regulators may choose not to take enforcement action.

The UK’s ‘limited’ approach also seems to be echoed generally in proposed
reforms to the corporate reporting regime. Under the proposed reforms, enhanced
responsibility is placed on the primary disclosers of information (i.e. directors to
supply more meaningful information to the market). The Financial Reporting
Council commissioned Lord Sharman to look into whether auditors should have
expressed more scepticism in the ‘going concern’ statements made by directors
of UK banks that failed in the global financial crisis. Lord Sharman’s review\(^79\)
is of the view that the bank directors are responsible for ‘going concern’ opinions,and it is directors’ disclosure that should be enhanced in this respect. Although
auditors should scrutinise disclosure and make a report to the audit committee,
directors’ responsibility for meaningful reporting is highlighted in no uncertain
terms. The UK government\(^80\) and Financial Reporting Council\(^81\) generally support
auditors to be able to have an enhanced role in assisting audit committees\(^82\) with
more detailed reports, which could be available to regulators for supervisory
purposes, but this seems not intended to reinforce any undue reliance by users
on auditors. Users of corporate reporting should look to the primary disclosers,
which are the corporations.

The UK’s ‘limited’ approach, discussed above, is to be juxtaposed with its more
general rhetoric on the role of auditors as assisting in regulatory governance. The
auditing industry is encouraged to develop a more critical and sceptical approach
to auditing. Auditing should be considered a dynamic concept, evolving so as to
foster the ‘governance’ aspects of such work. There is thus a long-term expectation
regarding the changes required within the audit culture to encourage greater
governance consciousness. In this sense, the dialogic relationship between auditors
and the regulator may be seen as a stealthy move on the part of the regulator to
influence long-term and gradual cultural change, which could actually be relevant
to addressing the ‘expectations gap’ between regulators and auditors.

4.3.2 The EU’s vision

In contrast, the EU’s proposals are an attempt to achieve a more overt and
involved role for auditors in assisting regulatory supervision and on a wider range of
matters. This also means that the ‘expectations gap’ is a crucial issue: enhancing

\(^79\) The Sharman Inquiry, Going Concern and Liquidity Risks: Lessons for Companies and Auditors:
Final Report and Recommendations of the Panel of Inquiry (June 2012).

\(^80\) Business, Innovation and Skills Department, *The Future of Narrative Reporting: A Further Consultation*
(September 2011).

\(^81\) Financial Reporting Council, Effective Company Stewardship: Enhancing Corporate Reporting
and Audit (January 2011).

\(^82\) Also see Basel Committee on Banking Supervision, *External Audits of Banks* (March 2013) at paras
123–139.
the role of auditors in regulatory supervision cannot productively be done without addressing the ‘expectations gap’.

In the EU, the European Commission Green Paper\(^3\) flagged up the possibility of enhancing the role of auditors in gatekeeping the financial health and risk profiles of financial sector firms they audit. In particular, it opined that auditors should be more sensitive to risk issues and should perhaps be asked to provide assurance statements in respect of prudential and risk compliance. In the Commission’s proposals at the end of 2011, the scope of the ‘financial audit’ is expanded to include ‘related financial audit services’ (such as assurances on corporate governance, social responsibility and prudential risk management), although the active design of risk management systems for firms is considered as non-audit and would be prohibited.\(^4\) This has the effect of encouraging the financial audit business to expand along the above-mentioned lines. The Commission also intends to impose duties to report to regulators if auditors become concerned about violations of reporting standards or regulations, or impairment to the continuing functions of the firm.\(^5\) The proposed reforms arguably intend to enhance the role of the audit and this may be pursuant to the potential governance role (a form of assistance or surrogate supervision) that the Commission sees in the auditing industry.\(^6\) In order to support the governance role envisaged for auditors, the EU proposes reforms to the audit industry structure, the idea being to mitigate the domination of the ‘big four’ auditing firms (i.e. Deloitte & Touche, Ernst & Young, Pricewaterhouse Coopers and KPMG Peat Marwick). The Commission also proposes to end the conflicts of interest culture by prohibiting auditing firms from being engaged in non-audit services\(^7\) where audits are provided to financial institutions designated as ‘Public Interest Entities’. This would be accompanied by the carrot of allowing auditing firms an EU passport to provide services across Member States.


\(^6\) The expansion of audit remit seems unsupported by the Basel Committee; see *External Audits of Banks* (March, 2013).

\(^7\) Commission, ‘Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities’ COM(2011) 779 final; Commission, ‘Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts’ COM(2011) 778 final. The Commission’s approach is to specify what are audit and what are non-audit services. Services involving assurances, such as corporate governance, risk management and social responsibility, would fall within the scope of audit.
The expansion of the auditor’s remit, as mentioned above, provides auditors with an opportunity to examine information that might otherwise be opaque. This role complements the role of regulatory supervision by providing more information to assist regulators. As regulatory resources are limited, regulators have to decide how to supervise and what appropriate action to take. The information platform provided by a risk audit could be very useful to regulators.

However, as risk management is a highly technical area, it is uncertain whether auditors can actually provide meaningful assurance of a financial sector firm’s strategy, processes and policies for risk management. Would the demands of such assurance merely result in a wider ‘expectations gap’? This ‘expectations gap’ may adversely affect public interest if regulatory supervision relies too heavily on such assurances as representative of the prudential soundness of firms.

Moreover, do the proposed Commission measures address the potential ‘expectations gap’? The authors doubt that controlling the structure of the industry or regulating conflicts of interest will address the likely ‘expectations gap’ that may follow in the expansion of auditors’ remit. Even if multiple business engagements between client and auditor are reduced by the compulsion of law, this does not mean that auditors will be able to address financial risk management profiles competently and provide useful input into the regulatory supervision process. Auditors may not perceive a financial institution’s risk profile as serving the regulator’s interest and may provide assurance if such a risk profile is in line with the client’s strategic and business objectives. There may need to be more direct accountability owed to regulators in order to address the ‘expectations gap’.

Further, regulators should be aware that risk profile audits could entail moral hazard for financial institutions (i.e. that firms may engage in suboptimal levels of risk-taking as long as they are audited and assured, whatever these may in fact achieve).  

Further, regulators should bear in mind the commercial incentives driving the expansion of the audit business. Regulators should not be too quick to treat these audits as complementary to supervisory monitoring of financial institutions. The UK has also considered whether the role of auditors should be expanded to include prudential and risk management matters in financial institutions, but concluded that auditors should not be mandatorily enrolled in vetting the governance role of auditors

88 Andrew A King and Michael J Lenox, ‘Industry Self-Regulation without Sanctions: The Chemical Industry’s Responsible Care Program’ (2000) 43 Academy of Management Journal 698, provide empirical evidence of how firms associate themselves with trade associations to look reputable and mask suboptimal behaviour. Would the situation be worse if firms could look reputable by engaging compulsory audit or assurance services?


prudential and risk management disclosures made by financial institutions, as such disclosures vary too much across different business lines and would be costly to undertake.91 Such assurance work may give rise to wider, unnecessary ‘expectation gaps’.

The EU’s approach will exacerbate the ‘expectations gap’ between regulators and auditors without putting in place adequate measures (such as enhancing auditors’ regulatory duties) to address the gap.92 This may have an adverse impact upon the quality of regulatory supervision if over-reliance is placed on auditors’ assurance.

4.4 Conclusion

The EU and the UK are taking different approaches towards enrolling auditors in a governance role in order to assist with regulatory supervision. An ‘expectations gap’ has always existed in respect of auditors’ roles and regulatory expectations in a range of auditing work from corporate reporting to CASS compliance. This ‘expectations gap’ may even be viewed as legitimate; enrolling auditors to improve firm transparency and accountability does not mean that they can secure their client’s compliance, or that they should be punished for clients’ infringements. The failure of Lehman Brothers in Europe has arguably triggered a rethink of the auditor’s role in relation to CASS compliance vetting and the auditor’s contribution to the work of regulatory supervision. The UK has attempted to minimise the ‘expectations gap’ and is now using auditors in a more limited way. There are, however, insidious possibilities relating to the enhanced intelligence and dialogic relationship. The EU’s proposals arguably achieve the opposite and are likely to enhance the auditor’s role. However, the commercial interests in expanding the role of auditors should not be conflated with an enhancement in their governance potential, as their enhanced auditing role is not accompanied by clearly articulated regulatory duties or liability.


92 The EU seems to wish to rely upon self-regulation of the accounting profession to uphold professional standards in the proposed expanded remits for auditors. The Monitoring Group, which is an international organisation comprising of regulators, international organisations and the accounting profession, is consulting on improving its governance and oversight of standard-setting by the profession. See Monitoring Group, Public consultation on the Governance (with Special Focus on Organisational Aspects, Funding, Composition and the Roles) of the Monitoring Group, the PIOB and the Standard Setting Boards and Compliance Advisory Panel Operating under the Auspices of IFAC (March 2012).
Part 2

Investor protection in financial regulation
5 The nature of investor protection

‘Investor protection’ is indisputably a fundamental principle in financial regulation supported by economic rationales for regulation and has given rise to the well-established transaction-oriented narratives discussed in Chapter 2. Post-crisis, policy rhetoric and regulatory reforms support enhanced investor protection in both the wholesale and retail markets. The hitherto minimalist regulatory approach to the wholesale sector has changed, in order to reflect policymakers’ concern with financial stability and, in particular, with the impact that wholesale sector behaviour has upon financial stability.

The global financial crisis shows that flaws in both the wholesale and retail sectors could cumulatively provoke a crisis. In the retail sector, unaffordable mortgages have been sold to sub-prime mortgage borrowers. The wholesale sector, which fashioned securitised products and derivatives based on these sub-prime foundations, suffered enormous asset losses when sub-prime mortgage defaults occurred. Financial sector losses turned into systemic risk and social losses followed:

(a) losses in investor assets and wealth, which could adversely affect saving and livelihood, and the consequential loss to the consumption and investment economies;
(b) losses suffered by financial institutions as investors and intermediaries, and even the loss of institutions where whole institutions have failed, causing consequential losses as credit and investment shrink;
(c) Losses to the real economy in terms of business and development.

It could therefore be argued that market failures in investor protection, whether in the wholesale or retail sectors, are inextricably related to systemic

The notion of ‘investor protection’ is now infused with wider financial stability concerns. Greater regulatory paternalism in both the wholesale and retail sectors may now be discerned.\(^5\)

The strengthening of investor protection in both wholesale and retail sectors in the post-crisis era is not based on an extension of the information asymmetry and market failure arguments supporting economic rationales for investor protection regulation. Rather, it is based on the overall financial stability objective, linking market failures in investor protection to the mitigation of systemic risk. Although the character of ‘investor protection’ has changed in the post-crisis reforms relating to wholesale and retail investor protection, we discern that the infusion of financial stability concerns continues to be based on the economic understanding of ‘public goods’, especially in the reforms relating to the wholesale sector. We are of the view that reforms in the wholesale sector are incremental in nature rather than reflecting transformative and fundamental changes in underlying premises. We question critically in Chapters 6 and 7 whether such an approach may be adequate in view of the challenges for financial regulation in the future. We also argue that reforms for investor protection in the retail sector are reflecting an emerging and fundamentally different underlying premise, and that the character of wholesale sector investor protection and retail sector investor protection will proceed along bifurcated lines.

As Moloney suggests, the profile of the ‘investor’ needs to be understood\(^6\) in order to consider what a regulatory design for the purpose of ‘investor protection’ should look like. The investment community consists of the wholesale sector and the retail or consumer sector. Wholesale sector participants include sophisticated individuals, corporations, institutional investors and collective investment vehicles, including hedge funds. The landscape of the ‘investor’ is therefore quite varied and, as McGee points out,\(^7\) financial intermediaries have themselves also become investors, making gains for themselves and not just their principals. The financial sector therefore takes on multiple roles in product development, intermediation and investment, beyond traditional intermediation roles matching capital suppliers and commercial and development needs. Wolf describes finance as ‘the brain of the market economy’.\(^8\) Increasingly, the ‘investor’ who participates directly in the

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4 See the discussion in Mads Andenas, ‘Harmonising and Regulating Financial Markets’ in Mads Andenas and Camilla Andersen (eds), Theory and Practice of Harmonisation (Cheltenham: Edward Elgar 2012).


6 Niamh Moloney, How to Protect Investors: Lessons from the UK and EU (Cambridge: Cambridge University Press 2010), ch 2 generally.


8 Martin Wolf, Fixing Global Finance (Baltimore, MD: Johns Hopkins University Press 2010), 1.
investment economy is the wholesale sector participant. Ordinary citizens in the UK generally channel savings to bank deposits and other saving accounts, guaranteed savings (such as premium bonds) and collective schemes (such as pension savings and other collective investment schemes). About one-fifth of savers may be directly accessing securities markets. The retail sector represents a limited source in direct participation in the investment economy.

Benjamin argues that the wholesale sector is dominated by an arms-length narrative, in that parties in financial transactions rely on contract, not regulation, to govern their relations and rights. The wholesale sector is characterised by regulators leaving sophisticated market players to govern much of their relations in financial transactions. Before the onset of the global financial crisis, hedge fund activities and transactions in financial derivatives, such as over-the-counter (OTC) derivatives, were market-driven and unregulated. The wholesale and retail sectors have arguably bifurcated in terms of activities, participants and market size, and consequently, regulatory treatment. For example, the European Financial Integration Monitor that carries out an annual survey of the financial sector across the EU shows marked differences between the wholesale and retail sectors. Both pre- and post-crisis, many banking financial institutions have grown through mergers and acquisitions, becoming large, complex and pan-European institutions. There is a high degree of integration in the interbank deposit market and government bonds market, both part of the wholesale sector. The retail sector is, however, predominantly domestic. The bifurcation of the wholesale and retail sectors results in different regulatory approaches: minimal, if any, regulatory intervention in the wholesale sector and relatively more regulatory intervention in the retail sector. For example, although the UK regulator identified potential effects on systemic risk and investor protection concerns in hedge fund practices in 2004, their preferred approach has been to engage informally with hedge funds.

On the role of financial markets in contemporary economic policy and the move from quantitative regulation in the 1980s, see the discussion in Mads Andenas, ‘Harmonising and Regulating Financial Markets’ in Mads Andenas and Camilla Andersen (eds), Theory and Practice of Harmonisation (Cheltenham: Edward Elgar 2012), 7–10.


See the analysis of the actors in financial markets and a strong argument in favour of maintaining different regulatory approaches in Jan J Dalhuisen, Transnational and Comparative Commercial, Financial and Trade Law (5th edn, Oxford: Hart Publishing 2012), vol III, ch 2. Dalhuisen also argues against the further development of EU powers in the wholesale or professional market.


instead of formalising a regime of regulatory rules and oversight.\textsuperscript{13} The arms-length narrative, appealing to regulators to trust sophisticated parties to govern their own relations, has been dominant in the wholesale sector.

Regulatory governance for investor protection has thus been based on the needs of the ‘retail investor’ as basic common denominator. The retail investor’s relations with issuers and intermediaries is well-trodden territory for regulation (e.g. the mandatory disclosure regulation of issuers and intermediary conduct of business regulation discussed in Chapter 2).

Interfering with transactional freedom and controls in the wholesale financial sector has previously been considered unnecessary. This position is now regarded as flawed and highly myopic in nature. It is now acknowledged that market failures in the wholesale sector need to be addressed and that improvements in investor protection could have wider systemic effects.\textsuperscript{14} However, the wholesale sector remains a decentred governance landscape where significant forces of governance may be exerted by a range of private sector actors, such as institutional investors and gatekeepers.\textsuperscript{15}

Post-crisis regulatory reforms have expanded in the wholesale sector, but we argue that regulatory governance in the wholesale sector seems to have refrained from excessive paternalism, addressing well-trodden areas of market failure but putting in place regimes to make investors exercise discipline and provide governance. Although there seems to be a rise in regulatory control over the wholesale sector, wholesale sector actors are relatively well-resourced and well-placed to exert governance, and this may encourage regulators to take more of a back seat in the future. The reliance on mobilising market discipline may also influence the character of regulatory governance, encouraging a return to a transactional focus on investor protection in the wholesale sector, instead of taking on the broader picture of financial stability. Chapters 6 and 7 will discuss the


\textsuperscript{14} See Lord Turner, ‘Chairman’s Speech’ (FSA Annual Public Meeting, London, 3 July 2012) www.fsa.gov.uk/library/communication/speeches/2012/0703-at.shtml accessed 20 December 2012: ‘And it’s fair to say that in the past the FSA has tended to a somewhat caveat emptor approach to wholesale conduct issues. After all, the logic went, we’re dealing here with relationships between professional counterparties . . . which ought to be able to make their own judgments. But . . . we have found we need to consider how far that caveat emptor approach is sufficient. An insurance company or pension funds may be itself a large institution, but sitting behind the company or pension fund are retail investors: and any poor practice which unreasonably shifts income to the industry is at the expense of some end retail customer. There are no free lunches, and shoddy wholesale practice is not a victimless act . . . We will therefore need to think carefully how far we should shift our past approach to the supervision of wholesale conduct . . .’ Dalhuisen accepts this, but cautions about the efficacy of regulation in limiting systemic risks as regulation will focus too much on avoiding yesterday’s crises. See Jan J Dalhuisen, Transnational and Comparative Commercial, Financial and Trade Law (5th edn, Oxford: Hart Publishing 2012), vol III, ch 2.

\textsuperscript{15} See Chapters 2 and 3.
regulatory regimes for alternative investment funds and credit rating agencies as highlights of the purported enhanced investor protection in the wholesale sector and will flesh out the governance dilemmas.

Where the retail sector is concerned, regulatory governance has moved overtly and markedly into greater paternalism. Chapter 8 will argue that such a shift has been in preparation since before the onset of the global financial crisis. Post-crisis concerns for financial stability have, however, given impetus to reforms in this area and have allowed more overt notions of social utility and justice to become important underlying notions in financial regulation. The role of social utility and justice is emphasised both by the consequences of the financial crisis and the policies put in place to counter it. The sheer scale of financial and social costs turns what before was an abstract and distant issue into one of pressing constitutional concern, not only at the national level, but also at the European and international levels.

The future trajectory of ‘investor protection’ in financial regulation is likely to continue to be bifurcated, as governance in the wholesale sector, although initially enhanced through substantial regulatory reform, continues to be framed around the notions of market failures and improvements in market discipline. Governance in the retail sector is, however, increasingly framed around notions of social utility and justice. The governance of finance remains a complex issue and it is a remote prospect that financial regulation can be framed into a simple governance system based on singular objectives.\(^\text{16}\) We will now turn to examine what the new ‘investor protection’ means in the wholesale sector.

\(^{16}\) Niall Ferguson argues that much regulation was unnecessary, counterproductive or non-existent where needed in the lead up to the global financial crisis of 2008–9. He calls for regulatory regimes to be simpler, more nimble and dynamic. Niall Ferguson, ‘The Rule of Law and its Enemies’ (BBC Reith Lectures, London, June–July 2012), part 2. The authors are not sure that a return to simpler regimes is necessarily sound or possible, but we argue that financial regulation needs to be dynamic in order to remain salient.
6 Regulatory governance of alternative investment fund managers

6.1 Rationale for regulation

The de Larosière Report recommends that the regulatory net be extended to the parallel banking system, which includes alternative investment funds such as hedge and private equity funds. Transparency is required of the activities in this sector to be able to assist in systemic risk oversight and appropriate regulation may be necessary in the interests of maintaining financial stability. The comprehensive regulatory reforms in EU financial regulation following the global financial crisis may be criticised as a form of regulatory creep, but on the other hand, they are based on the rejuvenation of the financial stability objective in financial regulation. Although these funds have been acknowledged as having little part to play in the causes leading up to the global financial crisis, the extension of regulatory reach to alternative investment funds has been argued to be necessary in the de Larosière Report as ‘appropriate regulation must be extended, in a proportionate manner, to all firms or entities conducting financial activities which may have a systemic impact . . . even if they have no direct links with the public at large’. The Report is of the view that hedge funds, in particular, could pose


a systemic risk by virtue of their investment activities and scale, or their connections with other financial institutions. The European Commission’s proposal to regulate alternative investment funds also outlines that although alternative investment funds were not at the forefront of the global financial crisis, they could generate systemic risk in the future. 4

In the European Commission’s perspective, alternative investment funds may give rise to systemic risk due to their connections with other financial institutions, their trading activities and investment strategies such as short selling, and the scale of potential investor losses if they should fail. 5 These three key factors are discussed below.

First, the Commission is of the view that alternative investment funds may pose systemic risk because other financial institutions, such as banks, may be exposed to them and thus be subject to the macro-prudential and micro-prudential risks 6 of hedge fund behaviour. The macro-prudential risks refer to the risks that follow the typically pro-cyclical behaviour of alternative investment funds. Such pro-cyclical behaviour could lead to an extensive build-up of leverage in exuberant times, which could then cause widespread financial stress and instability if deleveraging should become necessary. 7 The practice of taking on leverage by hedge funds has been widely documented 8 and their role in exacerbating a


5 The systemic risk dimension necessitates the institution of a regulatory regime, and Andreas Engert argues that such a regime should be harmonised internationally and not just at the EU level in order to prevent regulatory competition from undermining it. See Andreas Engert, ‘Transnational Hedge Fund Regulation’ (2010) European Business Organisation Law Review 330, whose article examines self-regulation, regulatory competition and transnational harmonisation as possible options for governing hedge funds, concluding after an even-handed assessment that transnational harmonisation meets best the needs of enforcement and systemic risk monitoring.


situation of stress is quite undisputed. Further, it is suggested by some commentators that hedge funds could also contribute further stress to a situation of asset price decline; they account for almost a third of all daily trading activity in the US and unwinding their positions could become very stressful for the market in terms of the sudden and massive withdrawal of liquidity.\textsuperscript{9} Hedge funds account for a significant amount of trading volumes despite the fact that the amount of assets under management remains globally small compared to pension and mutual funds.\textsuperscript{10} Micro-prudential risks may come from hedge funds’ internal risk management and valuation procedures that are less than robust. Although the collapse of most hedge funds need not be systemically significant,\textsuperscript{11} the above-mentioned concerns about linkages – especially due to leverage, the withdrawal of liquidity, and the potential exacerbation of asset price collapses due to the difficulty in valuing illiquid hedge fund positions\textsuperscript{12} – could entail wider stress on the rest of the financial sector.

Next, the Commission highlights that alternative investment funds may be inadequately robust in protecting and being accountable to their investors. Although shortfalls in investor protection and investor losses may not necessarily trigger systemic risk, widespread investor losses could have an impact on liquidity in the markets. Further, if investor losses result from the exposure of pension funds or insurance companies,\textsuperscript{13} these losses may be indirectly borne by individual savers and the wider public may thus be brought into exposure with alternative investment

\textsuperscript{9} Dale B Thompson, ‘Why We Need a Superfund for Hedge Funds’ (2010) 79 Mississippi Law Journal 995.
\textsuperscript{10} Jennifer Ralph Oppold, ‘The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principle-Based Approach’ (2008) 10 University of Pennsylvania Journal of Business and Employment Law 833 suggests that up to half of global equity trading is undertaken by hedge funds.
funds. In this way, any shortfalls in investor protection in the alternative investment fund market could arguably have an impact on a systemic or social scale.

Further, the Commission is of the view that the use of strategies by hedge funds, such as short selling, and the general opacity in hedge fund strategies, which may involve market abuse, are reasons for greater regulatory scrutiny of hedge funds. These risks are largely to be overcome by mandatory disclosure regimes, in the Regulation on Short Selling and Certain Aspects of Credit Default Swaps 2010, as well as in the Directive for Alternative Investment Fund Managers (AIFM), which will be discussed in detail shortly. The general transparency of alternative investment funds is also thought to be important for systemic risk oversight.

The Commission is also particularly concerned about hedge funds building stakes in companies to carry out activism in order to make short-term gains in ‘value extraction’. Hedge funds can also take positions that lead them to vote against the common welfare of their investee companies, as in cases where an acquisition may be imminent. Finally, the Commission is of the view that private equity funds may load investee companies with debt and subject them to stressful debt management, including redundancies. Such behaviour may affect a significant economic population where buyouts relate to public companies that are important employers. The practices of alternative investment funds, especially in relation to leverage management, could generate social costs, such as job or asset stripping of the general corporate sector.

Not all of the Commission’s regulatory objectives relate to systemic risk oversight and maintaining financial stability. Some issues are actually long-standing issues relating to market failures in investor and stakeholder protection. However, the
resurgence of public regulatory power in financial regulation has provided the opportunity for a range of different issues to be dealt with at the same time and to be ultimately legislated. It has, however, been critically commented\(^\text{20}\) that some of these concerns are overstated, for example, in relation to the leverage employed by hedge funds, as well as concerns relating to market manipulation or abusive forms of shareholder activism. The regulatory regime for alternative investment fund managers will now be critically explored.\(^\text{21}\)

### 6.2 Scope of application

The regulatory regime in the EU for alternative investment fund managers, the AIFM Directive, covers managers of hedge and private equity funds, as well as unregulated collective investment schemes marketed in the EU, whether the funds are themselves established in the EU or elsewhere.\(^\text{22}\) Article 2(3) contains some absolute exemptions from the Directive, including sovereign wealth funds, pension schemes, fund management by central banks, supranational or national institutions, and securitisation special purpose vehicles. Member States are responsible for authorising the operation of alternative investment fund managers and are given discretionary powers to exempt fund managers who are managing leveraged funds less than €100 million in assets or unleveraged close-ended funds with assets less than €500 million.\(^\text{23}\) The AIFM Directive is generally a maximum harmonisation measure but it cannot avoid providing for specific instances of discretionary exercise of power for national regulators, such as under Article 3 where exemptions may be made.

The UK has an active market in non-UCITS collective investment schemes aimed at retail investors, which will now have to be subject to the AIFM Directive.\(^\text{24}\) Although the AIFM Directive is aimed at the wholesale investment sector, Member States may allow marketing of alternative investment funds to

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retail investors, subject to more stringent rules and upon notification to the Commission and to ESMA. It is nevertheless noted that the decision to allow retail marketing under more stringent national rules does not require the approval of the Commission or ESMA, and hence regulatory divergences in this area may continue to exist. It may be argued that each national regulator is able to assess the needs of the retail market and, as such, this responsibility need not be centralised. Indeed, the lack of centralisation at the EU level need not be adverse to consumer protection. However, as alternative investment funds are entitled to an EU passport for marketing, as will be discussed later in this chapter, would such funds be marketable to another EU retail market? The Directive does not seem to forbid this and there are no provisions allowing host Member States to exercise further discretion with respect to the marketing of the fund to their own retail market. Will the initial approval of the fund by the home Member State be able to take into account concerns any host Member State may have in relation to the latter’s retail market? As one of ESMA’s key missions is to develop consumer protection policy, it is questioned whether such decentralisation of oversight of marketing regimes for non-UCITS collective investment schemes is in the interests of consumer protection. Further, large-scale failures in consumer protection could become an issue for systemic risk.

Article 6 provides that authorisation for alternative investment fund managers (AIFM) is required in order for them to manage one or more alternative investment funds (AIF) whether or not such AIF is established in the EU or in another jurisdiction. The core management function may be supplemented by additional functions as may be approved.

6.3 Prudential and risk management regulation

The imposition of prudential and risk management regulation on alternative investment funds may be justified by the post-crisis emphasis on the financial stability objective and the need for systemic risk monitoring and control. However, there is arguably also a European integration agenda behind the current legislative provisions. This section will now examine the prudential and risk management provisions in the AIFM Directive in order to critically understand the nature of governance in these provisions and the dilemmas between competing rationales in financial regulation in the EU.

25 AIFM Directive, art 43.
6.3.1 Capital adequacy

Capital adequacy requirements are imposed in respect of initial capital, own funds, and additional own funds, in relation to potential liability for professional negligence. The initial capital requirements for an AIFM, which is internally managing its AIF, is set at €300,000, while the initial capital requirements for an AIFM that is externally managing one or more AIFs is set at €125,000. Internally managed hedge funds are generally ‘funds of funds’, which invest in a portfolio of hedge funds. Where funds of hedge funds are concerned, the opacity of investing in fellow hedge funds, the pervasive lack of due diligence, the layers of fees upon fees of hedge funds and the requirement to commit substantial amounts to each fund are factors that have not necessarily helped funds of hedge funds manage risk or perform better. The higher initial capital requirement may reflect the inherent riskiness of funds of hedge funds.

Where the portfolio of an AIFM exceeds €250 million, an extra 0.02 per cent of own funds must be set aside for capital adequacy, a requirement that is consistent with that applied to UCITS. However, Member States may allow up to 50 per cent of such own funds to be provided for in the form of a guarantee by a credit institution or an insurance undertaking registered in the EU or in a third country whose prudential regulations are equivalent to those of the EU. This is a curious discretionary power, as linkages could then be encouraged between banks and insurance institutions and alternative investment funds, on top of other relationships in leverage and prime brokerage. This also means that banks and insurance companies may be liable to top up the capital adequacy of hedge funds if capital runs low. It is queried whether this provision is sound given that one symptom of systemic risk is the potential contagion effect among financial institutions due to linkages. If the guarantee exposures become significant or concentrated, this could be a source for systemic concerns. The authors caution that there may be unintended consequences in providing that AIFMs could seek recourse to guarantees provided by banks or insurers in order to maintain solvency. Adequate capitalisation of AIFMs may mitigate failures of AIFMs, but it may be undesirable to involve banks and insurers in capitalising AIFMs. The authors query whether the legal integration impetus has slightly overtaken the needs of financial stability underlying the micro-prudential regime for AIFMs here.

Article 9(7) further provides that additional own funds will be required of alternative investment funds, for the purposes of addressing the risks of liability for professional negligence in fund management. ESMA has prescribed 0.01 per

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31 AIFM Directive, art 9(3).
32 AIFM Directive, art 9(6).
33 Professional liability is identified as negligence vis-à-vis clients, or in respect of business disruption, or in respect of business losses caused by fraud or dishonesty where senior management has
cent of the value of the portfolios managed by the AIFM in additional own funds to cover professional liability risk.\footnote{ESMA, ‘Final Report: ESMA’s Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive’ (16 November 2011) ESMA/2011/379 www.esma.europa.eu/system/files/2011_379.pdf accessed 22 December 2012, 30.} \footnote{ESMA, ‘Final Report: ESMA’s Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive’ (16 November 2011) ESMA/2011/379 www.esma.europa.eu/system/files/2011_379.pdf accessed 22 December 2012, 32. This is now adopted by the European Commission, see Commission Delegated Regulation (EU) No 231/2013 of 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 December 2012), art 14.} Such own funds may, however, be replaced by professional indemnity insurance of an equivalent value.\footnote{ESMA, ‘Final Report: ESMA’s Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive’ (16 November 2011) ESMA/2011/379 www.esma.europa.eu/system/files/2011_379.pdf accessed 22 December 2012, 34. This is now adopted by the European Commission, see Commission Delegated Regulation (EU) No 231/2013 of 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 December 2012), art 15.} This measure arguably foresees the possibility of increased civil litigation against hedge funds by professional investors as a form of market discipline.\footnote{See Commission Delegated Regulation (EU) No 231/2013 of 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 December 2012), art 12 that sets out the circumstances under which professional liability may be incurred.} The authors are of the view that such market discipline is generally a positive development. In light of the investor protection requirements in the AIFM Directive that will be discussed below, and the increased transparency and accountability to investors, investor litigation is likely to be more highly supported than before as a measure of fund accountability. As much as litigation entails legal risk for hedge funds, it also allows bottom-up reflexive governance forces to work in the regulatory landscape. However, the exposure of insurance companies to the capital adequacy needs of alternative investment funds in providing professional indemnity insurance should be considered from the perspective of whether systemic risk may be exacerbated. If there is concentration in the market for insurers of hedge funds, as was the case with AIG and credit default swaps, systemic risk concerns could ensue. Further, systemic risk concerns could also arise if insurance companies end up taking on a significant volume of such business.

\subsection*{6.3.2 Organisational and risk management requirements}

The authors are of the view that the nature of regulation in areas of organisation and structure of investment firms and funds generally reflects the treatment of risk management regulation as an extension of prudential concerns. This approach

is taken in the AIFM Directive as well. Part 3 will make this argument in greater detail and explore the proliferation of risk management regulation in relation to investment firms generally in the post-crisis era.

In the AIFM Directive, Article 18 provides for general principles of organisational soundness, such as sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms. These are largely similar to general organisational requirements imposed for all investment firms under the Markets in Financial Instruments Directive (MiFID) 2004, suggesting that regulatory harmonisation is an important driver behind organisational and risk management regulation in the AIFM Directive. ESMA recommends that sound organisational arrangements refer to clear decision-making procedures and reporting lines, employment of competent staff and staff training, adequate internal control mechanisms, sound accounting policies, information flows, adequate record keeping, business continuity policies and regular review, and senior management oversight of key issues such as investment strategies and risk profile. Requirements under MiFID, such as the institution of a permanent and effective compliance function, have also been imported, as has the permanent internal audit function. The boosting of internal control within financial institutions is a key theme in post-crisis reforms, as regulators seek to address the financial stability regulatory objective by enhancing regulatory standards and supervision, as well as improving overall internal monitoring within firms.


Further, the AIFM Directive requires the functional separation of risk management from portfolio or other operational functions of the AIFM.\footnote{AIFM Directive, art 15.} This does not mean that risk management must be departmentally separate, as this may be disproportionate to the scale, size and complexity of the fund. However, the risk management function must be permanent and free from conflicts of interest.\footnote{See Commission Delegated Regulation \(\text{(EU)}\) No 231/2013 of 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 December 2012), arts 39, 42 and 43.}


\footnote{AIFM Directive, art 15.}
The next aspect of prudential oversight of AIFMs is regulatory monitoring of the amount of leverage employed by AIFs. AIFMs must establish a maximum amount of leverage to be employed for each AIF. This prescriptive requirement clearly shows that regulators are concerned with the implications of hedge funds’ use of leverage and how it may create future systemic risk effects. However, Awrey warns that interventions into leverage could cause premature systemic effects, exactly the consequence regulators wish to avoid.

On the whole, the regulatory regime for AIFMs prescribes in greater detail than under MiFID the operations and responsibility of internal control in order to enhance the prudential oversight of AIFMs. This approach, however, remains meta-regulatory in nature as AIFMs are still responsible for determining the risk limits, the risk management policy and how functional and hierarchical separation is to be achieved.

Even if internal control, such as compliance, internal audit and risk management, were made independent from the operational and business units of the AIFM, regulators should perhaps be healthily sceptical of the governance that can be provided by these ‘internal partners’ in governance. Organisation studies have shown that internal control functions, such as the internal audit, are starting to achieve a distinctive culture and purpose from the organisation they are situated in. Nevertheless, depending on management practices and pressures, they may still be influenced by general organisational and management culture. In some organisations, taking on a role in internal control is part of an employee’s rotating experience in the whole organisation or regarded as a relatively minor or peripheral unit. Hence, it remains to be seen if internal control functions may effectively develop a distinct identity and purpose and provide the governance that assists in meeting regulatory objectives. Regulatory supervision is likely to be necessary in monitoring the internal control functions themselves. Chapter 13 will elaborate on these issues further.

49 Jan Pfister, Managing Organizational Culture for Effective Internal Control (Berlin & Heidelberg: Physica-Verlag 2009) generally; Ronald MacEwan Wright, Internal Audit, Internal Control and Organizational Culture (DPhil thesis, Victoria University 2009) http://vuir.vu.edu.au/1989/1/R-M-Wright-Thesis-2009.pdf accessed 22 December 2012, with empirical research into three case studies where internal audit personnel were interviewed and the organisational cultures of the relevant firms investigated. See also Nancy Hala, ‘If Capitalists were Angels – An Interview with Sherron Watkins on the Fall of Enron’ (2003) 60 Internal Auditor 38 on how organisational and management culture compromised internal controls.
6.3.3 Liquidity management

Except for the management of unleveraged close-ended AIFs, Article 16 of the AIFM Directive provides that AIFMs must have liquidity management systems and procedures and must regularly stress-test their systems and procedures. ESMA specifies that AIFMs should establish a liquidity policy to manage the liquidity risks arising from different profiles of assets and to monitor the liquidity risks of each AIF under management. Liquidation management includes setting limits, the compliance with which needs to be maintained and monitored, and carrying out appropriate and regular stress testing of each AIF’s liquidity positions.

Liquidity buffers have been argued to be an important tool in mitigating risk where capital adequacy requirements may place stress on financial institutions having to liquidate assets in a declining price situation. Further, even if a crisis is more of a ‘capital’ crisis than a liquidity crisis, liquidity buffers could provide a cushioning period that may affect market confidence less adversely. However, another commentator is of the view that liquidity buffers are only effective against relatively minor liquidity squeezes.

Compared to the rather prescriptive liquidity standards under the international leadership of the Basel Committee, the liquidity management provisions in the AIFM Directive seem more open-ended in nature, leaving AIFMs to determine the appropriate liquidity levels to maintain. As AIFMs have different and more focused business models than universal banks, a slightly decentralised approach


to setting liquidity management rules may be more nimble and appropriate for national regulators. However, if the illiquidity risks of AIFMs pose systemic risk, as discussed above, this also means that there needs to be dynamic and continuous regulatory supervision of liquidity management at the national and EU levels. Allen and Carletti, for example, argue that banks hoarding liquidity in situations of stress may protect themselves but may adversely affect other deficient but solvent banks. Hence, the balance between hoarding and lending needs to be dynamically considered in a wider context by regulators, as individual institutions would not be able to take this collective view. It is unclear if the AIFM Directive envisages liquidity monitoring for such broader concerns or is taking a narrower perspective in relation to the risks to the fund as such.

6.3.4 Remuneration policies

Article 13 provides that AIFMs should establish remuneration policies and practices ‘that are consistent with and promote sound and effective risk management’. Financial sector remuneration policies have now become a matter of prudential concern. The Geneva Report on Financial Regulation produced in 2009 reflects upon the global financial crisis and possible causes and reforms and points out that inappropriately structured remuneration packages gave rise to incentives on the part of bank staff to take excessive risks. Bank/financial institution remuneration packages are argued to have contributed to weak risk management in financial firms and where the same flaw appears in many financial institutions, this results in systemic risk effects in economic systems. Chapter 13 further discusses the prudential impact of remuneration policies in financial institutions. However, the connection between remuneration policies and risk management is now legalised in the Capital Requirements Directive 2010. Ferranini and Ungureanu argue that ‘The short-term approach in banks’

remuneration policies contributed to [the global financial crisis], undermining the safety and soundness of banks.\textsuperscript{64}

The scope of application of Article 13 extends to ‘senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profiles of AIF they manage’, consistent with the above-mentioned Capital Requirements Directive 2010 and the UK Remuneration Code in SYSC 19A applying to other financial institutions. Detailed remuneration rules for AIFMs are set out in Annex II of the AIFM Directive, which also by and large dovetail the requirements in the Capital Requirements Directive 2010. Nevertheless, the authors query whether the streamlining of remuneration policy regulation across banks, financial institutions and AIFMs is necessary.

On the one hand, it may be argued that since remuneration policies are regarded as affecting the character of micro-prudential regulation, a consistent approach should be taken in all parts of the financial sector in the EU. This would be in line with the comprehensive vision for EU legal integration set out in the de Larosière Report. However, remuneration policies in AIFMs may be less of a systemic issue than in universal banks and other financial institutions, as AIFM remuneration may be subject to some investor oversight. As AIFMs are by and large exclusively marketed to professional investors (unless Article 41 applies), professional investors may be able to influence remuneration policies if it is perceived that such policies affect investment returns on the relevant AIFs managed. There is perhaps room to argue that transactional governance between investors and AIFMs could affect how much AIFMs are rewarded. This is to be distinguished from remuneration policies in universal banks, for example, where shareholders still struggle to influence pay.

Further, as AIFMs generally have a vested interest and their incentives are aligned with the investors (to pursue investment performance), generous remuneration policies may be perceived as providing the right incentives for investor protection. There is arguably potential for reflexive bottom-up forces that can be exerted by investors in establishing the appropriate levels of remuneration of the AIFM in relation to each AIF.\textsuperscript{65} Article 22(2)(e) and (f) state that information on total and aggregate remuneration should also be provided to investors.\textsuperscript{66}


Such information should be presented in relation to each AIF.\textsuperscript{67} In this area, investors are likely to be interested in the transfer of wealth to AIFMs and so information including a breakdown by AIF would be helpful in facilitating investor-led governance. The authors are of the view that a convincing connection still has to be made for any systemic impact of AIFM remuneration policies in relation to each AIF. Indiscriminate convergence in remuneration regulation should not be sought for legal integration as an end in itself.

6.3.5 Restrictions on investments or investment strategies

AIFMs must provide information to Member State regulators regarding their investment strategies and Member State regulators may restrict the use of certain strategies in relation to any AIFs managed by the AIFMs.\textsuperscript{68} The power to impose restrictions upon AIFMs in managing AIFs is discretionary in nature, but the Commission has set out in a supplemental Regulation\textsuperscript{69} the considerations upon which the discretion may be exercised. These conditions generally relate to concerns for financial stability and the materialisation of systemic risk. This is representative of the pre-emptive governance that post-crisis reforms seek to introduce in the interests of monitoring systemic risk and financial stability. Short selling restrictions may be imposed from time to time by regulators, as may restrictions upon leverage (e.g. Article 25(3)), as these are often seen to be connected to systemic risk. Wymeersch, however, cautions that the imposition of discretionary leverage limits by national regulators upon particular funds may cause distortions in the market and inconsistency in practice in the EU.\textsuperscript{70}

Where private equity funds are concerned, leverage is key to making private equity deals possible in the first place,\textsuperscript{71} but the leverage is not taken at the fund level, but by the companies to be invested in. Article 25(3) seems only to deal with fund level leverage and hence does not \textit{prima facie} deal with the investee company’s leverage. In the latter case, arbitrary regulatory intrusions may be inappropriate.


\textsuperscript{68} AIFM Directive, art 8(4).


However, excessive leverage, usually borne by the company, and not the fund, may cause undue hardship to stakeholders, such as employees, if the company hits hard times. The restrictions upon leverage in Article 25(3) possibly only relate to hedge funds; private equity funds, even if they employ leverage at fund level, are not likely to have a systemic impact due to their close-ended nature. Moreover, as will be discussed later, stakeholder protection in companies invested by private equity funds does not address the issue of leverage.

Article 17 is a reactive provision to the key cause of the financial crisis: investments in complex securitised debt obligations. Article 17 disallows AIFMs to invest in securitised products where the originator of such products does not retain at least a 5 per cent net economic interest in the underlying securities or financial instruments. Further, AIFMs must undertake due diligence concerning the credit policy of the originator of securitised obligations and must ensure that they have a thorough understanding of those positions and have implemented formal policies and procedures appropriate to the risk profile of the relevant AIFs under management. These investments should also be subject to regular stress testing and review, and be reported to senior management.

These direct interventions into portfolio management by AIFMs probably showcase the most intrusive aspects of the new pre-emptive governance architecture. However, as this chapter will go on to discuss, robust supervisory monitoring requires adequate information surveillance, but the reporting obligations in the AIFM Directive seems to have become excessively focused on investor protection and are comparatively lighter in terms of returns for regulators. This discrepancy should arguably be addressed in light of the systemic risk monitoring that regulators need to carry out in order to consider if any of the pre-emptive powers mentioned in this section should be exercised.

6.3.6 Outsourcing and delegation

Article 20 subjects the outsourcing of risk management or portfolio management by AIFMs to approval by Member State regulators. Such outsourcing must be


justified with objective reasons. The AIFMs that intend to delegate functions must also ensure that the outsourcee has sufficient expertise and resources and the persons who effectively conduct business have adequate experience, knowledge and skills, as well as good repute. Written arrangements must also be put in place between the home state regulator for the AIFM and the supervisory authority for the outsourcee so that information exchange and coordinated supervisory activities can be carried out. The AIFM must also satisfy its home regulator that outsourcing will not impede effective supervision of the AIFM. The sub-delegates and further delegates of outsourcees are mutatis mutandis subject to the same rules as above.

AIFMs need to ensure that delegation does not affect their obligations to comply with the regulatory regime or their duties to their investors, and that the arrangements between the AIFMs and their outsourcees would not affect the due and expedient discharge of the AIFMs’ functions. Delegation should also be managed such that the AIFM retains oversight of the delegated functions, ensuring continuity and quality in the performance of tasks, information reporting from the delegate, the protection of confidential information and the introduction of a contingency plan for disaster recovery. AIFMs are, however, not allowed to


outsourcing portfolio or risk management functions to the same institution that undertakes its depositary functions or where conflicts of interest may be present unless well managed.\textsuperscript{80}

Where an AIFM delegates so excessively that it becomes only a letterbox entity, Member State regulators may consider the AIFM no longer to be the actual fund manager of the AIFs and may require the outsourcee to be subject to the regulatory regime instead.\textsuperscript{81}

Outsourcing could create layers of supervisory complexity for regulators but it is often efficient in market practice to do so. Regulatory control of outsourcing and delegation is arguably used by regulators to maintain effective information surveillance over AIFMs. However, regulatory oversight seems to concentrate on the establishment of the outsourcing agreement, while AIFMs are responsible for ongoing monitoring of the outsourcees/delegates. The AIFMs’ ongoing monitoring of outsourcees and review of risk is imposed as a duty, but curiously these procedures are not part of the regular reports that must be sent to regulators under Article 24.\textsuperscript{82} Hence, there is a risk that although the AIFM Directive provides a framework for AIFMs to monitor and review outsourcees/delegates, the implementation of that framework may become self-regulatory. It is proposed that disclosure to regulators be bolstered in terms of AIFMs’ ongoing monitoring and review of their outsourcees/delegates, especially if outsourcing involves risk management, which is regarded as an important part of prudential regulation.

On the whole, the prudential and risk management regulation imposed on AIFMs features a fair amount of discretionary implementation by AIFMs. This is a meta-regulatory framework and should be supplemented by a fair amount of regulatory supervision. Regulators have to be mindful that dynamic and continuous supervision needs to be carried out in order to prevent meta-regulatory mechanisms from becoming self-regulatory. However, the authors are of the view that reporting to regulators seems a little thin to support the extent of regulatory supervision that may be required. We query whether regulators would devote significant resources to policing AIFMs or in fact leave much enforcement to market discipline. If the latter approach is to be relied on, then the regulation of the AIFM will evolve into a largely investor protection measure, perhaps


de-emphasising the financial stability narrative that underlined its conception. Further, the authors are also of the view that the regulatory regime is highly influenced by the impetus for legal integration, securing legal harmonisation with the MiFID or UCITS Directives. Such harmonisation, such as in the regulation of remuneration policies, may not always be warranted as the regulation of AIFMs could be tailored to unique aspects of the AIFMs that relate to financial stability concerns.

6.3.7 Reporting to Member State regulators

The levels of leverage and counterparties involved in the leverage exposure of AIFs managed by AIFMs are, as mentioned above, regarded as important to systemic risk monitoring.\(^83\) Hence, Article 24(4) and onwards of the AIFM Directive requires that AIFMs provide regulators with information on levels of leverage, breakdown of leverage, the five largest sources of borrowed cash or securities for each managed AIF, and other information that may be periodically required. Where leverage exceeds three times the net asset value of an AIF, Member State regulators are to consider such AIFs as employing substantial leverage and should monitor the relevant AIFMs more regularly by requiring half-yearly or quarterly reporting depending on the size of assets under management.\(^84\) Member State regulators must also provide information to ESMA and the ESRB for systemic risk analysis and oversight.\(^85\) Moreover, Member State regulators are empowered to impose restrictions\(^86\) upon the use of leverage in appropriate cases, after informing ESMA and the ESRB.

Besides the leverage reporting mentioned above, AIFMs are required to make regular reports to Member State regulators as regards the profiles of the AIFs they manage, the principal instruments and markets traded in and, in particular, the liquidity profiles, results of regular stress testing, risk profiles and risk management policies, and the annual report containing details of financial performance of the AIFs managed.\(^87\) The nature and management of assets in AIFs is perceived by regulators to be important to systemic risk, as trading activities affect liquidity in

\(^85\) AIFM Directive, art 25(3)–(5).
\(^86\) Discussed above under ‘Restrictions on Investments or Investment Strategies’.
the markets. The disclosures made to regulators by AIFMs generally concern micro-prudential and balance sheet information, as these are usually regarded as most relevant to the financial soundness of firms. ESMA views the reporting of regulatory information to be crucial in identifying any systemic risk build-up and in triggering the exercise of power to impose regulatory controls, such as to limit leverage under Article 25(3). Where an AIFM manages total assets exceeding €100 million, or €500 million for close-ended funds of funds, the AIFM is subject to half-yearly reporting. Where an AIFM manages total assets exceeding €1 billion, or manages an AIF whose assets exceed €500 million, the AIFM is subject to quarterly reporting to the relevant Member State regulator. Private equity funds are subject only to annual reporting. The varying intensity of reporting requirements imposed on AIFMs reflect the systemic interest in the potential impact from failure of larger AIFMs. Awrey queries whether the reporting regime adds anything more to the existing fabric of regulation in the UK to which hedge fund management activities are already subject. The authors also query whether the reporting requirements are too narrow in scope when compared to the range of information to be provided to investors, as will be discussed below. The information related to investor protection, such as valuation, may be useful in understanding asset profiles and could be useful in identifying signals of asset price problems.

Summing up the authors’ views on the regime for prudential regulation in the AIFM Directive and the supplemental Commission Regulation, although the AIFM Directive has responded to the financial stability and systemic risk rationale for regulating alternative investment funds, the prudential regulatory regime tends to rely heavily on convergence with the UCITS and MiFID regimes. There is room for regulatory monitoring and discretionary powers to be exercised, especially in relation to the use of leverage, but it is queried as to how much regulatory resources would be devoted to supervising AIFMs in light of the

regulators’ likely reliance on market discipline, an issue that will be discussed below. The next section will discuss the investor protection provisions and will argue that this seems to be the focus of the AIFM Directive. Although market failures in investor protection are linked to financial stability, we query whether the approach taken in the AIFM Directive is excessively focused on transactional and relational aspects (a historically dependent approach characterised by addressing agency problems and information asymmetry). Although we agree that involving the wholesale investment sector in the provision of more governance and discipline is a positive move, we are concerned that regulators may become excessively entangled in investor rights and AIFM liability issues when the starting point for extending regulation to AIFMs relates to financial stability concerns. This may affect regulatory scrutiny for systemic risk issues and may undermine the move towards mobilising market discipline through investor actions. Further, the legal integration objective also looms large in the form of the AIFM passport, which has become an issue of contention and a target for industry lobbying. We are thus concerned that the regulatory regime has not been framed with its key objectives in mind.

6.4 Investor and stakeholder protection

The AIFM Directive has also taken the opportunity to enhance investor protection, said by commentators\(^93\) to be inadequate if left to freedom of contract. Although investor protection concerns, such as valuation and side letters, were subject to critique prior to the global financial crisis, there was a lack of regulatory action until the post-crisis reforms. It seems to the authors that many of the improvements in investor protection introduced by the post-crisis reforms are not a response to the old arguments of market failure (which fell on deaf ears in the pre-crisis years too). Enhanced investor protection has in fact ridden on the back of the revitalisation of the financial stability objective in financial regulation\(^94\) and has taken on a new, more protective flavour. Although enhanced investor protection could play a part in the overall systemic well-being of the financial sector,\(^95\) investor protection is a different regulatory objective and could come to dominate the regulatory regime for AIFMs. Further, the conferment of investor rights could rejuvenate market discipline against AIFMs and create the effect of


framing the regulatory interest over AIFMs as centred upon investor protection. We query whether regulators would increasingly rely on market discipline in enforcing the regulatory regime over AIFMs. If so, then the regulatory character of the AIFM Directive will change over time and financial stability monitoring may become de-emphasised.

6.4.1 Duties in fund management

Article 12 of the AIFM Directive lays down six general principles of conduct of business, which are fleshed out in detail by the supplemental Commission Regulation based on ESMA’s technical advice.\(^{96}\)

AIFMs owe legal duties in care, skill and diligence, to employ resources effectively for the performance of due functions, to manage conflicts of interest, to act in the best interests of investors, to comply with all regulatory requirements and to treat investors fairly.

The care and skill required on the part of AIFMs relate to acting honestly, fairly and with due skills.\(^{97}\) Although these terms are widely worded, the Commission Regulation that supplements the AIFM Directive refers to the following attributes: (a) the adequacy of the collective knowledge, skills and experience on the part of senior management; (b) sufficient time commitment by senior management; (c) the qualities of honesty, integrity and independence of mind on the part of senior management; and (d) devotion of time and resources to adequate training of staff.\(^{98}\)

Diligence must be demonstrated in the selection and continuous monitoring of transactions undertaken in fund management and an adequate understanding of the assets invested in. Written policies and effective implementing arrangements must be put in place to discharge the duty of due diligence.\(^{99}\) AIFMs are imposed with duties of due diligence in the following particular respects: (a) investing in

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assets of limited liquidity, and (b) selecting appropriate counterparties and prime brokers. It is, however, noted that the duty of due diligence is not extended to the selection of outsourcees or to the valuation process, both of which may be related to investor protection. However, it may be argued that the valuation process is a highly prescribed one and failures to carry out valuation properly may still be subject to civil enforcement. The lack of attachment of the duty of diligence to valuation may not prejudice investors.

On the enforcement of the duties of care, skill and diligence, it is questioned whether regulators and courts will take an approach that focuses excessively on adherence and implementation of written policies. The requirement to put in place written policies on diligence, as mentioned above, allows compliance to be defined in very procedural terms. There are benefits and drawbacks to this. The UK’s experience is that a procedural approach may allow regulators to take pre-emptive enforcement action based on findings of unsatisfactory procedures, whether or not investor losses or complaints have ensued. However, this also means that regulatory inquiry may not go beyond looking at procedures and the spirit of diligence must thus be presumed from procedural compliance. Instituting procedures may create its own perceived legitimacy and shape regulatory acceptance of proceduralisation as adequate regulatory compliance. This problem is called ‘legal endogeneity’ and is discussed by Edelman in relation to proceduralisation undertaken to comply with employment law. Further, a procedural approach could even affect judicial interpretation of diligence in civil law cases, as per the problem of legal endogeneity raised by Edelman and others. Where UK case law is concerned, the court is unwilling to hold investment managers negligent for failure to predict general return patterns and risk materialisation, unless the investment manager falls below the reasonable standard of an investment banker. Instituting standardised procedures could assist the industry in constructing a framework of what the industry perceives as ‘reasonable

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102 FSA Enforcement against Wheatcroft Fox, July 2011.


standards’ of care. The industry could thus be in a position to determine for itself the parameters of diligence.

UK courts also currently uphold contractual exclusions where financial institutions disavow having an advisory relationship with their professional clients, since professional investors rightly classified would have a certain amount of knowledge and sophistication in investment matters.\textsuperscript{107} It is uncertain how the duty of diligence would be interpreted in such limited contractual relationships.

Further, the principles found in the AIFM Directive concentrate on post-sale diligence in fund management. But care, skill and diligence issues may occur at the stage of sale or distribution. The courts in the UK are keen to uphold investors’ responsibilities for assessing risks at the point of sale and will not too easily attribute any subsequent losses in investments to negligent advice at the point of investment.\textsuperscript{108}

On ‘acting in the best interests’ of investors, the Commission Regulation supplementing the AIFM Directive defines this duty as one of preventing malpractices that prejudice investors and to ensure that investors are not overcharged.\textsuperscript{109} ESMA’s initial advice\textsuperscript{110} on the interpretation of this duty is based on the MiFID 2004\textsuperscript{111} ‘gold standard’ of best execution and expeditious and proper client order handling. However, such an interpretation is rather narrow in scope and perpetuates the legal endogeneity problem mentioned above. Best execution is often developed in written policies, and an emphasis on establishing policies as compliance encourages a form of procedural compliance that could be narrow-minded in nature. The Commission Regulation has, however, enacted specific provisions\textsuperscript{112} to ensure that AIFMs are under a duty of best execution in the context of portfolio management, and that they should

\textsuperscript{107} CRSM v Barclays Bank Ltd [2011] EWHC 484 (Comm), [2011] All ER (D) 189 (Mar).
execute client orders fairly and expeditiously. The criteria for best execution in MiFID is adopted in the Commission Regulation, viz the objectives of the investment, the characteristics of the financial instruments to be traded, the characteristics of the order and the characteristics of the execution venue.

On treating all investors fairly, AIFMs are to ensure that their treatment of one or more investor does not result in an overall material disadvantage to other investors. However, hedge funds have always been engaged in the use of side letters, which are preferential terms individually negotiated with investors. The AIFM Directive now subjects the use of side letters to transparency measures and ab initio disclosure to all investors, but does not prohibit them. Hence, the Commission Regulation, read subject to the parent Directive, should not affect the use of side letters. But the wide wording in relation to material disadvantage may still entail questions as to whether very differential levels of treatment may be subject to civil enforcement. Top-down regulation of side letters is unwarranted given that the practice has subsisted for a considerable amount of time and that professional investors should be engaged in considering the level of protection they may be offered when participating in investments with unequal treatment. In fact, ESMA considers it overly prescriptive to set out which practices may be ex ante considered to be fair or unfair, recognising that discretionary application by national authorities is preferable. It will be curious to see how the UK regulator will implement this provision. Although the UK regulator has developed enforcement jurisprudence in applying its ‘Treating Customers Fairly’ principle, this relates exclusively to retail investors and hence a different set of considerations would have been applied. It is uncertain as yet under what circumstances wholesale investors will be regarded as having been treated ‘unfairly’ where greater levels of knowledge and bargaining power exist.

operating conditions, depositaries, leverage, transparency and supervision (19 December 2012), arts 27–29.


116 AIFM Directive, art 12(1).


118 Andromachi Georgosouli, ‘The FSA’s “Treating Customers Fairly” (TCF) Initiative: What is so Good About it and Why it May Not Work’ (2011) 38 Journal of Law and Society 405 even argues that the enforcement of this provision results in highly self-regulatory behaviour in terms of customer redress.
The introduction of new regulatory duties for AIFMs in EU law has opened up new possibilities for civil enforcement in Member States, as well as liability for breach of European Union law. At a national level, there will be a general tort liability and actions for breach of regulatory duties such as are facilitated under section 150 of the UK Financial Services and Markets Act. In practice, however, there is very limited case law in the UK and Europe as only ‘private persons’ are allowed to sue.\(^\text{119}\) In spite of some out-of-court settlements, civil liability does not play a sufficiently significant role in providing market discipline for financial institutions.\(^\text{120}\) Should the position be reformed so that wholesale sector investors such as institutions can bring civil actions in the breach of regulatory duties against AIFMs? However, courts are likely to have to grapple with causation issues (i.e. whether any breach of duty therefore causes investor loss) given that there is no default presumption of causation between breach and loss. Where courts find that investors would have persisted in a particular course of behaviour – such as buying, holding or selling – then ultimate losses on investment may not be attributed to particular breaches of duty.\(^\text{121}\)

Investor litigation can be a useful force in providing a form of bottom-up governance, complementing regulatory governance in reflexive ways. Individual shareholder actions will not be restricted by limited resources and the priorities of regulators. Regulators could be subject to capture, political intervention and challenges in balancing a suite of regulatory objectives. Regulatory controls may be based on assumptions and predictions that remain static and may not catch up with the dynamics of change in the financial sector. Public regulatory power may also be limited in resources, and insufficiently incentivised to follow through with enforcement, opting for settlements.\(^\text{122}\) Bottom-up reflexive forces of discipline allows other actors in the regulatory space, such as aggrieved investors, to provide governance. Regulators could observe and learn from these effects in order to engage with a governance paradigm that is dynamic in nature.\(^\text{123}\)

\(^{119}\) See, for example, \textit{Zaki and Ors v Credit Suisse (UK) Ltd}, [2011] EWHC 2422 (Comm) where breaches of regulatory duties in investment advice were alleged and upheld.

\(^{120}\) The UK Financial Services Act 1986 limited civil liability for breach of the regulatory duties under the act so that only ‘private investors’ could bring an action. Practically no actions were brought. Professional investors, including other financial institutions, would have had the financial resources to bring actions and private investors could have ‘piggy backed’ individual actions or used the case law that would have developed. Mass or class actions were not developed, again due to fears of US style litigiousness and floodgate problems. This is yet another example of calibrating civil liability such that it plays no role in the protection of private investors.

\(^{121}\) \textit{Camarata Property Inc v Credit Suisse Securities (Europe) Ltd} [2011] EWHC 479 (Comm), [2011] All ER (D) 145 (Mar).


Fears surrounding investor litigation often seem to be based on a worry about undesirable ‘floodgates’ and the overly litigious experience of the United States regarding issuer litigation. This explains why a proposal to expressly beef up investor litigation against investment funds in the UK Financial Services Bill 2010 was dropped in the final version of the Act. The authors suggest that reflexive bottom-up forces of governance, such as investor litigation, have an important role to play.

However, there are a few major drawbacks in enrolling investor litigation as a force for governance. One is that civil enforcement may not be successful in providing credible levels of market discipline as the nature of the regulatory duties seems focused on procedural approaches that could encourage box-ticking compliance and judicial affirmation for legal endogeneity. The need to provide legal harmonisation in interpreting AIFMs’ duties, which has resulted in legal prescriptions that are highly procedural in nature, may in fact entail weak forms of compliance and enforcement. Further, the mobilising of bottom-up reflexive forces may undermine the legal harmonisation project in the EU, and it is queried whether courts would be extremely cautious. Finally, bottom-up reflexive governance may end up substituting for regulatory governance and regulators may lose sight of the main financial stability objective. The authors do not think that this is a reason to weaken the potential of market discipline. However, the regulatory framework for civil enforcement should be appropriately designed so that market discipline will be strengthened and beneficial effects for financial stability can also be captured. The authors will make some suggestions in Section 6.6.


125 Amanda Rose, ‘Reforming Securities Litigation Reform: Restructuring the Relationship between Public and Private Enforcement of Rule 10b-5’ (2008) 108 Columbia Law Review 1301. There is controversy over the net positive effects of wider civil liability in the United States compared with the UK and the rest of Europe. This kind of analysis does not take account of the very limited role of civil liability in Europe and the very many different mechanisms in the US that facilitate liability there, not the least in civil procedure with juries and mass actions of different kinds, many of which where developed in legislation to create effective remedies.

126 After strong industry pressure, just as in the case of the Financial Services Act 1986 and at all the intermediate stages. The arguments were the same now and then. No lessons seem to be learnt from the experiences with the existing regimes where there has been no effective remedy for private investors in civil liability. The UK statute will not prevent liability under EU law.

127 EU law on liability for breach of EU rights could provide a new basis for market discipline here. However, the ECJ has been cautious in providing private investors, such as depositors, with EU rights that are protected in this way in a case about liability for omissions by the legislator and the banking supervisor. Concerning the EU law aspects of the BCCI litigation in the UK, see Mads Andenas, ‘Liability for Supervision’ [2000] Euredia 379.
The AIFM Directive seems to encourage civil actions as a form of investor discipline and the discussion on depositaries below reinforces this impression. Encouraging civil actions may reflect the contemporary regulatory need for co-governance and partnership with other actors in the regulatory space, especially given that the wholesale sector is well-resourced to contribute some form of governance. However, in order to make market discipline credible and robust, the authors suggest that more reforms are needed in relation to empowering institutions to sue and in limiting the extent of procedural prescription attached to each duty so that more room can be left for judicial interpretation to suit the circumstances of each case.

6.4.2 Management of conflicts of interest

The AIFM Directive requires AIFMs to identify, prevent, manage and disclose conflicts of interest. This framework for dealing with conflicts of interest is identical to the one under MiFID. The criteria in the AIFM Directive for determining whether a conflict of interests exists are identical to those under MiFID.

It is to be noted that the AIFM Directive and its supplemental Commission Regulation adopt a procedural approach in regulating the management of conflicts of interests (i.e. AIFMs are required to maintain written policies for management of conflicts of interest, monitor the efficacy of implementing such policies and make appropriate disclosure to investors). Such a procedural approach is also

mindful of the scale, size and complexity of the AIFMs’ operations. This approach is essentially a form of meta-regulation that allows AIFMs to apply discretion in identifying the potential conflicts of interest and determining how to manage those. The Commission Regulation provides that the procedures established by AIFMs should ‘prevent or manage’ conflicts of interest, but the authors query whether the regulatory regime really imposes an obligation to ‘prevent’, which is more challenging than ‘managing’ conflicts of interest. The prevention of conflicts of interest may mean that AIFMs should refrain from taking on certain transactions and hence limits transactional freedom. But an obligation to ‘manage’ would not impede so much upon transactional freedom. The authors are of the view that the regulatory tenor is geared towards ‘management’ and not ‘prevention’ of conflicts of interest as such. The permissive quality of this approach to regulating conflicts of interest has wider implications and Chapter 10 will discuss these further.

Article 14(2) states:

Where organisational arrangements made by the AIFM to identify, prevent, manage and monitor conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to investors’ interests will be prevented, the AIFM shall clearly disclose the general nature or sources of conflicts of interest to the investors before undertaking business on their behalf, and develop appropriate policies and procedures.

This provision seems to indicate that, as a last resort, disclosure and leaving it to investor governance may be a way out. This is a divergence from MiFID’s position, which is keen to ensure that disclosure does not become a ‘way out’ for investment firms and that firms demonstrate engagement with conflicts of interest by developing an intelligent and considered policy and reviewing it regularly. It is thus queried whether conflicts of interests are to be policed by investors who, empowered by disclosure, may exert forms of governance. Policymakers may assume that professional investors in AIFs are better placed to understand, negotiate and exert governance in the management of conflicts of interest that are disclosed to them. However, it could also be argued that the imposition of regulation inevitably undermines transactional solutions, as regulation has the effect of replacing and centralising transaction costs and removes the impetus

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136 MiFID, art 18.
towards private solutions. Hence, it is queried whether investors would be actively alert to having to engage with this issue or would rely on regulatory supervision and enforcement for protection. Moreover, it is uncertain whether disclosure of conflicts of interest will cause investors to consider how they may exert governance for their protection. Investors may find it difficult to assess the potential impact of conflicts of interest on their interests and the behavioural tendency of the availability heuristic may prevent investors from questioning AIFMs. The efficacy of investor-led governance is dubitable in this area. The Commission Regulation also imposes on AIFMs the duty to report to senior management if the procedures put in place by AIFMs are not sufficient to prevent damage to investors’ interests. It seems that there is scope for regulators to call senior management to account if investors are adversely affected by inadequate management of conflicts of interests by AIFMs.

Further, in terms of proscriptive duties imposed on AIFMs, the MiFID regime against inducements also applies to the AIFM Directive. The inducements regime under MiFID requires that third-party payments be made or received by the fund manager only if they do not impair service to clients and add value to such service. Such inducements must also be disclosed to clients. In the area of inducements, it seems that compliance with the requirement that inducements not impair service to clients would not be satisfied by mere disclosure to investors.

In sum, the approach of the AIFM Directive to investor protection is rather meta-regulatory in nature. Many duties are imposed on AIFMs, but adherence to these duties generally requires the AIFMs to establish a policy over which they have considerable discretion in setting parameters and determining implementation. Further, it is uncertain whether regulators or investors are to police

138 The availability heuristic is the human behavioural tendency to filter out which risks are salient and which are not. The ‘salience’ of risks may be affected by many psychological and sociological conditions that affect perception. Hence, one of the effects of this heuristic is to discount the impact of possibilities that are more remote or unimaginable or difficult to perceive. See Sendhil Mullainathan and Richard Thaler, ‘Behavioral Economics’ (September 2000) MIT Department of Economics Working Paper No 00-27 http://papers.ssrn.com/paper.taf?abstract_id=245828 accessed 29 December 2012; Daniel Kahneman, Paul Slovic and Amos Tversky, Judgment Under Uncertainty: Heuristics and Biases (Cambridge: Cambridge University Press 1982), 3; Cass R Sunstein, ‘Precautions Against What? The Availability Heuristic and Cross-Cultural Risk Perceptions’ (2005–6) 57 Alabama Law Review 75.
140 MiFID, arts 11–12; MiFID Commission Directive 2006, arts 25–26, on inducements.
AIFM behaviour, as investors could rely on regulator enforcement while regulators may view that the availability of investor civil actions and professional indemnity insurance for AIFMs should make market discipline the primary source of governance. It is unclear whether robust enforcement will be substantively difficult against AIFMs as many duties are framed in a procedural manner and AIFMs that adopt a box-ticking approach could be regarded as compliant. It is also unclear how courts would interpret the ambit and discharge of these duties and how contractual limitations would be upheld. There is scope for enrolling investor discipline as a form of governance by allowing civil litigation to be pursued in respect of breaches of such duties. However, it remains uncertain whether investors would be motivated to play such a role. Finally, it is questioned whether civil litigation will be more successful riding on the back of successful regulatory enforcement, as case law in the UK suggests. Section 6.6 will further discuss the prospect of investor litigation as a form of market-based governance in the wholesale sector.

6.4.3 Depositary separation

Article 21 now requires AIFMs to appoint an independent external depositary for each AIF managed, to be situated in the jurisdiction where the AIF is based, whether in the EU or in a third country, or in the home Member State of the AIFM where a non-EU AIF is concerned. An exception applies to closed-end private equity funds. As these funds only hold non-listed company shares, it is not necessary for a separate depositary to be appointed. The depositary provisions seem to be a response to the Lehman fallout in the global financial crisis, which resulted in a large number of civil actions being brought in respect of money or asset recovery. Further, the appointment of independent depositaries may mitigate the incidences of ponzi scheme frauds such as the Madoff scheme. The depositary provisions arguably have in mind investor protection for ease of recovery, but there is also a systemic risk element that intends to promote orderly resolution of money or asset returns held in custody. However, it has been commented that the depositary provisions, while they make sense for hedge funds, are ‘nonsensical’ when applied to private equity funds, which have been shoehorned into the same category of alternative investment fund management in order to be subject to the need of having a harmonised and one-size-fits-all regulatory regime.

Where the depositary is in a third country (where the AIF is situated), Article 21(5)(b) provides that the depositary will only be acceptable to the home regulator of the AIFM if the third country regulator responsible for the depositary has information exchange and cooperation arrangements with the home regulators.

(including on tax matters). The third country regulator must also have an equivalent regulatory regime for prudential supervision and dealing with financial crime and be expressly made subject to the delegation restrictions and provisions on civil liability to investors. The third country regulatory regime must also be substantively equivalent to the EU regulatory regime where prudential regulation, regulation of conduct of business and enforcement are concerned.\textsuperscript{145}

The independent external depositary is to be separate from the prime broker and other entities whose dealings with the AIFM may lead to a conflict of interest. The depositary will therefore focus on custodial functions and effective reconciliation of accounts and registers. Under Article 21(7), the depositary has a cash flow monitoring function,\textsuperscript{146} a custodial function over clearly defined financial instruments (including lending and collateral arrangements),\textsuperscript{147} a function to ensure that all information from the AIFM is received to verify the booking of subscription payments made by investors,\textsuperscript{148} a function to ensure that subscription and redemption orders are duly reconciled by the AIFM,\textsuperscript{149} a function to oversee

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valuation procedures implemented by the AIFM,\textsuperscript{150} a general obligation of oversight of the AIFM’s procedures\textsuperscript{151} and a duty of diligence to oversee any third parties to whom the depositary delegates any functions.\textsuperscript{152} The oversight duty will likely elevate depositaries’ functions to the status of an independent gatekeeper. In order to facilitate the due discharge of depositaries’ regulatory functions, the Commission Regulation that supplements the AIFM Directive provides for certain standardised mandatory features in the contractual arrangements between depositaries and AIFs.\textsuperscript{153} These provisions ensure that depositaries have access to information and that AIFMs carry out their responsibilities. Further, reporting by prime brokers to depositaries will be made mandatory so that the depositary has a full picture of accounts at the close of each financial day.\textsuperscript{154} These provisions show that EU policymakers intend to enrol depositaries in the governance landscape for AIFMs. The enrolment of depositaries into the governance landscape shows that regulators perceive the need to enhance governance and oversight in the wholesale sector, but doubt if significant regulatory resources should be committed to policing a sector where sophisticated parties may also supply monitoring and governance. The duty imposed on depositaries to maintain general oversight of AIFMs may constitute a form of governance over AIFMs,


but is nevertheless framed in a procedural manner. Depositaries are required to establish adequate procedures and arrangements to verify the AIFMs’ operations and asset positions, procedures for reporting and escalation where irregularities are detected and demonstrate that there are sufficient information flow arrangements in place between themselves and the AIFMs. The procedural requirements may not be difficult to discharge, although whether or not they are substantively efficacious for monitoring AIFMs remain to be seen. However, the governance role of alternative private sector actors in governance should still be monitored by regulators, or else ineffective, non-existent forms of governance or collusive arrangements in the industry may ensue. The governance role of depositaries is flanked by regulatory enforcement, on the one hand, and potential civil enforcement, on the other hand, as depositaries are subject to almost strict liability in terms of their custodial duties.

Would civil enforcement play a more significant role in supporting the governance role of depositaries? This could be a form of smart regulation if depositaries undertake gatekeeping functions for investor protection and are motivated to do so since they may be subject to civil liability to investors. Regulators may not be able to keep an eye on depositaries if they are not in the same jurisdiction.

Civil liability may now be incurred by the depositary to the AIF and to the investors in each AIF. The express provision of civil actions for the benefit of investors against the depositary is arguably a robust investor protection measure. This regime seems to hold out the promise of orderly resolutions in money and asset recoveries for investors and could be a measure that mitigates systemic risk. Further, by opening up depositaries to civil actions by investors, regulators also carve out this area of wholesale sector problem-solving for the wholesale sector itself. This measure may portend two advantages for regulators. First, regulatory resources need not be implicated in solving wholesale sector fallouts if investors are themselves empowered to bring civil action. Second, by carving out an area for private enforcement, regulators may be able to limit the spillovers from the wholesale sector. One of the issues in the Lehman fallout was that, although many civil actions for money or asset recovery were brought by wholesale sector participants and hence Lehman could have been a wholesale sector issue as such, the lack of orderly resolution and payout regimes caused a spillover to the rest of the investment banking sector in terms of loss of market confidence and chaotic behaviour.

The depositaries’ civil liability may, however, be subject to an exception. ESMA has clarified that the exception to liability laid down in Article 21(12) is to be interpreted in three stages: namely, that the loss has been caused by an external event, the event is beyond the control of the depositary even with reasonable efforts.

156 AIFM Directive, arts 21(11) and (13).
and the loss is also beyond the control of the depositary even with rigorous and comprehensive due diligence. In order to set reasonable parameters around the civil liability of depositaries, investors’ actionable loss must be a permanent loss of rights based on deprivation of ownership, excluding insolvency or administration and all cases where legal proceedings could be taken to recover ownership. This will prevent depositaries from being sued the moment an AIFM goes under. The ‘reasonable efforts’ of depositaries are interpreted as having procedures to identify external events of stress and putting in mitigation mechanisms. Further, depositaries that have delegated custodial functions may be able to secure a contractual discharge from liability based on a prior written agreement with its delegate. Such discharge would be available if the delegation is necessary, to comply with a national law for example, and is limited to precise and concrete circumstances only. Contractual discharge cannot operate as a blanket discharge of liability.

It may also be argued that the depositary requirements encourage AIFMs or AIFs to be established in jurisdictions where the private market infrastructure for depositaries in the financial sector is well developed, such as in London. Further, the stringent requirements in terms of duties imposed on depositaries discussed above may also mean that jurisdictions with more developed and mature financial institutions may be more likely to support the operating environment required for AIFMs. There is also a need to consider if the potential concentration of such activities in a few jurisdictions may pose challenges to systemic risk.


160 AIFM Directive, art 21(13).

6.4.4 Valuation

Valuation is an issue at the heart of investor protection as investments in alternative investment funds such as private equity funds are often difficult to value if there are no market price references available. ESMA also requires that an AIFM not invest in a particular type of asset unless the valuation methodology for it has been identified.\(^{162}\) Payne comments that private equity funds may find it harder and costlier to comply with the valuation requirements as they deal with private companies with no market price.\(^{163}\) Hence, how far can regulation go in achieving a satisfactory form of investor protection in the wholesale sector, bearing in mind that such investors may also be willing to engage in higher levels of risk in order to pursue higher returns?

The AIFM Directive provides for the valuation function to be exercised properly and independently.\(^{164}\) Excessive prescription for the valuation process or methodology is not possible as it would be limited by contractual stipulations in each AIF enforceable in the jurisdiction of the incorporation or establishment of the AIF and by the laws applicable in the jurisdiction of the AIF. However, a framework for valuation has been put into place by the Commission Regulation that supplements the AIFM Directive. The framework provides for the fair, appropriate and consistent application of documented valuation procedures, and where models are used, such models need to be fully explained and justified.\(^{165}\) Valuation procedures and models should also be subject to senior management oversight and input from risk management, and regularly reviewed.\(^{166}\) The valuation methodologies need to be able to calculate individual asset values.\(^{167}\)

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\(^{164}\) AIFM Directive, art 19.


Valuations need to be carried out whenever the net asset value of the fund needs to be calculated for redemption purposes, or at least yearly.\textsuperscript{168} The ‘independence’ of the valuation function is to be achieved either by the appointment of an external valuer – who is professionally registered and is able to furnish professional guarantees of competence in performing the valuation function – or by the establishment of a valuation function in the AIFM that is functionally separate from portfolio management, remuneration setting and other functions, in order to ensure its independence and freedom from undue influence.\textsuperscript{169} Where the valuation function is not external, the Member State regulator may require that the internal but independent valuation function be verified by an external valuer or auditor.\textsuperscript{170} An external valuer must also be a professional that is registered and subject to regulation, and must furnish an adequate professional guarantee.\textsuperscript{171}

Article 19(10) of the AIFM Directive provides that AIFM liability to investors will be unaffected by the appointment of an external valuer but the external valuer may itself become liable to the AIFM for negligence or intentional failure to perform tasks. It may be queried whether the external valuer owes a duty of care to the AIF investors. One might argue that the valuer can reasonably foresee its valuation will affect the AIF investors, or least the group seeking redemptions to which the valuation pertains. However, the jurisprudence in \textit{Caparo Industries v Dickman}\textsuperscript{172} concerning auditors may present impediments to the valuer’s duty to AIF investors. In that case, auditors for a company were sued for negligence in verifying mistaken financial accounts, therefore causing loss to a shareholder who consequently offered a high price in a takeover offer. The House of Lords stated that the takeover offeror could not sue on the basis that the auditors did not owe a duty of care to the shareholders at large. Instead, the duty would only be owed in situations of sufficient proximity between auditors and shareholder, where the shareholder informs the auditors, in advance, of his or her purpose in consulting


\textsuperscript{169} AIFM Directive, art 19(4).


\textsuperscript{172} [1990] UKHL 2, [1990] 2 AC 605.
the financial statements. If there is no prior knowledge or proximity where investors are affected by a valuation, could *Caparo* weaken investor discipline against valuers?

On the whole, however, the AIFM Directive provides for many avenues of investor-led governance and civil litigation as a means of exerting governance and asking for redress against AIFMs and depositaries. Empowering and rendering responsible wholesale sector participants – such as depositaries, valuers and wholesale sector investors – is necessary as there are constraints on regulatory resources in enforcing wholesale sector investor protection. However, in the interests of regulatory monitoring for financial stability risks, the authors will propose a framework for regulators to have a form of involvement in the outworking of investor-led governance in Section 6.6.

