Title: Why Regulate at all? A critical analysis of the rationale and effectiveness of UK bank Regulation.

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Why Regulate?

Abstract.

The Global Financial Crisis (GFC) represented the biggest shock to the world economy since the Wall Street Crash of 1929 and subsequent banking crisis that precipitated the Great Depression of the 1930's. Since this event the debate on the structure and rationales of regulation have pervaded the banking industry. The position of regulation and the part it played in the GFC is of fundamental importance in understanding the key issue of why we regulate banks and financial services and avoid repeating the failures of the past. This thesis provides an investigation of the phenomena of bank regulation using the GFC as its anchor point to answer the question of why we regulate. With reference to relevant theory the thesis looks to analyse the structure of regulation in the period up to the emergence of the GFC in the Autumn of 2007 to gain understanding if that structure was, at least partly to blame, or was the overall macroeconomic environment the driving force behind the crisis. The thesis will then consider the reform packages that followed the impact of the GFC, with particular focus on those reforms that followed the 2010 UK general election. To answer the question of why we regulate, the thesis analyses the key components that were central to the emergence of the GFC and continue to play a central role in understanding the key rationales behind why we regulate banks and how policy makers should approach the overall architecture of bank regulation. The thesis posits that the past approaches to regulatory architecture failed to understand the full macroeconomic forces that resulted in the GFC creating complex regulatory structures that lacked the transparency needed to provide a stable environment in which banks could operate to the benefit of society. The thesis presents the argument that a simpler and more focused structure with properly delegated functions and a focus on specialisation would provide a basis

for sound bank and financial services regulation. The conclusion is that UK policy makers should look to provide a regulatory environment that will allow bank failure to occur in a manged and orderly manner without creating systemic risk, limiting the impact on ordinary bank customers, and without recourse to UK taxpayer bailout. One way to achieve this is to reduce regulation to a bare minimum, to disincentivise the moral hazard created by the complexity and opacity of past regulatory structures.

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This thesis is dedicated to Ffion Elizabeth, I never got to meet you, but you are always with me.

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[1] See R Lastra Systemic Risk and Macro-Prudential Supervision in N Moloney, E Ferran, J Payne eds The Oxford Handbook of Financial Regulation, (Oxford 2015)

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Abbreviations and Glossary

A

ABS – Asset Backed Security – Investment backed by a pool of assets.

AFBD – Association of Futures Brokers and Dealers – US regulator

AIG – American Insurance Group – Insurance corporation that acted as a Shadow Bank

ATM – Automatic Teller Machine – Automatic Cash Machine

B

BACS – Bankers Automated Clearing System – Automated payment system

BBA – British Banking Association – UK bank trade association

BCBS – Basel Committee on Banking Supervision – International organisation based in Basel with influential coverage of global banking

BIS – Bank of International Settlements – Basel based financial institution at the heart of the BCBD

BofE – Bank of England – Central Bank of the United Kingdom

BCCI – Bank of Credit and Commerce International – Investment bank that collapsed due to massive fraud

C

CDO – Collateralised Debt Obligation – A structured financial product split into layers or tranches backed by different grades of asset. Blamed for significant impact in the global financial crisis (GFC).

CDS – Credit Default Swap – Form of insurance product allowing an event to be insured even in the absence of an insurable interest.

CFTC – Commodity Futures Trading Commission – US regulator.

CHAPS – Clearing House Automated Payment System – Automated payment system used by banks to pay each other.

D

DTI – Department of Trade and Industry – Former government ministry responsible for trade and industry.

E

EMP – Efficient Market Hypothesis – Theory that financial markets are self-correcting.

F

FCA – Financial Conduct Authority – UK conduct regulator created following the GFC.

FDIC – Federal Deposit Insurance Corporation – US regulator.

FHFA – Federal Housing Finance Agency – US regulator

FCA – Federal Credit Administration – US regulator

FSA - Financial Services Authority – UK single regulator at the time the GFC emerged

FSB – Financial Stability Board – Influential international body monitoring global financial stability.

FSCS – Financial Services Compensation Scheme – UK compensation scheme for failed banks.

FSMA 2000- Financial Services and Markets Act 2000 – UK primary legislation that reformed the UK financial services sector being place as the GFC emerged.

FSA 1986 – Financial Services Act 1986 – Previous UK legislation for the regulation of financial services.

FSOC – Financial Stability Oversight Committee – US regulator

FPC – Financial Policy Committee – UK regulatory authority with oversight of financial services regulation.

FIMBRA – Financial Intermediaries, Managers and Brokers Regulatory Association – Historic UK regulator.

G

GFC – Global Financial Crisis – The financial crisis emerged during 2007/8 causing the failure of several banks.

G-SIFI – Globally Systemically Important Financial Institutions – Financial institutions that may cause systemic problems if they fail.

G-SIB – Globally Systemically Important Banks – Banks that may cause systemic problems if they fail.

H

HBOS – Halifax Bank of Scotland – UK bank that required taxpayer assistance.

HSBC – Hong Kong and Shanghai Banking Corporation – Global banking group.

I

IMRO – Investment Management Regulatory Organisation – Historic UK regulator

L

LAUTRO – Life Assurance and Unit Trust Regulatory Organisation – Historic UK regulator.

LOLR – Lender of Last Resort – Usually a Central Bank that provides emergency funding to financial institutions in distress.

M

MoA – Memorandum of Association – Agreement between the FSA, Bank of England and HM Treasury outlining regulatory responsibility prior to the 2010.

MBS – Mortgage-Backed Security – Investment backed by a pool of mortgage assets.

N

NCUA – National Credit Union Administration – US regulator.

O

OCC – Office of the Comptroller of the Currency – US regulator.

P

PCBS – Parliamentary Commission on Banking Standards – UK Parliamentary commission tasked with maintaining standards in banking.

PIA – Pensions Investment Authority – Historical UK regulator.

PRA – Prudential Regulation Authority – UK prudential bank regulator for systemically important banks that resulted from the post GFC reforms.

R

RFB – Ring Fenced Bank – Bank that is required to separate investment banking from retail banking activity.

RBS – Royal Bank of Scotland – UK banking group bailed out by UK government.

RPB - Recognised Professional Body – Trade organisation authorised to supervise and regulate specific areas.

S

SFA – Securities and Futures Authority – Historical UK regulator.

SIB – Securities and Investment Board – Historical UK regulator.

SPV – Special Purpose Vehicle – Entity created, usually off-shore to hold assets off balance sheet.

SRO - Self-Regulatory Organisations – Regulators that are made up of the organisations they regulate.

T

TARP – Troubled Assets Recovery Programme – US measures to support distressed financial institutions as a result of the GFC.

TBTF – Too Big To Fail – Description of financial institutions that have grown so large that governments cannot allow to fail due to the risk to the overall financial system.

TSA – The Securities Association – Trade body

Chapter 1. Introduction

"Those who cannot remember the past are condemned to repeat it".[2]

1.1 Introduction

This purpose of this chapter is to introduce the rationale, aims and initial outcomes of the thesis. The chapter provides the framework upon which the thesis will build its analysis with the structure designed to lay that framework for the discussion and analysis that follows.

Chapter 1 introduces the research while Chapters 2 and 3 respectively set out the methodology and literature review. The conceptual framework underpinning the research is laid out in Chapter 4 which links with Chapter 5 setting out the overall rationales for regulation. The analysis of bank regulation in the UK is benchmarked to the global financial crisis (GFC) which exploded the debate regarding regulation and triggered an extensive reform package. Chapter 6 analyses the perceived causes of the crises with Chapter 7 undertaking a critical review of the legislation in place during the years preceding the GFC. Chapter 8 analyses the reform package that followed. Chapter 9 provides the conclusion.

1.2 Contribution to knowledge

Linked to the research question and the rationales for regulation set out in the section below is the need to view the GFC from a different viewpoint. A significant volume of material in this

[2] G Santayana quoted in A E Wilmarth, Taming the Megabanks; Why we need a new Glass-Steagall Act (Oxford 2020).

area has focused on the causes and effects of the banking crisis and its overall impact on the global economy, with an analysis of the legislative and regulatory measures that have been blamed for the crisis and the reforms that have been subsequently enacted. The consensus amongst commentators suggests that greater levels/layers of regulation are the antidote to failure. The aim of this research is to focus on whether bank regulation has become so complex that it is failing to undertake the role for which it is required; to question whether a simplification would be a better choice. The premise behind the research is that less regulation, more focused on key elements will prove more successful than just more layers of regulation. The research argues against advocating more layers of regulation but for a stronger focus on the structure of regulation. The thesis is not designed to be an advocate of unfettered deregulation; it is unarguable that some form of control over the activities of banks and bankers is required, but that complexity leads to obfuscation and avoidance, whereas simplicity and transparency lead to efficiency.

The key element missing in the debate regarding bank regulation which the thesis addresses is the influence of politically driven decisions in the design process which prevents the development of a sufficiently robust regulatory system. The issue of political influence is addressed at the relevant points throughout the analysis. The political elements impact the causes, pre and post-crisis position, and continues to pervade. In contributing to knowledge, the thesis answers the research question of why regulate alongside an analysis of the political decisions that influenced the design of the regulatory structure. The lack of literature that focuses on the political drivers is addressed in the overall construction of the thesis which reflects, at relevant stages within the chapters, the politically driven decisions that underpin the processes that influenced the regulatory design.

1.3 Research Question

The research question is 'Why Regulate? This revolves around understanding why a need is there to regulate banks. The route to the answer is supported by an exploration of a series sub-questions designed to draw out the overall outcome. The question of why regulate is answered through a critical analysis of bank regulation in the United Kingdom, the rationales and effectiveness through an analysis of the causes, the regulation before and during the crisis and the reforms that followed.[3]

The research was originally formulated while an undergraduate at the University of Glamorgan. The module Law Relating to Financial Services ran at the same time the Financial Services and Markets Act 2000 was proceeding through Parliament. This allowed for debate on the shape and form of regulation at the same time the significant reforms were being enacted. The reforms being a response to the perceived failure of the previous regulatory regime. As with all reform packages the effectiveness of the change is not known until challenged by some event – that event was the Global Financial Crisis.

The core of the thesis originates in the fallout from the collapse of Northern Rock in the UK in the late summer of 2007, continuing through the autumn of 2007, which precipitated the UK banking crisis of 2008. Northern Rock was a well-known but relatively small player in the UK financial services industry, a former building society that demutualised on 1st October 1997, and by the end of that year as a newly formed bank had consolidated assets of £15.8 billion. However, by 2006, just nine years later this had had risen to £101.0 billion, primarily as a result

[3] Chapters 6, 7 and 8 respectively.

of secured lending on residential property.[4] As the Commons Treasury Committee noted on the morning of Thursday 13th September 2007 the BBC reported that Northern Rock had received emergency financial support from the Bank of England.[5] As Brummer noted, Northern Rock had advised the Bank on the 10th August 2007 of potential disaster, with the FSA informing the other tripartite authorities on the 14th of August.[6] Following the BBC announcement large queues started to form outside Northern Rock branches as customers became increasingly worried about their savings; between 14th and the 17th September 2007 some £2 billion in deposits were withdrawn by Northern Rock customers.[7] During this period and by the end of 2007 the bank's share price had dropped to £1.22 per share from £12.60 per share propped up by almost £25 billion in borrowings from the Bank of England, at a punitive rate,[8]prompting Michael Fallon MP to comment how "extraordinary" is was that the management board of a British bank "had been allowed to destroy £4 billion to £5 billion worth of value".[9] Only a year later this was mirrored in the United States (US) banking crisis following the collapse of the investment bank Lehman Brothers, the largest corporate insolvency in history,[10] resulting in the global financial crisis (GFC). The collapse of the Northern Rock and subsequent failure of Lehman Brothers was a direct consequence of the collapse of the sub-prime mortgage market which led to the seizing up of global money markets.[11] The reliance by Northern Rock on wholesale funding from these markets and the

[4] House of Commons Treasury Committee, The Run on the Rock, Fifth Report, 2007-8, Volume 1, 11
[5] Ibid, 5
[6] A Brummer, The Crunch: The Scandal of Northern Rock and the Escalating Credit Crisis (Random House, 2008), 75; See Chapter 7 for analysis of the Pre-crisis regulatory structure.
[7] Ibid
[8] Ibid
[9] Ibid, p86. Michael Fallon MP was a member and chair of sub-committee of the House of Commons Treasury Committee
[10] Statista.com, Largest bankruptcies in the United States as of June 2019, by assets at time of bankruptcy, https://www.statista.com/statistics/1096794/largest-bankruptcies-usa-by-assets/, last accessed 22/01/21.
[11] For analysis of the causes of the GFC see Chapter 6

use of offshore special purpose vehicles to securitise their mortgage back assets to further growth led to its demise when the global credit markets dried up. [12]

This chain of events unfolding at a UK bank was virtually unprecedented and laid the basis of the research in this thesis.[13] The question formulating in my mind as a result of studying financial services regulation as an undergraduate and delivering a module as a lecturer was how this could be allowed to happen in one of the most advanced economies in the world with one of the most mature and sophisticated financial services sectors in the world. The same question surfaces in the Autumn of 2008 following the near collapse Wall Street bank Bear Stearns and the actual collapse of Lehman Brothers. The days following the collapse of Lehman, the rescue of AIG and the $700 billion Troubled Assets Relief Programme (TARP) again highlighted how the much-vaunted regulatory regimes on both sides of the Atlantic supported by Bank of International Settlements Basel Accords failed to insulate the global economy against the excesses of the banks.[14] How could this happen in such well-developed economic systems?

The legislative basis for analysis is the Financial Service Markets Act 2000 (FSMA 2000), which was enacted on the perceived failures of the previous reforms legislated by the Financial Services Act 1986 (FSA 1986). This programme of reform was lauded as a major step in the right direction of consumer protection in the financial services sector, but what we saw was the need for governments to rescue and provide backstops for failing financial institutions with significant volumes of taxpayer money. As above, this resonated with regard to the previous

[12] See Chapter 7 for analysis of Pre-crisis regulatory structure.
[13] The Last true run on a UK bank was the Overend, Gurney and Co crisis of 1866 – See House of Commons Treasury Committee, The Run on the Rock, Fifth Report, 2007-8, Volume 1, 8
[14] For analysis of shadow banks see Chapter 6.10. For analysis of the Basel Accords see Chapter 4.9.

study of financial services regulation and the surprise that the now fully statutory regulatory regime failed. Consumers of financial services products were faced with potential disaster. The research further originates in that multiple legislative reforms had proved insufficient to prevent failure, and that with each regulatory iteration that even with the promises made there were still examples of regulatory failure associated with each version of regulatory reform. No matter which form the regulation took consumers ultimately paid a price for the failure of that version of regulation. This ultimately prompted the questions and the analysis in the thesis.

A feature of both these reform packages is the political influence of the government of the day. The 1986 reforms brought in a period of deregulation, ushering a new and expansive period for the UK financial sector transforming from a vibrant financial services sector to a globally significant player. The 2000 reforms were themselves the product of further political machinations resulting from the election of the New Labour government in May 1997. The previous regulatory regime had been heavily criticised as insufficient to prevent a range of financial scandals such as BCCI and the collapse of Barings Bank.[15] The FSMA 2000 was lauded as creating a one-stop-shop for all financial service providers, and to include for the first time the momentous decision to move the regulation of banks away from the Bank of England to the newly minted Financial Services Authority (FSA).[16] What emerged, however, was a failure of the 2000 regime to insulate the UK from the fallout of the collapse of the US subprime mortgage market which had infected the US financial system.[17] The instance of contagion related spillages from one economy to another provided further support for the need to understand regulatory structure. The possibility of a financial dislocation in one place, such

[15] See Chapter 7.3
[16] Bank of England Act 1998, s 21.
[17] See Chapter 7

as the sub-prime mortgage collapse in the US ossifying financial product innovation, infecting another means that understanding the operation of regulation and its effectiveness is of vital importance.

The emerging GFC was responsible for a near collapse of the western banking system and only government intervention backed by taxpayer money was sufficient to prevent such a disaster. The 2000 legislation was introduced with a fanfare promising that the new framework would deal with the excesses associated with the deregulatory regime of the FSA 1986. The regulatory regime failed with UK banks facing collapse, with some requiring significant funding and one requiring nationalisation to prevent actual collapse.[18]

In developing the primary research question a range of initial points of inquiry were noted, and while these were considered in background, they form a basis upon which the central theme developed. These initial points of inquiry were why do we regulate and supervise banks in the first place, leading to a second query of should we regulate and supervise? In thinking about these points, we can then consider how regulation should look like in respect of what the regulatory structure should look like.

The research question is tackled throughout the thesis while the sub-questions are dealt with at the appropriate points, with the discussion of a simpler regulatory system undertaken in chapter 4. The issue of which structure is best is discussed and analysed throughout the thesis with the conclusion outlining the optimal option.[19] As the research matured the question of why

[18] Northern Rock
[19] See Chapter 9.

regulate crystallised into one where the rationales of regulation required understanding against an overall environment in which the regulation of banks operate, to include broader economic thought and political drivers in the design of regulatory processes.

The research question reflects the period of immediate impact of the bank failures and from this initial research position the overall research aims of the thesis is to assess, with the GFC as the anchor point, the approach of policy makers to the function, utility and operation of bank supervision and regulation. The contribution to knowledge is linked to the need to understand the ultimate rationale of bank regulation in which the pre-crisis regime failed to analyse the link between structure and financial stability. The post-crisis literature has now acknowledged stability as a potential policy goal, however, there is still a missing analysis of the role that deregulation played in the GFC and the importance of understanding the role that the structure of regulation plays in the effective operation of bank regulation. Additionally, there is a missing analysis of the role that political drivers play in the design of regulation, often at the expense of regulatory need. The missing political analysis in the literature is of significant interest to understanding the debate on regulation. The focus on the minutiae of regulation as opposed to the overall structure misses how regulation originates and therefore how it should be applied. This thesis analyses the structure rather than the minutiae which better serves the research question and to understand the rationale for regulation, however, the analysis needs to understand the political drivers behind the regulatory policy decisions.

The GFC is explained in more depth in chapter 6 in the context of its causes, however, the GFC can be described in simple terms as the outcome of five decades of deregulation and innovation, coupled with an incorrect regulatory focus that managed firms rather than the system. This was based on resurgence in neo-liberal economic thinking within banking and financial markets that eventually created an asset bubble based around the US housing market which burst during 2007-8. This resulted in a retraction in the availability of credit that led to a 'credit crunch', followed by a banking crisis as the scale of the asset bubble became evident and the consequences of interconnectedness between banks realised.[20] Given the perceived ineffectiveness of regulation to spot and prevent the GFC, it created several important questions. Whether banks should be subject to regulation at all? What were the benefits of regulation? Is there any benefit in removing banks from the structured constraints of the regulatory frameworks that had developed alongside banking? The GFC provides evidence that regulation can amplify and cause failure, by creating opaque rules and regulations that can lead to information asymmetries and are prone to 'capture' by the very entities they should be regulating. A defining feature of the regulatory failure in respect of the GFC is the failure to properly identify the pressures that resulted in the emergence of GFC. The UK tripartite regulatory structure proved inadequate to deal with the systemic pressures created by the period of deregulation, resulting in failure and bailout.

