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Teil II: Finanzmarktrecht

Banking Regulation and Financial Stability

Kern Alexander

I. Introduction

It is no exaggeration to say that any scholar who comes into contact with Swiss business, corporate, and capital markets law almost invariably will encounter a concept originally created by Professor Hans Caspar von der Crone. The name Hans Caspar von der Crone could legitimately be seen as a household name[1] in Swiss legal circles, and commands at least equal amounts of respect as those of other renowned names in Swiss business law, such as Arthur-Meier-Hayoz, Peter Forstmoser, and Peter Böckli.

Professor von der Crone's outstanding reputation as a scholar in Swiss corporate and financial law is supplemented by his experience as a regulatory policymaker and corporate board member: He was the president of the Swiss Takeover Board from 1999-2005

and currently serves as a board member of Komax Holding AG as well as Heineken Beverages Switzerland AG (the Swiss subsidiary of the Heineken group).

Professor von der Crone's research has covered a wide area in corporate law and financial regulation: He has written about fundamental questions regarding capital raising via crowdfunding, the law governing private placements, and over-the counter trading (OTC) of securities in private companies[2], executive compensation[3] as well as a number of legal issues during mergers and acquisitions.[4]

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1 See Lukas Hässig, Juristen auf der Bühne, Handelszeitung of 19 May 2011, in reference to the law firm of Hans Caspar von der Crone.

2 Hans Caspar von der Crone/Kaspar Projer, Privatplatzierung, Crowdfunding, OTC-Handel: Eine rechtliche Analyse alternativer Wege, in: Gericke (ed.), Private Equity V: Fundraising, Investition, Realisation, Reinvestition – Aktuelle Entwicklungen und Herausforderungen im Ökosystem Private Equity, Zürich 2016.

3 Among other papers: Hans Caspar von der Crone/Valentin Jentsch, Aktuelle Entwicklungen in der Vergütungslandschaft des Finanzplatzes Schweiz: Vergütungen, Marktversagen und Regulierung, SZW 84 (2012), 377 ff.; Hans Caspar von der Crone/Daniel Brugger, Salärgovernance, SZW 86 (2014), 241 ff.

4 Hans Caspar von der Crone/Matthias Nänni/Eric Sibbern, Bankaufsichtsrechtliche und vertragsrechtliche Aspekte von IPOs, in: Emmenegger (ed.), Bankhaftungsrecht, Schweizerische Bankrechtstagung 2006, Basel 2006, 141 ff.

In fact, anyone attempting to understand the underlying structure of Swiss capital market regulation, both in an international context as well as within the Swiss system, will almost invariably consult one of Professor von der Crone's books on this topic.[5] Concepts and ideas that are only now appearing in economic, legal, and finance literature (partially as a result of the great recession and crisis of 2007/2008), such as questions of efficiency within capital market regulation[6], transparency within markets as a core competency of regulators and a benchmark for their credibility[7], the emergence of institutional activist investors[8], as well as the concept of a single supervisory framework in Switzerland with the creation of the Swiss Financial Market Authority (FINMA) in 2009.[9] These developments were foreseen by Professor von der Crone long before their emergence as essential elements in discussions regarding the reform of Swiss financial regulation.

Professor von der Crone has actively influenced current regulatory policy regarding systemic risk and crisis aversion in regards to systemically important financial institu-

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tions. Professor von der Crone was a member of the «too big to fail»-commission of experts established by the Federal Council of Switzerland to examine the question of limiting the economic risks posed by large companies.[10] Following the commission's final report («TBTF Report»), he has continued to influence the debate on banking regulation and bank corporate governance by publishing articles and commentaries on these issues.[11]

In these publications, Professor von der Crone discusses not only those measures implemented by the regulator (in part as a consequence of the TBTF Report), but also discusses alternative ideas and solutions, such as the taxation of financial institutions[12] and insurance schemes[13] for banks. Professor von der Crone also extensively discusses capital adequacy requirements for banks. He warns that capital requirements are always a balance between the stability and security of the financial institution and the higher cost of capital that an institution may be forced to cincture as a result of stricter requirements. The objective should be an optimal balance between risk and opportunity and reward.[14] He also addressed the issue of contingent convertible bonds («Cocos») as an important instrument that potentially imposes losses on bank creditors thereby making state intervention and bailouts unnecessary. In essence, these bonds are equivalent to an additional layer of subordinated debt.[15] Also, the market in Cocos could act as an indicator of riskiness for the regulator, as the price fluctuations of these bonds could be

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5 Such as Hans Caspar von der Crone, Aktienrecht, Bern 2014.

6 Hans Caspar von der Crone, Ein Aktienrecht für das 21. Jahrhundert, SZW 70 (1998), 157 ff. NZZ of 20 June 1998, 18.

7 Von der Crone (Fn. 6), 19

8 Von der Crone (Fn. 6), 20

9 Von der Crone (Fn. 6), 19; Professor von der Crone's idea was eventually realised through the creation of the Swiss Financial Market Authority (FINMA) through the merger of the EBK, BPV, and Kst GWG in 2009.

10 Final report of the Commission of Experts for limiting the economic risks posed by large companies, 30 September 2010, available at: <https://www.google.ch/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0ahUKEwimq4XiqvrMAhVLPRQKHRpyCi0QFggnMAA&url=https%3A%2F%2Fwww.sif.admin.ch%2Fdam%2Fsif%2Fen%2Fdokumente%2FTBTF%2F101004-SB-TBTF-EN-FINAL.pdf.download.pdf%2F101004-SB-TBTF-EN-FINAL.pdf&usg=AFQjCNFgCQ-XZijOK3Np7kIjfMfnEEJs3A&cad=rja> (accessed 26 May 2016), 3, 63.