### 6.4.5 Disclosure to investors

The provisions on disclosure to investors should support the governance role envisaged in the AIFM Directive for investors. We now turn to consider these provisions.

Article 22 of the AIFM Directive provides that an annual report of financial performance should be made available to investors upon request. The provision is minimal as some AIFs established as corporations would be subject to company law reporting in the jurisdiction of the AIF. Article 22 merely provides a right for investors to have at least annual access to such information. The Commission Regulation supplementing the AIFM Directive elaborates on the items that are required in annual reporting but seeks to introduce only a minimum form of harmonisation.\(^{173}\) Annual reports may of course contain more, and qualitative information too.\(^{174}\) Article 22(2)(e) and (f) provide that information on total and aggregate remuneration should also be provided to investors. The authors argued earlier in this chapter that further classification of such information by AIF may be relevant to stimulating investor scrutiny/governance.

Article 23 deals with pre-investment disclosure and periodic ongoing disclosure post-investment. A list of items is prescribed as pre-investment disclosure for AIFs: a description of investment objectives, investment strategy and investment restrictions; levels of leverage and use; how changes to investment policies may be made; the main features of contractual terms, applicable law and investor rights; the identity of the AIFM, its depositary, its auditors, external valuers where

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applicable and other service providers, such as its prime broker and the main features of contractual arrangements with the prime broker; delegation of functions; liquidity and risk profiles and management; valuation policies; redemption procedures and rights; all fees and charges; the most recent annual report; net asset value; and historical performance, where applicable. Although the pre-crisis position on the wholesale end of the financial market relies on transactional governance, leaving intermediaries and professional investors to bargain freely, Mendales argues that complete freedom to bargain does not necessarily facilitate effective investor scrutiny and protection, if investors rely on professional intermediaries for information and advice. Hence, post-crisis, the regulatory standardisation of disclosure of key investor protection items and risk profiles has been brought in. Such standardisation may help facilitate investor scrutiny and governance, as investor scrutiny is now based on comparable and standardised information. Regulatory standardisation does not mean that investor scrutiny is replaced by regulatory enforcement; professional investors have resources to impose market discipline, via civil litigation for example. The AIFM Directive is arguably trying to strike a balance between recognising where regulatory intervention may be needed for investor protection, without overdoing investor protection where investor governance can be brought to bear.

Article 23(4)–(5) provides for post-investment periodic disclosure of how each AIF is managing its liquidity. Disclosure items include percentages of illiquid assets (in particular, whether redemption rights may be affected if investments are made in illiquid assets), the management of risks by each AIF, amounts of leverage, use of leverage and any changes thereto. The periodic disclosure required relates generally to fair treatment of investors, and revolves around whether side letters and arrangements are in place, and whether there may be changes in liquidity positions that may affect redemption rights. Periodic reporting also includes risk management techniques and the risk profiles of the AIFs.

175 See Chapter 3.
Regular disclosure is also imposed on AIFMs to inform investors of issues in relation to the leverage levels employed by AIFs.\textsuperscript{179} ESMA has provided prescriptive guidelines on the computation of leverage, not leaving it to discretionary Value-at-Risk methods preferred by the industry.\textsuperscript{180} Leverage is to be reported to investors in accordance with those standards.

Reporting prudential issues to investors may engage them in individually considering their investment decisions, but such investor protection may sometimes be contrary to systemic risk concerns. The authors are doubtful whether investor governance over prudential issues is the appropriate approach. The likely investor action or reaction to any misunderstood prudential disclosures is redemption or flight and hence regulators should monitor the systemic impact of investor governance in this area. On the whole, the disclosure provisions may be inadequate for the new investor protection regime in the AIFM Directive. There is an excessive focus on pre-sale disclosure that harks back to the days when disclosure was meant to address market failures and information asymmetries. Moreover, pre-sale disclosure may not significantly alter the irrational exuberance and herding tendencies in investing behaviour.\textsuperscript{181} in good times. Post-sale disclosure, which is more important for the new regime of investor protection and civil litigation, should relate to the causes of action relevant to civil litigation, such as the discharge of duties, valuation activities and how these are undertaken and management of conflicts of interest. Instead, post-sale disclosure relates largely to prudential issues, such as liquidity and leverage. It is not suggested that such information is not important. Rather, the authors propose: (a) that post-sale disclosure should support possible causes of investor civil action in order to make the prospect of investor governance possible; and (b) that although information relating to leverage and liquidity is important, it is uncertain what investor


governance in relation to these issues would bring to the overall governance landscape. In particular, the potential systemic impact of chaotic investor behaviour at any sign of bad prudential news should be considered.

6.4.6 Stakeholder considerations for private equity fund acquisitions of non-listed companies

Articles 27–30 of the AIFM Directive deal with the operations of private equity funds acquiring significant stakes and/or control of non-listed companies. Article 27 provides for mandatory disclosure of acquisition of stakes from 10 per cent onwards, and subsequently at the thresholds of 20 per cent, 30 per cent, 50 per cent and 75 per cent. These notifications must be made to shareholders, employee representatives or the body of employees and to Member State authorities. Article 28 further provides that the AIFM must set out its policies on managing conflicts of interest between the AIFM, AIFs and the target company concerned, the policies for internal and external communication regarding employees, its future intentions regarding the company and likely repercussions on employment and material changes to the business and shareholding. These mandatory requirements of disclosure are principally intended to provide important stakeholders, such as employees, with timely access to information. Any exertion of stakeholder power or governance will, however, largely depend on contractual provisions and the laws of the target company’s jurisdiction.

Article 29 provides that AIFMs must ensure that each AIF that has acquired control of a non-listed company be subject to annual reporting, presenting a fair review of the company’s business, including important and material events over the previous financial year, the company’s likely future development and any acquisitions of own shares. This report should be made available to employees of the company. This provision may be compared to the best practice recommended for private equity funds by the Walker Review 2007 in the UK.182 The Walker Review, however, focuses on public companies that have become private after being acquired by private equity funds and recommends that private equity funds disclose financial information, fund management objectives, plans for the acquired company and impact on employees, the environment and other stakeholders (such as suppliers, customers and community). This requirement would not apply unless the target company has a certain social impact by virtue of its economic size and employment capacity.183 The limited parameters of the Walker recommendation reflect the need for disclosure based on the social interest of accountability where employment and the impact on stakeholders may be relatively more significant. However, Article 29 widens the disclosure obligation to all AIFMs where an AIF


183 Market capitalisation of at least £300 million (or £500 million where acquisition is made largely on-market) or 1,000 equivalents of full-time employees.
gains control of a non-listed company. This provision may be said to be introducing an even level of stakeholder protection however small the non-listed company that is acquired. The authors are of the view that increasing stakeholder protection and governance is generally a positive move, as these reflexive bottom-up forces can motivate financial sector actors, such as AIFMs, to take into account a broader set of risks and social concerns.  

Article 30 provides for prohibitions to be imposed on AIFMs to stop them supporting, or voting to support, asset stripping of acquired companies in the form of distributions, capital redemptions or share buybacks for a period of 24 months after the acquisition of control of the company. This interference with the private proprietary right to vote is perhaps based on consideration of stakeholder interests and the social cost of activities carried out by private equity AIFs. The accountability and stakeholder-focused provisions concerning private equity funds in these Articles are not directed at investor governance, but at stakeholder protection.

Regulatory prescriptions to provide for stakeholder protection are welcome, as stakeholders have often felt disempowered and excluded from business restructuring processes following private equity takeover of companies and there is at least a role for regulation to address any externalities that may be imposed on them. However, it is to be noted that although stakeholder protection is prescribed in the disclosure provisions and the provisions prohibiting asset stripping, stakeholders are not provided with governance power in the form of legal recourse. This means that stakeholders must rely on regulatory enforcement to ensure compliance or redress non-compliance with these provisions. It is queried why stakeholders are not given direct governance power in the form of civil actions since the range of stakeholders (e.g. employees) is relatively identifiable and does not threaten to expand indefinitely. As mentioned in Chapter 1, the authors note that the post-crisis governance landscape relies almost exclusively on expert actors in the private sector to provide governance. This strategy may be elitist, narrow-minded and disempowering for a significant body of constituents whose concerns and voices may be diverse and valid.

6.5 Marketing of AIFs

Articles 31–40 of the AIFM Directive deal with the marketing and passport provisions applicable to EU AIFMs or non-EU AIFMs authorised by a Member State, in relation to the management of EU AIFs or non-EU AIFs. The passport

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185 Northern Counties Securities Ltd v Jackson & Steeple Ltd [1974] 2 All ER 625; Her Majesty’s Commissioners of Inland Revenue v Laird Group Plc [2003] UKHL 54, [2003] 1 WLR 2476 [35]: ‘It is customary to describe [a share] as “a bundle of rights and liabilities”, and this is probably the nearest that one can get to its character, provided that it is appreciated that it is more than a bundle of contractual rights . . . These rights, however, are not purely personal rights. They confer proprietary rights in the company though not in its property’.

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provisions are regarded as the ‘carrot’ counterpart to the regulatory regime for AIFMs in the AIFM Directive and serve to further the inexorable legal and market integration project in the EU.

Where an EU AIFM managing EU AIFs is concerned, marketing is allowed in the home Member State, as well as in other Member States, on the basis of the passport for the EU AIFM. The passport process shall involve notification of host Member States by home Member States, similar to the operation of the passport for prospectuses and investment firms, with the establishment of branches requiring further information to be provided to the home Member State in respect of the organisational structure and activities of the branch.

Where an EU AIFM manages a non-EU AIF, it is permitted to manage without marketing in the EU if the AIFM complies with all but Articles 21 (depositary separation) and 22 (annual reporting to investors) of the AIFM Directive and the third country in which the non-EU AIF is established maintains appropriate cooperation arrangements for exchange of information with the EU home Member State. However, the home Member State may permit marketing on its territory without a passport only if all provisions of the AIFM Directive, but for Article 21 on depositary separation, are complied with by the EU AIFM, and provided that custodial functions, functions relating to reconciliations and monitoring of money flow are vested in separate entities external to the AIFM. The home Member State must, however, be satisfied that the third country in which the non-EU AIF is established fulfils certain conditions: it must have appropriate cooperation arrangements for exchange of information with the EU home Member State, adequately discharge international obligations in combating financial crime and money laundering, and have signed an agreement with the home Member State that fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention, ensuring effective exchange of information in tax matters, including multilateral tax agreements. EU AIFMs may only market non-EU AIFs if the AIFM complies with all the obligations imposed in the AIFM Directive and the third country, in which the non-EU AIF is established, fulfils all the cooperative conditions previously mentioned. The host Member States to which such an EU AIFM wishes to market non-EU AIFs may, however, disagree with home Member State approval in relation to the adequacy of third country cooperation and anti-money laundering arrangements and could refer the matter to resolution by ESMA. The marketing of non-EU AIFs is to be delayed by two years after the AIFM Directive passport goes live for EU AIFs in 2013.

186 AIFM Directive, arts 31, 32.
188 AIFM Directive, art 34.
189 AIFM Directive, art 36.
190 AIFM Directive, art 35.
191 AIFM Directive, art 35(2).
192 That is, non-EU AIFs will be marketed from 2015.
A non-EU AIFM may manage an EU AIF or non-EU AIF and attain certain passport marketing rights if it is authorised by a Member State, which will be its home Member State of reference. The home Member State of reference is determined by considering where most of the AIF concerned will be established and where the largest amount of assets managed is located. Where the non-EU AIFM intends only to market in one Member State, that Member State will become the home Member State of reference.\textsuperscript{193} The non-EU AIFM must comply with all of the provisions of the AIFM Directive, unless compliance conflicts with another mandatory law applicable to the non-EU AIFM, thus excusing the non-EU AIFM. But such respite from AIFM Directive compliance is only possible if the third country, to which the non-EU AIFM is also subject, imposes an equivalent rule having the same regulatory purpose and offering the same level of protection to the investors of the relevant AIF.\textsuperscript{194} The non-EU AIFM may only be authorised if it establishes a legal representative in the Member State of reference, to act as a contact point for regulators in supervisory activities,\textsuperscript{195} and if the third country, in which the non-EU AIFM is established, fulfils all the cooperative conditions previously mentioned. The EU home Member State of reference must effectively be able to exercise supervisory functions over the non-EU AIFM.\textsuperscript{196} A home Member State of reference may exempt a non-EU AIFM from complying with provisions of the AIFM Directive,\textsuperscript{197} or allow the non-EU AIFM to continue its operations despite changes to its marketing strategy,\textsuperscript{198} but these exemptions are subject to notification to ESMA and receipt of ESMA’s advice. A Member State regulator is not bound to comply with ESMA’s advice, but must give its reasons for non-compliance, and these may be published by ESMA.\textsuperscript{199}

Where a non-EU AIFM is authorised and markets to a host Member State, the host is entitled to disagree with the home Member State of reference’s determination (in relation to the adequacy of information exchange arrangements, or anti-money laundering regimes, the appointment of a legal representative or the effectiveness of the home Member State’s supervisory discharge) and such disagreements will be referred to ESMA.\textsuperscript{200}

Where a non-EU AIFM is duly authorised, it may manage AIFs without a passport from its home Member State of reference, as long as it complies at least with the annual reporting and disclosure requirements to investors under Articles 22–24. Where private equity funds are concerned, the non-EU AIFM must comply with Articles 26–30 on appropriate stakeholder and regulatory notifications, annual reporting and prevention of asset stripping. The third country, in

\textsuperscript{193} AIFM Directive, art 37(4).
\textsuperscript{194} AIFM Directive, art 37(2).
\textsuperscript{195} AIFM Directive, art 37(3).
\textsuperscript{196} AIFM Directive, art 37(7).
\textsuperscript{197} AIFM Directive, art 37(9).
\textsuperscript{198} AIFM Directive, art 37(11).
\textsuperscript{199} AIFM Directive, art 37(9) and (11).
\textsuperscript{200} AIFM Directive, art 37(7).
which the non-EU AIFM is established, must also have appropriate cooperation arrangements for exchange of information with the EU home Member State of reference and adequately discharge international obligations in combating financial crime and money laundering. Member State regulators overseeing such non-EU AIFMs may impose more stringent rules in marketing.

Where a non-EU AIFM is duly authorised, upon compliance with the AIFM Directive, the passport rights in marketing the EU AIFs it manages are automatically acquired, including the right to establish branches with the provision of additional information (as applies to branches of EU AIFMs). Where the duly authorised non-EU AIFM wishes to market non-EU AIFs it manages, marketing rights will only be granted if the third country, in which the non-EU AIF is located, fulfils all the cooperative conditions previously mentioned.

ESMA is empowered to conduct peer reviews of Member State regulators’ authorisation and supervision of non-EU AIFMs to determine supervisory efficacy and convergence. ESMA may issue guidelines for Member State regulators, based on these peer reviews, on a comply-or-explain basis.

The provisions on marketing and passport rights are likely to compel more AIFs to establish onshore rather than offshore. They are also likely to push non-EU AIFMs to raise their game in order to meet the AIFM Directive requirements, even if these AIFMs choose to limit marketing to one jurisdiction and forego any passporting opportunities. This is most likely to affect American hedge funds with management offices in London. National regulators have some discretion to exempt, and they use this discretion, but are watched carefully by ESMA. A jurisdiction such as London is likely to experience tensions in between complying with the EU supervisory convergence agenda and promoting its attractiveness and competitiveness as an international financial centre.

The treatment of non-EU AIFMs and AIFMs managing non-EU AIFs does not bar these entities from being able to offer investment opportunities and operate in the EU. However, they must be capable of coordinated global supervision. These entities are further encouraged to adopt the AIFM Directive standards in order to enjoy marketing rights, so providing an opportunity for EU standards to reach out as a major force for international convergence. The role of the AIFM Directive in facilitating dialogue on international convergence could be helpful in fostering global coordination, perspectives and systemic risk oversight of alternative investment fund activities. However, policymakers should

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201 AIFM Directive, art 40.
203 AIFM Directive, art 39bis.
204 AIFM Directive, art 39.
205 AIFM Directive, art 37a.
206 Subject to non-EU AIFs being allowed to be proposed in the EU from 2015 only.
be mindful of compromising prudential requirements in view of promoting access or fostering market integration. The needs of systemic risk oversight should be assessed carefully when the AIFM Directive comes up for review.208

The next section will discuss how investor governance in civil litigation – a major governance feature of the AIFM Directive – works and how it may be enhanced.

6.6 Proposing a ‘structured’ approach to professional investor litigation

The AIFM Directive encourages investor governance with respect to conduct of business and accountability of AIFMs. In a decentred governance landscape, this is the post-crisis regulatory strategy of seeking governance potential from ‘other experts’, as a countervailing form of governance vis-à-vis financial intermediaries themselves.209 Will investors take on this governance role? Are there sufficient self-interest incentives for investors to do so? In the UK, the Hedge Funds Standards Board was set up in 2009 to encourage best practice in the accountability of hedge fund managers to investors under the Large Report.210 Although the Large Report (which presents the code of best practices administered by the Hedge Funds Standards Board) provides investor disclosure similar to that under the AIFM Directive, there is no evidence of investor discipline by litigation so far in the UK. Perhaps investor discipline takes place in the form of exit from investment, rather than by way of expensive litigation. The only case of litigation211 by a pension fund against its investment manager for underperformance was settled out of court. Hence, courts have not had an opportunity to examine issues relating to sophisticated investors and fund managers (apart from issues framed as pre-sale advisory failures).212 Whether investors can be motivated to discipline AIFMs is therefore very much open to question. Further, current jurisprudence from the court demands that investors prove causation of loss, which could be rather tricky,213 as a regulatory breach need not be the proximate cause for loss. Stringent positions on causation may discourage investor litigation.

That said, investors in hedge funds, particularly institutional investors, are arguably both resourced and motivated to monitor the governance and performance of AIFs and AIFMs. For example, institutional investors are calling for better

208 Four years after it comes into force: AIFM Directive, art 64.
209 Chapter 3. See also Helmut Wilke, Governance in a Disenchanted World (Cheltenham: Edward Elgar 2009).
211 Unilever Superannuation Fund sued Mercury Asset Management in the UK in 2001 for underperforming its benchmark. The case was settled for £70 million in compensation.
governance\textsuperscript{214} in the AIFs, usually structured as offshore companies, in relation to the appointment of skilled and independent directors to the Boards of these AIFs. The Boards of AIFs are expected to exercise oversight of AIFMs (who have contractual relationships with their AIFs) in such a way as to protect investors’ interests as shareholders in the AIF. However, investor governance in this area is exercised informally rather than visibly through civil forms of litigation such as derivative litigation against the Boards of AIFs.

The authors are of the view that visible forms of market discipline such as civil litigation could be effective, and in a landscape where such forms of market discipline have not flourished, regulators could provide an enabling framework to encourage such market discipline, and also remain involved to a certain extent in order to avoid the ills of civil litigation, much of which has been documented in American literature in relation to private securities litigation.

The authors advocate a ‘structured approach’ to the empowerment of bottom-up reflexive governance forces, such as investor litigation, in order to address the balance between investor protection, decentred governance potential in the private sector and the needs of wider systemic concerns and financial stability from the public good perspective.

A ‘structured approach’ is proposed in accordance with Ben-Porath’s ideas on how paternalistic regulatory governance may nevertheless co-opt individual choice and responsibility.\textsuperscript{215} Ben-Porath discusses how regulatory governance may be necessary in setting welfare goals, as these may not be adequately provided if left to individual free will and markets. However, the attainment of such welfare goals need not be achieved in a top-down command-and-control fashion. Regulators could design choice sets and facilitative environments to steer towards these welfare goals. These insights could be relevant to the relationship between regulatory governance and investor-led governance where AIFMs are concerned. The authors advocate a pre-vetting role for the regulator, in respect of civil litigation that may be commenced or considered by AIF investors, coupled perhaps with reporting to ESMA for monitoring purposes.

In relation to the undesirable effects of the litigious enterprise in American style class securities litigation against issuers, Rose argues that the US regulator, the Securities Exchange Commission (SEC), should be involved in pre-vetting the merits of the litigation in order to make an appropriate cost-benefit analysis before an action is allowed to proceed. This would be in addition to preliminary proceedings in court.\textsuperscript{216} As the AIFM Directive extends the possibility of civil litigation against AIFMs, it is important that regulators play a role in ensuring that such litigation is conducted in a responsible manner.


actions for regulatory breaches, it could be argued that the regulator has an interest in these actions and the ensuing jurisprudence interpreting the scope and meaning of the regulatory breaches. A role for the regulator in pre-vetting investor litigation may thus be warranted. It is proposed that wholesale sector investors should submit possible civil actions to dialogue with the regulator in order to obtain such approval. Approval could also be formalised as a mandatory requirement that must be met before the commencement of investor civil proceedings against AIFMs. The regulator’s approval, however, need not mean substantive approval of the merits of the case, but may simply act as a mechanism for filtering out obviously vexatious or ill-motivated litigation, promoting litigation that serves as a force for discipline.

The pre-vetting mechanism arguably does not obstruct the regulatory objective of investor protection and may in fact provide an initial form of legal advice as to the viability of proceedings. Further, the fostering of interaction between the wholesale sector investment community and the regulator may promote diversity of influence in a governance landscape that has hitherto been dominated by the industry. Regulator pre-vetting may encourage investor civil litigation to operate as a force for discipline and help avoid the pitfalls often discussed in relation to US securities litigation in terms of rent-seeking by lawyers and inflicting unnecessary costs upon other shareholders. Such proceedings may also act as a substitute for the expenditure of regulatory resources in enforcing regulation, achieving a form of ‘smart’ regulatory governance for regulators whose resources are inevitably constrained. Further, having regulatory oversight of bottom-up reflexive forces may prevent regulators from taking a back seat in supervision and enforcement in the wholesale sector and provide regulators with information that could feed into wider systemic monitoring and oversight.

One of the authors argued in an earlier paper that investor civil litigation could be channelled to specialist Tribunals dealing with financial services matters. The UK Upper Tribunal could be developed to have a primary role in developing financial regulation jurisprudence. Regulator-vetted actions could be heard and decided by the Tribunal and made appealable to the Court of Appeal on issues of law. The Tribunal could be in an appropriate position to frame investors’ rights and AIFM duties, developing specialist jurisprudence in statutory interpretation, as these issues of fund-client relations framed in traditional private law actions of contract and negligence are increasingly being dovetailed with regulatory duties anyway.

218 Upper Tribunal for Tax and the Chancery.
6.7 Conclusion

The regulatory regime in the AIFM Directive reflects a mixture of objectives, from concerns about systemic risk, to investor protection and empowering investor-led governance, to market integration in the EU. The mixture of objectives reflects the difficult political process that has been taken to allow the regulatory regime to materialise. Ferran points out that many voices at both European and international levels have pointed out the need for hedge funds to be regulated but the remoteness of regulation was due to the power of industry resistance. The crisis provided an opportunity for the political resistance to give way but the ultimate regulatory regime is fraught with compromises and a fundamental lack of clarity about its goals. She opined that '[f]rom its inception, the EU’s post-crisis agenda with respect to the regulation of alternative investments was . . . dogged by lack of clarity about the underlying goals'. However, the authors are of the view that although it is understandable that the regulatory regime encompasses many objectives and approaches, the mixture of objectives has confused the use of regulatory strategies.

First, we are concerned that the key objective of supervisory oversight for systemic stability, which has justified regulatory extension to the alternative investment fund sector, is being compromised. Article 37(9) allows non-EU AIFMs to be exempted from AIFM Directive provisions at the discretion of a Member State, and under ESMA scrutiny. These provisions uphold deviations from the AIFM Directive based on minimum compliance with investor protection provisions, but this means deviations may also be made in relation to micro-prudential or risk management regulations. Concerns in relation to financial stability and systemic risk oversight should entail the even application of micro-prudential or risk management regulation across all AIFMs operating in the EU, whether they are EU AIFMs or non-EU AIFMs duly authorised. It is queried whether a uniform approach to micro-prudential and risk management provisions would not be preferable if the concern is that AIFMs may have an impact on systemic risk. Nevertheless, one could argue that much of the regulation of internal control and liquidity management is meta-regulatory anyway, and so would regulatory supervision of the prudential position of exempt non-EU AIFMs necessarily add much to systemic risk monitoring? Further, although regulators have the power to impose leverage limitations and restrictions on investment in securitised products, it is doubted that regulators will exercise such powers as the imposition of such restrictions may send unduly worrying signals to investors and precipitate self-fulfilling prophecies for AIFMs.

As the AIFM Directive is keen on enrolling investor governance, it is uncertain whether a backseat will be taken with respect to conduct of business supervision,

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affecting the regulatory approach to prudential supervision as well. If regulators rely on investors to share in the monitoring, as investor disclosure includes leverage and liquidity matters, the authors very much doubt that investor governance is ideal in respect of prudential issues, as investors’ views on prudential issues will be narrow and not systemic in perspective.222 Further, prudential issues may either be perceived as having no immediate impact or their impact misunderstood causing behavioural tendencies such as panic. The authors advocate that regulators should clearly take on responsibility for monitoring prudential issues and systemic risk related concerns in relation to AIFMs. Further, is the AIFM Directive too concerned about the objective of allowing market access on reasonable terms for non-EU AIFMs and the management of non-EU AIFs? The objective of market access and integration may affect systemic risk governance; there is a need for vigilance.

It is uncertain whether the AIFM Directive will actually enhance investor protection in the wholesale sector if reliance is placed on bottom-up civil litigation to address this issue. The lack of market discipline in the wholesale sector has been a market failure. It is not clear whether the AIFM Directive adequately turns this market failure around to create a form of credible governance. The AIFM Directive has standardised many investor protection provisions, such as depositary, valuation and disclosure requirements, and the duties of care, skill, diligence and fairness. These duties are, however, subject to procedural prescriptions and so procedural compliance may suffice to show that AIFMs’ duties have been duly discharged. The authors are concerned that judicial interpretation of the duties and their discharge may be trammelled. Further, it remains to be seen whether the AIFM Directive’s disclosure regimes adequately support investor litigation and whether investor litigation may be impeded by a lack of incentives (as discussed in relation to conflicts of interest above) or hurdles in court (as discussed concerning conduct of business and valuation). There are outstanding issues in respect of how easily investors may be able to call gatekeepers, such as depositaries and valuers, to account. Will regulators have to devote resources to supervision and enforcement in order to protect wholesale sector investors?

The AIFM Directive has taken minimal interest in using prime brokers as possible parties that could exert governance upon AIFMs. The Hedge Fund Standards in the UK have envisaged that the appointment of more than one prime broker by large hedge funds could serve governance purposes of multi-lateral scrutiny and monitoring.223 However, King and Maier224 argue that, although prime brokers have the ability to impose certain controls and undertake monitoring of hedge fund risks, they are unlikely to do so, left to their own devices,

as the competition in the market entails incentives to race to the bottom in order to attract hedge fund engagement. They argue that, instead, regulation should be increased for prime brokers, so that direct regulation over prime brokers provides indirect governance over hedge funds through transactional controls that prime brokers would have to implement. Direct regulation of prime brokers may also provide regulators with key information on leverage and asset allocation that could be important for an overall picture of systemic stability. The AIFM Directive has not taken steps to enrol the help of prime brokers in regulation, nor does it regulate them more stringently in their relations with AIFMs, preferring a regime that focuses on investor governance and regulatory oversight.

It is also to be noted that the voluntary Hedge Fund Standards mentioned above require hedge funds to institute systems of risk management against market abuse and to prohibit inappropriate shareholder activism, such as using borrowed stock to vote. Only the issue of AIFMs exercising voting rights is cursorily dealt with in the Commission Regulation supplementing the AIFM Directive. It could be argued that the general scrutiny of hedge fund strategies by regulators could allow regulators to monitor use of activism strategies and impose limitations on inappropriate forms of activism that may have an adverse impact on the wider corporate sector.

In general, the AIFM Directive is not the centralised top-down regulatory regime once feared. However, it is highly debatable whether the various objectives in financial regulation have been adequately balanced in this regime. Although the AIFM Directive has responded to the financial stability and systemic risk rationales for regulating alternative investment funds, the prudential regulatory regime may be too standardised with the UCITS and MiFID regimes, lacking consideration of some of the unique features of AIFMs, and also too procedural in nature, allowing AIFMs considerable discretion in determining their own levels of safety and soundness. The authors do not believe that mandatory disclosure to regulators adequately supports systemic risk oversight. There may also have been undesirable compromises made in view of market access interests in the passport provisions. Investor protection has become the highlight of the AIFM Directive, but we query whether the AIFM Directive has taken a historically dependent approach by addressing agency problems and information asymmetry. We agree that the wholesale investment sector should play a more important role in governance and discipline, but we are concerned that the regulatory regime has not done enough to credibly mobilise investors and may yet take a regulatory backseat in view of the governance that is expected to be exercised by investors. There is still room for the AIFM Directive to be reviewed and shaped in response to its key objective, which is financial stability.

7 Regulation of credit rating agencies

Investment products are often referred to as ‘credence goods’,¹ whose quality is difficult to discern at the outset. Hence, the market produces ‘certifier’ products to help investors discern the quality of such credence goods. Credit ratings are intended to provide an opinion on the credit-worthiness of debt, and other investment instruments. The purchasers of credit ratings as certifier products have historically been investors. But an issuer-pays model has evolved as modern technological advances have made it easy to disseminate rating information in investor circles and investors have ceased to purchase such information directly from rating agencies.² Issuers, for the purposes of enhancing the attractiveness of their products, remain willing to pay for ratings.

There has hitherto been no need for certifier products to be regulated, in respect of the procedures giving rise to them and the soundness or integrity of these procedures. Certifier products are merely information signals. Not subjecting them to regulation is not necessarily a per se regulatory gap. There is a role for market discipline: the market itself could test the accuracy of these information signals and user feedback would affect issuer demand, so providing a form of market discipline for certifier products. Unregulated certifier products abound in the marketplace, from restaurant ratings to consumer goods reviews and, in the financial or investment sectors, corporate governance and corporate social responsibility (CSR) ratings. However, the global financial crisis has been partly attributed to the flawed quality of credit ratings concerning complex collateralized debt obligations rated by credit rating agencies.³ The perhaps unwarranted

The exuberance of the market for structured products, which collapsed in the financial crisis, is attributed to overly optimistic ratings issued for the products. The flawed credit ratings in relation to structured products and their consequences are not disputed. The debate here concerns whether regulatory governance could and should exert influence over the creation of more reliable credit ratings. This chapter will argue that, although it is doubtful whether regulatory controls over rating methodologies will directly influence rating accuracy, the EU is keen to address all of the well-established market failures in the credit rating industry as a response to the global financial crisis. However, the EU’s regulatory response does not, in our view, adequately encourage market discipline to be restored and in fact introduces a form of product regulation for these certifier goods. As wholesale sector investors are important users of credit ratings, investors in the wholesale sector should be encouraged to adopt a governance role to mitigate market failures in relation to the credit rating industry. The authors are concerned that the form of product regulation introduced will not necessarily improve rating accuracy. If this is so, EU regulation may end up as an expensive investor protection measure that exacerbates moral hazard. ESMA may nevertheless be in a position to obtain enhanced disclosure useful for systemic risk monitoring. However, it is uncertain if ESMA will realise this particular strength in the EU regulatory regime. ESMA may instead be distracted by the legal integration project, thus providing a form of governance that overemphasises the path-dependent trajectory.

7.1 Should regulatory governance attempt to exert influence over the quality of ratings?

There are certain well-documented and endemic features of the credit rating industry, which have been argued to be linked to suboptimal rating quality. Market discipline for credit rating quality may arguably be poor, as ratings themselves are credence goods whose quality is difficult to discern at any point in time and the lack of competition in the credit ratings market may mean insufficient market discipline. In other words, there is a number of market failures associated with the credit ratings market. But if credit ratings are wrong and investment losses follow, these are nevertheless private losses. It remains an open question whether regulatory cost should be incurred to attempt to mitigate or prevent these losses. That is to say, even if there are market failures in providing market discipline for rating quality, should regulation step in to address market failures or assume the role of providing discipline altogether? The question

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4 Goodhart argues that structured products have tended to be overrated more than the usual corporate bonds, as rating fees for these are much higher (due to exuberant market demand and super-normal profits in this market). See Charles Goodhart, *The Regulatory Response to the Financial Crisis* (Cheltenham: Edward Elgar 2009), 121.
whether regulatory governance should exert influence over rating quality is arguably contingent on the answer to the question whether regulatory governance could exert an effect upon the quality of credit ratings. The global financial crisis of 2008–9 has shown that private investment losses, such as pension fund losses, are actually social losses, since such collective investments represent a large part of the population’s savings. Hence, market failures in the credit rating industry could have social implications.

The authors are of the view that the post-crisis regulation of credit rating agencies would achieve the effect of reinforcing the public interest importance of credit ratings, although there seems to be awareness of the dangers of this position, particularly in exacerbating moral hazard. Policymakers also concurrently pursue the apparently contrary direction of downplaying the public interest profile of credit ratings in encouraging more market discipline, private accountability of credit rating agencies and less regulatory endorsement of ratings. We are of the view that there would be a need to eventually reconcile these conflicting positions.

The role of unregulated credit rating agencies in the pre-crisis era has often been described as that of a ‘gatekeeper’, providing market-based verification services to assist investors in making allocation decisions, therefore acting as a form of market-based governance. Kruck argues that the indispensability of credit ratings has developed for some time as a form of state-sanctioned ‘risk measurement’ of investment products provided by the private sector as a form of delegated or quasi-governance. Such risk measurement is not capable of being provided by the state due to resource limitations and the state’s dependence on the expertise and resources of credit rating agencies has led to such a form of delegated or quasi-governance. In other words, the rise of credit ratings is a form of state-sanctioned governance in investor protection. In the wake of the global financial crisis, credit rating agencies have let down the state’s expectations of their governance role in investor protection. However, the authors argue that the EU still continues to regard credit rating agencies’ role in investor protection to be an essential market institution and the regulatory regime would, we will argue, maintain credit rating agencies’ investor protection role. It may also be argued that credit rating agencies have let down the trust reposed in them by investors and regulators, and the official line from the EU in 2013 is that reliance on credit ratings issued by private institutions should be reduced. However, despite the official line, will the market find a ready alternative or engage in individual costly

due diligence instead? Could the role of the EU regulatory regime be said to be in the provision of a framework for regulating and supervising credit rating agencies so that the use of rating agencies’ information products may actually be credibly continued?

This chapter is of the view that the post-crisis regulation of credit rating agencies is not aimed at stripping them of their governance potential, but there is more caution in perceiving credit rating agencies as governance actors. However, this means that regulatory responsibility is taken on in overseeing that credit rating agencies perform that governance role. By 2013, there are initiatives to boost the restoration of market discipline over credit rating agencies by the institution of an investor civil action regime. Let us turn now to the specific market failures that regulation intends to address.

The credit rating industry has often been criticised for operating under conflicts of interest, as the issuer-pays model could align the rating agency’s interests with the issuer, therefore producing inflated ratings for the issuer and encouraging inaccurate allocational decisions in the investment market. Bai provides a detailed analysis of the situations of conflicts of interest that could arise on a personal level for analysts in the rating agency, as well as conflicts of interest that could arise for the agency itself.

On a personal level, a conflict of interests may arise where analysts have personal or business relations with an issuer (e.g. ownership of stock, former employment relations, receipt of gifts) and where personal remuneration is tied to business from issuers. At the agency level, although the issuer-pays model does not in practice result in any issuer becoming a significant paymaster for the credit rating agency, the range of other business relations, such as consultancy business between credit rating agencies and issuers, could be a source for conflicts of interest. Further, Kormos argues that, as credit rating agencies wish to retain

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10 Brigitte Haar, ‘Civil Liability of Credit Rating Agencies – Regulatory All-or-Nothing Approaches between Immunity and Over-Deterrence’ (2012) at http://ssrn.com/abstract=2198293, however, argues that framing the cause of action may pose challenges to policymakers as such a cause of action may be inconsistent with the fabric of national tort law in Member States. Further, she cautions that such actions should not achieve the extreme opposite effect of chilling credit rating agencies’ role altogether.
ongoing business with issuers, the friendly agency-issuer relationship often includes rating pre-meets where issuers may be coached into structuring certain features or adopting certain modifications in order to attain a certain rating. Credit rating agencies also allow issuers to appeal against a rating and such appeals often result in more favourable ratings thereafter, thus supporting the argument that ratings tend to be inflated under the issuer-pays model where relational closeness between credit rating agencies and issuers is an important feature. In relation to the ultimately toxic collateralised debt obligations, which were favourably rated pre-crisis, credit rating agencies also relied on issuers’ expertise in explaining the quality of such complex and novel products and allowed issuer confidence in the underlying risk management of these products to convince rating agencies of their quality.15

However, several commentators do not think the conflicts of interest situations materially affect ratings quality. Hill argues that credit rating agencies have by and large done a credible job with most corporate debt issues and the range of credit ratings given for different debt products manifests the rating agency’s independent opinions. Hence, it is too far-fetched to suggest that all credit ratings are inflated because of the issuer-pays model. She suggests that the exuberant credit ratings for collateralised debt obligations are a result of inexperience and misjudgement on the part of credit rating agencies, which is a business error, one not uncommon when dealing with complex and innovative products.17 Earlier empirical evidence also points to the minimal effect of the issuer-pays model on credit ratings quality.18 These arguments are, however, not to be understood as simplistic assertions that conflicts of interest in the rating agencies’ business model have no effect on ratings quality. Rather, any such effects are not material and the significant errors in judgement relating to collateralised debt obligations are unique business errors to be put down to inexperience and a lack of understanding of the nature and risks of such products. Goodhart, however, argues that although the issuer-pays model has not adversely affected the integrity of corporate bond ratings, the pressures to overrate collateralised debt obligations in this model


17 Also supported by Nicole B Neuman, “‘Sarbanes-Oxley’ for Credit Rating Agencies? A Comparison of the Roles Auditors’ and Credit Rating Agencies’ Conflicts of Interests Played in Recent Financial Crises” (2010) 12 University of Penn Journal of Business Law 921. Jeffrey Manns, ‘Rating Risk after the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability’ (2009) 87 North Carolina Law Review 1011 also argues that it is not clear that conflicts of interest have a direct and material effect on rating quality.


exceed those relating to corporate bond ratings. He argues that the enormous profits in the structured products market and the corresponding rating fees have incited credit rating agencies to overrate, if even slightly. Johnston\textsuperscript{20} further argues that such enormous profits had a direct bearing on the remuneration of rating agency executives and so there were perverse incentives on the part of rating agencies to inflate ratings for structured finance.

It should also be noted that as conflicts of interest inherent in the issuer-pays model have been recognised for a long time, the International Organisation of Securities Commissioners (IOSCO) has issued a Code of Conduct Fundamentals for Credit Rating Agencies to encourage agencies to make disclosures of rating methodologies and management of conflicts of interest.\textsuperscript{21} This is supplemented by internal best practices issued by leading credit rating agencies – Standard and Poor’s, Moody’s and Fitch – which exceed Code requirements.\textsuperscript{22} Further, reforms to the US Securities Exchange Commission (SEC) rules pursuant to Section 15E of the Securities Exchange Act 1934 have allowed the SEC to impose restrictions on analysts’ personal conflicts of interest and to require that certain information be disclosed to the SEC (on the management of conflicts of interest, the 20 largest subscribers to the agency and the performance of ratings). The SEC may also prohibit credit rating agencies from entering into ancillary business with issuers. These rules have applied to the big three credit rating agencies – Standard and Poor’s, Moody’s and Fitch – who are designated as ‘Nationally Recognised Self-Regulatory Organisations’. The market failures pertaining to credit rating agencies’ management of conflicts of interest attracted regulatory attention even before the global financial crisis. Section 7.3 will discuss the EU regulatory regime in detail.

Next, the oligopolistic structure of the credit rating agencies market may also contribute to suboptimal rating quality due to the lack of competition. Credit rating agencies are not subject to sufficient user/market discipline because the oligopolistic market\textsuperscript{23} for credit rating agencies makes rather meaningless any reputational sanctions\textsuperscript{24} that might flow from inaccurate ratings identified by the market. However, it is noted that there is some competition in the credit rating

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\textsuperscript{20} Andrew Johnston, ‘Corporate Governance is the Problem, not the Solution: A Critical Appraisal of the European Regulation on Credit Rating Agencies’ (2011) 11 Journal of Corporate Law Studies 395.


\textsuperscript{23} Many argue that the US SEC’s regulation to register only established and tested credit ratings agencies created further barriers to entry for competitors, protecting the incumbents’ oligarchy; see 15 USC § 78o-7 and Jeffrey Manns, ‘Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability’ (2009) 87 North Carolina Law Review 1011.

\textsuperscript{24} Jerome Mathis, James McAndrews and Jean-Charles Rochet, ‘Rating the raters: Are reputation concerns powerful enough to discipline rating agencies?’ (2009) 56 Journal of Monetary Economics 657.
market, but that such competitive forces have produced a race to the bottom rather than a race to the top. First, the competition for credit ratings on the demand side comes from issuers, who shop for the most favourable rating.\textsuperscript{25} Hence, competitive forces reinforce inflationary tendencies in ratings. Further, credit rating agencies often put out low unsolicited ratings in order to attract the business of the relevant issuer, who may then feel pressured to engage the rating agency. Subsequent solicited ratings for the issuer may tend to change upwards, reflecting again a race to the bottom supporting inflated ratings.\textsuperscript{26} So, improving competition in the credit rating industry need not necessarily entail effective reputational sanctions.\textsuperscript{27} Further, the credit rating industry is subject to network effects (i.e. the more ratings issued by an agency are used, the more such agency attracts a following and users are encouraged to rely on the ratings). As White explains, users’ desire for consistency of ratings across investment products helps to sustain reliance on the few incumbents in the credit rating market.\textsuperscript{28} The multiplication of rating providers may decrease comparability and fuel race-to-the-bottom tendencies, as discussed above. Although competition issues seem to be market failures in the credit rating market, addressing them may not necessarily be productive. Further, it could be argued that the perceived failure of reputational sanctions may not be due so much to the lack of competition in the credit rating industry as to regulatory endorsement of credit ratings, which has created an indispensable market for ratings.

In the US and EU, credit ratings have been coupled with ‘regulatory licences’.\textsuperscript{29} Partnoy explains, for example, that pension fund regulations in the US, requiring funds to invest only in ‘investment grade’ instruments, tie the definition of ‘investment grade’ to credit ratings. Hence, credit ratings from recognised credit ratings agencies may be used as proxies for traditional disclosure regulation, encouraging investors to make easy allocational decisions relying on credit ratings instead of on more costly and laborious due diligence.\textsuperscript{30} Further, the leading international prudential standards, in the Basel II Capital Accord applicable to banks, recommend that capital adequacy requirements for banks should be


\textsuperscript{27} Also the view of Frank Partnoy, ‘Rethinking Regulation of Credit-Rating Agencies: An Institutional Investor Perspective’ (2010) 25 Journal of International Banking Law and Regulation 188.


computed with reliance upon credit ratings issued for the assets that banks hold.\textsuperscript{31} This position is not likely to be changed with the reforms under the Basel III Accord.\textsuperscript{32} Regulatory reliance on credit ratings in the design of regulatory regimes has become the most significant influence in rendering the market for credit ratings indispensable\textsuperscript{33} and in increasing reliance by the investment market on such ratings over and above their own due diligence. Regulatory incorporation of credit ratings into regulatory design without further checks has arguably obliterated market discipline for credit rating products,\textsuperscript{34} as the market is no longer being asked to ascertain accuracy. The market assumes accuracy due to regulatory approval, entailing a form of moral hazard. The European Commission has now issued a general call for systematic removal of reliance on ratings in capital adequacy standards and investment fund regulation, such as UCITS,\textsuperscript{35} and this is generally supported by policymakers in the EU.\textsuperscript{36} However, the reversion to more investor due diligence or issuer disclosure would have to accompany such removal of reliance on credit ratings. Even if reliance on ratings is no longer supported by legislation, the investment market may be reluctant to move away from heavy reliance on credit ratings in the absence of an alternative information product that helps to overcome information asymmetry and improves investor protection.\textsuperscript{37}


\textsuperscript{32} Basel Committee on Banking Supervision, \textit{Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring} (Basel: BIS 2010) www.bis.org/publ/bcbs188.pdf accessed 4 December 2012. However, the European Union’s implementation of Basel III into legislation would avoid references to externally issued credit ratings.


\textsuperscript{37} Staikouras also argues that a move to internal evaluation models could lead to more information opacity and asymmetry in the market, see Panagiotis K Staikouras, ‘A Theoretical and Empirical
As credit rating agencies are still likely to dominate informational governance in investment markets at least in the immediate future, whether or not regulatory decoupling from ratings takes place, Forster, an economist, argues that at least a minimum level of regulation would be optimal for social welfare. The EU’s regulation of credit rating agencies may be understood in this light: the credit rating industry is unlikely to diminish in influence soon and so market failures need to be addressed. However, it is the global financial crisis that put such market failures on the regulatory agenda. Without the crisis, this resurgence of regulatory power and policy will to address the long-standing issues in the credit rating market may never have taken place.

7.2 Can regulatory governance exert an effect upon the quality of ratings?

This section is a preface to the discussion that follows, critically examining the EU Regulation on credit rating agencies in detail. It seeks to address the issue of whether or not the imposition of a regulatory regime could make a difference to the quality of ratings.

Forster argues that the chief difficulty in discerning the reliability of credit ratings lies in the opacity of the standards and methodologies used to produce the ratings. By using economic analysis, Forster shows that if rating agencies were subject to regulatory demand to make transparent their standards and methodologies, this would offer significant improvements in regulatory efficacy and user reliance, leading to increases in social good. However, do regulators have the technical expertise and capacity to evaluate and examine rating methodologies and assumptions? Ford argues that regulators generally need to increase staff and expertise in order to be able to critically evaluate industry developments. If so, the ability to critically examine credit rating quality and agencies’ procedures and methodology may come down to more robust recruitment by the regulatory sector. Nevertheless, Stolper argues that it is inherently difficult for regulators


to detect whether optimal and accurate credit ratings have been delivered by agencies, as these are often *ex ante* technical judgements, leaving the accuracy of regulatory supervision potentially subject to as much doubt as the accuracy of the ratings themselves.\(^{44}\)

However, a more important concern is the implication of regulatory supervision for the perception of the quality of credit ratings. Would the existence of a regulatory regime and supervision lead the investment market to trust credit ratings as being somewhat endorsed by regulators? Would this introduce new moral hazards in investment decisions?\(^{45}\) Although this is a different point from that of regulatory coupling with credit ratings mentioned earlier, the existence of an overall regulatory regime could give rise to the same perception. Regulatory retreat from coupling with credit ratings may then be rendered meaningless if the existence of a regulatory regime continues to give the same impression of regulatory endorsement to the investment sector. We suggest that regulation of credit rating agencies should minimise the level of moral hazard by: (a) focusing on the systemic risk elements of monitoring credit rating agencies; and (b) making the wholesale investment sector play a more active governance role in relation credit rating agencies’ role in mediating information. Reforms have been instituted\(^{46}\) to open up the space for civil litigation against credit rating agencies, so that investors may also exercise *ex post* discipline over the rating sector given the difficulties of *ex ante* monitoring. This has traditionally met many judicial obstacles as shown by the series of unsuccessful cases in the US,\(^{47}\) although the Australian Federal Court has opened the way by upholding investors’ negligence claim against Standard & Poor’s, Moody’s and Fitch for erroneous ratings for a structured finance product sold to 12 local councils.\(^{48}\)

### 7.3 The Regulation (EC) No 1060/2009 on Credit Rating Agencies (and amendments)

The EU Regulation on Credit Rating Agencies is one of the earlier pieces of reform legislation passed in September 2009 pursuant to the de Larosière

\(^{44}\) Anno Stolper, ‘Regulation of Credit Rating Agencies’ (2009) 33 *Journal of Banking and Finance* 1266.


When the European Securities and Markets Authority (ESMA) was formally established at the end of 2010, amendments were made to the Regulation in order to designate ESMA as the European regulator for credit rating agencies. Its role was to take over registration and approval, standard-setting, ongoing supervision and enforcement, so replacing a fragmentary coordinated approach to registration, supervision and enforcement undertaken by a college of national supervisors. However, by late 2011, the Commission had proposed another round of amendments to this young Regulation.

This section will critically examine the regulatory regime for credit rating agencies in the EU, in particular whether the EU regulatory regime is likely to be able to exert influence over rating quality and address the market failures discussed above in order to improve investor protection.

### 7.3.1 Scope of application

The Regulation applies to all credit rating institutions that intend to issue credit ratings for distribution by subscription or public disclosure in the European Community, excluding private credit ratings that are tailor-made and not intended for public disclosure or distribution, consumer and commercial credit scores, and ratings produced for export credit agencies and central banks. Credit rating agencies who wish to disseminate ratings information in the EU or be engaged by subscribers in the EU must be registered with ESMA.

The Regulation will cover rating outlooks in the light of amendments proposed by EU policymakers. The Regulation also provides time frames of between 30 and 40 days from the time a completed application is received by ESMA to ESMA’s decision, such time frames being extendable by a further 15 days should the applicant agency be involved in outsourcing or endorsement of third country agency ratings.

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ESMA’s decisions are communicated to the European Commission and national regulators, as a measure of accountability.\textsuperscript{55}

There are three types of credit ratings allowed by the Regulation to be disseminated or distributed by subscription in the EU, namely: the registered credit rating agency’s rating, endorsed credit ratings issued by a third country credit rating agency, and credit ratings issued by a third country credit rating agency certified by ESMA.

A credit rating agency may only be registered with ESMA if it has a registered office in the Community\textsuperscript{56} and is a fully functional outfit with staff and a compliance function.\textsuperscript{57} Hence, it is not likely that a credit rating agency that operates largely outside of the EU would be able to obtain an EU registration based on a minimal or shell registered office. A registered credit rating agency may endorse ratings issued by a third country credit rating agency in the EU,\textsuperscript{58} if all of the conditions below are met:

(a) the registered rating agency and third country agency belong to the same group;
(b) the third country rating agency is registered under and subject to a regulatory regime in the third country that imposes rules on the avoidance and management of certain conflicts of interest, disclosures of rating methodologies and assumptions, periodic and ongoing transparency and supervision concerning outsourced functions that are equally as stringent as those imposed by the Regulation, and the registered credit rating agency is able to demonstrate that ongoing compliance by the third country agency with these rules has been verified;
(c) ESMA’s ability to assess and monitor the compliance of the third country rating agency with its applicable third country rules is not limited and that ESMA has cooperation arrangements in place with the relevant third country regulator; and
(d) the endorsing credit rating agency is able to provide all necessary information requested by ESMA, there is an objective reason for the third country rating agency to be located in that third country, and the regulatory regime of the third country does not interfere with the content and methodologies of the ratings.\textsuperscript{59}

Credit ratings issued by third country credit rating agencies in relation to financial instruments established in third countries may be disseminated in the EU, if the relevant third country credit rating agency is certified by ESMA. The relevant third country credit rating agency must apply for certification and certification is based on fulfilment of all the following conditions:

(a) submission of the credit rating agency to an existing authorisation and regulatory regime in the third country, held to be equivalent to that imposed by the EU Regulation;
(b) the existence of operational cooperation arrangements and mechanisms between ESMA and the third country regulator; and
(c) the credit ratings issued by the credit rating agency and its credit rating activities are not of systemic importance to the financial stability or integrity of the financial market(s) of one or more Member States.

Although it was feared the Regulation would lock out all third country credit ratings if key differences existed between the Regulation and regimes elsewhere, ESMA’s practice has been tolerant of key jurisdictions such as the US and Japan. The then Committee of European Securities Regulators (CESR), now ESMA, issued equivalency decisions in favour of the US and Japan while acknowledging key differences. Where relevant, applicants for certification may also apply for exemptions from specific provisions relating to management of conflicts of interest and from having a physical presence in the EU where either or both are burdensome and disproportionate given the nature, scale and complexity of the business.

The two key American incumbents – Standard and Poor’s and Moody’s (who between them provide ratings for at least 70 per cent of the corporate debt market) – are already authorised by ESMA. Fitch, the UK-based ratings provider, has also been registered, covering about 90 per cent of the existing ratings sector. Other registered rating agencies generally operate at a domestic level in individual Member States.

We will now turn to the features of the EU regulatory regime in order to discern the nature and purpose of the governance provided by the regulation. The EU

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Regulation addresses a number of issues relating to ratings quality, which will be detailed below.

### 7.3.2 Regulating conflicts of interest

The Regulation targets the problem of conflicts of interest, as a proxy for improving ratings quality. The Regulation provides a mixture of prescriptive detail and meta-regulatory approaches in respect of management of conflicts of interest by credit rating agencies.

#### 7.3.3 Prescriptive regime

On a personal level, the Regulation provides for various measures to prevent credit rating analysts and other employees from being affected by conflicts of interest. These avoidance measures include a prohibition on persons directly involved in the rating process engaging in negotiations for fees;\(^64\) the mandatory rotation of lead analysts, analysts and approvers of credit ratings;\(^65\) the decoupling of analysts’ and approvers’ compensation from the rating agency’s revenues;\(^66\) and prohibitions imposed on persons directly involved in the credit rating activities from having some form of personal, business or financial interest or relationship to rated entities and their associated entities.\(^67\)

In terms of mandatory rotation of analysts, lead analysts must not be exposed to the same rated entity for a period exceeding four years, other analysts must be rotated after five years, and approvers of credit ratings for the same rated entity need to be rotated after seven years.\(^68\) In late 2011, the Commission proposed that even if analysts leave an agency for another agency, the prohibition in exposure to the same client after four years must also be applied.\(^69\) It is queried whether the mandatory rotation of approvers is necessary. Approvers are likely to be in senior executive positions in the rating agency and are likely to have overall charge of a number of client accounts. The mandatory rotation exercise could give rise to the transfer of client accounts from one senior executive to another among a small coterie of persons. It is queried whether mandatory rotation will necessarily achieve a significant amount of independence in the rating process,

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beyond the mandatory rotation of analysts who are involved in the complete mechanics of the process.

All persons directly involved in credit rating activities are also prohibited from having financial investments directly, or that would give rise to conflicts of interest, in the rated entities and its associates.\(^{70}\) Nor may they have any personal or business relationship with the rated entity or its associates, including a previous employment relationship.\(^{71}\) If a rating analyst terminates employment with the rating agency and joins the rated entity or its associates, the Regulation requires the credit rating agency to review the work of the analyst over the preceding two years to determine if any conflicts of interest may have affected the quality of ratings.\(^{72}\) Further, any person directly involved in credit rating activities is prohibited from taking a key management position with the rated entity or its associates within six months of the issue of the rating.\(^{73}\)

All persons directly involved in credit rating activities are also prohibited from soliciting or receiving gifts or favours from anyone ‘with whom the credit rating agency does business’,\(^{74}\) making the prohibition against any form of inducements very wide.

The independence requirements imposed on credit rating agency employees far exceed those that apply to natural persons acting as investment advisers or brokers in the intermediation business and who may have direct customer-facing roles. In particular, the lack of a complete prohibition on inducements for investment firms makes the blanket prohibition against gifts in Section C of Annex I of the EU Regulation appear rather harsh. It is questionable whether or not rated entities may buy a meal for a team of analysts after a meeting or whether minor hospitality gestures are caught by the blanket prohibition. The provisions in Section C of Annex I do not just cover management of conflicts of interest, but also avoidance of such conflicts in most cases.

Although the Regulation believes in the control of conflicts of interest as a proxy for improving rating quality, we must still question whether the avoidance of conflicts of interest promotes more reliable or accurate ratings. As rating accuracy is not a measure of exact science and highly susceptible to evaluation only by \textit{ex post} observations, it could be difficult to evaluate the achievements of regulatory controls relating to the \textit{ex ante} production processes for credit ratings. Even if the


avoidance of conflicts of interest provides an environment for ‘more accurate’
ratings to be developed, how far along the spectrum of accuracy have we moved?
Hill\(^{76}\) and White\(^{77}\) argue that regulatory governance of contextual matters, such
as avoidance of conflicts of interest, is not likely to materially affect rating quality.
Should regulators place more emphasis on the factors that could materially
affect rating quality, such as rating competence and methodology,\(^{78}\) rather than
regulating conflicts of interest?

At the agency level, some prescriptive detail may be found in terms of corporate
governance arrangements for credit rating agencies of 50 employees or more, but
which may also apply to credit rating agencies with less than 50 employees if
ESMA is of the view that the structure of the agency is designed to avoid
compliance with the corporate governance provisions.\(^{79}\) Such credit rating
agencies must have at least one-third, but no less than two, independent directors
on the Board, to monitor the development of credit rating policies and
methodologies, the internal quality control systems, the measures and procedures
to manage any conflicts of interest and the effectiveness of compliance, governance
and review procedures.\(^{80}\) Further, these credit rating agencies must also establish
a permanent and independent compliance function, with the necessary resources,
expertise and independence to monitor compliance with the Regulation.\(^{81}\) For all
other credit rating agencies, an exemption needs to be sought from ESMA to avoid
having to comply with the above if compliance is disproportionate with the size,
scale, nature and complexity of the business.\(^{82}\) All rating agencies must also
establish an independent review function for the ongoing monitoring of its issued
ratings.\(^{83}\)

In terms of corporate governance, it is uncertain whether the presence of
independent directors necessarily improves rating independence and the manage-
ment of conflicts of interest, or indeed improves rating quality. General empirical

71 University of Pittsburgh Law Review 585.

\(^{77}\) Lawrence J White, ‘Credit-rating Agencies and the Financial Crisis: Less Regulation of CRAs is

rating agencies [2009] OJ L302/1, art 7(1) and Annex I, Section D.


research has provided mixed evidence regarding the impact on conflicts of interest where investment funds or firms have recruited independent directors. Blanchard and Dionne, in relation to banks and insurance companies, conclude that the independent directors assist in mitigating situations of conflicts of interest that affect risk management. Kim, however, surveying the US, is of the view that independent directors in mutual funds have not played a significant part in addressing conflicts of interest that undermine shareholder protection. Johnston also doubts that corporate governance would have a significant impact upon rating independence and advocates that there should be direct regulatory oversight of remuneration packages in credit rating agencies instead. In terms of the relationship between independent directors and improved rating quality, dedicated empirical research needs to be undertaken in this area to discern whether corporate governance bears a relation to rating accuracy.

There are also certain blanket prohibitions in place, applicable to the agencies themselves, to control conflicts of interest. Credit rating agencies are prohibited from issuing ratings for entities (or their associates) in whom agencies have made a financial investment, where the rated entity or its associates is related to the rating agency by ownership or control, where any person directly involved in rating activities under the agency’s control is a member of the Board of the rated entity or its associates, and where any rating analyst involved in the rating activity has had a relationship with the rated entity or its associates that causes a conflict of interest. Where an analyst is subject to avoidance of conflicts of interest as defined in Section C of Annex I, the agency has a corresponding obligation not to issue or to withdraw relevant credit ratings. However, Section C of Annex I applies to a range of persons wider than analysts (e.g. no person having a direct role in the rating process should have had a previous employment relationship with the rated entity or its associates). It would appear that only where analysts are implicated in the situations identified in Section B would a rating agency be mandated to withdraw or refrain from issuing a rating. However, in relation to

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87 Where any shareholder or member of the rating agency holds at least 10 per cent of the rated entity, clarified by Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies, Annex I, Section B, para 3(aa) and (ba).

other persons mentioned in Section C, it is unclear whether the obligation not to issue or to withdraw a rating applies. Given the stringent nature of the regulatory regime, the broader regulatory interpretation may be favoured such that where any person employed by the agency and directly participating in the credit rating process is compromised, the credit rating should not be issued or should be withdrawn. In late 2011, the Commission proposed to subject credit rating agencies to rotation every six years, but the EU Parliament prefers mandatory rotation after four years.

Credit rating agencies are also prohibited from providing advisory or consultancy services, although ancillary services (such as market trends or price forecasts) are permitted provided they do not present conflicts of interest. Agencies also have to ensure that rating analysts or persons who approve ratings do not make formal or informal proposals or recommendations to assist issuers in the design of structured finance instruments. The latter is a direct response to what is perceived as having contributed to severely inflated ratings in respect of collateralised debt obligations that crashed in the global financial crisis after obtaining the highest ratings.

7.3.4 Meta-regulation

Much of the organisational and operational requirements imposed on credit rating agencies under Article 6, and elaborated in Sections A and B of Annex I, are meta-regulatory in nature. This means that the Regulation only provides a framework for systems, procedures or controls but is not able to prescribe excessively, since this would amount to a form of micromanagement.

The key framework principles for credit rating agencies are: senior management responsibility; ‘adequate policies and procedures to ensure compliance’; sound administrative, accounting, internal control and risk management systems and procedures; clearly documented and communicated decision-making procedures and reporting lines; appropriate and effective organisational arrangements and

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procedures to identify, eliminate or manage and disclose conflicts of interest;\(^{96}\) appropriate systems and resources to ensure regularity and continuity in the pursuit of rating activities;\(^{97}\) a review function for the adequacy and effectiveness of the systems, procedures or arrangements mentioned above;\(^{98}\) and appropriate and adequate record keeping.\(^{99}\)

The provisions mentioned above are not dissimilar to those found in the regime for regulating investment firms, such as under the Markets in Financial Instruments Directive 2004. Such meta-regulatory approaches – that make reference to adequate, effective, appropriate or sound systems, arrangements, procedures and policies – have become a template applicable for the supervisory oversight of most financial institutions, from investment firms, to UCITS, to alternative investment fund managers. The open-textured terms of ‘adequate’, ‘effective’, ‘appropriate’ or ‘sound’ provide an opportunity for the regulated entities themselves to engage with the spirit and purpose of the regulatory regime, in designing structures and procedures that meet the needs of the firm and the regulator. A key challenge of meta-regulation is how to motivate regulated entities to engage meaningfully in the design process and not merely opt for minimal or lowest cost possibilities. Another challenge concerns how regulatory supervision and enforcement may be carried out in view of evaluating procedures, policies and systems.

Further, how can meta-regulation coexist coherently with the prescriptive regulatory regime that is concurrently in place? Bright line rules and prohibitions often entail a compliance mindset that is focused on the boundary between what is compliant and not compliant. But meta-regulation requires the application of a different mindset, that of understanding and willingness to achieve the spirit and purpose of regulatory regimes. Will senior management be able to embrace the requirements of both types of regulatory regimes?

Further, ESMA’s supervision of rating agencies’ procedures and internal systems and controls may be limited if there is no perceived link between organisational frameworks and rating quality. The provisions on organisational frameworks are similar and largely borrowed from the provisions in EU legislation governing investment firms and fund managers. Hence, these provisions have a legal integration and convergence character, but it is uncertain whether they relate directly to rating quality.

Finally, the question may be raised as to how a registered credit rating agency in the EU can endorse a third country rating agency’s ratings on the basis of compliance with meta-level organisational and operational requirements, especially


when such verification is likely to be based on subjective judgement? Further, the subjective judgement must be made on an ongoing basis to support continued endorsement.

Conflicts of interest and the familiar agency paradigm may per se give rise to concerns that investor protection is compromised, and in such a case, regulation can play a role in addressing market failures. However, the verdict is not out on whether regulatory controls concerning conflicts of interest bear a clear relationship with rating accuracy. Next, we turn to the regulatory regime for regulating rating competence, more directly related to rating accuracy.

### 7.3.5 Regulating rating competence

The Regulation does not interfere with the content of credit ratings or methodologies used in credit ratings, but it seeks to implement a regime to support the accuracy and quality of credit ratings by prescribing specific guidelines on how ratings may be carried out and on the development of rating methodologies, as well as mandatory public disclosure of standards and methodologies used by credit rating agencies. Specific rules also apply to structured finance products as a direct response to the diagnosis of the global financial crisis, and to sovereign debt ratings.

Article 1 of the EU Regulation on credit rating agencies states that the Regulation is intended to contribute to ‘reliability of credit rating activities, contributing to the quality of credit ratings issued in the Community’. This objective cannot be an end in itself. The interest in the reliability of credit ratings must pertain to the purposes served by credit ratings (i.e. assisting investor decisions in the wholesale market). In other words, the Regulation regards the allocational decisions made by investors as a matter of public interest. It may be said that the above statement says nothing new as investor protection has always been a matter of public interest and a key rationale for financial regulation. However, in the pre-crisis era, investor protection has always been seen as a micro-level transactional issue, revolving around information asymmetry and the agency problem in financial intermediation. In the post-crisis era, investor protection is no

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102 Discussed in the next section.


longer seen only as a transactional or market failure problem. Investor protection seems now to be connected to public interest objectives such as financial stability and mitigating systemic risk.\textsuperscript{105}

The emphasis placed on financial stability as a regulatory objective in post-crisis financial regulation has allowed more paternalistic forms of regulatory intervention in the financial sector to be accepted.\textsuperscript{106} In this light, an extraordinary step is taken – direct regulation to ensure rating accuracy. Such direct regulation arguably amounts to a form of product regulation.\textsuperscript{107} The regulatory regime governs rating competence by prescribing standards for the processes leading up to the production of ratings in order to meet the standard of rating accuracy. Product regulation has not been a dominant feature in financial regulation. This means that financial regulation has seldom prescribed the features of investment products, leaving the design of such products to market forces and leaving it to the wisdom of market demand to judge the quality of products. There are regulatory rules requiring UCITs to diversify their portfolios and not to engage in leverage,\textsuperscript{108} but direct or extensive prescriptions as to how products should be designed are not the norm. In the wake of the global financial crisis, there is a noted trajectory towards increasing product vetting and intervention in the consumer market in particular.\textsuperscript{109} However, in the wholesale sector, product regulation is not the norm. Hence, it is arguably unusual to have product regulation of information products such as credit ratings that are ancillary to primary securities or structured products. We now turn to the prescribed standards for the production processes leading up to the generation of credit ratings.

First, Article 8(2) requires credit rating agencies to undertake a thorough analysis of all information available to them and relevant to the rating process.\textsuperscript{110}

Under prospective amendments to the Regulation, Article 8 applies to ratings and

\textsuperscript{107}Raquel Garcia Alcubilla and Javier Ruiz del Pozo, Credit Rating Agencies on the Watch List: Analysis of European Regulation (Oxford: Oxford University Press, 2012) are arguably of a different view, as will be discussed shortly.
\textsuperscript{110}Raquel Garcia Alcubilla and Javier Ruiz del Pozo, Credit Rating Agencies on the Watch List: Analysis of European Regulation (Oxford: Oxford University Press 2012), 186ff states that this requirement is already present in the IOSCO Code of Conduct for Credit Rating Agencies.
The duty to undertake a thorough analysis of information, however, stops short of an express duty of diligence. This means that credit rating agencies may be required to thoroughly analyze all information available to them, but is nonetheless not obliged to ensure that the information available to them is comprehensive. Nevertheless, it is arguable that a duty of diligence may be inferred. First, credit rating agencies have to disclose ‘whether it considers satisfactory the quality of information available on the rated entity and to what extent it has verified information provided’. This could mean that there is at least a duty to consider the quality of information being worked on, and perhaps suggest that credit ratings should be issued only on the basis of adequate levels of information. Credit rating agencies also need to make mandatory disclosure of all information about underlying assets, cash flow and collateral supporting securitization as pertaining to structured finance products and so there could be an implicit duty of diligence to discover and appreciate sufficiently such information in order to make disclosure. The authors are of the view that adequate diligence affects rating accuracy, as post-crisis reflections on the flawed credit ratings for toxic structured finance products pinpoint the lack of relevant information, diligence and accountability as causes for the flawed ratings. However, it could also be argued that there is no such duty of diligence in the absence of express wording as rating agencies are asked to state the level of due diligence conducted in relation to structured finance, thereby implying that no objective duty of diligence is imposed. There also seems to be no duty as such to verify issuer provided information. Credit rating agencies issuing ratings for structured finance products are also allowed to rely on third party assessments as long as they disclose the extent of their own diligence and reliance on third-party assessments. It could be argued that stopping short of an express duty of diligence is a weakness in the Regulation. Surely the regulator would consider diligence to be a salient factor that could adversely impact rating accuracy?

114 Herwig and Patricia Langohr, The Rating Agencies and Their Credit Ratings: What They Are, How They Work and Why They are Relevant (Chichester: John Wiley & Sons 2010), 367ff.
117 A number of commentators agree that the lack of diligence on the part of credit rating agencies was a key reason why the risks in relation the failed structured finance products in the global financial crisis were not earlier discerned by the market; see Raquel Garcia Alcubilla and Javier Ruiz del Pozo, Credit Rating Agencies on the Watch List: Analysis of European Regulation (Oxford: Oxford University Press 2012), 29; Herwig Langohr and Patricia Langohr, The Rating
Next, credit rating agencies must use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing. It is not entirely clear what ‘systematic and continuous’ mean and to what extent rating agencies may maintain discretionary differences in methodology between rating procedures relevant to different products. The Commission Regulation that supplements the parent Regulation defines ‘systematic’ as being associated with analytical models, key rating assumptions, the capacity to promptly incorporate new findings, and application across the same asset without idiosyncratic divergence. ‘Continuous’ is defined as being capable of persistent application, unless there is an objective reason to modify, and being capable of incorporating new findings. There is a clear overlap between ‘systematic’ and ‘continuous’ in terms of rating responsiveness to new findings, so perhaps responsiveness is a key quality indicator of rating accuracy. However, this may simply go to show that the criteria for rating accuracy are not altogether clear. Further, there may be an inherent contradiction between being capable of persistent application and being responsive to change.

‘Rigorous’ means robustly developed, incorporating all driving factors affecting creditworthiness, taking into account all asset classes featuring the same risk factors, and having analytical models and key rating assumptions that are reliable and relevant. Rating agencies may produce policies that show that their templates encompass comprehensive categories of information but ESMA may be none the wiser as to how the categories of information have been applied by analysts. Further, rating agencies have a tendency to make pro-cyclical assumptions based on the information matrix before them. This may mean that rating responsiveness will be affected as ratings will be slow to react when tides

Agencies and Their Credit Ratings: What They Are, How They Work and Why They Are Relevant (Chichester: John Wiley & Sons 2009), 189.


121 Commission Regulation, art 6.

122 Herwig Langohr and Patricia Langohr, The Rating Agencies and Their Credit Ratings: What They Are, How They Work and Why They Are Relevant (Chichester, John Wiley & Sons, 2009), 334 opine that rating accuracy in terms of responsiveness may be contradictory to rating ‘stability’ or consistency.

123 Commission Regulation, art 4.

turn, yet from an *ex ante* point of view, pro-cyclical could mean making appropriate assumptions based on a present understanding of information. If the matrix of information relevant to a rating may encompass comprehensive but conflicting informational signals, how will a regulator be able to judge the soundness of an analyst’s application of discretion in using the informational matrix? Further, there is duplication in the assessment of rigour and being systematic in referring to the quality of analytical models and rating assumptions, a very general descriptor that provides little guidance for how ESMA may make its judgments. ‘Subject to validation’ means the use of appropriate assessments for historic credit ratings, in order to show the extent of predictive power and historical robustness of rating methodology.

In sum, rating quality seems to be equated with rating consistency, responsiveness and historical robustness. The authors are of the view that these proxy indicators may produce unintended consequences.

Rating responsiveness may not be an altogether sound proxy for rating accuracy. One of the criticisms many commentators make of credit rating agencies is that the informational value of a rating has become poor as ratings are not responsive and hence reliance on them has become a hazard. However, rating changes may themselves become triggers for significant developments in the issuer and investment community even if the rating is, at its core, an ‘opinion’. This may explain rating agencies’ slowness in revising ratings. Further, Justensen argues that it would be very difficult to design a regulatory regime to encourage or compel rating responsiveness in providing leading information to the market on the likely prospects of an investment product. Proactive ratings could be as wrong as unrevised ratings and any enforcement based on a duty to review will necessarily focus on procedural compliance rather than substantive judgement on the quality of a rating. Credit rating agencies now have a duty to review ratings at least annually or when material changes occur, and in the case of sovereign

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125 Commission Regulation, art 7.
126 Raquel García Alcubilla and Javier Ruiz del Pozo, *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (Oxford: Oxford University Press 2012) regard the requirements in Art 8(3) as being procedural in nature, providing a broad framework of principles for implementation by credit rating agencies, see 190.
This duty to review does not differ significantly from what credit rating agencies practice at the moment, as rating change can be reactive to changes that have occurred rather than providing insight to the trajectory of a particular investment product. EU policymakers also propose that rating agencies give the rated entity, whether private sector corporate or sovereigns, at least a full working day’s notice if ratings will be changed. This requirement increases the length of notice from the previous 12 hours. This prospective reform shows that EU policymakers are trying to strike a balance between the objective of encouraging rating responsiveness and the objective of mitigating any systemic impact that may be caused by rating changes. Rating responsiveness may not be an unequivocal good and it remains to be seen if the pursuit of ‘responsiveness’ as a quality indicator will be more nuanced in light of the potential systemic risks involved.

In late 2011, the Commission proposed a ‘middle way’ between mitigating the systemic impact of rating amendments and encouraging responsive and accurate ratings: rating agencies should be required to issue a ‘rating outlook’ opinion if a rating amendment is contemplated. The proposal is not adopted but EU policymakers are including rating outlooks into the scope of the Regulation so that ‘outlooks’ issued by rating agencies may be subject to the same regulatory regime as ratings themselves.

As to rating consistency, it is important for the comparability of ratings and therefore products. However, the Regulation discourages the achievement of rating consistency at the price of maintaining outdated rating models and stipulates that there is a need for rating agencies to revise their methodologies regularly. Rating agencies are now compelled to develop review models that take into account macroeconomic conditions and general financial market conditions. In other words, the Regulation supports readiness for the review of rating methodologies in light of changing wider economic and market conditions. Where a credit rating agency revises its methodologies for rating, it must disclose which previously issued ratings will be affected by the change and such ratings must be reviewed and rerated using the revised methodologies. This may be regarded as a way to maintain the comparability of ratings but it is queried if the users of such ratings would be able to keep up with the changes and not be confused. If regular revisions of rating methodologies and reratings take place, such may

produce information overload or confusion in comparison for investors, and diminish the utility of the credit rating as an information mediation product.

The authors are rather sceptical as to ESMA’s ability to make *ex ante* judgments regarding rating quality. Judgments may be made much more easily *ex post*, rather than *ex ante*, when events have proved the historical inaccuracy of the credit ratings. This begs the question of whether regulatory supervision over rating competence will really improve credit rating agencies’ role in information mediation. In order to facilitate ESMA’s supervision, reporting by credit rating agencies (see Section 7.4) is standardised and monitored via the Central Repository (CEREP) system that ESMA has established, so that ESMA can monitor the reported rating assumptions and methodologies. However, it is anticipated that any enforcement is likely to be based on *ex post* developments rather than *ex ante* information. But if *ex ante* information does not raise alarms, then can *ex post* enforcement be justifiably taken? ESMA has also commenced hands-on supervisory monitoring of credit rating agencies’ procedures and methodology. The maiden round of on-site inspections was carried out by ESMA between 2 and 21 December 2011 and ESMA produced a report, as well as individual confidential responses to the inspected agencies, on aspects of unsatisfactory procedures or methodologies that would need to be improved. This Report provides some insight into how ESMA judges if rating accuracy is affected but shows that such judgments are necessarily qualitative in nature.

Many of ESMA’s first-round concerns relate to organisational or procedural matters, such as the effectiveness of independent directors, the transparency and documentation of policies and meetings, the turnover of staff, and the reliance on automated IT systems. This report gives a flavour of the difficulties in being critical from an *ex ante* supervisory position: supervisors are not likely to be able to make frontal judgments about rating quality, or about the models and assumptions

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136 Herwig Langohr and Patricia Langohr, *The Rating Agencies and Their Credit Ratings: What They Are, How They Work and Why They are Relevant* (Chichester: John Wiley & Sons 2009) argue that rating accuracy is essentially backtested, based on the consistency of association with defaults, and their ability to discriminate well on hindsight, 333.


138 ESMA, ‘Report on the Supervision of Credit Rating Agencies’ (22 March 2012) ESMA/2012/207 www.esma.europa.eu/system/files/2012-207.pdf accessed 3 January 2013. For example, ESMA found less than satisfactory the records kept of internal meetings that are crucial in the lead-up to the issuing of the rating (para 17), the decision-making procedures in internal committees finalising a rating (paras 20, 23), the time pressures under which analysts may be working (para 24), and high staff turnover that may affect rating competence and consistency (para 29).
supporting the ratings as such. The limitations of *ex ante* pre-emptive judgments raise the question of how regulatory supervision improves the role of credit rating agencies. However, in July 2012, ESMA\(^\text{139}\) announced an investigation into the big three agencies’ mass downgrade of banks in the euro area. The results of this investigation\(^\text{140}\) show greater engagement with the processes generating credit ratings. For example, ESMA points out the unexplained and discretionary weighting given to certain information by rating committees as possibly being contrary to the requirement of ‘rigorousness’ in rating methodologies under Article 8(3) as comprehensive categories of information have not been thoroughly considered.\(^\text{141}\) Further, ESMA also discovered that the agencies have used rating methodologies that have not been previously disclosed and so this round of investigations may result in improvement in rating agencies’ accountability going forward. ESMA’s expertise is developing in this area of engagement with rating methodologies and making judgments on likely impact on rating quality. However, one must bear in mind the necessarily subjective approach to drawing inferences about rating accuracy and the supervisory costs of such investigations.

Even if ESMA may develop more sophisticated *ex ante* judgment in due course, one wonders if enforcement action may still be lacking. The supervisory process is essentially a dialogic one and rating agencies are likely to be given an opportunity to improve upon dissatisfactory findings rather than suffer enforcement.\(^\text{142}\) The results of ESMA’s investigation into the big three agencies’ mass downgrade of banks in the euro area also did not result in enforcement action, but in dialogue with the credit rating agencies so that remedial actions may be taken.\(^\text{143}\) It may, however, be argued that enforcement is not necessary if supervision and follow-up achieves responsiveness from credit rating agencies. Regulatory scrutiny could contribute towards enhancing accuracy of credit ratings.

Where structured finance products are concerned, EU policymakers are contemplating making it mandatory for issuers to engage at least two rating agencies, one of which should not be one of the big three of Standard & Poor’s, Moody’s or Fitch.\(^\text{144}\) Further, EU policymakers also wish to prohibit cross-ownership of credit rating agencies so that rating agencies would remain

\(^\text{139}\) ‘Esma Probes Agencies’ Views on Banks’, (London, 1 July 2012).
\(^\text{140}\) ESMA, Credit Rating Agencies: Annual Report 2012 (March 2013).
\(^\text{141}\) ESMA, Credit Rating Agencies: Annual Report 2012 (March 2013), 13ff.
\(^\text{142}\) ESMA, ‘ESMA’S Report on the Supervision of Credit Rating Agencies’ (22 March 2012) ESMA/2012/207 www.esma.europa.eu/system/files/2012-207.pdf accessed 3 January 2013, paras 56, 59; ESMA, Credit Rating Agencies: Annual Report 2012 (March 2013) also shows that ESMA provides opportunities and follows up with remedial actions taken by credit rating agencies after supervisory findings are fed back.
\(^\text{143}\) ESMA, Credit Rating Agencies: Annual Report 2012 (March 2013), 13ff.
independent of one another.\textsuperscript{145} It may be argued that engaging at least two rating agencies to issue ratings for structured finance may minimise rating inaccuracy as conflicts of interests may be minimised, and misjudgements that may be made by a single rating agency would not become overly influential in a market. However, the authors query whether the admonition to use a small rating agency as the second rater may render the intended safeguards meaningless. The small rating agency may be more captured by a prominent issuer. Further, there could be concerns about whether a small rating agency may find it more challenging to rate complex structured finance products accurately, in which case investors may not be helped by having that additional rating as part of the information matrix surrounding the structured finance product.