Therefore, the overall aim of the research is to assess, with the GFC as the anchor point, the approach of policy makers to bank supervision and regulation to answer the primary research question of why regulate. It is a theme of the thesis to fill a gap in the debate that policy makers around the globe have 'rushed to regulate', based on political influences, and that what has resulted is to increase the complexity of bank regulation, leading to increased opacity in how they would be applied. This could result in a repeat of the supervisory and regulatory failures, which did not directly cause the GFC but failed to insulate the global economy from the impact

[20] See K C Engel, P A McCoy, The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps (Oxford 2011).

of the crisis.[21] A properly structured and functioning regulatory system can act as a 'vaccine against the contagion of bank failure'.

One of the great questions that pervades the debate into financial regulation is whether to regulate at all. Regulation is the exercise of state control over an element of society and will polarise opinion in respect of the volume and extent to which regulation should impact on its sphere of responsibility; bank and financial regulation polarises more than most.[22] The debate positions itself between those that advocate a free market in banking providing banks with the ability to issue their own money in an environment without central banks, to those that advocate close control over banks and their activities.[23] The GFC, which was precipitated by the 'credit crunch'[24] has led to a wide range of legislative and regulatory measures, however, what is less certain is whether the reforms have been little more than a political reaction, fuelled by the shock at the scale of the GFC, rather than a fully considered view based on wider economic and societal need. What has become clear is that unregulated banking is too dangerous to contemplate. This issue links to the origins of the research idea where the creation of the consolidated module arguably created a "regulatory monster" in the FSA that had the potential to obfuscate good regulation just to satisfy political opportunism.[25]

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[21] It is widely accepted that regulation of banks is not about creating a zero-failure regime, indeed failure is a natural part of the corporate cycle, but the failure of systemically important financial institutional failure has an impact beyond merely the failure of the individual institution. Bank and financial services regulation plays a role in ensuring standards are met and that the impact institutional failure is minimised. A key drive in the wake of the global financial crisis has been a change in the focus towards financial stability.

[22] R Baldwin, M Cave, M Lodge, Understanding Regulation: Theory, Strategy and Practice (2nd Edition, Oxford 2012).; Baldwin R, Cave M, Lodge M, Understanding Regulation (2nd Edition, Oxford 2012)

[23] F A Hayek, A Free-Market Monetary System (1977) Journal of Libertarian Studies, Vol3.No.1; See https://mises.org/library/free-market-monetary-system, last accessed 26/01/21

[24] Credit crunch is the term given to the period prior to the emergence of the GFC where inter-bank lending slowed down due to problems in pricing investments.

[25] A Alcock, A Regulatory Monster (1998) Journal of Business Law, Jul, 371, 371

Embedded in the research is the need to understand the utility of these measures, and it suggests, that there was, in at least some circumstances evidence of a 'knee-jerk' reaction to the crisis, a need to be seen to be doing something rather than a considered, analytical understanding taken of the causes and effects of the crisis. Some of the decisions in respect of bringing forward legislative and regulatory reforms were motivated by a political rather than socio-economic need, and this has led to measures that could fail in the future, just as the arguably politically motivated reforms leading to the FSA1986 and subsequently FSMA 2000 failed to prevent the largest financial markets collapse since the Wall Street Crash of 1929.[26]

Further, to understand the research questions there is a need to analyse the banking crisis' impact on the UK regulatory structure, to analyse whether the structure imposed by the legislative measures in place at the time truly failed and whether the measures that have since been enacted were necessary or were they a knee jerk reaction to be seen to be doing something. A primary aim of the research is to ascertain what an effective prudential regulatory structure or architecture should look like in practice and whether a 'stripped' back prudential regulatory and supervisory regime would meet the aims more effectively.[27]

There are several different approaches towards regulation within the context of bank regulation. Prior to the FSMA 2000 UK financial regulation could be classified as self-regulatory, albeit within a statutory framework.[28] However, this was altered by the introduction of a wholly[29]

[26] History.com, Great Depression History, https://www.history.com/topics/great-depression/great-depression-history, last accessed 22/01/21
[27] See Chapter 7
[28] I MacNeill, The Future for Financial Regulation: The Financial Services and Markets Bill (1999) Modern Law Review, Vol 65(5), 725
[29] Wholly here refers to the fact that the previous regulatory regime had been characterised as self-regulatory within a statutory framework, whereas the FSMA 2000 created a fully statutory regulatory regime.

statutory regulatory regime by the enactment of the FSMA 2000, administrated through a single regulatory authority, the FSA within a tripartite regulatory regime with the Bank of England and HM Treasury. Akinbami notes that the system favoured by this regime could be classified as meta-regulation, whereby the government regulator utilises the internal management and control processes of the regulated entities, in effect a form of self-regulation.[30] The FSAs use of its rule making powers created a system whereby the regulated entities were responsible for their own systems and controls to meet the overall regulatory requirements of government and its agency regulator. The regulatory process that evolved from FSMA was one where firms were left, in large measure, to decide their own regulatory processes on the basis that they remained compliant with the overall regulatory requirements set out in legislation, the FSA rules and guidance, most notably as detailed in the FSA Handbook. As the thesis posits this system failed, firms were poor regulators of their own activities developing innovative investment products in their search for profit, resulting in catastrophic decisions at key times.[31]

Regulation and its architecture play an integral role in the success of achieving the stated regulatory rationales. Understanding the architecture requires an understanding of the theoretical context in which regulation operates; such an analysis could be a project on its own, so this research does not propose to undertake a complete analysis of regulatory theory, but to limit such analysis to the context of bank regulation, the focus of this research project. The focus is on the central question of what the best regulatory structure for UK banks is, to maintain safety and soundness of the financial system, to ensure financial stability, and to remain globally competitive. The question of why regulate then becomes clearer.

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[30] F Akinbami Is Meta-Regulation all it's cracked up to be? The case of UK financial Regulation', (2013) Journal of Banking Regulation, 14(1), 16

[31] See The Turner Review: A Regulatory Response to the Global Banking Crisis (March 2009), FSA London

1.4 Scope of the Research

The research illustrates that the overall and primary functions of bank regulation is to maintain financial stability, the lacunae at the centre of the GFC, and this leads to a need to focus more on the structure and in particular the architecture of bank regulation in the UK. The GFC provides the benchmark opportunity to analyse the development of regulatory structures in the UK and to ascertain the effectiveness of such structures. While Brexit will have an ongoing impact on how the UK regulates banks a detailed discussion of the impact of Brexit is beyond the scope of this research, however, some relevant issues will be included as required.[32] The term GFC is used here to describe a confluence of events that resulted in the near collapse of the global financial system. It is not a single 'shock' type of event but is the product of financial policy and financial institution actions since the 1970's which came to its zenith between the late summer and early autumn of 2007, and early 2009.[33] The origins of the GFC pre-date this time and the pressures that resulted in the GFC were evident in at least mid-2006. However, the emergence of the GFC as a global phenomenon that can be seen in the actions of BNP Paribas from August 2007 and the actions of other financial institutions, regulators, and governments from this point. The early part of the GFC is characterised as a credit-crunch, which in turn became a credit crisis followed by a wider financial crisis. This research refers to the impact of this period on the banking and financial sector, and the wider global economy following the emergence of the GFC.

[32] The thesis was developed either side of the referendum on whether the UK was to leave or remain in the EU with the original proposal blind to the possibility of such an event. The decision to leave will have an impact on the long term of bank regulation in the UK, with some undoubted short-term amendments, for example the EU Passporting system. See J Herbs and S Lovegrove, Brexit and Financial Regulation (Oxford 2020). See Appendix A for commentary on Brexit and impact.

[33] M King, Banking: From Bagehot to Basel, and Back Again (2010), Speech, The Second Bagehot Lecture, Buttonwood Gathering, New York, 25th October 2010; T F Rotheli, Causes of the financial crisis: Risk Misperception, policy mistakes, and banks bounded rationality (2010) The Journal of Socio-Economics, 39, 119

Additionally, the research is focused on the regulation of banks in the UK and therefore references to wider financial services regulation will be included only for context and where relevant to the overall thesis. Therefore, no detailed analysis will be included on such as issues on MIFIID/2 and similar provisions looking at the detailed rules and regulations. The focus is to ascertain what the optimal structure of bank regulation should be to prevent a repeat of the GFC.

The research concentrates on gaining an understanding of why the regulation of banks is necessary and why one potential structural option should be chosen over another. Reference will be made to structural options available to governments in the pursuit of overall regulatory aims. The GFC opened the debate on regulation generally. This debate encompasses the whole sphere of regulatory activity from the activities of national governments and through to regulatory agencies and authorities created to regulate banks and banking services. Regulation covers the structure and the minutiae of governing and controlling banks, however, the primary thesis of this research is that structure over substance is the key to maintain liquid markets in a stable financial system. [34]

Why regulate becomes an important question in this context; the key issue to understand is what the rationale for regulating banks is? Prior designing the structure and architecture of regulation it is fundamental to ask why it is needed, asking what the required outcomes from regulation are. To understand why regulation is needed, focusing on the basis and purpose,

[34] This refers to the multitude of rules that regulatory authorities promulgate in pursuit of the overall regulatory objective set. This thesis does not delve into the minutiae of the rules of regulation.

will allow for a stronger understanding of what the structure and architecture of regulation should look like to optimise the outcomes of that regulation.

1. 5 Conclusion

The aim of this research is to ascertain why regulate banks from the view of what the optimal regulatory and supervisory landscape should look like. The current approach has an increasingly complex layering of regulation; however, insufficient analysis has taken place in respect of whether increasing the layers of regulation will prove more effective than removing layers. The thesis is structured to answer the research question, laying out the conceptual framework initially, before setting out the rationale of why regulation is necessary.[35] The thesis then delves into analysing the regulatory rationales with reference to the GFC, analysing the causes and moving to an analysis of the pre-crisis regulatory structure.[36] The thesis then analyses the post-crisis structure noting a rush to regulate based on political rather than economic needs.[37]The thesis then concludes with a review of the analysis with a view on providing the answer to avoid the premise of the quote at the top of the chapter.

[35] See Chapters 4 and 5 respectively
[36] See Chapters 6 and 7 respectively.
[37] See Chapter 8.

Chapter 2 Methodology

2.1 Introduction

This chapter will consider the methodologies chosen to undertake the research articulated in this thesis. One of the key secondary aims of the thesis is to add to the debate on the regulatory lessons learned from the global financial crisis (GFC). Tafara noted that the "most recent financial crisis is of paramount concern … but in the long run, what it reveals may be of greater concern".[38] Thus suggesting that analysis and scholarship will provide solutions and plans to avoid a repeat. This chapter outlines the research methodology utilised in this research, discussing, and analysing the methods used and sets out the strategy undertaken in the research. The methodology of scholarship allows the subject of the research to be undertaken with specific goals in mind, for example empirical research allows for a data-based analysis of a specific issue or area.

2.2 The Choice of Methodology

While the thesis ultimately employs a range of research methodologies it will primarily utilise two key methodological processes, namely sociolegal and doctrinal. Both methodologies provide the optimum viewpoint in which to analyse the regulatory processes that led to the GFC and the debate that has ensued. There is, however, a tension between the methodological approaches employed due to the nature of the subject area under investigation. From a classical perspective doctrinal research or black letter law methodologies provide the obvious approach to an analysis of the GFC. Posner notes that doctrinal analysis "is the traditional and still the

[38] E Tafara, Observations about the crisis and reform , in E Ferran, N Moloney, J G Hill, J C Coffee, The Regulatory Aftermath of the Global Financial Crisis (Cambridge 2012)

dominant mode of legal scholarship".[39] Doctrinal research refers to a research process which is derived from the Latin *doctrina*, meaning instruction, knowledge, or learning. Doctrinal refers to research where "legislation and case law are examined critically and then all the relevant elements are combined or synthesised to establish an arguably correct and complete statement of the law on the matter in hand".[40] The thesis involves a detailed review and critique of the legislative provisions enacted to provide the regulatory environment for banks with detailed analysis of selected literature on bank regulation, including official and semi-official reports, books, and journal articles. Hutchinson and Duncan provide a direct link to the research in this thesis with specific reference to the GFC:

> "With the Global Financial Crisis as a backdrop, it is not surprising that government policy is attempting to direct research money towards whatever is judged to be 'quality' research. Now, more than ever, it is imperative that academic lawyers, working within an increasingly sophisticated research context, explain and justify what they do when they conduct 'doctrinal research'".[41]

The clear advantage of doctrinal research is that it allows for an analysis of the regulatory provisions and legislation in place that provided the environment for the GFC to emerge, alongside a qualitative analysis using the published material on the GFC as the basis of that analysis. However, there are limitations to the doctrinal methodology. For example, Salter and Mason have described it as being too formalistic and leading to the potential of oversimplification,[42] and possible description. As they note a key 'pitfall' is that while

[39] R A Posner, The Present Situation in Legal Scholarship (1981) The Yale Law Journal, Vol90, No.5. Symposium on Legal Scholarship: Its nature and Purposes, 113.
[40] D Watkins and M Burton eds, Research Methods in Law (2nd Edition, Routledge 2018), 13.
[41] T Hutchinson, N Duncan, Defining and Describing What We Do: Doctrinal Legal Research (2012).
[42] M Salter and J Mason, Writing Law Dissertations: An introduction and guide to the conduct of legal research (1st edn Pearson 2007)

doctrinal analysis claims to address issues such as the utility of legislative provisions, the nature of the subject being analysed a socio-legal approach would be the appropriate methodology on the basis that such an approach would better "address policy aspects of the law in context".[43]

Socio-legal methodologies has been described as a an "umbrella term",[44] its use is contentious [45] and there is no accepted definition.[46] Harris notes that in relation to regulatory control socio-legal research is a relatively newcomer, however, there has been a significant momentum shift in favour of socio-legal research methodologies.

Whilst the starting point for this thesis was the use of the doctrinal analysis of the relevant legislative provisions, banks operate within a wider social context which can only truly be analysed through socio-legal methodologies. Rhode supports this assertion in stating that this is key for anyone seeing law as a key component of social development.[47] As Cotterrell states:

> "For some… [socio-legal research] …it has been a promise of sustained commitment to moral and political critique of law and theoretical and empirical analysis of laws social consequence and origin".[48]

This point resonates with a key theme of the thesis in respect of the knee jerk politically driven regulatory changes that followed the GFC. While the provisions can be subject to

[43] ibid
[44] F Cownie and A Bradney, Socio-legal studies: A challenge to the doctrinal approach in D Watkins and M Burton (eds), Research Methods in Law (Routledge 2013)
[45] ibid
[46] D Harris, The development of Socio-Legal Studies in the United Kingdom (1983) 3 Legal Studies 315
[47] D Rhode, Legal Scholarship, (2002) 115 Harvard Law Review 1327
[48] R Cotterrell, Subverting Orthodoxy, Making Law Central, A View of Sociolegal Studies (2002) 29 Journal of Law and Society 632

the doctrinal analysis the context in which those provisions are applied clearly sit within the socio-legal sphere. Cotterrell noted that socio-legal research methodologies allow a "breakout from the claustrophobic world of legal scholarship"[49]. Socio-legal scholarship provides the opportunity to fully analyse the impact of regulation on banks and bank like entities as doctrinal approaches tend to focus on the technical, lacking a focus on the social consequences of law[50]. The thesis analyses regulatory reform and its application in a societal context which requires a socio-legal lens to provide the most effective analysis.

2.3 Method

The overall approach utilised is a qualitative review of published literature in this field. The GFC ignited a debate about all aspects of regulation resulting in a large volume of literature and reports available on this subject covering an extremely wide view. The issue of bank regulation has long been an emotive subject with significant material published on the subject area. The GFC exploded the debate and therefore the literature on the subject and as such the research utilises the literature published in the years preceding the GFC and the immediate aftermath.

To support the primary doctrinal analysis the thesis employs a qualitative approach. The debate surrounding regulation is not approached through a single lens, and to a large extent can polarise opinions linked to political preference generally supported by economic thought. The work of neo-liberal economists such as Hayek and Friedman would advocate a light touch approach to the creation and application of regulation, whereas the work of Keynes and Minsky would advocate a more hands on level of control. Therefore, there is an incredibly broad range

[49] Ibid
[50] Ibid

of literature generated at opposite ends of the debate, as well as in the middle. Qualitative research methodologies cover a range of approaches, however, the emphasis in this thesis is on the case study approach. The case study utilised here is the Global Financial Crisis with the use of case study analysis being “particularly well suited to new research areas for which existing theory seems inadequate”.[51] The utility of the GFC as a case study is that the criticism of the incumbent regulatory regime led to significant reforms resulting in major shifts in emphasis. This allows the analysis to analyse two distinct regulatory architectural viewpoints, namely the single consolidated regulatory model as analysed in chapter 7 and the modified twin peaks system brought in following the GFC; analysed in chapter 8. Both systems, however, are the result of political influence which has the possibility of clouding the case study.

The second method utilised is the review of official and semi-official reports. The subject of bank regulation is an important consideration for national governments and as such governments, particularly those in the developed world have regularly undertaken review and reform of regulation in this sphere. This generates significant documentary discussion of the key issues, including consultation papers, white papers, and draft legislation.[52] In addition the subject of bank regulation attracts significant supra-national discussion. Organisations such as the Bank of International Settlements, the United Nations, OECD, and the EU.

[51] K M Eisenhart, Building theories from case study research (19890n14) Academic Management Review, 532, 548-549.