11 See von der Crone/Rochet (eds.), Finanzstabilität: Status und Perspekiven, Zürich 2014; Hans Caspar von der Crone/Lukas Beeler, Regelung Systemrelevanter Banken aus wirtschaftsrechtlicher Sicht - Lösungsansätze zur Too-big-to-fail-Problematik in der Schweiz, ZSR 130 (2011) (zit. Regelung), 177 ff.; Hans Caspar von der Crone/Lukas Beeler, Die Regulierung von systemrelevanten Finanzinstituten nach schweizerischem Recht, ZBB 1 (2012) (zit. Regulierung), 12 ff.

12 Von der Crone/Beeler, Regulierung (Fn. 11), 10; von der Crone/Beeler, Regelung (Fn. 11), 16 – von der Crone very correctly writes however, that a taxation as compensation for past or future costs to society (usually in the form of some kind of bail-out) would formalize (the now only implicit) guarantee of a state aided bail-out, leading to a moral hazard of an even more problematic kind than currently already exists.

13 Von der Crone/Beeler, Regelung (Fn. 11), 16 – von der Crone discusses these concepts, but he is concerned that both taxation and insurance schemes might create the wrong incentives and reduce liquidity in the markets.

14 Von der Crone/Beeler, Regelung (Fn. 11), 16.

15 Von der Crone/Beeler, Regelung (Fn. 11), 25, stating «[Es wird] innerhalb des Fremdakpitals eine Rangordnung geschaffen.»

signals of a looming financial crisis.[16] He has also made the interesting observation from a Swiss law perspective that Cocos might actually enhance the constitutional principle of economic freedom by reducing the likelihood of regulatory intervention in a crisis. Cocos are to be encouraged as they are a form of market discipline that limit the scope of potential intervention into the functioning of the market by regulatory and official sector bodies.[17]

Generally, Professor von der Crone strongly advocates limiting official intervention whenever possible and is suspicious of much regulatory intervention. Starting from a basic analysis of the principle of economic freedom, a pillar of the Swiss legal system and explicitly guaranteed in article 27 of the Swiss constitution, the case is made for a balance between risk and utility, security and efficiency, public intervention and self-correction. This balance is apparent in the Swiss constitution, where article 27 guarantees economic freedom on the one hand, but article 98 explicitly allows and requires the Swiss Confederation to legislate in the areas of banking and stock exchange regulation. The necessity of this balance of interests is strongly intertwined with the principle of subsidiarity, an essential element of Swiss legal doctrine. Professor von der Crone is a strong advocate of this principle and for him any discussion of regulation must be analysed under this aspect to avoid overregulation and preserve basic constitutional principles.[18]

Moreover, Professor von der Crone strongly criticizes the (Swiss) regulator's concept of what he calls «constructive ambiguity»[19], which represents the idea of intentionally remaining vague to increase one's flexibility and number of options.[20] This is especially problematic in light of the fact that the regulator's own reputation and that of the financial market being regulated is tied directly to this uncertainty. He illustrates this with the example of the failure of Lehman Brothers by stating that the reputation of the regulator likely would have been severely damaged by another collapse after Lehman

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Brothers.[21] He would stand behind the proposition that he who regulates, must also provide a guarantee.[22]

This chapter is inspired by this fascinating body of work that Professor von der Crone has produced over the years. It is therefore only fitting to provide an international and comparative context to the concepts and themes he has developed in the area of banking regulation and to discuss in particular the changing philosophy of prudential banking regulation and how it has evolved to address macroprudential risks in the banking sector and the broader financial system. In doing so, this chapter will discuss the evolving nature of banking regulation and the necessity for law and regulation to keep pace with financial innovation and evolving market structures.

II. From Micro-prudential to Macro-prudential Regulation

International regulatory reforms emphasise macroprudential principles and objectives for banking regulation and supervision and encourages countries to develop the concept of microprudential regulation to include a macroprudential framework of regulation and supervision that aims to control systemic risk. In considering macroprudential reforms, the following sections consider how the evolving structure of banking and credit provision in the United Kingdom and other advanced market economies has necessitated macroprudential regulatory reforms. Following the banking crisis, the UK adopted the Financial Services Act 2012 that created a macroprudential supervisor – the Financial Policy Committee – located in the Bank of England (the UK central bank). The FPC has explicit responsibility to monitor financial stability risks and to coordinate microprudential regulatory practices of the two microprudential regulators – the Prudential Regulation Authority and the Financial Conduct Authority. It is argued that although UK regulatory reforms have taken important steps in coordinating macroprudential regulation and policy with microprudential regulation,

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16 Von der Crone/Beeler, Regulierung (Fn. 11), 19.

17 Von der Crone/Beeler, Regelung (Fn. 11), 26.

18 The complete discussion can be found here: von der Crone/Beeler, Regelung (Fn. 11), 7-9.

19 Hans Caspar von der Crone/Isabelle Monferrini, Kapital und Notfallplanung – Standortbestimmung zur Regulierung systemrelevanter Finanzinstitute, SZW 84 (2012), 494 ff., 498.