Credit rating agencies also have to use different rating categories and symbols to clearly distinguish them from other investment products.\textsuperscript{146} This has been criticised as being meaningless, as the differentiation of structured finance product ratings is not likely to assist investors in making an informed judgement about them.\textsuperscript{147} The authors are of the view that there is a rational basis for treating structured finance products distinctly, as the rating methodologies and assumptions, as well as information upon which the rating should be based, are likely to be different. However, due to the opacity of some structured finance products, it may be more useful for rating agencies to develop a ‘limited or qualified rating’, clearly labelled as such,\textsuperscript{148} and it may also perhaps be useful for regulatory guidance to provide that credit rating agencies should err on the side of caution for structured finance products, providing a more conservative rating in cases of any possible doubt.

On sovereign debt ratings, rating agencies can only issue such ratings based on analysing the individual specificity of a country. Rating agencies also have to set three dates in advance for publishing any unsolicited sovereign debt rating.\textsuperscript{149} These provisions intend to achieve a compromise between the EU’s political interest in ratings and the maintenance of objectivity and independence in its regulatory regime. As a number of EU Member States are affected by or in jeopardy of rating downgrades, the provisions above intend to ensure that ratings or


\textsuperscript{148} Annex I, Part I, Section D, para 1(4) requires credit rating agencies to disclose whether they consider the quality of information used by them to be satisfactory. This, however, does not amount to a limited or qualified rating, and investors may be unsure of how to treat such disclosures.

Outlooks issued do not create any unnecessary systemic impact. The provisions intend to prevent the situation where ratings downgrades are carried out indiscriminately for EU countries based on perceived dangers in the euro area without taking into account of each Member State’s economic profile and unique features. The requirement for advance notification of dates of rating publications is also intended to allow the EU policymakers and regulatory bodies to mitigate any systemic impact of rating or outlook changes. However, the political interest in these provisions is clear. The prospective extension of the scope of the Regulation to cover rating outlooks may also reflect the EU’s political interest.

7.3.6 Enhancing the governance for rating accuracy

Besides imposing direct regulatory standards in relation to rating competence in order to boost rating accuracy, the regulatory regime is also considering using other means of governance to boost rating accuracy. Regulators are considering including competing credit rating agencies and investors in the wholesale sector as possible actors in governance to contribute to improving rating quality.

In the Commission’s 2010 proposal to amend the Regulation, credit rating agencies were to be compelled to provide a password-protected website listing all of the structured finance products rated and the names of issuers. Further, issuers of structured finance products were mandated under the draft Regulation to maintain password-protected websites containing all the information provided to the rating agency it appoints and access to the website must be granted by the appointed rating agency to any other rating agency that requests such access. Concern over the accuracy of ratings for structured finance products is a direct result of the diagnosis of the global financial crisis. Thus, these provisions seek to encourage credit rating agencies not appointed by the issuer to play a check-and-balance role in the information mediation process. This form of ‘smart regulation’, as discussed in Chapter 3, opens up space for these other actors to contribute a form of governance towards achieving the difficult objective of ensuring rating accuracy. In the final 2011 amendment Regulation, the provisions on sharing information to enable rival ratings have been dropped. However, the preamble to the 2011 amendment Regulation indicates ESMA’s commitment to promote rival ratings, although more consultation is deemed desirable. EU policymakers are finally convinced that competing rating agencies may play a role in checking and balancing each other, adopting a provision that mandates all issuers of structured finance to engage at least two rating agencies, one of whom should

ideally be a smaller rating agency. The authors are of the view that there is potential in these forms of reflexive governance, as the matrix of information could be enriched by other rating agencies’ involvement. However, we have also earlier voiced some doubts about how far a smaller rating agency could contribute to rating accuracy for structured finance products. Regulators also need to observe if this ‘smart regulatory’ process may turn into a competitive process with a tendency to adopt race to the bottom strategies as discussed earlier.

The Regulation has adopted the strategy of specifying certain proxies for rating quality as a means of checking the power of rating agencies and maintaining their useful function. However, it is difficult to supervise ex ante for rating quality. If ESMA penalises rating agencies for suboptimal rating quality via administrative penalties, this could chill the industry. If ESMA does not enforce but merely supervises and admonishes, how much will this improve rating quality? If ESMA leaves it to investor discipline, the consequences for enforcement are uncertain. Investor litigation may also be seen as an opportunistic measure to demand loss-sharing with credit rating agencies after the fact. ESMA needs to be able to keep the industry under check and to deflect any risks of ESMA itself taking on a role in information signalling, while nevertheless preserving the utility of the industry. Is the Regulation trying to achieve an inherently impossible balance? In fact, now that investors will be enlisted in the regulatory space, would legislative acceptance of investor civil actions, perhaps accompanied by mandatory disclosures that would facilitate such investor discipline, restore market discipline for rating agencies, thus rendering regulatory intervention unnecessary?

7.3.7 Investor participation and civil litigation as a form of governance

The regulatory regime for credit rating agencies has placed ESMA at the centre of wholesale sector investor protection, as the accuracy of credit ratings is now subject to regulatory supervision and monitoring. Although there is a move towards systematic removal of references to credit ratings in legislation, the entrenched reliance upon credit ratings in the investment market is unlikely to diminish soon. Hence, EU policymakers now contemplate engaging the wholesale investment sector in monitoring and enforcing market discipline for credit rating agencies.

First, the Commission suggests making stakeholder consultation mandatory when rating agencies develop new methodologies and subjecting new methodologies to ESMA approval. These measures show that the regulator ESMA intends to

enrol the help of investors and other stakeholders so that the dominant role in information mediation undertaken by credit rating agencies can be checked by other actors in the regulatory space. Although *ex ante* scrutiny of rating competence remains an inherently difficult issue, reliance on a variety of governance forces may provide insight and add value, as well as forcing wholesale sector investors to consider what information would assist them or they would like to see. Gerding,\(^{156}\) for example, suggests that opening up the platform of proprietary information in various areas to encourage ‘open source’ work could improve the quality of systems and information in general. The reinstatement of investor interest in the purpose of credit ratings could incentivise a form of governance from the investor quarter.

Second, investors will be empowered to take civil actions against credit rating agencies.\(^{157}\) Legislative reforms now provide a civil action for investors where a credit rating agency has infringed the Regulation intentionally or with gross negligence, such infringement having an impact on rating quality. Under these proposals, an obvious lack of diligence or rating methodologies that are not well-developed or back-tested could provide evidence of intentional or grossly negligent breaches. This would be a form of *ex post* action, perhaps flanked by regulatory enforcement. In order not to chill the rating industry or create perverse incentives for investors to sue, the standard of care for civil enforcement is established as intentional or grossly negligent breaches of the Regulation. Further, as credit ratings remain only ‘opinions’,\(^{158}\) investors need to show that they have reasonably relied on these ratings in the broader context of their due diligence.\(^{159}\) The burden of proof is placed on investors to prove the infringement in question and the impact on rating quality caused by the infringement.\(^{160}\) Issuers may also sue rating agencies for infringements of the Regulation that have an impact on rating quality where the inaccurate rating is not as a result of inaccurate information furnished by the issuer. This action may conceivably be taken by issuers affected by an erroneous rating, or where issuers are sued by investors in securities regulation.

Haar\(^{161}\) argues that one of the fears surrounding the investor’s civil enforcement action is that investors may see credit rating agency liability as a way out to


compensate them for their primary investment loss. Rating agencies’ liability should only be secondary and perhaps capped to a multiple of the revenues received, and not subject to indeterminate and open-ended amounts. Excessive liability for credit rating agencies would be counterproductive and possibly destructive of the industry. However, the two requirements imposed on investors, viz the burden of proof and the need to show that reliance on credit ratings is reasonable in the context of wider diligence, could provide the necessary balance so that investors cannot hold rating agencies to account unless in a meritorious case. In fact, one may be concerned that the burden of proof may not be easily discharged as investors will find it difficult to prove the requisite mental element of intention or gross negligence without access to information regarding the inside operations of the rating agency. However, this strategy of mobilising market discipline also involves national courts in enforcing governance and developing jurisprudence, which could foster divergent tendencies in EU financial regulation. Perhaps, in the post-crisis era, the EU is striking a balance between the various objectives in financial regulation and not doggedly shaping its governance according to market and legal integration alone.

A number of commentators support the introduction of investor actions for civil liability to discipline credit rating agencies. However, there is a need to address some of the problems highlighted by US experience in private securities litigation.

162 In the Australian case of Bathurst Regional Council v Local Government Financial Services [2012] FCA 1200, it could be argued that a few characteristics that made the case successful for the investors would also be established successfully under the civil action in Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies, art 35a. These are the proximate relationship between the agencies and specifically identified investors giving rise to the reasonable reliance by the investors, the relatively unsophisticated position of the investors in relation to structured finance and the false and misleading nature of the rating, which was based on inaccurate information known to the rating agency, which could amount to an ‘intentional’ breach or ‘gross negligence’.

163 At the same time, an emerging liability for breach of EU rights could lead to core common rules. The primary forum would remain national courts, and procedures too would be national, but there would be references from national courts to the ECJ for preliminary rulings under Article 267 (ex Article 234) of the Treaty on the Functioning of the European Union and investors would also be supported by the principle of effectiveness of EU law.


165 Supporters refer to how investor discipline bolsters the quality of disclosure and the robustness of securities markets: Rafael La Porta, Florencio Lopez-De-Silanes and Andrei Shleifer, ‘What Works in Securities Laws’ (2006) 71 Journal of Finance 1; Stephen J Choi, ‘Do the Merits Matter less after the Private Securities Litigation Reform Act?’ (2007) 23 The Journal of Law, Economics and Organization 598. Sceptics, on the other hand, refer to the need to control litigation floodgates and the phenomena of making issuers subsidise some litigating shareholders out of the corporation’s assets: Amanda Rose, ‘Reforming Securities Litigation Reform: Restructuring the Relationship...
An oft-cited concern is the fear of floodgates of litigation\textsuperscript{166} and perverse incentives on the part of investors looking for credit rating agencies to share in their losses after the fact.

Assumptions about ‘floodgates’ and American-style litigiousness have resulted in civil liability regimes in the UK and Europe being subjected to such restrictions that they have not had any practical role in investor protection for a long time.\textsuperscript{167} There are very many different mechanisms in the US that facilitate liability there, not least in civil procedure with juries and mass actions of different kinds, many of which were developed in legislation to create effective remedies. In the UK and EU, there is strong industry pressure on the law-making process against liberalising the prospects of investor civil litigation and we discussed above how a proposal to beef up investor litigation against investment funds in the UK Financial Services Bill 2010 was dropped in the final version of the Act. A similar episode took place in relation to the now-repealed Financial Services Act 1986 (FSA 1986). Section 62 in that Act introduced civil rights of action in the regime for financial services, while section 62A of the FSA 1986 was later inserted by section 193 of the Companies Act 1989 so that, except in specified circumstances, only private investors could bring actions under section 62. The entry into force of the FSA 1986 was postponed until the adoption of section 62A after strong industry pressure. Industry pressure has been maintained at all intermediate stages of law-making, as for instance with section 150 of the Financial Services and Markets Act 2000 and the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001, the successors to sections 62 and 62A of the FSA 1986. The arguments are the same now as then, and no lessons seem to have been learnt from the experiences with regimes where no effective remedy for private investors in civil liability has actually been provided. UK legislation will not, however, prevent liability under EU law.

Investor civil litigation against credit rating agencies would have traditionally faced two uphill hurdles under tort law. These hurdles are mitigated by the proposed amendments to the Regulation but we will argue that it remains difficult to establish civil liability successfully. Hence, the fear that investors would only

\textsuperscript{166} Although the HM Treasury, \textit{Davies Review of Issuer Liability: Final Report} (March 2007) (Davies Report 2007) was quick to refer to floodgates of litigation as a reason for providing a limited cause of civil action against issuers for breaches on ongoing transparency regulations. See www.hm-treasury.gov.uk/d/davies_review_finalreport_040607.pdf accessed 16 January 2013.

sue credit rating agencies in order to find a deep pocket to share in their losses may be overstated.

First, credit ratings are regarded as opinions and it has traditionally been difficult for opinions to be actionable as misrepresentations. Misrepresentations are misrepresentations of facts, or opinions that are not actually held or patently unwarranted due to the supporting context of facts. Credit rating agencies have constantly asserted that they are entitled to the freedom to publish opinions on creditworthiness and should not be taken to task. In the US, courts have now increasingly ruled that rating agencies are not entitled to First Amendment protection on the basis that the circulation of ratings concerns a limited audience of financial sector participants.

Amendments to the Regulation attempt to address this issue. Although the Regulation continues to accept credit ratings as opinions, these opinions are nevertheless actionable if they have been issued upon infringement of the Regulation, the infringement has an impact on rating quality and there is reasonable reliance on the part of investors in the wider context of investor due diligence.

Even if rating agencies are not able to sustain the shield of ‘right to opinion’ against civil litigants, the next traditional hurdle is whether civil law would frame a duty of care owed to investors. In the classic English case of Caparo Industries v Dickman, a potential takeover bidder, who had built up a shareholding large enough to launch a takeover bid in Fidelity Plc, sued the auditors Dickman when it was subsequently discovered that a negligent audit had allowed the financial statements to paint a rosier picture of Fidelity’s financial health than thought. The House of Lords dismissed the action on the basis that the auditors did not owe a duty of care to the shareholders at large and that the duty would only be owed in a situation of sufficient proximity between the auditors and the shareholder, whose purpose for consulting the financial statements had been made known to the auditors in advance. As credit rating agencies are no longer commissioned

169 For example, With v O'Flanagan [1936] Ch 575.
170 Smith v Land and House Property Corporation (1884) 28 Ch D 7.
171 Known as the ‘First Amendment’ right in the US. Although in an earlier case where CalPERS, the pension fund, sued Moody’s Corp, the judge in the California court ruled that Moody’s ratings were protected under the First Amendment. California Public Employees’ Retirement System (“CalPERS”) v Moody’s Corp., CGC-09-490241 (Super Ct Cal, SF County).
175 See the discussion of Caparo above in Part 1: The Objectives and Governance Landscape of Financial Regulation, Chapter 4: The Governance Role of Auditors in Financial Regulation. The House of Lords overturned the Court of Appeal. Sir Thomas Bingham, in the majority with Taylor LJ, held that it followed from the general rule that the auditors should be liable. There was
This duty of care hurdle is overcome in the proposed amendments to the Regulation, which explicitly confer a right to sue for breaches of duties in Article 35a(1). This would mean that, in the UK, the right to sue for civil litigants would be based on a breach of EU law. In such an action, the civil litigants must nevertheless prove that their loss has been caused by the statutory breach. For example, if a credit rating agency breaches a bright line duty by failing to rotate its analysts and its rating quality has also been inaccurate resulting in misplaced reliance by investors, investors have to prove that the rating inaccuracy that has caused the loss is correlated with the failure to rotate the agency’s analysts. Unless the analyst who was not rotated produced the inaccurate rating that resulted in investor loss, investors are unlikely to be successful in alleging that a statutory breach should be actionable. The causal link to loss must be established. In relation to more open-textured statutory duties, such as ensuring the rigour, continuity or historic validity of rating methodologies, a breach may be difficult for investors to prove and the Regulation does not appear to impose a duty of diligence, as discussed earlier.

Further, article 35a(1) of the proposed amendment Regulation requires that the credit rating agency has committed the infringements ‘intentionally or with gross negligence’. This raises serious doubts about the possible efficacy of liability. Negligence liability for professionals in the UK and several civil law countries requires a higher standard than negligence in general. The Commission has in this instance augmented the challenges for investors to subject credit rating agencies to liability. With the very few cases of investors succeeding in actions against issuers, intermediaries and advisors under the general rules, there is every reason to query if the standard of care should be pitched at higher than negligence.

Liability is traditionally limited, or attempts can be made to completely exclude it, by contract. Article 35a(5) continues to allow this if such limitation is reasonable and proportionate or in accordance with national law. This is a deviation from the Commission’s original proposal to bar such exclusions. Hence, sufficient proximity or ‘closeness’. Bingham LJ cited Cardozo CJ [in the famous US case Ultramares Corporation v Touche, 174 N.E. 441 (1931)]. Lord Bingham returned to the case on several occasions, see for instance Lord Bingham of Cornhill, ‘The Uses of Tort’ (2010) 1 Journal of European Tort Law 3, and referred less formally to the House of Lords’ decision as ‘judicial activism’, here to limit liability.

176 See concerning the development of liability under EU law and such cases in English courts, Mads Andenas and Renato Nazzini, ‘Awarding Damages for Breach of Competition Law in English Courts – Crehan in the Court of Appeal’ [2006] European Business Law Review 1191. The case also illustrates the relationship to regulatory enforcement and the very high threshold courts set for private individuals or small businesses. The claimants lost in the House of Lords, Inntrepreneur Pub Company (CPC) and others (Original Appellants and Cross-respondents) v Crehan [2006] UKHL 38, [2007] 1 AC 333.

it remains to be seen to what extent limitations of liability will be drafted and upheld in court. It is envisaged that such limitations may be contractually provided between issuers and rating agencies and so may operate to exclude issuers’ actions. Such limitations between issuers and rating agencies may be sound as issuers could have perverse incentives to pass their losses on to their rating agencies if investors sue issuers in securities regulation. It may be more difficult to exclude investors’ actions given that there is no contractual relationship between rating agencies and investors.

ESMA’s endeavour to situate investor litigation in the governance landscape demonstrates the general post-crisis trajectory towards the expansion of regulatory control through the involvement of alternative actors in the regulatory space. But as discussed above, there are challenges for investors in the application of the proposed breach of statutory action and it remains to be seen if investors will be willing to sue.

Investors may be inhibited from suing if they wish to continue to rely heavily on credit ratings and do not wish to chill the industry. After the onset of the global financial crisis, credit rating agencies seem to have declined to rate a number of structured finance products. It could be the case that rating agencies’ fear of liability is manifested in more conservative behaviour and they may decline to act as intermediaries of information where there is doubt. However, investors, who are used to relying on credit ratings, may not be motivated to undertake extensive and costly due diligence themselves. This could be a factor influencing investors in considering whether or not they will bring civil litigation against credit rating agencies.

In sum, mobilising wholesale sector investors to contribute to governance in this area may achieve limited progress in restoring market discipline. The elusiveness of market discipline is reinforced by ESMA’s continued responsibility for rating accuracy, which the wholesale market could rely upon as a form of substitute investor protection even if the efficacy of credit rating agencies’ gatekeeper role is doubted. We are of the view that the Regulation has not taken sufficiently robust steps to rejuvenate investor discipline and it remains uncertain if any measure intended to enable investor litigation will achieve that effect. Next, we turn to the mandatory disclosures that credit rating agencies have to make to ESMA. We argue that these disclosures are perhaps more useful to ESMA than the regulatory regime envisages, in relation to the financial stability objective. We argue that ESMA should perhaps gear governance of credit rating agencies towards the contribution these agencies can make to ESMA’s systemic risk monitoring role.

7.4 Mandatory disclosures required of credit rating agencies

The EU regulatory regime has established a disclosure regime that credit rating agencies have to comply with. This section will examine the disclosure regime and argue that its real regulatory potential lies in obtaining information from credit
rating agencies that could be useful in systemic risk monitoring. This section will
argue for improvements to be made to these areas of information disclosure.

Credit rating agencies have to include certain disclosures with their ratings,
such as their material sources (including third-party sources), rating methodologies,
the meaning of each rating category, any limitations and attributes in ratings
and whether the product is rated for the first time or the date the initial rating
was issued.\textsuperscript{178} Reforms in 2013\textsuperscript{179} will impose similar disclosure requirements with
respect to rating outlooks. For structured finance products, credit rating agencies
have to provide specific information on loss and cash flow analysis,
the level of due diligence, rating methodologies, assumptions and limitations.\textsuperscript{180}
These disclosures could provide suitable bases for investor civil action if the
Commission’s proposal to facilitate investor litigation is adopted.\textsuperscript{181}

Legislative reforms will enhance rating agencies’ disclosures accompanying the
issue of sovereign debt ratings or rating outlooks.\textsuperscript{182} Rating agencies are to make
publicly available a detailed research report on any ratings or outlooks issued in
respect of sovereign debt. Such a report must explain the quantitative and
qualitative assumptions made, and must set out the limitations of the rating or
outlook, and attach a summary of the minutes of meeting of the rating committee
that makes the decision on the sovereign debt rating or outlook. These provisions
are intended to hold rating agencies to enhanced accountability in relation to
issuing sovereign debt ratings or outlooks, given that they are highly susceptible
to causing systemic impact. It is also queried whether sovereigns could, using
the disclosed information, unpick a rating or outlook issued by a rating agency and
sue the rating agency on the same basis as any issuer under the proposed civil
enforcement action discussed above.

Credit rating agencies are required to provide six-monthly updates on
historical default rates for each rating category, distinguishing between the main
geographical areas of the issuers and showing whether default rates have evolved
over time.\textsuperscript{183} The collation of such information provides the opportunity for credit

\textsuperscript{178} European Parliament and Council Regulation (EC) 1060/2009 of 16 September 2009 on credit
amending Regulation (EC) No 1060/2009 on credit rating agencies, Annex I, Section I, Section D, Part I,
paras 1 and 2.
\textsuperscript{180} European Parliament and Council Regulation (EC) 1060/2009 of 16 September 2009 on credit
rating agencies [2009] OJ L302/1, Annex I, Section D, Part II.
\textsuperscript{181} Andrew Johnston, ‘Corporate Governance is the Problem, not the Solution: A Critical Appraisal
of the European Regulation on Credit Rating Agencies’ (2011) 11 Journal of Corporate Law Studies
395, however, doubts that the nature and volume of mandatory disclosures assists much in \textit{ex ante}
and \textit{ex post} monitoring by investors in relation to rating accuracy.
amending Regulation (EC) No 1060/2009 on credit rating agencies, Annex I, Section D, Part III.
\textsuperscript{183} European Parliament and Council Regulation (EC) 1060/2009 of 16 September 2009 on credit
rating agencies [2009] OJ L302/1, Annex I, Section E, Part II, para 1. Such information is now
rating agencies to consider the quality and accuracy of their ratings and the public disclosure provides a channel for public scrutiny and perhaps investor action as mentioned above. This is also supplemented by a requirement to provide ESMA alone with information on historical performance data, including the ratings transition frequency and information about credit ratings issued in the past and any changes thereto.\textsuperscript{184}

Next, credit rating agencies have to make annual public disclosures of matters such as their largest clients (contributing at least 5 per cent of revenue),\textsuperscript{185} their conflict of interest policies, a list of ancillary services, their main rating methodologies, any material changes thereto, compensation structures and codes of conduct if any.\textsuperscript{186} Part II of Section E, Annex I also provides that the largest 20 clients must be disclosed and that any client contributing to threshold growth in revenue must also be disclosed. Legislative changes have now been made to require disclosure of all the fees charged to each individual client, and the pricing policies applied by the rating agency in respect of each service it provides.\textsuperscript{187} Information on fees charged may provide an indication of the relational closeness between the rated entity and the credit rating agency and allow ESMA to monitor if any rating may be compromised.

Credit rating agencies must further produce an annual Transparency Report containing information on ownership structures, rotation of analysts policies, internal control systems, record-keeping policies, annual internal reviews of compliance, revenue information from credit rating and non-credit rating work and governance statements.\textsuperscript{188}

These public disclosures largely have to do with management of conflicts of interest and assist in ESMA’s supervision and enforcement in this area. Although the Regulation regards the achievement of better rating accuracy to be correlated with the successful elimination of conflicts of interest, earlier discussion in this chapter has pointed to doubts about such a correlation. The nature of mandatory disclosures shows that the regulatory regime focuses very much on being able to exert controls over rating accuracy. The authors caution against supervisory collated and made available to the public via ESMA’s database CEREP, see http://cerep.esma.europa.eu/cerep-web/homePage/displayAbout.xhtml accessed 1 June 2013.


obsession with rating accuracy, as rating accuracy is a qualitative judgement and often made with the benefit of hindsight. It is highly uncertain whether, and if so how, any \textit{ex ante} action may be taken except in the clearest cases of regulatory breach. Further, ESMA’s concern for rating accuracy may entail unintended consequences where the market relies on ESMA’s judgement on credit ratings, exacerbating moral hazard. The authors suggest that the accountability and mandatory reporting by rating agencies could arguably assist ESMA in a more meaningful way in terms of monitoring systemic risk.

Information disclosure provided by credit rating agencies could prove useful to ESMA in overseeing systemic risk.\footnote{ESMA Regulation 2010, arts 24–25.} In particular, credit rating agencies are in a position to provide information on product trends and issuing patterns. The development of products provides an idea of how risk is being allocated in the investment economy and trends in market demand may give ESMA an overview of resource allocation in the markets. Further, product development information and market demand information could also generate early signals regarding price and asset bubbles. Asset prices\footnote{Andrey D Pavlov and Susan M Wachter, ‘Systemic Risk and Market Institutions’ (2009) 26 \textit{Yale Journal on Regulation} 445.} have been argued to be an important indicator of systemic risk and information disclosed by rating agencies could provide ESMA with insight into such developments. Perhaps what should be disclosed in annual reports are products rated by category and applicable rating methodologies and assumptions, volumes of products rated and the percentage of revenue tied to the products. Such information would provide much more insight into product and market trends for evaluation of investment conditions, asset prices and market behaviour. The general tenor of the Regulation and mandatory disclosures are arguably too concerned with imposing compliance with the proxy indicators regarded as being relevant to rating accuracy.

7.5 Promoting comparability of ratings

As the EU regulatory regime for credit rating agencies is the first attempt to centralise regulatory power, supervision and enforcement in ESMA, there is an almost natural tendency for the pursuit of market and legal integration to become important issues in ESMA’s governance role.

In line with the legal integration and regulatory convergence objective, ESMA endeavours to develop a single scale for comparability of credit ratings for the EU. ESMA has proposed developing a European standard for credit ratings, consolidating all published ratings whose dissemination is permitted in the EU into a standardised scale, in order to improve comparability.\footnote{The proposed European Rating Index (EURIX) is now known as SOCRAT. See Commission, ‘Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EC) No 1060/2009 on credit rating agencies’ COM(2011) 747 final, recital 23; ESMA, ‘Annual}
European Rating Index (EURIX) is to be established with the help of an information technology tool called SOCRAT developed by ESMA. This allows the European scale to be the convergent standard for the internal market. To facilitate the development of the convergent scale, ESMA has first developed a database known as CEREP. CEREP consolidates in one place the statistics on the performance of and historical default rates associated with published ratings so that both ESMA and investors can make informed judgements about any rating agency’s record of rating accuracy. By late 2012, it seems that the pursuit of a standardised rating scale for public use has been shelved as ESMA now regards SOCRAT as an internal tool that will assist in supervision. The authors are of the view that the pursuit of a standardised European rating scale is a misplaced one, for the following reasons.

We question whether the standardisation of all published credit ratings in the EU will discourage rating agencies from producing divergent opinions. Divergence may marginalise ratings that fit difficultly with a standardised scale. An unintended consequence of a standardised rating scale may be to introduce incentives to undermine objectivity in rating competence and rating quality, which is contrary to ESMA’s objective in regulating for rating accuracy. Further, the creation of a standardised rating scale could mean that ESMA is responsible for consolidating ratings and making judgements about which ratings to rely on and which to marginalise. Could this amount to a form of *ex ante* regulatory endorsement of particular ratings? Would this create moral hazard in investment markets or expose ESMA to liability if the representations on the standardised rating scale become misplaced judgements with the benefit of hindsight? Any mistaken assumptions fed into the standardised scale may become magnified across European markets and result in systemic impact. The creation of a standardised rating scale needs to be considered in terms of whether it may undermine regulatory efforts to control rating accuracy, and contribute to adverse systemic impact. Investors could perceive the standardised rating scale as the gold standard and it needs to be considered whether ESMA should take on such responsibility in substituting itself as a gatekeeper for investor protection, in view of the possible unintended consequences mentioned above and the liability ESMA could potentially be subject to for the representations made in a standardised rating scale.

The development of CEREP may be a useful information one-stop shop, but ESMA needs to consider its regulatory role and governance objectives in regulating credit rating agencies before embracing a standardised rating scale.

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7.6 ESMA’s supervisory and enforcement powers

A unique feature of the regulatory regime for credit rating agencies in the EU is that of direct registration with and supervision by ESMA. The Regulation, which was first enacted in 2009, envisaged a system of national registration supported by the CESR. Supervision was undertaken by a college of supervisors. This set-up was criticised as unwieldy and as ignoring the fact that the issue and use of credit ratings are not constrained by national boundaries. The 2011 amendments to the Regulation now designate ESMA as the body that registers credit rating agencies for the issue of ratings to be used in the EU and as the supervisor and enforcement agency in respect of non-compliance and breaches. Direct regulation and supervision by ESMA may arguably be an experimental phase for considering whether any further direct regulatory capacity may be assumed by ESMA in the future. One of the authors argued in an earlier book that the inexorable pace of regulatory convergence, pursuant to the almost constitutional goal of market integration, may need to be supported by some form of institutional centralisation, although total centralisation is perhaps not ideal or necessary.

A key area where ESMA capacity may be expanded is in direct registration or supervision of entities with significant cross-border operations or pan-European operations. Credit rating agencies fall within this category. ESMA demonstrated, in its first annual report, its engagement with supervision in the form of on-site inspections, dialogue and feedback with credit rating agencies. Although ESMA’s supervisory capacity may be confined to credit rating agencies, ESMA may see this as creating a template for its future supervisory capacity and therefore undertake supervision zealously. One should, however,
question whether supervisory costs are justified in an area where wholesale sector
investors could perhaps contribute more to governance. One may argue that
ESMA may only assume responsibility for pan-European wholesale sector issues
anyway as there are economies of scale in assuming such responsibility and
the advantage of eliminating fragmentation in national implementation. Pan-
European regimes with retail interests are likely to be primarily administered by
national regulators who are closer to their constituents’ interests. If this is so, then
the expenditure of any future supervisory cost to protect the wholesale sector will
be an issue that will require constant justification.

Article 23a provides ESMA with a suite of investigative powers to facilitate direct
supervision of credit rating agencies. Article 23b provides for the power to request
information from credit rating agencies, individuals involved in the agencies,
outsourcers, rated entities and their associates. Article 23c provides all powers
necessary to carry out investigations, such as taking copies and extracts of
documents, interviewing persons and examining any data traffic, while Article 23d
provides for the power to carry out inspections on the production of ESMA’s
written authorisation. Member State regulators may be requested to assist ESMA
where relevant. Where on-site inspections in a Member State are carried out,
national judicial intervention may control the proportionality of ESMA’s measures
but may not question the basis for the exercise of powers.200 Article 23e also allows
ESMA to appoint an independent investigator if infringement is suspected.

Article 24 allows ESMA to impose a range of sanctions including suspending
the use of credit ratings, temporarily prohibiting the issue of ratings, requiring the
rating agency to bring an infringement to an end, issuing public notices and
withdrawing registration. Affected persons are given an opportunity to be heard
before the above powers are exercised.201 Articles 36a and 36b also allow ESMA
to impose fines or periodic payments for infringements and ongoing infringements,
respectively. The supervisory and enforcement powers are, however, subject to
due process and judicial review. In terms of due process, ESMA must conduct a
hearing for affected persons before the imposition of any sanction or fine,202 where
such persons have the right to be defended. Article 36e provides that ESMA’s
decisions to fine or impose a periodic penalty payment may be subject to judicial
review. However, other sanctions in Article 24, such as withdrawal of registration

or suspension of ratings, may not be reviewable in the absence of an express provision.

One question that arises is the accountability and liability of ESMA in view of its enhanced powers and responsibility. The authors will argue that there are concerns regarding ESMA's accountability in view of the limited avenues and possibilities in holding ESMA to account in civil liability. This point will be explored further in Part 4 as critical examination is undertaken of the regulatory architecture in the UK and EU.

7.7 Concluding remarks

The regulatory regime is focused on monitoring the accuracy of rating quality akin to a measure in product regulation. Prospective reforms in 2013 allow investors to bring civil enforcement against rating agencies attempt to revive market discipline in the future. The aspect of public interest-based product regulation achieves contrary effects to the aspect of revival of market discipline to encourage the viability of ratings as a market good. However, the pursuit of potentially contrary directions indicates that policymakers are undecided about the fundamental objectives in regulating credit rating agencies. At some point in time, there should be a review of the regulatory regime in terms of whether it is necessary to continue putting ESMA in a position to supply wholesale sector investor protection by supervising the quality of credit ratings as an essential information good for the wholesale sector.

This chapter argues that controlling proxies for rating accuracy, such as conflicts of interest, and compelling disclosure of rating assumptions and methodologies may only go so far in ensuring rating accuracy. Given the Regulation’s emphasis on rating quality, has the Regulation in fact characterised credit ratings as public goods? ‘Public goods’ are defined as goods that are collectively enjoyed by society, but the provision of which is often subject to a collective action problem, and so the state is ultimately looked to in order to supply it. Ratings do not exactly fit the above definition as they have arisen as a private good to satisfy market demand for information mediation. The failure of a private good need


\[204\] A number of commentators are of the view that ratings as a good enjoyed by both issuers and investors serve an important purpose in mitigating information asymmetry for publicly issued securities and mitigates moral hazard and shirking by issuers, therefore akin to a ‘public good’, see Herwig Langohr and Patricia Langohr, *The Rating Agencies and Their Credit Ratings: What They Are, How They Work and Why They are Relevant* (Chichester: John Wiley & Sons 2009), 420; Raquel Garcia Alcubilla and Javier Ruiz del Pozo, *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (Oxford: Oxford University Press 2012), 249.

\[205\] Such that each individual’s consumption of the good does not lead to a reduction in any other individual's consumption of that good.

not warrant regulatory intervention to the extent of instituting product regulation (which entails high regulatory commitment and cost). However, the Regulation’s approach in product regulation may effectively reinforce or elevate the status of ratings in the investment markets without engaging in bolder or more radical reforms that would overtly address how a public interest-based regime for regulatory governance should be designed. Although the prospective reforms of 2013 indicate moves towards enhancing more private accountability and market responsibility for the viable functioning of credit ratings, the maintenance of a product regulation approach in the EU regulation could detract from policymakers’ hopes of less investor reliance and increased market discipline. The potential for moral hazard is high, and ESMA’s supervisory role may not radically bring about a cultural shift in the rating agency industry to see itself as performing a service that has public interest impact.

We also question whether the regulatory regime has explored the potential of other forms of governance to address the lack of market discipline for rating accuracy. Goodhart,\(^\text{207}\) for example, suggests a more limited form of oversight, by an independent government agency set up to monitor credit rating agencies’ methodologies and to back-test the accuracy of ratings. This would confine the supervisory oversight of credit rating agencies to the precise issue of rating quality and competence. Moreover, the body would be a technocratic body that could match the rating agency in terms of expertise. Nevertheless, we question whether the existence of such an agency would not give rise to the same issues of moral hazard and lack of engagement by the wholesale investor community as mentioned previously.

Other commentators advocate alternative governance options to mitigate conflicts of interest, an issue often confounded with rating accuracy. Alternative models of funding for credit rating agencies have been proposed in order to move away from an issuer-pays model. Manns suggests a user-pays model where investors would make contributions into a pool administered by a central regulator and raters would need to win a bid to rate based on tender specifications put out by the regulator. Successful raters would then be paid out of the pool.\(^\text{208}\) Rating agencies would have proximate and contractual relationships with the user base and this could make discipline much easier. Lynch argues for a public-pays model to pay for ratings that are relevant to public risk analysis.\(^\text{209}\) This can be done in three possible ways: (a) by creating a taxpayer-funded public institution whose role is to conduct and provide substantive risk analysis; (b) by having the government


\(^{209}\) But the running a public credit rating agency may result in greater investor reliance and less development of due diligence, exacerbating moral hazard and the lack of competition, see Raquel Garcia Alcubilla and Javier Ruiz del Pozo, *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (Oxford: Oxford University Press 2012), 250.
pay selected private rating agencies for rating services; or (c) by providing tax or
other financial incentives to private rating agencies that provide accurate ratings.\textsuperscript{210} On one level, it may be argued that these models deal with the old conflicts of
interest problem, previously shown to have little effect on the quality of ratings. But, at a more fundamental level, these ideas or a combination thereof could change the mission or purpose of credit rating agencies such that ratings may be seen not only as information products for the market, but as services for
governance and gatekeeping.

We suggest that it would be more fruitful for ESMA to include the supervision
of credit rating agencies in its systemic risk oversight. In this way, more meaningful
information (such as product and market trends) could be discerned from the
disclosures made by rating agencies, which in turn could contribute to macro-
prudential supervision (another of ESMA’s roles)\textsuperscript{211} and to its mandate to assist
the European Systemic Risk Board (ESRB).\textsuperscript{212} Further, we are concerned that
certain measures may even promote systemic risk, such as the unintended con-
sequences of promoting a standardised European rating scale. The \textit{Financial Times}
observes that:

Regulators, particularly those in Europe, have been keen to clamp down on
rating agencies ever since the crisis. But the motives have never been entirely
noble. It has been governments with weak state finances and banks with
troubled balance sheets that have squealed loudest about the unfettered
power of the agencies.\textsuperscript{213}

The regulatory regime in the EU for credit rating agencies highlights the
contest between different forces in financial regulation. Intrusive controls into
rating accuracy provide the opportunity to exert politically motivated control over
credit rating agencies, while legitimately addressing ‘market failures’. This
approach may, however, inhibit the extent to which the regulatory regime may
be shaped to address the needs of systemic risk monitoring and maintaining
financial stability. The expansion of regulatory control over credit rating agencies
and the transfer of such regulatory responsibility to ESMA provide a novel
opportunity for ESMA to develop direct regulatory expertise. However, it is
arguably imperative that ESMA bring its governance to bear on pan-EU financial
stability and systemic risk issues. In view of the dangers of moral hazard and the
question of sustainability of the product regulation approach in the Regulation,
we support reinforcing the governance potential of wholesale sector investors as
a step in the right direction and that the viability of credit ratings should ultimately
be an issue returned to the market for discipline and scrutiny. Perhaps the civil

\textsuperscript{210} Timothy E Lynch, ‘Deeply and Persistently Conflicted: Credit Rating Agencies in the Current
\textsuperscript{211} ESMA Regulation 2010, arts 23–24.
\textsuperscript{212} To be discussed further in Part 4.
\textsuperscript{213} Patrick Jenkins, ‘Rating Groups could Self-Regulate’ \textit{Financial Times} (London, 26 June 2012).
litigation action in the prospective reforms of 2013 should in fact be bolder, allowing civil actions against flawed ratings based on negligence, perhaps also easing investors’ burden of proof and proof of causation of loss. Finally, ESMA should carefully consider whether the pursuit of other objectives, such as dogged legal integration, may not have an adverse effect at times.

In the next chapter, we will examine regulatory reforms in the retail market and the markedly paternalistic approach taken in relation to consumer protection.
Consumer protection in the retail market has become the poster boy for financial regulation reforms in the wake of the global financial crisis of 2008–9. Evans argues that regulatory intervention in consumer protection is an attractive option for policymakers who wish to be seen to be doing something important to redress the crisis even if consumer protection may not be directly relevant to the causes of the crisis. However, the authors do not view the post-crisis consumer protection reforms as being merely sound and fury. The authors suggest that the ideological currents of renewed strands of paternalism supporting consumer protection reforms were in motion prior to the crisis. Renewed strands of paternalism, such as libertarian paternalism, are finding favour with commentators, and libertarian paternalism is often described as relevant to consumer behaviour, which is arguably irrational and subject to behavioural limitations, therefore requiring regulatory protection.

The reassertion of regulatory power in the post-crisis phase has given a boost to underlying currents of greater paternalism in consumer protection, but such paternalism, initially based on transactional suboptimalities such as bounded rationality on the part of consumers, is being infused now with protective elements that relate to the public interest of financial stability. Further, the post-crisis emphasis on consumer protection could usher in a regulatory

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2 See, for example, Cass R Sunstein and Robert H Thaler, *Nudge* (New Haven, CT: Yale University Press 2008); this point will be elaborated upon shortly.
culture that is socially minded and based on regulatory objectives that seek to achieve more socially oriented outcomes such as stability, justice and welfare. The fundamental premise of the regulatory objective of ‘investor protection’ in the retail sector is changing from an efficiency-based narrative that supports proportionate regulatory intervention to a more protective narrative that hints of the social dimension of public interest. However, it could also be critically argued that the increase in paternalistic consumer protection is necessary in order to prevent consumer withdrawal from the financial market and hence consumer protection may be intended for more insidious objectives such as supporting financialisation. But the authors suggest that such a critical argument may fail to acknowledge that access to finance may serve social utility purposes and hence a protective regime for consumers who wish to access finance should not merely be seen as assisting the financial sector. Although there is a concurrent movement to enhance consumer financial literacy in the UK, the regulatory tenor is not geared towards ‘responsibilising’ the consumer in such a way that the consumer becomes the backstop of market discipline. In the UK and in the EU, the regulatory stance in consumer protection is increasingly one that is paternalistic and protective, hinting of shifting underlying premises in consumer protection regulation towards a more social dimension.

In the UK, the Retail Distribution Review, a major initiative to reform the conduct of sale and distribution of investment products, was launched in 2006, before the onset of the global financial crisis. The crisis has, however, provided an opportunity to rethink consumer finance in light of the rise in the importance of ‘financial stability’. Although the global financial crisis of 2008–9 imploded in the wholesale sector, Gerding argues that the underlying layer of consumer activity in the US sub-prime mortgage market was key to the precipitation of the financial crisis. 


7 Such as by the establishment of the Consumer Financial Education Body (Financial Services and Markets Act 2000, sch 6) and www.moneymadeclear.gov.uk, the FSA’s website for improving consumer financial awareness according to its objective (Financial Services and Markets Act 2000, s 3). See also discussion in Toni Williams, ‘Empowerment of Whom and for What? Financial Literacy Education and the New Regulation of Consumer Financial Services’ (2009) 29 Law and Policy 226.

8 Ronen Shamir, ‘The Age of Responsibilization: On Market-Embedded Morality’ (2008) 37 Economy and Society 1. But see critical discussions in Martin Schütz, ‘Financial Education for the Poor in the US’, in Peter Mooschlechner, Helene Schuberth and Beat Weber (eds), The Political Economy of Financial Market Regulation (Cheltenham: Edward Elgar 2006), 140, who argues that there is a limit to what responsibilisation can do and that it would be insidious if consumers in need of protection were left to their own devices in the name of ‘responsibilisation’.

The impetus in governing the retail sector is now arguably derived from the rejuvenation of the regulatory objective of financial stability and mitigation of systemic risk. The financial stability narrative supporting increased paternalism in consumer protection seems to take on a character relating to public interest in the sociopolitical dimension and is not merely based on an economic understanding relating to the supply of public goods.

This chapter will now examine the rise in paternalistic reforms to consumer protection in financial regulation and critically discuss the challenges ahead. We will argue that the enhanced paternalism in consumer protection is initially based on research on behavioural limitations, which could support an extension of the ‘market failure’ basis for enhanced consumer protection. The new post-crisis emphasis on financial stability and systemic risk now seems to have allowed the introduction of more overt public interest and social justice rationales for consumer protection. Post-crisis consumer protection reforms are arguably based not only on preserving financial stability and mitigating systemic risks, but on questioning the social utility of financial services and ensuring that such social utility is delivered for consumers. Notwithstanding the overtly paternalistic stance of much post-crisis consumer protection reform, there are pockets of reflexive forces of governance that support consumer choice, discipline and redress. This chapter will discuss how such reflexive bottom-up governance forces may be strengthened, while avoiding the pitfalls of ‘responsibilisation’ in the retail sector.

8.1 Justifying paternalism in consumer protection in the financial sector

The rise in behavioural economics, studying the cognitive limitations of human beings in making choices and decisions, has paved the way for the theoretical rejuvenation of paternalistic intervention in general policymaking. Behavioural economics has inspired the rise of behavioural law and economics. Behavioural law and economics rejects the overly simplistic assumptions of consumers as rational actors in their transactions and perhaps rightly argues that economic

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11 Key classics on behavioural economics are Robert Prentice, ‘Whither Securities Regulation? Some Behavioral Observations regarding Proposals for Its Future’ (2002) 51 Duke Law Journal 1397; Thomas Gilovich, Dale Griffin and Daniel Kahneman (eds), Heuristics and Biases: The Psychology of Intuitive Judgment (Cambridge: Cambridge University Press 2002). However, there are also commentators who doubt that behavioural tendencies require a move towards regulatory paternalism to achieve optimal social outcomes; for example, Roman Inderst, ‘Retail Finance: Thoughts on Reshaping Regulation and Consumer Protection after the Financial Crisis’ (2009) 10 European Business Organization Law Review 455, who argues that the unqualified good of regulatory paternalism should not be assumed and that market innovation and competition can provide mitigating forces. Part of the critique against paternalism based on behavioural limitations will be discussed shortly.

theories of transactional regulation, such as disclosure, are insufficient to protect consumers. As consumers are boundedly rational, softer forms of paternalism such as libertarian paternalism attempt to strike a balance between recognising the transactional freedom of consumers while providing nuanced paternalistic intervention in order to help consumers meet their needs in the market. The UK regulator also believes that behavioural biases affect consumer choices and is committed to informing regulatory interventions by research into behavioural law and economics.

Sunstein and Thaler argue that softer forms of paternalism, such as libertarian paternalism, are necessary in order to nudge citizenry towards more optimal outcomes. Paternalistic governance is justified because governments and regulators may be able to make more optimal welfare choices than those made by individuals, but paternalism need not be oppressive or disempowering. Libertarian paternalism could frame choice sets for citizens in order to encourage reflection, without allowing them such freedom of choice that poor and suboptimal choices are made. Libertarian paternalism is seen to be especially appropriate for the financial sector where a dizzying array of products in credit or investment can easily obfuscate and confuse consumers. A critic, however, points out that if softer forms of paternalism such as libertarian paternalism are to assist consumers overcome cognitive biases and limitations, then such paternalism should be limited to addressing the biases or limitations such as through education or advice. The paternalism often goes much further and is in fact directed towards predefined policy outcomes. Hence, softer forms of paternalism are based more on political choices than on overcoming behavioural biases. It is feared that softer forms of paternalism may mislead citizenry into accepting political choices without subjecting such choices to debate and scrutiny. In this way, softer forms of paternalism may be more insidious and disempowering, as citizens may subconsciously be persuaded to adopt the consensus view without subjecting the issue to due debate and accountability.

Ben-Porath acknowledges that paternalistic intervention provides predetermined welfare choices. However, he argues that predetermined welfare choices could promote individual benevolence and general civic well-being as a whole. Paternalistic interventions may benefit individuals whose choices may have been poorer for cognitive limitations and balance the welfare interests of different groups in society.\textsuperscript{21} It may seem simplistic to assert that individual well-being and collective well-being would simultaneously be achieved. Would not there be potential conflicts between individual optimality and aggregate welfare needs?\textsuperscript{22} Further, commentators\textsuperscript{23} argue that paternalism that provides for predetermined welfare choices has to be implemented at the individual level, and such an approach may actually miss meeting the objective of securing aggregate optimal welfare.

Further, can the argument be sustained that bureaucrats would make better choices than consumers in the market, justifying paternalism in framing consumers’ choices? If all human beings are subject to the same cognitive biases and limitations, then even bureaucrats are subject to them. Bureaucrats in charge of governance will not necessarily make better welfare choices than individuals.\textsuperscript{24} Although Munro acknowledges that paternalistic intervention may also be subject to cognitive limitations on the part of bureaucrats, Munro remains optimistic concerning the collective deliberations of bureaucrats and policymakers. He also argues that groups of bureaucrats, especially with external consultant input, may be better placed to make what are objectively more optimal welfare choices.\textsuperscript{25} He advocates paternalistic interventions in the short term, to be accompanied by bottom-up learning over the longer term so that citizen choices can be guided towards optimal decision-making in the long term.\textsuperscript{26}

However, it remains to be seen if increased paternalism would entail moral hazard in the long term. An empirical study\textsuperscript{27} on financial decision-making finds that increased paternalism generally results in poorer levels of information in the market, declining quality of advice and the lack of motivation on the part of

\textsuperscript{24} Edward L Glaeser, ‘Paternalism and Psychology’ (2006) 73 University of Chicago Law Review 133, arguing also that bureaucrat choices could also be subject to lobbying and capture; On Amir and Orly Lobel, ‘Stumble, Predict, Nudge: How Behavioral Economics informs Law and Policy’ (2008) 108 Columbia Law Review 2098, arguing that political choices underlie the welfare choices made by bureaucrats and that it is democratically questionable whether softer forms of paternalism can make such political choices look appealing and acceptable.
\textsuperscript{25} Alistair Munro, \textit{Bounded Rationality and Public Policy: A Perspective from Behavioural Economics} (Dordrecht: Springer 2009), ch 6.
\textsuperscript{26} Alistair Munro, \textit{Bounded Rationality and Public Policy: A Perspective from Behavioural Economics} (Dordrecht: Springer 2009), ch 6.
consumers to learn. So, although increased paternalism may overcome weaknesses in consumer decision-making and market discipline, such paternalism needs to be balanced with the encouraging consumers to take reflexive approaches to contribute to discipline and governance in the financial services landscape. This chapter will discuss the weaknesses in the consumer market and how post-crisis reforms that are characterised by increased paternalism intend to overcome them. It is, however, important to bear in mind the limitations and flipsides to such paternalism, and the chapter attempts to flesh out the intended achievements and dilemmas in each reform. The concurrent emphasis on improving consumer financial literacy and education may equip consumers to consider the ‘choice sets’ offered to them, mitigating some of the concerns regarding moral hazard and disempowerment. The long-term benefits and effects of consumer financial literacy enhancement may provide some much-needed reflexive bottom-up governance to complement paternalistic governance and ensure adjustable levels of paternalistic governance in the future.28

Further, the accountability of regulators is a major issue that must be contended with in the face of the rise of paternalistic and pre-emptive forms of governance. This issue will be returned to and discussed in greater detail in Part 4, which deals with regulatory architecture and macro-prudential supervision.

Where consumer protection in financial services is concerned, the increasing appeal of paternalistic approaches may be attributed to the following factors: the perceived inadequacy of disclosure-based regulation in the face of consumer bounded rationality,29 and the empirically proven lack of consumer market discipline30 for product providers and distribution conduct in the financial sector. These two factors underlie the ‘market failure’ basis for increased paternalism in consumer protection.

The inefficacy of disclosure regulation as a form of consumer protection has long been debated. Weil and others argue that user discipline in the market is only effective to support disclosure regulation if the information disclosed is ‘embedded’ in the user’s decision-making process.31 However, a number of commentators argue that this is where disclosure regulation fails.32 Consumers,

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28 Elizabeth Warren, ‘Priorities for the New Consumer Financial Protection Bureau’ (Consumer Federation of America (CFA) Financial Services Conference, Washington, DC, 2 December 2010), also hints at this balance between regulator-led governance and consumer empowerment in the strategy of the US Consumer Financial Protection Bureau.

29 See references in Footnote 11.


especially of financial products, are inundated with a massive quantity of mandatorily disclosed information, but such information is most often not read, analysed or remembered. The delivery of mandatory disclosure does not help to highlight key information or facilitate comparability; it serves merely as a formality to be accomplished to avoid legal liability.\footnote{Van Dyck’s study also shows that prospectuses issued in Belgium are not read, downloaded from websites or analysed. This cognitive resistance to the thorough processing of financial product information extends even to well-educated and sophisticated persons.} Further, both van Dyck and Avgouleas\footnote{Van Dyck, ‘(Opt-out) Intermediation as an Alternative for Ensuring a True Protection for European Retail Investors?’ (December 2009) http://ssrn.com/abstract=1527767 accessed 6 January 2013.} argue that strong heuristics and biases – such as optimism in a bubbly asset market, herding and loss aversion in a weak market – all perpetuate suboptimal decisions in investment and trading behaviour, even in the sophisticated sector. Howells argues, for example, that the optimism bias can induce consumers to downplay the significance of risk warnings when they are interested in pursuing particular financial products.\footnote{Emilios Avgouleas, ‘The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a New Orthodoxy’ (2009) 9 Journal of Corporate Law Studies 23.} The UK regulator’s commissioned research into consumer behaviour in 2004\footnote{Conquest Research Ltd (for the FSA), ‘Consumer Understanding of Financial Risk’ (November 2004) CR33 www.fsa.gov.uk/pubs/consumer-research/crpr33.pdf accessed 6 January 2013.} shows that consumers of financial products generally fall into three categories: trusters, partners and controllers. Trusters are consumers with low sophistication, relying heavily on advice given to them, keen on returns and little able to appreciate downside risks. Partners are consumers who do some independent research and have a better understanding of their needs and products, but still rely on advice and distribution channels to complete product applications. Controllers are more sophisticated, generally do independent research and are capable of avoiding using advisers or information intermediaries. The research indicates that trusters and partners form the major part of the financial consumer population. They are usually less than critical of financial products or advice and rely heavily upon the services provided by financial intermediaries. They seldom research or process information independently. Hence, disclosure regulation empowering choice relates very remotely to the behavioural profile of the majority of financial product consumers.\footnote{Niamh Moloney, How to Protect Investors: Lessons from the UK and EU (Cambridge: Cambridge University Press 2009), ch 2.} Indeed, the mismatch between consumer needs and the regulatory framework could result in losses and regulatory waste.\footnote{Even Ogus agrees that where such social losses occur, there may be a case for paternalistic intervention. See Anthony Ogus, ‘The Paradoxes of Legal Paternalism and How To Resolve Them’ (2010) 30 Legal Studies 61.
Second, there are severe difficulties in the exercise of consumer power as market discipline for the financial sector. Leaving aside the issue of market competition, consumers face difficulties in exercising market discipline in the pre-contractual stage, the post-sale stage and the enforcement of redress. This chapter will discuss how and to what extent regulatory intervention has attempted to overcome the imbalances in consumer discipline in all three stages. In the pre-contractual stage, the inadequacy of consumer market discipline is largely down to inequality of bargaining power and sophistication between consumers and product distributors including advisers, and the tendency for consumers to trust the investment professional. Consumers are often obfuscated by the variety of incomparable products and subtle differences in terms and conditions. Hence, paternalistic intervention has long existed in the form of various measures, such as disclosure, cooling-off periods, financial promotion prohibitions and so on. Post-crisis reforms will embark on even more interventionist trajectories, such as product intervention and controls over perverse incentives in the conduct of business (e.g. Retail Distribution Review reforms). In the post-sale stage, consumers may realise that the product does not match their needs or they may be treated harshly if they fall into financial difficulty. The general common law in the UK has not been able to meet consumer needs even if civil actions have been taken. Post-crisis reforms in the UK – in the form of the MCOBS (dealing with mortgage arrears), the BCOBS (dealing with banking customers), and the UNFCOG – all attempt to provide more robust paternalistic intervention to protect consumers. In terms of consumer redress, although there are channels for informal and relatively inexpensive forms of consumer redress, consumer ignorance or inertia can prevent them from seeking redress. Wolf opines that consumer market discipline is lacking, disorganised, ill-incentivised and weak. Further, there is a lack of credible and unexploitative collective avenues for similar consumer claims to be managed together to seek redress. Consumer

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41 Financial Services and Markets Act 2000, s 21(1).
42 See, for example, The Office of Fair Trading v Abbey National Plc & Ors [2009] UKSC 6.
43 Mortgage Conduct of Business Sourcebook in the FSA Handbook.
44 Banking Conduct of Business Sourcebook in the FSA Handbook.
redress is also to be beefed up with interventionist action taken by the UK regulator, such as the setting up of redress schemes under section 404 of the amended Financial Services and Markets Act (as of 2010) and the special redress provisions in DISP App 3\(^{48}\) applicable to consumers who have purchased payment protection insurance (an area that is regarded by the UK regulator to have fallen into widespread mis-selling). Several commentators\(^{49}\) who have undertaken a general comparative study in consumer protection regulation further opine that there are many unique features in consumer financial services that require consumer protection to be specifically provided for as the market will not be able to address them.

In the wake of the global financial crisis, paternalism in consumer protection has been boosted,\(^{50}\) and support for this does not seem to be solely derived from a market failure thesis based on behavioural economics research. The heightened social aversion to misdeemeanour in the mis-selling of financial products (albeit long-running problems not unique to these times) has given rise to media and academic articulation of public interest narratives underlying consumer protection in financial regulation.\(^{51}\) Consumer protection in financial regulation is now not only regarded as a transactional problem fraught with persistent market failures, but an area of abuse and exploitation, exposing the disconnect between finance and social utility. The key consumer protection measure of product intervention that will be discussed below is the highlight of post-crisis reforms in consumer protection, reflecting a shift in the fundamental premise of consumer protection regulation in finance from an extended market failure thesis towards critical scrutiny of the social utility of consumer finance.

We will now address the post-crisis reforms in all three stages of the consumer’s relationship with financial service providers.

8.2 Enhanced regulatory intervention in pre-contractual consumer protection

In the context of pre-contractual consumer protection, information asymmetry and inequality in bargaining power between the consumer and financial institutions are the key reasons for more paternalistic forms of regulatory intervention.

\(^{48}\) Dispute Resolution: Complaints in the FSA Handbook.


for consumer protection beyond disclosure regulation. Such paternalistic measures are already in place: namely, financial promotion restrictions, conduct of business regulation in pre-sale representations, pre-sale conduct (such as cold-calling) and assessments of suitability and appropriateness where personal recommendations are made. Where distance selling is concerned, the Distance Marketing of Consumer Financial Services Directive also provides for mandatory cooling-off and refund rights on top of disclosure regulation.

The tempo of post-crisis paternalistic intervention has been stepped up to address pre-contractual conduct and mis-selling to consumers. In the UK, a major conduct of business reform, in the form of the Retail Distribution Review, seeks to address perverse incentives that may affect the quality of pre-sale advice to consumers. Further conduct of business reforms are also being considered in the EU with possible amendments to the Markets in Financial Instruments Directive (MiFID). These reforms may introduce the power of product intervention and narrow down the scope for execution-only products that can be sold without advice.

54 Financial Services and Markets Act 2000, s 145; FCA Handbook (as of 30 April 2013, formerly FSA Handbook) COBS 4.8.2, 4.8.3.
60 Distance Marketing of Financial Services Directive, art 8.
8.2.1 Retail Distribution Review

The Retail Distribution Review (RDR) aims to address conflicts of interest in the provision of investment advice and also seeks to clarify for consumers what advice they may be getting in relation to financial products. The RDR does not apply to personal pensions and protection insurance products. The RDR intends to improve the quality of advice through the prohibition of product provider commissions. From 2013, the RDR requires investment advisers to draw up a scale of charges for advice up front, so that remuneration is calculated according to the adviser charges and not paid by way of product commissions. This regime will also apply to online platform providers. This is intended to remove any perverse incentives that may be introduced by product commissions influencing advisers to encourage consumers to purchase any particular products. However, some concessions are made to mitigate the potentially high cost for consumers. Advisers may be paid via deductions made to the customer’s investment amount but, however the payment is made, payment for advice must not be linked to product providers. Product providers are banned from giving customers cash rebates to pay advisers. Customers may obtain ‘unit rebates’ from product providers. Factoring is also banned in order to prevent the return of remuneration incentives influencing the quality of advice.

The RDR requires advice to be clearly labelled for consumers in the form of ‘restricted’ or ‘independent’ advice. Advice should not be labelled as independent...
unless the adviser is able to carry out a comprehensive and fair analysis of the market in order to find products suitable\textsuperscript{70} for the customer’s needs and the advice is capable of being unbiased and unrestricted to any range of products.\textsuperscript{71} The ownership of an investment firm by a product provider need not affect the labelling of the advice, as long as the advice is truly ‘independent’. Independent advice is evidenced by the breadth of research and evaluation of suitability for the customer.\textsuperscript{72} However, advice to invest in one product that invests in a number of underlying investments should not automatically be regarded as fulfilling the ‘independence’ requirement.\textsuperscript{73} The RDR’s standard of independence is not merely about managing conflicts of interests, but is related more to suitability and the ability to show customers that the adviser is free from any particular incentives to recommend particular products. ‘Independence’ is hence closer to ‘tailor-made’ advice. An FSA empirical research study found that tailor-made encounters are one of the most useful mechanisms for meeting the needs of consumers,\textsuperscript{74} the benefits to consumers ranging from the satisfaction of having made appropriate investments to longer-term learning and enhancement in the capacity of consumers to make financial decisions in general. The RDR may entail longer-term effects in improving financial literacy and perhaps also empowering consumers to better exert market discipline as a form of governance. In the short term, however, regulatory supervision of dispensers of ‘independent’ advice is important to foster the credibility of the ‘independent’ advice standard.

One commentator,\textsuperscript{75} however, doubts whether ‘independent’ advice is in consumers’ interests. As product commissions provide advisers with incentives to become more knowledgeable in product information, the removal of any remuneration links to products may drive down the general quality of knowledge

\textsuperscript{70}Within the meaning of ‘suitability’ or ‘appropriateness’ defined in FCA Handbook (as of 30 April 2013, formerly FSA Handbook) COBS 9 and 10. ‘Suitability’ requires investment advisers making a personal recommendation to obtain sufficient information from the customer to ensure that the product purchased meets the customer’s investment objectives, is understood by the customer and that the customer is able to bear the financial risks associated with the product. See Zaki & Ors v Credit Suisse (UK) Ltd [2011] EWHC 2422 (Comm), [2011] 2 CLC 523.

\textsuperscript{71}FCA Handbook (as of 30 April 2013, formerly FSA Handbook), COBS 6.2A.3.

\textsuperscript{72}FSA, ‘Distribution of Retail Investments: Delivering the RDR – Feedback to CP09/18 and final rules’ (March 2010) PS10/6 www.fsa.gov.uk/pubs/policy/ps10_06.pdf accessed 6 January 2013, paras 2.8–2.13.

\textsuperscript{73}FSA, ‘Distribution of Retail Investments: Delivering the RDR – feedback to CP09/18 and final rules’ (March 2010) PS10/6 www.fsa.gov.uk/pubs/policy/ps10_06.pdf accessed 6 January 2013, para 2.13.

\textsuperscript{74}Adele Atkinson (for the FSA), ‘Evidence of Impact: An Overview of Financial Education Evaluations’ (July 2008) CR68 www.fsa.gov.uk/pubs/consumer-research/crpr68.pdf accessed 7 January 2013. However, another study finds that commissions drive advisers to research and become more acquainted with product information, while a lack of incentives (such as commissions) may tend towards a generally low standard of banal and boilerplate advice; see Roman Inderst, ‘Retail Finance: Thoughts on Reshaping Regulation and Consumer Protection after the Financial Crisis’ (2009) 10 \textit{European Business Organization Law Review} 455.

and advice. The UK regulator acknowledges that it remains to be seen if independent advice will meet consumers’ needs and that regulatory supervision needs to be intelligent and intensive\textsuperscript{76} to make the ‘independent’ standard credible, as well as to monitor its effects in the consumer market. However, consumers themselves may not yet be in a position to be able to critically reflect upon the quality of any ‘independent’ advice sought and received.\textsuperscript{77}

Where advisers are unable to offer ‘independent’ advice, they may offer other forms of advice under the label ‘restricted’ advice. ‘Restricted’ advice is usually given when advisers are tied to a range of preselected products. Advisers need to disclose that advice is ‘restricted’ and why it is ‘restricted’.\textsuperscript{78} The regulator recognises that advisers may present their restrictions in such a way that the scope of their services is misleading to consumers. Hence, intensive and intrusive forms of supervision are again necessary to prevent abuse.\textsuperscript{79} Whether advice is ‘independent’ or ‘restricted’, upfront charges for advice may pose an obstacle to access to financial products. The regulator recognises that the RDR may mean that investment advice could become costly and out of reach for many. The regulator is therefore willing to allow two categories of restricted advice that may be more cheaply offered to consumers. One is basic advice, which is tied to a stakeholder product such as a deposit or savings account, and the other is simplified advice that can be offered online or over the telephone.

Basic advice may be provided via scripted questions and answers so that the cost of advice may be driven down.\textsuperscript{80} But such advice must be clearly presented as restricted and must nevertheless satisfy the requirement of suitability for the consumer.\textsuperscript{81} Simplified advice\textsuperscript{82} allows advisers to set up automated online procedures to sell products or telephone-advised sales. Simplified advice is tied to a range of preselected products that must be disclosed, and the advice is therefore restricted in nature. The advice is also likely to be cheaper for the consumer. The regulator is concerned that telesales procedures and automated online procedures must be suitably robust in order to meet the requirements of suitability, but simplified advice is not prohibited as such. In these two cheaper categories of advice, adviser charges must be disclosed up front.

\textsuperscript{76} FSA, ‘Distribution of Retail Investments: Delivering the RDR – Feedback to CP09/18 and final rules’ (March 2010) PS10/6 www.fsa.gov.uk/pubs/policy/ps10_06.pdf accessed 6 January 2013, para 5.3.
\textsuperscript{77} Alistair Munro, \textit{Bounded Rationality and Public Policy: A Perspective from Behavioural Economics} (Dordrecht: Springer 2009), ch 6.
\textsuperscript{79} FSA, ‘Distribution of Retail Investments: Delivering the RDR – Feedback to CP09/18 and final rules’ (March 2010) PS10/6 www.fsa.gov.uk/pubs/policy/ps10_06.pdf accessed 6 January 2013, para 5.3.
\textsuperscript{80} FCA Handbook (as of 30 April 2013, formerly FSA Handbook) COBS 9.6.
\textsuperscript{81} FCA Handbook (as of 30 April 2013, formerly FSA Handbook) COBS 9.6.12.
Adviser charging and the independent advice standard are key reforms in the RDR, complemented by reforms to enhance the training and qualification requirements for investment advisers. Further, all advisers, whether providing simplified advice or otherwise, will be subject to the same training and qualifications requirements imposed on advisers. This provides a minimum standard in terms of adviser competence, which acts as a consumer protection measure. Although the industry has retorted that competence requirements for simplified advice providers would drive up the cost of simplified advice and would be counterproductive to consumers seeking cheaper alternatives to expensive tailor-made advice, the RDR looks set to maintain a high level of consumer protection. It is true that such a high level of consumer protection imposes costs on both industry and consumers, but cost concerns for consumers may be alleviated through promotion of competition in the industry, which is one of the objectives of the UK regulator. Although it may be argued that costs will be passed on to consumers and that consumers will be locked out of the product market, it should not be assumed that competitive pressures are unable to help consumers alleviate cost.

The RDR arguably marks a step towards a changed tenor in consumer protection. It compels investment advisers to engage more intensively with customer-centred suitability and not merely to treat suitability as a duty that can be discharged by adhering to policies and procedures or box-ticking. In a broader sense, the RDR also compels the investment advice industry to consider the social utility of their role, going to the heart of the culture of conduct of business, and forces the industry to grapple with social justice narratives that increasingly permeate consumer protection regulation. The improvement in engagement with suitability may address one of the problems raised by the global financial crisis: the mis-selling of sub-prime residential mortgages. We also suggest that, in the longer term, consumer-focused behaviour that supports notions of consumer welfare and justice are likely to feed back into product development, perhaps encouraging the development of products that correspond more with social utility and not just industry-centred short-term profit-chasing, as Part 3 will discuss.

However, the RDR does not deal with situations outside of the ‘investment’ context. Although the RDR states expressly that it deals only with investment and packaged products with an investment element, it is queried whether the RDR should not be applied, in due course, to all financially related advice in order to stem the pervasive mis-selling culture in relation to all aspects of consumer finance. Outside of the ‘investment advice’ or portfolio management context, consumers may be given financial or financially related advice by claims firms, for example, who cold-call consumers and advise them on claiming refunds for payment

85 Where a personal recommendation is made, as is consistent with the threshold for attracting the duty of suitability or appropriateness, FCA Handbook (as of 30 April 2013, formerly FSA Handbook), COBS 6.1A.
protection insurance mis-selling. Such consumers would likely benefit from an extension of the RDR to these situations in order to prevent biased advice from being given due to commission incentives.

It may be argued that the extension of the RDR is not the cure for other advisory contexts not related to investment. The RDR only mitigates conflicts of interest in the advisory context, but does nothing more concerning the quality of advice, which is governed by the harmonised European legislation regarding investment advisors’ conduct of business and the duties of suitability and appropriateness. The interpretation of ‘suitability’ is rather limited and this may inherently limit what the RDR can do in terms of improving the overall quality and culture of investment advice. ‘Suitability’ requires investment advisers making a personal recommendation to obtain sufficient information from the customer to ensure that the product purchased meets the customer’s investment objectives, is understood by the customer and that the customer is able to bear the financial risks associated with the product. Hence, ‘suitability’ takes a micro view of the recommendation made to the customer: it asks the question whether the recommendation meets the suitability requirements, but does not ask the question whether there are other recommendations that may better meet the suitability requirements. Consumers arguably need advice that is based on comparative intelligence and this seems to be the point of the RDR’s ‘independent advice’ standard. Although the ‘independent advice’ standard in the RDR encourages that diligence precede the giving of advice, how is this diligence to be enforced? The legal interpretation of the advisory duty of ‘suitability’ may be too narrow and limited to compel this.

The EU is considering the relationship between product provider commissions and the quality of advice, but does not seem inclined to adopt the RDR. Instead, ESMA has provided a more general framework requiring remuneration policies in MiFID firms to be aligned with sound conflict of interest management and be subject to compliance vetting, senior management approval, and regulatory oversight for the purposes of investor protection. Although the RDR is a bold


87 However, it may also be argued that the requirements of suitability when applied robustly could improve the experience of consumers in seeking investment advice as such requirements are insufficiently adhered to at the moment. See FSA, Assessing the quality of Investment Advice in the Retail Banking Sector: A Mystery Shopping Review (February, 2013).


90 ESMA, Consultation Paper on Remuneration Policies and Practices (Sep 2012).
move to address a long-standing conflicts of interest issue that has dogged the investment advice industry and intends to promote better quality advice if advisers choose to provide ‘independent’ advice, Ferran warns that the opposite result could instead be achieved, viz that advisers choose not to be independent and leave the industry or provide only restricted advice. If the financial advice industry is dominated by restricted advisers, then regulatory intervention would ironically bring about a landscape of poorer choice for consumers, without any improvement in securing better quality of advice. This would be contrary to the UK regulator’s (the Financial Conduct Authority (FCA)) objective of promoting consumer choice. This area needs to be further monitored in terms of whether the paternalism introduced brings about an increase in consumer welfare.

Another development on the horizon is the narrowing of the scope of execution-only services, which do not require advice and therefore do not attract the imposition of suitability or appropriateness duties. The MiFID 2004 allows non-complex transactions to be performed at the request of clients without attracting suitability or appropriateness obligations. Such non-complex transactions include purchase of UCITS units, equities, bonds and money market instruments in a liquid market. Consumers who engage in ‘non-complex’ transactions do not benefit from the protective regulatory regime. ESMA is considering the exclusion of investment instruments that embed a derivative or are based on securitised debt from the ‘non-complex’ realm so that advice obligations are attached. This measure would allow consumers who purchase non-plain vanilla products to be entitled to greater protection via the regulatory duties of suitability or appropriateness imposed under the Directive. The EU is not likely to change the basic suitability and appropriateness regulatory principles, but may extend their application. Further, the EU also proposes to tackle product bundling, which refers to the sale to consumers of a range of products as a package. Product bundling may result in consumers purchasing unnecessary products and being unable to make comparisons with the option of purchasing each product separately. The Commission proposes that advisers must provide advice on the cost of each product if purchased separately. Moloney is of the view that the above measures shows that EU policymakers are now more willing to engage in

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protective regulatory intervention on behalf of the consumer, moving away from the pre-crisis approach of leaving consumers to make sense of mandatory disclosure and make informed choices. These forms of paternalism arguably address the potential of mis-selling in non-advised sales and bundled products. However, consumers should note that these reforms only ensure that more information and advice is provided, and it remains important that choices are made with care. The limits of paternalism should be addressed by enhanced consumer education, which will be discussed in Section 8.5.

Another pre-sale consumer protection reform to which we will now turn is product intervention. Product intervention represents the high watermark of post-crisis regulatory resurgence in consumer protection, as it adopts a pre-emptive, paternalistic approach to consumer protection and is prepared to impose top-down command and control powers upon the industry.

### 8.2.2 Product intervention

Product regulation has not been a dominant feature of financial regulation. This means that financial regulation has seldom prescribed the features of investment products, leaving the design of such products to market forces and leaving it to the market to judge their quality. There are regulatory rules requiring UCITS to diversify their portfolios and not to engage in leverage, but direct or extensive prescriptions as to how products should be designed are not the norm. However, as the investment products available to retail customers have become more complex or exotic, it is increasingly difficult for retail consumers to exercise judgement in evaluating product features. Kay, for example, discusses the ‘kickout’ bond as a retail product, which allows investors to buy a product that is tied to the performance of the FTSE index. The bond has a maturity of five years. It pays out a 10 per cent return on the investment if the FTSE index outperforms itself from one year to the next and simply rolls on for a subsequent year otherwise, holding out for a 20 per cent return if the index outperforms itself two years down the line. If the FTSE index has still not risen above its initial level two years down the line, the bond rolls on again, promising a 30 per cent return if the FTSE index outperforms its initial level in the third year, and so on. At the end of five years, investors may thus make gains based on the year in which the FTSE Index outperformed its initial level (10–50 per cent) or they may recover their capital minus management fees and charges if the FTSE index has not outperformed its initial level during the period. Such a product makes the claim that it is capital-safe with the potential for high gains. However, such a product may also potentially...

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lock investors into following non-performance, and dis-incentivises them from allocating their capital elsewhere that may be more productive. The features of products such as the ‘kickout’ bond have become increasingly difficult for consumers to judge and products combining saving, investment, credit and insurance features are increasingly common in the consumer market. Bundled and complex products are prima facie unclear as to their economic functions, objectives and unintended consequences.\textsuperscript{99} Further, there are limitations to what disclosure regulation can achieve in the face of consumer cognitive limitations.\textsuperscript{100} The UK, in particular, is considering more intrusive early-stage supervisory intervention in product design, before products are released to consumers, as a form of pre-emptive paternalistic governance.

The UK regulator is considering a form of supervisory governance that lies somewhere between all-out product vetting and approval,\textsuperscript{101} and merely waiting for ex post complaints or consumer sanctions to take place.\textsuperscript{102} The regulator would be empowered to scrutinise the early stages of product design and to consider the risk and governance features of such products, the potential consequences of risk materialisation for consumers, the possible impact on the consumer market and so on, in order to determine whether pre-emptive intervention is necessary. Pre-emptive intervention may be in the form\textsuperscript{103} of banning products, at the most severe end, or attaching more severe conditions at point of distribution or sale, such as disallowing non-advised sales. The regulator could also make price interventions, require the use of warning labels or impose additional requirements in the process

\textsuperscript{99} A number of practitioners have reflected on the lack of product developer inquiry into key issues such as economic functions, objectives, unintended consequences, underlying values and accountability when new products are designed. See Margaret Armstrong, Guillaume Cornut, Stephane Delacote, Marc Lenglet, Yuval Millo, Fabian Muniesa, Alexandre Pointier and Yamina Tadjeddine, ‘Towards a Practical Approach to Responsible Innovation in Finance: New Product Committees Revisited’ (2012) Journal of Financial Regulation and Compliance 147.


\textsuperscript{102} FSA, ‘Product Intervention’ (January 2011) DP11/01 www.fsa.gov.uk/pubs/discussion/dp11_01.pdf accessed 7 January 2013. This is authorised by the Financial Services Act 2012 inserting new, s 137C into the Financial Services and Markets Act 2000, also FCA, Journey to the FCA (Oct 2012) on the pre-emptive, judgment-based style of supervision that will be carried out in relation to considering product design at an early stage.

of product design and development. Similar product intervention powers are considered in the EU. Indeed, ESMA has already used its discretionary warning power to intervene in certain consumer-oriented foreign exchange products, indicating its will to adopt more specific product intervention powers in due course. Further, as the UK brings consumer credit regulation and supervision, previously managed by the Office of Fair Trading, under the auspices of the FCA from 2013, the more overtly paternalistic and interventionist stance of the FCA will be applied to consumer credit sectors, such as credit cards and payday lending.

The authors argue that product intervention is not only a form of paternalistic consumer protection, in response to the behavioural limitations and lack of market discipline on the part of consumers, but is also one of the governance mechanisms for mitigating potential systemic risk and ensuring financial stability, and supporting the relation of social utility in finance to financial stability. Although systemic risk concerns due to consumer loss are not explicitly given as reasons for product intervention, the regulator is concerned about ‘incentives in the market’ generally, ‘credible deterrence’ for firms so that product design may be made more robust and suitable for consumers and, as far as possible, avoidance of ‘problems affecting large numbers of consumers’. The wider concerns about the systemic impact of poorly designed products, mass mis-selling and consumer losses are key drivers in shaping the post-crisis consumer protection regulatory regime. In determining how to exercise its powers in product intervention, the

108 Financial Services Act 2012, inserting sections 1H and 107 into the Financial Services and Markets Act. And see Martin Wheatley, ‘My Vision for the FCA’ (Speech at the British Bankers’ Association, London, 25 January 2012), in which the Chief Executive of the FCA expressly disavows the ‘rational consumer’ and seeks to take a more protective and interventionist approach to consumer protection, compelling product providers to design products on the basis of consumer needs.
109 This seems to be the position in the FCA, Journey to the FCA (Oct 2012), 12.
UK regulator will rely on information concerning the general retail sector outlook, firm data, press data, whistleblower information and other intelligence. The nature of regulatory governance in product intervention, although geared towards consumer protection, could also take into account wider financial stability. One concern is that regulators may exercise protective powers in a rather discretionary fashion. Such discretion may result in a hard-line approach to products when the reputation of financial regulation is at risk, such as upon the eruption of a scandal, and lighter touches in better times so as not to be perceived to be overreaching. The exercise of regulatory discretion in product intervention could result in opaque and inconsistent decision-making. However, it may be argued that the UK regulator will have to lay every product intervention decision before Parliament and so there is some channel of accountability, although accountability mechanisms may have to be developed further in the future.

A similar approach in product intervention is proposed to be taken in the EU. ESMA is tasked with consumer protection and the role of developing policies in consumer protection, and may collect intelligence on consumer market trends, financial literacy profiles and developments, and industry and firm information, in order to develop its policies and regulatory measures. ESMA is further empowered to ‘temporarily prohibit or restrict’ financial activities if systemic risk concerns arise. This suggests that ESMA’s approach to consumer protection may be aligned with its systemic risk role and hence a broader approach may be taken in the development of regulatory rules and policies. However, the development of consumer protection policies is an area where domestic regulators have great interest and say. Mak argues that domestic regulators will still take the lead in this area, leaving key cross-border issues to be dealt with at the EU level. In future, there could be tensions in the regulatory space between ESMA and domestic regulators such as the FCA.