[52] See for example, ; HM Treasury, Reforming Financial Markets (White Paper, Cm 7667 July 2009) House of Commons Treasury Committee, The run on the Rock, Fifth Report of Session 2007-08, Volume 1, HC 56, 26th January 2008; House of Commons Treasure Committee, the FSA’s report in the failure of RBS, HC 640, 19th October 2013; Parliamentary Commission on Banking Standards, An Accident Waiting to Happen: The failure of HBOS, HL Paper 144, HC 705, 4th April 2013

To a lesser extent the thesis employs a comparative analysis. Hantrais notes that comparative research methods have utility when analysing similarities and differences across societies.[53] With regard to bank regulation and the GFC this allows a comparison to be made with jurisdictions that have faced similar issues. The focus of the thesis is on the UK approach to regulation, however, some comparative analysis to other countries regulatory structures permits a comparison to be made with respect to the optimum structure of bank regulation, with the aim to prevent future crises. To this aim, the thesis makes comparisons with the USA where the crisis originated, and where the overall regulatory structure is different to the UK. A comparison with Australia, which has a different regulatory structure and the impact of the GFC was less felt, with the interesting outcome that the UK has now moved to such a structure. Further comparison is made with the Netherlands which operated a structure like Australia but where the impact of the GFC was more severe. Comparative analysis in this field allows the analysis of other systems to ascertain whether one structural option is more optimal than another, or even to conclude that none of the employed structures offer particular benefit on their own. A failure with such analysis in respect of the GFC is that the two primary regulatory systems in the US and UK which were badly affected by the crisis had two very different approaches to regulatory structure, and both failed so it cannot be determined that one was better than the other. What can emerge from an analysis of the UK and US approaches is that both systems need to learn lessons.

While the thesis employs a hybrid socio-legal/doctrinal research methodology with qualitative method other methodologies were available and considered. A more empirical quantitative approach with primary data collection was briefly considered but did not match with the

[53] L Hantrais, Comparative Research Methods: Social Research Update (1995) University of Surrey Social Research Update, https://sru.soc.surrey.ac.uk/SRU13.html, last accessed 27/01/21

outcomes to be achieved. The subject area is large, and the research focus was why regulate by understanding the architecture employed to undertake regulation which made it more appropriate for a qualitative approach to be employed.

Chapter 3 Literature Review.

This chapter undertakes a review of some key themes in the literature with reference to the structure of regulation. The chapter identifies a skewed view to regulatory approaches in so much that the response to crisis is a call for reform, with an inevitability that political considerations cloud judgement preventing the true rationales for regulating from emerging. This point is noted throughout the thesis and is an issue lacking in the literature addressed by the thesis. Most of the analysis focuses on causes and effect by looking at the regulatory environment that applied at the material time, however, it is the wider economic and political environment that provides stronger illumination of the issues and the need for reform. The reform agenda as analysed in chapter 8 predominantly corresponds with an increase in both the volume and complexity of regulation however, this presents significant dangers for regulation in that it creates opacity in regulatory approaches leading to information asymmetries which result in a failure of the structure to achieve the needed goals. Chapter 8 additionally explores the political drivers behind regulatory design, which is lacking in the literature of the GFC generally. The global financial crisis (GFC) that emerged in 2007 presented the regulatory authorities with the largest financial dislocation since the 1930's with significant criticism placed on regulators for multiple failures; to recognise that major pressures were building up within the financial services sector, the runaway development of innovative products, and the failure to act with sufficient haste to prevent a near collapse of the banking system.[54] The impact of the GFC has led to a significant body of literature on causes, effects, and how to prevent a repeat. The frantic pace of legislative reform that followed the GFC, both domestically and globally has generated further discussion.

[54] M Melvin, M P Taylor, The global financial crisis: Causes, threats and opportunities. Introduction and Overview (2009) Journal of International Money and Finance, 28, 1243

3.1 Thematic approach to literature review

The analysis of the GFC reveals several themes under which a review of the literature can take place. The first theme is the need to understand the rationale and need for regulation. Breyer notes that a key driver is the "alleged inability of the market-place to deal with particular structural problems".[55] This was evident in the GFC where the regulatory structure in operation failed to provide the necessary protection from the actions of banks in the financial marketplace. Chapter 5 sets the background in respect of the overall thesis question of why regulate, providing further analysis of the failure of policy makers to address the true needs of regulation. The chapter explores the rationales for regulation in the context of banking and financial markets. The chapter outlines some key issues in respect of bank regulation and theory, in particular capture theory which posits that the regulation serves a self-interest position, and that the regulator is prone to being 'captured' by the industry that it is supposed to regulate, impacting the effectiveness of the regulatory system. There is a broad literature on capture theory, the most important of which is its origin in Stigler's, 'The Theory of Economic Regulation' in which he first noted that "as a rule, regulation is acquired by the industry and operated primarily for its benefit", highlighting the practical implications when he noted that "the power to insure banks has been used by the Federal Deposit Insurance Corporation to reduce the rate of entry into commercial banking by 60 per cent".[56]This is an important issue as regulation cannot be effective if it is subservient to the industry it regulates. This further links to too big to fail in that the regulatory capture theory has led to a reduced level on new entries into the banking sector.

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[55] S Breyer, Typical Justifications for Regulation, in Baldwin Robert, Colin Scott, Christopher Hood eds, A Reader on Regulation (1998, Oxford),60

[56] G J Stigler, The Theory of Economic Regulation (1971) The Bell Journal of Economics and Management Science, Vol.2, No.1, 3, 5

The second theme is analysed in Chapter 6 which explores literature about the causes of the GFC. What emerges is that the literature does not sing with a single voice. Acharya and Richardson focus on the boom-and-bust cycle common in economies[57], which is taken up by Diamond and Rajan who note a lax monetary policy from central banks in the years immediately prior to the GFC, further noting that low interest rates led to a surge in the demand of housing, and by extension mortgages.[58]This further evidences the influence and even interference of political decision-making processes in the design of regulatory architecture.

This links but diverges with another often-cited cause of the GFC, namely the subprime mortgage crisis that immediately preceded the ossification of financial markets. Engel and McCoy undertake a comprehensive analysis of what they term "the subprime virus' reflecting the spread of the subprime failure to global financial markets and its overall impact.[59] The study is comprehensive and recommends a range of specific solutions focusing on consumer protection and systemic oversight, however, it does not seem to deal specifically with the need for a more policy-based approach. Further literature centres on the failure of regulation and the regulators, for example Tomasic and Akinbami reflect on the failure of regulation in which the light touch approach taken by the regulators ultimately led to a regulatory race to the bottom.[60]While the literature notes the oft cited causes it does not explore the concepts of political influences linked to a deregulatory macro-economic environment which the thesis posits as a key cause of the failure of regulation.

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[57] V Acharya, R Matthew , Causes of the Financial Crisis, (2009,) Critical Review, 21:2-3, 195

[58] D W Diamond, R G Raghuram, The Credit Crisis: Conjectures about Causes and Remedies, 2009, American Economic Review: Papers and Proceedings, aeaweb.org/articles.php@doi=10.1257aer.99.2.606

[59] K C Engel and P McCoy, The Subprime Virus: Reckless Credit, Regulatory Failure, and next steps (2011, Oxford)

[60] R Tomasic, F Akinbami, Towards a new corporate governance after the global financial crisis (2011), International Company and Commercial Law Review, 22(8), 237

The third theme focuses on the legislation in place in the years prior to GFC, analysing the structure that was in place at the time the Northern Rock bank failed. This theme is investigated in Chapter 7 which focuses on the regulatory system in place during the period leading up to the GFC, and its immediate impact. The earlier literature in this area comments on the creation of what Alcock termed "regulatory monster" in the FSA, however this was not borne out by the GFC.[61] The focus on consumer protection and lack of understanding of systemic risk, in an environment that Turner noted as "light touch" actually created a 'regulatory monster' without bite, that proved weak in the face of the emerging GFC.[62] The literature also exposes problems with the overall regulatory structure in place in the UK in claiming the existence of a consolidate model around a the FSA as a single regulator, however, the reality was a 'three-headed' regulatory system than included the Bank of England and HM Treasury, which failed to work effectively. There is a significant body of work on the structure at the time of the GFC and notes the poor working relationship but does truly focus on the core fact that the UK did not operate a consolidated model, but in fact employed a worst of all cases option of placing all the regulatory objectives within the FSA but was reliant on a weak communication process between the tripartite authorities. Lomnicka and others focus on issues of accountability in the consolidated model, however the literature generally does not make a strong case for bank regulation to remain with the Bank of England.[63] Taylor's influential twin peaks proposal focuses on splitting regulatory functions between two 'peaks, one covering prudential regulation with a systemic stability function at its core; the other 'peak' would manage conduct related issues within firms and markets.[64] While this structure was available in the latter half

[61] A, Alcock A Regulatory Monster, (1998) Journal of Business Law, Jul, 371, 371
[62] The Turner Review: A Regulatory Response to the Global Banking Crisis (March 2009), FSA London
[63] E, Lomnicka Making the Financial Services Authority Accountable, (2000) JBL,Jan, 65
[64] M Taylor, Twin Peaks; a regulatory structure for the new century (1995), Centre for the Study of Financial Innovation.

of the 90's it was not implemented; the single consolidated model preferred by the government of the time. It is a conclusion of this thesis that the decision to opt for a hybrid single regulator model was an error, and the twin peaks model should have been adopted as part of the FSMA 2000 reform package. The stronger focus on systemic, macroprudential elements makes this an overall stronger structure. What is less clear from the literature is the role of the Bank of England in respect of direct bank regulation. As with previous themes missing from the debate is the correlation between regulatory design and political influences. The evidence provided in Chapter 7 supported by the conceptual framework and regulatory rationales chapter show that the insufficiently robust system was the product of designing a regulatory system around political needs rather than one based on need.

An additional issue to emerge from the literature on the pre-crisis regulatory structure is the lack of bank resolution mechanisms available to an institution in distress. The failure of Northern Rock and the enactment of emergency legislation to nationalise followed by the permanent provisions of the Banking Act 2009 evidence this lacuna. As Singh notes the need for an early intervention mechanism to step in prior to the complete failure of a regulated institution is fundamental to ensuring financial stability, stating that the Banking Act 2009 provisions clearly show the importance of a strong relationship between the central bank and regulator in managing systemic stability.[65] This debate and focus on stability is missing from the pre-crisis literature generally, but has exploded post-GFC. There is now a wealth of literature on regulation meeting financial stability, however, much of this remains focused on regulators creating detailed rules and regulations and required compliance, whereas this thesis posits that a simpler and more transparent regulatory environment would allow the regulators

[65] D Singh, The UK Banking Act 2009, pre-insolvency and early intervention: policy and practice (2011) Journal of Business Law, 1,

to maintain stronger oversight of their regulatory responsibilities, as analysed in Chapter's 5, 6, 7 and 8. The focus of this thesis is to start with regulatory rationales, and to understand the important under pinning principles to provide a clear plan for regulatory architecture. This must also include an understanding of unseen forces that impact on regulatory design decisions, in particular Moral Hazard. The importance of understanding moral hazard was noted by Partnoy where he claims that financial crises can be brought about by moral hazard due to the presence of insurance in the form of bailout, deposit guarantee and lender of last resort facilities provided by central banks.[66] Chapter 4 sets the conceptual framework and looks at the impact of moral hazard on banks and regulation and focuses on the macroprudential issues that pervaded the regulatory systems during the 50 years of financial liberalisation that preceded the GFC. Once again this reflects on the change in prevailing economic thought linked to politically motivated drivers. The chapter looks to analyse the underlying conditions that made the GFC possible, looking at key issues of moral hazard and too big to fail. Chapter 7 investigates the regulatory structure in place at the time the GFC emerged towards the end of 2007. The chapter reviews the regulation in place prior to the FSMA 2000, namely the Financial Services Act 1986, leading up to the enactment of the FSMA 2000 and the installation of the single consolidated regulator, the FSA. The chapter analyses the performance of the regulatory structure reflecting on the criticism levelled at the FSA and the tripartite regulatory structure in place at the time. It is clear that the regulatory process failed in the years prior to the emergence of the GFC. The tripartite regime worked poorly together with uncertainty between the three authorities of what their exact role was. The chapter subsequently investigates the initial responses to the emerging crisis, the special resolution regime that allowed Northern Rock to be nationalised and then placed on a permanent footing by virtue of

[66] G Partnoy, Financial Systems, Crises, and Regulation, in The Oxford Handbook of Financial Regulation (2015 Oxford)

the Banking Act 2009, followed by the insertion of a financial stability objective into legislation.[67]

The fourth theme looks at the literature surrounding the reform measures that followed the impact of the GFC. In the UK the single regulator, consolidated model was abandoned in favour of a modified twin peaks structure. The literature in this area exposes the political influence in regulatory design yet fails to fully link the two issues. A lone voice in this area is Ferran who notes this in asking whether the decision to replace the regulatory structure provided for by the Financial Services and Markets Act 2000 was based on political considerations[68]. Political rationales for regulatory structure reform, focused on the need for the optics of being seen to be doing something, but not fully explored in the literature. Chapters 4-8 attempt to show how strong that link was and still is.

A key element in the literature is a realisation that the focus of the regulatory structure was skewed toward the micro-prudential, firm specific view, in so much that the authorities were concerned with individual bank collapse and missed the wider picture of systemic failure.[69] The literature exposes a narrow viewpoint taken by all regulatory authorities including the FSA. The GFC exposed a clear problem with this approach and the failure to understand the interconnected nature of domestic and global banks, so that the failure of one bank could lead to a domino effect of failures within the banking system. Chapter 8 investigates the post-crisis regulatory reforms following the UK General Election of May 6h 2010. The then Coalition set

[67] P Rawlings, Bank Reform in the UK: Part II – Return to the Dark Ages (2010) International Corporate Rescue, 10
[68] E Ferran, The Break up the Financial Services (2011) Oxford Journal of Legal Studies, Vol31, No.3, 455 Financial Stability Board
[69] P Jackson, Financial Stability as a Policy Objective, Journal of Financial Crime (20040, 11(4), 356, 356

forth an ambitious programme of legislative reform, replacing the FSA as the single consolidated regulator with a twin peaks system based around a two-pronged system of larger banks subject to prudential regulation by the Prudential Regulation Authority (PRA) and conduct regulation undertaken by the Financial Conduct Authority (FCA), under the oversight of the Financial Policy Committee a macroprudential oversight body tasked with monitoring the wider economic issues.

The fifth theme picks up on the macroprudential issues that impact regulatory design. This issue pervades the debate on regulatory success and is a theme discussed in chapters 4-8. The GFC exposed the missed focus for regulatory authorities noted above. The literature in regard this theme picks up the issues of financial innovation and moral hazard. The almost exponential growth in growth and use of innovative investment products in the search for yield has its origins in the wake of the collapse of the Bretton Woods agreement which had maintained economic growth in the post-war years, however, faced with economic crises of the early 1970s pressures to liberalise economic processes led to a sustained period of deregulation under a re-emergence of pre-war economic though based on free market thinking. The works of Hayek[70] and later Friedman[71] moved economic thinking away from the economics of Keynes[72] in which governments play a much more central and interventionist role in the management of the economy.

[70] F A von Hayek, The Road to Serfdom (originally published 1944, Routledge 2001)
[71] M Friedman, Capitalism and Freedom, (originally published 1962, Chicago 2002)
[72] John Maynard Keynes, J M Keynes, The General Theory of Employment, Interest and Money (First published 1936 Springer, 2018)

Pesendorfer investigates the growth in market liberalisation and the focus on neo-liberal thinking that led to the GFC concluding that it would be difficult, but “doable”, to “get rid systematically of all the speculative, risky and at the end of the day, costly financial innovations and aggressive profit-maximising funds”.[73] With respect to the argument there is no need to get rid of financial product innovation, and in trying to do so would cut off important liquidity generation vehicles that economies rely on. A focus on understanding regulatory rationales in designing regulatory structures will allow financial innovation to thrive in a sound and safe system. Avgouleas agrees with the position that financial innovation has been of value, however, concludes that greed from within financial organisations with particular reference to the unregulated sector, and noting that the reforms that have followed the GFC do little to deal with this issue.[74] This provides evidence that the basis for creating a strong banking sector lies outside the minutiae of rules and regulation but in ensuring that the regulatory structure meets the overall rationale which lies beyond the mere control of firms, and focuses on a wider picture of systemic stability.

Another important discussion in the literature following the GFC is the debate around the failure of economics with respect to banking, particularly the reliance on the efficient market hypothesis which as Bliss comments that prices of financial securities in their respective markets correctly reflect all available information.[75]This posits that markets are rational and that market actors make rational choices in respect of investment, however, as Krugman notes

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[73] D Pesendorfer, Goodbye neo-liberalism? Contested policy responses to uncertain consequences of the 2007-09 financial crisis, in K Alexander and R Dhumale, Research Handbook on International Financial Regulation (2012 Edward Elgar), 431
[74] E Avgouleas, Regulating Financial Innovation in N Moloney, E Ferran, J Payne eds, The Oxford Handbook of Financial Regulation (Oxford 2015)
[75] R R Bliss, Market Discipline in Financial Markets: Theory, Evidence and Obstacles in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014),

real world investors are not as rational as modelling would suggest.[76] On the other side of the debate is Minsky's 'financial instability hypothesis'.[77]As McCully notes that Minksy declared that "stability is ultimately destabilising because of the asset price and credit excesses that stability begets…stability can never be a destination, only a journey to instability". [78] As Minsky himself notes "over a protracted period of good times, capitalist economies tend to move from a financial structure dominated by hedge finance units to a structure in which there is large weight to units engages in speculative and Ponzi finance".[79] This accurately reflects the GFC where a prolonged period of boom resulted in increased innovation to drive yield growth, dependent on ever more desperate measures to 'feed' the securitisation process made possible by the huge increases in subprime mortgage lending, often on the basis of fraud. Chapter 6 discusses the subprime mortgage issue, while. Chapter 4 explores this issue looking at linked issues of moral hazard, financial innovation in a deregulatory and market liberalising environment and the creation of the too big to fail institution.

While the GFC has created a wealth of literature on analysing cause, regulation, and reform there is a paucity on specific recommendations beyond the official documents. Taylor posited the twin peaks structure in the period prior to the enactment of the FMSA 2000, although ignored by policy makers at the time[80]. Kay is one that has advocated a radical alternative to

[76] P Krugman, How did Economists Get It So Wrong?, The New York Times (New York, September 6th 2009), http://faculty.econ.ucdavis.edu/faculty/kdsalyer/LECTURES/Ecn200e/krugman_macro.pdf, last accessed 27/01/21.
[77] H Minsky, The Financial Instability Hypothesis (1992) Levy Economics Institute of Baird College,Working Paper No.74
[78] P McCulley, The Shadow Banking System and Hyman MInskey's Economic Journey, (2009) Insights into the Global Financial Crisis: Economic Theory and Philosophy, The Research Foundation of CFA Institute; https://www.cfainstitute.org/-/media/documents/book/rf-publication/2009/rf-v2009-n5-15.ashx, 261
[79] H Minsky, The Financial Instability Hypothesis (1992) Levy Economics Institute of Baird College,Working Paper No.74, 8
[80] M, Taylor Twin Peaks; a regulatory structure for the new century (1995), Centre for the Study of Financial Innovation

the norm in his “Narrow Banking” concept.[81] In looking to address systemic risk and moral hazard issues he advocated that retail banks be limited to a very narrow set of activities such he equated with traditional banking services, such as deposit taking and payment services.[82] The issue of narrow banking is considered in Chapter 4 in more detail.