20 Von der Crone/Monferrini (Fn. 19), 499; Hans Caspar von der Crone/Simon Bühler, Aktuelle Entwicklungen im Bereich der Finanzstabilität, in: von der Crone/Rochet (eds.), Finanzstabilität: Status und Perspekiven, Zürich 2014, 43. As an example, without explicitly guaranteeing a bail-out and not regulating the process, the regulator can avoid target-specific speculation on a state financed bail-out. Of course, the flip side of this coin is that the trust in the stability of the financial system is eroded and a substantial amount of (regulatory and financial) uncertainty is created.

21 Von der Crone/Monferrini (Fn. 19), 498, 500.

22 Von der Crone/Monferrini (Fn. 19), 501.

challenges remain in monitoring systemic risks across the financial system and in addressing risks posed by the shadow banking system.

III. Financial Stability and Banking

Monetary and financial stability are important governmental objectives.[23] Crockett defines financial stability as the «absence of stresses that have the potential to cause measurable economic harm beyond a strictly limited group of customers and counterparties.» Lastra sees financial stability as an evolving concept, the achievement of

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which encompasses a variety of elements that are typically the subject of oversight by the supervisory authorities.[24] Padoa-Schioppa defines financial stability as «a condition in which the financial system would be able to withstand shocks, without giving way to cumulative processes, which impair the allocation of savings to investment opportunities and the processing of payments in the economy.»[25] Defining financial stability is difficult as it encompasses several disparate elements. Financial stability is however easy to identify by the absence of financial instability and is sometimes defined as the absence of financial instability.[26]

Financial stability and stable banks are interrelated concepts with both impacting equally on the stability of the other. The presence of financial stability enhances the process of intermediation and the efficient allocation of resources, while the presence of unsound banks in an economy threatens financial stability. It is however ironic that long periods of financial stability often induce greater risk taking by banks. Banks all over the world, especially in the developed countries, buoyed by long periods of financial stability prior to the 2007-09 financial crisis, took risks in a manner that was unprecedented.[27] The subprime mortgage loan crisis in the US is an example.[28] Another example is how financial innovation and technology can enhance banks' capacity to provide credit to the economy and to shift risk away from banks to investors who are willing to invest in bank-originated assets. Moreover, some banks now approve loans using an automated process whereby the customer applies for a loan online and a decision is made without the customer having to meet with the bank officials. Despite the obvious economic benefits of encouraging innovation in banking practices, bank risk officers and regulators should be aware of the associated risks of new business practices.

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IV. What is a bank?

The legal definition of banks is crucial for determining the scope and application of laws that regulate and supervise them. Although there is no universal definition of banks, the common law historically defined banks as businesses that accepted deposits for their customers' accounts while negotiating cheques on behalf of their customers that either drew on, or credited, their accounts vis-à-vis third parties. The problem of defining banks has been made more difficult by the emergence of multifunctional banks that operate in complex financial groups providing a variety of financial services, including commercial banking, merchant banking and securities broker-dealers. In the words of Lord Denning «a banker is easier to recognise than to define».[29] Rather, regulators in different jurisdictions have adopted quite different approaches to defining

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23 Kenneth Spong, Banking Regulation: Its Purposes, Implementation, and Effects, 5. ed., Kansas City 2000.

24 *Ibid*, 92, these elements include good licensing policies, good supervisory techniques, adequate capital and liquidity, competent and honest management, internal controls, transparency and accountability.

25 See Tommaso Padoa-Schioppa, Central Banks and Financial Stability. Exploring a Land in Between, in: Gaspar/Hartmann/Sleijpen (eds.), Second Central Banking Conference, The Transformation of the European Financial System, Frankfurt am Main 2002 (<http:www.ecb.int/home/conf/cbc2/tps.pdf>; accessed 26 May 2016).

26 Rosa María Lastra, Central Banking and Banking Regulation, Financial Markets Group London School of Economics and Political Science, London 1996.

27 See Financial Stability: The Better you Do, The Greater the Risk, The Economist of 28 April 2007 (<http://www.economist.com/node/9086520>; accessed 26 May 2016).

28 See Subprime Lending: Rising Damp, The Economist of 8 March 2007 (<http://www.economist.com/node/8829612>; accessed 26 May 2016).

29 See *United Dominion Trust LTD v Kirkwood* [1966] 2 QB 431, 453.

banks.[30] Under EU banking law, banks are defined as undertakings «whose business it is to receive deposits or other repayable funds from the public and to grant credits for its own account»[31].

The UK has adopted a definition under Part 4 of the Financial Services and Markets Act 2000 (FSMA) (as amended) that the carrying on of the business of banking is a regulated activity for which permission must be obtained from the UK regulators, the Prudential Regulation Authority and the Financial Conduct Authority.[32] The business of banking includes accepting deposits (within the meaning of section 22 of FSMA

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2000, taken with Schedule 2 and any order under section 22). Under the FSMA 2000 (Regulated Activities) Order 2001, accepting deposits is a specified kind of activity if:

- •money received by way of deposit is lent to others; or,
- •any other activity of the person accepting the deposit is financed wholly, or to a material extent, out of the capital of or interest on money received by way of deposit.