At a broader level, how will the exercise of discretionary pre-emptive powers in the name of consumer protection shape the social perception of financial risk? Beck warns that we have become a ‘risk society’. Could regulatory governance in this pre-emptive and protective manner cause consumers to become more

118 ESMA Regulation 2010, art 9(5).
119 ESMA Regulation 2010, arts 23–24.
intolerant of financial risk than is necessary. Will regulatory paternalism encourage a form of behaviour that minimises personal responsibility but seeks third-party responsibility for risks? Financial regulation that seeks to achieve consumer protection based on social justice and welfare narratives could become overprotective and result in unintended consequences such as individual irresponsibility. Luhmann warns that ‘pre-emptive’ strategies (such as those used in regulatory governance) may themselves change the social perception of risk, incentivising more risky behaviour on the part of individuals. Will individuals be more willing to engage in financial risks because they perceive that financial products are now more or less ‘pre-vetted’? Will the general tenor of paternalistic consumer protection cause moral hazard: individuals to think that financial risk responsibility lies with financial institutions and that they may assume they are taken care of? It may nevertheless be argued that, as the consumer protection regimes and narratives relating to social justice and welfare were relatively weak in the pre-crisis years, it is time to enhance consumer protection and to embrace these narratives of social welfare and justice. Perhaps any concerns over the effect of paternalism in financial regulation on consumer incentives should be addressed later with the benefit of empirical observation. Ferran also suggests that the impact of product intervention on product choice also needs to be monitored, in particular with respect to whether product innovation is diminished. However, if regulatory scrutiny weeds out ‘socially useless’ financial innovation, that may not be a completely disadvantageous development. In sum, the authors welcome the infusion of social welfare and utility narratives into consumer protection in financial regulation, but the implementation of regulatory powers and their impact on the industry and consumers needs to be monitored in order for lessons to be learnt regarding the objectives of consumer protection, social welfare and industry behaviour.

We now turn to the final discussion on a possible reform in pre-sale consumer protection in the area of plain vanilla products.

### 8.2.3 Plain vanilla products

In the wake of the global financial crisis, policymakers across the globe are considering introducing plain vanilla products for consumers in order to mitigate the risks of more exotic products and their potential social impact in the event of loss. In the US, for example, it was earlier proposed that the newly established

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Consumer Financial Protection Bureau should introduce prescriptive measures to prohibit the sale of exotic products to consumers, so that consumers may only be exposed to plain vanilla products. This proposal has now been dropped due to concerns regarding the lack of innovation and choice. In the UK, it is proposed that a range of simple, ‘plain vanilla’-type products should be expressly made subject to a simple products regime so that consumers would be assured that such products in fact meet their basic and essential needs.

Product regulation in the form of simple products would mean that the product objective is set by regulatory prescription and mandatory features in the design of the products would reflect the objectives to be achieved, such as no risk to capital or no element of investment. Product providers may be able to add discretionary elements provided these are disclosed in a way that facilitates comparability, such as on a simplified risk scale. The simple product regime reflects the reality that some basic financial products are simply not an option for many people; a basic current account, credit card or mortgage may be essential items that should not be wrapped up in more exotic risks. A survey in 2006 showed that consumers were more unhappy with investment-related products that they purchased than other financial products such as insurance. Financial products wrapped up in a number of investment elements generally appear opaque and complex and do not cater for consumer preferences. The consumer representation body, the Financial Services Consumer Panel, has also expressed a need for straightforward-outcome products to be defined and provided to consumers. Following a consultation completed in 2010, the UK is going ahead with reforms to introduce a simple products regime, starting with savings accounts with straightforward standardised terms and life insurance.

A simple product regime may be criticised for limiting market innovation and creating moral hazard if consumers view the regime as underwriting the expected performance of the product. However, the simple product regime arguably contributes to meeting the needs of social utility in banking and finance. The regulation of simple products will likely reflect social needs, as the first range of

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simple products proposed by the Treasury\textsuperscript{132} relates to saving needs and provision for dependents in the event of death. A simple products regime may introduce a greater awareness of social responsibility in the design of products by financial institutions. Further, such products should not \textit{prima facie} be seen as profit-driven. The simple product regime should therefore be understood not only as a consumer protective measure, or as addressing market failures in the power of consumer market discipline, but should be understood as a regime that is geared towards determining the social utility and desirability of the role of banking and finance. If simple products are subsequently considered in credit products, such a regime could also arguably address problems such as the mis-selling of sub-prime mortgages. The residential mortgage product may be subject to mandatory features in a simple product regime, mitigating the possibility of opportunistic, opaque or harsh contractual terms.

In sum, the pre-sale consumer protection reforms outlined above have taken a markedly paternalistic leaning, aiming to mitigate individual, social and systemic risks in the consumer sector and moving towards compelling industry to act in a manner consistent with the realisation of consumer social utility. This is a unique area in financial regulation as financial regulation in general has shied away from asserting social utility and welfare narratives even in its renewed concern for financial stability and systemic risk. However, regulators need to be aware of changing perceptions of financial risk as a result of paternalistic governance in consumer protection. Next, reforms to post-sale consumer protection will be discussed with particular reference to the regulatory initiatives in the UK that intend to ensure that consumers are treated with more benevolence and fairness in post-sale situations.

### 8.3 Post-sale consumer protection

Consumer protection has also been reformed in the post-sale situation, particularly with respect to loan defaults and arrears. The values of fairness and benevolence are being emphasised in the treatment of consumers and, in the UK, the principle of ‘Treating Customers Fairly’\textsuperscript{133} refers not only to legal compliance and discharge of duties, but also to a spirit of fairness\textsuperscript{134} and from the avoidance of harshness, opportunism or abuse.

In the UK, the Mortgage Market Review\textsuperscript{135} is a major initiative to intervene in the post-sale contractual relations between mortgage borrowers who face financial difficulties and their lenders. The Review now prevents lenders from


\textsuperscript{133} FCA Handbook (as of 30 April 2013, formerly FSA Handbook) PRIN.

\textsuperscript{134} See FSA Enforcement Notice against Kensington Mortgage Co Ltd (12 April 2010).

imposing harsh contractual terms on borrowers. Thus, direct regulatory intervention into contractual relations may assist borrowers in paying off arrears quicker and avoiding being penalised harshly in an already difficult situation. For example, lenders are not allowed to impose additional charges on borrowers once an alternative payment arrangement has been established following default. Lenders are also prohibited from using borrower payments to pay off charges and interest before clearing arrears, thus ensuring that borrowers in financial difficulties may pay off arrears first and not be trapped in a vicious circle of ever-increasing charges and interest on arrears. The Review also prevents foreclosure from being a primary means of lender enforcement, requiring other repayment mechanisms to be exhausted first. The Review therefore allows regulatory governance to combat some of the harsher contractual terms for consumers.

Bank account charges for unauthorised overdrafts have also been featured as an example of harsh financial sector practice causing adversity to consumers who already have cash flow problems.136 The Office of Fair Trading, which administers the Unfair Terms in Consumer Contract Regulations, has identified four basic categories of relevant charges that it has sought to challenge as reviewable for unfairness: unpaid item charges, paid item charges, overdraft excess charges and guaranteed paid item charges. Each applies when the customer has insufficient funds in his or her account to make a payment. A number of banks have applied to the court to challenge the review of these terms, arguing that they cannot be subject to fairness review as they form part of the ‘consideration’ for the bank account service provided under contract. The Supreme Court finally agreed with the banks, saying that where bank charges applied to ‘free-if-in-credit’ accounts, the charges form part of the contractual package of consideration although not everyone pays them.137 It has therefore been up to the regulator to address the social consequences of the Abbey decision, which is confined to legal reasoning in contract law. The social consequences of the Abbey decision are that those with the weakest cash flow management or biggest cash flow problems may be penalised more heavily as they have failed to keep the account in credit. Reforms have been made to introduce a provision in the Banking Conduct of Business Sourcebook to treat customers fairly especially if in financial difficulties.138 The general principle of ‘fair treatment’ arguably includes avoiding harsh practices and allowing more room for benevolence in customer treatment.139

Further, the FSA has taken over the administration of unfair terms in financial contracts from the Office of Fair Trading and may be able to take a more

136 See, for example, a long-standing campaign by financial journalist Martin Lewis: Richard Evans, ‘Overdraft charges: it’s not over yet, says Martin Lewis’ The Telegraph [London, 25 November 2009].
138 FCA Handbook (as of 30 April 2013, formerly FSA Handbook) BCOBS 5.1.4.
139 For example, see FSA Enforcement Notice against Kensington Mortgage Co Ltd (12 April 2010), albeit in the mortgage context, the enforcement was based on the general principle of treating customers fairly, FCA Handbook (as of 30 April 2013, formerly FSA Handbook) PRIN2.1.6.
intrusive supervisory approach to scrutinising contractual terms that are harsh on consumers. Pre-emptive action on questionable contractual terms may be taken by the regulator. The regulator may first express concern about the terms directly to firms, giving them a chance to reconsider modifying questionable terms. Although Annex 1 in the UNFCOG sets out a list of terms that may cause concern with the regulator, the regulator’s discretion to inquire into the general unfairness of terms is not limited to the Annex. The exercise of pre-emptive governance powers under the UNFCOG is yet another example of how regulatory governance in consumer protection may actively promote greater post-sale benevolence to consumers despite contractual provisions.

The expansion of regulatory intervention into post-sale contractual relations between consumers and financial institutions introduces a social dimension of benevolence and fairness to the nature of regulatory governance. The embrace of increased paternalism in consumer protection in financial regulation facilitates the introduction and legitimization of social utility and welfare narratives into financial regulation, a development that is needed to provide balance to the dominant market-efficiency narratives in financial regulation. Moreover, such benevolence and fairness is not only oriented towards protecting individuals in difficult circumstances. Arguably, the wider concern of financial stability and systemic risk monitoring may permeate this approach, as widespread failures in the consumer market could create systemic crises. However, will the extent of regulatory intervention in pre- and post-sale consumer protection create moral hazard with consumers, an even greater failure of market discipline? This would boil down to placing inordinate demands on regulatory supervision to provide a public good that may amount to underwriting the private utility that consumers seek to obtain from their banking and financial products.

It may, however, be argued that, post-crisis, we are only just starting to acknowledge the social welfare and justice narratives in financial regulation in respect of consumer protection. Regulatory learning needs to take place after the light-touch regulatory approach that has persisted for years, even if there is a risk of overdoing consumer protection. Further, the weaknesses against which consumers must be protected are the very same reasons that render consumers unlikely to be able to provide a force for market discipline. However, that does not mean that steps to improve or allow consumer redress and enforcement should not be taken, as individual actions may still provide some form of discipline, as well as intelligence and information to regulators. The next section argues that the post-crisis consumer protection reforms aim to boost consumer redress; we will discuss what this may achieve.
8.4 Consumer redress and enforcement

The post-crisis reforms in consumer protection include empowerment of the consumer in seeking redress and enforcement. Empowering consumer redress and paternalistic governance are not contrary in nature and empowering the consumer does not necessarily mean that more is left to laissez-faire and market discipline. The two movements could converge into a single narrative of consumer protection that is pre-emptive and governance-led, but also reflexive in nature, so that governance learns from and mobilises the wider regulatory space including consumers. We will argue that, on close examination, consumer empowerment in seeking redress is fundamentally regulator-led (i.e. the possibility of seeking consumer redress is led by regulatory mechanisms that facilitate such redress and not by ground-up efforts alone). This form of ‘assisted’ consumer redress is arguably instituted in view of the weaknesses of consumer discipline in the financial sector. These weaknesses are due to the behavioural limitations of consumers, their weak bargaining power vis-à-vis the financial industry, the long-term and opaque nature of financial product performance and the diffuse nature of any consumer market discipline. Moreover, mobilising and empowering consumers may encourage a form of responsibilisation that mitigates some of the more perverse incentives discussed earlier.

An existing consumer redress avenue has been instituted since the establishment in 1997 of the FSA as a single regulator in the UK. The Financial Ombudsman service is an accessible redress platform for consumers. It operates independently, though under the wing of the UK regulator, and it has ‘compulsory jurisdiction’ over all persons registered or authorised by the regulator. The Ombudsman is able to decide cases based on principles of general fairness and justice without necessarily applying any principles of law. Although the Hunt Report in 2007 suggests that the service could be made even more consumer-friendly by having regional offices and out-of-office operating telephone lines, the Ombudsman is by and large a successful consumer empowerment initiative allowing aggrieved consumers to bring actions where legal costs and court procedures may previously have deterred such action.

The post-crisis reforms enabling consumer redress have gone further. The post-crisis UK Financial Services Act 2010, which amends the Financial Services and Markets Act 2000, provides for governance-led ‘consumer redress schemes’ under the new section 404. This scheme arguably showcases the new balance struck between paternalistic consumer protection and facilitating consumer discipline.

144 Financial Services and Markets Act 2000, ss 226, 226A, which relate to consumer credit matters.
147 Inserted via Financial Services Act 2010, s 14.
Under section 404, if the regulator considers that there is widespread regulatory failure by financial firms that may cause loss or damage to consumers, such loss and damage being actionable in a court of law, the regulator may demand the establishment of a ‘consumer redress scheme’ for such firms. The consumer redress scheme requires the affected firms to investigate their own breach and to inform affected consumers of such investigations and provide possible redress for them. Consumers who are not satisfied with the proposed redress and nevertheless wish to seek redress with the Ombudsman may do so.\(^{148}\) The power to require the establishment of a consumer redress scheme under section 404 may be exercised in relation to a number of firms, or even a single firm, where mass claims on a single issue are envisaged.\(^{149}\) As these powers put the regulator in a position of being able to make a judgement of regulatory failure without going through disciplinary or litigious procedures, the regulator will subject itself to a consultation process\(^{150}\) before establishing any consumer redress scheme, unless the power is to be exercised only in respect of a single firm.\(^{151}\) To date, the power under section 404 has been exercised in respect of two instances of mis-selling. One instance involves a single firm, Welcome Financial Services, where a consumer redress scheme was established in view of the firm’s insolvency and the need to address existing complaints against its mis-selling of personal protection insurance policies.\(^{152}\) The other instance involves well-known multinational bank HSBC Plc and its distributor and depositary, in relation to the mis-selling of investment products known as the Arch Cru funds. The Arch Cru funds allowed investors to invest in umbrella companies, which in turn owned companies in Guernsey. The Guernsey companies invested in high-risk assets such as private equity, which were also illiquid. The Arch Cru funds were marketed as low or medium risk to many retail customers, although the profile of the funds were obviously high risk and should only have formed a small part of any retail investor’s portfolio. A consumer redress scheme was established in December 2012\(^{153}\) after consultation for retail investors who have invested in such funds. The UK regulator is further examining\(^{154}\) how communications regarding possible redress are made to consumers, and is determined that such communications will encourage and not deter any consumer from coming forward.

\(^{148}\) Financial Services and Markets Act 2000, as amended by the Financial Services Act 2010, s 404B.

\(^{149}\) Financial Services and Markets Act 2000, as amended by the Financial Services Act 2010, s 404(7).

\(^{150}\) FSA Guidance Note No 10 (2010).


\(^{153}\) FSA, ‘Consumer Redress Scheme in Respect of Unsuitable Advice to Invest in Arch Cru Funds’ (December 2012).

A variant of the section 404 power has been exercised in the FSA’s establishment of specific dispute resolution procedures for financial firms involved in the sale of personal protection insurance (PPI). The PPI market has been the subject of consumer complaints for some time, with allegations suggesting the selling procedures are misleading, insufficient information is provided and consumer assessments are inadequate. In August 2010, the FSA established new rules specifically in relation to PPI. The new rules require that PPI firms carry out investigations into whether its selling practices have been unfair and misleading. However, this approach is unlike the section 404 consumer redress scheme: the section 404 scheme is a one-off enforcement event, but the FSA has made rules with respect to PPI firms, meaning that PPI firms are subject to consumer redress on a continuing basis. The rules require PPI firms to undertake ‘root cause analysis’, to reflect upon their complaint handling systems and to consider whether systemic and recurring problems may be present in their management control and complaint handling systems. The key approach to consumer redress is to require firms to consider whether consumers would have purchased PPI had it not been for the firm’s misconduct. The rules also introduce a presumption that consumers would not have bought PPI, unless the firm can prove that the consumers would have purchased PPI even in the absence of the firm’s mis-selling. Where a firm cannot fairly show that consumers would have purchased PPI anyway, the firm must refund the premiums paid or, where a loan is outstanding, arrange for the loan to be restructured taking into account the cancelled PPI and the amounts repayable to the consumer. Where a single premium PPI has been purchased, the firm must either refund the single premium or offer an alternative regular PPI policy. The above remedies are not exhaustive and the firm may offer other remedies that are appropriate. If firms fall short of offering


158 FCA Handbook (as of 30 April 2013, formerly FSA Handbook) DISP App 3.4.

159 FCA Handbook (as of 30 April 2013, formerly FSA Handbook) DISP App 3.6.


161 FCA Handbook (as of 30 April 2013, formerly FSA Handbook) DISP App 3.7.

adequate remedies to consumers under DISP App 3, the FSA may conceivably require enforcement under the general principle of ‘treating customers fairly’.

The British Bankers’ Association, on behalf of affected PPI firms, brought an action for judicial review of the special rules regarding PPI, arguing that the FSA had wrongfully used general principles of fairness to augment the Handbook rules in dealing with PPI issues and that PPI issues should be dealt with under the section 404 consumer redress scheme procedure. By enacting specific rules regarding PPI, the Association alleged that the FSA had wrongfully evaded the requirements of section 404. However, the court dismissed the Association’s arguments, upholding the regulatory power to make rules for PPI. The court argued that the general principle of ‘treating customers fairly’ is the substrata upon which more detailed rules rest and hence it is not beyond the regulator’s jurisdiction to make specific rules in relation to PPI. The judgment also suggests that section 404 is not the only tool at the regulator’s disposal for dealing with consumer mis-selling cases. Section 404 should be regarded as one of the powers that can be exercised, if appropriate, and is not to be regarded as a limitation on how the regulator may exercise its consumer redress powers. The court endorsed wide discretionary powers in the interests of treating consumers fairly. However, industry pressure has continued to bear upon the regulator as the industry seeks closure of the PPI issue as soon as possible. A public consultation is likely to be issued as to whether there should be a time limit for bringing PPI claims under the special PPI rules mentioned above.

Another special dispute resolution process has been enacted in DISP App 1 in the UK regulator’s Handbook to deal with mortgage endowment complaints. It requires firms to establish that customers would have bought the product in the absence of mis-selling and to restore the customer to a position equivalent to that in which no endowment mortgage was purchased, such as conversion to a regular mortgage on appropriate terms.

Further, there are reforms proposed to encourage consumer-led governance. As consumers are disparate and unlikely to be capable of organised action, the UK has initiated reforms under which the Treasury may endorse certain organised consumer interest groups so that these groups have the right to make a complaint to the regulator (the FCA from 2013). The complaint may be in respect of any feature or combination of features in the financial services markets that may be significantly damaging to the interests of consumers. The regulator is obliged to respond to such a complaint within 90 days of receipt stating whether it will take any action and the reasons for its response. The UK has also opened up an avenue for whistleblowers in the financial services industry to

165 FCA Handbook (as of 30 April 2013, formerly FSA Handbook) DISP App 1 generally.
166 Financial Services and Markets Act 2000, as amended by the Financial Services Act 2012, s 234C.
167 Financial Services and Markets Act 2000, as amended by the Financial Services Act 2012, s 234E.
168 Financial Services and Markets Act 2000, as amended by the Financial Services Act 2012, s 234D.
make a complaint to the regulator if an investment fund or a financial services provider is in breach of regulatory provisions and has caused, or is likely to cause, damage to consumers that could be legally actionable. Such complaints will be dealt with in the same way as those brought by consumer interest bodies recognised by the Treasury.

The discussion above shows that the UK regulator is developing leadership to facilitate the exercise of discipline by consumers. The regulator identifies the possible areas of concern in order to mobilise consumers seeking redress and provides out-of-court redress mechanisms in order to ensure accessibility to consumers. In so doing, the regulator takes upon itself the risk of judicial review and the cost of consultation, assuming a greater share of the private cost of consumer enforcement. In this regard, facilitating consumer redress is not only seen as a private, but also as a public good. The facilitation of consumer redress encourages consumers to be motivated to engage in some form of market discipline, therefore providing a necessary balance to overcome some of the moral hazard dangers mentioned above that are associated with the general increase in regulatory paternalism. The UK regulator continues to carry out research\textsuperscript{169} in how consumers may be motivated to seek redress and will recommend the adoption of certain styles and formats in consumer communication to motivate them. The book also supports the view that consumer protection is a public good from the point of view of how the consumer market may affect financial stability and systemic risk. Thus, governance-led consumer redress mechanisms should not be based only on the market failure of consumer discipline, but should also take into account broader systemic risk implications and considerations, and possibly the perspective that financial stability is linked to restoring social utility in banking and financial products for the consumer. Systemic risk perspectives could offer new insights into consumer redress. Hence, increased paternalism in empowering consumer redress addresses multiple objectives in financial regulation. For example, the personal credit card debt of the UK spending population could be a time bomb\textsuperscript{170} and increases in household savings in the post-crisis years could be exploited by unsuitable products.\textsuperscript{171} In the UK, it is important that the split of the UK regulator into a consumer protection authority and a prudential regulation authority does not undermine the infusion of wider stability concerns in consumer protection.


\textsuperscript{171} FSA, ‘Retail Conduct Risk Outlook 2011’ (2011) www.fsa.gov.uk/pubs/other/rcro.pdf accessed 8 January 2013, showing that with the onset of the global financial crisis, households have to some extent started deleveraging and attempting to save, but as interest rates on deposits remain low, the risk of channelling to investment products that may be unsuitable then becomes high.
As Martin Wheatley, the first Chief Executive of the UK’s FCA, states in relation to the trajectory of post-crisis regulatory supervision for the purposes of consumer protection, ‘Consumers of course have a role to play, and we need a cultural change at the regulator as well’. The cultural change in regulatory strategy and approach is towards paternalistic intervention at all stages of the consumer transaction, from pre- to post-sale. However, moral hazard following from increased paternalism may already have been foreseen. Hence, consumers are to be empowered through regulator-led channels, such as redress schemes and consumer interest bodies endorsed by the Treasury, and educated through a longer-term programme undertaken by the Consumer Financial Education Body. The balance between instituting protective paternalism and avoiding moral hazard is a difficult one, and that balance is also affected by industry pressures championing market efficiency perspectives, less intrusion and more room for innovation. Ferran is of the view that one must anticipate regulatory mistakes in this new landscape. However, the authors support the move towards this new landscape as narratives such as financial stability and social utility, long missing in financial regulation, are finally allowed to flourish. Further, there are concurrent developments to improve consumer financial literacy and education. These may provide the necessary balance to address some of the moral hazard dangers mentioned above that are associated with the general increase in regulatory paternalism.

8.5 Consumer financial literacy and education

The push towards improving consumer financial literacy has greatly increased since the global financial crisis, as the underlying cause of the crisis – the purchase of sub-prime mortgages by people who could ill afford these mortgages in the US – clearly reflects a global issue of consumer competence in making financial decisions. In the EU, the ESMA is tasked with ‘review[ing] and coordinat[ing] financial literacy education initiatives taken by national regulators’. In the UK, a dedicated consumer financial education body (CFEB) has been established under the umbrella of the FSA, to be subsumed under the FCA from 2013.

Consumer financial literacy education is meant to increase consumer competence in making financial decisions. There are various dimensions to

173 Discussed in Section 8.5.
175 ESMA Regulation 2010, art 9(1)(b).
177 General support for the relationship between enhanced financial literacy and better financial outcomes for the individual can be found in Justine S Hastings, Brigitte C Madrian and William I. Skimmyhorn, ‘Financial Literacy, Financial Education and Economic Outcomes’ (NBER
improving consumer competence. Consumer financial literacy education could aim at overcoming behavioural limitations and biases or it could aim to inform consumers of the various choices that must be made in meeting their needs. It could also aim to improve financial decision-making competence, by enhancing numeracy skills, motivating consumers to plan ahead and educating consumers in skills relating to budgeting, for example. In general, improving consumer financial literacy may be argued to be a public good if: (a) literacy levels are suboptimal generally or in vulnerable groups; and (b) there is a relationship between improving financial literacy and better financial outcomes for the individual and in aggregate. Characterising financial literacy improvement as a public good would then legitimate the role of regulation in providing for it. Tatom, however, argues that there is difficulty in establishing correlations between financial literacy improvement and better collective economic outcomes, although not arguing that improving financial literacy is useless or counter-productive. Difficulties in establishing these correlations will not provide support for regulatory intervention in improving financial literacy or characterising improved financial literacy as a public good. The authors also argue that characterising financial literacy improvement as a public good can be justified because improved financial literacy can enhance consumer responsibility and discipline, mitigating the increased moral hazard that may be associated with greater paternalism in other consumer protection reforms discussed earlier. It is, however, important that the CFEB and other national regulators involved in improving consumer financial literacy appreciate that there are multiple dimensions to financial literacy so that regulatory initiatives may be designed appropriately for the relevant contexts.

The improvement of consumer financial literacy is a necessary long-term complement to consumer protection regulation, but there are limitations to consumer financial literacy being an eventual substitute for regulatory oversight. The improvement of consumer financial literacy is unlikely to be sufficient to overcome the many market failures surrounding consumer market discipline as discussed above. The improvement of consumer financial literacy should therefore be seen as a way to mitigate moral hazard dangers that are associated with

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the general increase in regulatory paternalism, and not as supporting market efficiency narratives that would call for eventual regulatory retreat. The improvement of consumer financial literacy should not result in the obliteration of consumer protection as a public good, leaving only to private contractual market discipline.

On the potential for consumer financial literacy education to overcome heuristics and biases that limit consumer rationality in financial decision-making, a number of empirical studies raise doubts. The FSA survey on financial capability carried out in 2008[180] showed that variations in financial capability between people is highly correlated to subjective psychological factors and subjective perceptions. Hence, there may be limits to how informational empowerment or educational initiatives can change these predispositions. General insights from psychology on consumer behaviour also paint a complex picture of subjective factors, general heuristics and biases and social conditioning affecting consumers differently.[181] Hence, it may be too far-fetched to hope that a one-size-fits-all strategy in ‘rationalising’ consumers will change consumers’ behavioural limitations or dispositions.

This book therefore argues that educational initiatives should feature a combination of information and skill enhancement strategies that could be rolled out based on the average consumer profile. Advice-based services could also assist individual consumers with individual situations and needs. In other words, consumer financial literacy education is unlikely to help consumers attain an ideal position of optimal ‘rationality’[182] and so it should not be regarded as an eventual regulatory substitute capable of reinstating rational consumer market power and discipline. Williams[183] and Willis[184] also argue fervently against regarding consumer financial literacy education as a form of responsibilisation that makes consumers entirely responsible for weak financial decisions, shielding regulators and the industry from liability or responsibility.

In order to improve consumer information, the CFEB issues guidance concerning the main categories of financial products, such as credit cards, loans, mortgages, savings and pensions. The CFEB also issues specific guides for key sectors of the population that may be in need of financial planning and advice, such as new parents, young persons, persons experiencing a turning point in their lives, such as divorce and retirement planning.[185] The industry is also very keen

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to assist in informational enhancement initiatives such as the ‘Citi Financial Education Strategy’,\textsuperscript{186} which showcases how Citibank has reached out to young persons, small businesses and borrowers through microfinance globally. The industry’s involvement in providing information on products is valuable, but the incentive to sell cannot be ignored. Hence, regulatory oversight of industry involvement should be maintained. There is also a role for the CFEB in providing basic information such as that found on its website.\textsuperscript{187} Further, empirical research\textsuperscript{188} has found that, even with enhancements in financial literacy education initiatives, the industry tends to increase obfuscation in order to sell to segments of the population that are less sophisticated. Although industry input cannot be ignored as the industry is ultimately responsible for developing the products and services in the financial market, there should be a healthy dose of scepticism concerning industry-led education. The regulator may, however, be able to assume an invaluable role in framing the contents of information, in the articulation of the information and in its delivery in order to assist in consumer understanding. There may also be a role for intermediaries of information that cater to consumer needs, such as comparative websites\textsuperscript{189} and volunteer initiatives (e.g. those taken by journalist Martin Lewis in the UK).\textsuperscript{190} Such information intermediaries need not be regulated unless consumer risk or perhaps even systemic risk is at stake.\textsuperscript{191}

In relation to skills enhancement, empirical research has shown that teaching consumers basic skills in financial planning and budgeting, and improving consumer confidence in engaging with numeracy, help in improving financial competence on the part of consumers.\textsuperscript{192} Further, a number of other studies show that such enhancement in financial competence generally entails financial well-being\textsuperscript{193} for the individuals who have benefitted from information and skill


\footnotesize{189} For example, www.moneysupermarket.com and comparative websites dealing with insurance quotations such as www.gocompare.com.

\footnotesize{190} www.moneysavingexpert.com/.


\footnotesize{193} Well-being may be subjectively evaluated (e.g. a greater sense of confidence, greater retention of knowledge), but could also be objective (e.g. improvements in credit scores). See J Michael Collins and Collin Michael O’Rourke ‘Still Holding Out Promise: The Impacts of Financial Education’ (Networks Financial Institute Conference ‘Improving Financial Literacy and Shaping Financial
enhancement programmes as part of financial literacy education. The UK regulator has also committed to a national strategy of surveying financial capability every 4–5 years in order to understand what programmes are best suited to different sectors of the population. However, there may still be a need to research the more macroeconomic implications of financial literacy education, such as whether overall savings, household wealth and credit levels are sustainable.

Consumer financial literacy education should also include an advice-based aspect capable of taking into account individual situations and needs. Although the CFEB’s role is not to provide a comprehensive advice service, such as sales and legal advice, such a service is necessary to point out the further steps a consumer in need may take. Howells argues that an element of objective advice as a public good is necessary for consumer protection, as financial decisions are often complex and disclosure from financial product and service providers often cause obfuscation. However, the role of regulator-provided advice may be mistaken for a substitute for individual decision-making or considered a guarantee on the performance of financial products. Further, the role of regulator-provided advice is necessarily limited given that there is a market for commercially provided investment advice. Hence, the authors would advocate caution when considering the extent of the regulator’s role in assisting consumers in individual financial planning.

Wright and Zywicki raise an interesting point on consumer behaviour, which may point the way for further development of consumer financial literacy education in the future. They argue that the sub-prime mortgage crisis was caused by borrowers who took rational decisions to default on their mortgage loans rather than to pay increasingly high rates of interest on unaffordable mortgages. The authors thus challenge the presumption that consumers are irrational and vulnerable, and require regulatory protection. However, many commentators have


also pointed out industry irresponsibility in dangling teaser rates and obfuscating consumers into taking out sub-prime mortgages in the first place.\textsuperscript{198} It is therefore likely to be difficult to argue that the sub-prime mortgage debacle is a story of consumers exploiting lenders. This shows that consumer financial education is not about improving rationality and the behaviour of economic persons, but about making the appropriate financial decisions for one’s needs. Making appropriate financial decisions may be assisted by consumer financial education in numeracy, skills and information, which encourage consumers to consider affordability, financial management and responsible behaviour. There is certainly room to consider whether consumer financial literacy education may take on the role of encouraging values of financial affordability, sustainability and individual prudence, as it has been argued that consumer irresponsibility in taking out sub-prime mortgages sowed the seeds of the global financial crisis.\textsuperscript{199}

On the whole, consumer protection has moved from pre-crisis concerns about transactional efficiency and market failures to a more broad-based approach considering consumer interests from the points of view of financial stability and social justice and utility. In fact, the social justice and utility aspects are increasingly dominant in the paternalistic stance taken by UK and EU regulators in consumer protection, as intervention by regulators is made in order to ensure that customers purchase suitable products and are treated with fairness. The needs of social justice and utility will continue to be an important factor in influencing the development of regulator powers in consumer protection.\textsuperscript{200} This also seems to be the approach of the US Consumer Financial Protection Bureau.\textsuperscript{201} But this renewed form of regulatory paternalism is ‘softer’ in nature and seems to have the potential to mitigate lazy consumer reliance and moral hazard by encouraging governance-led consumer redress and improvement in consumer financial literacy. Over the longer term, it may even be possible to realise greater consumer discipline through feedback into product design and sales behaviour.\textsuperscript{202}

\begin{footnotesize}


\textsuperscript{202} A more libertarian vision can be found in Louis L Stern, ‘Consumer Protection via Self-Regulation’ (1971) 35 Journal of Marketing 47, a rather old article reflecting the ideology of the times.
\end{footnotesize}
Rutledge proposes that a culture of empowering consumers in the long term could mobilise bottom-up disciplinary forces from the consumer quarter to complement regulatory governance, especially in making complaints, seeking redress and enforcement. It is to be noted, however, that measures supporting consumer litigation, such as making class actions easier, have been resisted in the UK and do not appear to be a key goal in the EU. The preference seems to be for channelling consumer redress via out-of-court procedures, which are under the regulator’s wing. Thus, bottom-up reflexive forces exerted by consumers are likely to be regulator-led or regulator-scrutinised.

8.6 Concluding remarks

The post-crisis reforms in consumer protection perhaps reflect to the greatest extent the reassertion of regulatory power. The narrative underlying such resurgence, initially based on behavioural economics, is now punctuated with social justice, utility and welfare.

204 A proposal to bolster consumer class actions against investment firms was dropped in the Financial Services Act 2010.
205 The Ombudsman service, s 404 redress schemes or special redress schemes under FCA Handbook (as of 30 April 2013, formerly FSA Handbook) DISP App 1 and 3.
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Part 3

Regulating financial firms
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9 Regulating the soundness of financial intermediaries

As Chow and Surti aptly put it, ‘[t]he business of banking involves leveraged intermediation managed by people subject to limited liability and, typically, to profit sharing contracts. This combination is well-known to generate incentives for risk-taking that may be excessive’.\textsuperscript{1} The business of allocating and managing risks by intermediaries whose personal risks are generally limited creates mismatched incentives on the part of intermediaries and the suppliers of capital. Further, corporate finance theories such as the Modigliani-Miller theorem show that the ratio of equity to debt may not affect a business’ funding costs and this may mean that banks have the tendency to push risk-taking while maintaining a tiny sliver of capital.\textsuperscript{2} Clark,\textsuperscript{3} writing in 1976, therefore pointed out that financial intermediaries should be regulated for ‘soundness’ as financial intermediaries are prone to excessive risk-taking with others’ money and the failure of these institutions greatly affects ‘public suppliers of capital’, such as deposit savers, insurance policy holders and pension savers. Without regulation, public suppliers of capital are unlikely to exert market discipline, being ‘systemically disadvantaged by significant imperfections in the market for their funds’.\textsuperscript{4}

The rationale for regulating the soundness of financial institutions in terms of capital adequacy and risk management is paternalistic in nature, protecting the public suppliers of capital from their inability to exert market discipline in an inherently risky landscape. Such prudential regulation would also benefit the ‘elite suppliers of capital’,\textsuperscript{5} such as shareholders and bondholders, as regulatory governance absorbs some of the cost of their monitoring. Hence, regulating for the soundness of financial firms relates to the provision of the public good of

financial stability in the economic sense. There is, however, a consequent moral hazard issue in relieving shareholders and creditors from monitoring.

Before the global financial crisis, prudential regulation in the EU extended beyond banks, deposit-taking institutions, insurance companies and pension funds, to investment firms generally and collective investment vehicles, such as the UCITS, which can be generally marketed across the EU. Post-crisis, the reach of prudential regulation has been extended to alternative investment funds. This is a more extensive application of prudential regulation than what is commonly applied internationally. The standards under the Basel I and II Capital Accords directly concern international banking institutions alone.

At the heart of prudential regulation is the endeavour to make financial institutions ‘safe’. However, it may be queried whether such ‘safety’ legislation has resulted in a Peltzman effect. The Peltzman effect is a concept developed on the basis of empirical studies of US automobile safety regulation, stating that persons benefiting from safety legislation may be incentivised to take more risks because it is perceived that safety frameworks are already in place. In the global financial crisis, the excessive risk-taking culture at many global banks seems to be a reflection of such a Peltzman effect, in addition to the competitive pressures that have fuelled aggressive profit-chasing and growth. The global financial crisis has exposed the inadequacies of pre-crisis micro-prudential regulation in dealing with increasingly ungovernable and opaque financial institution empires – the systemically important financial institution (SIFI). SIFIs are not only opaque and difficult to supervise, but perverse incentives pervade them in testing the boundaries of safety maintained by prudential regulatory frameworks. The SIFI epitomises the regulatory challenge in financial regulation: how far will and should financial regulation go to protect the public interest by ensuring that financial institutions remain ‘safe’? Further, the avoidance of failure is not an end in itself. In the event of failure, the regulatory framework should mitigate the systemic risk

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consequences of institutional failure upon other institutions and the markets. The regulatory framework should not only consist of *ex ante* measures of capital preservation and risk management, but also *ex post* measures relating to crisis management if a financial intermediary should fail. The crisis has also revealed the lack of legal frameworks dealing with crisis management and resolution. Hence, post-crisis reforms intend to address the weaknesses in micro-prudential regulation, the regulation of SIFIs and crisis management frameworks, all of which may be regarded as under-supplied as public goods relating to financial stability. We will argue that in the discourse on institutional safety and soundness, questions also arise as to the purposes financial institutions serve as a matter of social utility. Perspectives from social utility seem to have been infused with structural reforms proposed in the UK, as will be discussed in Chapter 11, and there is potential for such perspectives to inform transformative effects in financial regulation. We are, however, of the view that micro-prudential regulation reforms generally take only incremental approaches in a path-dependent way, reflecting a much narrower understanding of the fundamental premise of financial stability as a public good.

**Chapter 10** will provide the context for how large SIFIs have come to dominate international banking and finance. These institutions have sprawling businesses in many parts of the world and may be managing money exceeding the value of any one country’s gross domestic product. These institutions present challenges to the design of adequate *ex ante* ‘safety’ measures and *ex post* crisis management strategies. This chapter discusses the growth of economic and political power in the financial sector, and how law and regulation tolerates this development, encouraging the growth of SIFIs (‘too-big-to-fail’ financial institutions).

**Chapter 11** then examines the regulatory reforms that attempt to grapple with SIFIs, including structural reforms and reforms dealing with crisis management and resolution. It will be argued that the UK structural reforms attempt to address the SIFI threat to institutional and systemic soundness, as well as social utility issues. We argue that structural reforms may import of changing fundamental premises in financial regulation, conceptualising financial stability not only as a public good in the economic sense, but as relating to public interest in the social utility of finance. **Chapters 12 and 13** will examine the regime of micro-prudential

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12 Systemic risk can be explained by banks’ fragility, as in the Diamond-Dybvig model on bank runs and related financial crises. Fragility is a consequence of the imbalance in banks’ assets and liabilities, with illiquid assets in their lending (e.g. mortgages) and liquid liabilities in their borrowing (typically deposits that may be withdrawn at any time) giving rise to self-fulfilling panics among depositors. See Douglas W Diamond and Philip H Dybvig, ‘Bank Runs, Deposit Insurance, and Liquidity’ (1983) 91 *Journal of Political Economy* 401. A run on one bank can turn into a run on the banking sector. This risk is aggravated by the interconnectedness of financial institutions and payment systems with open liabilities and uncleared transactions as further sources of contagion. The Bank for International Settlements defines systemic risk as the risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default with a chain reaction leading to broader financial difficulties’ (Bank for International Settlements, *BIS 64th Annual Report* (Basel: BIS 1994), 177).
regulation and its sprawling reach into internal risk management and control within financial institutions. These measures cannot, however, be overly prescriptive as they must be implemented within the internal operations of financial institutions. As regulatory frameworks directed at internal risk control by financial institutions are inherently meta-regulatory in nature, this chapter will flesh out the challenges in implementing them. Chapter 13 will also discuss how regulators attempt to involve shareholders in the governance framework for monitoring the safety and soundness of financial institutions. We are of the view that micro-prudential reforms continue along an incremental and path-dependent approach and they may only play a complementary role to the more radical reforms such as structural reforms and macro-prudential regulation, discussed in Part 4.
This chapter discusses the context that has given rise to the domination of powerful financial institution empires (the SIFI), an issue exposing the inadequacies of regulating for institutional safety and soundness in the pre-crisis years.

The abolition of the Glass-Steagall Act in the United States is often blamed for giving rise to the growth of financial institutions that became too big to fail in the global financial crisis of 2008–9. However, one should perhaps look to the evolution of the intermediary business model to see how the SIFI phenomenon developed in an incremental manner. Universal banking as such need not be a toxic business model. It has been practised for a long time in Europe and was also the prevailing model in most countries, long before the US embraced universal banking following the abolition of the Glass-Steagall Act. McGee argues that the evolution of financial intermediaries from partnerships to for-profit companies and publicly listed companies changed their outlook over the years. In Anglo-American jurisdictions, McGee argues that we have witnessed a move from demutualisation to profit-maximisation and empire building in the largest banking groups, a phenomenon described as ‘chasing Goldman Sachs’, the leading investment bank.
According to Pacces, banks have been driven by two key factors in the obsession with short-termist corporate profitability. These are competition from alternative financial institutions in the maturity transformation business and short-termism, supported by the ideology of ‘shareholder value’, especially in diversified shareholding jurisdictions such as the US and UK. Ho, an eminent anthropologist, argues that the business model of banking has changed in embracing ‘shareholder value’, an ideology that encourages the corporate world to be obsessed with stock market prices and to take a short-termist approach to profitability. In order to generate persistent and higher profits, financial intermediaries innovate and take greater risks, generating the highest fees possible from all kinds of intermediation regardless of the ultimate purpose of capital allocation. She argues that ‘[b]ankers are motivated to squeeze as much out of the short term as possible, to do as many deals in the shortest amount of time’ and:

... this temporal identification with the market does not lead investment bankers to be ‘future oriented’; their anticipation of potential market failures has little effect on restraining or shifting their practices. To the contrary, planning and strategy are frequently discounted as bankers work almost solely in the moment.

Folkman and others further argue that financial intermediaries generate a lot of short-termist corporate restructuring and finance work in order to extract rents


rather than to help companies achieve long-term growth and value, showing that not only have banks become short-termist, but they have become profit hunters divorced from serving social needs. Santoro and Strauss also argue that the profit generation by financial intermediaries has become a form of ‘profit disjunction’ as profits could be generated through complex innovations that do not serve the purposes of social utility and in fact pass risks on to unsuspecting investors. Profit generation has become disengaged from the generation of social utility, unlike in the days of relationship-based financial services, which are highly dependent on serving clients’ best interests.

Further, an increase in financial sector liberalisation and competition has taken place since the 1990s. The deregulation championed by the US Financial Modernization Act 1999, which lifted restrictions on banks engaging in investment activities, has been the major driving force behind financial empire building and the growth of the financial sector in the US and globally. A number of economists warned, in the early part of the twenty-first century, that liberalisation, which entails competition in the financial sector, would result in greater risk-taking behaviour generally by banks as the generation of profits becomes more challenging under competitive pressure. Hellmann, Murdock and Stiglitz, writing in 2000, argue that competition for deposits itself has provided banks with a larger loss absorbing base to conduct increasingly risky business. This has been affirmed by a couple of European economists. Frenetic profit chasing, the ever-expanding scope of financial intermediation and increased risk-taking have come to characterise the modern banking business model. The banking business has lost

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17 Giving further effect to the abolition of currency and credit controls in the 1980s, see the discussion in Mads Andenas, ‘Harmonising and Regulating Financial Markets’ in Mads Andenas and Camilla Andersen (eds), Theory and Practice of Harmonisation (Cheltenham: Edward Elgar 2012), 7–10.
sight of the longer-term social utility of its intermediation role, that of effective
capital allocation for the growth of social wealth.23

Neuroscientists Wargo and others24 argue that the industry’s approach to risk
is not in line with the normal balancing tendency of loss aversion that may control
risk-taking behaviour.25 Such excessive risk-taking has been driven by several
developments: first, the advent of ‘new era’ theories that convince investment
banks that quantitative models can somehow effectively and precisely manage and
mitigate risk;26 second, behavioural heuristics that are exacerbated by financial
sector practices.

In her journalistic account, Tett27 shows how financial sector elites from large
universal bank JP Morgan have developed innovative credit derivatives based on
the assumed unassailability of their quantitative models. However, the opaque risks
inherent in these instruments are not well understood,28 and excessive exposure
to credit derivatives almost brought down AIG.

Behavioural finance researchers have further identified a few tendencies that
courage risk-taking behaviour in the financial sector, such as the ‘familiarity/
competence’ bias where a feeling of competence often precedes greater risk-
taking. The financial sector has, in response to competitive pressures, aggressively
sought to populate the sector with talent by proposing unprecedented remun-
eration packages (to be discussed in Chapter 13). Individuals who perceive
themselves as elite, competent and ‘masters of the universe’ are more likely to
display the competence bias by engaging in excessive levels of risk-taking.29
Further, in a fiercely competitive market where everyone else is engaging in

23 Van der Elst and Bogaert define the financial sector as ‘the part of the economy that provides
financial services to the other parts of the economy’; see Christoph Van der Elst and Filip
Bogaert, ‘Risk Management in Financial Law’ in Marjin van Daelen and Christoph Van der Elst
(eds), Risk Management and Corporate Governance (Cheltenham: Edward Elgar 2010), 114; Roy C Smith
and Ingo Walter, Governing the Modern Corporation (Oxford: Oxford University Press 2006), 192ff.
25 On the prospect theory or loss aversion heuristic that brings the risk-taking part of human
behaviour into homeostatic balance and mitigates excessive risk-taking, see Amos Tversky and
Daniel Kahneman, ‘Advances in Prospect Theory: Cumulative Representation of Uncertainty’
(1992), Journal of Risk and Uncertainty 297. See anecdotal accounts in Frank Partnoy,
Infectious Greed: How Deceit and Risk Corrupted the Financial Markets (London: Profile Books 2003) on the rise of
quantitative risk management innovations whose purpose is to make risk disappear.
Journal 18.
27 Gillian Tett, Fool’s Gold: How Unrestrained Greed Corrupted a Dream, Shattered Global Markets and
28 The flaws in risk management in banks and financial institutions are now well discussed; see Joel
Bessis, Risk Management in Banking (Chichester: John Wiley & Sons 2011) at xii; Douglas Hubbard,
The Failure of Risk Management: Why It’s Broken and How Do we Fix it? (Chichester: John Wiley &
Sons, 2009) for a detailed account of the errors and flaws in bank risk management.
29 Lawrence J Belcher, ‘Prior Perceptions, Personality Characteristics and Portfolio Preferences
greater risk-taking and chasing greater profits, the herding tendency pushes the sector towards this consensus behaviour.\textsuperscript{30}

Banks and financial institutions have arguably become more and more self-serving at the expense of their social utility purposes, being concerned about out-competing their rivals and generating more wealth and growth for the institutions themselves.\textsuperscript{31} The most competitive institutions have acquired other institutions, consolidating into ever larger behemoths.\textsuperscript{32} Empire building in the financial sector is especially observed in banks with entrenched management who are rewarded in stock; their concern for stock price value gears management preferences towards empire building for selfish reasons.\textsuperscript{33}

Financial sector practices, such as remuneration design, are also structured around promoting behaviour that will drive growth and profits for the institution.\textsuperscript{34} Remuneration in the financial sector may amount to a significant proportion of the institution’s wealth, sometimes between 50 per cent and 80 per cent of shareholder equity,\textsuperscript{35} in much the same way as partners share profits in partnerships.\textsuperscript{36} This is often justified in terms of retaining talent in the fierce battle to attract the most talented to join the financial sector.\textsuperscript{37} However, Gregg and others show that firm and balance sheet size have the greatest correlation with remuneration size in the financial sector, suggesting that remuneration ratcheting may be connected to financial institution empire building.\textsuperscript{38} Hence, remuneration ratcheting panders to both institutional and individual pursuit of prestige.\textsuperscript{39} The typical media representation of the talented and successful banker is an elitist and influential individual, leading a fast-paced and luxurious life.\textsuperscript{40} The phrase ‘masters
of the universe’, incorporating notions of competence, influence and affluence, has become associated with investment bankers.\footnote{See Richard Wachman, ‘Reborn Masters of the Universe’, The Guardian (London, 19 July 2009); Richard Anderson, ‘Masters of the Universe: Meet the World’s Best-Paid Men’, BBC News (London, 2 February 2011).} In short, as Bootle observes, the financial sector has become ‘too big, too greedy, too easily drawn to the fabrication of illusory wealth, and too focused on the distribution of the proceeds, rather than on the financing of wealth creation’.\footnote{Roger Bootle, The Trouble with Markets: Saving Capitalism from Itself (London: Nicholas Brealey 2009), 239.}

In the above context, the rise of the SIFI has not only given rise to suboptimal levels of risk-taking that affect financial stability, but has epitomised the disengagement of finance from social utility. However, as the book has so far argued, although post-crisis reforms acknowledge the need to reassert the importance of financial stability as a regulatory objective, the embrace of social utility narratives in shaping the future of financial regulation has been less forthcoming. Before the global financial crisis, some features of the regulatory regime were very tolerant of the phenomenon of financial institution empire building\footnote{See also Michael A Santoro and Ronald J Strauss, Wall Street Values: Business Ethics and the Global Financial Crisis (Cambridge: Cambridge University Press 2012) writing in the US context, chs 3 and 4.} – the relatively minimalist regulatory treatment of the wholesale sector in the pre-crisis years, the relatively tolerant regulatory regime in respect of the financial sector’s management of conflicts of interest that has dovetailed with the industry’s growth and expansionist ambitions, and the rise of regulation theories supporting decentred governance approaches that have been used to justify greater involvement in governance by the financial institutions themselves, as discussed in Chapter 3. Post-crisis, there is very little reform of the key regulatory regime relating to management of conflicts of interest, as will be discussed below, and Chapter 3 has painted a picture of slow and minimal change in the composition of the regulatory space.

We will now turn to examine how the regulatory regime’s tolerant approach to management of financial sector conflicts of interests has arguably assisted in the phenomenon of financial institution empire building.

### 10.1 The meta-regulation of conflicts of interest management

In this section, it will be argued that the regulatory approach taken by the EU and UK regulatory regimes, in dealing with the management of conflicts of interest by financial institutions, tolerates the self-serving tendencies of financial institutions that motivate empire building. First, this section will show how regulators and policymakers have been convinced by the industry to limit the application of general fiduciary law to the financial sector, thus depriving themselves of a potentially useful form of control in the form of private litigation.
Second, it will be argued that although the regulatory regime for conflicts of interest management, based on a type of fiduciary narrative, is intended to temper self-serving tendencies, the meta-regulatory approach to conflicts of interest management in the EU Markets in Financial Instruments Directive (MiFID) is in fact friendly to financial institution empire building.44

Financialisation has greatly expanded the scope of business for banks and financial institutions, but the scope for conflicts of interests has also greatly increased.45 If financial institutions were subjected to stringent fiduciary-style regulation of conflicts of interest, then many financial institutions would be unable to take on as many clients or enter into as many lines of business, as there would inevitably be potential for conflict between the institution’s interests and a client’s, or between clients.46 By the early 1990s, it had become more and more accepted in the UK that the intermediary nature of certain businesses could give rise to potential conflicts of interests. However, the industry view was that there was no prohibition of conflicts of interests, so avoiding them was not necessary.47 Were general fiduciary principles still applicable to the financial sector? Such principles create broader duties to act in the interests of a client. They cannot always be restricted in contract and can give rise to actions on the part of clients beyond the regulatory protections imposed in conduct of business rules. One such instance is compliance with regulatory conduct of business rules concerning ‘Chinese walls’48 between activities in firms, which could nonetheless result in conflicts of interest according under general fiduciary principles.

The financial services industry in London formulated this as an issue of increased ‘legal risk’ that was inimical to the interests of the industry and the economic functions the industry engaged in. The financial services industry also saw an interest in exclusive jurisdiction for their own regulatory rules and regarded the courts’ application of general fiduciary principles as arbitrary and not helpful in creating a well-functioning regulatory regime. As such, the industry had every interest to support limitations in private law remedies for clients in breach of contract, breach of fiduciary or statutory duties, or tort liability.49

45 Roy C Smith and Ingo Walter, Governing the Modern Corporation (Oxford: Oxford University Press 2006), 248ff.
47 For example, see the Privy Council decision in Kelly v Cooper [1993] AC 205 (PC).
48 Chinese walls are barriers erected between different activities or parts of a firm such that knowledge received in one part of the firm does not reach other parts. Chinese walls may constitute more or less extensive barriers, from internal rules about not sharing information to regulatory requirements about not sharing common corporate services (personnel, back-office, post room, lunch room) to complete physical and organisational separation. The UK version is lighter than that imposed by the US Securities and Exchange Commission. The effectiveness of Chinese walls, even in their US version, remains disputed.
The English Law Commission, in its 1995 report, concluded that the general law on fiduciary duties had limited application to the financial sector, as this application had been developed in the case law.\(^{50}\) One of the Law Commissioners, Jack Beatson, advocated a safe haven for firms that had complied with regulatory rules in a study\(^{51}\) preceding the Law Commission’s final Report, drafted by Beatson’s successor, John Burrows.\(^{52}\) Although the Law Commission ultimately resisted pressure by the financial services industry to introduce statutory limitations on private law liability, the Law Commission decided that where there were regulatory rules, these could be read as contractual usages modifying the nature and scope of any fiduciary duty.\(^{53}\)

The clarification provided by the Law Commission’s final report meant that financial institutions could contractually delineate the scope of their fiduciary liability vis-à-vis clients, within the scope of the regulatory principles, and that this would be accepted in courts as the substance and extent of any duty owed to clients.\(^{54}\) General fiduciary law is now of limited relevance to governing the management of conflicts of interest in financial firms. Hanrahan rightly points out that general fiduciary law is no longer able to provide the ‘public good’ of client protection with respect to regulating conflicts of interest.\(^{55}\)

We turn to the regulation of conflicts of interest management in financial firms, and find that the regulatory regime manifests the unwillingness of policymakers to unduly restrain financial intermediary business.\(^{56}\) The approach adopted in the EU and UK is therefore a meta-regulatory one that allows financial firms to

\(^{50}\) See Law Commission, *Fiduciary Duties and Regulatory Rules* (Law Com CP No 124, 1995).


\(^{52}\) Law Commission, *Fiduciary Duties and Regulatory Rules* (Law Com No 236, 1996). Andrew Burrows was altogether less amenable to industry pressure. His position could be witnessed in relation to the review of auditors’ liability. He drafted a report rejecting industry initiatives limiting the private law liability of auditors by introducing new forms of proportionate liability replacing joint and several liability for audit firms that are essentially formed as partnerships. The accountancy industry later prevailed in limiting liability with the introduction of limited liability partnerships.

\(^{53}\) But this would remain subject to judicial review, see Law Commission, *Fiduciary Duties and Regulatory Rules* (Law Com CP No 124, 1995).


identify, manage and disclose conflicts of interest. But, as Kumpan and Leyens rightly point out, firms do not often see refraining from acting for a client as being part of the suite of strategies they will employ in the management of conflicts of interest.

The pan-EU regime in the MiFID 2004 implemented in the UK for dealing with conflicts of interest is based on the principles of identifying, managing and disclosing conflicts of interests. Disclosure is not regarded as a panacea substituting for management of conflicts of interest. There is a list of non-exhaustive criteria to assist in identifying conflicts of interest, as well as non-exhaustive suggestions for how they may be managed (e.g. using Chinese walls, the removal of cross-subsidising remunerative incentives and avoidance of personnel sharing across different departments). It is largely up to firms to draw up their own conflicts of interest policy to identify the conflicts of interests they face and the strategies for managing such conflicts. This is characteristic of a meta-regulatory approach where firms are primarily responsible for tailor-making strategies for governing certain issues, over which they have control, in order to deliver outcomes according to broader regulatory principles. Where inducements are concerned, there are more precise rules demanding that firms only engage in giving or receiving inducements if benefits can be demonstrated for clients and duties owed to clients are not compromised. Firms are still in control of how


59 MiFID, art 18.


such justifications are made and so the regulatory approach is arguably one of meta-regulation. The controls over investment research production and labelling are arguably more prescriptive. In general, there are few prescriptive bright lines and limits imposed on financial institutions in the area of management of conflicts of interest.

Enriques argues that leaving primary responsibility to firms to write up their own conflicts of interest policy is likely to be an ineffective regulatory approach. Policies may be written in a general boilerplate so that no real wisdom can be garnered as to what conflicts of interest may actually arise and how they will be dealt with in practice. Firms may also not be motivated to monitor and evaluate their policies and implementation as this may be contrary to their business interests. Further, supervisors may find it difficult to check how firms have dealt with conflicts of interest and whether there has been any adverse impact. There has been no regulatory enforcement against ineffective management of conflicts of interest as such, although the widespread phenomenon of mis-selling to consumers, often linked to remuneration incentives for increased volumes of sales, is now targeted by the UK regulator.

As the regulatory regime also requires the disclosure of conflicts of interests to clients, will clients be able to exert some form of governance to complement the meta-regulatory regime? Article 18 of the MiFID requires investment firms to disclose conflicts of interests they face and the policy for managing conflicts of interest to clients. Disclosure, however, is not to be presumed to be an adequate form of management or else investment firms that have made disclosure may pass the risk of conflicts of interest to their clients and do nothing more for them. That said, it could be argued that disclosure establishes a form of informed consent in regard of sophisticated clients, making such clients unlikely to claim fiduciary protection afterwards. Empirical research has shown that disclosure of conflicts of interest needs to be accompanied by either credible investor or regulator

66 Such as prohibiting investment analysts from undertaking personal transactions, promising issuers favourable coverage or showing issuers drafts of research reports, see MiFID Commission Directive 2006, art 25; FCA Handbook (as of 30 April 2013, formerly FSA Handbook) COBS 12.2, 12.3.
67 Luca Enriques, ‘Conflicts of Interest in Investment Services’ in Guido Ferranini and Eddy Wymeersch (eds), Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond (Oxford: Oxford University Press 2006).
68 Such as the mis-selling of payment protection insurance, dealt with under FCA Handbook (as of 30 April 2013, formerly FSA Handbook) DISP App 3 and discussed in Chapter 8; and the mis-selling of endowment mortgages, dealt with under FCA Handbook (as of 30 April 2013, formerly FSA Handbook) DISP App 1.
70 This area is reformed by the Retail Distribution Review, which comes into force in 2013, as discussed in Chapter 8. The UK regulator is also specifically looking into the design of incentive schemes for sales staff in financial firms, and has published a guidance, see FSA, Final Guidance: Risks to Customers from Financial Incentives (January 2013).
71 Such as in the Australian case of ASIC v Citigroup Global Markets Australia Pty Ltd (No 4) [2007] FCA 963.
sanctions in order to achieve an effective supervisory regime for managing conflicts of interest. Investors are not well placed to police adherence to conflicts of interest policies, nor are they likely to be aware of any suboptimal outcomes in their transactions that have been affected by conflicts of interest. Walter has argued that, given the meta-regulatory nature of the regulatory regime, it is not easy for regulators to identify whether a particular way of managing conflicts of interests is inadequate or has failed. Civil litigation is likely to be an ineffective instrument too as contractual limitations to fiduciary duties could be upheld by the court and causation of loss may sometimes be hard to prove.

Further, an empirical survey comes to the conclusion that financial institutions may, in the name of managing conflicts of interest, design measures that systemically disadvantage clients’ interests. This empirical survey shows that, in dealing with conflicts of interest, sampled banks removed stocks from their proprietary trading portfolio so that retail trading in these stocks would not pose a conflict of interest. But the survey shows that the stocks moved out of the proprietary portfolio are generally lower performing and hence the surveyed banks may systemically have an upper hand over retail clients and clearly prefer their own interests over clients. This survey shows the limitations of regulation in dealing with the management of conflicts of interest.

The argument in this chapter, perhaps controversial, is that a rather tolerant conflicts of interest regulatory regime supports the generally unhindered growth of large and interconnected financial businesses. Financial institutions are subject to a duty to manage conflicts of interests, the discharge of which is not easy to judge, nor is it easy to obtain civil redress. Declining business or refraining to act is not an optimal strategy in the management of conflicts of interest. Growing business lines and taking on more clients that may present conflicts of interest situations is an issue that only needs to be managed, not avoided. The regulatory regime is of no hindrance to business growth and expansion even if the range of

74 In Seymour v Ockwell [2005] EWHC 1137 (QB), [2005] All ER (D) 297 (Jun), for example, although the financial adviser did not disclose a commission obtained after the sale of an investment product, and hence was in breach of fiduciary duty, the losses suffered by the investors in this case were attributed to unsuitable and negligent advice rather than the breach of fiduciary duty.
76 Smith and Walter would go further, arguing that the lightly regulated conflicts of interests regime for financial institutions has allowed many corporate ills and abuses to prevail, inflicting social losses through corporate demise. Roy C Smith and Ingo Walter, Governing the Modern Corporation (Oxford: Oxford University Press 2006), 248.
conflicts of interest must increase. Although a number of commentators point out that the expansion of financial intermediation activities that can be undertaken by any one institution may achieve economies of scale, bring about social utility through greater efficiency and benefit clients, the expansion of some financial institutions into behemoth businesses also meets their self-serving desires for empire building and wealth concentration.

Walter argues that the response to concerns regarding management of conflicts of interest in financial institutions needs to come from senior management willing to commit to ethics and a sense of loyalty to clients, and entrenching such ethics into the corporate culture. Hence, a ‘fiduciary’-type commitment, which perhaps cannot appropriately be framed as a legal duty, is needed as part of the culture or ethics of financial business. However, where market or regulatory discipline is ineffective, being ‘ethical’ may not be as attractive as empire building, wealth concentration and the opportunity for individuals to share in such wealth. What motivates business behaviour to become ‘ethical’ or go beyond compliance is a complex issue featuring many interacting factors such as organisational attributes, individual motivations and relations with regulators. Some commentators argue that the fostering of best practices in conflicts of interest management could be assisted by a more competitive landscape in financial intermediation, providing the impetus for a race to the top. The issue of competition is beyond the scope of this book, but it could be relevant to controlling certain large and complex financial conglomerates in an oligopolistic market. Competition measures may also help mitigate the systemic risks posed by these financial conglomerates.


81 It has been empirically researched in literature dealing with regulation and compliance that firms are seldom motivated to go beyond compliance in the absence of regulatory controls, although regulatory controls do not on their own motivate a behaviour that is beyond compliance. It seems that regulatory controls are a necessary context for but not the causa proxima for behaviour that is beyond compliance. See Robert A Kagan, Neil Gunningham and Dorothy Thornton, ‘Fear, Duty and Regulatory Compliance: Lessons from Three Research Projects’ in Christine Parker and Vibeke Lehmann Nielsen (eds), Explaining Compliance: Business Responses to Regulation (Cheltenham: Edward Elgar 2011) at 37.


10.2 Regulatory regimes favourable to sophisticated financial institutions

Finally, this chapter argues that besides tolerating the growth of giant financial conglomerates, the pre-crisis regulatory regime (in the form of capital adequacy regulation in the Basel II Capital Accord) has also accorded privileges to sophisticated financial conglomerates, viewing them as more capable of developing self-regulatory micro-prudential governance. The misplaced trust in the self-regulation of sophisticated financial institutions has also resulted in regulatory latitude concerning these institutions, further incentivising financial institutions to become SIFIs in order to enjoy such privileges.

The EU Capital Requirements Directive 2006 implements the Basel II Capital Accord, which is the international leading standard for capital adequacy regulation. In particular, the Basel II Capital Accord has made provision for differential treatment between banks concerning the extent of capital to be set aside for credit risk. Under the Basel I Capital Accord of 1988, a simple one-size-fits-all approach was taken in determining the extent of capital to be set aside for credit risk. Categories of risk weights were established to determine how much capital was to be set aside against different types of loans. The categories of risk weights were few in number (four main categories), not very refined and applied across the board. The Basel II Capital Accord introduced three tiers of increasingly sophisticated approaches to determine capital charges for credit risk. The first tier was the Basel I Capital Accord’s approach with standardised risk weights. An innovation was, however, introduced to allow banks to apply more precise risk weights according to the published and recognised credit ratings of borrowers.

The second tier was a ‘foundation internal ratings based’ approach (or foundation IRB) allowing banks to use their own internal methodologies to assess the risk of loans and therefore their capital needs. Such banks were, however, required to demonstrate that adequate risk management and evaluation systems were in place to determine the probability of default and to use standard measures for estimating loss at default and exposure to default. Some banks may be permitted to set their capital charges according to the methodology in the third tier of the Basel II Capital Accord’s approach to credit risk, the ‘advanced internal ratings based’ approach (or advanced IRB). The advanced IRB approach allows banks with sophisticated and established risk management and evaluation systems to determine the probability of default, loss at default and exposure to default of the loans on their books, in order to determine the precise capital charges required. The IRB approaches are supposed to be supplemented by Pillars 2 and 3 of the Basel II Capital Accord, referring to regulatory and supervisory oversight, along

86 Capital Requirements Directive, arts 84-89, annex VII.
with transparency to shareholders and stakeholders in order to facilitate market discipline.

The IRB approaches clearly treated the more sophisticated banks, mostly financial conglomerates, as being in the best position to govern themselves in capital adequacy and to deliver sound outcomes. The criteria became so complicated that effective enforcement was impractical: non-compliance was a matter of discussion and consultation between the regulator and the regulated institution. The regulatory regime placed an enormous amount of trust in the self-regulatory ability of financial institutions to determine their own ‘soundness’ due to the sophistication of such institutions. Dragomir\(^87\) rightly points out that the failure of banking conglomerates in the global financial crisis raised the question of whether regulatory trust in larger and more complex financial empires was well placed. Both supervisory oversight and market discipline have been thin and lacking in rigour. In reality, as commentators have pointed out, banks that are in a position to determine their capital charges have tended to set aside less capital and take on more risk,\(^88\) in line with the profit-chasing and empire-building tendencies discussed above.

### 10.3 Concluding remarks

Post-crisis, very little has changed with regard to the regulatory regime for management of conflicts of interest. This may or may not be an important omission depending on what is achieved by the other reforms in relation to the regulatory objective of financial stability. The inadequacies of micro-prudential regulation and the lack of regulatory frameworks that address SIFIs and crisis management have been acknowledged and reforms are underway. Although the reforms address excessive risk-taking as key to affecting financial stability, only structural reforms that will be discussed in the next chapter reflect some cognisance for the importance of social utility perspectives in finance whose demise have also been important in sowing the seeds for the financial crisis. The next chapter will turn to the reforms addressing the SIFI issue – structural reforms and reforms dealing with crisis management. Chapters 12 and 13 will then discuss the micro-prudential and risk management regulatory regimes that intend to make each financial institution more resilient to failure.

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11 Addressing the consequences of financial empire building and systemic risk

The global financial crisis of 2008–9 has highlighted the fact that financial empire building could result in increased systemic risk. The growth of financial sector empires augments risk-taking, consequent losses and the potential of failure. As Chapter 10 points out, micro-prudential regulation has been inadequate to deal with the systemic risk posed by SIFIs’ risk-taking behaviour and the regulatory framework in general has indeed pandered to the business interests of SIFIs. This chapter will explore the post-crisis reforms in structural regulation and crisis management that purport to deal with the systemic risk posed by SIFIs.

The relationship between financial empire building and systemic risk has now been encapsulated in the popular term ‘too big to fail’. The size of a financial institution, as examined by a number of commentators, is not necessarily related to systemic risk. However, with large financial empires and increased complexity in group structures, interdependencies as well as interconnectedness with other institutions are likely to follow. Hence, although size may not per se be the most important factor in systemic risk, factors identified by commentators are: interconnectedness; more risk-taking backed by financial empire growth (such as excessive levels of leverage); development of greater complexity, driven by competition in the industry for financial empire building; and the rise in complacent practices, as a result of misplaced confidence in the ability of the

financial empire to absorb and manage risk. All of these are somewhat related to the growth of the financial institution empire, a major characteristic of which is size. Further, if large and significant financial institutions encounter a crisis, such news has a disproportionately adverse behavioural effect on markets, from overconfidence to herding loss aversion behaviour. Lastra, for example, argues that the modern term ‘Systemically Important Financial Institutions’ (SIFIs) is an apt extension of the idea of ‘too big to fail’. The rest of the chapter will refer to the SIFI.

As Chapter 2 points out, the problem with SIFIs is their threat to financial stability in the event of a crisis or failure. Further, if governments step in to rescue SIFIs for fear of the adverse impact on financial stability, the cost of a SIFI failure is social and not private in nature. The global financial crisis in 2008 has led to countless bank bailouts in the US and EU, continuing even into 2012 with the state rescue of Spanish bank Bankia. A number of countries have endured these bailouts at great fiscal cost to their economies and ordinary citizens are continuing to feel the punishing impact of austerity measures in the aftermath.

There are three broad strategies in addressing the systemic risk impact of SIFI behaviour. One strategy deals with the SIFI structure itself, calling for forms of segregation, ring-fencing or fire-walling in order to minimise intra-group

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9 Baxter points out other risks of ‘big banks’ that outweigh benefits (such as economies of scale, financial supermarkets and financing governments), viz huge implied public subsidies, repression of competition, distorting political influences, increasing cost of supervision and generating huge and systemic risks by engaging in complex structures and transactions. See Lawrence G Baxter, ‘Betting Big: Value, Caution and Accountability in an Era of Large Banks and Complex Finance’ (2012) 31 Review of Banking and Financial Law 765.
10 Bank bailouts have been a significant portion of fiscal cost, burdening economies already in deficit, such as the UK, Ireland and Spain. The figure stood at £450 billion in the UK in 2011 and 31 per cent of GDP; see Simon Rogers, ‘Bank reforms: how much did we bail them out and how much do they still owe?’ The Guardian (London, 12 September 2011). In Spain, the figure could be US$78 billion; see ‘Spain: Auditors determine bank bailout could cost as much as $78B in worst case scenario’ Washington Post (Washington, DC, 21 June 2012). In Ireland, the figure stood at US$84 billion at the end of 2011; see Jamie Smyth, ‘Ireland seeks EU help over bank bail-out’ Financial Times (London, 24 November 2011). In the US, volunteers have put together a website to calculate the consolidated cost as well as the cost of individual bank bailouts; see http://projects.propublica.org/bailout/main/summary.
interdependency, vulnerabilities and contagion. This theme encompasses ideas such as separation between commercial and investment banking; narrow banking focused on protecting retail depositors; and adaptations of these ideas. The second strategy is less draconian than the first, requiring SIFIs to prepare contingency plans, including restructuring possibilities in the form of ‘living wills’. Restructuring is therefore contingent and not imposed up front. The living will also focuses more on recovery and resolution than on structural regulation. The third strategy also allows SIFIs to operate structurally as they are but regulatory intervention will attempt to reduce the systemic risk of failure, perhaps in the form of micro-prudential regulation relating to capital charges. This is proposed by the Basel Committee, as well as the Financial Stability Board.

The UK is pressing ahead with all three strategies. The first strategy – reforms that would result in the reordering of the SIFI structure – is the most controversial in nature and is not the subject of international consensus. Policy rhetoric underlying structural reforms reflect concerns for financial stability as a public good that is inadequately supplied by other regulatory strategies, and is also punctuated with notions of public interest in maintaining the social utility of finance. Although there is much more hesitation in the EU in pursuing such reforms, ‘[t]here is evidence to suggest that, as well as supporting financial stability and reducing the risk to the taxpayer, separation has the potential to change the culture of banks for the better and to make banks simpler and easier to monitor.’ Structural reforms are based on the economic rationale for supplying financial stability as a public good, as well as the broader public interest in the social utility and culture in banking. The US may arguably also have adopted a form of structural regulation in the Volcker Rule, which will be discussed shortly.

### 11.1 Addressing the SIFI structure

This section addresses structural reform as a way to mitigate the systemic risk associated with SIFIs. The Vickers Independent Commission on Banking Reform established by the UK coalition government in April 2010 set out the context for structural regulation:

> In theory, ideal behavioural regulation could entirely correct undesirable private incentives, making structural regulation unnecessary. In practice, however, there are circumstances where structural rules solve the problem

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more effectively, and in the process save on the need for behavioural regulation.\textsuperscript{14}

Mayer\textsuperscript{15} also argues that the mix of investment and retail banking that constitutes the SIFI is a ‘toxic’ combination, as the short-termist pursuit of profits in investment banking infects the behavioural management of retail banking, driving innovations into traditional loan and deposit products, making them more exotic but risky. Thus, he supports the separation of utility banking from investment banking on the basis that utility banking will almost certainly be compromised if it is not separated and focused. Structural reform may thus achieve not only a mitigation of systemic risk, but may also restore the social utility aspect of core banking services and end the malpractice of SIFIs using cheap deposits to subsidise risky investment activities.\textsuperscript{16}

A number of structural options have been suggested; some have become law, such as the Volcker Rule in the US.\textsuperscript{17} The structural reform options are the following:\textsuperscript{18}

- separation of retail from investment banking;
- narrow retail banking; and
- Volcker rule-type prohibitions.

The separation of retail from investment banking may sometimes be termed as a return to the US ‘Glass-Steagall’ era where banks were prohibited from underwriting and dealing, therefore largely preventing them from being involved in capital markets. The Vickers Independent Banking Commission in the UK has affirmed\textsuperscript{19} that separation or ring-fencing is the way forward and will be adopted in legislative reform in the UK for 2015.\textsuperscript{20} A similar approach is recommended

\textsuperscript{17} Dodd-Frank Wall Street Reform and Consumer Protection Act 2011 (Dodd-Frank Act), Pub.L. 111–203, § 619.
in an independent expert report commissioned\textsuperscript{21} for the European Commission, in the structural separation of ‘trading activities’ from retail banking for banks with at least 15 per cent of total assets comprising of trading assets. But the resolve to commit to such structural regulation in the EU is relatively lacking. This book will focus discussion on the UK Vickers Commission recommendations that has found overt support with the coalition government in the UK.

11.2 Vickers Commission recommendations

The Vickers Report proposes to ring-fence banks that accept retail deposits and provide individual and small business loans, in order that they may be structurally separate from the larger parent banking group, which may undertake activities exposed to market risk. Ring-fenced banks are prohibited from trading activities, sale and purchase of securities, and derivatives trading generally, but are allowed to undertake legitimate hedging activities\textsuperscript{22} and engage in wholesale funding arrangements that are ancillary to the retail deposit-taking and lending business.

Ring-fenced banks must provide ‘mandated activities’, a list of services set out in the Report, which preserve the social utility function of retail banks. The list of ‘mandated activities’ are services that, if interrupted, would result in severe economic costs, usually borne by customers who are least able to bear such costs.\textsuperscript{23} A bank labelled as a ‘retail bank’ in the UK would have to provide mandated services such as retail deposit-taking, payment systems and facilities, and individual and small business credit. Legislation supporting the structural reform would further specify the list of mandated activities. A ‘retail bank’ is ring-fenced in the sense that it cannot participate in ‘prohibited activities’, defined as banking services that meet any of the following criteria:

(a) make it significantly harder and/or more costly to resolve the ring-fenced bank;
(b) directly increase the exposure of the ring-fenced bank to global financial markets;
(c) involve the ring-fenced bank taking risk and are not integral to the provision of payments services to customers, or the direct intermediation of funds between savers and borrowers within the non-financial sector; or
(d) in any other way threaten the objectives of the ring-fence.\textsuperscript{24}

\textsuperscript{21}Erkki Liikanen, High-level Expert Group on Reforming the Structure of the EU Banking Sector (Final Report, October 2012) at para 5.5.1.
\textsuperscript{22}HM Treasury, Banking Reform: Delivering Stability and Supporting a Sustainable Economy (White Paper, Cm 8356, June 2012), para 2.38ff.
The HM Treasury White Paper, in affirming the political will to implement the Vickers recommendations, defines the per se prohibitions as:

- origination, trading, lending or making markets in securities (including structured investment products) or derivatives;
- secondary market purchases of loans and other financial instruments;
- conduit financing or securitisation of assets originated outside the ring-fenced bank; and
- underwriting of securities issues.\(^{25}\)

The HM Treasury White Paper did, in response to industry reactions, modify several of the restrictions and did not universally accept the model set out in the Vickers recommendations. Several of the modified features are intended to reduce cost. Sir John Vickers criticised the relaxed standards in the White Paper and subsequent events in the UK and US banking sectors may weaken industry reaction and strengthen the prospect of more extensive adoption of the Vickers recommendations.\(^{26}\) Legislation is likely to be proposed to finalise a larger list of prohibited activities based on a precautionary approach.\(^{27}\)

The ring-fenced retail bank may, however, engage in risk management and ancillary activities that expose it to market instruments and market risk. The Report, however, proposes that the scope of ancillary activities be subject to authorisation and supervision by the banking regulator.\(^{28}\)

Besides a prescriptive approach to what a ring-fenced retail bank can or cannot undertake, the Vickers Report proposes that such banks be structurally separated from the rest of the parent banking group. The ring-fenced retail bank would be a separate subsidiary with its own Board. Although the Report has considered the elimination of all ownership connections between ring-fenced retail banks and their universal banking group parents, the Report is of the view that common management or sharing of resources is much more detrimental to potential contagion than common ownership. Hence, there is no prohibition on common ownership. The ring-fenced retail bank should be separate from its universal bank parent in respect of management, legal and economic connections. Structural separation attempts to ‘carve out’ the retail bank for the purposes serving social utility and easier resolution but does not ban the model of the large financial group

\(^{25}\) HM Treasury, Banking Reform: Delivering Stability and Supporting a Sustainable Economy (White Paper, Cm 8356, June 2012), para 2.36.
\(^{26}\) As recommended by the House of Commons and House of Lords, Parliamentary Commission on Banking Standards: First Report (21 December 2012), Chapter 3.
\(^{27}\) HM Treasury, Banking Reform: Delivering Stability and Supporting a Sustainable Economy (White Paper, Cm 8356, June 2012), para 2.37; Financial Services (Banking Reform) Bill 2013, which allows specific permitted activities and exclusions to be made in secondary legislation.
as a conglomerate. This is seen to be particularly important in the EU as universal banking has been practised for a long time.\textsuperscript{29}

In terms of management separation, the ring-fenced retail bank should have its own Board and be ‘suitably independent’ from the rest of the group.\textsuperscript{30} Only one director on the Board of the ring-fenced retail bank is allowed to have a cross-directorship with another entity in the group.\textsuperscript{31} The government is, however, keen to recommend that at least half the Board be independent, hence refining Vickers’ original recommendation.\textsuperscript{32} Ring-fenced banks should also have their own independent Board committees on nomination, remuneration, audit and risk.\textsuperscript{33}

In terms of legal separation, the ring-fenced retail bank would be a separate legal entity with operational independence. This means that the ring-fenced entity should be independent in terms of its access to resources, staff, operational facilities and infrastructure. This access should not be compromised, irrespective of the health of the group.\textsuperscript{34} The government is considering the possibility that ring-fenced subsidiaries have some funding reliance on the parent company, but may set limits on such arrangements.\textsuperscript{35}

On economic links, the Report proposes that ring-fenced entities not transact with the rest of the group in such a manner as to render the fence meaningless. Hence, all dealings with group companies should be on a third-party basis,\textsuperscript{36} on arm’s-length terms that are no more favourable than in third-party relationships. In particular, asset sales or swaps must be on a third-party basis.\textsuperscript{37} This proposal is intended to prevent ring-fenced entities from being used to support the rest of the group and thus exposed to the solvency and liquidity risks of the group. The government agrees in principle and will no doubt consider more explicit limitations.