[81] J Kay, Narrow Banking: The Reform of Banking Regulation, (2009), Johnkay.com; https://www.johnkay.com/2009/09/15/narrow-banking/,

[82] See Also P Rawlings, Bank Reform in the UK: Part I – The Future of Banking Commission (2010) International Corporate Rescue, 3

Chapter. 4 – A conceptual framework

4.1 Introduction

Banks and the regulation of banks do not operate in a vacuum, but within a complex and interconnected matrix that brings together a range of issues linked significantly to economic activity. The complexity creates an opaque environment that creates problems for effective regulation of banks and bank like entities. This chapter will provide a background framework to the analysis in subsequent chapters. It will lay the framework to provide understanding of the nature and importance of regulation in the context of banks. The chapter provides the context that banks operate within a complex environment linked closely to economic thought and activity, but also to political decision-making processes driven by which political party is in government at the material time. As Dowd states:

> "In country after country, we see governments panicked into knee-jerk responses and throwing their policy manuals overboard: bailouts and nationalisations on an unprecedented scale, fiscal prudence thrown to the winds, and the return of no-holds-barred Keynesianism".[83]

This quote illustrates the knee jerk approach with which national authorities approached the GFC, but it also evidences the web of complex and interrelated issues at the heart of banking and its regulation. This chapter will analyse the conceptual framework underpinning the thesis, playing a key role in the research contribution. The chapter links the operation of banks, and the supervision and regulation of banks with a broader debate into the operation and role of

[83] K Dowd, Moral Hazard and the Financial Crisis, 2009, Cato Journal, Vol 29(1), 141-166, 141.

banking. The chapter will analyse the part that several interrelated issues that emerged from the GFC played in creating a regulatory environment which was insufficiently robust and incorrectly focused to deal with the stresses encountered during the crisis. Such key issues include Too Big To Fail (TBTF) and moral hazard[84] in addition to the part that economic thought and theory played regarding the GFC. A further point for analysis is the over reliance and ultimate failure of long held economic principles, coupled with the emergence of complex and difficult regulations which were initially designed to control moral hazard yet played a central role in both the emergence of the GFC and the severity of its impact. It was the application of these elements at a policy level that created the GFC. The chapter provides an underpinning of the analysis that follows. The chapter builds a foundation to the thesis premise with respect to the rationale for regulation, which is investigated in chapter 5, outlining issues that show the pre-GFC regulatory regime to be unfit for purpose due to an incorrect focus. The chapter contributes to knowledge on the basis that there is still insufficient depth to the debate surrounding the reasons why the pre-GFC approaches failed, namely that the regulatory environment was impacted by poor policy level decision making which led to a 'rush to regulate'.

The GFC created a panic in the financial services industry that has led to a wide-ranging debate surrounding both the nature and rationale of regulation. In chapter 5 the overall rationales for regulation are analysed and in chapter 6 it is further noted that there are a broad range of issues that have been cited as a cause of the global GFC and its impact, however, the central argument of this thesis is that the true reason for the GFC was a general failure of economic theory applied to banks, financial services and associated activities and that the application of these theories

[84] See 4.3 below.

was misapplied; all of which was exacerbated by the linkages to the US sub-prime mortgage crisis. The sub-prime crisis provided a key element that created the ‘perfect storm’ under which contemporary thinking regarding financial markets and financial products failed. The sub-prime crisis created the critical mass to ignite a chain reaction in global economic markets. Further, the sub-prime crisis was evidence, at least in part, of poor overall control of important drivers of the economy, namely the financial services industry, with banks at the centre of this. This was based on a failure to understand two fundamental issues, namely a misunderstanding at both regulatory and firm level the issues of systemic risk, and a reliance on economic principles that had insufficient regard to the imperfections in the financial services markets.

4.2 A shift in emphasis – the Macroeconomic debate.

A feature of the post GFC regulatory landscape is the clear shift in emphasis from microeconomic and micro-prudential, firm specific regulation and supervision to the wider macroeconomic and macro-prudential focus. Tucker noted that a vital element of UK regulatory architecture reform following the GFC was the creation of the Financial Policy Committee (FPC).[85] The creation of the FPC is a clear sign of the mistakes made in the pre-GFC regulatory orthodoxy and as Turner further noted the FPC was designed to “fill the macroprudential gap left by our previous division of responsibilities between a micro prudential regulator and an inflation targeting central bank”.[86] This was replicated in the US with the development of the Financial Services Oversight Committee to undertake the same macroprudential oversight of the US financial services sector[87]. The clear lacuna in the

[85] P Tucker, S Hall, A Pattani, Macroprudential policy at the Bank of England (2013), Bank of England Quarterly Bulleting 2013 Q3
[86] Speech given by A Turner: Credit Creation and Social Optimality, (2011) Southampton University, 29th September 2011
[87] Financial Oversight Council, see https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc, reviewed 14/10/22

previous regime was the inward looking firm specific focus which missed the wider systemic stresses that had built up globally.

4.3 Moral Hazard -The safety net that creates more problems than it solves.

The phenomena of moral hazard represents probably the most significant challenge to creating robust regulatory process. As Guesnerie notes:

> "In the literal sense, moral hazard refers to the adverse effects, from the insurance company's point of view, that insurance may have on the insuree's behaviour","[88]

An important contributing factor in the GFC and a significant dilemma for regulators is the existence of the phenomena known as moral hazard. In the simplest terms moral hazard can be used to explain the behaviour undertaken by institutions and individuals in the period preceding the GFC in which the regulated institutions operated in an environment that was effectively bankruptcy remote.[89] Banks operated under an assumption that national governments and their regulatory authorities would step in and prevent their collapse, whether in the form of central bank liquidity support or, as was seen in the GFC full scale, taxpayer funded bailouts of banks with additional economic support provided as a result of the fallout from the banking crisis[90]. The underpinning thinking is that if someone is insured against a

[88] R Guesnerie, Hidden Action, Moral Hazard and Contract Theory, in J Eatwell, M Milgate, P Newman eds Allocation, Information and Markets (1989 Palgrave Macmillan)
[89] This refers to the position that banks operated in an environment where should they come under stress and face potential insolvency the central bank and regulatory authorities would step in to rescue the institution, thus making actual bankruptcy an unlikely event.
[90] See F Breedon, J S Chadha, A Waters, The financial market impact of UK quantitative easing (BIS) Papers No.65 https://www.bis.org/publ/bppdf/bispap65p_rh.pdf, last accessed 10/12/20

risk, they are less likely to plan for the potential outcomes of the risk materialisation. Mervyn King, the Governor of the Bank of England acknowledged the problem of moral hazard in expressing caution when asked to step in to support Northern Rock, reflecting on the issue that "it is crucial that, in making their lending and borrowing decisions, banks face the right incentives",[91] further noting that to take such action "encourages the very risk-taking that caused the present problems".[92] With respect the Governor's comments here the 'horse had already bolted' as to the risk bearing activities taken by banks, and by the time Northern Rock was requesting assistance very little could be achieved without recourse to bailout. Regarding banks, moral hazard is the environment created by policy makers that provide both explicit and implicit guarantees, 'safety nets' in the event of failure. As Veljanovski states "moral hazard is a situation where the prospect of compensation to cover risks and losses increases the likelihood and the size of the losses because risky behaviour cannot be monitored and prices appropriately, and excessive losses are compensated".[93] Moral hazard in banking created a culture of growth leading to the other major issue relating to banks, namely the Too Big To Fail (TBTF) conundrum that left the authorities with very little room for manoeuvre, other than to rescue the financial system. The presence of moral hazard allowed risky behaviour to become the norm as firms, their senior management and employees clearly felt they were operating in an environment where catastrophic failure would lead to rescue; that if a financial institution runs into significant financial stress national institutions and governments will step in to prevent systemic stresses from building up, which was borne out in the actions taken by the UK government from the Autumn of 2007.

[91] M King, Speech to the Northern Ireland Chamber of Commerce and Industry, Belfast, 9th October 2000
[92] Ibid
[93] C Veljanvski, Economic Approaches to Regulation in Robert Baldwin, Martin Cave and Martin Lodge (eds), The Oxford Handbook of Regulation (Oxford 2013), 23

The paradox in this situation is that the moral hazard of rescuing a bank is created out of a desire to prevent systemic failure but stems from a lack of foresight into the systemic risks in banking and lack of specific measures to deal with systemic risk. The pre-crisis regulatory focus was on the micro-economic firm specific measures, yet the GFC exposed the fact that it was failure to manage systemic risk that amplified the wider economic impact of the crisis. As shown in Chapter 8 the initial response of the UK authorities was to insert a new statutory obligation requiring the FSA to ensure financial stability, that is to ensure stability of the financial system which had been lost due to the financial position of several large banks. The evidence of the importance of systemic management is shown in the actions of governments in providing liquidity assistance, bailouts and nationalisation that were undertaken in the immediate aftermath of the emergence of the GFC. These actions were undertaken because systemic collapse was a real possibility, but they represent a reactionary *ex-post* approach to the emergence of financial chaos. The evidence that this was an incorrect approach comes from what we have seen develop since the GFC which is an ex-ante approach to systemic risk; a stronger focus on proactive management of system wide stress factors has become the feature of post crisis regulatory debate, the identification of systemically important banks that are subject to enhance capital regulation. Further evidence of this is in the creation of the Financial Policy Committee (FPC) in the UK and Financial Services Oversight Committee (FSOC) in the US, both of which are specifically charged with oversight the financial system and control of systemic risk.

Additionally, Dowd notes that moral hazard is “where one party is responsible for the interests of another”,[94] which in the case of the financial services sector and reference to the GFC is

[94] K Dowd, Moral Hazard and the Financial Crisis (2009) The Cato Journal, 29, 141, 146.

reflected in the position that taxpayers through the decisions and actions of government and regulatory authorities takes ultimate responsibility for the risk taking of financial institutions. The scale of the GFC was so large that usual central bank support such as liquidity support was ultimately insufficient. Usual central bank support is provided to one or two institutions in trouble, but the GFC is characterised by the failure and near failure of multiple banks within the system and subsequently the economic system, coupled with the threat of a domino effect. This level of support is beyond the means of the central bank thus requiring governments to step in, which means taxpayer funded interventions that result in wider ranging economic impacts[95]. The lack of systemic risk focus in the pre-GFC period forced governments to take wide-ranging measures to support their economies. While this is termed a taxpayer funded bailout this relates to government funded bailouts where the money is provided for from central government funds, it is termed taxpayer as the long-term impact of such bailouts is felt among taxpayers possibly in the form of increased taxes, but also in the reduction of services available to society or increased costs across a range of economic activity.

The moral hazard created by such guarantees can have a positive outcome in so much that the system is protected where failure is imminent which in turn protects the most vulnerable people in society from the outcome of such systemic failure. The Northern Rock failure and the systemic impact illustrated that the collapse of a retail bank would have significant negative impact on 'ordinary'[96] citizens. The policy implications for even a single bank failure will cause hardship if wages and salaries are not received and payments cannot be made. This is amplified as the failure sends shockwaves through the banking and financial system. As such

[95] The GFC required unprecedented action by national governments including record low interest rates which restrict governments and central banks from undertaking normal economic decision making.
[96] Ordinary is used here to describe the position of the general depositors in the bank which would be drawn from all parts of society.

this outcome linked to moral hazard, that institutions that may impact on ordinary citizens and have possible systemic implications, will be rescued ensures continuity of service alleviating possible hardship and wider economic impact. The downside, however, is that moral hazard comes at a price. It creates an environment where risk becomes normal, and where regulated institutions operate without the motivation that imprudent action will result in failure. The moral hazard presented by the GFC showed what little consequence for risky behaviour existed. Indeed, as Partnoy posits moral hazard can even be a contributing factor in creating financial crises, "the taking of excessive risks in the presence of insurance" encourages the very behaviour that can lead to collapse.[97] The GFC is evidence of this where banks and other bank like entities operated within an environment where failure was unlikely to be permitted by the regulatory authorities. [98]

Moral hazard and the GFC cannot be attached to a single policy initiative but because of a combination of different but interconnected policy mechanisms that were designed to prevent or militate failure. Instead, these policy initiatives and the application of accepted economic theory and practice played a significant role in creating and amplifying the crisis. Such policy initiatives include deposit guarantee schemes, lender of last resort facilities, and bailouts. Surprisingly, regulation itself may amplify moral hazard as it seeks to provide a safe environment within which financial institutions operate. As noted above the corollary of moral hazard is Too Big To Fail (TBTF) whereby institutions achieve a critical mass so that they become a risk to the system itself in the event of failure. The interconnectivity of banks and the contagion risk of failing banks makes it essential that national authorities step in to limit

[97] G Portnoy, Financial Systems, Crises, and Regulation, in The Oxford Handbook of Financial Regulation (2015 Oxford).
[98] For example see the discussion on Shadow Banks – Chapter 6

the impact on the economy overall. The failure to deal with TBTF has resulted in a failure to deal with moral hazard and as a result there is failure to eradicate the underlying issues that fuelled the GFC.[99] The feature of the pre-GFC era is the development of banks that became so large that they were too big for national governments to allow them to fail. In addition, the growth of these organisations and the interconnectedness they displayed. In the analysis of the GFC the outcome of the moral hazard is the creation of the banks that are now termed Global Systemically Important Banks (G-SIBS) or Globally Systemically Important Financial Institutions (G-SIFI), or what Wilmarth refers to as "megabanks". Such banks continue to provide uncertainty in the banking industry and require regulatory focus on the basis that failure would be a systemic event.[100] The post GFC reforms have failed to fully deal with this issue.

The result is that moral hazard in banking and finance can have an inverse influence on bank decision making and behaviour. The availability of a safety net leads financial institutions to take decisions that they may avoid in the absence of such guarantees. As Jackson notes banks believe that they will be saved when "engaging in unsafe lending if many other banks are doing likewise".[101] Therefore, with this guarantee in mind banks are willing and even actively engage in risk bearing activities. Jackson's point also refers to herd mentality in decision making where banks will engage in risk bearing activity as a group, engaging in the same risky activity knowing other banks are also engaged. This further exacerbates the interconnectedness of banks and the issues that arise from such close connections. Banks engage in activity as a 'herd' as the cost of a systemic failure is higher than a single institutional failure and as such authorities are more likely to provide rescue and recovery measures when the banking and

[99] A E Wilmarth, Taming the Megabanks: Why we need a new Glass Steagall Act, (Oxford 2020).
[100] Ibid
[101] P Jackson, Financial Stability as a Policy Objective, Journal of Financial Crime (20040, 11(4), 356, 356.

financial system is in danger of collapse. Moral hazard as illustrated below acts as a disincentive to safe and sound practice, especially in respect of the ‘herd’; it is in the interests of banks as a collective to take risks.[102]

4.4 The instances of Moral Hazard and the GFC

4.4.1 Bailouts.

It is now widely recognised that publicly and private safety nets, whether they take the form of public bailouts, Lender of Last Resort (LoLR) facilities or deposit insurance, bear the risk of creating moral hazard. Knowing that protection is available in the form of a government backed rescue may incite banks to take higher risks or may. The most clear and obvious policy mechanism that generates moral hazard is the implicit and sometimes explicit guarantees that financial institutions may receive from regulators, central banks, and national governments, that they will be rescued. These actions during the GFC that were applied from the summer of 2007 created an environment which itself may have amplified the impact of the failures. In an analysis of actions, the approach of the authorities can be categorised as confused, inconsistent and hesitant, but what emerged on both sides of the Atlantic as the crisis reached its zenith was a clear message from the relevant authorities to ensure that failure in the financial services sector could not be allowed to impact on the economy as a whole. The collapse of Lehman Brothers stands an outlier in this respect which the US authorities allowed to fail, however this created significant unease in the banking sector which required US authorities to step in 24 hours later to rescue AIG, followed by a large programme of support for the US economy under

[102] T F Rotheli, Causes of the financial crisis: Risk Misperception, policy mistakes, and banks bounded rationality (2010) The Journal of Socio-Economics, 39, 119.

the $700[103] billion Troubled Assets Relief Programme (TARP) with $250 billion committed to stabilise the banking system. [104] Unfortunately, the hesitation shown in the early stages and the failure to act on the obvious early signs of an emerging crisis resulted in significant economic impact.[105]

As the crisis in the banking sector gathered pace it became increasingly evident that authorities would be willing to step in and rescue failed institutions. This became even more evident following the Northern Rock failure in the UK where initial hesitation was followed by a taxpayer rescue package. The GFC has been described as the greatest moral hazard in history.[106] Bailouts represent the apogee of moral hazard, the ultimate statement that failure will not be allowed. Institutions that are confident they will be rescued will continue to take risks incompatible with sound and safe banking practices.

The existence of moral hazard provides clear evidence that the approaches to regulation and supervision of our financial institutions are misguided and that there is a danger of repeating the same mistakes that led to the GFC. By providing insurance against failure, the system in which financial institutions operate can run risks with the knowledge that the consequences of risk minimised by the existence of the insurance. A different train of thought is based around the removal of the bailout option as a rescue method, to provide inverse incentives for banks

[103] $700 billion was the headline figure announced by the US Treasury, of which only $450 billion was committed; US Department of the Treasury, TARP Programmes; https://www.treasury.gov/initiatives/financial-stability/tarp-programs/pages/default.aspx, last accessed 24/01/21.
[104] US Department of the Treasury, TARP Programmes; https://www.treasury.gov/initiatives/financial-stability/tarp-programs/pages/default.aspx, last accessed 24/01/21.
[105] See A Darling, Back from the Brink: 1000 Days at Number 11 (Kindle Edition Atlantic Books 2011).
[106] M King, Banking: From Bagehot to Basel, and Back Again (2010), Speech, The Second Bagehot Lecture, Buttonwood Gathering, New York, 25th October 2010; https://www.bankofengland.co.uk/-/media/boe/files/speech/2010/banking-from-bagehot-to-basel-and-back-again-speech-by-mervyn-king. Reviewed 11/10/22

to manage their risk profiles in a more efficient manner. If a bank knows it will be allowed to fail it will be forced into different choices.

4.4.2 Central Banking and Lender of last Resort.

Further moral hazard is evidenced through the existence of lender of last resort facilities, usually by the central bank. However, this may be provided by the designated regulator or by relevant treasury department. A characteristic of the GFC is that LoLR facilities were provided, or at least guaranteed, by treasury departments rather than central banks, one clear example being the US governments troubled asset recovery programme (TARP). Lastra notes that the LoLR role remains the central rationale for central banking around the globe, both in developed and developing countries, indeed the traditional view of central banks is linked to their function in providing liquidity support to institutions under stress and has long been the method used to prevent bank failure. [107] This rationale remains a key component of central banking even where other functions of central banking have faced reform. The problem for UK banking is that while the Bank of England retained its LoLR function it lost its bank supervision and regulation function which proved to be costly error in the long run.