The Banking Act 2009 goes further to exclude certain institutions, such as building societies and credit unions, from being classified as banks, even though they perform similar functions to banks such as accepting money by way of deposit and lending the money to others.[33]

The UK statutory approach to defining banks provides the Treasury with discretion to expand the definition to include other financial firms engaged in the banking business - that is, borrowing short-term from depositors and other lenders and making longer-term credits available to borrowers. This approach, though not without its problems, is preferred to the common law approach, which had not appreciated the intermediary function of banks in the economy and the role of innovation and technology in changing the banking business. By making banking a licensable activity, the question of whether an institution is a bank or not can be quickly resolved by inquiring whether it has been licensed by a regulatory body or not.

V. Why define Banks?

Banks are highly regulated institutions, largely due to the nature of the banking business and the risks associated with banking and the negative externalities that banking poses to society. The blurring of the distinction between banks and non-bank financial institutions has resulted in a clear need for regulators to be able to identify and supervise firms that are engaged in the banking business, that is, maturity transformation involving the taking of short-term deposits or other types of short-term liabilities and providing longer-term credits to borrowers. For instance, some non-bank financial institutions provide services similar to those provided by banks and could be easily confused for banks.[34] The prevailing argument is that banks require a higher level of regulation than other financial institutions, thereby necessitating the need for regulators to identify banks by setting out a satisfactory framework for the definition of banking

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30 Cranston identifies three approaches to the definition of banks; the first approach defines a bank as a body recognised as such by a governmental authority, whilst the second approach lists the activities which banking encompasses, see section (1) (1) of the German Banking Act, which adopts this approach. Cranston identifies a difficulty with this approach. «Which activities if not all, a body must perform to be treated as a bank.» Is a bank confined to just those activities or are incidental ones permissible? «More fundamentally, the list approach will soon become dated as the business of banking changes […].» A third approach known as the formulary approach under EU law defines banks in terms of a few generalised characteristics such as «taking deposits from the public coupled with granting credits for its own account.» See Cranston (2002).

31 See article 1 of Directive 77/780/EEC on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (1977) OJEC L 322/30; and article 1 of Second Council Directive 89/646/EEC on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC (1989) OJEC L386, and article 3(1) of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directive 2006/48/EC and 2006/49/EC (2013) OJEU L/176/338.

32 Section 19 of Financial Services Market Act (FSMA) 2000 (as amended).

33 The Act expressly states that a bank does not include: (a) A building society (within the meaning of section 119 of the Building Societies Act 1986), (b) A credit union within the meaning of section 31 of the Credit Unions Act 1979, or (c) any other class of institution excluded by an order made by the Treasury.

34 For instance the building societies and the credit unions in the UK provide services very similar to banking as they accept deposits and give out loans.

and what constitutes the banking business.[35] Without such a framework, much of what constitutes banking would escape regulation and pose undue risks to the financial sector and economy.

Internationally, the importance of defining banks and the permissible activities which they can engage in is captured in Core Principle 2 of the Basel Revised Core Principles For Effective Banking Supervision, which provides that «the permissible activities of institutions that are licensed and subject to the supervision as banks must be clearly defined, and the use of the word 'bank' in names should be controlled as far as possible.»[36] Moreover, Basel Core Principle 1 suggests that bank supervisors should be monitoring risks across the financial system that may threaten the stability of individual banks.[37]

VI. The Economic Importance of Banks

Banks play an important economic role as they, through the process of intermediation aid in economic growth by providing funds to those engaged in the production of goods and services vital to economic growth.[38] They are a source of funds for many businesses and without banks commercial activities would grind to a halt.[39] The importance of having strong banks in an economy can never be over-emphasised. By monitoring the repayment of loans, banks exert sound governance over funded firms, they foster innovation and growth by lending to entrepreneurs, they also allocate and mobilise savings efficiently by allocating capital to those endeavours with the highest expected social return.[40] The power of banks to create money can also have negative effects on the economy if left unchecked. Banks create money by providing liquidity in the system; excessive liquidity resulting in too much money chasing too few goods can

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lead to inflation necessitating the intervention of the Central Bank in mopping up excess liquidity through market operations.[41]

Studies have shown that economies with strong financial institutions or banks record greater levels of growth than those with weak banks.[42] The UK economy is an example of how the banking sector can contribute to economic growth. In 2012, the UK financial services sector, accounted for 10% of UK GDP, the highest of all G7 economies.[43] However, the ability of banks to aid in economic growth or mobilise and allocate savings efficiently is largely dependent on how well capitalised they are and the liquidity of their balance sheets. Sound banks promote the efficient allocation of resources, the efficiency of investment and economic growth in an economy, while weak banks slow down growth and put a strain on economic resources as public funds are utilised to bail them out of crises to maintain financial stability or pay off depositors in order to maintain confidence in the financial system.

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35 That argument has become stronger due to the financial crises of 2007-2009.

36 See Basel Committee for Banking Supervision (BCBS), Core Principles for Effective Banking Supervision (1997) Bank for International Settlements (BIS) (<http://www.bis.org/publ/bcbs30a.pdf>; accessed 26 May 2016).

37 See BCBS, Revised Core Principles for Effective Banking Supervision (2012), Core Principle 1 states in relevant part that the primary objective of banking regulation «is the soundness of banks and the banking system».

38 Ross Levine, Finance and Growth: Theory and Evidence (2004) NBER Working Paper No. 10766; Martin Brownbridge/Colin Kirkpatrick, Financial Regulation in Developing Countries (2000) Finance and Development Research Program Working Papers Series, Paper No 12/2006.

39 Charles A. E. Goodhart, The Macro-Prudential Authority: Powers, Scope and Accountability (2011) 203 LSE Financial Markets group Paper Series.