\textsuperscript{29} Erkki Liikanen, High-level Expert Group on Reforming the Structure of the EU Banking Sector (Final Report, Oct 2012) at 5.5.1.
\textsuperscript{32} HM Treasury, Banking Reform: Delivering Stability and Supporting a Sustainable Economy (White Paper, Cm 8356, June 2012), para 2.71.
\textsuperscript{33} HM Treasury, Banking Reform: Delivering Stability and Supporting a Sustainable Economy (White Paper, Cm 8356, June 2012), para 2.73.
\textsuperscript{35} HM Treasury, Banking Reform: Delivering Stability and Supporting a Sustainable Economy (White Paper, Cm 8356, June 2012), para 2.68.
on specific transactions. In particular, the ring-fenced entity’s exposure to the rest of the group will be controlled under existing legislation on large exposures; the ring-fenced entity should not provide any form of unlimited guarantee or indemnity to the group; limits should be placed on the total intraday exposures permitted between ring-fenced entities and the rest of the corporate group; and the ring-fenced entity should not be party to agreements that contain cross-default clauses or be subject to similar arrangements triggered by the default of entities in the rest of the group. Chow and Surti, however, warn that ring-fenced banks may contract more on an intra-group basis due to the restrictions placed on permitted activities and hence the concentration of intra-group exposure may itself pose a risk to the ring-fenced bank. The exact mechanics of separation are further debated and may be enhanced by the UK government in relation to separate risk management, human resourcing and remuneration structures in due course.

Further, as ring-fenced retail banks serve social utility purposes, providing intermediation and deposit services for the retail and small business sectors, the Report proposes that they should be subject to separate and more stringent prudential regulation in order to make them more robust against potential failure. On this point, the Liikanen review in the EU also seems to support affording local discretion in imposing more stringent micro-prudential regulation in order to meet local needs. The Report proposes that ring-fenced retail banks must hold more loss absorbing equity and debt than other financial institutions. Ring-fenced retail banks should hold a minimum of 10 per cent of its risk weighted assets in equity capital, much higher than the international standard of 8 per cent. Moreover, the Vickers Commission would have recommended an even higher level had it not been for compromises made after receiving representations from industry as weighed against research opinions. This threshold applies irrespective

38 HM Treasury, Banking Reform: Delivering Stability and Supporting a Sustainable Economy (White Paper, Cm 8356, June 2012), para 2.69.
42 Erkki Liikanen, High-level Expert Group on Reforming the Structure of the EU Banking Sector (Final Report, Oct 2012), p iii.
of extra capital surcharges already proposed in the Basel III Capital Accord.\textsuperscript{46} The government supports the higher capital charge but proposes that the higher capital charge should only be three percentage points above the capital conservation buffer, which can be reduced in times of stress. This brings the total capital adequacy charge for ring-fenced banks to one percentage point less than the Vickers recommendation.\textsuperscript{47} The Report also supports the Basel III standard of applying a 3 per cent leverage ratio to equity to the ring-fenced bank on a standalone basis.\textsuperscript{48} These proposals are intended to make ring-fenced banks more resilient to failure.

Further, the UK Parliamentary Commission on Banking Standards has proposed that regulators should have a reserve power to force a parent entity to divest its ring-fenced subsidiary, subject to such power being exercised in a transparent and accountable manner.\textsuperscript{49}

The objective of structurally ring-fencing the retail bank is to achieve a form of separation from its parent banking group and immunity from contagion. Does structural separation minimise the systemic risk posed by the banking group? It may be argued that systemic risk is mitigated as:

(a) structural separation forces the scale and size of both the retail and parent entities to shrink, thus making either less difficult or perhaps less expensive to resolve; and

(b) the interconnectedness between the retail and parent entities is reduced and therefore losses occasioned by one entity are less likely to infect the other, resulting in a cascade of losses.

With regard to (a), simplifying the SIFI structure may mean that the ring-fenced bank, as well as its parent conglomerate, are less likely to become so important that government bailout is needed in the event of failure. However, what makes a SIFI is a combination of factors, as discussed earlier, and structural separation of retail banks may not necessarily reduce the systemic importance of such retail banks. For example, a retail bank such as Lloyds TSB has a major share of the residential mortgage market and, even if the retail arm of the bank is structurally separate, the significance of the bank in relation to its retail market share could still pose systemic risk. Further, a retail bank such as Tesco is affiliated with a

\textsuperscript{47} HM Treasury, \textit{Banking Reform: Delivering Stability and Supporting a Sustainable Economy} (White Paper, Cm 8356, June 2012), para 3.11ff.  
\textsuperscript{49} House of Commons and House of Lords, Parliamentary Commission on Banking Standards: Banking Reform: Towards the Right Structure (11 March 2013), para 10ff.
larger diverse business in a non-bank sector. Tesco's significance as a retail institution on the whole could affect whether or not it should be regarded as sufficiently SIFI if it were to need rescuing. On the other hand, it may be argued that even if a bailout may be in the public interest where a ring-fenced bank fails, the social cost may be more manageable compared to the cost of bailing out a financial conglomerate such as the Royal Bank of Scotland in 2009.

Another concern is that structural separation of the retail bank does not mean that the remainder of the parent banking group, which may be involved in investment banking activities, is no longer entitled to ask for state rescue. The structural separation thesis could lull one into thinking that separation along the lines of social utility necessarily puts retail banks in a better position than other financial institutions in the event of needing rescue. But there is no presumption that state rescue will be limited to retail banks. SIFIs could require rescue as a result of wholesale sector activities, such as AIG in the US whose exposure to credit default swaps in relation to toxic sub-prime mortgage-backed assets seriously threatened its survival during the global financial crisis of 2008–9. A significant amount of real commercial activity depended on AIG’s viability as an insurer, such as the operation of commercial flights and shipping routes. Hence, a financial institution operating only in the wholesale sector may still be a SIFI and may still call upon the state for rescue.

Next, in relation to (b), does structural separation reduce the interconnectedness of entities and hence act as a firewall to prevent contagion of systemic risk? (b) seems to be based on the assumption that losses and risk emanate from the non-retail financial activities and hence the retail bank must be protected from such contagion. (b) also assumes that retail banks are less likely to fail by virtue of their more utility-based activities. These assumptions are misplaced. Investment banks are exposed to credit, market and operational risks and retail banks are likely to be exposed only to credit and operational risks. Retail banks are as likely to fail for taking on high levels of credit risk in lending to the retail sector or as a result of operational failures. Wallison argues that structural reform separating retail banking from investment banking does not achieve the aim of consumer protection. Structural reform is not able to deal with bad business decisions and business failure: a narrow bank can fail for bad or imprudent lending decisions. Thus, structural reform need not provide added security against institutional failure. Activities endogenous to the retail banking sector can themselves be highly risky and cause a retail bank to fail. For example, the failure of Dunfermline Building Society in the UK is largely due to poorly performing domestic


51 Just as in the secondary banking crisis in the UK in the 1970s, see Margaret Reid, The Secondary Banking Crisis, 1973-5 (London: Macmillan 1982).

commercial loans. The removal of the connection between retail and investment banks in a group may only mean that retail deposits no longer form the capital base for investment banking activities that expose the institution to market risk. However, this does not mean that retail deposits cannot form the capital base for other retail sector related risks, such as credit card lending and small business lending. Further, it may also be queried whether structural separation will have the effect of concentrating certain domestic credit risks in the ring-fenced banks. This could have the effect of augmenting systemic risk in the ring-fenced sector.

Weber argues that excessive complexity already exists in financial institution organisation, financial markets structures and networks, heightening risk and causing inexplicable dysfunctions such as the flash crash of 6 May 2010. Structural simplification contributes towards reducing excessive complexity and could entail general risk moderation in the financial sector. Further, it may be argued that structural separation may entail easier resolvability of financial institutions and so minimise the need for state bailout, or any state bailout may be less costly and manageable. Structural separation could also complement the regulatory regime of ‘living wills’, which will be discussed shortly. ‘Living wills’ compel banks to reflect on how structural simplification may be used to dispose of parts of the financial institution’s business in the event of a crisis or how resources may be called upon to assist the financial institution. Avgouleas, Goodhart and Schoenmaker argue that in drawing up living wills, financial institutions are compelled to think about how structure can be made simpler. If financial institutions could be resolved without having recourse to state rescue, then systemic risk would be substantially mitigated.

Moreover, a number of commentators regard the upholding of the social utility aspects of banking as being crucial to mitigating systemic risk. There is a need to prevent consumer confidence and markets from collapsing too quickly.


exacerbating the adverse behavioural patterns of herding and loss aversion in a financial crisis. In the words of Sheng, ‘Glass-Steagall set up firewalls between networks to prevent contagion between them. Repeal of the act in 1999 set the stage for complete network integration and therefore massive contagion’. The protection of the social utility core of banking and the public’s knowledge that such protection is in place could mitigate the effects of information contagion.

However, Chow and Suri warn that structural separation may cause systemic risk to migrate to the non-retail sectors and become concentrated there, heightening systemic risk in the non-retail sector. Further, systemic risk may unfold through the mechanisms of real contagion as well as information contagion. ‘Real contagion’ refers to negative effects spreading to financial institutions which are connected to the failing institution through counterparty default or other transactional connections. ‘Information contagion’ refers to negative effects spreading to financial institutions due to perceptions of weakness, whether justified or otherwise. Such perceptions of weakness can result in declining asset prices and seizure of activity, which then affect the real viability of the institutions. Structural separation within a financial institution group may not mitigate the forces of information contagion that lead to a loss of market confidence and adverse market perceptions. If information contagion is at work, then it may still be necessary to resort to state rescue in order to stem market panic. This is arguably the rationale behind the rescue of Halifax Bank of Scotland and the Royal Bank of Scotland in the UK in 2009.

Zingales argues that structural separation achieves a couple of other important purposes: promoting competition and shrinking the lobbying power of the banking and financial sector. Structural separation is perhaps the most frontal assault on banks’ sprawling empires and the systemic threats this phenomenon entails. Zingales argues that structural separation allows smaller focused financial outfits to develop in each sector, providing more competition. This development may then unravel the consolidations in the financial sector, which followed earlier liberalisation and deregulation, and this could have a positive impact in terms of de-complexifying and downsizing SIFIs. Further, he also argues that smaller focused outfits, divided by sector, are less likely to agree on objectives and consolidate power to form a monolithic and powerful lobbying force. In fact, their

59 Andrew Sheng, From Asian to Global Financial Crisis (Cambridge: Cambridge University Press 2009), 326.
objectives may play off against each other, mitigating undue political influence. Haldane also argues that structural separation and de-complexifying financial institutions could allow financial institutions to be priced more effectively by the market and this may be in the interest of financial institutions in terms of attracting equity financing.

There are a variety of other structural reforms suggested by other commentators in order to mitigate systemic risk. For example, Avgouleas suggests a three-tier classification of banking business and Kay suggests narrow-banking (see below) as a specific category of banks that would benefit from regulatory oversight, lender of last resort facilities and possibly government support.

Avgouleas suggests that banks should be licensed ex ante only in respect of certain activities. The bottom tier would comprise retail banks whose remit resembles that of Vickers’ ring-fenced banks. An intermediate tier would concern banks participating in some capital markets activities but limited by regulatory licence. These banks should have limited access to lender of last resort and government support channels. Finally, a third tier of banks engaging in investment banking should operate without a deposit-taking licence and with no guarantee of lender of last resort or government support. This would pave the way for the banking sector to become more diversified, so that homogenous risk-taking patterns are avoided. Further, there would be ex ante limitations to state rescue and fiscal commitments. Consumer choice and customer service could be improved with specialist narrow banks focusing on their needs. The need for regulatory oversight and intervention may also become more manageable.

Narrow retail banking has been proposed by John Kay. In Kay’s view, the mitigation of systemic risk in financial institution activities lies in the engineering concept of ‘modularity’ (i.e. the separability of the core utility function of the banking business, which is in the public interest and therefore deserving of regulatory intervention and support). The other banking functions would not be entitled to receive state support. Kay proposes that consumer deposit-taking and payments business be structurally separated from the rest of banking business, which should be allowed to be subject to market forces. He also advocates that institutions focusing on the utility aspect of banking alone be allowed to be called ‘banks’, so that banking itself becomes a narrow concept, with other business treated as financial business generally. Narrow banks may engage in consumer and small business lending as well as residential mortgages, but would not enjoy a monopoly of these functions. Narrow banks could be subsidiaries of other companies. As narrow banks carry out a utility function, which is in the public interest, they should be regulated for safety and soundness, with consumer

63 Andrew Haldane, ‘We Should Go Further Unbundling Banks’, Financial Times (3 October 2012).
protection being a top priority. Kay also suggests that in order to ensure robust consumer protection, deposits should be 100 per cent liquid and invested only in government bonds. Pacces\textsuperscript{66} defines core banking as the maturity transformation function (i.e. the ability to issue short-term liabilities based on capital adequacy) and other financial institutions should not be allowed to engage in this activity. This is also a form of narrow banking. However, Pacces’ proposal would constrain all short-term borrowing to banks and hence might counterproductively concentrate any systemic risk in that activity to narrow banks.

Structural reforms that modularise banking activities necessarily create impediments to certain economies of scale or operational efficiencies. The Vickers Commission accepts this trade-off; promoting competitive advantages for the financial sector cannot come at the expense of financial stability concerns and social cost.\textsuperscript{67} However, are regulators able to define banking business in modules and then parcel them out via regulatory licences?\textsuperscript{68} As regards the Vickers Commission recommendations, the dilemma in parcelling is clearly seen in the concessions concerning ‘ancillary’ activities, such as hedging using derivatives and engagement in wholesale market funding. These exceptions are not subject to hard limits, but require the bank concerned to manage and monitor risk. The modularisation of banking activities, which is at the core of structural separation reforms, is not easy to implement given the functionalisation of financial intermediation that has taken place over the last decade. Chow and Surti also predict that banks may innovate to challenge the boundaries of authorised and unauthorised activities. They also question whether it is worth wasting regulatory resources on boundary definitions and closing loopholes.\textsuperscript{69}

Kregel argues that banks are in the habit of looking for innovative ways, through tax and regulatory arbitrage, to reduce risks and costs. Hence, innovative models will always be developed that pose problems for regulatory classifications.\textsuperscript{70} As Persaud argues, the limiting of banking activity to a much smaller regulated sector is unlikely to appeal to international banks, given the size of their businesses and the profits that they have become used to. This may explain the Vickers Commission’s compromise on international banking operations of UK groups, which are not to be affected by the ring-fence proposals.


\textsuperscript{68} Commentators are of the view that belief in structural separation is founded upon ignorance as to how the practical world of universal banking operates, see Saptarshi Ghosh and Swetkaitu Patnaik, ‘The Independent Banking Commission (Vickers) report: Squaring the Circle?’ (2012) \textit{International Journal of Law and Management} 141 at 145.


Although the Vickers Commission seems to support structural separation, it has nevertheless acknowledged that structural separation will not necessarily eliminate systemic risk. The key objective underlying ring-fencing seems be the restoration of social utility and the consequent redefining of the public interest profile of banks (limited to aspects of social utility). Although the authors do not think that systemic risk is necessarily mitigated or that state bailout measures will never again be applied to investment banks, structural reforms could initiate a gradual process of redefining the terms upon which the state will act in the public interest and develop a sociopolitical stance against bailing out non-ring-fenced entities. In other words, the longer-term ramifications of structural reforms may be a more limited definition of the public interest profile of financial institutions, clearer articulations of the extent of any commitment of state resources to resolution and, possibly, a bifurcation of regulatory regimes in prudential regulation. Structural reforms are a good example of shifting fundamental premises in financial regulation, allowing perspectives from social utility to participate in the dialectical process shaping financial regulation for the future. However, one must not forget the lobbying cries against the Glass-Steagall separation of commercial and investment banking in the 1990s. Arguments against regulatory straitjacketing of financial business are likely to be in vogue when the markets recover. As the Vickers Commission proposals are subject to a long phase-in period from 2015, it remains to be seen whether the ideological underpinnings of the structural reforms in social utility and in redefining the public interest will continue to hold.

Structural reform to preserve the social utility of banking is based on the assumption that there is an absoluteness and timelessness to what we assume to be ‘social utility’ today. Ring-fenced banks will not be able participate in potentially socially useful projects such as project finance. Will ring-fencing ironically reduce the social utility of banks as they become locked into the mandatory provision of a narrow list of services? Will other unregulated institutions develop to meet other financial needs in society, marginalising the usefulness of the ring-fence? Kay has also identified a key dilemma in regulatory governance of businesses that also provide core utility services (such as electricity): short of nationalisation, a business needs to be disciplined by market forces and be allowed to fail. Hence, there is a need to maintain a balanced approach to avoid over ‘socialising’ the banking business.

In the US, the Dodd-Frank Act 2011 ultimately supported another limited structural response. The Volcker rule limits proprietary trading for banks and caps any investment that banks may make in hedge or private equity funds at 3 per cent of its Tier One capital. It also prohibits banks from entering into transactions where there may be ‘material conflicts of interest’ with investors.

There are however a number of exceptions to the Volcker rule, such as in relation to government securities, transactions for customers and risk management activities, such as hedging.

The Volcker rule could be regarded as a structural reform in that it prevents banks from taking on the risks of certain lines of business, such as proprietary trading and investing in the perceivably riskier alternative investment fund sector. However, a critique that could be levied against the Volcker rule is its confused foundation: is the Volcker rule a structural-type reform aimed at mitigating systemic risk or does it really deal with management of conflicts of interest? If the Volcker rule is aimed at the latter, although the management of conflicts of interest could, as discussed in Chapter 10, relate to financial empire building and the increase in the systemic risk impact of a financial institution, it could also merely relate to simple consumer protection. In terms of the Volcker rule being ‘structural’ in nature, Tuch argues that it is a weak form of imposed segregation (or limitations on banking activities), as the hedging exception and the ‘material conflict of interest’ qualification regarding transactions in general open up a broad scope of activities that banks can still engage in. In other words, Tuch sees the limitations on proprietary trading as likely to be narrowly interpreted. As such, they would only relate to conflict of interest management and not structural reforms as such. Harding also argues that the Volcker rule is not related to mitigating systemic risk, as it does not deal with interconnections between and within financial institutions and contagion possibilities. Hence, there is no real correlation between the Volcker rule and making the financial institution more resilient to crisis or failure. Scott also regards the Volcker rule as one of the ‘negatives’ in the Dodd-Frank package of reforms, arguing that investments in alternative investment funds have nothing to do with the financial crisis of 2008–9 and that such arbitrary limitations placed upon US banks’ business models will only hamper their development and competitiveness. The authors are of the view that the Volcker rule does not bear a strong correlation to systemic risk mitigation.

As a conflict of interest management measure, the Volcker rule may be overly prescriptive without having a more comprehensive game plan in dealing with the relationship between management of conflicts of interest, customer protection

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and the systemic effects of empire building. Bunting argues that if the Volcker rule is intended chiefly to protect customers by reducing the scope for conflicts of interest, then it is certainly not robust enough as the key to customer protection lies in ensuring suitability and making financial intermediaries take more responsibility for advice and distribution. Thus, issues such as proprietary trading may be symptomatic in nature if the underlying objectives are not clearly related to the regulatory measure.

It is also pertinent to note that structural reform measures are proceeding along national lines and there seems to be no convergence in sight at the international level. Hence, perhaps the greatest obstacle to effective structural reform may be the lack of international harmonisation in this area, as regulatory arbitrage could occur, limiting the impact of any measure pursued along national lines only.

### 11.3 Living wills for SIFIs

The UK Financial Services Act 2010, passed in the wake of the global financial crisis of 2008–9, provides for the regulator to require financial institutions to draw up *ex ante* ‘recovery and resolution plans’ in order to set out how they would deal with a potential crisis. The ‘recovery plan’, more popularly known as the ‘living will’, is an internationally endorsed measure to facilitate orderly resolution of a financial institution in crisis at minimum social cost. It is also envisaged that ‘recovery plans’ would likely bring in a form of structural modularisation for SIFIs in the event of a crisis, hopefully reducing the potential need for state rescue. Such ‘recovery plans’ would be drawn up under the supervision of the regulator. The flip side of the recovery plan is the ‘resolution plan’, which would involve regulatory intervention where the troubled financial institution may not be able to turn around on the strength of its recovery plan alone.

The ‘recovery plan’ may be regarded as a soft form of structural regulation, as Avgouleas, Goodhart and Schoenmaker argue that, in drawing up recovery plans, financial institutions are compelled to think about how structure can be made simpler so that the sale of assets or even partial liquidation could be a viable resolution option in a crisis. They also argue that the discipline imposed on financial institutions in drawing up recovery plans may also compel them to consider the difficulties of resolution for groups which have many cross-border

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77 Financial Services Act 2010 (UK), s 139B.


businesses. Thus, the recovery plan is a regulatory strategy that is intended to address the systemic impact of SIFIs from both the structural and resolution perspectives, although the structural aspect is contingent upon the materialisation of a crisis. Work is also in progress at the EU level to provide a framework for recovery and resolution plans as a measure of legal harmonisation.

The European Commission’s proposed Recovery and Resolution Directive envisages that information from recovery plans could assist regulators in taking pre-emptive actions to address likely obstacles to the successful implementation of the plans.\(^{81}\) However, Liikanen is of the view that the prospect of structural simplification should not be left implicit in reforms dealing with recovery and resolution plans. The Liikanen review\(^{82}\) supports the feeding in of structural simplification into recovery and resolution plans and calls for local resolution authorities to have powers to impose structural separation requirements upon review of recovery and resolution plans that may not be adequate. Structural simplification would thus amount to a pre-emptive measure justified on the basis of likely difficult resolution of the financial institution. There would not be a general implementation of structural reforms. Structural simplification would be a discretionary measure contingent upon the regulator making a judgment regarding the difficulties of resolvability. Such an approach may avoid some of the pitfalls of the more general approach recommended by the Vickers Commission discussed earlier, but may have less impact in terms of reflecting fundamental shifts in the premises of financial regulation relating to social utility and banking culture.

Feldman\(^{83}\) is less optimistic about the structural impact of recovery plan regulation. He argues that unless structural reform is imposed so that changes are seen and observed, it is unlikely that financial institutions will forego the ease, convenience and, possibly, tax and arbitrage advantages of economies of scale and interdependencies and voluntarily subject themselves to pruning even before a crisis looms. Hence, recovery plans should be regarded as institution-specific crisis management plans, working in tandem with regulatory intervention through ‘special resolution regimes’ (SRRs) under the UK Banking Act 2009, for example. One could add to this that recovery plans that appear to be viable could increase the costs of activities that are to be severed and disposed of in the event of such a crisis. Even where plans are not actually viable, the existence of a plan as such

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82 Erkki Liikanen, High-level Expert Group on Reforming the Structure of the EU Banking Sector (Final Report, Oct 2012) at para 5.5.2.
could strategically give the management of a financial institution in crisis the upper hand in negotiations with creditors and authorities. The regulation of recovery plans could give rise to perverse incentives and the industry’s motives can never be taken for granted.

In the UK, the regulator has commenced dialogue with SIFIs, requiring them to draw up recovery plans.\textsuperscript{84} It is envisaged that the recovery plan should have elements of capital and liquidity planning that can be credibly executed in a short time span and that the range of options should be as diverse as possible in order to adapt to the situation at hand. The main recovery options are likely to be raising additional capital by forcing debt conversions into equity, looking into liquidity funding by ‘running down the book’ (i.e. asset sales) or running down the business (if divisions of business in a financial institution can be readily compartmentalised and sold), and calling upon other entities within the group in order to fulfil collateral requirements without allowing for unlimited intra-group guarantees, which would have the opposing effect of dragging the group down with the stricken part.\textsuperscript{85} Goodhart\textsuperscript{86} has, however, warned that it is crucially important to determine the threshold at which the recovery plan kicks in. If recovery plans contain very low-value crisis triggers (i.e. when the financial institution’s value has dropped tremendously, as opposed to the first signs of a crisis), then the plan could be rendered unworkable if the markets for assets or liquidity have already dried up. Earlier crisis triggers are supported by a number of commentators,\textsuperscript{87} but it is queried whether earlier crisis triggers would nevertheless feed into a form of informational contagion, causing market confidence to plummet prematurely anyway.\textsuperscript{88} The window period for any recovery plan to work may be extremely small and, hence, the effectiveness of a recovery plan in avoiding systemic risk effects is highly doubtful. The prospective systemic risk may also be an advantage for management of a financial institution (or group of institutions or a whole sub-sector or sector) seeking bailout.

\textsuperscript{84} Thomas Huertas, ‘Living Wills: How Can the Concept be Implemented?’ (Speech at the Wharton School of Management, University of Pennsylvania, Philadelphia, 12 February 2010) www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0212_th.shtml accessed 2 March 2013. The power to require recovery plans to be drawn up applies broadly in the UK and not only to SIFIs, but it seems that the first phase of supervision has focused on SIFIs.

\textsuperscript{85} Basel Committee on Banking Supervision, Resolution Policies and Frameworks – Progress so far (Basel: BIS 2011) www.bis.org/publ/bcbs200.pdf accessed 2 March 2013, para 183. See further, FSA draft FINMAR rules on recovery plans (May 2012) and the EBA’s proposal to harmonise recovery plans in the EU (May 2012).

\textsuperscript{86} Charles Goodhart, ‘Basel on wrong path to tackle systemic risk’ Financial Times (London, 8 July 2011). Goodhart has made the possibility for actual enforcement one of the central themes of his analysis, which very few have recognised the importance of.


\textsuperscript{88} See discussion of systemic risk in Chapter 2.
Huertas,\textsuperscript{89} for instance, predicts that recovery plans may be more effective in an institution-specific crisis as opposed to a systemic problem. However, where a SIFI is concerned, the line between what may be contained within an institution and what may be contagious or systemic is hard to draw. As a recovery plan is neither a clearly structural reform nor a comprehensive private resolution regime, the recovery plan can only work in systemic risk mitigation in conjunction with two regulatory regimes: \textit{ex ante} micro-prudential measures, which will be discussed shortly, and resolution regimes put into place by legislation, such as the UK Banking Act 2009, which contains a suite of regulatory intervention powers.

Many commentators\textsuperscript{90} see adjustable micro-prudential charges, especially if they are enhanced for SIFIs, as the way forward rather than potentially crude structural reforms. That said, the recovery plan may be useful in another way: as an information provision platform for regulatory supervision of SIFIs so that micro-prudential supervision can be refined. The move towards a regulatory surveillance age in the post-crisis landscape will be discussed further in Part 4.

As for resolution plans, financial institutions are required to put these in place to show how they may be wound down and resolved if recovery fails.\textsuperscript{91} The authors note that these plans are required to be prepared by the financial institutions themselves in the UK, but the EU approach seems to be different. The proposed Recovery and Resolution Directive requires resolution authorities to put in place resolution plans for each relevant financial institution upon consultation with national regulators.\textsuperscript{92} Although making resolution authorities responsible for maintaining resolution plans indicates certainty in the resolution process, and this is in the interests of preserving stability in the financial markets, we wonder if such pre-commitment could exacerbate moral hazard, as financial institutions become aware of the extent to which they could push their limits? We prefer the UK approach in making financial institutions responsible for suggesting resolution options. Resolution plans submitted by financial institutions could mitigate information asymmetry between regulators and firms and allow regulators to consider pre-emptive regulatory strategies to mitigate the financial institution’s likely systemic impact, as well as weigh up the likely outworking and cost of any resolution.


In sum, living wills is a regulatory strategy that intends to limit the risk of state bailout, facilitate orderly resolution, and possibly reduce the systemic impact of financial institutions by inspiring structural simplification. The literature review above shows that doubts are cast regarding the achievement of all of the above objectives as recovery or resolution plans may not operate in a timely manner or in the manner planned for the purposes of orderly resolution, therefore never actually relieving the state of the prospect of bailout. Further, making financial institutions involved in preparing recovery and resolution plans may not inspire *ex ante* structural simplification if there are conflicting business objectives that financial institutions wish to pursue. That said, the authors are of the view that compelling financial institutions to draw up recovery and resolution plans may force them to confront their risks, the sustainability of their business models and the issue of wider responsibility in their intermediary functions for the real economy. The authors agree with the views of the Liikanen review that the regulation of recovery and resolution plans could feed into more pre-emptive action taken by regulators to mitigate the systemic risk impact of SIFIs. The authors are also of the view that the resolvability of SIFIs could form the basis for wider discourse regarding the sustainability and social utility of certain banking business models. We encourage regulators to take leadership in providing such a platform for discourse and in supporting shifts in the fundamental premises of financial regulation to reflect the importance of public interest in the sociopolitical sense.

### 11.4 Bank resolution regimes

The global financial crisis exposed a gap in the landscape of prudential regulation – the lack of crisis management and resolution regimes for banks and financial institutions. Although prudential regulation deals largely with *ex ante* measures such as capital adequacy, the existence of a credible crisis management and resolution framework could provide stability and confidence in the orderly resolution of a failing institution, achieving the same effect of stemming systemic panic as intended to be achieved by prudential regulation. The authors regard crisis management and resolution as part of the prudential regulation landscape, as the objective of preserving financial stability is the common end.

A number of commentators also agree that the existence of orderly crisis management and resolution regimes is likely to foster market confidence in the event of a crisis and thus stem systemic risk. Hoggart, Reidhill and Sinclair,

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writing in 2004,\textsuperscript{96} opined that whether in an individual bank crisis, such as Barings in 1998, or in a systemic wide banking crisis, state-led crisis resolution may be indispensable. State-led crisis resolution may include, at the outset, the provision of liquidity (as lender of last resort), which may subsequently turn into a full-scale bailout. The key issue in any state-led crisis resolution is the balance between short-term/immediate financial stability and longer-term moral hazard and fiscal cost. Hence, crisis management and resolution regimes should be designed in such a way as to strike a balance between the needs of financial stability and avoiding ‘lemon socialism’.\textsuperscript{97} ‘Lemon socialism’ is a term that refers to the phenomenon of governmental nationalisation or bailout of weak enterprises that should have been allowed to fail in the natural working of market capitalist forces. The adverse effects of ‘lemon socialism’ are social cost in supporting weak and uncompetitive enterprises and the consequent distortions in the competitive landscape. However, making a judgment on whether a stricken enterprise is a ‘lemon’ is not an easy exercise and involves some extent of crystal-ball gazing.\textsuperscript{98} In other words, the social cost of instability that may result from the systemic impact of a failing financial institution needs to be weighed against the social cost of potential ‘lemon socialism’, an exercise that is more judgement-based than susceptible to precision.

Short-term financial stability may be achieved by robust state-led crisis resolution, but often the long-term effects of fiscal cost drag the economy into the doldrums for at least five to seven years. Moreover, a bad legacy of moral hazard may be left for the rescued financial institutions and the industry in general.\textsuperscript{99} The response to the global financial crisis in the UK, US and parts of Europe has been to stem short-term instability by extensive bailouts, for fear that systemic collapse will inflict even greater injury on the financial sector and economy. In view of the almost inevitable role of the state in any bank crisis, an \textit{ex ante} framework for resolution could provide assurances as to state action but also provide limits as to the commitment and cost of any state action. The longer-term fiscal cost and moral hazard in the role of state intervention is a question that is both acute and alive in the post-bailout countries such as the UK, Ireland and Spain.


\textsuperscript{97} See, for example, Robert Reich, ‘How America Embraced Lemon Socialism’ (23 January 2009) http://robertreich.org/post/257310131 accessed 1 June 2013.

\textsuperscript{98} Judgments need to be made as information about potential transaction costs and the going concern surplus of a financial institution if kept afloat may not be perfect. See Randall D Guynn, ‘Are Bailouts Inevitable?’ (2012) 29 \textit{Yale Journal on Regulation} 121.

In the absence of a crisis management and resolution framework in 2007, the UK was faced with its first bank run in decades.\textsuperscript{100} When news of Northern Rock’s request for liquidity assistance by the Bank of England broke on 13 September 2007, depositors queued up outside the branches of Northern Rock to withdraw deposits en masse.\textsuperscript{101} This was followed by the Chancellor’s announcement on 17 September 2007 that deposits in Northern Rock would be completely guaranteed and that the Bank of England would inject liquidity into the bank. After unsuccessful negotiations for a private sale of Northern Rock in late 2007, the government ultimately nationalised Northern Rock in February 2008.\textsuperscript{102}

The Northern Rock debacle triggered the enactment of the Banking Act 2009,\textsuperscript{103} which provides for a legal framework for crisis management and resolution of banks. We turn now to critically explore the legal framework in the Act before discussing the prospective European reforms in recovery and resolution. We argue that although the UK Banking Act 2009 framework provides some certainty as to the range of state-led actions that may be taken at a sufficiently early stage of a bank crisis, the legal framework reflects a perhaps excessive fear of systemic risk.\textsuperscript{104} We question whether such risk is overestimated, and whether the legitimate public interest in avoiding ‘lemon socialism’ has not been sufficiently addressed.

\textsuperscript{100} http://news.bbc.co.uk/1/hi/business/7007076.stm accessed 1 June 2013.


\textsuperscript{102} Northern Rock has eventually been sold at a loss to Virgin Money in late 2011. See ‘Northern Rock Sold to Virgin Money’, \textit{BBC News} (London, 17 November 2011).


\textsuperscript{104} The fear of systemic risk is the fear that the liquidation of a financial institution would result in value-destroying or fire sale liquidation, wiping asset and business value out more than is necessary. In which case a bailout provides a kind of moratorium against the destructive forces of rapid liquidation. See Randall D Guynn, ‘Are Bailouts Inevitable?’ (2012) 29 \textit{Yale Journal on Regulation} 121 at 127.
11.4.1 The UK Banking Act 2009

The UK Banking Act 2009 applies to banks defined as deposit-taking institutions and so does not apply functionally across the financial sector. The Act provides for the regulator (the Prudential Conduct Authority from 2013) to decide if a resolution power needs to be exercised, but the entities discharging the resolution power may be the Bank of England or the Treasury. The Bank of England may arrange a private sector purchase for the ailing bank or a transfer of all, or part, of the ailing bank’s business to a bridge bank owned by the Bank of England. The Treasury may decide to take the ailing bank into temporary public ownership as it did with Northern Rock in 2008. These resolution regimes are accompanied by a suite of powers (including management powers and property expropriation or transfer powers) that may be exercised by the Bank of England or the Treasury.

Although the Banking Act 2009 has enacted a resolution framework for ‘banks’ only, defined with respect to deposit-taking functions, the framework was extended to the resolution of Dunfermline Building Society in 2009. It remains to be seen whether the resolution regime will apply to non-bank financial institutions as well. The cases of Lehman Brothers and AIG in the US serve as reminders that non-bank financial institutions may also be systemically important, as it is not just deposit-runs that spark systemic crises. The drying up of repo funding in the wholesale market and materialisation of derivative exposures may also be significant precursors to a systemic crisis. However, Brierly cautions that special resolution regimes may need to be applied with modification to different types of SIFIs, due to the complexity of issues that each SIFI group presents.

The Banking Act 2009 sets out three SRRs for banks that are ‘failing or likely to fail to satisfy its threshold conditions’ and where it is ‘not reasonably likely that . . . action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions’. The threshold conditions refer to the conditions under which the bank was authorised to operate in the first place, such as capital adequacy. Čihák and Nier argue that it may have been better if the conditions...

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105 Banking Act 2009 (UK), s 2.
106 Banking Act 2009 (UK), s 7. This power is devolved to the Prudential Regulation Authority upon the dissolution of the FSA in 2012.
107 Banking Act 2009 (UK), ss 11, 12.
109 See Banking Act 2009 (UK), ss 16–72.
110 Banking Act 2009 (UK), s 2.
113 Banking Act 2009 (UK), s 7.
for SRRs to kick in were defined in a more discretionary manner, so that the regulator could also have recourse to the SRRs in the case of developments of systemic concern that do not fall squarely within the hard capital targets. We, however, think that the criteria relating to capital thresholds are sufficient to allow early action\textsuperscript{114} to be taken, as falling short of capital thresholds does not necessarily mean that a financial institution has come close to insolvency. SRRs could therefore apply at a sufficiently early stage to preserve market confidence and as much of the business that is viable. In view of the trigger conditions for resolution proposed by the EU, as will be shortly discussed, the criteria in the Banking Act 2009 may even seem to be premature. The readiness of bringing in SRRs at the first signs of a crisis could exacerbate moral hazard in the markets and industry, if banks perceive that the safety net could be called upon in a wide range of circumstances, incentivising perverse risk-taking behaviour. There is a difficult balance to be struck in the implementation of SRRs. If SRRs are brought in only when a financial institution is clearly beyond recovery, then options involving fiscal cost could be inevitable. The application of SRRs would also have to be mindful of the need to preserve the viability of the bank so that shareholder value can be returned, and so that shareholder expropriation may not be too readily carried out.\textsuperscript{115}

Does the application of SRRs mean that the financial institution in crisis may as far as possible be preserved so as to minimise fiscal cost in rescuing it? Whether or not the existence of SRRs give that impression, we argue that in fact, two out of three of the options in SRRs, as will be discussed below, involve fiscal cost. Hence, the UK framework for SRRs is not likely to help reduce the incidence of fiscal cost, even if the ‘confidence’ effect of having SRRs may mitigate systemic risk.

The SRRs under the UK Banking Act 2009 are: private sector sale, bridge bank and temporary public ownership. A private sector sale would be led by the Bank of England,\textsuperscript{116} which is responsible for drafting the share and property transfer orders. The state may provide assistance in order to encourage a private sector solution (such as in the Lloyds-HBOS merger). There are some safeguards instituted in order to prevent cherry-picking in property transfers.\textsuperscript{117} A resolution


A bridge bank, is a scheme whereby the business of the failing institution may be transferred to a company owned by the Bank of England, in order to buy time for the outworking of a private sector sale or to transfer good assets to good banks while keeping troubled assets away. The bridge bank scheme was implemented in the resolution of Dunfermline Building Society in 2009, where the viable parts of Dunfermline’s business retail and wholesale deposits were transferred to Nationwide Building Society while troubled social housing loan assets remained at the bridge bank.

Temporary public ownership, or nationalisation, is decided upon by the Treasury, only if a serious threat to the financial stability of the UK is occasioned. The same powers in respect of share and property transfers, and removal and appointment of management exist where the Treasury nationalises a bank as where the Bank of England leads a private sector purchase under section 11 of the Act. However, this measure is likely to be the most costly in fiscal terms, as Northern Rock proved to be. The sale of Northern Rock was slow, concluded at a loss to taxpayers in November 2011, almost three years after nationalisation. The Financial Stability Board has warned that exit strategies must be planned where bailouts have taken place, in order to mitigate fiscal cost and long-term moral hazard.

The UK Banking Act 2009 also provides for a special administration and liquidation regime to be led by the banking regulator, Bank of England or Secretary of State to the Treasury if failure cannot be avoided. The discontinuity of a banking business, as Hoggarth, Reidhill and Sinclair have pointed out, may have adverse consequences that are still tolerable where only an individual bank is concerned. That said, the insolvency of BCCI, a Luxembourg bank with significant UK operations in the commercial banking sector, in 1990 still triggered

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118 Banking Act 2009 (UK), ss 54–58.
119 Banking Act 2009 (UK), ss 59–60.
120 Banking Act 2009 (UK), s 12.
121 This strategy is discussed in Peter Went, ‘Lessons from the Swedish Banking Crisis’ (February 2009) http://ssrn.com/abstract=1343200 accessed 2 March 2013, as a way of preserving as much as possible the viable value of the business of the failing bank, while keeping troubled assets away so that such assets may be gradually realised over the longer term under more favourable market conditions. Fire sales of troubled assets, which may provoke further downward spiralling of the asset price on the market, are thus avoided.
122 Banking Act 2009 (UK), s 13.
125 Banking Act 2009 (UK), ss 96–97, 143–144.
an inquiry\textsuperscript{126} and long drawn out private claims, as well as claims against the regulator,\textsuperscript{127} then the Bank of England. In light of the SRRs set out in the Act, liquidation and administration are not likely to be preferable options, especially if their effects are unpredictable and systemically disturbing in the short term. This also means that the UK is prepared to deal with systemic risk by potentially incurring fiscal cost, unlike the US approach. Although the operation of SRRs would result in losses being borne by creditors and shareholders, longer-term fiscal cost may be significant, as observed in the case of the UK. The SRRs are likely to be preferred to administration or liquidation, but it is difficult to compare the cost of institutional failure to the fiscal cost of state intervention and the cost of moral hazard. The SRRs address the systemic risk posed by SIFIs by promising a backstop that ultimately has recourse to fiscal cost. Whether a bank is sold to a private sector purchaser outright or after a bridge bank has been put in place, some fiscal cost is involved if private sector purchasers must be incentivised to rescue the bank. Fiscal cost is of course incurred if nationalisation of the bank takes place. Could it therefore be argued that SRRs are in fact a form of guaranteed state bailout for SIFIs and may give rise to perverse incentives to increase risk taking and moral hazard?

Would a liquidation or administration regime work better in terms of mitigating moral hazard? A liquidation or administration regime may be harsher on shareholders and bondholders and less costly for the state. Coffee argues that SRRs are superior to the US regime, which is likely to force early liquidations under the receivership of the Federal Deposit Insurance Commission as the Dodd-Frank Act is averse to the possibility of future public bailout.\textsuperscript{128} But a number of commentators\textsuperscript{129} are of the view that orderly liquidation or administration could also have a ‘confidence’ effect, perhaps superior to that of SRRs as SRRs tend to be too dependent on fiscal backing. Having SRRs in place may also cause policymakers to be resistant to the idea that financial institutions should perhaps fail, a possible recipe for moral hazard.\textsuperscript{130} The UK Banking Act 2009 places more emphasis on rescue ultimately backed by the state than ‘orderly failing’ preferred in the US. As such, policymakers have to consider if such a high price should be paid for the needs of financial stability\textsuperscript{131} or whether these needs are


\textsuperscript{127} \textit{Three Rivers DC v Bank of England} (No.3) [2000] UKHL 33, [2000] 2 WLR 1220.


\textsuperscript{131} It is argued that state bailout could itself be regarded as a public good. See Xavier Freixas, ‘Crisis Management in Europe’, in Jeroen Kremers, Dirk Schoenmaker and Peter Wierts (eds), \textit{Financial Supervision in Europe} (Cheltenham: Edward Elgar 2003), 102.
overestimated. However, it could be argued that the SRRs need to be viewed as part of an integral framework in the UK, which would include structural reforms that are *ex ante* in nature. The *ex ante* implementation of structural reforms may indeed provide clearer guidance for policymakers in due course as to whether any financial institution ought to be rescued in the light of social cost weighed against public interest.

SIFIs are likely to have cross-border operations. Will SRRs result in states incurring fiscal cost for SIFI activities that extend well beyond the state? On the one hand, a lack of a transnational or international framework for resolution may give rise to uncertainty and drive a lack of confidence and systemic risk. On the other hand, such transnational frameworks could also augment moral hazard at the transnational level, as SIFIs see that there are backstops to match the scale of the systemic risk they pose. SRRs could arguably become firefighting strategies that deal with the aftermath of damage, but do not deal with and may indeed create perverse incentives for the behaviour that gives rise to the damage in the first place. The EU is working on a common legal framework for preventive supervision, recovery plan development, crisis management strategies and fiscal burden sharing in relation to failures of cross-border financial institutions. To this we now turn.

### 11.4.2 The proposed European Recovery and Resolution Directive

As Kudrna points out, the pre-crisis arrangements in the EU for the resolution of banks that have cross-border operations were voluntary, loose and ineffective when tested in the global financial crisis. The lack of pan-EU harmonisation in this area has brought about an arbitrage opportunity for the institution of national legal frameworks that would favour national interests above the interests of coherently resolving cross-border problems for the multinational SIFI. The Icelandic resolution of its three failed banks Kaupthing, Glitnir and Landsbanki was a key example of overwhelming protection for national interests above achieving a coherent cross-border resolution for the banks’ deposit-taking businesses in the UK and the Netherlands. The UK response, seizing all the available assets of the banks licensed in Iceland, was an equally individualistic

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134 Michael Waibel, ‘Iceland’s Financial Crisis – Quo Vadis International Law’ (2010) 14 *ASIL Insight* at www.asil.org/insights100301.cfm. The Icelandic authorities did not give undertakings that they would make good their obligations under the Deposit Guarantee Directive. EU law on the other
solution (in relation to those banks’ non-UK depositors and other creditors). The resolution of Fortis by the Netherlands, Belgium and Luxembourg was also not straightforward although a Memorandum of understanding had been in place between the Benelux countries pre-crisis. The resolution of Fortis initially proceeded in a coordinated manner, but the Netherlands was the first to move away from a multilateral resolution of Fortis and nationalised the Dutch operations of Fortis. The unilateral action started by the Dutch was due to insufficient commitment to a multilateral solution and the perceived lower cost of national resolution. Belgium and Luxembourg then arranged for the rest of Fortis operations in their respective countries to be sold to the BNP Paribas Group. However, the lessons from the patchy resolution of Fortis seemed to have been learnt as the Dexia bailouts proceeded in a more coordinated manner between France, Luxembourg and Belgium. The European Banking Authority (EBA) has commenced an interim harmonised framework as of mid-2012 and policymakers at the EU level clearly see a need for a blueprint for multilateral action in resolving banks and financial institutions with pan-European or cross-border operations in the EU. Such a blueprint is being worked upon in the form of the proposed Recovery and Resolution Directive, largely premised on the Financial Stability Board’s guidance regarding the institution and design of recovery and resolution regimes.

Further, the Single Supervisory Mechanism in the form of the European Central Bank’s (ECB) direct prudential supervision of euro area banks and non-euro area banks that are subject to its supervision may also provide centralised guidance for multilateral action to be undertaken in the future if a need to resolve an ailing bank with cross-border operations arises.

The advantages of having a multilateral framework for crisis resolution in the financial sector have been pointed out by a number of commentators. The existence of a multilateral framework for crisis resolution could provide certainty as to how resolution may take place, even if national authorities lead the aspects of resolution in their own jurisdictions. Such a framework could also provide for

hand does not allow the seizing of assets as UK authorities undertook in response. The whole saga was a set-back for the Internal Market and the respect for EU law, and similarly the emerging principles of universality in the handling of insolvencies. However, see EFTA Surveillance Authority with the European Commission v Iceland Case E-16/11 (28 January 2013); Eyvindur G. Gunnarsson, ‘The Icelandic Regulatory Response to the Financial Crisis’ (2011) European Business Organisation Law Review 2.


the recognition of the legal effects of action undertaken taken in one jurisdiction in the rest of the EU so that long-drawn out litigation over rights attaching to assets may be mitigated. Further, such a framework encourages commitment between national authorities to coordinate with each other and to refrain from taking actions such as seizure of assets without considering spillover effects, and could also provide guidelines on the sharing of burdens and cost in the resolution process. However, achieving pre-commitment to crisis resolution and burden sharing is an inherently difficult matter as there is great temptation to defect from pre-commitment in order to address any conflicting national interest. We will examine the framework for resolution in the proposed Recovery and Resolution Directive and argue that the multilateral template provided in the Directive has been framed at such a general level that it may be insufficient to compel genuine pre-commitment by Member States or prevent subsequent unilateral actions. The approach taken by the Directive may reflect the compromises made in securing agreement among Member States in such difficult issues.

The proposed Recovery and Resolution Directive requires all Member States to establish national resolution authorities to oversee the implementation of recovery and resolution plans and to be responsible for taking resolution action when required. A framework is provided for crisis management of financial institutions in a number of phases. First, early intervention measures such as requiring the implementation of the institution’s own recovery plan may be taken. The criteria for early intervention seem, however, to be the same criteria for resolution to kick in under the UK Banking Act 2009. This raises the question whether the UK may be mistaken in bringing in crisis resolution and management at a too early stage thereby relieving financial institutions from the responsibility to recover and preserve shareholder value. The Financial Stability Board’s guidance on this matter also seems to suggest that resolution regimes should kick in when the institution is no longer viable or has no reasonable prospect of being so, and hence the UK Banking Act 2009’s trigger for resolution (i.e. ‘failing or likely to fail to satisfy threshold conditions’) may be relatively early. Next, if there is a significant deterioration in the financial institution, national authorities could appoint a special manager to manage the financial institution akin to an administrator. The Directive provides that national authorities should coordinate with each other in such early intervention measures and the EBA should provide overall oversight of Member State coordination so that multilateral rather than unilateral actions would be taken. Group resolution will be undertaken

by a college of resolution authorities, but such a college should have ex ante information-sharing, outlines of resolution plans and financing plans in place. The resolution colleges would be subject to the European Banking Authority’s oversight.

The proposed Directive provides conditions for triggering resolution measures, such as the unlikelihood of the financial institution to avert failure and a clear need for bailout. However, the resolution tools de-emphasise nationalisation and state bailout, providing for a framework for private sale, the establishment of a bridge bank, asset separation and the bail-in tool. The institution of a bridge bank and asset separation would require the separation of (usually bad) assets to asset management vehicles owned and managed by national resolution authorities. These measures are likely to involve some measure of fiscal cost.

Randell is of the view that the de-emphasis of nationalisation as a resolution tool in the Directive may mean that resolution authorities are encouraged to excessively rely upon bail-in by shareholders and creditors. Bail-in involves the expropriation of shareholder value, the conversion of debt into equity to support capital adequacy requirements, and overall business reorganisation. Bail-in is generally supported in order to limit the moral hazard of bailouts. The Cyprus episode (discussed below) also suggests that depositors could be asked to bail-in as well, although the proposed Directive purports to exclude insured depositors and short-term liabilities of less than one month (which could cover uninsured deposits). It may be argued that, at the very least, shareholder equity in banks and financial institutions is meant to provide a cushion of capital in order to absorb losses. However, it remains uncertain whether bail-in regimes would encourage those with capital to lose to monitor banks more closely, given

151 Above.
155 This position is, in a way, upheld by the European Court of Human Rights, which rejected the arguments of shareholders who suffered expropriation following the failure of the UK bank Northern Rock. The shareholders argued that shareholder compensation should have been made on the basis of the value of the bank including the value of state support. This argument was rejected as the value of the bank at the time of state support was held to be nil and shareholders’ equity as completely provided to absorb losses. See Grainger and others v The United Kingdom App no 34940/10 (ECtHR, 10 July 2012).
that monitoring itself is a difficult exercise if banks are complex and opaque.\(^{156}\) The UK government supports bail-in in its 2012 White Paper,\(^{157}\) and the EU Liikanen review further suggests that bank remuneration for executives and high-earning traders could be paid in the form of debt that should be bailed in during times of stress.\(^{158}\)

Although mandatory bail-in would have the effect of converting debt to equity for the purposes of shoring up the financial institution’s capital adequacy, there is no international consensus on mandatory bail-in as yet. Mandatory bail-in could cause disruptions and loss of confidence in financial markets. The Cyprus episode of early 2013 clearly shows that there are difficulties in terms of managing the conflicting interests affected by mandatory bail-in. On 18 March 2013, it was announced that two large Cyprus banks, which had suffered huge losses due to the wipeout of bad Greek sovereign debt, needed a bailout.\(^{159}\) The Cypriot government, the EU, ECB and IMF formed a group to structure the bailout, and one of the key measures was to impose a 6–10 per cent levy on all bank deposits so that, controversially, all depositors, whether insured or uninsured, would bear a share of the bailout. This measure sparked street protests and anger from Cypriots and fear across the EU regarding the safety of bank deposits. In exercising the discretion to make depositors bail-in ahead of shareholders and other unsecured creditors, the Cypriot authorities have been concerned about preserving its attraction to large foreign depositors,\(^{160}\) which is an important economic industry. This measure was later voted down by the Cypriot Parliament. After extensive renegotiations between Cyprus and the EU-led crisis resolution group, Cyprus secured a €10 billion bailout from the EU but had to carry out a €5.8 billion bail-in involving large uninsured depositors, senior and junior bondholders and shareholders. The discretion that national authorities have in determining bail-in responsibilities has to be exercised with care, transparency and accountability, as the Cyprus fiasco has led to social fallout, distrust in European institutions and loss of market confidence. This episode also goes to show that the legal regime for bail-in is subject to discretionary application and is affected by wider political, economic and social interests.

At the international level, policymakers recommend that banks and financial institutions issue debt to be structured as bail-in capital or Contingent Convertible bonds (CoCos)\(^{161}\) (i.e. voluntary or contractual bail-in). CoCos are bonds that are

158 Erkki Liikanen, High-level Expert Group on Reforming the Structure of the EU Banking Sector (Final Report, October 2012) at para 5.5.3.
160 In attracting foreign high net worth deposits such as from Russia.
issued at a premium coupon rate with the understanding that they will be converted into loss-absorbing equity should certain trigger conditions be met. Commentators are generally of the view that CoCos are able to provide deleveraging effects and increase the equity cushion in a timely manner provided that the trigger point of conversion and price is well-designed. CoCo bondholders may also provide a countervailing force of risk temperance in their governance role. In general, the empirical literature supports the role of CoCos in mitigating financial institution failure or distress. King and Wen find that, because bondholders are generally more risk averse and their interests are in preserving the viability of the company, bondholder governance could provide a risk-moderation effect in their monitoring of financial institutions, countervailing the opposite effects of shareholder governance in terms of raising the risk-taking profile of firms. This finding is of general application, but specifically for banks and financial institutions, Mülbert and Citlau suggest improving bondholder governance either through a director’s duty that is owed to them or through mechanisms such as bail-in capital.

Calomiris and Herring, however, are of the view that the governance role of bondholders is only significant if CoCos are issued in large quantities, forming a significant part of the corporate finance structure of a firm. On this point, the design of the CoCo is crucial as Calomiris and Herring argue that only where the CoCo provides for sufficient dilution of equity providers at a trigger point (when the financial institution is still a going concern and rescue has not become inevitable) will the CoCo achieve the effect of bolstering the financial institution through risks. See Charles W Calomiris and Richard J Herring, ‘Why and How to Design a Contingent Convertible Debt Requirement’ (2011) http://fic.wharton.upenn.edu/fic/papers/11/11-41.pdf accessed 2 March 2013. Other commentators have also contributed to the discussion on the appropriate design of a CoCo to maximise loss-absorbing potential without the need for a state bailout. See Paul Glasserman and Behzad Nouri, ‘Contingent Capital With A Capital-Ratio Trigger’ (August 2010) http://ssrn.com/abstract=1669686 accessed 2 March 2013; George Pennacchi, Theo Vermaelen and Christian CP Wolff, ‘Contingent Capital: The Case for COERCs’ (December 2011) INSEAD Working Paper No 2011/133/FIN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1656994 accessed 2 March 2013.


166 Discussed in Chapter 13, Section 13.5.


it remains to be seen if market forces will generate sufficient popularity for CoCos, which also meet policymakers’ interests. It has been reported that CoCos issued by Lloyds TSB and Dutch Rabobank have been oversubscribed and hence the premium coupon rate on CoCos may have market appeal. Moreover, CoCos could also be considered a candidate for mandatory capital adequacy requirements. This option had been adopted by the Swiss government. However, the Basel Committee has generally rejected the inclusion of CoCos in capital adequacy and hence this may dampen bottom-up trends in issuing CoCos. Moreover, Koziol and Lawrenz warn that CoCos may also trigger destabilising effects if institutional investors hold large quantities of them in order to benefit from the higher coupon, but engage in a massive sell-off of shares when converted. Such actions, if aggregated across institutional investors, could create destabilising effects, even if sell-offs may be rational for each individual institution.

The key achievement in the proposed Directive is the establishment of a template for crisis management, sketching the steps from early intervention to resolution, and this assists in preventing national authorities from resorting to nationalisation too quickly and exacerbating fiscal cost and moral hazard. The harmonisation of early intervention and resolution regimes in the EU may also prevent excessively divergent actions and provides for pan-European recognition of the exercise of resolution powers and their consequences. However, the key weaknesses in the proposed Directive relate to the need to further clarify how bail-in works, and in what circumstances nationalisation could still be contemplated. The proposed Directive is also still rather open-ended regarding cross-border coordination, which is an important concern.

The authors are of the view that the proposed Recovery and Resolution Directive provides only a broad ex ante framework that may be severely tested in the event of a crisis materialisation requiring pan-European coordination. In particular, the Directive downplays nationalisation as a resolution measure, but the Directive cannot prevent national resolution regimes from resorting to it in turbulent times. Levitin argues that the decision to bailout or otherwise is often a political decision as much as an economic decision, and hence an ex ante framework such as under the Directive would not be able to foreclose actions taken by Member States that may be supported by political legitimacy and social

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172 Kern Alexander argues that the close integration of the EU internal market demands a common crisis management framework on top of national ones to deal with cross-border issues and wider financial stability. See Kern Alexander, ‘Reforming European Financial Supervision: Adapting EU Institutions to Market Structures’ (2011) 12 ERA Forum 229.
demand. Further, as the provisions on group resolution leave it to the discretion of the resolution college to agree on resolution options and financing arrangements, one could argue that the Directive implicitly accepts that nationalisation is on the cards, and in this area, nothing has changed in that much is left to Member States to determine how nationalisation and burden sharing should be carried out. Although the Directive is unable to provide for any overly prescriptive templates, there is perhaps a need to institute a framework that prevents unilateral and diverging actions that could create negative externalities for other Member States. A number of commentators are of the view that the proposed Directive does not sufficiently prevent prospective diverging actions. Further, the endeavours to make Member States pre-commit to financing arrangements in resolution colleges may not achieve certainty in limiting fiscal cost in any eventual bailout. Changing situations and the unravelling of information in a crisis may affect commitments.

Nevertheless, it could be argued that the micro-prudential supervisory oversight of the ECB could, from mid-2014, facilitate coherent actions in bank supervision and crisis management so that political wrangling with Member State authorities may be minimised. Given the high profile involvement of the ECB in a number of bank bailouts already, such as in Ireland, Spain and Cyprus, it is clear that the ECB would have a central role in managing coordination in a crisis. The prospect of nationalisation may be minimised as Member States look to ECB-led bailouts. This would mean that bailouts would be generally coordinated by the ECB which could lead to coherence in action. However, the Cyprus episode may be a foretaste of the difficulties of crisis resolution led by European institutions. This is because bailouts are not merely economic phenomena based on a metricised approach to evaluating systemic risk, but also a political phenomenon that needs ultimately to be supported by stakeholders such as creditors, shareholders and taxpayers. Hence, national authorities remain crucially involved and the dynamics of crisis resolution are not likely to be as straightforward as imagined. One also questions what the EBA’s role may be in coordinating resolution once the ECB assumes micro-prudential supervision of euro area banks and other non-euro area banks voluntarily subject to its regime.

Does the EU need more centralisation in the form of a separate European resolution authority? Fonteyne and others at the IMF call for overall EU architecture for resolution vested in a European Resolution Agency, due to the integrated nature of European markets. Randell also sees the same need but

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argues that the EBA should play this role. In light of the Single Supervisory Mechanism, which involves the ECB being responsible for micro-prudential supervision of euro area banks and some non-euro area banks, we think that the ECB’s role as *de facto* European resolution authority would be a likelier prospect. Nevertheless, as mentioned, the surrender of sovereignty in crisis resolution would be an intractably difficult issue as the incurrence of fiscal cost at the EU level would still have to be underwritten by Member State contributions. The need for political and social legitimacy could continue to characterise bailouts (whether led by the ECB or by Member States) as a politically charged issue. Crisis resolution measures imposed by a central European authority that have an impact upon Member State citizens could be resisted and unsupported by citizens due to the perception of democratic deficit.\(^{179}\) Further, Member States could still try to take charge by supporting nationalisation,\(^{180}\) since the proposed Directive does not deal with nationalisation, leaving a lacuna. Conflicts between Member States and the ECB could ensue in crisis resolution, as already witnessed in the Cyprus episode. Given that discontent and anger are witnessed on the ground in the countries affected by EU-led bailout schemes, it is important that the ECB bears in mind the need for democratic and political support. The ECB should also tread carefully so that its intervention does not create incentives towards moral hazard as well.

On the other hand, Persaud\(^{181}\) argues that crisis resolution should be carried out along national lines and this approach has its advantages. One advantage is that national crisis resolution regimes could force banks to be structurally separated along national lines, therefore reducing the systemic risk impact of such banks. Such structural separation may mean that if bank operations in one country are under crisis, the lack of cross-subsidisation and interconnections could save the bank subsidiaries operating in other countries from similarly descending into crisis. Further, splitting multinational banks along national lines for the purposes of resolution could incentivise national regulators to plan resolution options, estimate cost and take pre-emptive actions based on resolution manageability in the interests of that jurisdiction. This, however, does not mean that crisis management frameworks need not be harmonised internationally. An internationally harmonised framework could provide for certainty in the mutual recognition of the exercise of resolution powers.

Developments at the international level on coordinated crisis resolution are far slower and more fragmented. The Financial Stability Board continues to press for coherent cross-border resolution principles, and the FSF Principles for

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179 The anger in Greece and Cyprus over the terms of EU-led structured bailouts could be evidence of such lack of support at national levels.

180 The decision to bailout being as much a political as economic issue, see Adam J Levitin, ‘In Defense of Bailouts’ (2011) 99 *Georgetown Law Journal* 435.

Cross-border Cooperation on Crisis Management provide for information sharing and the encouragement towards developing coordinated solutions but this blueprint remains skeletal. It remains to be seen how commitments to such broad principles may be realised when an actual crisis surfaces.

### 11.5 Conclusion

This chapter has discussed post-crisis measures aimed at dealing with the systemic risk impact of SIFIs, an issue that has been inadequately addressed by pre-crisis micro-prudential regulation. The needs of financial stability that support state bailouts for ailing banks in the crisis reflect policymakers’ fear of financial meltdowns and the seizure of financial systems. However, there is a need to maintain a balance between the public interest in financial stability and the avoidance of ‘lemon socialism’. Moral hazard in the industry and markets can be exacerbated by measures intended to address financial stability. We argue that a combination of structural and crisis management reforms are needed but both strategies feature pros and cons. Structural reforms may not eliminate systemic risk, but seem to be punctuated by an adequate consideration of perspectives in the social utility of finance. Striking an apt balance between maintaining financial stability and avoiding moral hazard in designing a recovery and crisis resolution regime remains a challenging quest. Next, we turn to the role micro-prudential regulation may play in preserving financial stability.

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12 Boosting micro-prudential regulation

Micro-prudential regulation has been developing since the Basel Committee, established under the auspices of the Bank for International Settlements (BIS), took leadership and issued the first Accord of 1988 (Basel I). The mainstay of micro-prudential regulation is capital adequacy, namely requiring banks to maintain a capital buffer in order to mitigate losses from loan defaults if credit risks materialise. Micro-prudential regulation is the hallmark of pre-emptive governance in financial regulation. The nature of capital adequacy reflects the key banking activity of providing credit and hence the emphasis on credit risk.

As Chapter 10 has pointed out, the liberalisation of the financial sector has changed the financial sector dramatically and many financial institutions have expanded into other areas of intermediation such as investment. The financialisation of the world economy has also given rise to the growth of financial conglomerates, or 'financial supermarkets', providing a diverse range of financial services. Over the years, micro-prudential regulation has been extended to take into account risks other than credit risks. The European Union, in particular, has applied a functional approach to capital adequacy across financial institutions and not just to banks. Has capital adequacy become inadequate to address modern financial risks?

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financial institution risks? Do the new post-crisis reforms address systemic risk and issues relating to systemically important financial institutions (SIFIs)? This chapter will explore the development of capital adequacy regulation and the post-crisis reforms and provide some thoughts on the above questions.

This chapter will show that, post-crisis, the concept of micro-prudential regulation has expanded beyond an emphasis on capital adequacy to a suite of tools that are both quantitative and qualitative in nature. The belief in micro-prudential regulation is based on the view that capital adequacy acts as a form of risk constraint. However, some commentators have pointed out that capital adequacy regulation and supervision is becoming irrelevant as far as the soundness of individual banks or the financial system is concerned. Banks and financial institutions may view micro-prudential regulatory thresholds not as constraints upon risk-taking behaviour, but as the limits to which risk-taking behaviour can be pushed. The crisis has provoked unrelenting efforts by international regulators to master the elusive objective of financial soundness. However, as risks undertaken in the financial institutions’ diverse businesses are dynamic and the management of risks by each institution cannot be overly prescribed due to perverse incentives (as well as the practical impossibility of overprescription), the post-crisis reforms intend to make banks more responsible for pre-empting crises and shareholders and creditors liable for absorbing losses. The pattern we observe involves a flurry of micro-prudential prescription for banks and financial institutions post-crisis, but as risk is tied up with business, a significant extent of regulatory governance is in the form of meta-regulation in order to incorporate the unique needs and contexts of firms.

It may be argued that the expanding scope of micro-prudential regulation indicates an expansion in regulatory responsibility. Micro-prudential regulation is essentially pre-emptive in nature and by setting such pre-emptive standards and engaging in ‘judgment-based supervision’, the micro-prudential regulator in the UK seems to be assuming more responsibility for ensuring micro-prudential soundness in financial institutions. Nevertheless, the nature of wider micro-prudential concepts, such as risk management and corporate governance, are so fundamentally firm-centred that we question how the regulator will strike a balance between meta-regulatory delegation and supervisory intrusion. The regulator-regulated relationship continues to be an important feature in the post-crisis outworking of micro-prudential reforms. The interface between pre-emptive regulatory governance in regulating for soundness and the inherently reflexive nature of firm-centred risk management and corporate governance.


presents opportunities for critical discussion of the balance of governance responsibility between regulator and regulated, especially in relation to powerful SIFIs.

The cost of regulation also remains uncertain. There are the direct costs to financial institutions of increased capital adequacy and liquidity. The previous Governor of the Bank of England, Sir Mervyn King, in a 2010 speech in New York, suggested that even large increases in capital would have only a small impact on bank funding costs. In the subsequent discussion in the Financial Times, a number of leading bankers challenged this assertion, including analysts at UBS and Vikram Pandit, former head of Citibank. They suggested that banks and their customers would be harmed by higher capital ratios and the complaint was widely echoed by the industry. Mervyn King’s argument is that the rate of return required by existing bank shareholders is high. This is because the leverage of banks is high, a level many times higher than most non-financial firms. The logic of a widely used theory of how companies are funded – the ‘Modigliani-Miller theorem’ – suggests that the impact of lower leverage on bank funding, by increasing equity, may be neutral.9 Simon Gleeson, however, points out that there is no empirical support for the theoretical effects on banking funding put forward by the theorem.10 He points out that the Bank of England considered this precise issue in its June 2009 Financial Stability Report and ‘produced a very good graph illustrating its conclusion that no matter how true this may be as a piece of theory, “there is not a strong relationship in practice between banks’ capital positions and the cost of debt”’.11 If banking funding follows laws other than those applicable to business in general, policymakers should reflect upon the trade-off between bank ‘safety’ and lending.12 Lending to particular domestic sectors may be affected in asymmetric and disproportionate ways. International investment may also be affected, with subsequent effects not only on the domestic economies of the countries of investment, but also on those investing. International development goals are immediately affected in a world where a high percentage of state expenditure in developing countries goes toward paying interest on loans that are sensitive to bank regulation, as is further development (and defence) spending.

9 Sir Mervyn King was supported by a member of the Bank of England’s monetary committee. See David Miles, ‘Banks fail to convince crying foul over Basel reforms’ Financial Times (London, 23 November 2010).
10 Simon Gleeson, ‘No strong link between banks’ capital positions and cost of debt’ Financial Times (London, 29 November 2010).
12 Some commentators however think that the trade-off or the threat by banks to shrink their balance sheets is exaggerated. Profitable banks do not need to shrink their balance sheets and can hold retained earnings to meet capital requirements, while non-profitable banks should rightly shrink their balance sheets. See Anat Admati and Martin Hellwig, The Bankers’ New Clothes: What’s Wrong with Banking and What to Do About It (Princeton, NJ: Princeton University Press 2013).
12.1 Capital adequacy

Capital adequacy is the mainstay of micro-prudential regulation and has been developed and refined in the Basel I, II and now III Accords. Under Basel I, a framework was developed to assign credit risk weightings to different categories of debt, so that banks could take precautions against the possibility of default. The consensus is to set the adequacy benchmark at 8 per cent of total risk-weighted assets, although the Accord document does not explain how this benchmark was reached. The Accord’s time frame and arrangements for transition and implementation by banks worldwide may suggest that 8 per cent was a sufficiently high threshold given the low levels of capital adequacy in the industry at the time. Since the global financial crisis, the 8 per cent adequacy threshold may seem inadequate to address multiple stressful default events, especially those experienced by SIFIs.

Under the Basel II Accord in 2003, capital adequacy has remained unchanged at 8 per cent. However, the attribution of risk weights has moved away from the one-size-fits-all standardisation under Basel I to more tailor-made approaches. There are two types of ‘tailor-made’ approaches: the IRB (internal ratings based) approach and the Advanced IRB (advanced internal ratings based) approach. The IRB approach allows banks to work out their own risk assessment of counterparties, using internal information and externally available credit ratings, and taking into account credit mitigation techniques. This means that banks may themselves estimate the probability of default of counterparties but must still apply standardised measures of exposure to default and loss given default. The Advanced IRB approach allows the most sophisticated financial institutions to work out not just the probability of default but also the exposure to default and loss given default, thus granting such financial institutions full responsibility for determining their credit risk profiles. These approaches are implemented by the 2006 Capital Requirements Directives in the EU. Under Basel II, although the adequacy

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15 Peter Boone and Simon Johnson, ‘The Future of Banking: Is More Regulation Needed?’ *The Financial Times* (London, 10 April 2011), commenting critically on the 8 per cent threshold compared to the Swiss reforms bringing in a 19 per cent threshold for Swiss banks. See also Sherman J Maisel, *Risk and Capital Adequacy in Commercial Banks* (Chicago, IL: University of Chicago Press 1981), 203ff, an earlier publication, in which Maisel opines that the risk profiles of large and complex financial institutions are difficult to pin down and hence large institutions should be mindful of their capital adequacy positions as a buffer against risk. As early as 2005, commentators argued that higher levels, such as 15 per cent, should be recommended, see Harald Benink and George Benston, ‘The Future of Banking Regulation in Developed Countries: Lessons from and for Europe’ (2005) 14 *Financial Markets, Institutions and Instruments* 289.
threshold has remained unchanged at 8 per cent, the determination of risk profiles is very much at the discretion of financial institutions themselves, particularly the more sophisticated institutions who demonstrate that they can use the Advanced IRB approach.

Besides credit risk, the Basel Committee started work on market risk in 1996.\textsuperscript{17} Other categories of risk are increasingly being recognised in the face of changes to business models in the financial sector, particularly conglomeration and the rise of financial ‘supermarkets’. In 1996, the Basel Committee\textsuperscript{18} recognised that banks’ trading books, particularly in foreign exchange and commodities, could also present a significant source of risk and recommended that market risk be taken into account in capital adequacy provision. Market risk is computed as the ‘value-at-risk’ figure (i.e. the maximum loss figure given certain assumptions, based on the daily trading book). The Committee recommends that the risk weight for market risk be set at 12.5 per cent against the daily ‘value-at-risk’ figure. This figure needs to be supported by the total 8 per cent of capital adequacy mentioned above, except that market risk can be supported by slightly lower quality Tier Three capital, such as short-term subordinated debt. In the Basel II Accord, market risk may also be computed based on a ‘mark-to-model’ approach, where ‘mark-to-market’ is not possible, and hence ‘value-at-risk’ may be computed entirely based on quantitative models with built-in suppositions of trading volatility and potential loss, particularly for illiquid assets.

The Basel II Accord has also recognised operational risk as another significant source of risk for financial institutions. Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This definition includes legal risk, but excludes strategic and reputational risk. There are three approaches to evaluating the risk weights for operational risk: (a) the Basic Indicator Approach; (b) the Standardised Approach; and (c) Advanced Measurement Approaches (AMA).

The Basic Indicator Approach takes 15 per cent of the average gross revenue of the institution as a broad-brush estimate of an institution’s typical operational risk profile. The Standardised Approach breaks down the business lines of the financial institution into up to eight standard categories and applies a standardised risk weight of 12, 15 or 18 per cent according to the business line. The AMA may only be undertaken by the most sophisticated banks that have extensive data covering the previous five years’ gross revenue and are able to provide analyses of operational weaknesses and estimated losses. Such financial institutions are allowed to work out an expected loss figure and an appropriate percentage of gross revenue representing the risk weight for operational risks.

Although Basel II has expanded its recognition of sources of risk for financial institutions and addresses such risks in its adequacy standards, it also allows

\textsuperscript{17} Basel Committee on Banking Supervision, \textit{Amendment to the Capital Accord to Incorporate Market Risks} (Basel: BIS 1996) www.bis.org/publ/bcbs24.pdf?noframes=1 accessed 5 March 2013.
financial institutions to develop their own approaches to evaluating risk profiles and weights in credit, market and operational risks. Allowing financial institutions to exercise their own discretion in determining risk profiles and the consequent capital charges that may follow is a form of meta-regulation that is currently in vogue with many regulation theorists, an approach to governance that co-opts the regulated themselves to institute governance and accountability measures in order to maintain a licence to operate. The Basel II Accord has been fully supported by the EU Capital Requirements Directives 2006 save that the EU further imposes a minimum ‘own funds’ requirement for the establishment of credit institutions, collective undertakings in investment instruments and investment firms.

On the quality of capital, the Basel I Accord introduced two types of capital to support adequacy, Tier One being superior to Tier Two. Tier One capital consists of paid up common equity and disclosed reserves, while Tier Two consists of preference shares, undisclosed reserves and subordinated debt. The Basel I Accord recommends that the 8 per cent capital adequacy should comprise at least 4 per cent Tier One capital. The composition of the Tiers has been preserved under the Basel II Accord, but Basel II introduces a Tier Three to support capital adequacy for market risks. Tier Three capital comprises short-term subordinated debt.

There is an inherent contest between freeing up capital to work in order to make profits and keeping capital as adequacy in order to mitigate risks. Empirical evidence on the application of internal approaches developed by banks for credit and operational risk under Basel II shows that the internal models have encouraged banks to set aside less capital than otherwise would have been the case applying standardised Basel II approaches. Hence, meta-regulation may not produce optimal governance outcomes that align private and public interest.

23 Cebenoyan and Strahan also comment that the application of Basel II by banks has not been to achieve better prudential risk management but to achieve greater profitability when engaging in higher risk activities. See A Sinan Cebenoyan and Philip Strahan, ‘Risk Management, Capital
SIFIs have also under-allocated capital\(^{24}\) as a buffer against risk and the drivers for such behaviour may be particularly acute in SIFIs whose enormous asset bases only serve to encourage more risk-taking rather than increased prudence.\(^{25}\) However, it could also be said that conservative applications of capital adequacy do not generate social benefit if financial access becomes restricted or lending for developmental and socially useful projects becomes limited.\(^{26}\) Where regulatory frameworks cannot be overly prescriptive and discretion is left to the regulated to implement a suitable approach, regulatory control needs to be exercised through accountability and supervisory monitoring. These are covered by Pillars 2 and 3 in the Basel II Accord. Pillar 2 refers to the exercise of supervisory scrutiny of internally developed approaches by banks and Pillar 3 requires transparency concerning such approaches and their assumptions in order to enrol shareholders, in particular, in the monitoring process.

In the wake of the global financial crisis, it is recommended that reforms shore up the amount of capital adequacy and improve Pillars 2 and 3 supervision and accountability of banks and financial institutions in order to scale back risk-taking and enhance regulatory and stakeholder scrutiny of risk-taking levels.

### 12.2 Basel III reforms

The post-crisis Basel III Accord attempts to address a range of micro-prudential issues but does not completely overhaul Basel II. Major reforms are made to supplement the capital adequacy regime in Basel II and to deal with other micro-prudential issues. The reforms deal with:

- extra capital buffers to be maintained by financial institutions;
- the adequacy threshold of 8 per cent;
- the quality of capital supporting the 8 per cent adequacy;
- some amendments to market risk computation; and
- other supporting micro-prudential tools (such as liquidity reforms and leverage ratio), risk management reforms (such as regulating remuneration)\(^{27}\) and corporate governance reforms as part of risk management.\(^{28}\)

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25 For example, when the Royal Bank of Scotland descended into crisis, its tier one equity stood at about 2 per cent, showing how it had squeezed its adequacy allocation to the margins in favour of risk-taking. See FSA, ‘The Failure of the Royal Bank of Scotland: Financial Services Authority Board Report’ (December 2011) www.fsa.gov.uk/static/pubs/other/rbs.pdf accessed 1 January 2013, 11, 22.


27 Chapter 13.

28 Chapter 13.
These reforms have by and large been adopted by the EU in the CRD IV package.\textsuperscript{29} The EU seems keen to adopt most of the capital adequacy reforms but is debating over the liquidity and leverage reforms that will be discussed shortly.

Basel III\textsuperscript{30} now recommends increases in the total level of capital adequacy. Three types of increases have been recommended: a capital conservation buffer, countercyclical capital charges and an extra capital charge for SIFIs.

A capital conservation buffer is recommended at an extra 2.5 per cent capital adequacy.\textsuperscript{31} This would be phased in gradually from 2016, to be fully implemented by 2019.

The countercyclical capital buffer of up to 2.5 per cent is only imposed at national authorities’ discretion and would be phased in from 2016 in parallel with the capital conservation buffer. It remains uncertain whether the countercyclical buffer will pose a threat to financial sector competitiveness and whether policymakers will be wary of the first-mover disadvantage in introducing it in national legislation. The EU proposes to allow national regulators to decide on the level of countercyclical buffers needed subject to the guidance issued by the ESRB.\textsuperscript{32}

The extra capital charge\textsuperscript{33} for SIFIs would be between 1 and 2.5 per cent for SIFIs identified based on an indicator approach.\textsuperscript{34} The five indicators, all equally weighted, are interconnectedness, size, the lack of readily available substitutes for services provided, cross-jurisdictional activity and complexity. They form a quantitative approach. The Committee has identified an initial group of 28 banks subject to the extra charge.\textsuperscript{35} The Committee also proposes a ‘top bucket’ that will be subject to a 3.5 per cent capital adequacy charge in order to prevent banks from arriving in this position. These recommendations would also be phased in from 2016 to achieve full implementation by 2019.


\textsuperscript{31} CRD IV Directive, art 129.

\textsuperscript{32} CRD IV Directive, art 130.


\textsuperscript{34} CRD IV Directive, art 131.