Alongside traditional LoLR functions central banks have long been the agency responsible for banking supervision and regulation, however, more recent trends have removed the supervisory and regulatory function from the central bank, often with a trade off with other functionality; in the UK this being responsibility for the setting of interest rates. While central banking has been the subject of debate and reform, the LoLR facility has remained firmly part of the central

[107] R Lastra, Lender of Last Resort, an international perspective, (1999), International & Comparative Quarterly 48(20), 340.

bank function. Lastra continues by noting the theoretical foundations of LoLR set out by Thronton and Bagehot[108], in which LoLR should be short term only[109], supporting temporary illiquidity within solvent banks; that they should lend freely, but at a penalty rate, that anyone with good collateral should have facilities available to them and finally the readiness to lend freely should be clearly articulated in advance, indeed According to Bagehot[110], the lender of last resort is concerned about overall stability of the financial system, not by the fate of any particular firm.

The final of these highlights the potential moral hazard risks of where the knowledge of possible bailouts by the central bank has led to the ignoring of risk. In addition to the above it is also noted that LoLR action is discretionary rather than mandatory and so there is doubt as to whether the facility will be advanced, thus countering possible moral hazard risks levelled at LoLR initiatives. A further point of note is that when the central bank is considering deploying LoLR facilities it needs to assess not the health of the individual firm but whether the health of an individual firm will impact systemic risk. The focus on individual firm soundness is to miss the central lesson of the GFC. LoLR liquidity should only be advanced under strict rules and where the failure of an institution would impact on systemic stability.

The problem for UK banks was that the signal that was sent by the UK banking authorities was that failure would be rewarded with rescue, or at least failure would be prevented and that there was little consequence for the management of banks in failure. In effect the authorities chose

[108] W Bagehot, Lombard Street: A description of the money markets (Wiley and Sons 1873)
[109] R Lastra, Lender of Last Resort, an international perspective, (1999), International & Comparative Quarterly 48(20), 340.
[110] W Bagehot, Lombard Street: A description of the money markets (Wiley and Sons 1873)

the worst option, hesitation leading to confusion and then an unavoidable bailout. In moral hazard terms this sends a dangerous message, in effect signalling to the banking sector that they operate in an environment where there is little impact from risk taking. Just over a year after the failure of Northern Rock a similar situation was faced by US authorities initially with Bear Stearns and then with Lehman Brothers. In this instance authorities supported a takeover of Bear Stearns but allowed Lehman Brothers to fail, in what is the largest corporate failure in history.[111] The collapse of Lehman Brothers, however, proved to be a catastrophic systemic event that ultimately led the US authorities with little option but to step in the following day to rescue American Insurance Group (AIG) and ultimately provide a system wide rescue package for US financial institutions, the Troubled Assets Relief Programme (TARP).[112] What this shows is that the banking, and the shadow banking,[113] sector had grown to a position where failure could not be permitted and taxpayer supported bailout would be the norm, albeit clothed to meet the political requirements of the home nation.

What the actions of national authorities' evidence is that rescue is the only action available and that the institutions and senior management teams are aware of this; the emergence of Globally Systemically Important Banks (G-SIB) and Globally Systemically Important Financial Institutions (G-SIFI) reinforce this position[114]. Throughout this period bank bailout was never an explicitly stated policy objective but a failure to create an environment where failure could happen without systemic collapse resulted in at least an implicit guarantee that institutions

[111] See A R Sorkin, Too Big To Fail: Inside the battle to save Wall Street (Kindle Edition, Penguin, 2010)
[112] US Department of the Treasury, TARP Programmes; https://www.treasury.gov/initiatives/financial-stability/tarp-programs/pages/default.aspx, last accessed 24/01/21.
[113] See Chapter 6
[114] The difference between G-SIB and G-SIFI entities can be illustrated by reference to AIG (American Insurance Group) while not a bank still put significant pressure on the US financial system when it came close to failure requiring a bail-out of $85 billion. See https://www.theguardian.com/business/2014/oct/08/aig-trial-bailout-us-financial-crisis-geithner-punish accessed 14/10/22

categorised as systemically important will be rescued, with little impact on the senior management teams. With this knowledge it is in the best interest of institutions to create critical mass to ensure that they meet the systemic risk threshold and as such fall within the category of institution that will be rescued in the event of probable failure. This is the TBTF paradox that haunts the banking sector and has failed to be addressed in the post GFC environment. It is in institutions interest to become TBTF thus ensuring that governments have no choice but to rescue them when they fail.

4.4.3 Deposit Guarantee Schemes.

A further example of initiatives that are designed to militate failure but in fact create moral hazard risk is deposit guarantee or deposit insurance schemes. Typically these are designed to provide insurance cover to depositors where a financial institution has failed, and is usually provided by a government agency against the risk of loss from institutional failure.[115] Goodhart, identifies two purposes for deposit guarantees, firstly that they allow for an orderly run down of a bank and prevent a run by depositors, with the second purpose allowing for the first to meet, and in addition he notes that both provide mitigation against political fallout.[116] Very often the funds used to cover the failure comes from a pool of funds that each institution is required to pay to regulators. In the UK deposit protection is provided by the Financial Services Compensation Scheme (FSCS) which is funding by levies on those institutions authorised and regulated by the Prudential Regulation Authority and the Financial Conduct Authority. In addition, it is usual that the compensation scheme only covers claims up to a certain value, currently £85,000 per person, per authorised institution or £170,000 for joint

[115] In the UK the agency is the Financial Services Compensations Scheme, and in the US by the Federal Deposit Insurance Corporation.
[116] C A E Goodhart, The Regulatory Response to the Financial Crisis, (2009 Edward Elgar

accounts.[117] In the US this service is provided by an independent agency, the Federal Deposit Insurance Scheme (FDIC) which insures to a limit of $250,000 per depositor.[118] Kleftouri notes that Friedman refers to federal deposit insurance as the most important structural change in the US monetary system. [119] This undoubtedly reflects the momentous change when the US introduced deposit insurance in 1933, in the wake of the banking crisis that emerged after the financial crash of 1929, the so-called Wall Street Crash. In the UK the financial services compensation scheme was set up in 2001 as a part of the wider revolution in financial services ushered in by the Financial Services and Markets Act 2000.[120]

In line with the discussion above the clear problem with deposit insurance schemes is their potential to alter behaviour of bank depositors and banks themselves. Bank deposit insurance schemes are designed to support failure but if customers and banks are convinced that customers will likely lose little or nothing then customers and banks are less likely to monitor their investments. Where deposit insurance schemes exist “it might be all but impossible to escape the moral hazard inherent in deposit insurance”.[121] Analysis in the aftermath of the GFC notes increased risk and systemic fragility where generous financial safety nets exist. Kleftouri suggests that these findings show the moral hazard effect of deposit insurance dominates in good times while the stabilisation effect of deposit insurance dominates in turbulent times[122]:

[117] FSCS.org, https://www.fscs.org.uk/what-we-cover/
[118] FDIC.gov, https://www.fdic.gov/resources/deposit-insurance/financial-products-insured/index.html
[119] N Kleftouri, Deposit Insurance system and moral hazard (2013), Journal of Internaitonal Banking Law and Regualtion, 28(7), 271
[120] A Alcock, The Financal Services and Markets Act 2000 (J0rdans 2001)
[121] P Maffat, A Campbell, UK depositor protection in the aftermath of the banking crisis (2010) Journal of International Banking Law and Regulation, 25(10), 486, 488
[122] N Kleftouri, Deposit Insurance system and moral hazard (2013), Journal of Internaitonal Banking Law and Regualtion, 28(7). 271

> "Nevertheless, the overall effect of deposit insurance over the full sample they studied remain negative since the destabilising effect during normal times in greater in magnitude compared to the stabilising effect during global turbulence".[123]

Gortsos further notes the issue of deposit guarantees and moral hazard:

> "The setting up of DGSs has been linked to two main negative effects: banks' exposure to moral hazard and the too bog [sic] to fail (TBTF) problem"[124]

Banks are most likely to take advantage of the insurance policy by taking additional risk and neglecting to maintain capital and liquidity reserves, on the ground that should the risk-taking prove to be successful, then the management and shareholders will benefit directly, but should the bank fail, it will be the deposit protection scheme will have to pay compensation to depositors, in effect banks shift their risk onto the insurer so that the corollary is that insured institutions take more risks than they would otherwise.

Combining deposit insurance with interest rate liberalisation makes moral hazard even more problematic because it permits banks to chase high-yield investment carrying heightened risk. In the case of deposit insurance, the danger is that reckless firms displace well-managed

[123] N Kleftouri, Deposit Insurance system and moral hazard (2013), Journal of Internaitonal Banking Law and Regualtion, 28(7), 271.
[124] C V Gortsos, The Role of Deposit Guarantee Schemes (DGSs) within the Crisis Management Framework (2020), European Banking Institute Working Paper Series, 2020-No.78; https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3737424, last accessed 23/01/21.

competitors, and when linked with TBTF the poorly managed institution is likely to be subject to a rescue package. This is the moral hazard of bank bailout; it creates an environment that does not reward good discipline. The corollary of this is that a well-managed institution will be allowed to fail whereas a poorly managed institution engaged in significant risk within in its portfolio of activities will not. As such it is not in the interest of institutions to operate with discipline. Again, this is where herd mentality discussed earlier creates challenges in so much that where one or two banks undertake risky activity the existence of moral hazard results in the other institutions undertaking risky activity.

The above highlights the moral hazard effect of deposit guarantee insurance and why it is seen as impossible to avoid moral hazard impacts where such insurance exists. In the absence of personal injury, insurance allows parties to undertake risk they would not normally undertake. Deposit insurance is not really insurance at all, but a guarantee against loss. The key challenge with the moral hazard impact of deposit insurance is that it rewards risk and failure which leads to behaviour modification in market participants both at the customer and institutional level. The cushion provided by deposit insurance provides institutions with the ability to run risk profiles which they could not without such protection.

As Aglietta and Mojon posit, Alan Greenspan "in recommending a hands-off approach in the upward phase of asset price rises and setting a floor under plummeting prices after bubbles had burst, he created a huge moral hazard".[125] However they go on to note that:

[125] M Aglietta, B Mojon, Central Banking in A N Berger, P Molyneux J O S Wilson, The Oxford Handbook of Banking (2nd Edition Oxford 2014), 446.

> "Contrary to the hypothesis that finance was self-regulating whenever shocks occurred, deregulated markets proved to be intrinsically unstable, as Minsky (1986) stated, following Keynes view on coordination failures induced by uncertainty that can spill over into systemic crisis".[126]

The fundamental problem is that we do not have a perfectly deregulated financial market situation, there are constant interventions by regulators and central banks which in themselves create information asymmetries. Bailouts, LoLR facilities and deposit guarantee schemes when considered together are the ultimate sign of this. This meant that the prevailing economic thought could not apply. For the efficient market hypothesis to fully work the markets needed to be properly deregulated not partially.

The other issue is that we cannot afford to truly deregulate financial markets. The question that may be impossible to answer is how to achieve a balance between no regulation and a highly regulated markets to achieve the correct outcomes needed for regulation to achieve is required outcomes. The outcome of this debate is that financial stability is now widely understood to be an objective in its own right, as Aglietta *et al* state:

> "At the very least, taking care of financial stability should reduce systemic risk both ex post and ex ante. Ex post management of crises, especially in the form of LoLR interventions are a classic attribute of central banks. However, such interventions

[126] Ibid.

> remain indicative of moral hazard by financial market participants in the upward phase of financial cycles". [127]

Further:

> "Authorities ought to prevent the build-up of financial vulnerabilities that accumulate in the financial system in the upward euphoric stage of the financial cycle. This is what macro-prudential policy is all about. It is meant to keep the generic price of risk sufficiently high in the upward phase of the financial cycle to avoid its destructive rise in the downward phase".[128]

It is clear from the GFC that macro-economic policy failures were at the heart of the crisis.

> "Given the market failures involving systemic risk and the potentially high costs of systemic crises, there are public policies designed to contain systemic risk and crises – notably macro-prudential policy".[129]

Policy initiatives come into two general approaches to dealing with failure, the first being Ex-Ante policies, which is pre-emptive action trying to contain systemic risks before they materialise as instability, where supervision and regulation is designed to contain systemic risk and create buffers against it. A properly functioning regulatory and supervisory system should have this at its core. The second is Ex Post, or reactive, that is crisis management policies that

[127] M Aglietta, B Mojon, Central Banking in A N Berger, P Molyneux J O S Wilson, The Oxford Handbook of Banking (2nd Edition Oxford 2014)Page 451.
[128] Ibid.
[129] O DeBandt, P Hartmann, J-L P Alcalde, Systemic Risk in Banking after the Great Financial Crisis in A N Berger, P Molyneux J O S Wilson, The Oxford Handbook of Banking (2nd Edition Oxford 2014)age 674

try to stem instability that has broken out, dealing with the outcomes of the crisis. Ex post actions lead to increased exposure to moral hazard. Reactions to crisis leads to a conclusion of rescue. The ex-post actions of authorities in the GFC lead to a conclusion that authorities will act to prevent failure, thus highlighting moral hazard.

Prior to the GFC most supervision and regulation was micro-regulatory in nature with the key distinguishing feature being that macro-prudential policies have the potential to manage and contain systemic risk, whereas micro-prudential policies are primarily designed to contain the risks to individual banks or markets. The focus on the micro-prudential side of regulation meant that the systemic issues were missed amplifying the overall impact of the GFC.

What emerges from the analysis on moral hazard is that it presents one of the most significant challenges to managing systemic risk. The fact that banks, especially the largest banks operate within an environment that insured against failure, was bound to encourage risk taking. The existence of moral hazard inducing components discussed above will always create risk taking. The conclusion from this is that the priority for policy makers should be to address the moral hazard possibilities that arise from regulation.

4.5 Misplaced Economics - The Efficient Market Hypothesis

The key economic principle that surfaces in the debate surrounding causes of the GFC is the 'efficient market hypothesis' in which asset prices reflect all available information or as Malkiel notes "a capital market is said to be efficient if it fully and correctly reflects all relevant information in determining security prices".[130] Ball states the premise behind the efficient market hypothesis is "deceptively simple" in that competition creates a link between revenues and costs and where profits are high new entry will reduce or eliminate those costs, and that changes in the price of assets is linked to the flow of information.[131] The hypothesis is premised on the function that information flows freely to market participants and as such decision making is informed by the flow of that information. By this measure risk is managed within the system. The GFC provides significant evidence that information does not flow freely, and that asymmetry of available information informed by irrational belief in markets accompanied by an equally irrational psychology of behaviour would lead to decisions where risky actions would result lead to huge losses and that regulation itself creates the information asymmetry. Turner noted that the GFC of itself does not justify major constraints on financial market activity, but that we should anchor approaches to our market economy, and not on quasi-religious beliefs.[132]

De Bandt *et al* cite the ECB definition of systemic risk in an economy as "the risk that financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer",[133] with "a 'systemic crisis' the materialisation of this risk.[134] Lastra notes that "systemic risks pose a threat to financial stability" noting that the GFC challenged the pre-existing conception about systemic risk in

[130] B G Malkiel, Efficient Market Hypothesis, in J Eatwell, M Milgate, P Newman eds, Finance (Palgrave Macmillan), 127.
[131] R Ball, The Global Financial Crisis and the Efficient Market Hypothesis: What have we learned? 2009, 21(4), Journal of Applied Corporate Finance, 8, 9.
[132] A Turner, Between the Debt and the Devil: Money, Credit and Fixing Global Finance (2015 Princeton University Press).
[133] O DeBandt, P Hartmann, J-L P Alcalde, Systemic Risk in Banking after the Great Financial Crisis in A N Berger, P Molyneux J O S Wilson, The Oxford Handbook of Banking (2nd Edition Oxford 2014)age 669
[134] Ibid

that markets are not actually rationale and self-correcting. [135] If the rational market hypothesis had held true then market corrections should have taken place at points earlier in the cycle, but this did not happen, and that "the onslaught of the financial crisis has triggered a change in the way that financial supervisors tackle systemic risk".[136] The history of financial markets display regular occurrences of 'boom and bust' with recurring, but infrequent crises,[137] situations where growth results in asset bubbles which eventually burst[138]. The rational market hypothesis explains this as part of the normal business cycle, with many busts explained as corrections. The busts could be explained by the fact that information flows have slowed and the lag results in a short-term asymmetry of information, with the resulting bust evidence of the asymmetry, the market reflecting true information about markets and institutions, the drop in asset prices and values being the correction. The GFC provides evidence that the flow of information can be skewed for extended periods of time so that risk is incorrectly priced within the marketplace and the resulting correction much more significant than would be provided for under the efficient market hypothesis position.

What remains largely unanswered, although various explanations have been advanced, is why the rational market hypothesis failed, why did markets act irrationally in the years preceding the GFC? [139] Caprio notes that procyclicality creates an environment that results in institutions failing to adequately manage risk. [140] Procyclicality is characterised by lending practices being eased in periods of expansion, and amplified in times of contraction, and the reliance on the

[135] R Lastra Systemic Risk and Macro-Prudential Supervision in N Moloney, E Ferran, J Payne eds The Oxford Handbook of Financial Regulation, (Oxford 2015), 311
[136] Ibid
[137] O DeBandt, P Hartmann, J-L P Alcalde, Systemic Risk in Banking after the Great Financial Crisis in A N Berger, P Molyneux J O S Wilson, The Oxford Handbook of Banking (2nd Edition Oxford 2014)age 674
[138] J K Galbraith, The World Economy Between the Wars (Mandarin 1995)
[139] See generally the work of Minsky cited in this research.
[140] G Caprio, 'Safe and Sound Banking: A Role for Countercyclical Regulatory Requirements' in Sylvester Eijffinger and Donato Masciandrano, 'Handbook of Central Banking, Financial Regulation and Supervision After the Financial Crisis, Edward Elgar, 2011.

accepted economic thought at the time created a form of "disaster myopia"[141] in which very little attention is being paid to the challenges that such an approach would provide in times of financial market stress. Disaster myopia can explain why financial crises are likely to recur as the further the financial sector moves away from the last crisis the memory of that crisis dissipates. This can be explained by applying the availability heuristic developed by Tverskey and Kahneman which posits that in the decision-making process people make judgements on how easily things come to mind.[142] Disaster myopia which I would also term institutional memory show that it is relatively easy to forget the last crisis and the causes for it. Additionally, governments change which adds further momentum to the loss of institutional memory, made worse when that new government is of a different political party.[143] This effect can provide further evidence of political influence over the design and application of regulation.