40 Ross Levine, Bank Regulation and Supervision (2005) NBER Reporter: Research Summary (<http://www.nber.org/reporter/fall05/levine.html>; accessed 26 May 2016).

41 Kenneth Spong, Banking Regulation – Its Purposes, Implementation, and Effects, Federal Reserve Bank of Kansas City Division of Supervision and Risk Management, 5th ed., 2000 (<https://www.kansascityfed.org/publicat/bankingregulation/RegsBook2000.pdf>).

42 Giovanni Favara, An Empirical Reassessment of the Relationship Between Finance and Growth (2003) IMF WP/03/123. The author disputes the link between economic growth and financial intermediation, he analysed the growth dynamics in the developed world and its relationship to the financial structure and reached the conclusion that the relationship between the two is weak.

43 Angela Monaghan, Seven Things You Need to Know About the UK Economy, The Guardian of 24 April 2014 (<http://www.theguardian.com/business/economics-blog/2014/apr/24/uk-economy-seven-things-need-to-know-ons-g7>; accessed 26 May 2016).

VII. The rationale and objective of banking regulation

The overriding objective of banking regulation is to safeguard financial stability and build resilience to financial shocks, wherever they may come from, and provide a sustainable source of credit, savings products and payment services to the broader economy. Banking regulation potentially can play an important role in mitigating the institutional and market impediments to the banking sector's ability to provide adequate capital and liquidity for the economy so that it can grow sustainably. Economic theory holds that policy and regulatory intervention in the banking sector is justified by market failures, which can arise from negative externalities resulting from asymmetric information, and competitive distortions.[44] Evidence suggests that market discipline, on its own, cannot adequately control the externalities in financial markets associated with excessive banking and financial risk-taking. Accordingly, policy or regulatory intervention may be necessary to prevent a misallocation of resources to unsustainable economic activity that relies on excessive financial risk-taking and to support a realloca-

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tion of capital to sustainable economic activity. Policy intervention, however, if not calibrated properly, can also produce its own distortions in the market that can result in further externalities and misallocations of bank capital and investment. A careful combination of market innovation and policy frameworks that suit national circumstances may be desirable for designing an effective and efficient banking regulation framework. In this way, banking policy can support the efficient operation of the economy by encouraging banks to harness more credit and investment for profitable and sustainable economic activity.

The justification for governmental intervention in banking regulation is strongly linked to the economic importance of banks, systemic issues and consumer protection. Sheng for instance, cites the ability of banks to create money, the involvement of banks in credit allocation, fostering competition and innovation through the prevention of cartels, consumer protection and banks vulnerability to crisis and collapse as the main rationale for bank regulation.[45] The recent 2007-09 financial crises seem to have swung the debate on who should regulate banking in favour of those institutions that have access to data and information across the financial markets in order to monitor better the systemic risks that can build up across the financial system.

The economic consequence of bank failures can be viewed as further justification for regulation. Bank failures are costly and dissipate vital economic resources that should have been channelled into more productive ventures. Since most governments undertake the responsibility of preventing bank failures or rescuing ailing banks by acting as a lender of last resort and operating a deposit insurance scheme, it's only natural that they regulate banks to reduce the potential for a call on the deposit insurance funds. Bank failures impact negatively on a country's GDP and on taxpayers' money and slow down economic growth. In a cross-country survey involving Indonesia, Chile, Thailand and Uruguay, it was discovered that governments spent an average of about 13% of GDP restoring financial systems after banking crises.[46] Another study estimates that between 1980 and 1998, banking problems cost developing and transition economies roughly $250 billion.[47] The Asian financial crisis of the late 1990s contributed in part to the development of international bank regulatory reforms known as Basel II that were designed to enhance the capital and risk governance of banks. Despite some incremental reforms, the Basel II framework increased the complexity of banking regulation and supervision that came to rely heavily on internal bank risk models to calculate

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regulatory capital and which ultimately resulted in an undercapitalised banking system.[48]

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44 See Joint Forum, Review of the Differential Nature and Scope of Financial Regulation – Key Issues and Recommendations (2010), 85.

45 Spong (n 41), 62.

46 Patrick Honohan/Daniela Klingebiel, Controlling the Fiscal Costs of Banking Crises, in: Klingebiel/Laeven (eds.), Managing the Real and Fiscal Effects of Banking Crises, World Bank Discussion Paper No 428 (2002).

47 Honohan/Klingebiel (Fn. 46).

48 «Before the 2007-09 financial crisis, regulators across the international financial system championed the economic benefits of rational, self-correcting markets and the merits of financial innovation. A global consensus emerged that new modes of finance had reduced systemic risks», see HM Treasury, Review of HM Treasury's Response to the Financial Crisis (March 2012) 5.

Under Basel II, prudential regulation was structured to support market-based governance models of banks that regulators heavily relied on to ensure that the banking system was safe and efficient.[49] The financial crisis exposed bank models as being seriously flawed in how they measured and managed financial risks. The crisis also proved that the market is incapable of providing the sort of monetary and fiscal stimulus that was provided by central banks and national governments to prevent a total collapse of the financial system.[50] And even though national regulatory bodies have been identified as being partly responsible for the crises,[51] greater powers have been invested in national regulators – and in particular central banks - who now have a wider financial regulatory remit with the move away from strictly micro-prudential regulation to macro-prudential regulation. Before we discuss the macroprudential regulatory reforms of the United Kingdom, it is important to discuss the significance of financial stability as an objective of financial regulation.