If all extra capital charges are implemented in full, these represent an additional 7.5 per cent of risk-weighted assets for a top bucket SIFI, almost double the current 8 per cent threshold. For a less significant SIFI, there may be a 6 per cent increase in capital charges, and perhaps 2.5–5 per cent for all other banking institutions. Increases in capital adequacy seem to be most pronounced for SIFIs, as we are looking at a minimum increase of 10.5 per cent and a maximum increase of 15.5 per cent for top bucket SIFIs. A couple of commentators, however, do not think this has gone far enough, suggesting that capital adequacy that actually acts as a loss absorber should be in the region of 20–30 per cent. On the one hand, it has been argued that the increase in the total amount of capital adequacy has a positive effect upon preventing failure and systemic risk, but on the other hand, the real increases may be minimal and the generous time frame for implementation may erode the sense of discipline that increased capital adequacy seeks to introduce.

Further, it is queried whether increases in capital adequacy result in counterproductive effects for the real economy (i.e. banks may hoard capital instead of putting money to work in the real economy). This is an acute problem in countries facing recessions in the wake of the global financial crisis, such as the UK. A number of Italian central bankers argue that the new Basel III capital adequacy regime would likely have an adverse impact upon economic output, although some UK economists argue otherwise.

In the UK, the Prudential Regulation Authority (PRA) responsible for micro-prudential oversight of important banks and financial institutions has indicated that it may introduce further unique capital charges tailored to the firm. These discretionary exercises of power to impose extra capital charges are referred to as Pillars 2A and 2B. Pillar 2A deals with capital charges that the regulator may impose due to the firm’s inadequacy in risk management or control. These are discretionary charges that are applied as a result of the judgment-based supervision that the regulator will carry out. Pillar 2B is the capital planning buffer but it may

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vary from firm to firm. It is forward-looking in nature, as the exact amount of the buffer will be determined based on the results of financial institutions’ stress tests (as will be discussed shortly).\textsuperscript{43} Although the Basel III extra capital charges are recommended to be phased in slowly so that banks and financial institutions may have time to adjust their behaviour, the implementation of extra capital charges in the UK may be sooner under the PRA, which commences its operations in 2013. The range of extra capital charges intended to address the thin adequacy levels post-crisis could now, as mentioned earlier, add up to a significant amount for financial institutions, especially SIFIs, and it remains to be seen if they are over-correcting or indeed appropriate.\textsuperscript{44} A commentator\textsuperscript{45} also warns that the discretionary imposition of capital charges upon financial institutions may not always be well-founded and needs to be considered in a wider macro-prudential context.

The effectiveness of the quantitative threshold increase also depends on how the quality of capital is defined. Basel III seeks to abolish Tier Three capital although it has only been used to support market risk. Further, financial institutions are called upon to set aside more Tier One capital (up to 6 per cent of the total 8 per cent adequacy, out of which common equity should form at least 4.5 per cent). The European Banking Authority (EBA) has in fact prescribed that European banks should maintain a core Tier One capital ratio of 9 per cent\textsuperscript{46} in view of the stressed conditions of many European banks due to the sovereign debt crisis in Europe. EBA stress tests\textsuperscript{47} have revealed that most European banks have met this ratio by October 2012. However, given the turbulent times in European banking, it remains to be seen if such indications of higher safety could significantly shore up confidence in these banks. It is also to be noted that the overall position on Tier One capital in Basel III will in fact have to be more significantly improved than 6 per cent as Tier One capital will be required for the new extra capital charges mentioned above (i.e. in the capital conservation buffer, the countercyclical buffer and the extra capital charge for SIFIs).


\textsuperscript{44} A continuum approach to capital charges to be applied in relation to the systemic risk profile of the financial institution, in order to ensure that SIFIs provide adequate capital cushions for their risks, see Cheryl Block, ‘A Continuum Approach to Systemic Risk and Too-Big-To-Fail’ (2012) 6 \textit{Brooklyn Journal of Corporate Financial and Commercial Law} 289, arguing that regulators tend to be excessively forbearing towards SIFIs’ capital adequacy.


Considerable emphasis has been placed on capital quantity and quality in the Basel Committee reforms. The emphasis on common equity as the ultimate loss absorber is understandable, but this also means that, in order to meet the enhanced capital quality requirements, many banking and financial institutions have to raise equity, which may be an expensive exercise in the post-crisis state of volatile and uncertain stock markets.\(^4\) Further, certain potential purchasers may bargain for favourable terms, such as those offered by Barclays Plc in its 2008 equity raising exercise to a member of the royal family in Qatar and a Qatari sovereign wealth fund,\(^4\) an offering that drew uproar from other institutional investors in the UK.\(^5\)

The difficulties in raising capital may compel banks and financial institutions to rethink their ambitions and structure, and this could act as a driver to control SIFIs. However, banks may decide to deleverage in order to avoid having to meet stringent capital adequacy rules and deleveraging may have an adverse impact upon general economic activity, as less credit is available for the real economy.\(^6\)

As the banking sector is dominated by SIFIs, the effect of collective deleveraging by SIFIs may itself be systemically adverse.

Further, the emphasis on equity capital being the ultimate loss absorber for financial institutions highlights policymakers’ stance that equity holders should be made to bear the brunt of financial institution risks and losses. Equity suppliers may even turn into gatekeepers, monitoring the risk profile and well-being of the financial institution. This prospect is discussed in Chapter 13. Shareholders and creditors of financial institutions have arguably been disinterested in taking on such gatekeeping roles as they assume that banks will be bailed out by the state in a crisis since depositors are also large suppliers of capital.\(^7\) Is the emphasis on equity as the ultimate loss absorber in Tier One capital effective to mitigate shareholders’ moral hazard? Some commentators argue that short of ring-fencing deposits\(^8\) or limiting the amount of deposits a

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\(^4\) In the third quarter of 2011, stock market returns fell by 4.1 per cent per annum, Sam Jones, ‘Market turmoil lands hedge funds with big losses’ Financial Times (London, 13 September 2011).


\(^6\) This capital-raising exercise is now under investigation by the Serious Fraud Office at the time of the completion of the book, see ‘Barclays Faces SFO Investigation’, BBC News (29 August 2012). The investigations deal broadly with whether the capital-raising exercise was a sham as the investment allegedly made by the investors to shore up Barclays’ capital adequacy position could have been lent by Barclays.


bank can take, equity suppliers will not be sufficiently disciplined to monitor or bear the risks and losses of financial institution failure. The Basel III recommendation effectively requires banks to increase the equity capital component of Tier One capital by 0.5 per cent. This may not be sufficient to kick-start the governance incentives for equity holders if no corresponding measures to reduce reliance on deposits are taken.

Another significant change introduced by Basel III is that market risk should be computed under more stringent conditions using ‘value-at-risk’ models that factor in stressed situations. Further, where ‘value-at-risk’ is computed based on a ‘mark to model’ approach, extra capital charges should be applied to compensate the greater risk of erroneous assumptions. These changes are a response to the cause of the global financial crisis (i.e. the rapid price deterioration of complex assets, such as collateralised debt obligations, which were structured around sub-prime mortgage loans). As these assets are not traded on a secondary market, price assumptions were made to value them. The massive price deterioration and loss in confidence concerning these assets caused stressful effects beyond the comfortable assumptions produced by market risk computations.

In general, however, Basel III does not affect credit or operational risk weight computation, such as the discretionary approaches that sophisticated financial institutions may use in determining their exposure to credit and operational risk. Nor do the reforms make changes to the categories of risk (i.e. the categorisation of risk as credit, market and operational risk mentioned above). In fact, it may be said that where market risk is concerned, financial institutions are still responsible for developing the ‘value-at-risk’ model. The co-option of banks’ and financial institutions’ discretion in designing models to determine their own risk profiles remains a key regulatory strategy in micro-prudential regulation. The main concern with such meta-regulatory strategies in micro-prudential regulation is that it may be difficult for regulators to assess the quality of firm-designed models and procedures due to information and expertise asymmetry. It is thus important that accountability channels under Pillars 2 and 3 are effective.

57 Charles Goodhart and others, Financial Regulation: Why, How and Where Now? (London: Routledge 1998) is a seminal book encapsulating the move from traditional top-down governance into a cooperative relationship with the regulated due to the regulated’s expertise and own interest in risk management as part of its business model.
58 CRD IV Regulation.
Basel III re-emphasises the importance of Pillars 2 and 3. In the post-crisis era, regulators have to come to terms with the fact that the governance of risk management in the financial sector cannot be overly prescribed but also cannot be left to the private incentives of the industry. The financial sector is too attracted by the pursuit of risk and profit, and is arguably not motivated to consider the aggregate effects of systemic risk or public interest. But can regulators actually intervene for the purposes of ‘risk moderation’? Moore argues that ‘risk management’ has essentially become ‘risk moderation’ in the post-crisis corporate sector, requiring risk management to be placed at the heart of the entrepreneurial business models themselves. Can regulators effectively check and assess internally determined models for credit and operational risks without meddling with the business objectives and strategies of each firm? Increased Pillar 2 oversight may allow regulators to question key business models and risk appetites that are the firm’s preferences. Would such oversight result in the imposition of regulatory judgments on firms’ business preferences? What implications does regulatory oversight have for corporate governance and accountability? The interface between regulatory intervention and corporate governance and accountability will be further fleshed out in Chapter 13.

It may be argued that Basel III has introduced a range of supplementary capital charges to shore up banks’ capitalisation and safety. However, the key methodologies in computing credit, market and operational risks in Basel II are only tweaked and preserved. Some commentators argue that the standard computations for credit risk are inadequate as the default measures are static and individualised in nature, failing to take into account enhanced default risks in difficult market conditions or under systemic risk effects. Hence, they advocate more dynamic calculations of credit risk, taking into account wider stresses, and hence achieving more stringent results. On operational risk, there are also critics of the Basel II computation approach. These critics argue that operational risk has been treated in a broad-brush manner and has not developed an intelligent mapping framework or taken into consideration the extent of losses. A number of commentators support a more rules-based micro-prudential approach for a change.

59 Moore is of the view that ‘risk moderation’ lies at the heart of the entrepreneurial business model itself, see Marc Moore, ‘The Evolving Contours of the Board’s Risk Management Function in UK Corporate Governance’ (2010) 10 Journal of Corporate Law Studies 279.
However, the outworking of extra capital charges and their impact on banks’ adjustment of risk preferences and profiles remains to be seen. Woo\(^{63}\) and Pacces\(^{64}\) warn that imposing even more prescriptive capital adequacy requirements to match the dynamics of stressed times could be counterproductive, as we may be moving too excessively from a pro-cyclical position of optimistic assumptions to an anti-cyclical position of overly pessimistic assumptions. Such standards would add too much stress to financial institutions recovering from the global financial crisis and would not enhance their roles as intermediaries in the real economy, forcing excessive withdrawal and conservatism. Allen and others\(^{65}\) argue that stringent requirements on capital provision would affect the business models that financial institutions adopt. Policymakers must thus decide whether they wish to compel financial institutions to operate in a more liability-driven manner and therefore adopt more conservative behaviour, bearing in mind the impact this may have on the real economy.

The meta-regulatory model at the heart of capital adequacy places the wider dilemmas between business and safety within an individualised framework. It means that as firms manage their credit, operational and market risks using discretionary models and methodologies such as the Advanced IRB approach to credit risk or the Advanced Measurement Approach to operational risk, firms are managing at a micro-level the trade-offs between business and safety. These individual firm preferences however have a collective impact upon conditions for the real economy. Regulators therefore have to deal with the twin challenges of scrutinising individual firm preferences and risk management designs in the face of information and expertise asymmetry, as well as monitoring the collective macro impact of firm preferences. Regulators have recognised the latter problem and have instituted macro-prudential regulation\(^{66}\) to accompany traditional micro-prudential regulation. The Basel III reforms have now introduced a suite of additional one-size-fits-all capital requirements such as the counter-cyclical and SIFI capital charges discussed above to bring about some rules-based regulation to shore up the capital positions of banks and financial institutions. Further, other microprudential tools are to be internationally harmonised. These are the liquidity and leverage ratios. The rule-based nature of these tools may provide a balance to the more meta-regulatory frameworks in capital adequacy. In fact, an important lesson regulators learnt in the global financial crisis of 2008–9 is that capital adequacy regulation is insufficient to deal with the safety and soundness of financial institutions and is part of a bigger mosaic of regulatory strategies. SIFIs,

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\(^{66}\) See Part 4, Chapter 14ff.
due to their complexity and multi-jurisdictional operations, are almost impenetrable for regulators trying to make sense of their profiles of safety and soundness. Financial sector innovation has also transformed the nature of many assets and liabilities, making the risk profiles of financial institutions and their balance sheets opaque. Hence, it is arguably inadequate to rely on capital adequacy regulation, which is balance sheet-based and has evolved to be more and more meta-regulatory in nature, to deal with the safety and soundness challenges of financial institutions. Capital adequacy regulation is now flanked by other micro-prudential tools in liquidity and leverage, as well as the measures targeted at SIFIs discussed in Chapter 11 and macro-prudential regulation discussed in Part 4. In the following section, we will examine the micro-prudential measures in liquidity and leverage. We will then examine how Pillar 2 is intended to be enhanced by new regulatory requirements in stress-testing.

12.3 Liquidity ratios

The post-crisis reforms have placed great emphasis on liquidity management at banks and financial institutions. Liquidity ratios were derided as a leftover from the quantitative regime dismantled in the 1980s and generally abolished in the UK. The liquidity requirements maintained by the ECB were strongly criticised, in particular with reference to the UK model. The view promoted was that this imposed unnecessary cost, that functioning financial markets would be able to provide liquidity and price it appropriately. Subsequent market failures have brought this into question. The whole argument may today appear surprising, as market failure relating to liquidity provides the basis for concepts such as lender of last resort and many features of both macro- and micro-prudential regulation.

Gleeson\textsuperscript{67} comments that, pre-crisis, although broad principles were provided by the Basel Committee\textsuperscript{68} to encourage sound liquidity management and regulatory supervision, bank regulators never placed great emphasis on this issue until the global financial crisis of 2008–9 and the Basel III reforms. That is certainly true for the Bank of England but less so for European bank regulators and central banks, including the ECB. Liquidity requirements were simply not harmonised under EU law. Under the EU banking directives, they remained the domain of the host states where the banking activity took place, so different regimes applied.

Basel III\textsuperscript{69} now recommends that all financial institutions maintain two core liquidity ratios for short-term and long-term stress management. Due to the


volatility of market sentiment, maintaining liquidity may be important in assuaging
the development of a crisis so that cascade effects may be mitigated. Liquidity
may entail resilience effects that could help mitigate potential systemic effects. An
empirical study further indicates that high liquidity ratios could help a financial
institution stave off a crisis or rescue. Even if a SIFI comes close to a crisis,
maintaining liquidity ratios may be important in staving off systemic risks caused
by information contagion or a collapse in confidence and could buy enough time
to allow recovery plans to work.

The Liquidity Coverage ratio (LCR) is a quantitative measure that is aimed at
ensuring that a financial institution has sufficient liquidity to meet its obligations
in the next 30 days following the onset of a ‘liquidity crisis’ (defined as a run on
retail deposits, a loss of unsecured wholesale funding, the loss of other forms of
short-term financing options and the need to repay obligations). Basel III refines
the LCR as

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\text{Total high quality liquid assets/total outflows and expenditures in next 30 days.}
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This ratio must be maintained at above 100 per cent. The UK regulator im-
poses even more stringent supervisory monitoring of liquidity by requiring intra-
day liquidity to be maintained and extensive reporting obligations. The types
and categories of liquid assets are defined in Basel III. One of the concerns regard-
ing the Liquidity Coverage ratio is its strong reliance on sovereign or sovereign-
guaranteed debt as reliable liquid securities. As the sustainability of Treasury
and some European sovereign debt comes into question, it is queried whether
assumptions about liquidity of such debt can be maintained. Will the liquidity
of such debt be affected by sovereign economic policy or debt downgrades, and
will asset prices be sufficiently stable? Should the Basel III recommendations
address the potential problem of concentration of holdings (e.g. European banks
holding too much European sovereign debt)? Further, it has been pointed out

70 Alison Lui, ‘Macro and Micro Prudential Regulatory Failures amongst Financial Institutions in
the United Kingdom: Lessons from Australia’ (Corporate governance and finance conference,
71 FSA, ‘Strengthening Liquidity Standards Including Feedback on CP08/22, CP09/13, CP09/14’
Handbook (as of 30 April 2013, formerly FSA Handbook) BIPRU 12.
72 Rym Ayadi, Emrah Arbak and Willem Pieter De Groen, ‘Implementing Basel III in Europe:
of Financial Analysis 159.
74 Massimiliano Neri, ‘The Unintended Consequences of the Basel III Liquidity Risk Regulation’
2013.
that distortions in asset markets would most certainly result from the imposition of liquidity ratios on banks and financial institutions.

The Net Stable Funding ratio (NSFR) is a long-term quantitative measure that is aimed at maintaining a long-term liquidity profile over a year. The NSFR is defined as

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\text{Amount of available stable funding/amount of required stable funding.}
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The NSFR must exceed 100 per cent. Available stable funding (ASF) is defined as comprising the bank’s capital, preferred stock with maturity of one year or less, liabilities with effective maturities of one year or greater and other short-term maturity liabilities and wholesale funding deposits that are expected to remain for one year or more. Required stable funding (RSF) is calculated by regulators in accordance with the asset/liability profiles of each financial institution. Regulators are required to use a standardised liquidity risk weighting scale to assign ‘stability factors’ to each asset. For example, highly liquid assets such as cash attract a stability factor of 0 per cent, meaning that its liquidity risk profile is very low. All potentially illiquid or hard to realise assets will be given a risk adjusted value according to the liquidity risk weighting scale. Financial institutions need to ensure that ASF exceeds the RSF measured according to the standardised liquidity risk weighting scale.

This NSFR is intended to ensure that capital and key funding channels for banks are able to cope with a stressful situation over a period of a year, and would compel banks to assess the quality of their balance sheets and the balance of asset profiles. Stressful situations include a downgrade of debt, a significant decline in profitability or a material event that affects the reputational risk of the institution. However, it is queried whether the NSFR and LCR would exert contrary forces upon a financial institution, exacerbating a stressful situation. The LCR requires sufficient maintenance of liquid assets to meet a short-term crisis but the NSFR requires sufficient holdings of longer-term assets so that pressures from maturing obligations would decrease.\(^7\) Although liquidity ratios appear to be precise and ‘hard’ targets to meet, the application of such ratios\(^8\) may be contextualised and tailormade according to regulator-regulated dialogue in designing the optimal liquidity management plan for each financial institution.

Liquidity management is a contingency plan in case of the onset of stressful conditions. As liquidity management is a contingency plan unique to each institution, its development is also subject to the regulator’s dialogue with individual institutions. The UK regulator requires all banks and investment firms to draw


\(^8\) CRD IV Regulation, arts 412, 413.
up individual Liquidity Management and Contingency Plans. These plans must be regularly stress-tested and the results reported to the UK regulator in Individual Liquidity Adequacy Assessments. Where stress test results reveal that liquidity management plans are inadequate, the regulated firm concerned would need to submit remediation plans and continue to monitor the performance of those plans by stress testing and reporting to the regulator. As will be discussed later, stress testing is a new regulatory strategy designed to improve the accountability of regulated firms and to overcome information asymmetry to boost Pillar 2 scrutiny. We will shortly discuss the effectiveness of such strategy.

Liquidity ratios compel financial institutions to re-assess and rebalance their balance sheets, but it should be questioned whether the maintenance of such ratios would really help stave off a bank crisis. Allen argues that top-down liquidity management rules may be seen by regulators as a way to avoid having to act as lender of last resort or to put taxpayers’ money at risk. However, the very prospect that lender of last resort facilities may be limited may itself affect market demand and prices. Hence, the assumptions surrounding the assessment of liquidity risk profiles should be clarified. Further, a commentator also cautions that liquidity is a relative concept dependent not only on external conditions, but the conditions of the firm itself and its unique balance of asset profiles. Both financial institutions and regulators should realise that false comfort must not be sought in the maintenance of liquidity ratios.

It cannot be ruled out that financial institutions encountering a liquidity crisis would look to the lender of last resort (i.e. central bank facilities). Hence, liquidity management, like living wills, may not avoid the ultimate incurrence of fiscal cost even if it may mitigate confidence crises and systemic risk. It is important that Basel III faces these potential hard truths and perhaps considers issuing standards to improve the transparency of lender-of-last-resort decisions.


The UK regulator recognises the need to establish principles for assessing central bank facilities without stigma, but Basel III has not adequately considered establishing principles on this issue. It is suggested that the establishment of principles concerning central bank facilities may provide more transparency, less panic and assist in assuaging market sentiment in the long run.

Basel III does not distinguish SIFIs for special consideration in liquidity management. There are a few features of SIFIs that may warrant special consideration. SIFIs are likely to engage in cross guarantees of debt, group credit lines and financial provision. Hence, liquidity stresses may become greatly augmented throughout the group. A SIFI in stress may also cause significant systemic effects if its contribution to the pool of wholesale funding is drastically affected. This may further trigger liquidity squeezes for other institutions. The inter- and intra-connectedness of SIFIs may exacerbate liquidity conditions for itself and for others. Hence, the rather individualised liquidity management framework developed in the post-crisis reforms may not adequately take into account dynamic and spillover effects. In the authors’ view, the limitations of liquidity management may be more acute in SIFIs. Regulators therefore need to consider developing principles on SIFI access to central bank facilities, perhaps in more than one jurisdiction. As such, principles for central bank access may need to be more transparent in order to strike a balance between providing a backstop to systemic panic and moral hazard.

12.4 Leverage ratio

Basel III has decided to recommend the introduction of a leverage ratio, as high levels of leverage are frequently associated with the risk of institution failure and systemic risk. The recommended level is set at 3 per cent of Tier One capital, to be phased in from 2013 and to be reviewed in 2017. The EU, however, seems...
more committed to harmonising the methodology for measuring and reporting leverage ratios instead of prescribing a hard ratio to be maintained.\textsuperscript{\textsuperscript{87}}

The leverage ratio is a much more prescriptive measure, attempting to introduce a type of cap upon the quantity of credit risk that a financial institution is exposed to. Some commentators are of the view that a leverage ratio is likely to be effective as a form of risk control. For example, Bolt and Tieman argue that, in today’s competitive financial sector, the incentives for growth, expansion and risk-taking are far stronger than self-controlling tendencies in risk management and, hence, an externally imposed measure such as the leverage ratio could keep the risk management of financial institutions in check.\textsuperscript{\textsuperscript{88}} This would be a form of regulator-imposed ‘risk moderation’, standardised across the financial sector.\textsuperscript{\textsuperscript{89}} However, a number of commentators argue that capping loan volumes is not likely to be effective, as credit risk lies in the quality rather than the quantity of loans made.\textsuperscript{\textsuperscript{90}} They predict that financial institutions will find various arrangements in order to fall outside the definition of ‘leverage’ so that they may continue to be able to engage credit-based activities.\textsuperscript{\textsuperscript{91}}

Post-crisis micro-prudential regulation has adopted a variety of measures to complement each other, but how far they are mutually supporting remains to be observed. Further, a large extent of micro-prudential regulation is meta-regulatory in nature, as regulators cannot overprescribe a mode of governance over what are essentially business choices made by firms in relation to their risk and asset profiles. In meta-regulatory frameworks where private incentives are not aligned with public regulatory ones, firms may implement micro-prudential frameworks in such a way as to favour their business interests, which could be contrary to regulators’ view of safety and soundness.\textsuperscript{\textsuperscript{92}} Not only is it difficult to scrutinise into

\textsuperscript{87} CRD IV Regulation, art 429ff.


the effectiveness of firm-designed models, but it may be difficult for regulators to make pre-emptive judgement calls on the ‘riskiness’ of certain firm preferences. More paternalistic imposition of regulatory controls, such the leverage ratio, may become one-size-fits-all. If financial institutions engage in clever reinterpretation and avoidance of such bright line measures, the leverage ratio could become under-inclusive and inadequate to deal with suboptimal risk-taking behaviour. It is difficult to frame prescriptive rules regarding the essential risk allocation functions of the financial sector without becoming trapped in the limited scope of the rules and their ultimate redundancy. Mirza\textsuperscript{93} points out that micro-prudential regulation needs to be dynamic in terms of the supervisory monitoring of bank balance sheets on both the asset and liability sides. He argues that there is a need to monitor loan volume and quality so that both attributes are commensurate with each other, and that the monitoring should be dynamic, intelligent, taking into account the financial institution’s risk adjustments and management. This suggests that for micro-prudential regulation to work, much more intensive supervision by the regulator under Pillar 2 is required. However, such supervision requires dedicated resources and will be costly. Further, it is uncertain to what extent regulatory supervision should and can become entangled with business strategies themselves.

Next, we move on to discuss the imposition of stress testing as a form of micro-prudential management by banks and financial institutions, as well as way of overcoming regulator-firm information asymmetry to assist regulators in supervision. Stress testing allows a bank or financial institution to ask itself how it would perform under various hypothetically difficult situations. It also provides a business-neutral platform for regulators to assess the risk profiles of banks and financial institutions. Regulators could thus embark on a critique of bank or financial institution risk management by referring to stress testing results, without needing to get into the intractable questions of whether certain business strategies are warranted or what the trade-off between business and prudence should be. The stress testing results could act as a presumptive conclusion that corporate strategies and governance need to adjust to meet the needs of risk management and not the other way around.

\section*{12.5 Stress testing}

Stress testing is required to be undertaken by financial institutions internally as part of risk management and stress test results must be reported to national regulators to assist in supervision. Regulators may also carry out stress tests of financial institutions as a form of hands-on supervision.\textsuperscript{94}


\textsuperscript{94} CRD IV Directive, art 100.
In the UK, stress testing applies to all financial institutions that meet certain thresholds in terms of assets under management, the value of assets on their balance sheet or revenue.\(^9^5\) This also reflects the regulators’ concern for the micro-prudential soundness of more significant financial institutions and SIFIs. The regulator adopts an integrated stress testing approach, which includes firms’ own reverse stress testing and accountability, selective stress testing by the regulator for ‘high-impact’ firms, and system-wide stress testing undertaken by the regulator and taking into account the wider economic context.\(^9^6\) Reverse stress testing requires firms to identify scenarios and possible adverse circumstances that may cause the firm to become unviable, and then carry out stress tests to determine how the firm may weather these hypothetical situations. The results of such stress tests are submitted to the regulator who may then require a firm to implement measures to enhance its resilience and/or make adjustments to its recovery and resolution plans according to the results of the stress tests.\(^9^7\)

The framework of stress testing undertaken by firms has the potential to improve accountability to regulators, assist regulatory supervision, and overcome the weaknesses in information asymmetry associated with the meta-regulatory aspects of micro-prudential regulation.\(^9^8\) The periodic and dynamic nature of stress testing provides opportunities for reflection and for adjustment of risk management in financial institutions. Reporting may also ensure accountability and allow preemptive regulatory intervention to be taken before key problems erupt. However, there remain some concerns about stress testing as a platform for the exercise of supervisory powers.

First, as the regulated firms determine the content of stress tests (i.e. what the hypothetical scenarios are and how they are going to meet such challenges), they could be perversely incentivised to design scenarios and mechanisms that are geared towards future regulatory evasion. Regulators need to be keenly aware of the persistent divergence in incentives between the regulator and regulated and develop more familiarity with the business operations of the regulated, especially SIFIs, in order to check for cosmetic compliance behaviour.

Next, stress testing is heavily based on the quantitative measures of micro-prudential soundness, that is capital adequacy, liquidity ratios and the leverage ratio. An emphasis on quantitative measures can provide room for manipulation


\(^{96}\) Such as those based on a wide survey/reflection undertaken each year by the regulator and covering macro- and micro-prudential risks and conditions; for example, FSA, ‘Prudential Risk Outlook 2011’ (2011) www.fsa.gov.uk/pubs/other/pro.pdf accessed 7 March 2013.

\(^{97}\) PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 20.2.6.


in order to ‘fix’ the figures and tick the right boxes. It is important that stress testing by firms also becomes qualitative and able to evaluate risk management processes, systems and principles.\textsuperscript{100} Regulators should engage with both the quantitative and qualitative profiles of stress testing in order to have a more comprehensive picture of firm risk management. The next chapter will discuss the post-crisis reforms in raising the profile of risk management and enhancing qualitative controls and responsibility for risk management in financial institutions. The authors are of the view that much more integration between the quantitatively focused stress testing templates currently in place and accountability for qualitative aspects of risk management (discussed in Chapter 13) is required.

Further, it is argued\textsuperscript{101} that stress testing based on quantitative measures in micro-prudential regulation is likely to be limited in its ability to foresee long-term and unexpected correlative effects.\textsuperscript{102} For example, the fat tail events leading up to the global financial crisis of 2008–9 are still unlikely to be quantitatively captured under current stress testing templates.\textsuperscript{103}

Next, it is argued\textsuperscript{104} that stress testing needs to be based on extreme but nonetheless plausible scenarios. Scenario framing in stress testing is usually done with the benefit of hindsight, and can be limited and backward-looking. Scenario planning is not yet well developed in either the regulatory toolkit or the reverse stress testing principles, leaving it largely to firms to figure out. This aspect of delegation to firms may entail weaknesses in scenario planning that are generous to firms. Further, it may remain unclear to the regulator whether the scenarios are sufficiently robust and whether all scenarios have been considered. This problem is especially acute in respect of SIFIs that may have cross-border operations. Such SIFIs need to plan for a range of scenarios but regulators may not be able to check the comprehensiveness and credibility of scenario-planning across varied international businesses.

It is also queried how stress testing results will be used. How will regulators develop supervisory strategies using these results? The UK regulator emphasises the importance of feeding results back into the firm’s recovery and resolution plans. So would the stress test results provoke judgement-based pre-emptive regulatory actions or would they merely provide an opportunity for the regulated firm to adjust its firm-based implementation of micro-prudential risk management? If the regulator prefers an emphasis on self-reflection and self-help, the regulator needs


\textsuperscript{101} Mario Quagliariello (ed), Stress Testing the Banking System: Methodologies and Applications (Cambridge: Cambridge University Press 2011), generally.


\textsuperscript{104} Mario Quagliariello (ed), Stress Testing the Banking System: Methodologies and Applications (Cambridge: Cambridge University Press 2011), generally.
to consider the balance between leaving immediate problems detected to be dealt with in the future as they are pushed into the recovery plan framework and making a judgement call for more intrusive regulatory interventions. Regulators thus need to consider whether Pillar 2 scrutiny should be carried out ‘on a long leash’ or in a more intrusive way, bearing in mind that there will be mistakes made in pre-emptive judgements.

Finally, will regulators keep stress testing results confidential in order to develop quiet supervisory strategies? Or will stress test results be made available to wider stakeholders or the public? The former approach could arguably promote a dialogic relationship between regulator and regulated and tailor-made micro-prudential risk management frameworks can be required to be implemented by regulated institutions. But opacity of the regulator-regulated relationships could result in the implementation of micro-prudential regulation in a negotiable manner friendly to industry needs. If stress test results are made available to the public, this could assist in bolstering Pillar 3 scrutiny, which has always been weak. But making stress test results publicly available may prematurely create systemic risk if less than favourable. The EBA’s annual stress tests of European banks and the public publication of results has attracted mixed reviews. On the one hand, such public accountability is laudable; on the other hand, it is queried whether the results are meant to massage market confidence. The authors, however, argue that Pillar 3 transparency and accountability play an important role in regulatory governance. Turnbull argues for stakeholder mobilisation in governing the financial sector due to the law of requisite variety and we have argued in Chapter 2 that widening the space for governance may avoid regulatory pitfalls. If regulators are concerned that stress test results may trigger systemic panics, regulator-vetted communications of stress test results could be published in order to optimally engage the public while mitigating systemic reactions.

12.6 Concluding remarks

In sum, micro-prudential measures have been boosted in terms of variety and detail, but it is inevitable that balance sheet based tools in micro-prudential regulation remains rather meta-regulatory in nature, subject to unique firm implementations that are appropriate for the context of the regulated firm. The post-crisis era promotes greater regulatory supervision in micro-prudential regulation. But Moloney argues that ‘supervision’ is not an exact science, that it is itself a


developing concept, with many forms and techniques bound up with the mandates, resources, structure and status of the regulator.\textsuperscript{108} Although Pillar 2 is being rejuvenated, there may also be unintended consequences. A more engaged supervisory relationship entails tendencies for regulatory closeness and capture, as outlined in \textbf{Chapter 3}, and also raises the question of whether ‘enforcement’ is part of the suite of regulatory tools in dealing with micro-prudential regulation. In \textbf{Chapter 3}, it was argued that supervisory dialogues promote informal exchanges of information and quiet adjustments of behaviour so that enforcement may be avoided. Nevertheless, Ferguson\textsuperscript{109} argues that having fewer, more principled and less complex rules is the only way to regulate effectively.

Post-crisis reforms augment and at the same time reduce the importance of micro-prudential regulation as a key technique to maintaining financial institution safety and soundness. The reduction of importance of ‘micro-prudential’ regulation may be seen in light of the reduced reliance on traditional balance sheet-based capital adequacy to achieve institutional soundness and safety. This also reflects scepticism in excessively hands-off approaches taken by regulators in the pre-crisis implementation of meta-regulatory frameworks in capital adequacy. However, we may also perceive micro-prudential regulation as having been augmented in new ways. The scope of this regulatory area has widened and novel regulatory strategies in micro and macro-prudential regulation, structural reforms and crisis management all now form part of the landscape for regulating safety and soundness. The augmentation of the concept of micro-prudential regulation may put more tools at the disposal of regulators but it is important to observe how the balance of tools is deployed and the outcomes that follow.

The next chapter will discuss how micro-prudential regulation extends into qualitative areas such as risk management and corporate governance and the challenges ahead such as the entanglement of micro-prudential regulation with the private world of corporate governance.

\textsuperscript{108} Supervision is in fact described as practical steps or procedures en route to securing compliance, see John H Walsh, ‘Regulatory Supervision by the Securities and Exchange Commission: Examinations in a Disclosure-Enforcement Agency’ (1999) 51 \textit{Administrative Law Review} 1229; Karen Yeung, \textit{Securing Compliance} (Oxford: Hart Publishing 2004), which shows supervision to be a dynamic and flexible toolkit.

13 The meta-regulation of risk management and corporate governance

13.1 The nature of regulatory governance in risk management

In the wake of the global financial crisis, regulatory scrutiny has been extended into the broader realm of risk management beyond the the micro-prudential matters of capital adequacy, liquidity, large exposures, and perhaps leverage. Qualitative matters, such as the systems and frameworks for risk management, and perhaps the culture of risk management in banks and financial institutions, have become important regulatory concerns.

At the EU level, regulatory harmonisation in the field of regulation of investment firms determined those aspects of risk management that are ‘regulable’ in 2004. The Markets in Financial Instruments Directive 2004 (MiFID) has enacted provisions regarding organisational arrangements, systems resilience and corporate governance arrangements. This shows an extensive recognition of procedures, processes, systems and governance as being an important part of the whole risk management profile of a financial institution. Financial regulation encompasses these areas, which are left to private governance in other corporate sectors. The UK regulator has also put in place a framework for risk management regulation applicable to all financial institutions including banks.

Although there is a regulatory framework recognising organisational, procedural, systems and governance aspects of a financial institution as regulable matters of risk and prudential management, such a framework cannot overprescribe

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1 This is not discussed in this book as Chapter 12 focuses on the Basel III reforms. See generally Simon Gleeson, International Banking Regulation (Oxford: Oxford University Press 2009), ch 18.
3 See, for example, PRA and FCA Handbook (as of 30 April 2013, formerly FSA Handbook) SYSC 3, 4, 6 and 7.
concerning the intricacies of how a financial institution should be run. Hence, the requirements for systems, processes and procedures are couched in qualitative language: they should be ‘sound’, ‘proper’, and proportionate to the scale, size and complexity of the business. Financial institutions engage in risk management as an inherent part of their business, and so the regulatory framework leverages upon firm implementation. The regulatory framework for the risk management of financial institutions is largely a meta-regulatory one, with certain qualitative principles of risk management provided in regulation, such as the ‘soundness’ of systems, ‘effective oversight’ by senior management and ‘independence’ and/or ‘permanence’ of internal departments (such as compliance and audit). But the exact implementation of such systems and controls is designed by firms to be proportionate with the firm’s needs, subject to accountability and supervision.

Meta-regulation encourages governance by private actors where there is alignment of activities or incentives. However, the global financial crisis of 2008–9 brought into sharp focus the inadequacies of firm-designed risk management, as such risk management is often subsumed under the business needs of the firm. Partnoy writes, pessimistically, on the inherent nature of diverging incentives between the regulator and regulated; firms are inextricably bound up with inward-looking and self-centred concerns. Behavioural drivers in hyper-competitive financial institutions persistently underestimate risk in order to pursue more aggressive growth and higher gains. Commentators explain how the aggressive profit-chasing and growth cultures at banks have persistently undervalued the

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5 For example, PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 7.1, SYSC 21.


7 MiFID Commission Directive 2006, arts 6 and 8. The independence of a compliance function is provided in the PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 3.2, SYSC 6, and the existence of an internal audit function, PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 3.2.16, 6.2.1.


importance of risk management and the devotion of resources to sound risk management.\textsuperscript{12} According to an empirical study, resource constraints are frequently a driver for lower quality risk management in firms.\textsuperscript{13} The incentives for firm-based risk management tend to diverge from what regulators seek to achieve in terms of the soundness of financial institutions\textsuperscript{14} and wider financial stability. The potential for meta-regulation is arguably undermined by such divergence in incentives and objectives.

Although we are witnessing a resurgence of regulatory power in the post-crisis era, in the area of prudential regulation (and risk management generally), the governance of risk management in a firm is inevitably meta-regulatory as risk management is unique to each firm. Empirical evidence increasingly shows greater internal awareness of the importance of risk management.\textsuperscript{15} Nevertheless, it remains uncertain whether internal approaches to risk management can be aligned with regulatory objectives, and if so, to what extent.

This chapter will argue that the post-crisis regulatory approach is based on two strategies. The first strategy consists of reducing the incentives that promote greater risk-taking that is contrary to the regulatory objective of financial stability. One such incentive to take greater risks is derived from the structure of remuneration packages of financial institution employees and management and so regulation has moved to control the design of financial sector remuneration. Next, regulatory principles are promulgated to raise the profile of risk management so that it becomes essential to the corporate governance of a financial institution. Regulatory scrutiny now compels responsibility for risk management to be taken at the highest governing levels of the firm. There is thus a regulatory framework for certain aspects of corporate governance in relation to risk management but this framework is rather open-ended in nature. These two strategies represent an enhanced interventionist stance in an essentially meta-regulatory landscape. Regulators are attempting to challenge aspects of business that are contrary to the public interest. However, this chapter will argue that the regulator faces two challenges: first, there are limits to what can be achieved in making financial business safer without overly interfering with the freedom to generate wealth and, second, regulators must be wary of becoming confused between the firm-centric and public interest aspects of risk management. It is important to distinguish the rationale for risk management as a public interest concern from firm-centric


concerns such as financial performance. The regulatory approach to risk management and corporate governance should not be bound up with private transactional paradigms.16

In a decentralised landscape, the governance potential of other actors is being sought in order to complement regulatory governance in an essentially challenging area. Shareholders are being looked to as alternative actors of governance. This chapter will point out that although the book generally supports the co-governance of other actors in the regulatory space, the co-option of shareholders may entail certain pitfalls, such as the obscuring of regulatory objectives by more firm-centric perspectives.

13.2 The rationales for regulating financial sector remuneration

A major reform introduced following the global financial crisis is the regulation of financial sector remuneration, targeting variable remuneration in particular, such as bonuses, which have become an important component of remuneration packages. Is the reform of financial sector bonuses merely a way of responding to the ‘snarky’ perceptions17 of the general taxpaying public, fed up of bearing the burden of bailing out financial institutions on the brink of failure, or is financial sector remuneration out of control and a genuine prudential concern?18

The legislative reforms in the EU – in the form of the Capital Requirements Directive 201019 – and the implementation of the UK Remuneration Code 20 as part of financial regulation in the UK will be discussed critically in Section 13.3,

16 As the global financial crisis has arguably ushered in a firm ideological basis for financial regulation based on systemic stability, such ideological clarity and distinctness from market-based ideologies needs to be maintained for the reforms to achieve its financial stability objectives, see Hilary A Sale, ‘The “New” Public Corporation’ (2011) 74 Law and Contemporary Problems 137; Christopher Arup, ‘The Global Financial Crisis: Learning from Regulatory and Governance Studies’ (2010) 32 Law and Policy 363; Curtis J Milhaupt and Kathleen Pistor (eds), Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World (Chicago, IL: University of Chicago Press 2008), written before the onset of the global financial crisis but indicating that corporate governance developments must be considered in tandem with regulatory contexts and hence that corporate governance is not merely an outworking of private transactional relationships albeit bound up in the culture and practices of different jurisdictions.


20 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.
in particular whether they effectively address prudential concerns. This section will also discuss several enhanced reforms in the CRD IV Directive of 2013.

The impact of financial sector remuneration on prudential stability is the reason why regulatory oversight in this area has been introduced. The structure of financial sector remuneration has arguably given rise to a number of perverse incentives on the part of financial sector employees and management, including short-termism and excessive risk-taking.

There is also the issue of the sheer size of remuneration packages, which, at first glance, may appear to be a source of social discontent. However, we will examine whether there is any substantive prudential concern regarding how much bankers and financial sector employees and management are paid.

Thannasoulis argues that much of financial sector remuneration is variable remuneration so that financial institutions can ‘insure’ themselves against poor performance, paying out only where there is performance to be rewarded. Seen in this light, the dominance of variable remuneration in the financial sector is a form of risk management by firms. However, the definition of ‘performance’ may be managed by financial sector employees and management such that the thresholds for eligibility for variable remuneration are aligned with their interests. Bender and Moir observe that much of executive remuneration, generally across sectors, is structured around performance measures that are readily measurable, such as earnings, profits, returns on equity, largely accounting measures. In the financial intermediation business, remuneration is also structured around ‘hard’ targets, such as assets under management and the volume of sales of financial products.

There is arguably a mismatch between the measures of performance related to remuneration and ‘performance’ in terms of the purpose or quality of outcomes in financial intermediation activities. An investment manager’s performance may be measured according to yardsticks – such as total assets under management or returns on investment calculated on a yearly basis – and a bank manager may be remunerated according to his or her performance in loan sales. However, the ex post performance of the financial product does not feed back into the measurement of financial sector employees’ performance. This results in a short-termist and myopic view of what ‘performance’ means in financial intermediation. It also leads to a decoupling of the notion of ‘performance’ for the purposes of reward from the actual performance of the financial product sold or financial service rendered. Indeed, senior management pay may be linked to even shorter-term quarterly earnings results. Short-termism may be an expression of the efficiency of our

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Performance benchmarks in the financial sector may also be structured in such a way as to incentivise certain behaviour. As mentioned above, if performance benchmarks are based on total assets under management, then investment managers are incentivised to increase investment volume, without necessarily paying attention to suitability.\footnote{Philip Bond, David K Musto and Bilge Yilmaz, ‘Predatory Lending in a Rational World’ (November 2005) FRB Philadelphia Working Paper No 06-2 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=875621 accessed 9 January 2013.} This may also apply to the sale of loans, as a number of commentators have observed how remuneration incentives have propelled predatory lending in the sub-prime market.\footnote{Camarata Property Inc v Credit Suisse Securities (Europe) Ltd [2011] EWHC 479 (Comm), [2011] All ER (D) 145 (Mar).} In sum, the performance benchmarks used by the industry, and measures based on short-termism in general, are likely to result in a dislocation of reward from purpose in financial intermediation activities.

It may be argued that the dislocation of reward from purpose is also a feature of many other sectors. Do car salesmen, for example, really care about the long-term utility and durability of a used car sold to a customer? In the financial sector, it will be argued that the dislocation of reward from purpose is especially disturbing because of the dislocation of reward from risk. A used car salesman must face an irate customer for a defective used car, be it for servicing responsibilities or, worse, legal liability. Are financial institutions accountable for poorly performing loans or investments? For an investment product, it may be argued that performance depends on external circumstances. Further, where there is a liquid market for exit, it is for the investor to make a call as to whether exit is best at any given point in time.\footnote{Richard Lambert, ‘Sir Ralph’s lessons on short-termism’ Financial Times (London, 22 May 2011).} For loan products, penalty charges that banks may be able to levy on defaults represent another source of revenue and thus poorly performing loans may not be perceived to be a real problem for banks in the short term. In the longer term, poorly performing loans may threaten the survival of a financial institution. But if the financial institution is a SIFI, then it may be underwritten...
by government bailout, resulting in moral hazard and a large taxpayer bill. By this time, financial sector employees and management will already have benefitted from their performance-based remuneration.\footnote{Lucian Bebchuk and Holger Spamann, ‘Regulating Bankers’ Pay’ (2010) 98 Georgetown Law Journal 247.} Although imperfect performance targets and short-termism exists as much in the financial sector as in other corporate sectors, the dislocation of reward from purpose may be a more serious issue in the financial sector. The failure of purpose in financial services and products does not result in any responsibility or liability on the part of the financial sector, yet may have huge systemic consequences. This perception of immunity from responsibility further drives excessive risk-taking that is socially suboptimal.\footnote{Sugato Bhattacharyya and Amiyatosh Purnanandam, ‘Risk-Taking By Banks: What Did We Know and When Did We Know It?’ (November 2011) http://ssrn.com/abstract=1619472 accessed 9 March 2013.}

Financial institutions are not incentivised to manage such excessive risk-taking on their own, as Ford and Sundmacher argue that remuneration-driven risk-taking behaviour is not recognised as a possible source of ‘operational risk’ in many financial institutions.\footnote{Guy Ford and Maike Sundmacher, ‘Leading Indicators for Operational Risk: Case Studies in Financial Services’ (November 2004) http://ssrn.com/abstract=963235 accessed 9 March 2013.} Suntheim also argues that remuneration-fuelled incentives result in risk-taking behaviour that looks for more and more sources of income, such as engagement in higher levels of leverage and moving away from established forms of investment or products. These new sources of income are often not sufficiently or rigorously risk-tested.\footnote{Felix Suntheim, ‘Managerial Compensation in the Financial Service Industry’ (August 2010) http://ssrn.com/abstract=1592163 accessed 9 March 2013.} Such risk-taking behaviour has paid off in the benign monetary landscape of the last decade. The financial sector has, according to Lo, become anaesthetised to higher levels of risk and more exotic forms of risk-taking behaviour.\footnote{Andrew Lo, ‘Fear, Greed, and Crisis Management: A Neuroscientific Perspective’ (1 September 2009) http://freakonomics.blogs.nytimes.com/2009/01/09 accessed 9 March 2013.} In aggregate, such behaviour multiplied across many institutions in the financial sector gradually poses a level of systemic risk.\footnote{Viral V Acharya, ‘A Theory of Systemic Risk and Design of Prudential Bank Regulation’ (2009) 5 Journal of Financial Stability 224; Emilios Avgouleas, ‘The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a New Orthodoxy’ (2009) 9 Journal of Corporate Law Studies 23.}

However, could it be argued that financial sector remuneration is often rewarded in stock and, therefore, long-term stock price performance may impose a long-term outlook and discipline on managers in particular?

Gregg, Jewell and Tonks\footnote{Paul Gregg, Sarah Jewell and Ian Tonks, ‘Executive Pay and Performance: Did Bankers’ Bonuses Cause the Crisis?’ (2012) 12 International Review of Finance 89.} point out that although financial sector remuneration is structured around stock price performance in the US, this is much less common in the UK and EU, where cash bonuses are the norm. Nevertheless, Bebchuk and Spamman,\footnote{Lucian Bebchuk and Holger Spamann, ‘Regulating Bankers’ Pay’ (2010) 98 Georgetown Law Journal 247.} as well as Mülbert, point out that stock-based performance...
remuneration is not likely to ameliorate risk-taking and short-termist incentives on the part of financial sector employees and management. This is because financial institutions, such as banks, rely much more on deposits and other loans as a source of finance than on equity. Equity holders therefore prefer higher risk-taking to maximise returns, since losses are shared with a large base of creditors. If employees’ and management’s interests are aligned with shareholders, all would prefer higher than socially optimal levels of risk-taking. In fact, research suggests that shareholder incentives may exacerbate risk-taking tendencies, as they also pursue short-term returns on equity and tolerate high levels of risk-taking in business models. Mülbert also points out that micro-prudential regulation, which exacts capital charges for loans, ties up equity for that purpose. Equity holders therefore see greater risk-taking as the way to maximise returns given the constraints associated with micro-prudential regulation. Further, empirical research also shows that stock-based remuneration has not succeeded in imposing a long-term perspective on managerial behaviour, as managers at the failed banks Lehman Brothers and Bear Stearns cashed out stock options regularly before the failure of the banks. Thus, there may not be a discernible difference between the incentives shaped by stock-based remuneration and cash bonuses.

Ferranini and Ungureanu, however, argue that financial sector remuneration may not be a key prudential concern. They argue that financial sector


41 It remains to be seen whether strict long-term requirements on vesting and selling may work, see Lucian A Bebchuk and Jesse M Fried, ‘Paying for Long Term Performance’ (2009) 138 University of Pennsylvania Law Review 1915.

remuneration has become competitive and has taken on certain common features in bonus structure and performance benchmarks, pushing most banks to adopt very similar remuneration structures for employees and management. If failed banks and banks that have survived adopted similar remuneration structures, then remuneration structure cannot be said to be a pivotal cause of bank failure or the crisis. Even if remuneration structures have an impact on risk-taking incentives, one must ask why financial institutions that implement more or less similar remuneration structures are not equally hit.

Davies argues that the financial crisis has been the culmination of many excesses and that these excesses work to different extents in the financial institutions affected by the sub-prime mortgage failure in the US and the subsequent global credit crunch. The remuneration issue may not be a pivotal issue, but it does not mean that it has no systemic significance. The heightened incentives for short-termist risk-taking have been well discussed and accepted by both economists and policymakers. The regulatory trajectory tends towards control of the prudential impact that remuneration may have on financial institutions, but such controls are necessarily entangled in the private relations of contract and the private realm of the firm’s needs. Regulatory governance is inevitably meta-regulatory and this chapter is sceptical as to what the regulatory framework can achieve. The chapter warns against regulatory entanglement with firm-centric perspectives, a warning sounded in Chapter 12 as well. This chapter also queries whether it would not be preferable to encourage greater responsibility, by introducing remuneration clawbacks, for example, for longer-term non-performance or bail-in in case of institutional failure, instead of being involved directly in remuneration regulation. These will be discussed shortly.

Finally, the prudential concern surrounding financial sector remuneration is exacerbated by the fact that the size of the remuneration packages may be disproportionately large. The question of ‘size’ (i.e. the quantitative amount of reward) generates newspaper headlines and social discontent, but there is a very real problem of transfer of wealth that academic commentators have pointed out. Thannasoulis has found that bank remuneration may constitute 50–80 per cent of the institution’s balance sheet. Gregg, Jewell and Tonks also find that

43 It has been commented generally that remuneration structures in competitive industries tend to look alike as pay negotiations are centred around peer practices and not on the individual characteristics of the company, see Ruth Bender and Lance Moir, ‘Does “Best Practice” in Setting Executive Pay in the UK Encourage “Good” Behaviour?’ (2006) 67 Journal of Business Ethics 75.
remuneration packages rise in size relative to the size of an institution’s balance sheet. Financial intermediaries, whose purpose is to allocate resources and assist in wealth creation in the real economy, have transferred vast amounts of wealth to themselves. It is pertinent to raise the question of the social cost of such behaviour. The remuneration problem not only relates to prudential management of financial institutions, but also relates to the issue of whether social utility is undermined by the transfer of wealth to individuals in the financial sector.

13.3 The EU and UK’s approach to regulating financial sector remuneration

The EU has recognised that the ‘inappropriate remuneration structures of some financial institutions have been a contributory factor’ to the failure of various financial institutions during the global financial crisis.49 Hence, a general principle of aligning remuneration policies to sound and effective risk management is provided.50 Some prescriptive detail on how remuneration packages should be structured is also introduced.51 These, together with the guidelines issued by the Committee of European Banking Regulators (CEBSR), which is now the European Banking Authority (EBA), have been transposed into the UK regulator’s Remuneration Code.52 The Code is envisaged to further implement new changes to remuneration regulation introduced by the EU in the form of the CRD IV Directive 2013.53

This section will examine the provisions in the UK Remuneration Code in order to evaluate the likely effect of the Code on the alignment of remuneration incentives with risk management.

The Remuneration Code applies to:

. . . senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the firm’s risk profile.54

The regulatory control of remuneration includes certain prescriptive policies supported by meta-regulatory principles on risk management. It also imposes a

50 See also CRD IV Directive, art 92.
51 Capital Requirements Directive 2010, annex V, para 11. These have been recast in CRD IV Directive, arts 92–94.
52 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.
54 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.4, 19A.3.6 further provides a list of office holders likely to fall within the scope of the Code.
reporting obligation on financial institutions with respect to compliance with and breaches of the remuneration rules.\textsuperscript{55} The regulator may carry out enforcement and disciplinary actions against firms in breach and, where applicable, the regulator could order firms to pursue civil recovery for wrongfully paid remuneration above certain thresholds.\textsuperscript{56}

The regulatory rules provide some prescriptive detail targeted at the design of variable remuneration. The reforms deal with how ‘performance’ criteria should be established, as well as how variable remuneration should be structured and proportioned as part of the total remuneration package. The Code states that performance should be based on measures (such as profit)\textsuperscript{57} and other non-financial metrics (such as risk management),\textsuperscript{58} over a multi-year business cycle,\textsuperscript{59} taking into account current and future risks\textsuperscript{60} and the performance of the business unit as a whole.\textsuperscript{61} The Code attempts to change metrics used by the industry, such as revenue-based measures or returns on equity, in order that performance may not be measured merely by easy benchmarks. The reference to longer-term business cycles and future risks also attempts to introduce a longer-term perspective to measuring performance. These measures could be seen as ways of dealing with short-termist incentives and the reward/purpose mismatch.

Prescriptive rules on the structure of variable remuneration also intend to deal with short-termist tendencies. Rules such as the mandatory deferral of at least 40 per cent of variable remuneration\textsuperscript{62} (subject to ongoing performance review and not to vest until review)\textsuperscript{63} and the deferred vesting of long-term plans (such as share options only after three to five years)\textsuperscript{64} are examples of the techniques used to combat the pursuit of short-termist remuneration.

The Remuneration Code also provides for a clampdown on guaranteed bonuses unless for new staff and only in the first year of employment or for exceptional performance.\textsuperscript{65} Further, variable remuneration should be limited in its cash component: at least half of variable remuneration must be non-cash, in either shares or other capital instruments that are subject to retention.\textsuperscript{66} These provisions intend to deal with the issue of transfer of wealth to individuals in the financial sector. New EU legislation in the CRD IV Directive 2013 further regulates the awarding of variable remuneration by placing a cap on yearly variable

\textsuperscript{55} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.1.7.
\textsuperscript{56} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A Annex 1, para 5A.
\textsuperscript{57} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.25-28.
\textsuperscript{58} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.37.
\textsuperscript{59} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.38.
\textsuperscript{60} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.22-23.
\textsuperscript{61} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.36.
\textsuperscript{62} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.49.
\textsuperscript{63} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.51.
\textsuperscript{64} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.24.
\textsuperscript{65} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.40-41.
\textsuperscript{66} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.47.
remuneration to the annual basic salary, allowing the cap to be increased to twice the annual basic salary only upon shareholder approval.67

Another measure that deals with the reward/purpose mismatch states that payments for early termination must be performance-based and must not reward failure. This provision also allows contractually agreed terms to be reviewed so that early termination for failure does not result in the payout of undeserved rewards.68 It may be said that this provision is a response to the public outcry over the contractual payments made to bank executives who stepped down in the wake of the global financial crisis, including Fred Goodwin, the Chief Executive who ran the Royal Bank of Scotland aground in the crisis.

The prescriptive measures above are unlikely to capture all aspects of remuneration package design in financial institutions. Hence, much is left to remuneration committees69 (where applicable) or to the Board responsible for overseeing the design of remuneration packages, who must ensure that such packages are aligned with the promotion of risk management. However, risk management is defined in terms of the business objectives and strategies of the firm concerned.70

13.3.1 Does the Remuneration Code address the issues of risk, purpose, social utility and cost?

The EU Directive and the UK Remuneration Code are premised on aligning remuneration policies with sound risk management. Van der Elst and Bogaert point out that risk management is a developing discipline that has grown out of financial reporting obligations and is now increasingly included in corporate governance and internal control systems and arrangements.71 Risk management is essentially firm-focused and is intended to support business objectives.72 The issues that regulators wish to address in remuneration design have to do with perverse designs, such as the reward/purpose mismatch, which entails excessive risk-taking and the excessive transfer of wealth to financial sector individuals. Have the regulatory reforms effectively addressed the issues that are of concern, such

68 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.45.46.
69 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.12.
70 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.7-9.
71 Christoph Van der Elst and Filip Bogaert, ‘Risk Management in Financial Law’ in Marjin van Daalen and Christoph Van der Elst (eds), Risk Management and Corporate Governance (Cheltenham: Edward Elgar 2010), 109ff.
as financial stability, or have they become mired in firm-centric perspectives supporting firm-centred views of risk management?

It may be argued that remuneration regulation does intend to deal with excessive risk-taking and short-termism in individual institutions and that this could have a collective systemic effect. The rules on deferral of at least 40 per cent of variable remuneration, to be vested subject to ongoing performance review, force individuals to wait for variable remuneration and may change behaviour as deferred remuneration may not vest in the event of longer-term failure of performance. Financial institutions can, however, mitigate the ‘sting’ of this rule by enhancing the fixed component of remuneration and this, in Thannasoulis’ view, is a worse form of risk management for financial institutions. Hence, the cap on variable remuneration introduced recently in EU legislation may not be able to address the incentives that drive risk-taking by financial sector employees. Further, deferring rewards over the longer term may not deal with the issue of whether the reward is attained ‘easily’. If rewards can be attained with relative ease, then deferring the reward may not significantly change behaviour.

In relation to the measures in the Remuneration Code on structuring at least half of variable remuneration in shares or capital instruments, we are of the view that this measure allows the issue of suboptimal risk behaviour to be entangled with the private nature of firm-centric corporate governance. Aligning remuneration incentives with shareholders’ incentives only emphasises the profit-making objectives of financial institutions, without introducing the language of responsibility and regard for systemic risk into remuneration incentives. Arguably, the risk-taking, profit-chasing behaviour prior to the global financial crisis is not misaligned with shareholder objectives; it is more aptly described as misaligned with wider social and stakeholder objectives, such as those of customers, depositors and borrowers. The authors are concerned that objectives of remuneration regulation will become inevitably entangled with firm-centric perspectives and will lose their focus on systemic risk and financial stability.

Although the Code deals with symptomatic issues, such as variable remuneration and deferral of payments, the overarching principle in the Code is meta-regulatory in nature, stipulating that rewards must be tied to longer-term profits viewed as a whole and must take into account non-financial metrics such as risk management. The precise details of performance criteria may still be elaborated internally by the firm. Firm risk management is likely to be firm-centric, taking little account of the wider systemic impact. In the regulatory supervision of the

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76 Christoph Van der Elst and Filip Bogaert, ‘Risk Management in Financial Law’ in Marijn van Daelen and Christoph Van der Elst (eds), Risk Management and Corporate Governance (Cheltenham: Edward Elgar 2010). The chapter discusses how risk management first developed to support
design of remuneration packages, regulators must engage with firm-centric perspectives on the alignment of remuneration packages with firm needs and will necessarily find it difficult to judge the appropriateness of firm needs. Further, being entangled in such firm-centric perspectives may make it difficult for regulators to maintain a critical position based on wider financial stability concerns. Where firms have Remuneration Committees on the Board, the Code requires that such Committees oversee the general design of remuneration packages. Remuneration Committees serve the firm and are likely to bring firm-centric perspectives to dominate remuneration design. The Code should not assume that the incentives of Remuneration Committees will be aligned with the public good of financial stability. The meta-regulatory nature of remuneration regulation co-opts elements of corporate governance, such as remuneration committees, and alignment with shareholder interests as controls upon remuneration packages. However, corporate governance deals with internal accountability and not socially optimal risk-taking or risk management. Hence, the conflation of corporate governance aspects with remuneration regulation may be a sign of a confused regulatory approach to the systemic risk posed by remuneration incentives in financial institutions. This also applies to the discussion on regulating aspects of corporate governance more generally, as we will show in Part 4.

We are also of the view that the approach of the remuneration regulation regime as it currently stands may rightly introduce corrections for the problematic incentives that arose in the global financial crisis, but this approach is also static and backward-looking in nature and may not be sufficiently flexible to address other driving factors or incentives for behaviour. Okamoto and Edwards argue that regulators cannot define what is socially optimal risk-taking for the purposes of a financial institution’s business anyway and therefore are not in a position to regulate remuneration packages in order to control risk-taking. Hence, they argue that remuneration regulation is a poor proxy for the regulatory objective of financial stability and merely panders to populist anger against the global financial crisis. We do not argue that remuneration regulation is unnecessary, but we argue that the current approach is limited and misguided. We support a remuneration regulation regime that would affect risk-takers’ incentives in relation to encouraging them to take a wider view of their responsibility and accountability in risk-taking. Such an approach would be more dynamic and would also allow regulators to focus on scrutiny for systemic risk impact when looking at remuneration packages.

We propose that remuneration regulation should be based on two aspects: first, bail-in in cases of failure, and second, claw-back in cases of non-performance that...
may be defined by regulatory guidance.\textsuperscript{79} We believe that imposing \textit{ex post} responsibility instead of \textit{ex ante} controls addresses risk-taking incentives in a more effective way, and will save regulators from being entangled with firm-centric perspectives in remuneration package designs.

First, we support the Liikanen proposal\textsuperscript{80} to compel the bail-in of outstanding variable remuneration due to bank staff in cases of institutional failure. This approach introduces incentives to encourage bank staff to regard the preservation of the viability of the institution as key to their own private benefit, and therefore supports micro-prudential regulation objectives. For this approach to work, the variable remuneration component of bank staff may ironically have to be of a sufficient proportion, and therefore prescriptive rules such as capping variable remuneration to the amount of yearly basic salary as approved by the EU may be counterproductive.

Second, we support the institution of a claw-back regime for variable remuneration that is paid. We argue that claw-back should be triggered by well-defined regulatory criteria, such as the non-performance of financial products that were mis-sold, or the imposition of regulatory enforcement for transactions that are in breach of regulations. Regulators should be empowered to order firms to take claw-back or civil recovery proceedings against staff where regulatory criteria have been satisfied and regulation should provide that anti-claw-back exceptions in contracts are to be void. The regulatory criteria for claw-back should be defined with reference to concerns regarding the alignment of reward/purpose and prudent risk management of the firm. This approach could then align the incentives of bank staff with regulatory criteria as the meeting of regulatory objectives affects the attainment of private benefits.

It may be argued that the Remuneration Code already provides for the possibility that deferred rewards may not vest subject to performance review. Further, contractually agreed payments may be invalidated if early termination is a result of poor performance. Firms may also be forced to pursue claw-backs in civil recovery if the regulator finds relevant breaches of the Remuneration Code. The claw-back provision in the Code only provides for mandatory civil recovery if the remuneration has been paid in breach of the Code, is in excess of £500,000 and constitutes more than 33 per cent of a person’s remuneration package.\textsuperscript{81} We believe that claw-back provisions should be widened in scope so that breaches of financial regulation more widely and not just breaches of the Remuneration Code could trigger a claw-back obligation on the part of the firm. We also do not support limiting the operation of the claw-back mechanism to amounts in excess of £500,000. We suggest that the imposition of personal


\textsuperscript{80} Erkki Liikanen, High-level Expert Group on Reforming the Structure of the EU Banking Sector (Final Report, Oct 2012) at para 5.5.3.

\textsuperscript{81} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 19A.3.54.
responsibility at a micro-level is more important in influencing risk-taking behaviour, which could have a collective impact on the sector. Enhanced clawback mechanisms would be able to introduce ‘skin in the game’ incentives for bank staff in their risk-taking decisions.

We are of the view that the imposition of personal responsibility for remuneration losses also addresses the issue of disproportionately large remuneration packages in the financial sector, which have given rise to social concern. In our view, the social discontent, or ‘snarky’ comments, regarding remuneration in the financial sector are not merely superficial, reflecting envy. There is a real issue of whether remuneration packages that form 50–80 per cent of a financial institution’s balance sheet are in the interests of micro- and macro-prudential objectives. Thannasoulis argues that it is the proportion of financial sector remuneration that may pose a problem in micro- and macro-prudential risk management and proposes that remuneration be capped at a prudent proportion of the balance sheet. Such significant transfers of wealth should entail greater accountability by those who have gained private benefits so that certain adverse consequences of risk materialisation (which should be defined by regulatory criteria) are shared by the firms and the individuals who have most benefitted in the short term.

We suggest that the Remuneration Code and the EU legislation have focused on the symptomatic issues in financial sector remuneration and have therefore taken a regulatory approach that may become entangled in firm-centric perspectives and may not directly address systemically suboptimal risk-taking behaviour. We have suggested adjustments to the regulatory approach above. We also regard remuneration packages as a form of information that could be used intelligently by regulators to discern systemic risk signs, as great risks may follow great flows of money and reward. Remuneration reporting could assist regulators in their overall scrutiny of the financial system and markets in macro-prudential supervision, as will be discussed in Part 4.

We would like to briefly address the prospect of regulating remuneration by instituting mandatory shareholder voting to approve or reject executive remuneration packages. This has been instituted in Switzerland following a referendum and is likely to gain traction in the EU.

82 Dowd and others are of the view that personal liability was more pronounced in the early days and bankers were also more prudent and conservative, see Kevin Dowd and others, ‘Capital Inadequacies: The Dismal Failure of the Basel Regime of Bank Capital Regulation’ (July 2011) Cato Institute Policy Analysis No 681 http://ssrn.com/abstract=1961708 accessed 9 March 2013; Frank A Sloan and others, ‘Liability, Risk Perceptions, and Precautions at Bars’ (2000) 43 Journal of Law and Economics 473, arguing generally that legal liability rules have a direct impact on risk perception by regulated entities, such as bar owners, and will influence the prudence of their behaviour.


In the UK, the Directors’ Remuneration Report Regulations 2002 compels all quoted companies to submit annually to shareholders a remuneration report and to ask for an advisory vote by shareholders. The vote is not binding but rejections of remuneration reports have caused embarrassment to companies. Policymakers in the UK and EU\textsuperscript{86} are in favour of making the advisory vote a binding vote so that shareholders can exert control over remuneration packages.

However, shareholder scrutiny of remuneration packages does not extend to below the Board level, and revolves around perspectives of firm performance and shareholder value. These concerns are private in nature and do not relate to the public interest of financial stability that has initially underpinned the Code. If regulators tend to rely more and more on corporate governance as a form of surrogate governance in remuneration issues, this reliance may be misplaced. As mentioned earlier, corporate governance deals with internal accountability and not socially optimal risk-taking or risk management. Hence, the conflation of corporate governance aspects with remuneration regulation may be a manifestation of confusion in terms of regulatory strategy. A KMPG survey of 2012\textsuperscript{87} has shown that shareholders approve of over 90 per cent of remuneration packages as long as performance expectations are met, showing that shareholder scrutiny is based on very different concerns from public interest, and has the tendency to be pro-cyclical, making it a less than ideal corporate governance mechanism to keep risk management in check.

The next section will discuss regulatory reforms to corporate governance in order to address risk management failures at banks and financial institutions. The idea is to reframe corporate governance so that leadership can be provided to institute more effective risk management. This approach is still meta-regulatory in nature, with some prescriptive procedural aspects. We will discuss what may be achieved by these reforms and whether this strategy can help align firm-centric incentives and regulatory objectives.

13.4 Raising the profile of risk management and corporate governance

The global financial crisis has led to serious scrutiny of banking and financial institutions in respect of risk mismanagement. The crisis has highlighted poor risk management at banks to be a key factor in the failure of a number of financial institutions,\textsuperscript{88} and so regulators have stepped up regulation of risk management generally as part of micro-prudential regulation. The pre-crisis regulatory

\textsuperscript{86} UK Enterprise and Regulatory Reform Bill, 2012 and EU Company Law Action Plan (December 2012).


framework for risk management at banks and financial institutions was skeletal in nature. European legislation on banks or credit institutions did not require the institution of any particular internal control functions, leaving it to the regulated firms to define what ‘adequate internal control’ may be proportionate to the ‘nature, scale and complexity’ of the firms’ activities. The MiFID, which applies to investment firms, mandated the establishment of separate and permanent compliance and internal audit functions in investment firms, but left firms the discretion to decide if a separate risk management function would be necessary and proportionate to the nature, scale and complexity of the firm’s business. In the UK, the regulator applied MiFID requirements across the board to authorised financial institutions including banks that are not insurers, reinsurance underwriting agents or building societies. The very skeletal nature of the regulatory framework for risk management is a form of meta-regulation, outlining broadly the option to establish a risk management function and leaving firms to implement the organisational roles, governance, accountability and objectives of such functions.

Empirical evidence not only links the quality of risk management in a financial institution to the avoidance of loss/failure, but also to better financial performance, credit ratings and stock market valuations. A number of empirical studies have shown that financial institutions with a higher quality of risk management (based on variables such as the presence of enterprise risk management systems, the establishment of a risk committee with expertise and time commitment, the profile of a chief risk officer, etc.) have not suffered as much in the global financial crisis. On the flipside, financial institutions with poorer risk management become entangled in a downward spiral when high risks materialise. Hence, effective


91 MiFID Commission Directive 2006, art 7. Even if firms consider that a separate risk management function is not necessary, Art 7 does require firms to put in place effective and adequate risk management policies and procedures.
92 PRA and FCA Handbooks (as of 30 April 2013, previously FSA Handbook) SYSC 1A.
risk management seems to be key to loss prevention or mitigation, especially in stressed conditions.\textsuperscript{95} A study also suggests that effective risk management in firms may be rewarded with higher stock market valuations and credit ratings,\textsuperscript{96} improving short-term performance as well.\textsuperscript{97}

The meta-regulatory nature of the framework for risk management has allowed firm implementation of risk management to suit firm needs. The inadequate resourcing and empowering of risk management has been highlighted in one bank\textsuperscript{98} that failed in the global financial crisis and another that suffered a massive loss due to failure to control a rogue trader.\textsuperscript{99} Risk management in banks is regarded more as a function that is intended to add business value\textsuperscript{100} than as a gatekeeper for prudent or socially optimal levels of risk-taking. Policymakers in the post-crisis reforms seek to enhance the profile of risk management for the prudential purposes by introducing more regulation of aspects of corporate governance in banks and financial institutions related to risk management.\textsuperscript{101} Risk management in financial institutions is considered to be bound up with corporate governance because corporate governance is perceived to be the framework within which risk management operates.

The next section will discuss the EU and UK’s post-crisis reforms that introduce a meta-regulatory framework in corporate governance that relates to risk management.\textsuperscript{102}


\textsuperscript{96} However, reliance on incentives such as the improvement of short-term performance may not encourage the development of robust risk management in financial institutions. The objective of risk management is to protect the corporation and its stakeholders, and the study may have relied too much on shareholder incentives alone in correlating with short-term stock market performance.


\textsuperscript{99} Andrea Resti and Andrea Sironi, \textit{Risk Management and Shareholders’ Value in Banking: From Risk Measurement Models to Capital Allocation Policies} (Chichester: John Wiley & Sons 2007) at xxiiiff; do not argue that solvency concerns are unimportant but a recognition of the balance and trade-off between safety and value creation is needed and risk management is important for working out the optimal creation of value.

\textsuperscript{100} See CRD IV Directive, arts 88, 91.
man...tions will be effective in addressing the weaknesses of the meta-regulatory framework for risk management. The following section will ask the broader question of whether corporate governance relates to the financial stability regulatory objective.

13.4.1 Corporate governance as a framework for risk management

Poor risk management and excessive risk-taking in banks and financial institutions have been diagnosed as being closely linked to the nature of corporate governance in those institutions. Failings in risk management identified by commentators relate to narrow-minded conceptions of risk management adopted by firms and the lack of emphasis and leadership in risk management, both of which are high-level issues of corporate governance. There is much commentator support, which will be elaborated upon below, for the perspective that the effectiveness of risk management is dependent on the corporate governance of banks and financial institutions.

In the development of conventional corporate governance best practices, Boards are required to maintain proper oversight of audit and internal financial reporting. Hence, the general perception of Board responsibility for risk management centres upon these areas. Moore points out that UK corporate governance has developed based on the need for audit and accounting integrity in response to the failure at BCCI in 1990. Subsequently, the Turnbull review further emphasised the need to have reliable internal and external reporting systems as part of ‘internal control’ and ‘risk management’. The language of ‘internal control’ used in the Cadbury and Turnbull reports deals with systems that process financial information and reporting and how to ensure that such systems underlie integrity in financial reporting. Although the Turnbull Guidance views internal control


107 Turnbull Guidance, para 19.
as a form of risk management that ‘enable[s] [companies] to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company’s objectives’, the more precise language surrounding risk management and internal control targets the prevention of accounting fraud and ensuring the integrity of financial reporting. The previous Codes (preceding the current UK Corporate Governance Code 2012) always considered ‘internal control’ to be key to safeguarding shareholders’ interests and corporate assets and tasked the audit committee of the Board with supervisory oversight. Such an approach indicates that the emphasis is placed on the integrity and accountability of financial reporting. In this sense, corporate governance reforms are very much led by the securities regulation ideology of supporting transparency to facilitate market discipline.

Van der Elst\textsuperscript{108} argues that the evolution of ‘internal control’ as a corporate governance issue in the EU has also been led by the need for reliable securities disclosure, as ‘risk’ is dealt with in disclosure-based regulation in the Prospectus Directive 2004 dealing with public offers and in the Transparency Directive 2005 providing for ongoing reporting. However, the disclosure of ‘risk’ is seen as a qualitative form of disclosure and is therefore not subject to further precision or standardisation. The emphasis placed on accounting and reporting integrity is also found in the US response to Enron’s collapse in 2000, the Sarbanes-Oxley Act, although the Act also prescribes certain forms of internal control (such as controls over auditor appointment\textsuperscript{109} and mandatory certifications by Chief Financial Officers).\textsuperscript{110}

The renewed emphasis on the importance of risk management in financial institutions following the global financial crisis is not merely a reiteration of the disclosure-based ideology in securities regulation aimed at ensuring reliable financial reporting and the prevention of securities fraud. Post-crisis, the importance of risk management has arguably moved away from being a facilitator of market discipline, to a more public interest-based concern for preserving the viability of firms that may affect financial stability. Risk management is therefore now looked at in a much more holistic manner encompassing all forms of business, financial, legal, social and other risks that may threaten the viability of the financial institution. Corporate governance is now seen as the framework in which leadership and emphasis can be provided to give risk management a new character and a key place in corporations.\textsuperscript{111} This is supported by findings in empirical research carried out to investigate correlations between management leadership, the quality and profile of risk management in financial institutions and the performance of the financial institution in the financial crisis.

\textsuperscript{109} Sarbanes-Oxley Act 2002, ss 502, 503.
\textsuperscript{110} Sarbanes-Oxley Act 2002, s 302.
In general, commentators have identified the following corporate governance characteristics that correlate with poorer risk management and adverse bank or financial institution performance:

(a) failure of Board leadership due to lack of information and knowledge of risk profiles of departments;
(b) failure of Board leadership in giving risk management a sufficiently high-level profile for Board attention and strategic direction; and
(c) lack of Board emphasis on risk management as being a concern distinct from compliance or audit.

A number of commentators opine that the lack of Board competence or expertise has been correlated with failures and adverse performance at banks and financial institutions. Mehran, Morrison and Shapiro provide a literature review showing that empirical evidence points to a correlation between a lack of meaningful leadership in banks and financial institutions and poorer quality risk management. Harald Hau and Marcel P Thum’s empirical study finds correlations between the lack of financial expertise and experience on the part of supervisory boards in German financial institutions and larger losses suffered by those institutions in the global financial crisis. The UK Walker Review is now explicit on the requirement that the Chairman and non-executive directors should have adequate knowledge and skills to enable effective leadership of the business, along with a greater time commitment. The EU has introduced reforms into the issue of Board competence and expertise, requiring that regulators should scrutinise the qualifications of proposed directors before approving their position on the Boards of financial institutions. The UK has always imposed an approval regime for persons who are appointed to senior management and to Boards of financial

116 Financial Services and Markets Act 2000, s 59; PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) APER and FIT.
institutions and is now scrutinising even more closely\textsuperscript{117} proposed candidates’ skills, expertise and qualifications. However, regulators should bear in mind that \textit{ex ante} approval regimes may only go so far in vetting financial expertise and qualifications. Further, although financial expertise may have some correlation with leadership in due risk management and the preservation of firm stability, the empirical studies mentioned above have all been confined to this episode of the global financial crisis. Thus, further refinements may be needed in studying what leadership characteristics may promote proper risk management in financial institutions.

Further, the lack of meaningful monitoring or challenge by Boards – whether due to a weak Board or a dominant Chief Executive Officer\textsuperscript{118} – is also, it has been suggested, a crucial distinguishing corporate governance feature between banks and financial institutions which were in jeopardy and those that remained viable.\textsuperscript{119} Chesney, Stromberg, Wagner\textsuperscript{120} and Ramirez\textsuperscript{121} have all suggested that the weaknesses and lack of independence of risk management in failed banks, such as the Royal Bank of Scotland and Northern Rock, are correlated with the autonomy of risk-taking and aggressive CEOs, driving the banks towards excessive risk-taking and ultimate failure in the global financial crisis. By this time, CEO turnover is no longer a viable corporate governance mechanism as the financial institution rapidly heads into losses.\textsuperscript{122} It has also been suggested that the Boards of failed banks, such as Bear Stearns and Lehman Brothers in the US and Northern Rock and HBOS in the UK, were not well-informed of risky profiles and operations and hence could not have provided leadership in considering the strategic impact of risk management.\textsuperscript{123} Thus, there is a need to

\begin{itemize}
  \item[117] Alison Smith, Alistair Gray and Kate Burgess, ‘FSA scrutiny comes under the spotlight’ \textit{Financial Times} (London, 5 June 2012).
  \item[118] Steven A Ramirez, ‘Lessons From the Subprime Debacle: Stress Testing CEO Autonomy’ (2009) 54 \textit{Saint Louis University Law Journal} 1, argues that CEO domination in setting a risk-taking strategy has been key in the banks that failed in the financial crisis.
look into reforms that enhance information transmission and reporting channels to the Board. The lack of information transmission may also have been due to the insufficiently high profile of risk management as a core Board function.

Poorer quality risk management is also indicated by narrow conceptions of risk management according to business lines. Narrow conceptions of risk management could also result in a silo departmental approach to risk management, and the objectives of risk management are often not clearly articulated or reviewed.

Many commentators have observed that, in the banks that failed in the crisis, risk management was largely undertaken on a silo-based approach (i.e. each department separately managed their distinct risks according to their lines of business). Such narrow-minded approaches do not encourage a holistic appreciation of risks and may have contributed to the lack of discernment and communication of risks. Further, due to the prevailing regulatory concern for accounting integrity as mentioned earlier, many Boards also see risk management as confined to the audit committee’s remit and as generally distinct from business strategy. Some firms may view risk management as being narrowly confined to legal compliance. Risk management in many financial institutions and in the corporate sector has also suffered from having an uncertain identity: firms treat risk management as being pro-business and hence play down its independent capacity to act as a check and monitor.