The pro-cyclical nature of banking amplifies the 'boom and bust' phenomena in which banks engage in increasingly risky behaviour when the economy is expanding and undertake activities that look to continue and even expand such activity, however, in a downward economic cycle financial institutions contract and withdraw from economic activity which has a significant negative impact as it is particularly important during the downward cycle that access to banking and credit services is maintained. This is characterised by the actions of lenders during the GFC and termed the "paradox of debt" by Ryoo in which banks look to reduce their indebtedness by cutting investment spending, whereas in an expansion phase the same mechanism works in the opposite direction.[144]

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[141] C Cornand, C Gimet, The 2007-2008 financial crisis: Is there evidence of disaster myopia (2012) Emerging Markets Review, Vol13, issue 3, 301, 301.
[142] A Tverskey, D Kahneman, Judgement under uncertainty (Science) Vol185, Issue 4157, 1124.
[143] The term institutional memory comes from an episode of the West Wing titled 'institutional memory' which explores the need for persons to stay in post when an administration changes so that the information stored up can continue into the next administration. Full reference needed here,
[144] S Ryoo, The Paradox of Debt and Minsky's Financial Instability of Hypothesis (2011) Metronomica 64:1, 1.

What emerges from the debate surrounding the crisis is the failure of the economic theory that was applied by financial institutions to their operations within the economic environment in the years preceding the GFC and during the event itself. As noted, the basis on which they operate is the efficient market hypothesis on the presumption that markets and market participant act rationally and will self-correct at appropriate times.

Contrary to this is Minsky who, *inter alia*, developed his own theory of financial instability hypothesis, where:

> "The financial instability hypothesis…is a theory of the impact of debt on systems behaviour and also incorporates the manner in which debt is validated. In contrast to the orthodox quantity theory of money, the financial instability hypothesis takes banking seriously as a profit-seeking activity. Banks seek profits by financing activity and bankers. Like all entrepreneurs in a capitalist economy, bankers are aware innovation assures profits".[145]

This statement illustrates the situation that permeates the GFC debate. The yield maximising financial institutions drive for profits blinded them to the risks inherent in their activity leading to inherent instability, and when coupled with 'unbridled' innovation this led to further difficulties. It is noted among commentators that the GFC is an example of a 'Minsky

[145] H Minsky, The Financial Instability Hypothesis (1992) Levy Economics Institute of Baird College,Working Paper No.74, available at https://www.econstor.eu/bitstream/10419/186760/1/wp074.pdf last accessed 10/01/21.

Moment'.[146] Put succinctly this shows that the continued growth of the financial services sector and the growth of innovation in financial services products and in what has been termed "financialisaton" achieved a critical mass in respect of what maybe termed 'risk loading'.[147] Risk loading is the ratio of risk to activity that financial institutions take on board reaches a point where failure of the institution is a possibility, and where, if the institution is systemically important, could lead to potential systemic risk and failure. This is clearly linked to the risk appetite and risk management processes that existed in the period preceding the autumn of 2007.

That the GFC is not an example of a Minsky Moment has its supporters. For example, Palley concludes that the GFC was "part of a larger economic drama involving the neoliberal growth model that was implemented around 1980".[148] It is clear that to call the GFC a 'Minsky' moment as such requires some modification of Minsky's financial stability hypothesis as the sub-prime crisis was one factor among many, however, it is equally clear that a broad analysis of the GFC leads to a conclusion that the GFC was predictable within the hypothesis and more generally the writings of Minsky and other Keynesian leaning economists. What is less clear is how to fix such failure when it emerges or more importantly to prevent such failure occurring in the first place. As is noted elsewhere in this thesis the call has been for increased and increasingly complex regulation, but this only creates more problems, markets are complex enough.

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[146] See P McCulley, The Shadow Banking System and Hyman Minsky's Economic Journey, in L B Siegel ed, Insights into the Global Financial Crisis (CFA Institute 2009); https://www.cfainstitute.org/-/media/documents/book/rf-publication/2009/rf-v2009-n5-18.ashx, last accessed 24/01/21

[147] S Storm, Financialization and Economic Development: A Debate on the Social Efficiency of Modern Finance (2018) Development and Change, Vol.49, Iss 2, https://onlinelibrary.wiley.com/doi/full/10.1111/dech.12385, last accessed 24/01/21

[148] T I Palley, The Limits of Minsky's Financial Instability Hypothesis as an Explanation of the Crisis (2009) IMK Working Paper No.11/2009

Minsky's financial instability hypothesis can be linked with what Bandt et al note as the "financial fragility hypothesis".[149] This notes that, unlike other sectors of the economy, the interrelated features of banking, such as the structure of bank balance sheets, the high level of interconnectedness, and the nature and intensity of contracts in banking with a focus on future payments make the financial services sector more vulnerable to systemic risk and "can give rise to particularly violent adjustments of behaviour, powerful feedback, and amplification mechanisms that make financial problems spread widely in non-linear ways".[150] This latter position was borne out during the financial crisis.

4.6 Financial Stability as an economic and regulatory objective

The above analysis sets out the position that in designing a regulatory system financial stability needs to be the key element focusing on the rationale that needs to underpin regulatory design, to answer the why regulate question. As Allen *et al* note one of the primary functions of the financial system is to share risk, indeed the growth of bank interconnectivity and the range of intermediation services provided by the range of financial institutions serves as an indicator of the risk mitigation inherent in the financial system. [151] However, this risk mitigation role only works if risk is accurately priced and a key feature of moral hazard is under-pricing risk, that is they did not sufficiently understand the risk profiles they were running and therefore they did not properly budget for any losses that accrued from their activities. The risks that were taken by financial institutions placed the entire financial system under stress and without the

[149] O DeBandt, P Hartmann, J-L P Alcalde, Systemic Risk in Banking after the Great Financial Crisis in A N Berger, P Molyneux J O S Wilson, The Oxford Handbook of Banking (2nd Edition Oxford 2014) 670
[150] Ibid, 673.
[151] F Allen, E Carletti and X Gu, The Roles of Banks in Financial Systems, Oxford Handbook of Banking, (2nd edition 2015 Oxford University Press).

intervention of the national governments committing significant taxpayer resources the financial system may have collapsed.

As a result, it is now become clear that financial stability has become a policy objective in its own right[152]. The Financial Services and Markets 2000 made this a requirement by virtue of section 3[153] but a lack of regulatory application and the regulator misunderstanding the scope of the section prevented such a policy from gaining traction. The regulatory environment since the GFC has embraced a much more direct approach to financial stability. In chapter 8 it is noted that one of the first actions of the government following GFC was to address the perceived lacunae of the missing financial stability objective by introducing a new statutory objective into the Financial Services and Markets Act 2000[154] tasking the regulator to ensure financial stability. The reality is that this was little more than being seen to do something. The existing provisions had always required such action, with the regulator "asleep on the job"[155]. In addition, the Banking Act 2009 was enacted to provide the regulatory authorities with the tools to "protect financial stability" with a focus on bank and similar institution resolution. Section 4 of the Banking Act 2009 set out seven objectives[156] relating to stability. In a mirror of the FSA's New Regulator for a New Millennium defines "stability of the financial system of the UK' refers to the stable functioning of the systems and institutions", with Section 7A providing the Bank of England with a statutory objective in relation to financial stability.[157]

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[152] See P Jackson, Financial Stability as a Policy Objective (2004), Journal of Financial Crime, 11(4), 356
[153] Section 3. See Chapter 7 for analysis
[154] Section 3A FSMA 2000
[155] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.
[156] HM Treasury, Banking Act 2009: special resolution regime code of practice, HM Treasury, London December 2020, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/945165/SRR_CoP_December_2020.pdf last accessed 18/01/21
[157] FSA, A New Regulator for A New Millennium, FSA, London

Further evidence of this change in focus toward financial stability can be seen in the structural changes made to regulation in the UK and the US, with the establishment of the Financial Policy Committee[158] and Financial Stability Oversight Council.[159] Both jurisdictions were significantly impacted by the GFC and post-GFC actions have centred around a better understanding and a stronger focus on systemic risk factors rather than individual institution factors. In addition, the global banking community sought to strengthen its approach to systemic stability mechanisms with the creation of the Financial Stability Board (FSB) whose role is to "promote international financial stability". [160] The FSB has a coordinating role designed to bring together national authorities acting as a forum for best practice dissemination. The authority for the FSB lies in the personal, the members of the FSB, drawing on senior central bankers and finance ministers from across the globe.[161]

The full realisation that the interconnectedness of financial institutions and markets has resulted in financial stability as a national, regional, and international target, but in putting measures in place to ensure financial stability this increases the risk of moral hazard emerging. The realisation that this is the case has resulted in an increased focus for authorities on what to do when financial institutions run into trouble, to develop a supervisory framework that attempts to ensure a sound and safe financial system but without the problems posed by moral hazard by financial institutions that have become too important to be allowed to fail, or to create

[158] See Bankofengland.co.uk; https://www.bankofengland.co.uk/about/people/financial-policy-committee
[159] See home.treasury.gov; https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc
[160] See fsb.org; https://www.fsb.org/about/history-of-the-fsb/
[161] As at 10th December 2020 the Chair of the FSB is Randal K Quaries, Governer and Vice Chair of the US Federal Reserve. One former Chair until 2018 was Mark Carney, the then Governor of the Bank of England with the UK's current representative being Andrew Bailey, the current Governor of the Bank of England, Katherine Braddick, Director General, Financial Services, HM Treasury and Nikhil Rathi, Chief Executive Officer of the Financial Conduct Authority.

resolution mechanisms that allow for orderly failure without recourse to public funding; neither has been achieved ten years after the GFC.

As Armour *et al* posits large financial institutions present governments and their regulatory authorities with dilemmas. [162] It is clear from an analysis of the actions of regulatory authorities during the GFC that they are unwilling to allow large financial institutions to enter normal insolvency processes, correctly put they were panicked into rescuing institutions, panicked by the perception that the economy will be significantly impacted by financial institution failure, although it is actually as a result of the fact that authorities are unsure of the impact of single institution failure and as such the panic really revolves around the possibility of contagion related failure and the outcomes of such failures.

This has resulted in a change of emphasis from law makers from the micro-prudential institution focused supervisory approach to one where authorities develop tools and policies to resolve financial institutions in distress with a wider view to protect the overall financial system, in other words a more macro-economic approach to financial services regulation. The issue that creates the paradox, as noted above, is the too big to fail conundrum. This is a major factor driving moral hazard, organisations that have become too large, too complex, and too connected[163] to be allowed to fail will be rescued. It therefore has become a major priority to explore ways to create a banking and financial system that is resilient against external shocks

[162] J Armour, Making Bank Resolution Credible in N Moloney, E Ferran, J Payne eds, The Oxford Handbook of Financial Regulation (Oxford 2015), 453

[163] Too connected refers to the fact that modern banking is characterised by the interconnectivity of financial institutions in a global financial system.

but where there are such externalities affecting the market individual institutions that fail or come close to failure will not create the systemic crisis that characterised the GFC.

Chapter 6 below looks in part at the general causes attributed to the global financial crisis and that no single cause can be attributed to the emergence of the crisis, but what is clear is that underlying economic conditions and reliance on principles played a key role in providing an environment which allowed institutions and individuals.

4.7 Too Big To Fail, Too Complex To Fail, Too Connected To Fail[164]

The above analysis correlates with a key issue in respect of bank regulation and its ability to discharge its primary function of maintaining financial stability, namely Too Big To Fail (TBTF). This refers the phenomena whereby financial institutions have grown to a scale that when they enter a period of financial stress there is little option for regulatory authorities to step in and provide rescue mechanisms, ranging from liquidity assistance to bail-out.

It is difficult to place Northern Rock into this TBTF categorisation, however, Northern Rock was a bank that was growing very fast, but it was not on a scale that should have meant that failure on its own would lead to systemic crisis. In the case of Northern Rock, it was the interconnectedness of financial institutions and the point that Northern Rock was the lead domino, which if total collapse had occurred would have led to the collapse of larger and more systemically important institutions, the true TBTF banks, in particular Royal Bank of Scotland

[164] See R Lastra Systemic Risk and Macro-Prudential Supervision in N Moloney, E Ferran, J Payne eds The Oxford Handbook of Financial Regulation, (Oxford 2015)

(RBS) and Halifax Bank of Scotland (HBOS). These latter two institutions also point to another issue with the challenge of the regulation of banks over the last 50 years: bank consolidation. A feature of banking because of the 1970's deregulation era is the growth in banking conglomerates, which is the emergence and growth of banking groups. The growth of banks has been driven by bank merger and acquisition. This was acutely felt in the UK at the GFC in the shape of RBS and HBOS. Both of these institutions are more than just a bank and are the process of bank consolidation, with RBS comprising two of the UK's largest high street banks, RBS and NatWest, but also including Ulster Bank, Coutts Private Banking, alongside a wide range of other banking and financial services providers.[165] Similarly HBOS was created from a merger of the Bank of Scotland and Halifax creating at the time the fifth largest bank in the UK, behind Barclays, HSBS, Lloyds and RBS/NatWest. The Halifax itself was a product of financial liberalisation, formed from the demutualisation of the Halifax Building Society, at the time the largest UK building society. The failure of the regulatory process to identify the dangers associated with allowing the creation of such large entities created an environment that provided little option for the UK government to step in when the GFC emerged. The regulatory deficiencies can be further evidenced by the post-GFC banking structure where even larger banking groups have emerged with the assistance of regulator and government, for example the solution to the near collapse of HBOS was to merge with Lloyds Banking Group, already one of the UK's largest banking organisations to create the UK's largest banking conglomerate. Following the merger, the problems at HBOS proved to be so large[166] that the new Lloyds Banking group required to bailed out itself.

[165] See Natwestgroup.com; https://www.natwestgroup.com/our-brands.html.
[166] Parliamentary Commission on Banking Standards, An Accident Waiting to Happen: The failure of HBOS, HL Paper 144, HC 705, 4th April 2013.

During the GFC central banks provided significant volumes of liquidity to alleviate liquidity shortages and to prevent the interbank market from breaking down completely.[167] They provided this liquidity on very generous terms, letting virtually every bank access their facilities. Among the many banks that received liquidity assistance several were insolvent.[168] This runs contrary to the principle advocated by Bagehot that insolvent banks should not be provided with liquidity[169]. However, as the banks constitute a risk to the financial system, regulators have had no choice but to save them. This suggests that TBTF problems exists still, although many now call too connected to fail referring to the contagion risk from a large bank failing.

In addition to the liquidity provisions by central banks, governments around the world have constructed very large rescue packages to restore confidence in the financial system. While this fixes the short-term issue it does not create long term mechanisms to ensure financial stability. Halfway through 2009 total resources committed to the range of packages amounted to 18.8% of GDP for 11 western economies, around $5trillion. Nijskens and Eijffinger's analysis indicate that without any safety net, banks take excessive risk and hoard too much liquidity, but the introduction of a safety net, in the form of central bank liquidity provision, can decrease excessive liquidity hoarding but also leads to engagement in moral hazard by banks, noting a range of literature that argue that banks should face some uncertainty about

[167] R Nijskens, S Eijffinger, The Lender of Last Resort: Liquidity Provision versus the Possibility of Bailout, in S Eijffinger and D Masciandaro eds, Handbook of Central Banking, Financial Regulation and Supervision: After the Financial Crisis (Edward Elgar 2011).

[168] Insolvency refers not to the usual position in fractional reserve banking where all banks run technically insolvent position due to leveraging deposits, but to the more traditional position of insolvency indicating possible failure of the institution.

[169] W Bagehot, Lombard Street: A description of a money market (Wiley and Sons 1873)

whether the central bank will provide liquidity support.[170] The evidence from the GFC and the apparent abandonment of the Bagehot principle suggest that the central bank will provide liquidity as a right, thus adding further support to the TBTF paradox. Regulators face a trade-off. On the one hand, making capital assistance very costly for the bank increases productive investment, but also increases excessive risk taking. On the other hand, relatively less costly capital assistance decreases moral hazard at the expense of investment.

The Bagehot Principle states that the LoLR should always provide liquidity to illiquid but solvent banks at a penalty rate and against good collateral.[171] This was not a feature of the GFC where long held principles were abandoned in favour of rescue at all costs. However, even the Bagehot principle is an example of moral hazard. While the principle requires the bank to be solvent it will undoubtedly be in distress, whereas the counter argument is that banks should face uncertainty about whether it will receive liquidity support. Havranek, well before the GFC unfolded noted that "to create an economically sound and competitive financial system, institutions which are poorly managed must be allowed to fail…the fittest survive and the unfit fail".[172] Therefore, the only real way to avoid moral hazard is to ensure that financial institutions are able to fail but without significant impact on the system itself. It is for this reason that financial stability has come to the foreground as a policy objective. If the object of bank regulation is to maintain financial stability it should act to prevent poorly managed institutions from emerging, but in allowing institutions to fail will place a stronger focus on discipline. It is clear from the GFC and the debate surrounding the actions of banks that they

[170] R Nijskens R, S Eijffinger, The Lender of Last Resort: Liquidity Provision versus the Possibility of Bailout, in S Eijffinger and D Masciandaro eds, Handbook of Central Banking, Financial Regulation and Supervision: After the Financial Crisis (Edward Elgar 2011)
[171] W Bagehot, Lombard Street: A description of a money market (Wiley and Sons 1873)
[172] M Havranek, The Bank of England and bank failures, (2000) The Insolvency Lawyer, 2(Apr), 73, 74.

lacked discipline in their decision making. Much has been written about the failure of corporate governance of banks in the years preceding the GFC which has led to significant changes with regard to their internal workings.[173] The approach to growth as seen in Northern Rock, RBS, and HBOS, and in the use of innovative financial instruments to drive yield evidence the lack of discipline shown in banking in the pre-GFC time.

At the very least a focus on financial stability should reduce systemic both ex post and ex ante. Ex post management of crises, especially in the form of LoLR interventions are a classic feature of central banks, however, such interventions remain indicative of moral hazard by financial participants in the upward phase of the financial cycle.[174] As chair of the Federal Reserve Alan Greenspan operated a hands-off approach in the upward phase of the financial phase but setting a floor under plummeting prices when bubbles had burst created a moral hazard.