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VIII. The UK Approach to Macroprudential Regulation[52]

In analysing UK regulatory failures before the crisis, the Turner Review found that a lack of macro-prudential regulation and oversight of the financial system was more directly relevant to causing the financial crisis than any specific failure relating to an individual firm.[53] The Review suggested that had there been a better understanding of the link between financial stability and macroeconomic stability there could have been more effective measures formulated to address specific risks of individual banks and firms.[54] The Review cited indicators of macro-prudential risks, such as the liquidity risks manifest in the maturity transformation function of banks, the level of asset prices in property, equity and securitised credit as well as the level of leverage in the financial system as areas where regulators and supervisors could develop a better understanding of how systemic risk can arise. The Bank of England comes under specific criticism in the Review for not formulating policy to offset the risks identified in the Bank's Financial Stability Reviews conducted in the years before the crisis.

Whilst the supervision of individual financial institutions was a great concern to the FSA (a chiefly micro-prudential perspective) there was not enough investigation into sectoral or systemic risks present in the structure of the system.[55] To remedy this, the Financial Services Act 2012 created a new institutional framework for financial regulation consisting of a «Twin Peaks» approach to micro-prudential supervision consisting of a Prudential Regulation Authority, responsible for supervising individual banks and insurance firms, and a Financial Conduct Authority, responsible for investor protection and market abuse. Overseeing both supervisory authorities is the Financial Policy Committee (FPC), responsible for macro-prudential oversight and making recommendations and issuing directives regarding the use of macro-prudential measures and in-

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49 Moritz Renner, Death by Complexity – The Financial Crises and the Crises of Law in World Society, in: Kjaer/Teubner/Al Febbrajo (eds.), The Financial Crises in Constitutional Perspective, Oxford 2011, 93.

50 To prevent a total collapse of the financial system, the UK had to part-nationalise two of the largest banks in the world and introduce financial sector interventions costing hundreds of billions of pounds. See HM Treasury, A New Approach to Financial Regulation: Judgment, focus, stability (July 2010) Report presented by HM Treasury to Parliament (<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81389/consult_financial_regulation_condoc.pdf>; accessed 26 May 2016).

51 See The Origins of the Financial Crises: Crash Course, The Economist of 7 September 2013 (<http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article>; accessed 26 May 2016).

52 Most bank regulation has proceeded in response to a financial sector. The UK is a case in point. The shift from self-regulation to legal regulation in the field of financial services was prompted by a series of crisis: the enactment of the 1979 Banking Act followed the secondary banking crisis, and the 1987 Banking Act was enacted following the Johnson Matthey Bankers' failure. In the US the creation of the 1913 Federal Reserve System and the Federal Deposit Insurance Corporation in 1933 were responses to the financial crisis. At the international level, the emergence of the Basle Committee on Banking supervision was prompted by the collapse of Franklin National Bank in the united States and of Bankhaus I. D. Herstatt in Germany during the summer of 1974. See Lastra (n 1), 72. In Nigeria, regulation of the banking sector was only institutionalised after the first banking crisis in the 40s which led to the Paton Report that recommended formal regulation of banks as the only means of protecting depositors and encouraging sound and efficient banking. This in effect led to the enactment of the Banking Ordinance in 1952. See Brownbridge/Kirkpatrick (Fn. 38).

53 The Financial Services Authority (FSA), The Turner Review (2009), 83 (<http://www.fsa.gov.uk/pubs/other/turner_review.pdf>; accessed 26 May 2016).

54 Turner Review (Fn. 53), 85.

55 Turner Review (Fn. 53), 85.

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struments, and assessing macro-prudential conditions in the financial sector. The Financial Services Act 2012 authorises the FPC to implement a «macro-prudential» regulatory model to control systemic risks in the financial system. Macro-prudential regulation can be divided into three main areas: 1) the regulation of individual firms must take into account both firm level practices and broader macro-economic developments in determining how regulatory requirements will be imposed (ie., growth of asset prices and contra-cyclical bank provisioning), 2) controls on the levels of risk-taking and leverage at the level of the financial system, and 3) the regulation of the infrastructure of the financial system – clearing, settlement and payment systems – along with requirements that OTC derivative contracts are centrally cleared and that securities and currency settlement networks are robust and resilient.

IX. The Financial Policy Committee's supervisory function

The Financial Policy Committee (FPC) has conducted research on macro-prudential risks and raised questions about conventional banking supervisory practices by raising concerns about the need for the FPC to consider loan-to-income ratios for mortgage loans, counter-cyclical capital requirements, and limitations on lending exposures to the buy-to-let mortgage market. This is part of a wider effort to challenge conventional wisdom in micro-prudential regulatory practices by considering the application of macroprudential principles and regulatory tools. For instance, the FPC has been sceptical by challenging conventional wisdom, the FPC is expected to challenge the judgments of other supervisors and international organisations, such as the International Monetary Fund which issued a report a year before the crisis began in 2006 claiming that «the dispersion of credit risk by banks to a broader […] group of investors […] helped make the […] financial system more resilient»[56]. It must be argued that greater and more vocal challenges to conventional views as those held by the IMF and many national regulators before the crisis should go some way to preventing them becoming generally accepted.