13.4.2 Post-crisis reforms in the regulation of risk management and corporate governance

Post-crisis, the kind of risk management that policymakers and regulators wish to encourage is closer to the enterprise-wide risk management model, where risk management is led at the strategic level by the Board, rolls out into all aspects of
business and operations, and is considered holistically. Further, risk management should be an independent function, not compromised by conflicts of business interest, and should have a sufficiently high profile, perhaps led by a Chief Risk Officer or an independent risk committee on the Board.\footnote{129}

In the UK, the Walker Review has recommended raising the profile of risk management at banks and financial institutions by recognising the special position of risk management as a Board function.\footnote{130} It also recommends the dedication of high-level resources to risk management via the creation of a Risk Committee.\footnote{131} In appropriate financial institutions of a certain scale, size and turnover, the Review recommends the appointment of a Chief Risk Officer.\footnote{132} The UK Corporate Governance Code, which was amended to take into account the Walker Review, calls for effective leadership by the Chairman of the Board,\footnote{133} sufficient time commitment by the Chairman and Board members (including non-executive directors)\footnote{134} and critical monitoring of internal controls and systems of risk management by non-executive directors.\footnote{135} The Board collectively is responsible for risk management monitoring and should conduct a review of risk management effectiveness on an annual basis.\footnote{136} These provisions apply generally to the corporate sector and hence do not incorporate some of the more precise recommendations of the Walker Review in relation to banks and financial institutions. The UK financial regulator has adopted the Walker Review’s recommendations on senior management responsibility for risk management,\footnote{137} the

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\footnote{133} Corporate Governance Code 2010 (UK), paras A.1, A.3.

\footnote{134} Corporate Governance Code 2010 (UK), para B.3.

\footnote{135} Corporate Governance Code 2010 (UK), para A.4.

\footnote{136} Corporate Governance Code 2010 (UK), para C.2.

\footnote{137} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 4.1, 12.1.
establishment of a risk committee by the Board\textsuperscript{138} and the appointment of a Chief Risk Officer,\textsuperscript{139} where appropriate, according to the size, scale and complexity of the financial institution business. The Risk Committee of the Board is to have overall oversight of risk management and internal controls, working with the audit and remuneration committees in terms of providing risk-based input into these high level Board issues. The Chief Risk Officer is also to have a high profile; to be independent, well-resourced and able to gain access to institution-wide information; and to provide general advisory expertise to the Board for the strategic considerations of risk.

The EBA’s consolidated Internal Governance Guidelines also take a similar view.\textsuperscript{140} The Guidelines address risk management from the point of view of Board leadership, commitment and effective oversight, as well as structural aspects in the organisation of the financial institution.\textsuperscript{141} The importance of the Board’s role in risk management, the establishment of a dedicated risk committee, and where appropriate, the appointment of a chief risk officer are all supported in prospective EU harmonised legislation.\textsuperscript{142}

The EBA’s Internal Governance Guidelines\textsuperscript{143} call for more effective leadership by the Chairman in the form of an overall risk appreciation of the business profile,\textsuperscript{144} sufficient time commitment by the management body\textsuperscript{145} and adequate skills and competence to be represented on the Board.\textsuperscript{146} The Internal Governance Guidelines promote a ‘know your structure’ requirement that management bodies must be able to monitor the business lines and subsidiaries and ensure that structure does not get too complex to monitor.\textsuperscript{147}

The EBA reconceptualises ‘Internal Control’ as a structural necessity in all financial institutions, comprising independent Compliance, Risk Control and Audit functions that are to be distinct from each other. Compliance and Risk Control are envisaged as part of a holistic institution-wide risk management

\textsuperscript{138} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 21.1.5, 21.1.6.
\textsuperscript{139} PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 21.1.2.
\textsuperscript{140} European Banking Authority, ‘EBA’s Guidelines on Internal Governance (GL 44)” (27 September 2011).
\textsuperscript{141} As of 27 September 2011, European Banking Authority, ‘EBA’s Guidelines on Internal Governance (GL 44)” (27 September 2011).
\textsuperscript{142} CRD IV Directive, arts 75, 86 and 87.
\textsuperscript{143} European Banking Authority, ‘EBA’s Guidelines on Internal Governance (GL 44)” (27 September 2011).
\textsuperscript{144} European Banking Authority, ‘EBA’s Guidelines on Internal Governance (GL 44)” (27 September 2011), para 14.4.
\textsuperscript{145} European Banking Authority, ‘EBA’s Guidelines on Internal Governance (GL 44)” (27 September 2011), para 12.
\textsuperscript{147} European Banking Authority, ‘EBA’s Guidelines on Internal Governance (GL 44)” (27 September 2011), para 18.6. For example, non-transparent or special purpose vehicles should only be used if the risks are clearly understood and there are legitimate reasons, such as operating in a foreign jurisdiction, tax, etc.
system that feeds into business decisions, such as product development and procedures, in what is termed the ‘NPAP’ (the New Product Approval Procedure), which must be implemented in all financial institutions. The Audit function is viewed as a third line of defence, after Compliance and Risk Control, as a check and monitor on the monitoring functions of Compliance and Risk Control. The EBA thus sees the beefing up of multiple layers of internal control and self-discipline within financial institutions as key, all of this functioning within an overall risk culture whose development should be encouraged in financial institutions.148

The EBA even encourages the development of internal whistleblower procedures to assist the Compliance or Audit functions in their monitoring. Internal Alert Procedures,149 for example, allow employees to warn and provide information with respect to concerns ‘outside regular reporting lines’.

The EU and UK reforms perceive that risk management can be enhanced by improved corporate governance. Thus the EBA’s Guidelines, the UK regulator’s rules, as well as the UK Corporate Governance Code have prescribed framework principles that raise the profile of risk management to Board level and encourage due monitoring and scrutiny of such functions. However, we argue that there are a number of concerns with this regulatory approach.

First, the main weakness in the meta-regulation of risk management lies in firm implementation that diverges from regulatory objectives. We wonder to what extent meta-regulation of aspects of corporate governance can really address the main weakness in the meta-regulation of risk management. The meta-regulation of corporate governance provides for structural aspects such as the institution of a Chief Risk Officer, as discussed above. Structural and procedural approaches in meta-regulatory frameworks have to be implemented within the organisation’s objectives and culture and hence could be subject to organisational manipulation.

Second, we are concerned that regulatory intervention into aspects of financial institution corporate governance may pave the way for more regulatory creep in this area. Corporate governance is essentially bound up in private paradigms of shareholder and stakeholder accountability, and this is why corporate governance is not subject to a prescriptive regime for the general corporate sector, but instead subject to a soft law regime based on ‘comply-or-explain’ to facilitate shareholder and stakeholder scrutiny.150 We caution against regulatory creep in the corporate governance of financial institutions as many aspects of corporate governance may not be sufficiently relevant to financial stability concerns and regulation may create unintended consequences.

Turning to our first concern, it may be argued that meta-regulatory frameworks could facilitate change in firm behaviour, supported by intelligent and intensive

However, meta-regulatory frameworks allow firm-centric objectives to influence implementation. The meta-regulatory nature of the regulatory framework for risk management essentially allows risk management to be implemented according to firm needs and organisational design. For example, the mission of the risk management outfit, its organisational positioning, reporting lines and powers are firm-specific in nature and can be infused with firm-centric objectives and perspectives. Enhancing Board control over risk management does not mean that the Board would not emphasise firm-centric objectives over regulatory objectives. The conventional corporate governance framework deals with internal accountability (primarily to shareholders) and not socially optimal risk-taking or risk management. Tomasic explains how Boards in the pre-crisis years have sanctioned high levels of risk-taking and rapid expansion as these were seen to be in the interests of the firm. Mikes also opines that firm risk management serves dual and potentially conflicting objectives in adding value to business and instituting forms of credible control. Raising the profile of risk management to the level of corporate governance may not change the orientation of risk management objectives from firm-centric ones to ones more aligned with public regulatory objectives. Greater prudence as desired by the regulatory objective towards financial stability may be contrary to value creation and maximisation for shareholders. It may be unrealistic for regulators to expect that by raising the profile of risk management to the level of corporate governance, firms would choose risk moderation behaviour as being optimal for the firm. Difficult judgements of trade-off between safety and profit generation would still have to be made at a strategic level.

The introduction of a regulatory framework to raise the profile of risk management to the level of corporate governance would not provide easy answers for risk management and would instead raise anxiety at Board level in terms of responsibilities and liability. As the regulatory framework for corporate governance in relation to risk management is meta-regulatory in nature, Boards may choose


152 Conflicts between firm and regulatory objectives could affect the implementation of meta-regulatory frameworks, see Joanna Gray and Jenny Hamilton, Implementing Financial Regulation: Theory and Practice (Chichester: John Wiley & Sons, 2006) at Chapter 7.


to embark on excessive proceduralisation in firm implementation in order to show due discharge of responsibility. Resorting to proceduralisation is likely an attractive prospect for the Board as the existence of processes and systems may provide good evidence of Board engagement with risk matters and hence discharge of Board responsibility. However systems and procedures could serve as window dressing to please regulators. Boards may also take false comfort from the institution of systems and procedures when the art and science of identifying and managing risks is still an emerging discipline.

Further, proceduralisation may also be manifest in the adoption of computerised and automated systems for risk control. Bamberger warns against the tendency of turning risk management into a streamlined, manageable and easy-to-use system in terms of automated processes and mechanisms. These systems and models may run the risk of perpetuating erroneous assumptions, encouraging automation bias and replacing more discretionary and considered human judgement. Power has warned that the well-established practices in internal audit and financial reporting will likely push the design of risk management systems towards more technical, calculable and quantifiable systems. Although such systems may be easier to use, they may turn risk management into a narrow-minded exercise or a compliance-based exercise, thus undermining the general spirit of an internal critical culture that the regulatory framework intends to stimulate.

Wong also questions whether the raised profile of risk management will entail shifting blame to risk committees or chief risk officers, therefore providing convenient scapegoats for the same risk-taking and profit-chasing pursued in the pre-crisis years. Firm implementation of meta-regulatory frameworks could indeed achieve outcomes that are diametrically opposite to what regulation intends.
Next, we caution against regulatory creep in aspects of financial institution corporate governance. Policymakers should avoid taking the post-crisis opportunity for law reform to intervene indiscriminately into aspects of corporate governance, as many aspects or concerns in corporate governance have little relevance to financial stability concerns.

Hopt argues that regulatory intervention in the corporate governance of financial institutions is based on the systemic risks that may be posed by financial institution failure and hence does not apply generally to corporate governance in the corporate sector. Wymeersch also rightly points out that:

The relationship between corporate governance and financial stability is an indirect one, as the stability of firms and markets are essential elements for maintaining financial stability. Corporate governance tools do contribute to the intermediate objectives at the firm level, but not directly to financial stability.

Policymakers should thus bear in mind that regulatory intervention into corporate governance may not necessarily relate to or enhance the achievement of the regulatory objective of financial stability. Many corporate governance concerns are rooted in agency and transaction paradigms and regulatory intervention may indeed result in distortions and unintended consequences.

Some studies have shown that conventional suboptimalities in corporate governance practices in banks and financial institutions have significantly increased the risk of firm failure and contribution to systemic risk. For example, Cornett, McNutt and Tehranian find that the ‘usual’ corporate governance suboptimalities – such as a smaller composition of independent directors, friendly nomination committees and the Chairmanship of the Chief Executive Officer – exacerbated adverse performance and losses in small and large banks in the US in 2008 at the onset of the crisis. Although corporate governance practices may not be ‘causal’ in relation to financial institution failure or the wider context of financial instability, the ‘usual’ suboptimalities may have contributed to the speed or intensity of the adversity. Peni and Vähämäa also find that the lack of the ‘usual’ corporate governance suboptimalities may have enhanced financial performance at banks and financial institutions, as a correlation between ‘good’

corporate governance (according to a mainstream Corporate Governance score) and better stock market valuations can be found.

However, some commentators argue that corporate governance reforms should not be too quickly launched as corporate governance suboptimalities, if any, are not causal in relation to the failure of banks and financial institutions in the global financial crisis. A number of commentators, looking at a range of ‘usual’ corporate governance suboptimalities on bank and financial institution Boards (such as independence, size and high CEO remuneration), have found that these suboptimalities do not significantly exceed those of other non-financial firms and hence they cannot be said to have had a significant causal effect upon the global financial crisis. Gupta, Krishnamurti and Tourani-Rad also find that, even where there have been suboptimalities in corporate governance in banks, such corporate governance practices are not causal factors of bank or financial institution failure or adverse performance.

Further, it may be argued that the corporate governance paradigms of banks and financial institutions are unique and prescribing conventional best practices in corporate governance for banks and financial institutions may actually be contrary to regulatory objectives. Ciancanelli and Gonzalez have argued that the corporate governance paradigm of banks and financial institutions may be distinguished from other non-financial corporations due to the highly leveraged nature of these firms, the existence of key residual claimant stakeholders (other than shareholders) and the difficulty and opacity in monitoring the asset and liquidity positions of these firms. Further, what is considered good corporate governance practice in non-financial sectors may not be ideal for the financial sector. For example, large Boards, generally considered to be inefficient and ineffective for the corporate sector, have been found to be particularly beneficial


for banks and financial institutions. The resource-based view, instead of the agency-based view, supports larger Board sizes in banks and financial institutions.\textsuperscript{172} Erkens, Hung and Matos\textsuperscript{173} also find that the generally accepted good corporate governance practice of staffing Boards with more independent directors could result in worse stock performance for banks and financial institutions with such Boards. Independence affects risk aversion on the part of Boards and hence Boards tend to recommend greater equity raising during a crisis in order to bolster capital adequacy. Such a move transfers wealth from stockholders to bondholders and thus results in worse stock performance and costlier finance. The special nature of capital adequacy regulation in relation to banks and financial institutions may distort the effects of what may be generally accepted as ‘good corporate governance’ in other sectors. Hence, the approach of looking into conventional corporate governance problems and attempting to fix them in relation to banks and financial institutions may be a mistake.

These empirical results confirm the earlier reservation that many aspects of corporate governance may be indirectly relevant to regulatory concerns for financial stability. This is because the fundamental nature of corporate governance deals with the conventional agency paradigm and accepted best practices (such as independence in Board composition, Board committees, Board size, and the separation of Chairman from Chief Executive Officer). The agency paradigm fundamentally regards corporate governance as an internal issue, where balances of power and accountability must be achieved to mitigate managerial abuse that may adversely affect other constituents in the corporate governance framework (e.g. shareholders, creditors, employees). Excessive regulatory concern with agency-based issues may entangle regulatory perspectives with essentially internal transactional perspectives on relations and dynamics, and focus on regulatory objectives may be lost. For instance, the CRD IV Directive and forthcoming legislative reforms in the EU now address gender diversity on Boards.\textsuperscript{174} Although there is research pointing out that the hormone testosterone has a significant impact upon excessive risk-taking behaviour at the individual level,\textsuperscript{175} this does not mean that male-dominated Boards are necessarily likely to engage in suboptimal levels of risk-taking. The authors advocate caution in pursuing corporate governance reforms per se as key reforms in relation to wider concerns of institutional and systemic stability.

In the next section, we will deal with whether enhancing directorial liability and shareholder monitoring/activism may contribute towards preserving firm


stability and systemic stability. In these discussions, we will also argue that the regulation of aspects of corporate governance may be fundamentally misguided as regulatory objectives are unlikely to be achieved through the essentially private paradigms of corporate governance, unless regulatory governance intends to challenge the fundamental paradigms of corporate governance (which we doubt). Public regulatory objectives, sought to be implemented in corporate governance paradigms may become endogenised\textsuperscript{176} in private paradigms and bear remote relation to the achievement of public regulatory goals. Further, regulation may also distort the dynamics in the private paradigms of corporate governance, such as encouraging shareholder activism, which is not an unequivocally ideal development that supports financial stability objectives.

### 13.4.3 Directors’ liability\textsuperscript{177} in the post-financial crisis era?

The post-crisis resurgence of regulatory power in prudential and risk management regulation has ushered in an enforcement age. The UK regulator has increasingly imposed direct liability and responsibility on senior management personnel\textsuperscript{178} for various breaches of regulations so that attitudes towards regulatory compliance and prudential risk management may change at the highest levels of financial institution management. Such liability is often premised on the ‘unfitness’ of individuals\textsuperscript{179} due to breaches of high-level principles of conduct, such as not having ‘adequate systems of risk management’\textsuperscript{180} or ‘not observing standards of proper market conduct’.\textsuperscript{181} In light of increased enforcement actions that call senior management to account to regulators, would reforms to directors’ liability regimes in corporate governance generally be aligned with the regulatory objectives of securing prudenti risk management at financial institutions and safeguarding financial stability?

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\textsuperscript{176} Lauren B Edelman and others, ’When Organizations Rule: Judicial Deference to Institutionalized Employment Structures’ (2011) 117 American Journal of Sociology 888.

\textsuperscript{177} See BBC interview with financial journalist Ian Fraser, 2 June 2012. But see opposing view, Stephen Bainbridge, ’Caremark and Enterprise Risk Management’ (2009) 34 Journal of Corporation Law 967.

\textsuperscript{178} Tracey McDermott, ’Credible Deterrence: Here to Stay’ (FSA Enforcement Conference, London, 2 July 2012), highlighting senior management personnel who have been indicted from, for example, BCG, Mitsui Sumitomo and Greenlight Investment Fund, along with compliance personnel at Greenlight and Barclays.

\textsuperscript{179} See FSA Final Notice against Yohichi Kumagai (8 May 2012), based on section 56, Financial Services and Markets Act 2000.

\textsuperscript{180} FSA Final Notice against Mitsui Sumitomo Insurance Company (Europe) Ltd (8 May 2012).

\textsuperscript{181} FSA Final Notice against Barclays Plc (27 June 2012).
Smith and Walter opined\textsuperscript{182} in 2008, before the onset of the global financial crisis, that unless director liability regimes were reformed so that the personal liability of directors was enhanced, there would not be sufficient incentives to pursue prudent risk management in the corporate sector generally. Vasudev suggests that minimum Board responsibilities that are non-delegable should be spelt out for directors of banks and financial institutions, such as:

[R]eviewing, approving, and monitoring fundamental financial and business strategies and the performance of the company relative to those strategies; assessing major risks facing the company; and ensuring that reasonable processes are in place to maintain the integrity of the company and the corresponding accountability of senior management.\textsuperscript{183}

Such precise duties could then attract personal liability for neglect and failures.

The authors are of the view that even if increased responsibilities are prescribed as directors’ duties, the Board’s role is usually supervisory in nature and the suggested prescription does not capture how effective supervision of Board delegation may be evaluated. This is the key issue that the Court in the US could not overcome when it dismissed the shareholder derivative litigation against the directors of Citigroup.\textsuperscript{184} How should directors be judged in terms of the quality of Board supervision over delegation of functions such as risk management? The UK Companies Act 2006 already requires directors generally to act with due care, skill and diligence.\textsuperscript{185} As the regulatory framework for risk management is meta-regulatory in nature, as long as directors adduce evidence of implementation in the form of systems and arrangements, such could be sufficient to show discharge of the duty of diligence. Would courts be able or willing to make judgements on the quality of systems and procedures and the monitoring carried out at Board level?\textsuperscript{186}

Sharfman\textsuperscript{187} suggests the use of enhanced standards of care as a yardstick to judge director liability, especially in key decisions such as wealth transfers out of the company through share buybacks or dividends or generous remuneration

\textsuperscript{182} Roy C Smith and Ingo Walter, \textit{Governing the Modern Corporation} (Oxford: Oxford University Press 2006), 281.

\textsuperscript{183} PM Vasudev, ‘Credit Derivatives and Risk Management: Corporate Governance in the Sarbanes-Oxley World’ [2009] \textit{Journal of Business Law} 331 at 351.

\textsuperscript{184} \textit{In Re Citigroup Inc Shareholder Derivative Litigation} 4 A.2d 106 (Del. Ch. 2009), based on the standard in \textit{In re Caremark International Inc Derivative Litigation} 698 A.2d 959 (Del. Ch. 1996).

\textsuperscript{185} Companies Act 2006 (UK), s 174.


\textsuperscript{187} Bernard S Sharfman, ‘Enhancing the Efficiency of Board Decision Making: Lessons Learned from the Financial Crisis of 2008’ (2009) \textit{34 Delaware Journal of Corporate Law} 813; Bernard S Sharfman,
packages for employees. The authors, however, query how such a standard that is enhanced beyond the standard of the reasonably diligent director in that director’s shoes can be framed and understood. Further, would the application of an enhanced standard of care have necessarily addressed the risk-taking decisions made by banks that failed in the global financial crisis? Bainbridge in the US has argued that risk management decisions, although flawed with the benefit of hindsight, are legitimate risk balancing decisions taken by directors of banks and financial institutions and should be protected under the business judgement rule.\(^{188}\) Further, it may be argued that personal liability regimes are \textit{ex post} in nature and do not safeguard \textit{ex ante} financial stability. In the UK, no proceedings for director disqualification by the state or private director liability actions have been brought in the courts.

Finally, some commentators suggest the formulation of a director’s duty to be consistent with the public interest of banks and financial institutions. Mülbert suggests, due to the moral hazard effects of deposit insurance and potential bank bailouts, that directors should owe a duty to the Financial Services Compensation Scheme and to stakeholders, such as depositors and creditors.\(^{189}\) Brittan, writing in the \textit{Financial Times},\(^{190}\) also calls for banks bailed out by the state to incorporate a public purpose objective. This would mean that directors could be held to the pursuit of wider objectives such as financial stability or economic growth or recovery instead of shareholder wealth maximisation. On the one hand, one might argue that the former objectives are core to the intermediation business of banks and financial institutions, and aligning directors’ duties with social utility is thus a move in the right direction. Further, as banks and deposit-taking financial institutions are financed to a large extent by depositors and creditors, shareholder primacy arguments are weaker in the context of banks.\(^{191}\) On the other hand, proponents of shareholder primacy have always maintained that such a corporate objective focuses directors’ efforts\(^{192}\) and is in sync with the private theoretical

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\textit{‘How the Strong Negotiating Position of Wall Street Employees Impacts the Corporate Governance of Financial Firms’ (2011) 5 \textit{Virginia Business and Law Review} 350.}
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\textit{Samuel Brittan, ‘Use the UK’s state bank holdings to speed a recovery’ \textit{Financial Times} (London, 22 September 2011).}
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paradigms underlying corporate governance. Extending the private liability of directors may be argued to be a misguided move. If directors may be at risk of being liable to multiple constituents, how should directors balance the conflicting interests of the different constituents? Are courts in a position to make judgments on the decisions made by directors in balancing different interests?

One commentator suggests that directors’ liability for risk management failures should be couched in public law actions led by the state or regulator (such as the directors’ disqualification action that can be taken by the Secretary for Business in the UK). If this is appropriate, it also means that director liability regimes within the framework of corporate governance are inherently unsuitable for dealing with corporate governance issues that may affect financial stability concerns. We agree and therefore deviate from the suggestions above that conflate director liability issues in the private paradigms of corporate governance with regulatory liability that may be imposed on directors. Corporate governance is about internal dynamics, transaction costs and incentives within a firm, and it may not simply be adapted to meet prudential regulatory objectives. The public interest of any director liability should be dealt with separately from the corporate governance paradigm, so that it is precisely and proportionately dealt with in regulation. In this light, the enforcement actions taken by the UK regulator as mentioned above should be the most appropriate means to address corporate governance failings that affect wider public interest such as financial stability. Such actions should not further feed into shareholder or stakeholder private litigation as an outworking of corporate governance or issues of private loss would be mistakenly entangled with issues of public interest. Shareholders could then perversely enjoy both the upsides of risk-taking and corporate profitability as well as corporate wealth transfer when spectacular corporate losses trigger regulatory actions. In sum, we are sceptical that much more could be tweaked in corporate governance such as in relation to director liability regimes that would be relevant to addressing financial stability concerns effectively.

The next section will discuss the role of shareholder monitoring and activism in preserving firm viability and hence, financial stability. The UK seems to have great faith in enrolling institutional shareholders as alternative actors in governance. However, we are similarly sceptical that regulatory tinkering with

193 The nexus of contracts paradigm, which, together with the agency paradigm, has made corporate governance an essentially firm-centric private matter. See discussion in Iris H-Y Chiu, ‘Institutional Shareholders as Stewards: Toward a New Conception of Corporate Governance’ (2012) 6 Brooklyn Journal of Corporate, Financial and Commercial Law 387.

194 Franklin A Gevurtz, ‘The Role of Corporate Law in Preventing a Financial Crisis: Some Reflections on In Re Citigroup Inc Shareholder Derivative Litigation’ in PM Vasudev and Susan Watson (eds), Corporate Governance after the Financial Crisis (Cheltenham: Edward Elgar 2011), 163.


corporate governance in relation to shareholders’ roles will assist in achieving regulatory objectives such as financial stability.

13.4.4 Shareholder monitoring as a force for governance?

The UK’s PRA, which has responsibility for the Remuneration Code in 2013, is keen to enrol shareholders in the governance landscape to act as gatekeepers in risk management supervision of financial institutions. Policymakers have also generally considered the corporate governance role of shareholders as being relevant to monitoring risk management in UK banks and financial institutions. In the wake of the UK banking crisis of 2008–9, institutional shareholders have been accused of having been ‘asleep’. The critique is that institutional shareholders have been uncritical of risky business practices in their investee banks and should have monitored Board risk management. Although the European Commission Green Paper acknowledges that the lack of critical scrutiny by institutional shareholders in financial institutions may be a ‘special case’ due to the complexity of banking businesses, the Green Paper nevertheless points out that shareholder apathy is a chronic problem in listed companies with dispersed ownership.

The Walker Review also suggests that shareholder engagement is relevant to corporate governance reforms in bank and financial institutions in the wider interest of risk management and financial stability. The Review is of the view that shareholder monitoring should take on a character of ‘stewardship’ in order to contribute to the governance potential of corporate governance, viz:

The potentially highly influential position of significant holders of stock in listed companies is a major ingredient in the market-based capitalist system which needs to earn and to be accorded an at least implicit social legitimacy. As counterpart to the obligation of the board to the institutional shareholders, this implicit legitimacy can be acquired by at least the larger fund manager through assumption of a reciprocal obligation involving attentiveness to the performance of investee companies over a long as well as a short-term horizon. On this view, those who have significant rights of ownership and enjoy the very material advantage of limited liability should see these as

complemented by a duty of stewardship. This is a view that would be shared by the public, as well as those employees and suppliers who are less well-placed than an institutional shareholder to diversify their exposure to the management and performance risk of a limited liability company.201

This quotation refers to both private and public interest interpretations of institutional shareholders’ investment role (i.e. that investment, particularly by institutions, be backed by social legitimacy and the investment role carries with it stewardship responsibilities). The Walker Review advocates that the future of institutional shareholder activism be an exercise in stewardship. The Review states:

Experience in the recent crisis phase has forcefully illustrated that while institutional shareholders enjoy limited liability in respect of their investee companies, in the case of major banks the taxpayer has been obliged to assume effectively unlimited liability. This further underlines the importance of discharge of the responsibility of institutional shareholders as owners, which has been inadequately acknowledged in the past . . .202

The role of shareholders as monitors in the risk management of financial institutions, providing a form of co-governance, is an idea that is embraced at many policymaking levels in the UK. However, it may be argued that shareholder primacy does not help in improving prudential risk management. As underlined earlier in this chapter, empirical research tends to suggest that shareholder incentives are aligned with excessive risk-taking.203 Some commentators argue that looking to shareholders to provide a form of governance is fundamentally wrong. These arguments are not premised on the weaknesses of shareholder monitoring and how to overcome such weaknesses (the position taken in the Stewardship Code), but rather on the fundamental unsuitability of shareholders to provide a form of governance through their monitoring. It is argued that shareholder incentives are incompatible with acting as a force for governance and encouraging shareholder monitoring/activism may possibly be completely irrelevant to banks


and financial institutions, or worse, harmful to bank and financial institution governance.

White\textsuperscript{204} argues that given the highly leveraged nature of banks and financial institutions, the risk-bearing capacity of residual losses is extended to stakeholders (such as creditors and depositors), as well as shareholders in the conventional contractarian paradigm of corporate governance. Hence, the unique nature of banks and financial institutions allows shareholders to prefer more short-termist risk-taking to maximise shareholder returns while being apathetic to longer-term viability. Hence, White and a number of other commentators\textsuperscript{205} argue that shareholder incentives make them a poor force for governance as their natural tendencies are at odds with a long-term perspective and prudential management in the interests of stakeholders. Indeed, encouraging shareholder monitoring as a corporate governance force may produce the contrary effect of increased risk-taking, rather than the hoped-for governance effect of monitoring for effective risk management.

Empirical studies also seem to support the adverse effect on banks and financial institutions of alignment with shareholder interests. Beltratti and Stultz\textsuperscript{206} find that although corporate governance suboptimalities did not affect bank performance in the crisis as much as capital regulation and the independence of financial regulators, the feature of shareholder-friendly Boards was still correlated with worse financial performance. This result is consistent with Gropp and Köhler’s\textsuperscript{207} and Westman’s\textsuperscript{208} findings that shareholder-aligned Boards – either because of the operation of a better shareholder rights protection legal regime or due to the presence of a controlling shareholder – led their banks into larger losses during the crisis. The results indicate that the risks taken, pursuant to these shareholder risk-taking preferences, have generally been greater and the materialisation of risks leading to losses has been more extensive. Erkens, Hung and Matos\textsuperscript{209} also find

\textsuperscript{204} Lawrence J White, ‘Corporate Governance and Prudential Regulation of Banks: Is There Any Connection?’ in James R Barth, Chen Lin and Clas Wihlborg (eds), Research Handbook on International Banking and Governance (Cheltenham: Edward Elgar 2012).


that dispersed institutional shareholders exhibit higher risk-taking preferences and their influence on Boards has not been salutary in the financial crisis: banks with institutional shareholders have recorded greater losses and worse stock performance.

These arguments would seem to indicate that the reliance placed on shareholder monitoring/activism is impracticable and may indeed be fundamentally incompatible with governance objectives. However, policymakers in the UK are not endorsing shareholder primacy as such, but shareholder stewardship. This may suggest that shareholders are enrolled in governance only insofar as they subscribe to the notion of stewardship. We turn now to examine what stewardship means.

The UK Stewardship Code 2010 has been rolled out in response to the Walker Review, to apply to institutional shareholders on a comply-or-explain basis. The key notions in ‘stewardship’ seem to be long-termism and taking a more holistic view of the well-being and performance of the company. This chapter argues that the notion of stewardship is not merely a reiteration of agency-based concepts of shareholder monitoring or the trusteeship relationship between institutions and their beneficiaries. Stewardship is intended to mean something else. We argue that the principles of the Code, along with the background of the Walker Review, point towards characterising institutions as a force for governance and hence recognising the public interest connotation in the term stewardship. However, the implementation of such ‘stewardship’ is not likely to be radical and may not fundamentally be different from the current practices of asset managers. We argue that in the absence of fundamental paradigm shifts in corporate governance, shareholders are likely to implement ‘stewardship’ in convenient and least costly ways that are not fundamentally different from current practices.

13.4.5 The UK Stewardship Code

The Code requires that as a matter of stewardship, institutional shareholders should ‘monitor’ their investee companies.210 Such ‘monitoring’ includes seeking to be satisfied that corporate governance arrangements are robust, carrying out meetings with company directors and/or the Chairman of the Board, maintaining records of such meetings, considering the use of voting power and attendance at general meetings. ‘Monitoring’ also includes the ‘escalation’ of shareholder engagement by, for example, intensifying meetings with Board members, making public statements and even requisitioning general meetings, where it is appropriate to do so to protect and enhance shareholder value.211 ‘Monitoring’ is couched in terms of protecting and, under Principle 4, ‘enhancing’ shareholder

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210 Stewardship Code 2010 revised 2012 (UK), principle 3.
211 Stewardship Code 2010 revised 2012 (UK), principle 4.
value. In this sense, it may be argued that the ‘monitoring’ in the Code is an outworking of private interest, reaffirming the well-accepted private corporate governance role of shareholders in the agency paradigm. So does ‘stewardship’ add any more to the shareholders’ role in monitoring investee financial institutions for prudent risk management?

It may be argued that there are a few features of the Code that encourage shareholders to be cognisant of wider public interest in their role, and therefore move away from traditional shareholder monitoring in the private agency-based corporate governance paradigm. First, Principle 5 of the Code envisages that institutions may step up engagement in collective terms, especially ‘at times of significant corporate or wider economic stress, or when the risks posed threaten the ability of the company to continue’. Collective institutional shareholder engagement may represent a type of market governance mindful of wider social concerns, beyond the atomistic concerns of investment purposes. The reference to ‘wider economic stress’ likely refers to a concern for public interest. Principle 5 thus seems to have the effect of framing shareholder engagement within normative expectations that are consistent with public interest objectives.

Principle 5, in the authors’ view, indicates that institutional shareholders are being overtly regarded as part of the governance landscape in order to further the public interest. Principle 5 seems to disavow collective activism in the interests of private gain or ‘shareholder value’. It is premised upon the context of wider corporate or economic stress, but its chief weakness is that it is not an overt reference to the public interest either.

Further, Principles 1, 2 and 6 require institutions to make public their general stewardship policy, their conflicts of interest management policy and their voting policy. Such disclosure does not merely target the beneficiaries of institutions. It is suggested that public disclosure encourages policymakers and regulators to scrutinise the stewardship activities of institutions in order to consider the governance potential of institutional shareholders. Given the context and rhetoric surrounding the Code, the Principles in the Code seem to endorse notions of the wider good. Thus, it is argued that the notion of stewardship embodies the aspiration of governance that policymakers and regulators hope to impress upon institutions. On the whole, the Stewardship Code exhorts institutional shareholders

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212 Stewardship Code 2010 revised 2012 (UK), principle 5.
214 However, if institutions choose to act collectively for a group purpose that is not representative of the wider good for other shareholders or stakeholders, there is no way of preventing institutions from using Principle 5 to do so. This critique may be drawn from Aviv Pichadze, ‘Institutional Investors as Blockholders’ in PM Vasudev and Susan Watson (eds), Corporate Governance after the Financial Crisis (Cheltenham: Edward Elgar 2011), 145, who argues that institutions can behave as blockholders where it is opportunistic to do so and that this creates an agency problem akin to the majority-minority shareholder divide in closely-held or family-held companies.
to take on a more explicit governance role, aligning private and public interest, but going beyond mere private interest.

However, this ‘public-interest’ oriented understanding of stewardship may be argued to be impracticable or ideologically weak, and would not significantly reorientate shareholders’ perceptions of their roles in corporate governance. Relying on the investment sector to monitor financial institutions in respect of prudent risk management for the wider good may be an unrealistic expectation.

13.4.6 Practical challenges and ideological weaknesses in the governance notion of stewardship

The aspirations of the Stewardship Code run into several challenges. On the practical front, the asset managers who manage institutional portfolios may not be willing to step into the position of ‘governance’ through corporate governance. On the ideological front, the conflation of public interest in governance with private paradigms of corporate governance is unlikely to result in an aspirational and effective solution for governance that policymakers hope for.

Institutions such as pension funds manage investments by outsourcing, relying on the skills and aptitude of investment managers to create returns. The competition between asset managers for the management mandate of pension funds allows pension funds to regularly hire and fire asset managers. Commentators have found that such ‘manager tournaments’ entail regular replacement of asset managers on the basis of performance, although other reasons also exist. Hence, asset managers have little incentive to engage in shareholder activism to improve the longer-term value of investee companies. Further, a pervasive emphasis on numbers exists in the pension fund industry and this has given rise to general scepticism regarding unquantifiable matters such as good corporate governance or risk management. Mitchell also argues that the modern investment economy has fundamentally changed from one that holds stock for the longer term, in order to gain dividends based on the actual operating profit of companies, to one that holds stock in order to make quick capital gains based on market movements. Smith and Walter argue that institutional investors have become dull in terms of providing discipline in the marketplace due to their own short-termism and conflicts of interests. According to Mitchell, shareholder gains are divorced from


actual operations, products and services provided by investee companies and so shareholders are not incentivised to behave as owners. The backdrop of the political economy and the attitudes of investment managers cannot be reformed by the mere rhetoric of ‘stewardship’.\textsuperscript{220}

One year on from the Stewardship Code, the \textit{Financial Times} reports\textsuperscript{221} that there is hardly any change in the investment management industry. The aspiration of governance is too remote from the immediate incentives that appeal to asset managers, unless institutions develop real substantive criteria to evaluate asset managers based on ‘stewardship’. Embracing ‘stewardship’ may also conflict with financial returns on portfolios that accord with beneficiaries’ interest. Engagement requires dedication of resources, which comes at a cost to institutions and asset managers, and ultimately beneficiaries. Who should bear such costs if the financial returns from stewardship remain unclear? Further, asset managers who embrace ‘stewardship’ may do so by outsourcing voting to proxy advisory and voting agencies (such as ISS, Manifest or PIRC) and it is questionable whether such outsourcing is a meaningful, considered form of engagement or an exercise in box-ticking, which allows outsourced agencies to determine voting policies.\textsuperscript{222} Cheffins also points out that given the high foreign ownership of UK listed companies, the stewardship of institutions, if any, could have a relatively insignificant influence upon the corporate landscape.\textsuperscript{223} Fundamentally, the incompatibility of the governance objective of ‘stewardship’ and the private nature of investment management could undermine the governance aspirations of the Code. Institutions are left to develop policies of stewardship and do not have an overt duty to consider the public interest. The path of the least resistance is likely to be taken, developing


\textsuperscript{221} Ruth Sullivan, ‘Investors Falling Short as Active Owners’ \textit{Financial Times} (London, 11 September 2011).


compliant-sounding policies while making as few changes as possible to the practice of investment management.

Next, it may be argued that the stewardship concept is ideologically weak as it is still unclear to whom shareholders are accountable as stewards. If accountability is to beneficiaries, they are probably too indifferent and dispersed to hold institutions to account and, in any case, such accountability does not apparently add anything to the legal trusteeship duties already owed. However, if shareholders’ ‘accountability’ as ‘stewards’ means something more, then the Code arguably does not clearly articulate to whom institutions are accountable.

One of the reasons for this perceived weakness in articulating the accountability channels may be that too much deference is still paid to the private agency-based paradigm of corporate governance. Policymakers may be too keen to avoid overtly introducing communitarian or ‘public interest’ models into corporate governance, as both the theoretical and legal landscape could change dramatically. But if we cannot pinpoint for whom institutions should act as stewards, it becomes difficult to judge the exercise of stewardship, and institutions may then dominate the definition of stewardship. Thus, it may be argued that the stewardship concept is doomed to be as weakly implemented as it is ideologically confused. The stewardship concept seems to infuse some concern for the wider good into the dominant shareholder-centred agency model of corporate governance, without being bold enough to embark on progressive theoretical changes. Institutions may implement stewardship by perhaps narrowly extending the criteria of assessment that they use in evaluating their asset managers, although well-established criteria based on short-term financial performance are difficult to overhaul.224 Further, ‘stewardship’ evaluation may also become proceduralised and subjective (i.e. institutions may look for the existence of corporate policies dealing with social responsibility and stakeholder engagement instead of critically considering the corporation’s substantive business vision and strategy). Narrow-minded interpretations of stewardship could undermine the wider ideological move towards a form of public interest.

A number of commentators have argued that the conventional agency paradigm that defines shareholders as residual claimants and principals, and management as agents is too simplistic when applied to the banking and finance sector.225

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Ciancanelli and Gonzalez argue that the agency paradigm is much more complex in the banking sector. As banks are highly geared, depending on deposits and wholesale funding to form a large part of their working capital, depositors and creditors share a substantial amount of residual risk. Further, the potential of state bailout, as mentioned above, puts the state in the position of key stakeholder, mitigating shareholder and creditor risk. Hence, the agency paradigm in the banking sector is not a simple binary shareholder-management model, but should also take into account key stakeholders, such as the state, depositors, and wholesale and repo market creditors.

The Stewardship Code, by putting shareholders in the central monitoring role, may be endorsing the simple agency paradigm in corporate governance and this may be retrograde given the Code’s governance aspirations following the global financial crisis. Given that the crisis provides a fitting opportunity for reform, it is curious to find such reluctance to introduce bolder shifts in the corporate governance paradigm in the banking sector. Bruner also argues that the re-emphasis placed on shareholders in the Stewardship Code is path-dependent rather than imaginative.

The next section goes on to discuss whether shareholders with an overt preference for socially responsible investing (SRI) may behave differently and whether governance potential may be found in socially responsible investors in terms of monitoring the risk culture at banks and financial institutions.

### 13.4.7 The role of socially responsible investing

The discussion of SRI in this chapter is an extension of the examination of the role of shareholders as corporate governance and governance actors in the regulatory space. The key question here is whether SRI is capable of putting pressure on banks and financial institutions to embrace ethical and cultural changes that may change risk management culture at banks and financial institutions.

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The rise of SRI has been noted: institutions are setting aside increasing amounts of investment for socially responsible companies and companies are increasingly motivated to improve their social performance in order to attract such investment.\(^230\) SRI literature focuses on three general themes: the motivations for SRI, the methodologies in SRI and the returns on SRI (in particular, whether the financial performance of SRI funds is comparable to that of conventional portfolios).\(^{231}\) For the purposes of this book, these lessons from SRI may be pertinent in two respects:

(a) to determine whether SRI is likely to drive changes in corporate behaviour generally, such changes potentially feeding into changes in the nature of investment, resource allocation and capitalism in general; and

(b) to determine whether the SRI approach is more sound in terms of risk assessment, in which case it may be able to offer general lessons in terms of financial risk management.

### 13.4.8 SRI as a force for changing corporate behaviour and investment capitalism?

First, what SRI means needs to be dealt with, in order to shed light on its potential to change corporate behaviour and the landscape of investment capitalism. It has been commented that SRI is an overly inclusive term that encompasses rather different motivations and investment strategies.\(^{232}\) SRI first developed as a way for religious groups and churches in the US to make corporate investments without undermining religious values.\(^{233}\) This later developed into investment boycotts of companies associated with the South African apartheid regime or involved in manufacturing toxic weapons during the Vietnam War. Thus, SRI began as a fringe movement to emphasise moral and ethical values and is not necessarily governed by conventional market values.\(^{234}\)

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\(^{230}\) Li-Wen Lin, ‘Corporate Social and Environmental Disclosure in Emerging Securities Markets’ (2009) 35 North Carolina Journal of International Law and Commercial Regulation 1, 5–7. However, it is also observed that SRI is still a minority player in the investment market and accounts for only about 10 per cent of institutional funds worldwide. See Allison M Snyder, ‘Holding Multinational Corporations Accountable: Is Non-Financial Disclosure the Answer?’ [2007] Columbia Business Law Review 565.


\(^{234}\) Neil Eccles, ‘New Values in Responsible Investment’ in Wim Vanderkerckhove and others (eds), Responsible Investment in Times of Turmoil (Dordrecht: Springer 2011), 20–23.
Therefore, one of the first key methodologies in SRI is negative screening, shunning stocks in the ‘sin sector’, such as tobacco, gambling and alcohol and companies that do business with decried regimes. Negative screening techniques have their roots in certain values and convictions, so that investments are made that are consistent with investor conscience. Negative screening methodologies do not make SRI a force for change: they are passive in nature, avoiding certain issuers and sectors, and there is also no evidence of proactivity or engagement with the investee companies.

SRI funds that focus on negative screening are unlikely to provide catalytic influence in the corporate sector or investment market. This may also explain why empirical evidence has largely found that SRI funds based on negative screening have generally performed no better and no worse than conventional portfolios, as financial motivation is not the underlying basis for such funds. Some empirical evidence has shown that negatively screened portfolios outperform conventional portfolios but the evidence is generally a mixture of some outperformance, some underperformance and generally no difference.

SRI gained mainstream acceptance and affirmation at the turn of the century. For example, the United Nations expressly endorsed the Principles for Responsible Investment in 2006, urging institutional investors to take into account environmental, social and corporate governance matters in making investment decisions, in engaging with their investee companies and in promoting the Principles in the investment industry. However, it is to be noted that although the United Nations’ Principles is a key moment in the mainstream acceptance of SRI, in general such acceptance seems to be encouraged in a top-down fashion. It remains to be seen whether SRI actually represents a fundamentally different species of investment that will provoke changes in the corporate and investment sectors. Is SRI driven by policymakers’ rhetoric as policymakers seek to enrol powerful non-state actors to exercise governance capacity in a decentred regulatory space?

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237 Hung-Gay Fung, Sheryl A Law and Jot Yau, Socially Responsible Investment in a Global Environment (Cheltenham: Edward Elgar 2010), 58.

238 The modernisation of SRI is discussed in Benjamin J Richardson, Socially Responsible Investment Law: Regulating the Unseen Polluters (New York: Oxford University Press 2008), ch 2.


240 Neil Eccles, ‘New Values in Responsible Investment’ in Wim Vanderkerckhove and others (eds), Responsible Investment in Times of Turmoil (Dordrecht: Springer 2011), 23ff.

241 Joakim Sandberg, ‘What are your Investments Doing Right Now?’ in Wim Vanderkerckhove and others (eds), Responsible Investment in Times of Turmoil (Dordrecht: Springer 2011), 165ff; Carlos Joly, ‘Reality and the Potential of Responsible Investment’ in Wim Vanderkerckhove and others (eds), Responsible Investment in Times of Turmoil (Dordrecht: Springer 2011), 193ff.

conventional investment objectives are aligned with social, environmental and governance concerns, so that SRI is not seen as compromising financial objectives, but rather as enhancing them. SRI strategies are not markedly different from conventional investment strategies, such as ‘best-in-class’ stock picking, tracking a ‘responsible’ index such as the FTSE4Good or Dow Jones Sustainability Indices or even shareholder activism.

The post-2000 ‘second-generation’ SRI funds are typically managed by positive screening, which involves selecting companies for their superior performance in environmental, social and governance (ESG) matters. Financial motivations are primary to this form of SRI, which is based on the belief that companies that have superior ESG performance are also likely to perform better financially and provide better investment returns. Good ESG performers suffer fewer social costs or externalities making the issuer a better investment in general. This is argued to be particularly important to large institutional investors, such as pension funds, who invest in different sectors of the economy as a whole, making them universal owners who may suffer the backlash of social cost in any one sector. The following reasons are key to the perceived link between good ESG performers and sound financial performance, especially in the long term:

(a) less susceptibility to litigation risk;
(b) indication of better strategic management;


244 Riikka Sievänen, ‘Responsible Investment by Pension Funds after the Financial Crisis’ in Wim Vanderkerckhove and others (eds), Responsible Investment in Times of Turmoil (Dordrecht: Springer 2011), 93ff, showing that most pension funds never really developed novel or unique strategies for SRI.


246 Craig MacKenzie, ‘The Scope for Investor Action on Corporate Social and Environmental Impacts’ in Rory Sullivan and Craig MacKenzie (eds), Responsible Investment (Sheffield: Greenleaf Publishing 2006), 35. See also Peter Jan Engelen and Marc van Essen, ‘Reputational Penalties in Financial Markets: An Ethical Mechanism’ in Wim Vanderkerckhove and others (eds), Responsible Investment in Times of Turmoil (Dordrecht: Springer 2011), 55ff, also argue that empirical evidence shows that a significant array of responsibility-related announcements may negatively affect stock price and hence are of direct and relevant concern to investors.


(c) better risk management for reputational risks that may affect long-term profitability and viability;

(d) better management of stakeholder relations, which has been proved to affect long-term financial performance.

There is empirical evidence to support the financial outperformance of SRI funds, as Derwall, Koedijk and Horst’s research published in 2011 seems to indicate. Comparing SRI portfolios that use different strategies, funds that use positive screening have outperformed others. An earlier piece by Derwall and others also suggests that positive screening for eco-efficiency leads to higher returns than conventional portfolios. These results are supported by Renneboog, Horst and Zhang’s later piece, which finds that positive environmental screening leads to outperformance. Engelen and Essen argue that responsibility-related announcements (concerning, for example, environmental liability, managerial fraud, product liability and recalls) may negatively affect stock price and hence are of direct concern to investors. However, positive screening entails research and screening costs, and other empirical analyses show that financial performance may only be on a par with conventional portfolios after taking into account such costs.

‘Third generation’ SRI funds now employ a mixture of positive and negative screening, with positive screening also including a ‘best-in-class’ approach, which selects a group of companies according to a category of performance and ranks them in order to inform investment decisions. This approach refines the positive screening approach by providing for a spectrum of companies’ ESG performance. Barnett and Salomon find that intensive screening may initially limit the issuers that SRI funds can invest in, causing a decline in returns due to the

250 Hung-Gay Fung, Sheryl A Law and Jot Yau, Socially Responsible Investment in a Global Environment (Cheltenham: Edward Elgar 2010), 73ff, 90ff.


255 Peter Jan Engelen and Marc van Essen, ‘Reputational Penalties in Financial Markets: An Ethical Mechanism’ in Wim Vanderkerckhove and others (eds), Responsible Investment in Times of Turmoil (Dordrecht: Springer 2011), 55ff.

256 Hung-Gay Fung, Sheryl A Law and Jot Yau, Socially Responsible Investment in a Global Environment (Cheltenham: Edward Elgar 2010), 58.


There are arguably a number of factors affecting the financial performance of issuers with perceived good ESG performance. The lack of diversification, the costs of screening and research, and the comparative undervaluing of ‘sin stocks’\footnote{Harrison Hong and Marcin Kacperczyk, ‘The Price of Sin: The Effects of Social Norms on Markets’ (2009) 93 Journal of Financial Economics 15.} may explain the relatively lacklustre financial performance of SRI funds. But these have to be weighed up against longer-term value creation for good ESG performers through better stakeholder relations, reputation and avoidance of litigation. It may be arguable that ‘doing well by doing good’ provides an incentive to ‘do good’,\footnote{Cary Krosinsky, Nick Robins and Stephen Viederman, ‘After the Credit Crisis: The Future of Sustainable Investing’ in Tessa Hebb (ed), The Next Generation of Responsible Investing (Dordrecht: Springer 2012), 9ff; Claire Woods and Roger Urwin, ‘Putting Sustainable Investing into Practice: A Governance Framework for Pension Funds’ in Tessa Hebb (ed), The Next Generation of Responsible Investing (Dordrecht: Springer 2012), 27ff.} but if doing well is the only incentive for doing good, the investment sector and the corporate sector share similar profit-chasing tendencies. How, then, can we expect SRI to usher in fundamental changes in corporate behaviour? The development of SRI beyond a fringe movement has led SRI to embrace mainstream ideas of the primacy of financial performance. Although SRI strategies do allow investors to vote with their feet on the basis of ESG concerns, is this sufficient to bring about fundamental changes in the corporate sector?

Hawley and Williams argue that for universal owners, such as pension funds, investing in ESG is also a ‘bridge between public policy, corporate governance
and the well-being of [beneficiaries], since such investments are seen as supportive of the public interest in ESG and sustainability and are not just assessed on their investment returns. As such, institutional shareholders who invest in most of the corporate economy could represent a force for change by voting with their feet.

Other commentators are of the view that socially responsible investors could act as drivers for corporate behavioural change only if the ethics and conscience of SRI are evident in their behaviour, whether through voting, engagement or activism. Sethi argues that pension funds should adopt SRI in order to monitor social cost generally. Richardson and Cragg support this stance, calling for pension funds to support the wider objective of economic development and to critically question their investee companies’ role in sustainable economic development. Some commentators are optimistic as to the stature of SRI, arguing that SRI genuinely represents an ethical and conscientious stance, with the potential to bring such convictions to bear in corporate governance. Statman’s survey of individual investors shows that convictions motivating the channeling of investment into SRI are supportive of ESG causes rather than being concerned about returns. Renneboog, Horst and Zhang’s study also shows that SRI funds with in-house research, active screening and active engagement often attract more money inflow, even when the performance of the fund declines. This seems to suggest that investors may support certain ESG issues as such and that their investment decisions are not wholly premised on performance. In this light, Sjöström argues that SRI funds could act as ‘norm entrepreneurs’ influencing changes in corporate behaviour concerning ESG issues. Soppe also argues that SRI may lead the way in framing corporate finance as ‘sustainable finance’, compelling issuers to embrace a holistic approach.

271 Andrea Larsson, ‘What is Socially Responsible Investment’ (University of Virginia Darden School Foundation, 2003) also suggests that SRI may encourage the visibility of certain CSR/ESG issues and influence corporate behaviour to change.
to corporate finance, taking into account the social cost of corporate activities and changing corporate strategy.

However, the governance role of the SRI investment community may also be viewed with scepticism. This is largely because ESG performance is not well-defined and may be manipulated by the corporate sector. Where banks and financial institutions are concerned, they could engage in ESG by sponsoring green forms of transport, such as Barclays' sponsorship of the hire bicycles in the city of London, or roll out schemes that improve employee satisfaction. But such ESG gestures may not relate to the core business of banking, where social interest abounds in crucial matters such as small business lending, predatory sales to customers and market abuse. One of the authors has argued that standardisation in ESG reporting by issuers, along with the rise in social responsibility rating services such as KLD and EIRIS, has in recent years contributed to a more coherent understanding of ESG performance. Nevertheless, the underlying diversity, subjectivity and complexity of different ESG issues continues to challenge any standardised perception of ESG performance. Indeed, the indeterminate and inherently diverse nature of ESG could be used to the corporate sector’s advantage if the corporate sector engages in peripheral ESG issues and looks good in reporting and ratings, but carries on a completely different culture in its core business.

Nevertheless, ‘fourth generation’ SRI funds may take on more proactive behaviour in terms of ESG issues. Shareholder activism may compel management to engage in dialogue and change their behaviour, or shareholder resolutions and voting power may be exercised to this end. However, an Allianz survey seems to suggest that SRI activism is rare and that SRI techniques are still likely to be based on screening rather than activism. The number of shareholder proposals related to CSR was relatively limited in the period 2000–5. But Fung, Law and Yau

273 Martha A Starr, ‘Socially Responsible Investment and Pro-Social Change’ (2008) 42 Journal of Economic Issues 51. This is echoed in Richardson and Cragg, who suggest that CSR should not be supported on the basis of its business case, but by distinctive reference to the social good and social cost; see Benjamin J Richardson and Wes Cragg, ‘Being Virtuous and Prosperous: SRI’s Conflicting Goals’ (2010) 92 Journal of Business Ethics 21.


report stealthy increases since then and argue that threatening to bring a proposal may galvanise companies to commit to changes in behaviour aligned with the proposals. Waygood also reports that investor engagement was key to changing the giant UK pharmaceutical company GlaxoSmithKline’s behaviour in addressing the need for accessibility to affordable medicines by sub-Saharan Africa and that this engagement was premised on social good and not on financial returns. Dhir has also documented shareholder activism in Canada against Goldcorp Plc in relation to human rights abuses in Guatemala as being a significant driver for corporate behavioural change. However, Dhir warns that shareholder activism should not be carried out by shareholders with presumptions of ‘Western’ morality for the good of local communities, without actually engaging in dialogue with affected stakeholders. Such shareholder activism may risk being presumptuous and exclusive, thus undermining its constructive potential.

In sum, although SRI may bring ethical and conscientious issues to bear on corporate governance, this is relatively rare and the mainstream form of SRI is largely premised on investment performance and voting with one’s feet, using strategies such as screening and stock-picking. The authors are sceptical of SRI becoming the main purveyor of cultural change in the banking and financial sector to support wider regulatory objectives such as financial stability.

We turn next to consider whether SRI may be able to impart a specific form of influence in the financial sector, in terms of its more holistic approach to risk management.

### 13.5 SRI as influencing change in corporate risk management?

Brandolini, Pallotta and Zenti opine that ‘[i]nvestment firms have often managed risk in an intuitive manner and risk management systems have been viewed as an avoidable costly investment’. The relatively weak risk management in many banks in the pre-crisis years – characterised as myopic, silo-based and incompre-

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In the post-crisis era, do SRIs have something to teach financial sector firms in terms of integrated and holistic forms of risk management? The Allianz survey on institutional investment shows that SRI investors, even the mainstream ones, take a comprehensive and long-termist approach to risk management in relation to their portfolios. A passive devotion to the portfolio diversification theory is no longer the Holy Grail. Such an approach is better able to take into account wider issues of negative externalities and social cost. As such, SRI may provide insights into how corporations themselves may perceive and manage risk.

Brandolini, Pallotta and Zenti show that, in practice, risk management in investment is based largely on historical price data and an excessively quantitative and ‘decontextualised’ approach to corporate performance. Chong argues that changes are afoot in contemporary investment management, especially in SRI, which adopts an ‘organic risk management’ approach. This approach contextualises investment risk in different quarters of operational risk, taking into account regulatory, market, economic, environmental, legal and stakeholder risk such as the interests of creditors and shareholders. Corporate governance and responsibility issues are a crucial part of this risk map. This integrated and holistic view of investment risks can then be used to evaluate the risks of investee companies and map out a list of relevant risk warnings for each investee company, as well as the possible strategic action to be taken on the part of the investment fund, such as whether to engage, litigate and so on. Proactive risk management is key and investment funds are admonished not to be passive, to act carefully and to use available information so that early signs of problems may be dealt with. In Chong’s words, proactive risk management involves ‘examin[ing] and conduct[ing] damage limitation to stop one infected part hurting the whole . . . entity’. SRI investors are capable of adopting such a proactive approach to risk management, by considering the risks from a wide context affecting investment.

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282 See Section 13.4 generally in this chapter.
287 Yen Yee Chong, Investment Risk Management (Chichester: John Wiley & Sons 2004), 179. This book deals generally with the risk in investments by corporations and funds.
288 Yen Yee Chong, Investment Risk Management (Chichester: John Wiley & Sons 2004), 179.
and the corporations concerned.\textsuperscript{290} Risk management in SRI may provide inspiration in the form of general lessons for a proactive and more holistic form of risk management in general.

Sabato\textsuperscript{291} has criticised risk management in many financial institutions as being silo-based, narrow-minded, lacking an integrated approach and based excessively on certain quantitative assumptions. Indeed, one could argue that the asset failures of collateralised debt obligations based on sub-prime mortgages, which many banks and investment banks held in large quantities, are attributable to poor initial risk management with respect to these derivative products. The risks in complex products may be multiplied due to sheer complexity\textsuperscript{292} and banks should have undertaken more contextual and comprehensive risk management in relation to such complex products. An organic approach to risk management that considers the dynamic and contextual possibilities opens up risk inquiries into ever-wider spheres and is likely to be more thorough despite being time-consuming and costly. SRI and its approach to risk management may therefore provide lessons that could be learnt.

13.6 Conclusions

The post-crisis resurgence in regulatory power to provide the public good of financial stability has been most pronounced in the flurry of micro-prudential and risk management regulation introduced. The authors are sceptical whether reliance on an expanse of \textit{ex ante} and meta-regulatory prudential and risk management regulation will improve levels of safety and soundness. Regulators may also be mistakenly relying on the potential of corporate governance to address wider regulatory objectives.

Perhaps the issue of safety and soundness should be otherwise approached: regulators and policymakers should consider minimising the significance of the issue by disentangling financial institutions and public interest. The entanglement of public interest in the private enterprise of banking and finance is the genesis of prudential regulation and its sprawling extension following the global financial crisis. However, this chapter has raised concerns regarding the limitations in regulating firm-centric matters such as risk management and corporate governance. This problem will be augmented in SIFIs.


We therefore echo Arup’s\textsuperscript{293} query: should finance be disentangled from the public interest, as far as possible? Regulators would have a clearer and more limited remit, limited perhaps to Peston’s four objectives of ‘custody of deposits, commercial lending, processing payments and honest behaviour’.\textsuperscript{294} This may be preferable to the continual regulatory reach into the recesses of financial institutions and their organisational structures, governance and culture, while achieving limited change. The many commentators\textsuperscript{295} who see structural reforms to shrink the public interest profile of banks and financial institutions as the only sound way forward, may be right. The disentanglement of finance from public interest, a prospect contrary to the current regulatory trajectory, could allow regulators to institute sustainable deposit guarantee schemes and crisis management regimes without the fear and uncertainty surrounding astronomical fiscal cost.


\textsuperscript{294} Robert Peston, interview with BBC News, 29 June 2012.

Part 4

Macro-prudential supervision
14 The rise of macro-prudential supervision

Macro-prudential supervision has become a key aspect of financial regulation in the UK, EU and globally in the aftermath of the global financial crisis. Wolf defines macro-prudential supervision as ‘oversight of the financial system as a whole’ and as different from the chiefly ‘micro-prudential’ approach taken in financial regulation up until the global financial crisis. Pre-crisis, banking and financial regulation focused on individual institutional soundness in terms of capital adequacy and conduct of business. This ‘micro-prudential’ approach is now regarded as inadequate: central banks and regulators need to have an overall picture of the build-up of risks in the financial system as a whole and to consider the linkages and connections between financial institutions in the assessment of risks. Macro-prudential supervision, providing a bird’s-eye view of the financial system as a whole, is better placed to support the regulatory pursuit of financial stability.

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3 FSA, ‘The Turner Review: A Regulatory Response to the Global Banking Crisis’ (March 2009) www.fsa.gov.uk/pubs/other/turner_review.pdf accessed 3 January 2013, 83, viz ‘The lack of such a [macro-prudential] perspective, and the failure to specify and to use macro-prudential levers to offset systemic risks, were far more important to the origins of the crisis than any specific failure in supervisory process relating to individual firms. Getting macro-prudential analysis and tools right for the future is vital’.


The EU and UK have institutionalised new regulatory infrastructures in order to carry out macro-prudential supervision. A suite of new regulatory techniques, many of them pre-emptive in nature, is also being developed for macro-prudential supervision. This part will examine the nature of macro-prudential supervision and how it is purported to be carried out. The authors will, however, raise certain concerns regarding the bureaucratic powers behind macro-prudential supervision and the technocratic nature of such supervision.

The purpose of macro-prudential supervision is:

[T]o contribute to the prevention or mitigation of systemic risks to financial stability in the [European] Union that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth.7

Macro-prudential supervision is, in essence, a supervisory framework or approach to monitoring systemic risk concerns.8

In order to monitor systemic risk concerns, the macro-prudential regulator needs to be supplied with a comprehensive range of information to facilitate the understanding and analysis of systemic risk in financial markets. Chapter 15 will discuss the exponential expansion in regulatory powers to collect information from the financial services sector and markets for the purposes of prudential supervision or systemic risk monitoring. Further, in order to develop the toolkit for macro-prudential supervision, both the UK and EU have established new bodies with a dedicated macro-prudential mandate but closely connected to the central bank; they are the UK Financial Policy Committee9 (FPC) and the EU’s European Systemic Risk Board (ESRB).10 Chapter 16 will explore how the new bodies work and Chapter 17 will critically discuss concerns that may arise with respect to the new bodies, particularly in relation to issues of accountability and technocracy.

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10 Established by the ESRB Regulation 2010.
Eriksson-Zetterquist\textsuperscript{11} argues that a flurry of ‘organisation’ often occurs after a catastrophe, when existing institutions are seen as inadequate to prevent or manage the catastrophe.\textsuperscript{12} However, the salience of the new institution must be tested once the dust of the catastrophe settles. Although macro-prudential supervision and its institutions have been quickly established, this part will critically analyse whether these institutions are likely to remain salient.

Macro-prudential supervision is intended to deal with systemic risks at a broad level. The EU Regulation establishing the ESRB in 2010 widely casts systemic risks as:

\textit{\ldots a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree.}\textsuperscript{13}

The sources of risk to be monitored for the purposes of macro-prudential supervision are wide-ranging and this immediately raises the question of whether regulators are able to deal with such a wide and potentially indeterminate range of risks. Joosen\textsuperscript{14} argues that indeterminacy in the scope of regulation is generally adverse to the framing of clear regulatory objectives, as regulators do not have specific indicators to focus on, entailing either inaction or discretionary and arbitrary judgements in the execution of their functions. The breadth and potential indeterminacy of the sources of systemic risk to be monitored is a recurring theme in our critical discussion of macro-prudential supervision in this part. We argue that such breadth and potential indeterminacy has resulted in the establishment of wide powers for regulators in terms of information collection and the development of macro-prudential tools. Further, the central banks (within which the FPC and ESRB are nested) seem to be embarking on bold and novel developments and this phenomenon may suggest that macro-prudential supervision is more than a new regulatory mandate for financial regulators. Macro-prudential supervision may actually be a form of general economic management importing more intervention by central banks.


12 Other aspects of the suboptimal outcomes of crisis driven regulation are developed in Mads Andenas, ‘Who is Going to Supervise Europe’s Financial Markets’ in Mads Andenas and Yannis Avgerinos (eds), \textit{Financial Markets in Europe: Towards a Single Regulator?} (The Hague: Kluwer Law International 2003), xv. The point is also made that only in the immediate post-crisis period will reactive measures be adopted: when the floodgates holding restrictive measures back burst, industry is no longer able to block reform effectively. Later on, with order re-established, reform may again be effectively blocked by industry.

13 ESRB Regulation 2010, art 2(c).

15 Information collection and surveillance in macro-prudential supervision

15.1 Introduction

Enriques\(^1\) has rightly pointed out that the trajectory of post-crisis regulatory reform will proceed along the lines of expanding the scope of regulation and overhauling existing regulation in order to compensate for perceived regulatory gaps. As the crisis has revealed a lack of regulatory discernment concerning unregulated parts of the financial sector (such as alternative investment funds),\(^2\) as well as complex financial transactions and linkages (particularly in derivatives transactions on the over-the-counter (OTC) markets),\(^3\) post-crisis reforms have therefore provided for the expansion of reporting to regulators by the financial services sector and through public disclosure.\(^4\) Extensive information surveillance hence forms the backdrop to macro-prudential supervision. Extensive information surveillance may be necessary, as surveillance for signs of systemic risk requires an approach that is open-minded, given the protean qualities\(^5\) of systemic risk. In the words of the Financial Stability Board:

The identification and availability of relevant data is critical for assessing systemic risk and calibrating policy responses. Improving information and data collection frameworks . . . is important to help authorities better

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understand interconnections within the financial system and common exposures to shocks that can lead to system-wide stress.\textsuperscript{6}

Enhanced regulatory disclosure will support the budding surveillance structure in national, EU and international financial supervision. At the same time, the general level of transparency and disclosure to investors and the public has also increased, although it is doubted that investors may be enrolled into surveillance roles for the purposes of macro-prudential supervision.\textsuperscript{7} Post-crisis, the role of transparency has arguably changed, from that of empowering the market to observe and discipline, to that of empowering regulators to discern and supervise.\textsuperscript{8} Goodhart,\textsuperscript{9} however, doubts that the pre-crisis levels of information were insufficient. He opines that what was lacking was macro-prudential supervision and tools to deal with potential macro-prudential issues.

Transparency has long been an ideological foundation for financial regulation as it facilitates market discipline. Brandeis’ famous quote, ‘Sunlight is said to be the best of disinfectants’, underlies the disclosure regime in US securities regulation since the 1930s. Financial markets are replete with sophisticated counterparties who may be in a position to exercise market discipline: counterparties to structured product, credit and derivative transactions; underwriters and issuers; gatekeepers such as auditors, rating agencies and stock exchanges; institutions and investment managers; issuers and analysts. There is potential for different actors, in this wide ‘regulatory space’,\textsuperscript{10} to exert discipline upon one another, creating a multi-faceted structure of private market-based governance.\textsuperscript{11} Werbach terms this structure as a ‘poly-opticon’, where multiple actors may have the capacity to observe and influence each other’s behaviour in unexpected ways. Such market-based governance is diffuse but pervasive in nature.\textsuperscript{12} In the securities law reform carried out by the EU since the Financial Services Action Plan (FSAP) 1999, disclosure

\textsuperscript{8} Iris H-Y Chiu, ‘Transparency Regulation in Financial Markets – Moving into the Surveillance Age?’ (2011) 3 European Journal of Risk and Regulation 303
\textsuperscript{9} Charles AE Goodhart, The Regulatory Response to the Financial Crisis (Cheltenham: Edward Elgar 2009), 30.
regulation has also been embraced in many aspects of securities regulation. Prospectus disclosure for issuer products acts as a disinfectant against issuer fraud in investment markets, whether wholesale or retail. Continuous disclosure by issuers (including ad hoc disclosure of price-sensitive information under Article 6 of the EU Market Abuse Directive or, where the US is concerned, as an obligation to avoid fraud-on-the-market) has further been imposed to support the efficient allocation functions of the secondary investment market. Disclosure regulation is extended to collective investment products – such as UCITS in the EU, non-UCITS collective investment schemes in the UK, structured complex products (e.g. asset-backed securities) in the US Regulation AB – as well as to intermediary regulation under the EU Markets in Financial Instruments Directive (‘MiFID’). The MiFID and its supplementary Regulation have also imposed mandatory price transparency for large investment firms acting as ‘systematic internalisers’, electronic trading platforms and traditional stock exchanges. In sum, the retail investment market is well covered by product, intermediary and market transparency.

However, the global financial crisis has shown that the assumption that market discipline is facilitated by transparency and is self-sustaining should be questioned. For example, Mendales argues that sophisticated investment banks and institutions failed to discern the quality of structured products, such as collateralised debt obligations, because of insufficient disclosure of relevant matters as well as poor judgement. Further, even sophisticated parties, such as credit rating agencies, involved in rating the complex collateralised debt obligations lack comprehensive information regarding underlying loan assets. In the post-crisis era, market discipline has been shown to be weak as market actors do not use information effectively and the adequacy of transparency is itself in doubt.

The post-crisis explosion of transparency reforms is not based on further

14 FCA Handbook (as of 30 April 2013, formerly FSA Handbook) COLL 1.2, 4.
stimulating market discipline, but based on empowering public regulatory authorities to carry out regulatory surveillance and supervision.

‘Surveillance’ may be understood as a process for creating visibility by the collection and analysis of myriad data, in order to identify matters of interest relevant to policy or politics. Older ideas of surveillance include Bentham’s Panopticon where total transparency is achieved in a hypothetical prison by having a centrally placed prison guard watch everything happening in prison cells. Typical conceptions of surveillance may involve CCTV cameras watching social and civic life. In the Panopticon, the transparency further causes the watched to internalise the knowledge of being watched, entailing a behaviour of compliance. In Foucault’s terms, ‘[the Panopticon is] at once surveillance and observation, security and knowledge, individualisation and totalisation, isolation and transparency’.

However, contemporary understandings of surveillance pertain to the element of bureaucratic control. The enhanced informational empowerment of regulators in the UK and EU for the purposes of macro-prudential supervision is arguably designed for surveillance.

15.2 Expansion in regulatory powers for information collection

There is an overall increase in regulatory reporting in micro-prudential and risk management matters for the financial sector generally. As systemic risk could be triggered by institutional failure, institution-based micro-prudential and risk management information are of key importance to regulators and are now subject to enhanced reporting obligations. The EU European Markets and Infrastructure Regulation 2012 (EMIR) has also introduced an increase in trade and price reporting over a comprehensive range of markets.

In terms of micro-prudential information, financial institutions now need to report liquidity management, stress testing results, the management of leverage, the design of remuneration packages and risk management generally, in addition to capital adequacy reporting that was the mainstay of pre-crisis micro-prudential reporting.

Capital adequacy reporting and large exposures reporting will be enhanced and standardised across the EU. Liquidity reporting has by and large been rolled

24 See European Banking Authority, ‘EBA Consultation Paper on Draft Implementing Technical Standards on Supervisory reporting requirements for Institutions (CP 50)’ (London, 20 December
out across the UK financial sector. Banks, building societies and banking groups with investment outfits are now required to carry out intra-day liquidity assessments, to report any deviations to the regulator and to submit remediation plans for these deviations. Alternative investment funds regulated in the EU will also have to establish liquidity plans and report to their respective national regulators. UCITS managers will also have to implement liquidity risk management processes but reporting does not seem necessary. Stress testing procedures and results are now also part of the regulatory reporting landscape. The UK requires all financial sector firms whose assets under management (or fee or commission income or assets and liabilities) are above certain prescribed thresholds to be subject to regular stress testing carried out in-house, and such results may be requested by the regulator. UCITS are also subject to regular stress testing obligations but again not reporting. Credit rating agencies, regulated directly by the European Securities Markets Authority (ESMA), are required to regularly back-test the validity of their models and assumptions, and to report back-testing results to ESMA. Alternative investment funds, too, are required
Information collection and surveillance

to report leverage levels to the national regulator to facilitate monitoring for systemic risk concerns. These reports may include, for example, a breakdown of leverage, the five largest sources of borrowed cash or securities for each managed AIF and the fund’s internal assessments of appropriate levels of leverage.\(^{33}\) UCITS are also required to report to the national regulator at least annually concerning their exposure to derivative instruments on the OTC market. This information must reflect a true and fair view of the types of derivative instruments used for each managed UCITS, the underlying risks, the quantitative limits and the methods that are chosen to estimate the risks associated with the derivative transactions.\(^ {34}\) As the remuneration policies of financial sector employees may affect risk management,\(^ {35}\) the disclosure of remuneration information in connection with risk management and quantitative information has been required of all banks, building societies, investment firms\(^ {36}\) and alternative investment funds.\(^ {37}\) Further, regulatory authorities in the EU require recovery and resolution plans to be submitted by financial firms,\(^ {38}\) in order to assist in the supervisory oversight of the firms.

The conception of systemic risk as emanating from a high impact market shock has also shaped regulatory reforms that relate to increasing regulatory demands for market data. Market-wide information has to be monitored and submitted to national regulators, primarily by market providers. Following the global financial crisis, the EU enacted a Regulation on short selling that compels short sales to be disclosed, so that enhanced data may be required for regulatory surveillance in adverse circumstances in the financial sector.\(^ {39}\)

Under the MiFID 2004,\(^ {40}\) the explosion in trade data that must be disclosed is based on improving investor choice and execution on competitive markets. MiFID ushered in comprehensive price transparency regulation, ordering offer

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33 AIFM Directive, art 24(4).
36 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) BIPRU 11.5.18ff.
and transaction details on most markets to be made transparent. Systematic internalisers in a liquid stock must disclose quotations and closed transactions. Moreover, the Commission Regulation 2006 that supplements the primary Directive further sets out the disclosure levels expected of electronic trading platforms and stock exchanges for pre-trade and post-trade transparency.\(^{41}\) In the wake of the global financial crisis, increased reporting of trade data is required, but the purpose of such enhanced transparency is to assist regulatory supervision rather than market discipline.

Proposed reforms further require market data on regulated markets, electronic trading facilities and ‘organised trading facilities’ to be disclosed.\(^{42}\) The term ‘organised trading facilities’ is likely to capture all forms of trading activity that are not simply ad hoc and irregular, leaving OTC or bilateral arrangements to be very narrowly defined. The range of market data collection is set to expand with the broadening of the scope of MiFID to cover more markets. The European Commission is looking at repealing MiFID to make way for a new Directive and Regulation. The new Directive proposes to usher in more risk management regulation for market operators, requiring them to monitor markets and report regularly on disorderly trading behaviour and market abuse, as well as reporting traders’ aggregate positions on a weekly basis. The Directive will also impose reporting and risk management requirements on firms carrying out algorithmic trading.\(^{43}\) The Regulation\(^{44}\) will further enhance the handling of trade information by facilitating consolidation of information services in the form of consolidated tapes. The EMIR, which was passed in June 2012, compels standardised OTC derivative instruments to be centrally cleared, requires market data to be reported by such derivatives trading markets and increases the categories of instruments for which trade data needs to be reported, including in systemic internalisation. Trade data returns will greatly increase, presumably to assist in information surveillance by regulators.

At the international level, surveys of economic outlook and financial stability have always been carried out (e.g. by the International Monetary Fund (IMF) and

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Organisation for Economic Co-operation Development (OECD)\textsuperscript{45} and specific issues in the financial sector have been surveyed and reported by international organisations (such as the Bank for International Settlements (BIS),\textsuperscript{46} the Financial Stability Board\textsuperscript{47} and the European Banking Authority (EBA)).\textsuperscript{48} Such international surveys and reports could provide a bird’s-eye view of macroeconomic conditions and useful insight that may feed into macro-prudential supervision. However, Davies and Green write from experience that international data has seldom fed into the UK Bank of England’s financial stability reviews.\textsuperscript{49} Post-crisis, will there be more resolve to use information from international surveys in the information surveillance carried out at the level of the national regulatory agency?

Regulators are increasingly equipped by legislation to obtain extensive amounts of information, but the link between the collection of more information and effective macro-prudential supervision still has to be established. How information will be analysed and used to inform policymaking or supervisory decisions is key to macro-prudential supervision. The following will discuss the challenges in effective analysis and use of the extensive regulatory information that may be collected.

15.3 The challenges in information surveillance at national and EU levels

We argue that there are inherent difficulties in the management of regulatory data collection in order to achieve the extensive information surveillance needed to support macro-prudential supervision. First, national regulatory agencies, such as the PRA and FCA in the UK, would be subject to challenges in terms of aggregating and mapping vast amounts of regulatory information, as well as identifying granularity and using such regulatory information meaningfully. Second, it will be argued that the expansive data reported to national regulatory agencies may


\textsuperscript{46} For example, the global liquidity survey found in Committee on the Global Financial System (Bank of International Settlements), ‘Global Liquidity – Concept, Measurement and Policy Implications’ (November 2011) CGFS Paper No 45 www.bis.org/publ/cgfs45.pdf accessed 23 March 2013.

\textsuperscript{47} Such as the quarterly thematic review of compensation practices at large financial institutions.


be disconnected from macro-prudential supervision, whether at the UK or at the EU level.

In order to achieve the ambitions of macro-prudential supervision, information surveillance to support macro-prudential supervision needs to be broad-based. However, a broad range of disparate information must be aggregated in order for it to be meaningful for analysis. The aggregation of information needs to take place at several levels: first, institution-specific information needs to be aggregated; then aggregated institutional information must be aggregated in order to provide a sectoral picture. Sectoral information should also be aggregated with the aggregated information of other sectors. However, it is also important that unaggregated information be nimbly used, compared or ‘composited’ with other information to create indicators that may be useful. This flexibility may be important as systemic risk may manifest itself in dynamic forms of structural vulnerability. In sum, macro-prudential regulators have to maintain a balance between being able to aggregate information in order to achieve a bird’s-eye view and being sensitive to disparate information signals that may raise concerns per se. Schwarcz is also concerned about the per se complexity of information reporting by institutions: such reports may themselves be too complex, as they may be based on risk management models and assumptions that are highly difficult to evaluate.

We suggest that given the organisational structure of the national regulators in the UK, there are limits to their ability to respond to the gargantuan needs of information management.