The question to answer is how authorities go about preventing the build-up of financial vulnerabilities. This returns to the issue of financial stability as a policy objective. A feature of good financial supervision is an understanding of the vulnerabilities noted above, seeing the stresses that accumulate in the upward euphoric stage of the financial system and can impact the financial system. This is the fundamentals of macro-economic prudential policy that was missing in the years prior to the GFC. A properly functioning macro-prudential policy should keep the price of risk sufficiently high in this upward phase of the financial cycle with a view to avoid the destructive phase associated with the downward phase. If the supervision system

[173] See for example K J Hopt, Corporate Governance of Banks and Financial Institutions: Economic Theory, Supervisory Practice and Policy (2020), ECGI Working Paper, March 2020.
[174] M Aglietta, B Mojon, Central Banking in A N Berger, P Molyneux J O S Wilson, The Oxford Handbook of Banking (2nd Edition Oxford 2014), 451.

works then the upward phase is properly managed and the systemic risks that created the environment that led to the GFC would be avoided, however, it is clear from the GFC fallout that the macro-economic policy failures were at the heart of the crisis.

Mayer notes that the financial crisis was evidence that the role of the state is equivalent to that of a catastrophic insurance provider where the state through its regulatory and supervisory bodies will do little or nothing but where failure is apparent, they step in with protectionary measures. [175] Mayer therefore posits that the regulatory changes that have been advanced since the GFC are justified.[176] In particular those that target the macro-prudential environment and, that the focus prior to the GFC was too focused on the micro-prudential conduct of individual banks, noting that "where they may well be inadequate is in imposing sufficiently high capital requirements"[177] and therefore when institutions are under stress or facing failure the state will not be required to intervene except the most extreme circumstances. While this is undoubtedly true what is required of the regulatory system is not the avoidance of the requirement of state intervention but that single institutions can and are allowed to fail without an impact on the system. At the centre of moral hazard and a theme that links all the issues together is too big to fail, and this continues to pervade the debate, preventing a full and proper solution from emerging. Too Big To Fail (TBTF) creates a paradox for financial institutions and for authorities. Bank and related financial institutions need to be safe and sound, but how do they achieve this?

[175] C Mayer, Economic Development, Financial Systems and the Law, in N Moloney, E Ferran, J Payne eds The Oxford Handbook of Financial Regulation, (Oxford 2015).
[176] Ibid.
[177] Ibid.

The preceding discussion focuses on macro-prudential approaches to the design and operation of the structure of regulation. This requires a change in the policy approaches to bank and banking services. Born *et al* posit that for macro-prudential policy options to meet the challenges that effective the policy makers need to be equipped with a set of effective policy instruments. One of the focal points of Born et al is on the role of macro-prudential communication.[178] One of the functions of regulation should be to monitor, find and warn of any impending stress factors that may impact either individual firms or the system, making communication an important feature of regulation. Born et al further note the importance of the communication role in commenting that "financial markets are inherently characterised by asymmetric information and co-ordination problems, characteristics which lie at the heart of the potential risks to financial stability".[179] This issue was a key point of failure during the GFC where the tripartite authorities failed to effectively communicate with each other, not fully understanding their respective roles under the memorandum of association.

4.8 Narrow Banking – The Solution?

If the premise of improving financial stability is based on allowing managed failure the question moves to how this is to be achieved given that the past and current environment set-up and maintain the TBTF paradox. A radical approach to achieve this is known as "Narrow Banking"[180]. Is it noted above that a strong feature of bank development over the last five decades is the rise of conglomerate banking, however, narrow banking is the antithesis of this. Narrow banking in its purest form mandates that a bank can only engage in a very narrow set

[178] B Born, M Ehrmann, M Fratzscher, How Should Central Banks Deal with a Financial Stability Objective? The Evolving Role of Communication as a Policy Instrument in S Eijffinger and D Masciandaro eds, Handbook of Central Banking, Financial Regulation and Supervision: After the Financial Crisis (Edward Elgar 2011)
[179] Ibid, 246
[180] J Kay, Narrow Banking: The Reform of Banking Regulation, (2009), Johnkay.com; https://www.johnkay.com/2009/09/15/narrow-banking/, last accessed 4/12/20

of activities, focused on just a few defined operations[181]. In the UK a prominent proponent of narrow banking is Key who produced an influential report, "Narrow Banking: The Reform of Banking Regulation" outlining the advantages of such an approach. [182] The report is not so much a reform of banking regulation but the reform of banking structure which would allow a new approach regulating banks. Kay advocates that a 'narrow bank', that is the only institution which would be able to call itself a bank and that would authorise to carry out narrow banking activity would be focused on what could be classed as the traditional activities associated with banks, these being accessing the payments systems such as CHAPS and BACS and taking deposits from the general public. Kay's proposal does allow for such banks to engage in lending, including mortgage lending and lending to businesses but within narrow constraints; and in addition, the proposal allowed for such 'narrow' banks to be subsidiaries of bank holding companies. Key to the proposal is the prohibition of proprietary trading by the narrow bank.

Kay posits that "in a free market, narrow banking would have emerged spontaneously and immediately".[183] He argues that left to their own device's banks would not outgrow their financial resources by engaging in risky activity. Kay further argues that depositors themselves would prefer conservative and transparent institutions, which do not engage in risky activity and investments. Kay is advocating an institution that is not bankruptcy remote, that is capable of being allowed to fail with minimal impact on depositors, who would have access to deposit insurance up the full amount of their exposure based on a maximum deposit value and would have minimum impact on the wider banking sector and economy. Interestingly Kay notes that the reason that banks have not remained as 'narrow banks' is the result of distortion created by

[181] Narrow banking is discussed further in chapter 8 as part of the post GFC regulatory options.
[182] J Kay, Narrow Banking: The Reform of Banking Regulation, (2009), Johnkay.com; https://www.johnkay.com/2009/09/15/narrow-banking/, last accessed 4/12/20
[183] Ibid, 53

government intervention. His argument revolves around the moral hazard created by government action in the banking sector, and the rise of the TBTF institution which as noted above creates an environment which perpetuates growth and the search for yield with insufficient regard to the consequences, based on the moral hazard implication of allowing such an institution to fail.

Kay's premise here is interesting in that it alludes to an important issue of the application of economics to retail banking, that if we remove the regulatory engagement that has evolved over the last 50 years it provides or creates an environment that allows failure as institutions that fear failure will take different approaches to their operations. If failure is a possibility and a more likely outcome of risky activity then narrow banks will not engage in them, leaving such activity to investment banks or the investment banking operation of their banking group.

What this suggests is that a low scale regulatory environment would provide positive benefits to the regulated sector. The bank and financial services sector have one of the largest and most intrusive regulatory environments controlling its everyday activities, and as shown in this research that regulatory environment has evolved at a significant pace over the last five decades in response to financial scandals, bank failure, and political changes brought about by Parliamentary elections. What Kay is pointing to is that the regulatory environment itself creates the conditions for failure. Would then a stripped back regulatory environment prove beneficial. Kay himself notes that his 'narrow banks' could be regulated but not supervised, that they would be subject to some form of regulatory oversight but not detailed supervision of their everyday activities as it would be unnecessary in an institution engaged in such a narrow range of activities and would have a low or lesser impact on failure, with the corollary position that a bank that knows it will not be allowed to fail will continue and even engage in increased risk.

4.9 <u>The Regulation of Capital - Supporting Financial Stability or Stand-Alone Tool</u>

A discussion regarding capital adequacy regulation is only party relevant to this thesis in so much as the focus of this research is on identifying the optimal structure for regulation, in other words a macroprudential approach, whereas the issue regarding how much capital a bank should hold is a micro-prudential tool, however a discussion of the issue is a worthwhile exercise in relation to financial stability as a regulatory aim. One area of focus following the GFC has surrounded the issue of capital and in particular the regulation of capital levels as it applies to financial institutions. Regulatory capital is seen as a key component in supporting bank and therefore overall financial stability[184] taking on "talismanic significance"[185]. As has been noted the traditional key function of banks is in the maturity transformation role by borrowing short, initially by leveraging deposits, and by lending long. [186] This has the obvious effect of making all banks effectively insolvent in the face of on call demands from depositors as their liabilities will always and overwhelmingly outstrip their assets. This is of course an important driver in domestic and global economies where banks provide the finance for businesses to grow, provide employment which in turn allows consumer spending to further expand economic activity. The downside of the so-called fractional reserve banking, borrowing short and lending long is that it brings risk as the bank is always effectively insolvent. As evidenced by the GFC banks took significant risk in the search for yield, and when coupled with ongoing deregulation this search for yield manifested itself in even greater

[184] K Alexander, The Role of Capital in Supporting Banking Stability, in N Moloney, E Ferran, J Payne eds The Oxford Handbook
[185] Ibid, 335
[186] I H Y Chiu, J Wilson, Banking Law and Regulation (Oxford 2019)

risk. The search for yield led banks to take increasing risks, developing innovative products, and increasing leverage rates to finance growth but reliant on mistaken assumptions about the risk. The depth of the risk led to systemic pressures and risk that prompted governments into a range of rescue measures for banks and economic support for the wider economy, for example TARP[187] in the US and quantitative easing[188] in the UK alongside historically low interest rates[189].

An obvious way to insure against failure is to require banks to support their risk bearing activity noted above with capital holdings. The simplest solution is to require banks to hold the same amount in capital as it lends out or invests in. In practice this is not a practical solution and would require banks to hold enormous amounts of capital which could otherwise be used to provide liquidity to the economy. Fractional reserve banking, leveraging deposits, has allowed banks to make a calculated 'gamble' in its investment and lending activity. The 'gamble' is that only a relatively small percentage of bank customers will remove their deposits at the same time allowing the bank to continue with lending and investing.

A key micro-prudential, firm specific, regulatory tool that has been employed is the regulation of capital. This refers to the amount of capital that a regulated entity must keep as a buffer to manage times of stress and refers to the amount or volume of capital a regulated institution must hold so that it can withstand significant levels of default in its loan or investment book,

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[187] TARP Programs, US Department of the Treasury; https://www.treasury.gov/initiatives/financial-stability/tarp-programs/pages/default.aspx, last accessed 25/01/21

[188] R Partington, The verdict on 10 years of quantitative easing, The Guardian (Manchester 8th March 2019); https://www.theguardian.com/business/2019/mar/08/the-verdict-on-10-years-of-quantitative-easing, last accessed 11/01/21

[189] J Weinberg, The Great Recession and its aftermath (Federal Reserve History, 22nd November 2013); https://www.federalreservehistory.org/essays/great-recession-and-its-aftermath, last accessed 25/01/21

designed to act as a “road hump’ to slow down the moral hazard of excessive risk taking[190], with the theory that linking capital holding requirements to activity that carry risk such as lending will force banks to manage their risk profiles as well as send a message to bank customers, the depositors, that the bank is able to withstand both internal and external stress factors[191]. Amati and Hellwig note that “capital regulation requires that a sufficient fraction of a bank’s investments or assets be funded with unborrowed money”, [192] it is the cash, equity, bonds etc. that a bank holds in reserve, to its assets, loans, and investments, that it makes to satisfy withdrawals or losses. Since the GFC capital adequacy has become synonymous with debate on capital buffers acting as a cushion in times of stress which reflects the reality of the rationale behind capital adequacy regulation. Capital adequacy regulation focuses on risk management at the micro-regulatory level, Chiu and Wilson note:

> “Capital adequacy regulation prescribes that banks can only take certain levels of risk that are supported by adequate levels of capital. In this way capital adequacy rules provide a form of assurance that banks with adequate levels of capital are likely able to withstand losses that may result from their risk-taking such as where the bank has made a loan and the borrower defaults”[193]

Capital regulation and bank leverage rates are closely aligned with capital adequacy helping to manage the risk inherent in leveraged lending. To significantly increase its

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[190] I H Y Chiu, J Wilson, Banking Law and Regulation (Oxford 2019),
[191] Ibid
[192] A Amati and M Hellwig, The Bankers New Clothes: Whats wrong with banking and what to do about it (Princeton University Press, 2013)
[193] I H Y Chiu, J Wilson, Banking Law and Regulation (Oxford 2019)

ability to lend without significant increase in deposits inevitably requires a bank to increase its leverage rate.

A key rationale behind capital adequacy regulation is to manage the risk profile created by leveraged lending practices, so that the risk of loan default is mitigated due to the bank having sufficient levels of capital to support their levels of lending. The practice of leveraged lending creates risk, with the higher the leverage rate the higher the risk[194]. Alexander posits four main purposes:

> "(1) to absorb losses against asset value declines of non-performing loans, expected losses arising from inadequate loan loss reserves, and ultimately bank failure; (2) to provide start-up funding for a bank's early operations; (3) to reduce losses to deposit insurance schemes by providing means to repay the claims of depositors and creditors of a failed bank; and (4) to create incentives for shareholders, directors and managers to exercise more prudence in overseeing the banks operations".[195]

Capital regulation has been driven by international cooperation. In respect of capital regulation this is a key requirement to prevent regulatory arbitrage. If different jurisdictions set differing capital requirements banks will migrate to those jurisdictions that require the lowest capital holdings.

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[194] Alexander, Principles of Banking Regulation
[195] Ibid, .87

Capital regulation links to a range of other regulatory priorities specifically linked to risk and if set to the correct level allows firms to manage their own risk profiles against their lending and investment practices. Capital adequacy regulation meets the objective of the institutions themselves managing their risk profiles with the goal of ensuring that such institutions can withstand stress with the ultimate rationale that institutions will not require state intervention or taxpayer bailout. As such capital regulation meets the specific regulatory aim of avoiding individual firm failure and if correctly managed will also deal with the too big to fail paradox of banking and therefore is intended to reduce systemic risk.[196]

Capital adequacy regulation has been in place since 1988 with the implementation of Basel I capital accord. To manage the capital adequacy regulation the Bank of International Settlements (BIS) instituted the Basel Committee on Banking Supervision (BCBS), from which the Basel capital accords take their name, a global standard setter for prudential regulation of banks, providing a forum for cooperation on issues relevant to banking with a mandate to "strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability"[197]. While the BCBS has no direct force of law its place at the centre global banking regulatory debate is ensured by its membership being comprised of 45 members from central banks and supervisory organisations from 28

[196] See M B Gordy, E A Heitfield, J J Wu, Risk Based Regulatory Capital and the Basel Accords, in A N Berger, P Molyneux J O S Wilson, The Oxford Handbook of Banking (2nd Edition Oxford 2014)
[197] https://www.bis.org/bcbs/index.htm

jurisdictions.[198] The weight of force for the Basel accords comes from the gravitas of its membership.

The so-called Basel Accords are an evolutionary tool that began with the Basel I Accord in 1988 and has been subject to frequent updates and modifications. Banks do not like holding capital, it ties up resources that could be employed in the search for yield and growth. As Alfon *et al* note the opportunity cost of holding capital acts as a disincentive to keep too much capital preferring to use that capital for lending and investment purposes instead. [199]

The Basel Capital accords are based on a risk-based approach and were designed to reward banks with the incentive to carry lower capital requirements if they could evidence that they had control over their risk profile, that their risk profile was diversified and could withstand stress. This approach is predicated on a notion that if regulatory authorities were satisfied that there regulated institutions were properly managing the risks then the individual institutions would remain stable and by extension they would not contribute to systemic risks beyond their own firm. To ensure this Basel I required banks to hold a minimum of 8% capital against their risk exposures, classifying those risk exposures in a few simple categories of balance sheet risk exposures.

[198] https://www.bis.org/bcbs/index.htm
[199] I Alfon, I Argimon, P Bascunanana-Ambros, The determinants of capital held by UK banks and building societies and the role of individual capital requirements in K Alexander, R Dhumale, Research Handbook on International Financial Regulation (Edward Elgar 2012)

The issue with Basel I was that it only applied to on balance sheet loans which resulted in banks looking for innovative ways to circumvent the need to keep large amounts of capital in reserve. Banks responding by moving the risk off-balance sheet developing new and innovative products such as securitisation products such as mortgage-backed securities and collateralised debt obligations, and credit derivatives like credit default swaps. As Alexander further notes, central banks and national authorities encouraged such diversification on the basis that it spread risk, however, as was seen the risk diversification was little more than a myth premised on mistaken beliefs in economic theory, inaccurate credit ratings and fraud.

As noted above the Basel capital accords have been subject to review and update; and is effectively an evolutionary process to meet the dynamic development of banking. This is doomed to failure as evidenced by the GFC itself. As with much of regulation and regulatory reform the development is based on response to failure, with reforms being a process of review following failure, either within the firm or the wider economy. This failure driven response approach evidences further failure of the regulatory paradigm in so much that it shows a failure of global regulatory bodies and national governments to create a regulatory environment that provides adequate regulatory protection to consumers and to the wider economy.

Banking is a dynamic industry sector that has considerable influence playing an important part in the operation of the economy. The maturity transformation operation carried out by banks has been the engine of economic growth and prosperity. It has allowed people to live better lives, buy their own homes, enjoy holidays, and enjoy the benefits of consumer growth. Banks and other financial institutions have played a central role in this economic growth and prosperity and have grown alongside the consumer boom, growing themselves., and to achieve this growth banks have taken increasing risk using innovation to support the search for yield.