Moreover, the move to a macro-prudential regulation has resulted in a modification of the UK principles-based regulatory regime to becoming more rules-based at the level of the financial system. Indeed, the new focus on macro-prudential regulation at the level of the financial system has resulted in the two microprudential regulators – the PRA and FPC – playing a greater role in monitoring systemic risk and imposing controls at the level of individual institutions. In other words, the FPC with support from the PRA and FCA has become the key player in the regulation of systemic risk. The FPC supervises the financial system as a whole by addressing the market failures that arise from inter-connected financial markets and the shifting of risk off-balance sheet

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to «shadow» sectors of financial markets. As a result, the UK's new regulatory regime, based on macro and micro rule-based controls, has resulted in a marked change in the nature of financial regulation; but it has also resulted in potential new regulatory risks that arise because of the responses of market participants who have sought to avoid these regulatory controls by adopting innovative financial instruments and structures.

X. UK macro-prudential «tools»

The area of macro-prudential tools is one where there is relatively little evidence and research. Goodhart, in particular, has highlighted that it would be good if macro-prudential authorities such as the FPC did more analysis to understand how the various tools will work.[57] In addition, he has highlighted the need to consider what happens if institutions fail to meet their prudential requirements, and whether a «ladder of sanctions» should be considered in respect of enforcement.[58] The FPC's thinking about macroprudential regulation has advanced significantly in comparison with other EU and US regulators. In 2011 and again in 2015, the FPC published papers in which it presented some of the possible macro-prudential tools that it could wield. There is a particular emphasis here on time-varying risks, countered through regulation which aims to deal with cyclicality in the economic cycle and within certain sectors of the economy.

One of the first tasks of the FPC was to recommend in March 2012 several macroprudential levers to the UK Treasury, which would have to submit them for approval as secondary legislation before Parliament. The Bank of England, however, recognised in 2011 that the choice of macroprudential tools was far from

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56 International Monetary Fund (IMF), Global Financial Stability Report, Market Development and Issues (April 2006).

57 Goodhart (Fn. 39).

58 Goodhart (Fn. 39).

straightforward, as they have could impinge substantially on economic activity and there was little hard evidence about how they would work in practice. For example, the Bank suggested that varying loan-to-value or loan-to-income ratios on mortgage lending would directly limit risky lending, but would also be very difficult to calculate because of «the trade-off between financial stability benefits, economic activity, and societal preferences for homeownership»[59]. Moreover, the paper notes that limiting or regulating bank remuneration or distributions to shareholders may have the effect of penalising well-managed banks alongside weak institutions. Similarly, the paper also observes that imposing too stringent controls on trading and clearing infrastructure may have the effect of driving this activity to less tightly regulated jurisdictions. The Australian experience of requiring banks to hold capital against off-balance sheet exposures was cited as a macro-prudential regulatory lever that could work effectively with limited downside effects. Finally, the paper raised the important issue of whether UK regulato-

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ry authorities would have enough discretion to apply macro-prudential levers without violating harmonised EU regulatory standards.

XI. European Union Macro-prudential Regulation and Supervision[60]

The European Union has embarked on a major institutional restructuring of financial regulation by creating a European System of Financial Supervision consisting of three micro-prudential supervisory authorities – the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational and Pension Authority – and a European Systemic Risk Board (ESRB) to conduct macro-prudential oversight of the European financial system. And the on-going Euro area sovereign debt crisis has led to further legislative proposals granting the European Central Bank bank supervisory powers and the creation of a Single Resolution Mechanism in the eurozone that will be administered by a Single Resolution Board and supported by a single resolution fund that will be financed by bank levies and supported by national resolution funds that would together finance the resolution of weak Eurozone banks. The section will address the ESFS with respect to how it coordinates macro and micro-prudential supervision and regulation, and also address the new supervisory powers of the European Central Banks and its related macro-prudential mandate.

The European System of Financial Supervision attempts to link in a coherent way the European Systemic Risk Board's (ESRB) macro-prudential supervision and oversight function with the three European Supervisory Authorities (ESAs) function for coordinating the harmonised implementation of micro-prudential supervisory powers.[61] Indeed, the linkage is essential for building an efficient EU supervisory regime that allows member states to exercise more effective supervisory oversight over individual firms and investors, whilst monitoring, measuring and issuing recommendations and warnings about systemic risk in the broader European financial system and across global financial markets. Moreover, the ESFS and the three European Supervisory

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Authorities will ensure that member state regulatory and supervisory authorities can work more effectively together at the micro-prudential level to control and manage systemic risk and develop a harmonised regulatory code and implementation across all EU states.[62]

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59 Financial Policy Committee, Report (Dec 2011: Bank of England).

60 The ESFS was adopted based on proposals by the De Larosiere Committee in February 2008 in the wake of the financial crisis that was aimed at further institutional consolidation of the previous Lamfalussy framework that had sought enhanced supervisory coordination and harmonised implementation of EU financial legislation. The Lamfalussy institutional framework, however, had failed to produce more harmonised standards of financial regulation across member states because it was not able to overcome different sets of national standards, responsibilities and powers of member state supervisors that had hampered the European financial integration process and had resulted in disjointed supervisory practices and a failure to identify and monitor risks building up in the financial system. See IMF (Fn. 56).

61 See Kern Alexander, Which Future Model for Europe?, (2010) Report to the Committee on the Financial, Economic and Social Crisis (<http://www.europarl.europa.eu/document/activities/cont/201103/20110324ATT16356/20110324ATT16356EN.pdf>; accessed 26 May 2016).