15.3.1 Information aggregation and mapping

This subsection discusses the potential difficulties in information management due to the organisational structure of the UK regulators. The Prudential Regulation Authority (PRA) in the UK is responsible for the micro-prudential supervision of major banks and financial institutions. It is derived from the Prudential Business Unit at the former Financial Services Authority (FSA), which was departmentally structured along sectoral lines. This means that the regulatory reporting in micro-prudential and risk management relating to banks and building societies go to one department, while reports from alternative investment funds or investment firms go to other departments. It is surmised that the sectoral structuring of


52 See www.fsa.gov.uk/pages/About/Who/Management/Retail/index.shtml.
departments will not be dramatically changed after the establishment of the PRA, as the former FSA has already operated with a twin peaks model while preparing for the structural changeover to the PRA and the Financial Conduct Authority (FCA) since 2011. The organisation of departments by sectoral responsibility could give rise to challenges in information aggregation across departments. Further, each department may expand in order to cope with the expansion of information surveillance. This means that each department may have plenty of unaggregated information to monitor and manage, as there will be volumes of micro-prudential information per institution, in terms of liquidity, stress testing, capital adequacy, large exposures and remuneration reporting. Can such information be meaningfully aggregated per institution? The Financial Stability Board has mentioned that different pieces of micro-prudential information from a financial institution may not be well-aggregated by the institution itself and suggests that financial institutions develop enterprise-wide systems to put together risk profile information. Can one depend on regulators to do this job?

Even if institution-specific micro-prudential information is aggregated for each financial institution, will institution-specific information be aggregated with that of other institutions to present a sectoral picture? Significant work is likely to be required to put sectoral information together. Although the Prudential Business Unit at the FSA had a department that deals with banking groups in order to capture systemically important financial groups’ risk profiles, the Banking Group department may not be able to capture links that are outside a group structure, such as derivative and swap exposures. There are likely to be further challenges in aggregating sectoral information, such as in information from the banking sector with information from the investment firm sector. The PRA suggests that it will endeavour to integrate work of departmental supervisors and risk specialists, and will ensure that key supervisory messages are passed on to senior management. But the question remains open as to whether there is adequate regulatory capacity to construct a cross-sectoral and sufficiently macro-level database of intelligence. The Financial Stability Board has found that most national regulators face difficulties in hiring sufficiently talented personnel to manage their albeit slightly increased resources and generally feel that there is inadequate supervisory talent in carrying out the task of effective macro-prudential supervision.

While regulators may be able to cope with the needs of information aggregation by hiring more personnel and making each department bigger and more resourced, the tendency for departmental differentiation is inherent to bureaucracies and this itself may undermine the regulator’s ability to achieve effective aggregation of information. Individual departmental growth may lead to more specialisation within each department and the extent of integrated perspectives that can be achieved across departments may become more limited.

Further, micro-prudential and risk management reports may be collated with other forms of regulatory data on market transparency or investor protection, for example. Liquidity information from institutions combined with market data may present a more complete picture of whether some assets are likely to maintain their liquid status in stressed times. Further, information that is made available in the public domain, such as valuation of hedge funds for the purposes of investor protection, may provide information on the risk profiles of certain hedge funds. If information-mapping exercises were carried out in more reflexive ways, they could generate unexpected insights into correlations and links that may be important in systemic risk monitoring, realising the ambitions of macro-prudential supervision.

The successful mapping of information may also be affected by the regulatory architecture in place. In the UK, micro-prudential and risk management information will be reported mainly to the PRA and market data will be collected by the FCA. Any mapping of information will therefore depend on the extent of inter-agency coordination. The PRA and the FCA have a formal Memorandum of Understanding covering regular information exchange and coordination in view of the financial stability objective. The two agencies will be jointly responsible for the administration of the Financial Services Compensation Scheme, in charge of the deposit guarantee and investor compensation schemes in the UK. They will also institute formal arrangements for supervising large financial groups. Further, there are formal requirements for the two agencies to exchange views and consult each other whenever new rules are made by either agency. These arrangements will facilitate inter-agency cooperation on specific matters.

58 See Draft Memorandum of Understanding (MoU) between the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) (November 2012) www.bankofengland.co.uk/financialstability/Documents/overseeing_fs/fca_pra_draft_mou.pdf accessed 11 April 2013.
59 Financial Services Act 2012 amending the Financial Services and Markets Act 2000 by inserting sections 3E to 3Q.
However, will these arrangements foster greater integration of information management and the development of perspectives across the two agencies? Organisation literature suggests that the effectiveness of information coordination between agencies is likely to be affected by how the objective for coordination is defined. Where coordination is defined with clear and narrow objectives, it may be more easily achieved, as agencies know what they are bringing to the table. They can devote a reasonably predictable amount of resources to achieve coordination. However, if coordination is of an open-ended nature, the agencies involved in the network of coordination may each succumb to the ‘free-rider’ tendency and let others do the work. The legislative framework instituting the PRA and FCA contains a mixture of defined shared objectives and more open-ended coordination, such as information exchange for the purposes of financial stability. The PRA and FCA may be more incentivised to focus on the defined aspects of their coordination, than on the more difficult and open-ended aspects. We suggest that it may not be easy to achieve effective and nimble information sharing across the two agencies.

At the EU level, the European Supervisory Authorities – the EBA, the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) – have all been asked to put in place a permanent capacity to monitor and respond to systemic risk. The three authorities will assist the macro-prudential supervisor in the EU, which is the ESRB. The three authorities will likely rely on information relay from national regulators, as they do not collect information themselves, except in the case of ESMA when directly regulating credit rating agencies. The quality and quantity of information relayed to the three authorities will depend on how national authorities have analysed and aggregated the raw information they


63 However, it is noted that the EBA carried out its own research among European banks in the preparation of its systemic risk monitoring report. See EBA, Report on Risks and Vulnerabilities of the European Banking System (July 2012) and (January 2013).
receive. However, the EBA is rolling out standard reporting templates for all Member States in respect of capital requirements, large exposures and other micro-prudential and remuneration reporting. Such templates could force national regulators to engage in the required information aggregation and mapping where relevant. However, with 27 national authorities to deal with, it is queried whether the EBA’s templates will prove overly standardised, failing to capture local nuances or highlight different issues that may be salient to different Member States.

Nevertheless, the regulatory architecture at the EU level is also organised in a sectoral manner. It is therefore queried whether European authorities will be able to map Member State information per sector and across sectors at the EU level to monitor for signs of systemic risk. It is to be noted that the systemic risk report prepared by the Joint Committee for the three European authorities show that a genuine effort is put into aggregating information and even across sectors. However, the three authorities need to have adequate recognition for granularity and pockets of issues that may be relevant to different Member States or groups of Member States.

In late 2012, political agreement was secured for the European Banking Union or the Single Supervisory Mechanism. The Single Supervisory Mechanism empowers the European Central Bank (ECB) to carry out micro-prudential supervision, for all euro area banks in the EU with at least €30 billion in assets or assets whose value represents one-fifth of a Member State’s gross domestic product. Non-euro area Member States may choose to participate in the Single Supervisory Mechanism and the UK has indicated its willingness to opt in. We are of the view that the Single Supervisory Mechanism is likely to create a differentiated tier of legal integration for euro area and non-euro area


66 The systemic risk reports produced by the EBA have thus far been highly aggregated, perhaps an achievement in the face of information aggregation and mapping challenges. However, it may perhaps lack adequate granularity. See EBA, Report on Risks and Vulnerabilities of the European Banking System (July 2012) and (January 2013).


participating banking sectors. The ECB will administer the micro-prudential and risk management information reports from banks subject to the Single Supervisory Mechanism and may also impose its own requirements. It remains to be seen to what extent the ECB’s role may result in deviations from the EBA’s development of the single rulebook for the EU. As the ECB becomes the main repository of micro-prudential information (submitted by financial institutions subject to its supervisory mechanism), it is queried whether the EBA’s information aggregation function will be affected. Moreover, marginalisation of the EBA could occur if the ECB works closely with the ESRB in its macro-prudential supervision as the ESRB is nested within the ECB. The dynamics between the ECB, ESRB and EBA may affect how any information aggregation and mapping is carried out.

Nevertheless, it may be argued that aggregating and mapping information across agencies at the national or EU level is not an insurmountable problem if regulators are able to develop technologically sophisticated systems to manage the data at both levels. Information technology experts argue that information technology systems could be constructed to pool together diverse sources of information to be shared, achieving information integration. However, the ability of such technological systems to deliver ‘integrated data’ may be heavily influenced by the policy and social environment of the agencies involved, affecting data definition and semantic translation. Human qualitative assumptions necessarily underlie the work of data integration systems and would affect the quality of information aggregation and mapping. Having data integration systems in place may assist in the information management process, but they cannot replace the human qualitative assumptions that are necessary for determining how aggregation and mapping should take place. The qualitative judgements may be affected by institutional ethos and dynamics with other institutions at the EU level, as well as between EU level institutions and national regulators. Williams and Bamberger also warn against excessive reliance on automated generation of signals for regulatory attention.

Policymakers already recognise the challenges faced by regulatory bodies to meet the massive informational needs of macro-prudential supervision. Hence, much of the aggregation of information is to be done by the financial sector itself. Financial institutions have to aggregate institution-specific information and

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70 Theresa A Pardo and others, ‘Modeling the Social & Technical Processes of Interorganizational Information Integration’ (37th Hawaii International Conference on System Sciences, Hawaii, 31 January 2004).
markets have to prepare aggregate information\textsuperscript{75} on trade data by the week or on market monitoring data, such as market abuse monitoring.

Delegating aggregation to the financial sector may mean running the risk of the financial sector introducing its own perspectives, embedded within the presentation of aggregated information. Such a presentation may be self-serving, unless the process and form of aggregation can be strictly prescribed. However, prescription may also become outmoded. Any form of ‘delegated governance’ to the private sector may entail a principal-agent problem.\textsuperscript{76} Hence, regulators may need to put in place checks in terms of process-based supervision and perhaps consider commissioning ad hoc independent audits\textsuperscript{77} into the reporting processes in financial institutions and markets.

\textbf{15.3.2 The regulatory objectives relating to data collection}

This section suggests that information surveillance undertaken by regulatory agencies may not feed into the macro-prudential supervision framework if the information collected is regarded as irrelevant to the objective of macro-prudential supervision.

There are different pieces of empowering legislation for collecting various types of information. Each may be couched in different terms, targeting different objectives and perspectives. If regulatory agencies interpret regulatory reporting narrowly within the objectives of the empowering legislation, the regulatory treatment of information collected may not be relevant to macro-prudential supervision. For example, the UK FCA will be setting up a Research Unit\textsuperscript{78} for monitoring market and product trends in order to be informed of any risks to consumer interests that may require early regulatory intervention. Such information surveillance is pursuant to the consumer protection objective, which may

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\textsuperscript{77} The UK regulator is looking at more regular dialogue with the audit industry in order to enhance its own information surveillance, e.g. PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SUP 3.8; FSA, ‘Code of Practice for the Relationship between the External Auditor and the Supervisor’ (May 2011) FG11/09 www.fsa.gov.uk/pubs/guidance/fg11_09.pdf accessed 5 January 2013. The Financial Stability Board has also recommended that regulators establish richer dialogue with auditors in order to better monitor institution risk, see Financial Stability Board, ‘Intensity and Effectiveness of SIFI Supervision: Progress Report on Implementing the Recommendations on Enhanced Supervision’ (27 October 2011) www.financialstabilityboard.org/publications/r_111104ee.pdf accessed 5 March 2013, 13.

\end{footnotesize}
assist in preventing consumer scandals and crises. Although the information may also be relevant to systemic risk monitoring, in terms of the risk profiles of assets for example, such information surveillance is more likely to feed into the objectives of the FCA, which revolve around consumer protection, than be regarded as relevant for systemic risk monitoring and macro-prudential supervision.

Although information surveillance has increased, it is uncertain how much intelligence will feed into macro-prudential supervision if information surveillance serves narrowly defined regulatory objectives administered by different departments. Further, narrow perspectives on information collection at the national level will affect the quality of information relayed to the three European authorities. Information surveillance undertaken by national regulators pursuant to specifically defined regulatory objectives could become disconnected from national macro-prudential supervision and even more so from EU-level macro-prudential supervision.

At this juncture, it may be useful to carry out a comparison with the macro-prudential supervision regime in the US, based on the reforms undertaken in the US Dodd-Frank Act 2010. The Act provides for the establishment of a macro-prudential supervisor and centralised intelligence and information surveillance agency for the financial sector. In the US, the new Financial Stability Oversight Council established under the Dodd-Frank Act is responsible for systemic risk oversight. The Council is a cross-sectoral committee consisting of all the relevant sectoral regulators such as the Securities Exchange Commission (SEC) and the Commodities and Futures Trading Commission as well as the Consumer Financial Protection Bureau and the Secretary of the Treasury. Under section 112, the Council is tasked with identifying risks to the US financial system and to financial stability, and with promoting market discipline. These objectives are to be achieved through the collection and analysis of information by the newly established Office of Financial Research. The Office’s analysis may then inform monitoring, supervision, discipline, rule-making and other regulatory action.

The Office of Financial Research is established to collect, use, analyse and share data. It is expressly provided that the Office will have a data centre as well as research and analysis capacity. The Office is also financially supported by a Financial Research Fund.

The Dodd-Frank Act contains a gamut of data collection powers. Although not all data collection is expressly stated to pertain to systemic risk oversight, nor is it all directly relevant to the new Financial Stability Oversight Council, data collected by the SEC must be reported to the Council, Congress and Senate under sections 961-4 and, hence, the Office can access regulatory reports submitted by

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80 Dodd-Frank Act (US), s 111.
81 Dodd-Frank Act (US), s 112.
82 Dodd-Frank Act (US), ss 153, 154.
83 Dodd-Frank Act (US), s 155.
the SEC to the Council. The data collection powers target firms as well as markets. The Act now abolishes the status of exempt private investment advisers for hedge funds and requires them to register with the SEC. Section 404 authorises the collection of data pertaining to fund management and assets under management. Credit rating agencies are also subject to mandatory disclosure of their ratings methodologies, due diligence and performance, thus enabling public comparison. They are also required to report annually to the SEC in order to facilitate supervision of internal control management and management of conflicts of interest.\footnote{Dodd-Frank Act (US), s 932.} Product providers of asset-backed securities are subject to enhanced disclosure to the SEC under section 942. Corporate issuers are also subject to enhanced disclosure of directors’ and employees’ trade and hedging activities,\footnote{Dodd-Frank Act (US), s 955.} and corporate governance arrangements.\footnote{Dodd-Frank Act (US), s 972.} Sections 727 and 766 compel all swap transactions on or off exchange to be publicly reported or reported to the Commission where no swap data repository is relevant. Data collected by exchanges, which may also act as swap data repositories, may be open to inspection by the SEC. As for data directly reported to the Financial Stability Oversight Council, section 620 requires all investment banks to report the state of their activities and management for a one-off comprehensive review. The Council may also require collection of data from central counterparties and clearing and settlement facilities under section 809.

The most significant point of comparison is the Office for Financial Research, a centralised and dedicated information surveillance agency directly supporting the macro-prudential supervisor. It remains to be seen if the Office of Financial Research can overcome the inherent difficulties in information aggregation and mapping discussed above, but at least the regulatory objective of the Office is to treat all information as intelligence for surveillance purposes. In the UK and EU, information surveillance is largely added on to the existing regulatory functions of national regulators and may be subsumed under those specific regulatory functions.

\section*{15.4 Concluding remarks}

As the G30 report on macro-prudential supervision puts it, ‘Comprehensive macro-prudential oversight requires regular and periodic fully integrated reviews of the entire financial system, which is technically demanding and possibly very costly for both public supervisors and the private institutions they oversee’.\footnote{G30 Working Group on Macroprudential Policy, Enhancing Financial Stability and Resilience: Macroprudential Policy, Tools and Systems for the Future (Washington, DC: Group of Thirty 2010).} Such integration begins at the level of information collection by the national regulator. Information integration must be carried out at many levels: within departments, across departments, between national agencies and European authorities.
Moreover, there is a need to establish frameworks for information aggregation and mapping with sufficient open-endedness and reflexivity in order to discern signals in the myriad of information collected. This is potentially a complex and difficult project, as paradigms for understanding information and frameworks for analysis will have to be established and will need to address the requirements of reflexivity and manageability. Moreover, difficulties will be compounded where information analysis is undertaken across agencies or national boundaries. In the UK and EU, besides these inherent difficulties in managing information surveillance, we have suggested that there is a potential gap between the various regulatory objectives of information surveillance and those of systemic risk monitoring. Information collection serves other more specifically defined regulatory purposes, as administered by the national regulators, and may not feed directly into macro-prudential supervision.

Augusto de la Torre and Alain Ize, ‘Regulatory Reform: Integrating Paradigms’ (2010) 13 International Finance 109, arguing that diverse paradigms for understanding financial sector trends are important, such as through the lens of collective welfare paradigms as well as the dominant agency paradigm.
16 The regulatory architecture for macro-prudential supervision in the UK and EU

In the UK, the Financial Policy Committee (FPC) is tasked with macro-prudential supervision. In the EU, the European Systemic Risk Board (ESRB) is designated to carry out macro-prudential supervision. The dedication of specific bodies to carry out macro-prudential supervision shows the political will to make macro-prudential supervision credible. However, the two dedicated bodies mentioned above are formalised networked structures bringing together a range of regulatory agencies. The networked structures underlying the FPC and ESRB seem to promise a supply of intelligence, dialogic perspectives and debate to support the difficult task of macro-prudential supervisors. This chapter will examine whether the architecture of these structures is in fact optimal for the future of macro-prudential supervision.

16.1 UK

In April 2013, the UK discarded its single regulator structure in the form of the Financial Services Authority (FSA) in favour of a twin peaks model featuring the micro-prudential regulator, the Prudential Regulation Authority (PRA), and the conduct of business regulator, the Financial Conduct Authority (FCA).¹

Further, a macro-prudential supervisor in the form of the FPC has been established.² The FPC is an inter-agency body chaired by the Governor of the Bank of England and has significant Bank representation alongside Treasury representation. The Chief Executive of the FCA is also a member of the FPC. The FPC is a sub-committee of the Court of Directors, to which the Bank of England is customarily accountable.

The FPC is empowered to take macro-prudential measures in respect of the financial services industry in general and not limited to specific persons. Such measures may take two forms: specific directions to the PRA or FCA to take

¹ Based on HM Treasury, A New Approach to Financial Regulation: The Blueprint for Reform (Cm 8083, June 2011) and the Financial Services Act 2012.
certain macro-prudential measures whose categories are specified in legislation;\(^3\) or recommendations to the PRA or FCA to take specific regulatory action, which the PRA and FCA must comply with or otherwise explain. The FPC is also tasked with producing two general financial stability reports for public disclosure each year. Being a high-level committee, the FPC is unlikely to have its own information surveillance capacity and will rely on the members in its networked structure for intelligence and analysis. The FPC will receive input from the PRA and FCA but the Bank’s representation indicates that the FPC will also be informed of economic outlook analyses by the Bank. The Treasury’s representation may bring to the table broader policy outlooks as well.

Although the FPC is essentially a networked structure, the authors suggest that it is likely to be dominated by the central bank. This will affect the character and trajectory of macro-prudential supervision. Some commentators are of the view that macro-prudential supervision is highly related to the central bank’s monetary stability role and hence it is natural for macro-prudential supervision to be an extension of central banking functions.\(^4\) Other commentators,\(^5\) however, are of the view that macro-prudential supervision should not be dominated by the central bank, as the central bank may have other conflicting objectives. Further, central bank dominance in macro-prudential supervision may give rise to certain assumptions about the sources of systemic risk – that it emanates largely from the banking sector, for example – and such assumptions may not be well founded. There are some early signs that much systemic risk monitoring carried out by the FPC is focused on the banking sector, but this may simply be the result of the impact of the European sovereign debt crisis which is directly felt by many banks. There are also some signs that the preferred toolkit in macro-prudential supervision in the UK is balance sheet-based (i.e. micro-prudential tools and other capital tools, such as capital conservation and countercyclical buffers, as recommended in Basel III). These early signs of the nature of macro-prudential supervision suggest that macro-prudential supervision is largely focused on the micro-prudential health of banking institutions. Such an emphasis could arguably be due to the regulatory architecture underlying the FPC.

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In the networked representation in the FPC, the PRA and Bank of England arguably share common objectives. The PRA is a subsidiary of the Bank of England, chaired by the Governor of the Bank of England, while the PRA Chief Executive is Deputy Governor of the Bank for financial stability. The governing body of the PRA is appointed by the Bank, with Treasury approval, and hence the PRA may not be independent of Bank perspectives. The government views the PRA as a necessary complement to the Bank of England’s financial stability oversight, viz ‘Locating the PRA within the Bank of England group is a reflection of the important role it will play in protecting financial stability. Its core objective will be to promote the safety and soundness of the firms it regulates’. It is likely that, due to organisational structure and common objectives, the PRA may be able to achieve greater integrated information surveillance with the Bank. This could mean that information surveillance brought to the table by the PRA and Bank may form the bedrock of FPC deliberations, thereby pointing the way for macro-prudential supervision. Further, the Bank undertakes its own surveys (i.e. the Bank of England’s biannual Systemic Risk Survey, which asks compliance and risk management officers in the financial sector what they consider to be high impact risks for the UK financial system). The Bank therefore carries out its own information collection and analysis and seems not to rely on information mapping with its other non-Bank partners in the FPC. It is queried whether the FCA, with its suite of different objectives, and the Treasury, with its wider economic objectives, are observers or active information suppliers in the FPC. If the FPC is dominated by information surveillance provided by the Bank and the PRA, the FCA may play a more peripheral role even if it is represented at the FPC.

The PRA has stated that it will adopt a judgement-based approach in its micro-prudential supervision role, considering both the risks of institutional failure and wider economy issues. This approach is said to be in sync with the pre-emptive nature of macro-prudential supervision. If the Bank becomes alert to any potential financial stability issue, the Bank may consider managing the issue...

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at the lowest level of micro-prudential supervision before moving the issue to the FPC’s table. Hence, the PRA, in response to micro-prudential information received from financial institutions or stress-test reports, may be able to act preemptively in its supervisory relationship with those institutions, introducing various balance sheet and micro-prudential measures (such as extra capital charges, amendments to recovery plans, or requiring that contingent capital instruments be issued). Such early intervention may be carried out by the PRA and could be regarded as a form of macro-prudential supervision using micro-prudential tools. In this way, many ‘macro-prudential’ issues could end up being managed by the Bank (including the PRA) as a whole and not being raised at the FPC level.

In principle, the FPC may exercise its powers by recommending or directing the PRA or FCA to carry out various measures in relation to balance sheet, terms and conditions in transactions and market structures. It is arguable that there is a preference for balance sheet or micro-prudential regulation in the implementation of macro-prudential supervision, although an emphasis on micro-prudential regulation would fly in the face of post-crisis critique that has pointed out the inadequacies of micro-prudential regulation. However, we suggest that the FPC may prefer balance sheet tools, chiefly administered by the PRA, than transaction intervention tools, which may have to be co-monitored with or monitored by the FCA. Balance sheet tools that are more micro-prudential in nature have also been further developed, especially under Basel III, and hence there is perhaps greater willingness to engage with these, as leakages from regulatory arbitrage may be mitigated given the international convergence towards Basel III. Policymakers prefer a predefined and narrow set of what may be termed as macro-prudential measures. The pre-definition of macro-prudential measures is preferred so that they do not themselves become ‘unexpected’ policy output, responsible for a systemic episode. The Interim FPC has indicated a preference for an initial narrow set of macro-prudential tools in order to subject them to experimental use and evolution over time. These preferences arguably tend to converge on balance sheet tools, as these have been well used since the international convergence of capital adequacy regulation under the Basel I capital accord. There appears to be a greater reluctance to intervene in transactional terms (such as loan-to-value mortgages or loan-to-income credit arrangements), as such restrictions may crudely and unduly interfere with the market-driven

allocation of resources. Market structure tools are dominated by EU-level regulation and hence the FPC may see balance sheet tools as being the preferred range of tools to use. A preference for balance sheet tools is likely to promote PRA-Bank leadership on the FPC.

The likely domination of the Central Bank’s perspective may arguably be observed in the deliberations of the interim FPC in 2011 and 2012. An Interim FPC was set up pending legislative formalisation for the FPC in 2013 and the records of its quarterly meetings are publicly available. The records do not show inter-agency discussion and present the consolidated recommendations agreed upon by the FPC, as addressed to the then FSA. The records of meetings in 2011 and 2012 show overwhelming concern for bank-related issues (including capital positions due to sovereign debt stress, liquidity and leverage matters), although there is also some concern that residential mortgage foreclosures be limited to prevent systemic impact on consumers. Although banking sector issues loom large in the FPC minutes, it is nevertheless premature to conclude that the FPC focuses excessively on the banking sector in monitoring systemic risk.

We suggest that the economic context in the UK and EU – where there is concern about banking sector weaknesses, due to exposures to weakly performing sovereign debt in the EU – and the preference for a narrow set of balance sheet-based tools will characterise macro-prudential supervision in the UK for the immediate future. This trajectory may be due to concerns about the parameters of responsibility and accountability, or may be due to assumptions made about the sources and nature of systemic risk. Although the networked nature of the FPC could allow it to take a more inductive approach to systemic risk monitoring, it appears, at least for now, that a narrower view of systemic risk monitoring is

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16 See, for example, Interim Financial Policy Committee, ‘Record of the interim FPC meeting held on 22 June 2012’ www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2012/record1207.pdf accessed 26 March 2013.
taken, which revolves around Bank perspectives. It will be important to see how the FCA brings its views and intelligence on product and market developments to bear. Further, it should be considered whether the Ombudsman service can be separately represented at the FPC, in order to provide intelligence on consumer market issues, as systemic risk issues can also arise from consumer product markets.

16.2 EU

As mentioned earlier, the EBA, EIOPA and ESMA have all been tasked with establishing a permanent capacity to monitor and respond to systemic risk.\textsuperscript{18} Systemic risk is defined as relating to ‘any particular financial institution’,\textsuperscript{19} and more broadly as any risk of disruption in financial services caused by an impairment in any or all parts of the financial system, which affects the financial sector, real economy, or both.\textsuperscript{20} The three authorities are to assist the ESRB in monitoring systemic risk, by establishing qualitative and quantitative indicators to facilitate the judgement of the ESRB in deciding whether any systemic risk action (e.g. warnings) ought to be taken.\textsuperscript{21} Together, the three authorities also form a committee for inter-agency coordination. The three authorities, the Joint Committee and the ESRB, together, form the framework for comprehensive macro-prudential supervision in the EU and the European System of Financial Supervision (ESFS).\textsuperscript{22} The ESFS is essentially a networked structure as well.

The networked structure of the ESRB and the three European authorities seems optimal to capture the monitoring needs of macro-prudential supervision. However, we suggest that it is more likely that the ECB is at the forefront of financial stability. Although the ESRB is a network consisting of the three European authorities and central bank representation, the ESRB is likely to be dominated by the ECB and central bank perspectives as the ECB and national central bankers comprise 29 of its 37-strong General Board.\textsuperscript{23} We predict that


\textsuperscript{19} EBA Regulation 2010, art 1(5); EIOPA Regulation 2010, art 1(6); ESMA Regulation 2010, art 1(5).

\textsuperscript{20} EBA Regulation 2010, art 22; EIOPA Regulation 2010, art 22; ESMA Regulation 2010, art 22.


\textsuperscript{22} ESRB Regulation 2010, art 1.

\textsuperscript{23} ESRB Regulation 2010, art 6.
the ESRB’s main role will be to act as a platform for high-level information exchange between the three European authorities, the ECB and national central banks, but not necessarily as a macro-prudential decision-maker. We are of the view that the ECB will take on the management of financial stability issues more pre-eminently than the three European authorities who are tasked with the groundwork of systemic risk monitoring. As the ECB takes over unified micro-prudential banking supervision of euro area banks and banks in non-euro area participating countries (in the form of the Single Supervisory Mechanism), the ECB’s perspective on institutional fragility and risk may become dominant in defining systemic risk issues. Pending the finalisation of the Single Supervisory Mechanism, the ECB is already at the forefront of financial stability issues, such as sovereign debt and bank crises in euro area Member States.\footnote{For example, see Ben Rooney and Chris Isidore, ‘ECB loans out €529.5 billion to European banks’ \textit{CNN Money} (New York, 29 February 2012) http://money.cnn.com/2012/02/29/markets/ecb_bank_loans/index.htm accessed 27 March 2013.}

Although the EBA, EIOPA and ESMA are responsible for monitoring and responding to systemic risk,\footnote{EBA Regulation 2010, art 3; EIOPA Regulation 2010, art 3; ESMA Regulation 2010, art 3.} the role of the three European authorities is to provide information in order to feed into decision-making by the macro-prudential regulator.

The three European authorities have pursuant to their systemic risk monitoring role, issued sectoral reports on a semi-annual basis\footnote{See, for example, EBA, ‘Report on Risks and Vulnerabilities of the European Banking System’ (July 2012) and [January 2013]; ESMA, ‘Trends, Risks and Vulnerabilities’ [January 2013].} to provide EU-level perspectives on key trends and risks in the banking, securities and insurance sectors. The commitment to issuing these publicly available reports manifests the authorities’ commitment to systemic risk monitoring. However, the authors are concerned that the three European authorities’ approach to systemic risk monitoring may be very much coloured by their focus on market and legal integration.

The three European authorities have evolved from networked committees whose main role was to assist the European Commission in establishing technical legislation to support primary legislation on the integration of EU financial markets.\footnote{Niamh Moloney, ‘The Lamfalussy Legislative Model: A New Era for the EC Securities and Investment Services Regime’ (2003) 52 \textit{International and Comparative Law Quarterly} 499.} The three European authorities are heavily involved in legislative reform: the EBA in the legislative implementation of Basel III in the form of the fourth Capital Requirements Directive (recast) and the Recovery and Resolution Directive; the EIOPA in the implementation of the Solvency II Directive on micro-prudential regulation for insurance firms; and ESMA in reforming the Markets in Financial Instruments Directive (MiFID), the Transparency Directive and the Market Abuse Directive, as well as drafting technical supporting legislation for recently enacted post-crisis legislation such as the Regulation for Credit Rating Agencies and the Alternative Investment Fund Managers (AIFM) Directive. Hence, it is likely that the three agencies will consider legal integration as a key means to address systemic risk issues. This approach may seem plausible, as legal
integration offers a platform for many issues to be considered and discussed at a pan-European level, contemporaneously dealing with systemic risk concerns. We are concerned where there may be a conflict between objectives, the European authorities are likely to favour market and legal integration as they are deeply ingrained in the workings of the authorities, and hence macro-prudential supervision may be viewed through the lens of these objectives. Systemic risk monitoring across the EU may reveal realities that are difficult for the European supervisory authorities to grapple with, given its market integration and regulatory convergence objectives. In the EU, the reality is that certain countries are more connected to others, such as German and French banks in Eastern European countries and the UK’s exposure to Ireland (which exceeds that of other Member States). The ‘systemic risk’ signals at the EU level may more correctly be described as pockets of signals that are geographically concentrated. However, the systemic risk reports of the three European authorities present information without any reference to possible pockets of issues that may require different treatment.

Nevertheless, can it be argued, contrary to the discussion above, that the three European authorities have carried out EU-wide systemic risk monitoring and have taken proportionate actions so far? For example, the sovereign debt crisis in the euro area has prompted the EBA to carry out numerous stress tests in order to survey the soundness of European banks in general. The credibility of these stress tests has been criticised, but the EBA has nevertheless made a micro-prudential/macro-prudential move to increase all European banks’ core tier one capital base to 9 per cent of risk-weighted assets.

Further, the Joint Committee of the three authorities may also have a significant role in monitoring systemic risk. The remit of the Joint Committee relates to financial conglomerates, accounting and auditing, micro-prudential analyses of cross-sectoral developments, risks and vulnerabilities for financial stability, retail investment products, measures combating money laundering, information exchange with the ESRB, and developing the relationship between the ESRB and the three authorities. Although the remit is wide, the Joint Committee has in early 2013 published its first report on EU-wide risks and vulnerabilities, manifesting its commitment to systemic risk monitoring in a cross-sectoral fashion. The report derives its findings from EU-level data and such data, supplied by the three European authorities, appears to be highly aggregated.

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29 James Wilson, ‘German regulator attacks stress tests’ Financial Times (London, 7 June 2011) concerning the July round in 2011. The need for further stress tests a few months on into the sovereign debt crisis was again criticised in Patrick Jenkins and Ralph Atkins, ‘European banks have €115bn shortfall’ Financial Times (London, 8 December 2011), on the basis that the capital shortfalls assessed by the EBA keep changing.
30 EBA Regulation 2010, art 54; EIOPA Regulation 2010, art 54; ESMA Regulation 2010, art 54.
The report highlights the common risks for the Union but is not an exhaustive list of risks.\(^{32}\) Although a genuine effort to grapple with EU-wide risks and presenting a EU-level perspective, it remains uncertain how pockets of differences may be dealt with and whether there may be individual Member States whose problems could become systemically significant. Further, the report highlights national fragmentation as being an EU-level risk to be dealt with.\(^{33}\) The authors therefore remain concerned about whether the relationship between market and legal integration and financial stability is perceived excessively through the lens of unwavering support for market and legal integration\(^{34}\) and wonder if the Joint Committee and the three European authorities may be overstating the panacea qualities of legal integration.

### 16.3 Concluding remarks

Going forward, we suggest that macro-prudential supervision, although officially reposed in the FPC in the UK, is likely to be dominated by the central bank’s perspectives. In the EU, the macro-prudential responsibility of the ESRB supported by the three European authorities may also become more dominated by the ECB. The Single Supervisory Mechanism under the ECB may become the home of micro- and macro-prudential supervision in the EU. In this respect, there may be similarities between the UK’s approach to macro-prudential supervision at the national level and the approach taken at the European level. We, however, advocate caution in regarding market and legal integration as an essential platform upon which to manage systemic risk in the EU.

One remaining point is that the ideology of macro-prudential supervision is highly pre-emptive in nature. We might even say that the rise of macro-prudential supervision, however carried out, is a key illustration of the movement of financial regulation into new ideological territory. The next chapter will discuss how the post-crisis regulatory architecture in the UK and EU will cope with changes in financial regulation towards a more pre-emptive and public-interest character.

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17 The pre-emptive approach in financial regulation and the accountability of regulatory authorities in the UK and EU

The determination to embrace new regulatory approaches has been clearly articulated by policymakers and regulators in the post-crisis era. The UK Prudential Regulation Authority (PRA) will embrace a pre-emptive and judgement-based approach,\(^1\) which the Financial Conduct Authority (FCA) will also adopt, in order to bolster consumer protection.\(^2\) The judgement-based approach in regulatory supervision is essentially pre-emptive in nature and allows regulators to take intervening actions before problems have actually occurred. This approach allows regulators to make judgements as to the likely consequences instead of acting \textit{ex post facto}. The judgement-based approach is very much in line with the change in the character of financial regulation away from facilitating market discipline and towards providing the public good of consumer protection or financial stability. Hence, the judgement-based approach is supported by changes to the capacity and powers of regulators. It is important to look into the nature of regulators’ accountability and to discuss how this may affect the trajectory of financial regulation.

Although the judgement-based approach to regulation requires more preventive forms of supervision, such as vetting and inspections, regulators are unlikely to be able to carry out the same intensive supervision for all supervised entities due to constraints on resources. The judgement-based approach is therefore likely to be risk-based, meaning that entities regarded as having riskier profiles or as likely to cause more harm upon failure may be subject to more intensive supervision. The PRA seems to indicate that its approach in supervision will be based on assessing the stability risk that each firm poses to the overall financial system and supervisory engagement is likely to be commensurate with the level of risk.


identified. This sounds strikingly similar to a risk-based approach that prioritises regulatory attention for ‘higher risks’. Further, the FCA is also likely to engage in a risk-based approach given its fourfold classification of firms (based on scale and consumer base) for the purposes of determining supervisory intensity. However, the judgement-based approach means that regulators are likely to take earlier intervention instead of waiting for market discipline to apply.

It may be argued that the judgement-based approach will be undermined if a risk-based approach to regulation continues to be taken. This is because a risk-based approach makes assumptions about risk and about the likely impact of risk materialisation, assumptions that may be mistaken from the outset or become misplaced over time. As the judgement-based approach is pre-emptive in nature, perhaps regulators should be more willing to question assumptions and adopt approaches that ensure that supervision is adequate for all supervised entities. Black and Baldwin suggest that ‘lower risks’ may over time become volatile and unstable through accumulation or through changes in context, thus warranting some regulatory attention. Nevertheless, the PRA will also examine the risk management and governance contexts of firms in assessing the risks they pose, so its approach seems to include a kind of responsiveness by keeping an eye on ‘lower risks’ as suggested by Black and Baldwin. The FCA has also indicated that it will engage in proactive surveillance and research to inform itself of signals and risks that may warrant pre-emptive action. The PRA and FCA may be indicating the adoption of a modified risk-based approach that is more dynamic in nature in order to ensure the judgement-based approach is a success.

The increased capacity and powers of financial regulators to make pre-emptive judgements may raise the question of whether such judgements are sound and accountable. One concern is that these judgements will be made by groups of technocrats that are insular, and financial regulation and supervision could in time take on an elitist character. This chapter will argue that the post-crisis character of regulatory agencies, whether in the UK or EU, is likely to become more technocratic and may be in danger of becoming too insular and elitist in the future.

Where regulatory agencies engage in more intelligence, surveillance and information analysis, they are likely to become technocratic bureaucracies. This is because financial, economic, legal and technological expertise are required to

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7 Technocracy is defined as ‘the government (or control) of society by scientists, technicians, or engineers – or at least the exercise of political authority by virtue of technical competence and
sort and analyse the intelligence and the professionalisation of staff characterises the role and work of the agency as technocratic. In this respect, national regulators (such as the PRA and FCA) and the three European authorities assisting the European Systemic Risk Board (ESRB) may develop into technocracies. Technocracy is not necessarily a drawback, as technocracy is often associated with focused problem-solving, greater objectivity and independence. However, commentators have warned about technocratic decision-making being more politically powerful because of the necessary difficulties surrounding the questioning of expert judgement. We therefore need to look into whether the new regulatory architecture in the UK and EU has adequately addressed issues of accountability in relation to the making of pre-emptive technocratic judgements in financial regulation and supervision.

First, it is queried whether the technocratic character of regulatory agencies renders them insular and inward-looking. This could be a concern as pre-emptive powers may be exercised so as to affect transactional and market freedoms, and the wisdom of pre-emptive judgements may be questioned if such judgements are made in an insular manner. Harfield, commenting on the Serious Organised Crime Agency in the UK, has observed that agencies with intelligence capacity tend to be ‘shielded from public scrutiny’ and maintain an aura of remoteness. Insularity may be useful for sensitive decision-making, shielded from unnecessary interference, but could also result in mistakes that follow narrow-minded and linear paths of inquiry. The UK Serious Fraud Office’s mistakes in relation to investigations against Vincent Tchenguiz in light of the collapse of Icelandic bank Kaupthing in 2009 may have been due to insular mindsets and blinkered decisions made by its officers.

17.1 The accountability of UK and EU regulators

In the UK, the FCA is subject to input accountability and ex post accountability. Input accountability refers to the channels of participation maintained by the FCA for outside stakeholders in the form of consultation for policy proposals. Ex post accountability refers to the political accountability of regulators through reporting and engagement with the government and Parliament, as well as judicial scrutiny of regulatory decisions.

11 For example, the Serious Fraud Office’s mistakes relating to enforcement against Vincent Tchenguiz, see Kate Mackenzie, ‘SFO Admits Tchenguiz Case Errors’ (FT Alphaville, 23 February
In terms of input accountability, the FCA is required to maintain four panels of stakeholders: the Practitioner Panel, the Markets Practitioner Panel, the Small Business Practitioner Panel and the Consumer Panel. It was initially envisaged at the draft stages of the Financial Services Bill 2012 that the PRA may institute and consult panels as and when it is perceived to be necessary, and so there is no formalisation of external stakeholder relationships. This has given rise to criticism in the press regarding concerns over the PRA’s accountability in its important role of micro-prudential supervision. The PRA’s lack of formal commitment to stakeholder scrutiny reinforces the concerns surrounding insularity, which may be undesirable given that the PRA and the Bank of England are likely to dominate macro-prudential supervision and pre-emptive measures in micro-prudential regulation. The final Financial Services Act 2012 has now provided for the PRA to be subject to a duty to consult a Practitioner Panel and a duty to consider its representations.

On ex post accountability, the FCA will institute a formal complaints mechanism and will also be subject to the scrutiny of the Upper Tribunal if its decisions against regulated persons are referred to the Tribunal. The FCA may be subject to judicial review but the scope of review is highly limited given the extensive powers and discretion conferred by legislation. The PRA will similarly be subject to Tribunal scrutiny.

In terms of reporting accountability, the FCA has perhaps the most extensive accountability regime, inherited from the FSA, with channels of accountability to the Treasury, the Parliament, the aforementioned stakeholder panels and the general public through public reporting and annual public meetings. However, the PRA, under the umbrella of the Bank of England, is accountable only to the Court of Directors. Although the Bank of England is accountable to the Court of Directors, which is further scrutinised by an Oversight Committee, the PRA is not directly accountable to the Oversight Committee and its accountability.

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12 Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012), ss 1N–1Q.
14 Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012), ss 2M and 2N.
therefore lies primarily to the Bank, and to the Court of Directors that oversees the Bank. On the whole, the PRA is more remote from political and public accountability compared to the FCA’s exposure to input accountability and forms of public scrutiny. The difference in accountability regimes may suggest that more accountability is deemed necessary in the realms of consumer protection and transactional supervision (the FCA’s remit), but is seen as less relevant to the delivery of financial stability as a public good. This may, however, allow the micro-prudential and macro-prudential supervisors in the UK to become relatively more insular and perhaps elitist.

At the EU level, the three European authorities are also subject to input accountability as they are assisted by a 30-strong stakeholder group (appointed by the ESA Boards of Supervisors following nomination by the relevant stakeholders), which changes every three years. The stakeholder groups are modelled on the Market Participants Consultative Panels of the Lamfalussy Committees. The ESRB is also assisted by the 15-strong Advisory Technical Committee. The largest group of appointees to the European authorities’ stakeholder groups are industry and market representatives, followed by academics who are considered to be experts in their field. The Commission and the ESAs are required to consult the stakeholder groups on regulatory action in the framework of the ESAs’ Regulations. There are four stakeholder groups: the Banking Stakeholder Group, the Securities and Markets Stakeholder Group, the Insurance and Reinsurance Stakeholder Group and the Occupational Pensions Stakeholder Group.

The ESRB’s Advisory Technical Committee is also made up of experts. Where ex post accountability is concerned, the three authorities are subject to appeals to a Board of Appeals before which Member States or private legal persons may disagree with an authority’s decision. The Board is composed of independent representatives from the three authorities, Member State regulators and experts from the private sector. The Board must publish its decisions with reasons and its decisions may be appealed and referred to the European Court of Justice.

Where reporting accountability at the EU level is concerned, the three European authorities are accountable to the Commission and Council in their

19 EBA Regulation 2010, art 37; EIOPA Regulation 2010, art 37; ESMA Regulation 2010, art 37.
20 The Lamfalussy Committees, at the request of the European Parliament, incorporated within their structures the so-called Market Participants Consultative Panels (MPCPs), composed of stakeholders with interests in financial regulation, see Eilis Ferran, Building an EU Securities Market (Cambridge: Cambridge University Press 2004), 84.
21 ESRB Regulation 2010, art 12.
22 Following the requirements of EBA Regulation 2010, art 37.6, ESMA Regulation 2010, art 37.6 and EIOPA Regulation, art 37.7, the SGs have adopted their own rules of procedure by a majority of two thirds of their members.
23 EBA Regulation 2010, art 60; EIOPA Regulation 2010, art 60; ESMA Regulation 2010, art 60.
legislative standard setting activities, and accountable generally to the Parliament and to the Council. The ESRB is nested within the ECB, but it is subject to separate accountability to the Parliament and the Council and is required to present its annual report to both institutions. The Chair of the ESRB may also be called upon by Parliament and Council to attend annual hearings or ad hoc hearings held when situations of widespread financial distress occur in the EU. The accountability channels of the three European authorities and the ESRB are confined to the EU level and must certainly seem remote to the public. Again, it may be argued that the relative remoteness of the three European authorities and the ESRB protects the independence of technocratic judgement. Under the Single Supervisory Mechanism, the ECB will be subject to input accountability through the mechanism of the Bank Supervisory Board where national authorities are represented for decision-making purposes. It has been proposed, in order to overcome issues of democratic deficit and inadequacy of accountability, that the ECB be made more directly accountable to Member States by reporting to and appearing in national Parliaments if requested to do so. In terms of reporting accountability, the ECB is accountable to the Council and Parliament by way of an annual report.

The ECB will further be accountable to the European Parliament and the Parliament may set up committees of inquiry to scrutinise the work of the ECB if an issue of concern arises. The ECB’s supervisory decisions may also be scrutinised by the European Court of Justice if a third party whose rights are affected by the legality of the ECB’s acts challenges such acts in the Court. European administrative law also provides certain control or accountability mechanisms, including individual remedies in judicial review or tort actions. The duty of the ESAs to give reasons is one such accountability mechanism. EU law imposes on EU decision-makers a duty to give reasons for their actions. This duty is clearly stated in Article 296 TFEU: ‘Legal acts shall state the reasons on which they are based and shall refer to any proposals, initiatives, recommendations, requests or opinions required by the Treaties.’ Article 41.2 of the Charter of

27 EBA Regulation 2010, art 3; EIOPA Regulation 2010, art 3; ESMA Regulation 2010, art 3.
29 ESRB Regulation 2010, art 19.
31 Proposed ECB Regulation, recital 34a, art 17a.
32 Proposed ECB Regulation, recital 34(b).
33 Proposed ECB Regulation, recital 34(c).
34 Proposed ECB Regulation, art 15b.
Fundamental Rights of the EU includes further administrative law guarantees under the heading ‘Right to good administration’. In the ESA Regulations, the general EU administrative law duty to give reasons is applied to three main types of decisions: those addressed to Member State regulators or to individual financial institutions in instances of breaches of EU law, emergency situations or settlement of disagreements. The duty applies to decisions with binding effects. It does not apply to all decisions adopted by the ESAs as most are not binding. Under Articles 17, 18 and 19 of the ESA Regulations, the ESAs must explain the reasons for their action. This may facilitate appeals and judicial review.

The duty to give reasons is related to transparency and access to documents, which also may facilitate accountability. The 2001 Regulation on public access to documents of the Parliament, the Council and the Commission will apply. The duty to give reasons and to provide access to information goes further than in English administrative law and will also have an impact on the work of domestic regulators.

Judicial scrutiny of regulatory decisions will secure compliance with the principle of proportionality, which is the EU law test of review of administrative action and of legislation. This, too, is generally assumed to go further than in English law and will have an impact on the work of domestic regulators.

Next, we consider if there is accountability in the form of regulatory or supervisory liability to affected groups of the public. The limitations of deposit guarantee may cause uncompensated depositors to shift residual losses onto the public sector via liability claims against the State or the supervisory authority in case of bank failure. However, the ECJ in the Peter Paul case refused to find that national regulators should be subject to Francovich liability in prudential supervision. National law provides for different forms of statutory immunity (e.g. Italy, Germany and, in an extreme form, the UK), liability under more stringent conditions than usual (e.g. France, where faute lourde is gradually being replaced by the general criteria of public responsibility) and liability without special liability criteria such as gross negligence (e.g. at least until recently, the Netherlands). The law regarding liability towards regulated financial institutions themselves is even more divergent (see Chapter 7 on liability for credit rating agencies). The current transformations in EU banking law and financial market regulation may increase pressure for a reconsideration of national liability rules. As different liability regimes create different market conditions and different levels of consumer protection in the domestic market, a fundamental European debate seems overdue.

37 Case C-222/02 Peter Paul and others v Germany [2002] ECR I-9425.
The current institutionalisation raises new questions of liability for EU institutions and the reach of EU liability for national institutions involved in financial market regulation. The tendency for legislators, and for courts, is to limit tort law or administrative responsibility, as there is no desire to open up the floodgates of financial liability, the extent of which may be difficult to assess. On the other hand, the consequences for accountability of limiting court review and liability are also difficult to foretell, in particular for supervisory institutions with a high degree of independence as in the present case. In our view, general principles of EU tort law or administrative responsibility should apply to financial market regulators and the case for statutory restriction of such liability has not yet been made.

17.2 Addressing accountability deficits or weaknesses

We suggest that, generally speaking, financial regulators in the UK and EU are subject to comprehensive channels of ex post political accountability but judicial scrutiny and input accountability seem to be relatively weak.

One concern is that regulators in the UK and EU subscribe only to an insular form of input accountability. We query whether the stakeholders welcomed to provide input need be experts in finance and financial regulation and whether this means that wider stakeholder participation is non-existent or severely limited. If technocratic regulators consult expert stakeholders, will both groups be subject to similar frames of mind and groupthink? For example, the Bank of England’s biannual Systemic Risk Survey targets the industry’s compliance professionals and there seems to be a tendency to seek input only from recognised experts. It is arguably disconcerting – given the breadth of systemic risk and the potentially broad-based effects systemic risk in the financial sector may have on the general economy – that the stakeholder base for assisting regulators in their new pre-emptive regulatory approach seems to be industry-centred or narrowly confined to experts. As systemic risk consequences often result in real economy disruptions and cost, a wider constituency base may quite legitimately be interested in such pre-emptive policymaking. It is also noted that the EBA’s semi-annual risk outlooks have also been prepared on the basis on surveys of European banks. The engagement of technocratic regulators with expert stakeholders may form a closed network that could become rather insular and elitist. Although such

42 EBA, Report on Risks and Vulnerabilities of the European Banking System (July 2012) and (January 2013).
characteristics may protect or reinforce the independence of regulators’ decision-making, the expansion in regulatory powers to include pre-emptive judgements should perhaps be accompanied by more and wider forms of input accountability.

Further, Barth, Caprio and Levine caution that regulators should not become too familiar with the regulated, as this may result in capture or, to a lesser extent, a form of complacency or blindness to problems that need to be addressed in the industry.

We query whether the mechanisms of accountability in the UK and EU will reinforce the characterisation of financial regulation and regulators as technocratic, insular, remote and elitist. This problem applies even more so at the global level where international financial regulation, discussed in the subsequent chapter, is concerned. Some commentators argue for a range of stakeholders to be drawn into the regulatory space. As such, they may play the role of ‘gatekeepers’, providing intelligence to regulators, acting as whistleblowers and disciplining the industry. These ‘gatekeepers’ could be professionals involved in internal controls, audit and legal compliance and whose professional stature and expertise could be leveraged upon to supply a form of governance to check on industry behaviour. Omarova, for example, argues that regulators should constitute public interest councils represented by independent stakeholders who would provide advisory services to regulators and be accountable to Parliament. However, the representation of stakeholders also means that diverse interests may be able to ‘lobby’ policymakers. Policymakers and regulators need to be aware of the potential informational advantages that can be obtained through contact with stakeholders, bearing in mind stakeholder agendas. Barth, Caprio and Levine suggest that an independent Sentinel agency should be established to be accountable to Parliament and to periodically review the efficacy of financial regulation. However, it remains uncertain how the Sentinel would avoid the influence of lobbies that affect parliamentarians. We are of the view that the expanded powers of regulators need to be matched with increased accountability, particularly to the wider public. As regulatory powers have been expanded to further the public good of financial stability, financial regulation has moved closer to social needs. Much more thought needs to be given to the regulatory design of participation, accountability and inclusion in order to adopt more diverse forms of governance and responsibility. Scott suggests that different areas of regulation could evolve into ‘regulatory regimes’ represented by diverse groups of stakeholders, including

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public-led authorities, the market and public interest groups. Such regimes could provide a blueprint for designing the governance roles of various actors and the accountability of regulators, and may prevent regulatory capture by experts in the industry.\textsuperscript{49} In such regimes, perhaps the Occupy movement,\textsuperscript{50} which has been endorsed by Bank of England official Andy Haldane, could find a voice to provide input to regulators at the UK and EU levels.

We would also like to suggest that accountability for the UK FCA, PRA, FPC, the three European authorities, the ECB as the Single Supervisory Mechanism and the ESRB could be further improved by adopting a form of regulatory ‘stress testing’, accompanied by public reporting of the results. We suggest that regulators could stress-test their regulatory capacity against worst-case scenarios of multiple firm failures and other internal or external factors that may affect supervision and the quality of pre-emptive action. Regulators may also need to stress-test against the unintended consequences of the deployment of various pre-emptive regulatory tools, of a regulatory decision not to intervene as compared to an erroneous judgement, etc. Legislation could also provide for the regulatory agencies to carry out stress testing on a mandatory basis before the introduction of pre-emptive regulatory measures. We suggest that the adoption of a stress-testing methodology for self-review and reflection at regulatory agencies would be beneficial and would go beyond the cost/benefit analyses that are customarily appended to policy and rule-making proposals. Regulatory procedures could also be required to be audited periodically, beyond the current legislative power to review efficiency\textsuperscript{51} (in the use of resources), which applies to the PRA and FCA. Such audits may be especially necessary at the EU level, as there does not appear to be a mechanism for review of efficiency as applicable in the UK.

Finally, we argue that accountability mechanisms for regulators need especially to be strengthened in times of crisis management and resolution. Crisis resolution may entail significant fiscal cost, arbitrary decision-making in apportioning bail-in losses and severe economic consequences for a broad base of stakeholders without going through channels of broad-based input or reporting accountability. It may be argued that regulatory authorities need to act quickly and that avoiding undue delay is in itself a way of delivering the public good of financial stability.\textsuperscript{52} However, the nature of pre-emptive judgements made in a crisis is more critical


\textsuperscript{50} http://occupyeconomics.org, accessed 11 April 2013.

\textsuperscript{51} Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012, ss 1S, 2O.

in terms of their cost, their implications and their long-term consequences. The social discontent concerning the handling of the global financial crisis – in the form of Occupy protest movements\(^{53}\) and media reports\(^{54}\) on losses suffered by the taxpayer because of bailouts and the social fallout from the resolution of two Cypriot banks in early 2013 – revolve around the question of whether more robust forms of input and reporting accountability are necessary, even in times of crisis. We are of the view that the Commission’s Proposal for a Recovery and Resolution Directive does not provide the accountability required to accompany the commitment of Member States to \textit{ex ante} crisis resolution agreements, fiscal burden sharing, and \textit{ex post} bilateral arrangements. International and European developments are excessively focused on the achievement of credible coordination and commitment to crisis management and burden-sharing frameworks. But as financial crises result in social cost, the wider public needs to have a voice in the developments of these arrangements and frameworks. The accountability of national and EU authorities, as well as international organisations involved in this area,\(^{55}\) is highly undeveloped.

### 17.3 Concluding remarks

Policymakers in the UK and EU took the opportunity in the heat of the crisis to credibly endow themselves with increased powers.\(^{56}\) This may have been more difficult to achieve in the absence of a crisis. Hence, the post-crisis deliberations must balance the needs of financial stability as a public good provided by new and expanded regulatory powers with the needs of credible accountability. However, it may be argued that as far as international developments go, regulating for financial stability will only become more remote and elitist. The next chapter examines this further.

\(^{53}\) The Occupy London and Occupy Wall Street movements.


18 The international framework for financial regulation

18.1 Introduction

This chapter does not purport to deal comprehensively with the volume of international developments in financial regulation to date, as myriad literature can be found on this issue.\(^1\) In light of the challenges surrounding macro-prudential supervision at the national and EU levels, we intend to discuss the potential for international supervision and coordination given the international significance of certain financial institutions and the international dimension of monitoring systemic risk.

The international framework for financial regulation has arguably led to standard-setting, with the Basel Committee at the Bank for International Settlements (BIS) leading the global standards in micro-prudential regulation since 1988;\(^2\) the International Organisation for Securities Commissioners (IOSCO) leading standard-setting for cross-border offering of securities\(^3\) and credit rating agency disclosures, etc;\(^4\) and the Financial Action Task Force (FATF) setting international standards on money laundering.\(^5\) The International Monetary Fund (IMF) has played a key role in ensuring convergence of banking regulatory standards by implementing the Basel Core Principles\(^6\) in its Financial Sector Assessment Programme.\(^7\) The Programme assesses individual countries for compliance with the Core Principles, in particular countries receiving IMF

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\(^2\) www.bis.org/bcbs/about.htm accessed 10 April 2013.


financial assistance. Standard-setting at the international level may create a more level playing field and reduce regulatory arbitrage that exacerbates systemic risk. However, the setting of common standards does not mean that financial sector risks have been definitively reduced. International supervision is necessary to monitor the implementation of standards, any unintended consequences and changing practices in the international financial landscape. Supervisory coordination at the international level has however not achieved significant substantive development.

18.2 International supervisory coordination

For internationally active banks, the Basel Committee has encouraged consolidated and adequate supervision by home and host regulators since the Concordat of 1975, which has been revised several times since. However, actual home-host coordination is largely left to bilateral arrangements on information exchange and supervision. Although a multilateral framework for home country control exists in the EU flanked by supporting host country supervision, the effectiveness of the framework has been questioned in the wake of the global financial crisis. Legislative amendments were introduced in 2009 to boost host country supervision for significant bank branches. Home country control is also the dominant framework in EU securities and investment firm supervision. The limitations of home country control have, however, been exposed in supervising

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international financial groups and meeting specific host country needs where cross-border entities operate. In this section, we will highlight the issues of international supervisory coordination and crisis resolution as being the most current and pertinent discussions in international financial regulation.

International supervisory coordination is intended to close any gaps in the patchwork of national supervision that may be taken advantage of by financial firms that have cross-border operations. Whether in international banking – the best practices for which were laid down in the Concordats of 1975 and 1983, and supplemented in 1992 and 1996 – or in the home country control frameworks adopted in the EU as mentioned above, supervisory coordination has largely depended on voluntary information exchange and engagement between national regulators. Lomnicka notes\(^\text{15}\) that, in relation to the EU, the partnership of home-host regulators in cross-border supervision may not adequately deal with two problems. The first is the home country’s slowness to address problems not on its shores and the second is the host country’s concern to impose its own regulatory regime so that it may maintain control over the protection of its own constituents. In the EU, host authorities’ concerns have found their way into legislation, allowing host countries to impose reporting duties,\(^\text{16}\) restrictions for ‘general good’ purposes,\(^\text{17}\) and intrusive supervisory measures for ‘significant branches’\(^\text{18}\) and ‘precautionary’ situations.\(^\text{19}\)

At the international level, some home country regulators have not provided adequate cross-border supervision, as in the case of the failure of Luxembourg-based international bank BCCI in 1990, while others have applied extra-territorial powers with perhaps excessive zeal, such as the US. Piccioto and Haines\(^\text{20}\) are of the view that:

> It is hard to avoid the conclusion that these ramshackle co-operation arrangements are far from adequate to maintain oversight over financial markets which, even if they remain substantially local in their roots, are globally interlinked by the ability of a substantial number of financial agents to engage in many types of transactions in and across all markets.


\(^{16}\) Capital Requirements Directive 2006, art 29; CRD IV Directive, art 40; Markets in Financial Instruments Directive, art 61, for example.

\(^{17}\) Capital Requirements Directive 2006, art 31, CRD IV Directive, art 44.


\(^{19}\) Capital Requirements Directive 2006, art 30; CRD IV Directive, art 43; Markets in Financial Instruments Directive, art 62, for example.

Brummer argues that, in the case of the US, international supervisory coordination has been used as a platform for states to exercise extra-territorial powers, particularly where US supervision of securities matters and market abuse are concerned. The dynamics of supervisory coordination, left largely free to evolve through bilateral relations, may be highly unpredictable.

18.3 Post-crisis initiatives in international financial regulation and supervision

Post-crisis, the Basel Committee and the Financial Stability Board (FSB) have led the way in recommending how international supervisory coordination should improve. They are in favour of instituting supervisory colleges. The FSF Working Group on Market and Institutional Resilience (FSF WG) has now identified the large banking groups in need of effective international supervision and instituted supervisory colleges for them. The Basel Committee guidelines also propose to formalise the loose home-host supervisory arrangements concerning cross-border entities, by instituting home country leadership and encouraging best practices for the structure and division of responsibilities in colleges. Colleges are also expected to adopt operational guidelines for information exchange such as documenting minutes of meetings, ensuring a common approach to information sharing and implementation of agreed outcomes, and maintaining a detailed checklist of risks to monitor. Colleges also need to agree on the implementation of stress-testing models, and engage in the sharing of findings upon the conduct of stress testing. Colleges are also responsible for jointly meeting the banking group that they are responsible for overseeing. Colleges are in general encouraged to bring the spirit of macro-prudential supervision to the table and to engage in joint crisis management where necessary. In relation to global SIFIs, the Financial Stability Board proposes that Crisis Management Groups be established for each SIFI so that a group of specified regulators would be able to engage with each SIFI regarding recovery plans and cross-border resolution possibilities and issues.

The Basel Committee and FSB recommend that regulators adopt a set of best practices including regulatory convergence in national crisis resolution regimes and contingency recovery plans, and cooperation with each other in information

exchange, planning for orderly resolution and burden sharing.\textsuperscript{25} The Financial Stability Board’s Principles in particular specify the types of information that should be shared, such as recovery plans prepared by firms, firms’ stress-testing results and risk profiles, and information regarding linkages and connections for each systemically important firm. The Board also recommends the development of common databases and regular annual meetings for colleges. Further, national resolution authorities should refrain from unilateral actions without consultation and should attempt to achieve coordinated understandings without jeopardising the needs of resolution.\textsuperscript{26} Van Meerten and Ottow\textsuperscript{27} argue that supervisory colleges should perhaps be directly responsible for the exercise of supervisory or enforcement powers, and this could perhaps make international supervision more institutionalised and effective. However, this may mean that national powers of supervision would have to be exercised through the college where internationally significant financial institutions are concerned. Would this unduly fetter national discretion and can colleges be sufficiently responsive to urgent needs? On the other hand, this could mean that the responsibility for providing the public good of financial stability in globally linked markets will be instituted at a suitably global level,\textsuperscript{28} and this could be superior to relying on the goodwill of cross-border coordination. But the idea of moving supervisory powers upwards to be exercised by an entity beyond the state level could give rise to questions of accountability and democratic deficit.

One school of thought is of the view that the potential for effective international supervision and crisis resolution would be realised if international institutions were more directly responsible and able to exercise powers over financial institutions that have international operations. This school of thought perceives the reason for the hitherto lacklustre performance of international coordination as due to the loose bilateral frameworks in international supervision. Even with the new supervisory colleges, international supervision is still carried out via networks, albeit with slightly enhanced formalities and clearer mandates. Could it be argued that international frameworks are not likely to be effective, unless they are formally instituted and endowed with distinct personalities, mandates and powers? If so, do we need new financial authorities or should we make existing international organisations more integrated and robust?


18.4 Global supervisory institutions

A number of commentators call for greater cohesiveness between existing international bodies such as the IMF, Basel Committee, FSB (both part of the BIS), IOSCO and the World Bank, to combine their expertise in surveillance and to formalise a form of macro-prudential supervision at the international level. Davies 29 argues that since a good number of international organisations have surveillance programmes and capacity, there is potential for them to join up their platforms and engage in high-level international macro-prudential surveillance. Arner and Buckley 30 also argue that as macro-prudential risk monitoring is highly connected to international financial and trade liberalisation, international organisations are well-placed to monitor the broader issues of trade, economic development and overall financial stability. Hence, perhaps the OECD and the WTO 31 should form part of the international framework for developing a cohesive view of international capital flows, economic development, macro-prudential supervision and financial stability.

However, Shigehara and Atkinson have pointed out the weaknesses in international organisation surveillance: analyses tend not to be well-integrated with the domestic economic specifics of individual countries and distinct conclusions that could amount to warning signals are rarely provided. 32 A number of commentators are of the view that what international organisations can do collectively in collaboration is limited. Brummer 33 is of the view that it is not easy to achieve a coherent global division of labour among a diversity of international organisations and that international organisations are in any case unlikely to be able to do more than produce enabling pieces of soft law such as they are currently doing. Further, Giovanoli 34 also opines that international organisations have well-entrenched mandates and operational structures and are only likely to work as loose confederations. Hence, the issues experienced with international coordination among national regulators will not be different where international organisations working together are concerned. Porter 35 has, however, argued that there

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is encouraging leadership from the BIS, in terms of the Basel Committee and the FSB, and hence there could be a coherent coordinated approach among international organisations with the BIS acting as a nucleus.

Some commentators prefer the establishment of a totally new global authority to respond to contemporary financial stability needs. They call for either the establishment of an international financial authority with specific mandates, such as crisis resolution, or the creation of a new mandate for an existing body, such as the IMF, as a centralised international financial regulator. The rationale for centralising some form of financial regulatory authority at the international level is largely based on the inability of states to deal with some international financial institutions whose scale of operations and risk may outstrip the regulatory capacity and resources of any one state. As early as 2001, Eatwell and Taylor recommended a World Financial Authority to undertake authorisation of internationally active financial institutions, to supervise them and exercise direct enforcement powers. However, such a strong form of centralisation is opposed by commentators who argue that it may introduce excessive technocratic uniformity in financial regulation, amplifying errors and suboptimal approaches. Further, such centralisation may also be dominated by the hegemony of countries that enjoy dominance in financial regulatory development. Avgouleas proposes a four-tier system where micro-prudential standard setting is internationally centralised by the Basel Committee, macro-prudential supervision is centralised at a global level, and two further distinct mandates are created for an international financial policymaking body and a crisis-resolution body. Such a system supports a great degree of centralisation but allows international responsibility to be managed by four discrete agencies. This may appeal to commentators who are concerned about the concentration of power in one internationally constituted but unelected body.

Other commentators propose less comprehensive forms of centralisation, pointing out that only key areas that will truly benefit from centralisation, such as crisis resolution and macro-prudential supervision, should be managed at the international level. Such an approach may be able to strike the balance between the need to ensure financial stability as an international public good, while

minimising the transfer of powers away from democratically elected governments to unelected and remote technocratic bodies at the international level.

Pan is of the view that an international financial agency with international surveillance powers should be formed and should have technical expertise and sufficient resources to serve the purposes of international supervision and crisis resolution of internationally significant financial institutions. Ocampo is also of the view that an international outfit focused on international supervision and crisis resolution would be superior to ad hoc decision-making led by the political leaders of the G-20 or G-30 and would have a permanent capacity to respond to supervisory issues. Such an outfit could also potentially house an international debt or bankruptcy court, as sovereign debt issues may affect financial stability significantly. Avgouleas is of the view that a world financial authority could have limited jurisdiction over internationally important financial institutions alone and thus need not disturb the fabric of national regulation and supervision of institutions that do not have the same impact. On a more limited scale, Lastra and Garicano and Eichengreen support the resolution of internationally important financial institutions at a centralised and international level. Eichengreen, in particular, supports a global system to address systemically important failures, sovereign bankruptcy and emergency liquidity assistance as international crisis resolution, if left uncoordinated, could result in states scrambling for the remains of a failed financial institution in order to satisfy liabilities to its constituents, resulting in disorderly resolution, beggaring thy neighbour actions and perhaps prolonged disruption to financial markets overall. However, can there be an internationally centralised crisis management system without antecedent macro- or micro-prudential supervision? Will the centralisation of authority at an international level result in future mission creep in more and more areas?

18.5 Conclusion

In reality, the post-crisis changes made to international financial regulation architecture are modest. The Financial Stability Board has taken the lead with responsibility for global standards of financial stability and is working with the

46 See the discussion in Chapter 2 on the action taken by Iceland and the UK in the wake of the Icelandic banking failure.
Basel Committee on micro-prudential and macro-prudential supervision. However, the Board’s current stance seems to be that of recommending frameworks and best practices. It is not in a position to assume a form of macro-prudential supervision at a global level and does not have a mandate to coordinate international crisis resolution as such. On the one hand, there seems to be a need for robust international financial regulation that goes beyond soft law standard-setting and networked coordination. On the other hand, the empowering and centralisation of international financial regulation may be resisted as being remote, elitist and lacking in accountability.

There is a role for global initiatives to deal with public goods at a high level (climate change, poverty, conflict, international crime and money laundering) and, post-crisis, a call for emphasis to be placed on financial stability. However, where public goods become global public goods, their provision may be subject to policymaking in international organisations whose accountability may be relatively weak and whose operations remain remote and opaque. These cautions have been voiced by Kaul and others who argue that the characterisation of global public goods should be undertaken with scrutiny and caution. Further, they suggest that developments in the provision of global public goods should take into account the need for adequate representation of the diverse public so that global public goods do not become elitist, removed from national or local needs and hijacked by the interpretations of the internationally powerful states or epistemic communities. The global provision of public goods, such as financial stability, continues to be fraught with problems of representation, coordination, distribution and equity. It remains to be seen whether the characterisation of financial stability as a global public good and the developments in enhanced international coordination led by the FSB will strike the right balance between centralisation and decentralisation, or will evolve towards a new international financial regulatory architecture in due course.


48 For example, the centralised standard-setting and surveillance carried out by the World Health Organisation for global health issues has been much affirmed. See Jennifer Prah Ruger, ‘Global Functions at the World Health Organisation’ (2005) 330 British Medical Journal 1099.

The rise of financial stability as a public good has led to a resurgence in regulatory power in financial markets. Financial stability has always been recognised as one of the objectives in financial regulation. Cranston identifies the maintenance of ‘systemic stability’ as a public good that ‘financial regulation’ can provide. Individual firms will not take collective action to protect the financial system as a whole and thus generate a classic market failure that the state is ultimately called upon to correct.

As Kaul and others argue, ‘Public goods theory often lags behind rapidly evolving political and economic realities’. In financial regulation, there is an additional reason for this: the academic community was overwhelmingly pro-industry and facilitative of market-based governance in the pre-crisis years.

In this book, we have provided a critical account of the key reforms in financial regulation which further the objective of financial stability and we have questioned whether financial regulation has fundamentally changed in nature.

The resurgence in regulatory power has to contend with the reality that regulators are far from being the only suppliers of governance in financial regulation. Kaul and others argue that modern public goods such as financial stability

3. Paul A Samuelson, ‘The Pure Theory of Public Expenditure’ (1954) 36 Review of Economics and Statistics 387. The correction of market failure brings with it the concomitant risk of moral hazard. In economic literature, the lesson of moral hazard has been described with the words ‘less is more’. Professor Stiglitz states: ‘[T]he more and better insurance that is provided against some contingency, the less incentive individuals have to avoid the insured event, because the less they bear the full consequences of their actions’, see Joseph E Stiglitz, ‘Risk, Incentives and Insurance: The Pure Theory of Moral Hazard’ (1983) 8 The Geneva Papers on Risk and Insurance 4, 6.
5. Helmut Wilke, Governance in a Disenchanted World (Cheltenham: Edward Elgar 2009) argues that it is not possible for states to do so.
arise from the complexities and interconnections caused by liberalisation and the expansion of private transactional freedoms. Hence, financial stability is a ‘framework’-type public good which is enjoyed by all in order to further private aspirations and utility. The intrinsic transactional nature of financial sector activity means that the regulatory space is replete with diverse actors. Kaul and others point out that these diverse actors, including regulators, are all responsible for the production and consumption of the same public goods. Hence, the role of the state as an exclusive producer is outdated; the state’s role is more that of a ‘public visible hand’. The authors view the development of post-crisis financial regulation in the EU and UK as very much an extension of a new ‘public visible hand’. However, the rise of this ‘public visible hand’ is countered by the dispersion of responsibility for governance in the new landscape. The regulated industry, which led the way in delegated and self-governance in the pre-crisis years, has been criticised for catering excessively to self-interest and supplying minimal or weak forms of governance.

Post-crisis, the industry remains an important actor in governance in financial regulation. Indeed, its leadership and authority in governance, stemming from its superior knowledge and lobbying power, is unlikely to be easily replaced. This seems to confirm Meyer and Drori’s theory that governance will be dominated by knowledge-based, epistemic actors, most often collectively organised in rational forms. The post-crisis reforms show that regulators are strategically pitting other sophisticated participants and gatekeepers against the industry to encourage the emergence of more responsible forms of governance.

The quality of governance emanating from these ‘alternative experts’ (institutional shareholders, auditors and even credit rating agencies) remains to be seen. It may be argued that these ‘other experts’ are in the same industry and of the same mould and therefore unlikely to challenge industry practices. Further,
Cowton\textsuperscript{10} and Coffee\textsuperscript{11} warn of the perverse self-interested motivations driving various experts. Hence, the quality of their governance may need to be monitored too.

In this book, the authors also note the concentration of governance in the hands of select groups and sound a warning against the development of elitism in financial regulation. One should not forget the strong post-crisis social criticism (e.g. the Occupy movements). McCormick\textsuperscript{12} also argues that the engagement of wider civil society may be crucial to changing the weak ethical culture in banks and financial institutions. Social action that is based on values, justice and sentiment is not in any way less legitimate or valid than the epistemic or knowledge-based rationales supporting contemporary governance, as described by Meyer and Drori.\textsuperscript{13}

In an age where the internet is able to bring together diverse voices and provide platforms that defy hierarchical structures and limitations on access to epistemic communities, new avenues can be explored to empower non-knowledge-based stakeholders. Blogs and wikis can bring together disparate individuals, and Wu\textsuperscript{14} has argued that collective action (such as disaster relief action) could be organised through blog participation and volunteer leadership. Further, many individuals are driven by honesty and genuine concern in the face of important social issues, so the galvanising of social voices via blogs and wikis has a lot of potential, despite some setbacks (e.g. the role of Facebook in fuelling the London riots of summer 2011). Further, McCormick also argues that there are many non-epistemic communities that have a voice and ought to be engaged with as a matter of wider governance: civil society groups, such as non-governmental organisations, the media, women’s groups, faith-based organisations, think-tanks, business development organisations and academic institutions.\textsuperscript{15} In this respect, Kaul and others are of the view that as global public goods affect many, the many should be systemically enrolled in the production process.\textsuperscript{16}

\begin{thebibliography}{99}

\bibitem{10} Christopher J Cowton, ‘Governing the Corporate Citizen: Reflections on the Role of Professionals’ in Jesús Conill, Christoph Luetge and Tatjana Schönwälder-Kuntze (eds), \textit{Corporate Citizenship, Contractarianism and Ethical Theory} (Surrey: Ashgate 2008).


\end{thebibliography}
broader social dimension may perpetuate a form of elitism in governance, which could affect the substantive purposes of financial regulation. Governance capacity is now diffused among more actors (e.g. investors, custodians, gatekeepers, such as auditors, and the mighty financial industry itself).\textsuperscript{17} The diffusion is arguably well-known but the definition of governance capacity depends on empirical observation of the incentives driving these actors and discussion of how regulatory design may influence their incentives.\textsuperscript{18} There seems, however, to be a certain reluctance to move towards wider stakeholder participation in the policy development of financial regulation; this is a weak feature of post-crisis reforms.

This book also argues that the rhetoric surrounding the ‘public visible hand’ of regulatory resurgence is perhaps stronger than the actual achievements of the new substantive reforms. Chapters 6 and 7 point out that although the EU has ushered in sweeping reforms to subject hitherto unregulated sectors (such as credit rating agencies and alternative investment fund management) to regulation, these regimes have focused largely on well-trodden investor protection issues rather than dealing more closely with systemic risk. Chapters 12 and 13 also show the challenges and dilemmas in regulating for institutional soundness and safety using a mixture of prescriptive and meta-regulatory measures that are dependent on firm implementation.

It may be argued that the change in the tenor of regulatory supervision to one of pre-emption and judgement-based supervision allows regulators to take more discretionary action based on public interest objectives. For example, Chapter 11 has discussed structural reforms as being a highlight of pre-emptive and public interest-based regulation in order to mitigate the catastrophic social consequences of SIFI failure. Part 4 also shows that regulatory resurgence in the rise of macro-prudential supervision empowers central banks to utilise a wider and more pre-emptive suite of regulatory tools to safeguard financial stability. However, pre-emptive judgements in this area are not free of mistakes and not necessarily free of possible negotiation with the regulated in the supervisory process.

The post-crisis landscape shows that responsibility for governing the financial sector and managing its risks – which have far-reaching effects upon the real economy – remains diffuse. Regulators have reinvigorated the public good narrative of financial stability but many substantive law reforms continue down well-trodden paths and truly revolutionary reforms (such as structural separation) are still works in progress.

\textsuperscript{17} Helmut Wilke, \textit{Governance in a Disenchanted World} (Cheltenham: Edward Elgar 2009) argues that this is ideal given the nature of the financial sector as a sophisticated and complex knowledge-based system.

\textsuperscript{18} Dino Falaschetti and Michael J Orlando, \textit{Money, Financial Intermediation and Governance} (Cheltenham: Edward Elgar 2008), arguing that understanding incentives in regulatory design is of paramount importance. Smith and Walter however warn that private commercial interests generally go against the incentives required to achieve sound forms of ‘governance’ and discipline, see generally, Roy C Smith and Ingo Walter, \textit{Governing the Modern Corporation} (Oxford: Oxford University Press 2006), 19; Ulrich Beck, \textit{World At Risk} (Ciaran Cronin tr, Cambridge: Polity Press 2009).
Beck predicts that in a world of ‘organised irresponsibility’, a transnational cosmopolitan movement will arise to challenge private spheres of responsibility to become more cognisant of and accountable to social demands. However, in the post-crisis era, the rupture of such ‘organised irresponsibility’ has not taken place. The financial sector continues to operate at a sophisticated distance from the social platform. This may be due to the stronghold on power that the industry has maintained over governanceor it may be due to the inherent ‘ungovernability’ of such a sophisticated and complex sector (i.e. the sector is not easily penetrable unless equipped with the relevant expertise). The regulators’ increased partnering in governance with other sophisticated parties in the financial sector (such as institutional investors or custodians) is likely to perpetuate an elitist circle of participation. Moreover, this limited circle could affect the way ‘financial stability’ is understood and managed. There is likely to be continued exclusion of the social sphere from governance, which is not ideal. Any social discontent outside of the relatively impervious financial sector system is a symptom of the artificial closing of systemic boundaries of participation. Such boundaries may be forced open in due course when confronted with normative arguments.

Responsibility for the future of financial regulation is a contested space featuring the interests of different stakeholders. As the rise in the importance of the objective of financial stability has refashioned the ‘public visible hand’ in finance, the opportunity for ‘financial stability’ to be conceptually developed to factor in social needs should also not be wasted. The regulator’s ultimate responsibility should be to restore social utility, accountability and credibility in the global financial system.

19 Beck has also more recently claimed that the euro crisis has precipitated a transformation of European governance: ‘Thus the threat to the euro has uncovered a novel, autonomous source of legitimation of a form of political action that aims at the political transformation of society and politics as found hitherto in the nation state. The conflict between supporters of nation-state orthodoxy, who wish to keep politics within the existing rules, and the Europe builders, who advocate rule changes, is fed by the clash between actions that are “illegitimate but legal” and those that are “illegal but legitimate” and whose legitimacy is derived from the urgent need to ward off imminent dangers. This emergency politics is illegal to the extent to which it undermines existing nation-state democracy. The impending catastrophe empowers and even forces the Europe builders to exploit legal loopholes so as to open the door to changes that are in fact ruled out by national constitutions or European treaties.’ Ulrich Beck, ‘Europe at risk: the cosmopolitan turn’ (‘Debating Europe’ conference, European University Institute, Florence, 31 October 2012), presenting the analysis in Ulrich Beck, ‘The Cosmopolitan Perspective: Sociology of the Second Age of Modernity’ (2000) 51 British Journal of Sociology 79.


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