62 *Ibid*, 'Reforming EU Financial Supervision: Adapting EU Institutions to Market Structures' (2001), 12 Journal of the European Law Academy 2, 229; id, 'Note on EU Bank Resolution and the ECB'(9 October 2012) written evidence before the House of Lords Europe Committee Appendix 2, 103.

In addition, some macroprudential regulatory reforms are evolving based on structural regulation models. The UK adopted the Finance (Banking) Act 2013 that implemented most of the proposals of the Independent Commission on Banking to segregate the retail banking operations of a financial group into a separate subsidiary and to prohibit it from transferring capital to its affiliate subsidiaries in the financial group.[63] Also, under the US Dodd-Frank Act,[64] the Volcker rule restricts banking groups with deposit-taking subsidiaries from engaging in proprietary trading, whilst the European Commission has proposed for most EU states that proprietary trading be banned in EU-based banking groups. The move towards structural regulation of banking groups is an important element of macro-prudential regulation that will change the business models of global financial institutions.[65] Macro-prudential regulation and supervision will also necessarily involve central banks – which are repositories of macroeconomic and financial data – in monitoring system-wide risks and working closely with micro-prudential supervisors to ensure that innovations in financial risk-taking do not undermine financial stability. Macro-prudential regulation will require that the practice of financial supervision is linked to factors in the macro-economy and broader financial system.[66] It will require greater intensity of prudential regulation by host country authorities, and less deference to the supervisory practices of a foreign banking group's home country supervisory authority. Traditional models of prudential supervision that rely on the principle home country control will become obsolete because the macro-prudential regulatory mandates of host country authorities will necessarily involve them in supervising the local activities of cross-border financial institutions and regulating cross-border capital flows to ensure that the host country's macro-prudential objectives are met.

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XII. Challenges for Macroprudential Regulation: Shadow banking

Macro-prudential regulation should also focus on the «shadow banking» system where financial intermediation occurs outside the formal banking sector by non-bank financial firms which engage in maturity transformation and take on leverage by issuing debt-linked instruments to generate capital to invest in longer-term assets. Of particular concern are intermediaries involved in the money and credit creation process. Regulatory instruments should aim to affect the balance sheets of financial institutions by limiting the aggregate level of leverage and maturity mismatch in the financial system as a whole. These controls could be tightened during periods when there are asset price bubbles (when asset prices exceed trend economic growth) and relaxed when the economy or financial sector slumps.

The existence of other, non-bank financial institutions therefore imposes a constraint on the ability to place requirements on banks, as there is a danger of risky activities moving into non-regulated sectors. However, this also suggests that it may make sense to consider reforms across the sector as a whole, rather than focusing too much on particular types of institutions. Indeed, Goodhart takes the view that there should be a degree of harmonisation of «margin controls» such as capital ratios, saying that:

> *«There is a 'level-playing-field' argument between institutional arrangements within countries, as well as between countries. The imposition of (asymmetric) penalties (taxes) on the most visible, largest and probably the most efficient intermediaries (i.e. the banks) may have an increasing effect in diverting such intermediation towards less visible, and possibly less efficient channels.»*[67]

In addition, insurance companies can also pose a risk to taxpayer money. For example, during the last crisis, AIG, a US insurance company, sold a substantial amount of credit default swap coverage to banks and other investors. These derivatives turned out to be riskier than assumed and AIG subsequently had to be bailed out by the Federal Reserve. If AIG had defaulted, banks to which AIG owed money would have experienced substantial losses that could have toppled the US financial system and several major European banks.

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63 See UK Finance Act (Banking) (2013) (ring-fencing of retail deposit-taking activities from rest of the group).

64 See The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 619 (<https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>; accessed 26 May 2016).

65 However, the European Banking Federation (EBF) contends that «there is no convincing evidence that structural reform has a direct influence on systemic risk and would make restructuring or resolution easier in the event of a crisis.»

66 For example, counter-cyclical capital requirements would base the determination of regulatory capital, in part, on the ratio of bank asset prices to the trend rate of economic growth.

67 *Ibid*.

XIII. Conclusion

This chapter is inspired by Professor von der Crone's fascinating body of work produced over a long and distinguished career. International regulatory reforms now mandate that national authorities adopt macroprudential regulatory principles and supervisory objectives. Under Professor von der Crone's influence, Switzerland has adopted significant bank regulatory reforms – especially with respect to Too-Big-To-Fail banks. This chapter discusses some of the main issues involving the evolution of banking regulation and supervision from a largely microprudential focus on individual firms to a macroprudential focus on systemic risk and financial system stability. The chapter discusses macroprudential regulatory reforms in the United Kingdom and some of the challenges that arise with the transition to a macroprudential supervisory framework and the lessons for other jurisdictions.

The chapter is designed to provide an international and comparative review of some of the concepts and themes Professor von der Crone has developed in his writings on Swiss banking regulatory reform and to suggest – as he might – that further regulatory intervention and reforms can create their own seeds of risks that can distort markets further and potentially destabilise them. The financial crisis demonstrates how systemic risk can arise because of the unforeseen risks associated with financial innovation, partly driven by regulatory changes. Macroprudential regulatory reforms are important because of their focus on system-wide risks, but the increased regulation of the banking sector raises important concerns about whether the provision of credit by intermediaries will be driven outside the formal banking sector and into the shadow banking markets. It remains to be seen whether macroprudential regulation and supervision can identify these risks and control them appropriately without unnecessarily undermining the provision of credit for the economy and creating future instability for the financial system.