The evolutionary nature of the capital accords in response to failure is evidenced by the number of changes made since the original 1988 accord. A key failure of the 1988 accord was that it only applied to credit risk and not to the wider range of risks that banks were engaged in. The process of deregulation that emerged from the 1970's resulted in banks looking for increased opportunities to increase yield outside the traditional banking sphere. Banks increasingly began trading on their own account, so called proprietary trading, dealing in the capital markets for which there is no requirement to hold capital, on the basis that a bank would trade itself out of any negative position.[200]

Chiu and Wilson reflect on the fact that the BCBS had recognised the increasing and diversified risks that banks were exposed to. In 1996 the Basel I accord was strengthened by the Market Risk Amendment which sought to factor in banks wider risk portfolio particularly in the international money markets. The market risk amendment would require a measurement weighted at 12.5% to be added to the weighted risk assets. The amendments made to Basel I developed into Basel II reflecting the BCBS ambition to undertake further development work in this area to incorporating. Cranston et al state that

[200] K Alexander , Principles of Banking Regulation (Cambridge 2019)

"in many ways the first Basel capital standards…were a great advancement in terms of levelling the playing field for international banking. The also had considerable flaws", chief among which was the rise of securitisation which as noted allow banks to move assets off balance sheet. [201] To meet this the BCBS developed the Basel II accords which represented an "innovation in theory and practice of bank capital regulation because it incorporated bank capital management practices into the regulatory framework".[202]

Basel II represented increased ambition from the BCBS and took a three pronged [203]or more accurately a three Pillar approach to capital regulation. Pillar 2 dealt with supervisory review processes, encouraging banks to develop better risk management processes putting the onus on banks to develop adequate internal control systems, while Pillar 3 dealt with and market discipline around disclosure requirements and how bank management viewed risks; Pillar 1 dealing with capital requirements to build on an strengthen the soundness and stability of the international banking system and started to look more closely at the quality of capital used. To this point Basel I had defined two types of capital to make up the overall requirement; Tier 1 capital or core capital was of the higher quality and consisted of equity, fully paid-up shares etc, and retained earnings, with Basel I requiring that 50%, or 4% of risk-based capital be Tier 1[204], of which 2% needed to be of the very highest common equity capital CET 1). The second form was Tier 2 capital which was less flexible and included such items as subordinated debt, and other forms of debt, lacking in transparency in comparison to Tier 1. Basel II updated and incorporate the market risk

[201] R Cranston, E Avgouleas, K van Zweiten, C Hare, T can Sante, Principles of Banking Law (3rd Edition Oxford 2017, 41

[202] K Alexander The Role of Capital in Supporting Bank Stability in N Moloney, E Ferran, J Payne eds The Oxford Handbook of Financial Regulation, (Oxford 2015)

[203] R Cranston, E Avgouleas, K van Zweiten, C Hare, T can Sante, Principles of Banking Law (3rd Edition Oxford 2017, 41

[204] I H Y Chiu, J Wilson, Banking Law and Regulation (Oxford 2019)

amendment and introduced a new category of operational risk designed to cover risks that originate from within a bank, such as with people or systems with three approached to measuring such risk.[205]

Basel II failed to meet the challenge of the GFC with the level of capital required remaining at 8% of risk weighted assets. This was insufficient and a poor indicator of risks associated with banks overall exposure with reference to increased involvement in credit derivatives. Basel II also permitted banks to estimate their own credit and market risks which in hindsight turned out to be insufficient leading to undercapitalisation.[206] As Alexander posits:

> "The main problem with Basel II in respect of regulatory capital was that the economic capital models used by banks were accepted by regulators as being valid reference points for the calculation of regulatory capital. The economic capital models under Basel II failed to anticipate macro-prudential risks, for example, drying up of liquidity in the wholesale funding markets – and utilised risk sensitive techniques that could exacerbate systemic risks in the face of extreme event"[207]

[205] Basic, Standardised and Advanced.
[206] K Alexander, Principles of Banking Regulation (Oxford 2019)
[207] K Alexander The Role of Capital in Supporting Bank Stability in N Moloney, E Ferran, J Payne eds The Oxford Handbook of Financial Regulation, (Oxford 2015), 346

Alexander further notes:

> "Essentially, Basel II embodied the failure of financial policy makers and regulators to incorporate systemic risks into the design of regulatory capital and risk management"[208]

This reflects the impact of the GFC on Northern Rock, and again evidences the regulatory failure to manage systemic risk. At all levels policy makers failed to understand and cater for systemic risk. At all levels of regulatory design there was policy failure to consider the macroeconomic impact of economic policy on the banking and financial system, which when coupled with market liberalisation and 'rampant' innovation led to the environment that fostered the GFC.

The GFC prompted the BCBS to undertake further review and enhance the capital regulations. At the same time a general debate around capital and its role in loss absorbance emerged, with the Vickers report recommending that "banks be much more loss absorbing that they were in the past"[209] with "large ring fenced banks and all G-SIBs headquartered in the UK with a G-SIB surcharge of 2.5% should maintain regulatory capital and bail-in bonds to at least 17% of RWAs; and a further loss-absorbing buffer of up to 3% of RWA should be required of these banks if the supervisor has concerns about their ability to be resolved without cost to the taxpayer".[210] The results of review were to

[208] Ibid
[209] Independent Commission on Banking, Final Report, September 2011; 30
[210] Ibid

become the Basel III capital accord which built on the micro-prudential focus of the previous approaches but sought a greater focus on the macroprudential risks that played a central role in the GFC, but there is still criticism that even Basel II will not address all the macro-prudential financial stability risks, with continued reliance on banking groups to use internal modelling to calculate credit, market and liquidity risks. Basel III does introduce additional capital requirements through the introduction of capital buffers on top of the 8% risk asset ratio. These include a mandatory capital conservation buffer of 2.5%, effectively raising the overall ration to 10.5%, to be made up of high-quality CET 1 capital. In addition, Basel III allows for a discretionary application of a countercyclical buffer of between 0 and 2.5% that will be applied by national regulators to manage potential pressure build up during a 'boom' phase, with the FPC [211]the appropriate authority in the UK for determining such need. This buffer addresses the macroprudential issue of an overheating economy where typically banks do not store capital for a 'rainy day' instead preferring to use as much of its resources to chase yield as they have. Further Basel III adds an additional systemic risk buffer of between 1 and 3 percent for large, interconnected banks, thus under Basel III it is possible that a large G-SIB entity will need to maintain regulatory capital of 15% of risk weighted assets.

A remaining flaw with capital adequacy regulation is that banks will always look to circumvent such regulation. Bank and regulators have frequently played a game of cat and mouse, the regulator trying to stay ahead of the innovation created by the banking industry. One of the key driving forces behind product innovation has been to circumvent prudential regulation; the development of securitisation and private over the counter derivatives

[211] The FPC set the rate as 0.00% on the 11th March 2020. https://www.bankofengland.co.uk/financial-stability, last accessed 25/01/21.

allowed banks to move assets and investment 'off balance sheet', away from the prying eyes of the regulator, and any innovation that allows banks to reduce its capital holding will be utilised. Regulatory capital is an important regulatory tool; however, it will be one that regulated institutions will look to 'game', using to innovation to circumvent. Banks will always look to ensure that they can maximise their yield based on maximum use of their capital.

A full analysis of capital adequacy regulation is beyond the scope of this thesis, however. since the 1980's a key micro-prudential tool[212] available to regulatory authorities has been the regulation of capital, referred to commonly as capital adequacy. As Alexander notes "capital has taken on a talismanic significance in banking regulation".[213] The regulation of capital provides a range of benefits to authorities. On one level if a bank is fully capitalised and all its liabilities are matched fully by assets the bank will be 'bankruptcy safe' and able to withstand virtually all stress events. This, however, is a utopian view and does not reflect banking practice. As we have seen, the traditional role of banks is to lend long and borrow short, playing central roles in maturity transformation. Banks play a central role in the functioning of the economy, providing consumers and business with access to finance and services. Capital regulation refers to a requirement by regulatory authorities mandating banks and other relevant credit institutions to hold specified volumes and types of capital. The difficult question is ascertaining what levels of capital and what types of capital should banks hold, and this has yet to be accurately decided. The argument in favour of capital regulation is that it can act as a risk management mechanism as Chiu and Wilson noted that

[212] Cranston et al, Principles of Banking Law (3rd Edition, 2017 Oxford0
[213] K Alexander, Chapter 12 in handbook of Financial Regulation

“fundamentally capital adequacy requirements act as a road hump to slow down the moral hazard of excessive risk taking”.[214]

While regulatory capital provides several positive regulatory opportunities for regulators it comes at a price. At a fundamental level regulating how much capital a bank must hold lies contrary to principles of the free market allowing privately formed, owned, and run business organisations to make decisions for their own based on their own requirements. This begs a question, should banks and other regulated credit institutions be allowed to set their own capital requirements?[215] This, however, sets in motion a number of other issues, chief among which will be the risk that banks will set capital levels at very low levels that have no chance of supporting the institution in times of stress.[216]This point, however, is an important consideration in analysing the use and utility of capital as a regulatory mechanism. What is clear is that there are opportunity costs involved in holding capital, and the more capital held the greater the opportunity cost of their ability to use the capital for profit generation. Any capital that a bank ties up in reserve is capital that it cannot use for lending and investment activities, to support growth, providing finance to individuals and business, driving the economy, and as such any regulation that removes capital from the banks’ balance sheet will impact on their ability to grow. It is clear that from the late 1980’s and through to 2007 the focus of bank activity was growth, the search for yield. This search for yield, however, created an environment for risk taking, without fully understanding the risks that were inherent and building up within the system. While regulatory capital will be unpopular among within banks

[214] Chiu and Wilson, Banking Law and Regulation (2019, Oxford)
[215] And for that matter liquidity ratios.
[216] The Counter argument is that if banks want access to lender of last resort facilities and possible bailout options then the trade-off will be to allow the regulatory authorities to set a level of capital adequacy requirement designed to prevent the need to access such facilities.

it remains an important regulatory tool. The primary function of regulating capital is to manage risk, risk that over extension could be the sustainability of the bank in doubt.

Capital adequacy regulation goes to the central issue of too big to fail. The primary focus prior to the GFC was non institution specific regulation to prevent systemic. The lack of systemic macro-prudential focus resulted in regulatory authorities failing to understand how to manage and prevent the wider issues at play in the provision of banking services. A properly capitalised bank should be able to withstand external market pressure so that it won't fail and will be more likely to implement internal resolution mechanisms.

4.10 Conclusion

This chapter has looked at some important issue with respect to regulation, issues that I will term the hidden dangers. The key issue here is the incidence of moral hazard that 'haunts' the regulation of banking. It is not exaggeration to note the dilemma that this presents to bank regulation. While moral hazard continues to play a central role, banks will operate in an environment that encourages them to take risks. This developed into the Shadow banking market which caused much of the issues associated with the GFC[217]. The conceptual framework provides the environmental context in which banks operate, however, to fully answer the research question it is important to also understand the rationales for regulation within the framework, as set out in the next chapter.

[217] See Chapter 6

Chapter 5 - Why Regulate? The Rationale for Regulation

5.1 Introduction

In Chapter 1 it was noted that the Global Financial Crisis (GFC) had exploded the debate on bank and financial services regulation, its utility and effectiveness. Regulation had failed to soften the impact of nearly five decades of deregulation, possibly playing a direct role in that failure. This chapter introduces the context of the underlying reasons in which bank regulation operates, analysing some theoretical concepts that underpin regulation that failed to operate in the expected way causing the GFC. The focus of the chapter is on the central 'why regulate' question, to develop the underlying understanding of why we impose regulation on banks with a specific focus on understanding the regulatory structures that are used in this context. A key element in this thesis is that the overall application and structural design is key to ensuring that banks operation within a financially stable environment which allows them to provide the essential services to individual customers and to wider economic development. A key debate missing in the literature and in the wider policy debate is a full understanding of the need for regulation. The thesis shows that such policy decision leading to regulatory design was not based on regulatory need but on forcing a political viewpoint into a regulatory function, and that this allowed failure to occur. The structure of the chapter outlines the needs and rationales of regulation in the context of banks and why there is a need to treat banks differently from ordinary corporate enterprises. Additionally, the chapter looks to provide further support with an exploration of relevant theory.

5.2 The Need for Regulation?

An initial question in assessing the regulatory structure is to ask whether there is a need for such activity? Regulation will be more effective if it is designed only in response to specific need and not just based on a perception that we must regulate for regulations sake. McVea notes that there is generally a consensus of a need for a comprehensive regulatory structure and control of financial institutions, and it is undoubted that the credit and resulting bank crises has put the issue firmly back on the agenda, but an analysis of regulatory reform has focused on the need to correct issues that develop from individual firm failure rather than a wider look at regulation itself. [218] [219] The reform that follows references amendments and development of regulatory systems but only as they apply to firms, rather than the system. This view is focused on the micro-prudential, firm specific control issues, however, as the thesis shows the GFC is characterised by a failure to control the macro-prudential environment pertaining to the system in which individual firms operate.

As noted above, the legislative response to the crisis of 2007/8 was swift, and continuous, there has undoubtedly been a trend to channel frustration and anger towards financial institutions, and in particular bankers, who were blamed for GFC and its subsequent economic impact. This has been used to great effect by global legislatures, in particular the United Kingdom (UK) and the United States of America (USA) to bring forward an increasing volume of regulations and rules which, *prima facie*, are designed to ensure no repeat of the crisis. [220] However, there is a political undercurrent to the process which poses a danger of missing the potential to create a

[218] H McVea, Financial services regulation under the Financial Services Authority: a reassertion of the market failure thesis?, (2005) Cambridge Law Journal, 64(2), 413-448.
[219] R Tomasic, Creating a template for banking insolvency law reform after the collapse of Northern Rock: Part 2, (2009) Insolvency Intelligence, 22(6), 81-88
[220] H Hill and E Ligere, UK: financial services – Financial Services (Banking Reform) Bill – expect the unexpected, (2013), Journal of Banking Law and Regulation, 28(4), 47-50.; D Igan, H Moussawi, A F Tieman, A Zdzienicka, G Dell'Ariccia, P Mauro, The Long Shadow of the Global Financial Crisis: Public Interventions in the Financial Sector (IMF, July 2019), IMF Working Paper WP/19/164, last accessed 25/01/21

regulatory structure that is resilient enough to withstand the shocks. [221] Where banks were once courted by politicians and a light touch, hands off, even friendly, regulatory environment lauded, the focus has changed to a much more intrusive supervisory regime, multi-layered and over-arching, and very complex[222].[223] This complexity creates moral hazard, developing information asymmetries that prevent a transparent and focused systemic view to bank and financial services regulation from emerging[224]. Gilligan writing prior to the FSMA 2000 noted that as the UK financial services sector evolved over last 300 years as has the overall scope, depth and breadth of regulation.[225] This is evident from just the last 30 years, with a change from a regulatory culture firmly embedded in self-regulation,[226] alongside specific company's legislation and specific investor protection measures, to one which placed self-regulation in a statutory framework,[227] to one which is wholly statutory,[228] with very specific objectives.[229]

Traditionally regulation and supervision of the UK banking industry had vested in the Central Bank, the Bank of England, whether on an evolutionary informal basis or as in the 20th Century on a more formal basis, although based more on the historical position of the Bank of England at the centre of UK banks rather than the application of statutory power.[230] This position remained unchallenged during 'Big Bang', the momentous reform of the UK financial services

[221] See E Ferran, The Break-up of the Financial Services Authority, (2011), Oxford Journal of Legal Studies, Vol 31, No.3, 455-480
[222] M Cole, The Seventh Annual AA Sommer Jr Lecture on Corporate, Securities & Financial Law: The UK FSA Nobody Does it Better, (2007) Fordham Journal of Corporate & Financial Law, 12 Fordham, J. Corp & Fin L. 259-281
[223] It is a submission of the research the only pressing and urgent need was for a bank resolution and bank insolvency regime, now enacted by the Banking Act 2009.
[224] I MacNeill, The trajectory of regulatory reform in the UK in the wake of the financial crisis (2010), European Business Organisation Law Review, 11(4), 483
[225] GP Gilligan, The Origins of UK financial services regulation, (1997) Company Lawyer, 18(6), 197-176.
[226] I MacNeill, The future for financial services regulation: the Financial Services and Markets Bill, (1999) The Modern Law Review, 62(5), 725-743
[227] Financial Services Act 1986
[228] Financial Services and Markets Act 2000
[229] The four objectives being Maintaining Market Confidence, Consumer Protection, Consumer Awareness and Preventing Financial Crime.
[230] F Giavazzi, A Giovannini, Central Banks and Financial System, in S Eijffinger, D Masciandaro, Handbook of Central Banking, Financial Regulation and Supervision: After the Financial Crisis (Edward Elgar 2011)

industry, transforming London from a 'gentlemen's club' into a global financial centre. [231] The Financial Services Act 1986 was the centrepiece of the then Conservative government's reform of the financial services industry, and the regulatory structure designed to govern it, however, bank regulation and supervision remained with the Bank. The focus of the 1986 reform was on investor protection during an expansionist and deregulatory phase in UK financial services history linked to a broader change in economic thought.[232]

5.3 The Rationale for Regulation

A key element for this research is to understand why regulation is needed. To answer the why allows policy makers to understand how to design the optimal regulatory structure for bank regulation. Ogus quotes Selznick in noting that regulation is a "sustained and focused control exercised by a public agency over activities that are valued by a community"[233]. The GFC evidences that there is little doubt that regulation and supervision, control, of banks and their activities is needed,[234] however, there needed to be a more considered debate on what that 'control' actually looks like. The rationale underpinning the need to regulatory regimes are strong in the wake of crises generally, with Gower noting that the "most usually stated public interest goal of mandatory financial disclosure is investor protection", but a key question is to ask how investor protection will be achieved; complex regulatory regimes create opacity preventing objectives being met. [235] A feature of the GFC is that focus on investor protection measures instead of a wider focus on systemic issues created 'blind spots' in the regulatory process. These issues are reflected where Davies,[236] noted that the two principal rationales for

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[231] LCB Gower, Big Bang and city regulation, (1988), Modern Law Review, 51(1).2
[232] See Fisher et al, The Law of Investor Protection, (2003) 2nd Ed, Thomson Sweet & Maxwell
[233] Selznick cited in AI Ogus, Regulation: Legal Form and Economic Theory, (1994), Clarendon Law Series, Oxford University Press
[234] H McVea, Financial services regulation under the Financial Services Authority: a reassertion of the market failure thesis?, (2005) Cambridge Law Journal, 64(2), 413
[235] LCB Gower, "Big Bang" and City Regulation, The Modern Law Review, 51(1) 1, 1
[236] H Davies, Why Regulate: Henry Thornton Lecture, City University Business School, 4th November 1998

financial regulation are the problems associated with systemic risk and information asymmetry. Failure to manage both effectively in the years leading up to the crisis had the result of amplifying the effects of the bursting of the US property bubble.

The Sassoon Report,[237] highlighted the regulators weak micro-prudential supervisory regime in the period prior to 2007 and the subsequent collapse of Northern Rock; indeed, both the Turner Review,[238] and the Treasury Select Committee,[239] criticised the supervisory regime, in particular the role the FSA played. The Select Committee reserving the harshest criticism for being "asleep on the job".[240] Sassoon analysed the rationale for regulation in quoting Herring and Santomero that the objective of financial regulation is:

> "Safeguarding the system against systemic risk; protecting consumers against opportunistic behaviour by suppliers of financial services; enhancing the efficiency of the financial system; and achieving a range of social objectives [using the financial system to achieve social/political objectives such as supporting the housing market]".[241]

This matches the objectives set by the FSMA 2000 and tasked to the FSA to carry out, within a tri-partite programme of co-operation with the Bank of England and HM Treasury. That this failed is not in doubt proving that the "institutional framework of financial regulation as a significant impact on whether regulatory regimes succeed or fail in achieving their objectives".[242]

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[237] The Tripartite Review: A review of the UK's Tripartite system of financial regulation in relation to financial stability. 'The Sassoon Report', March 2009
[238] The Turner Review: A Regulatory Response to the Global Banking Crisis (March 2007), FSA London
[239] House of Commons Treasury Committee, The Run on the Rock: Fifth Report of Session 2007-08.
[240] Ibid
[241] The Tripartite Review: A review of the UK's Tripartite system of financial regulation in relation to financial stability. 'The Sassoon Report', March 2009
[242] ibid

The provision of banking services is a public good as the provision of such services is a "commodity the benefit of which is shared by the public as a whole, or by some group within it",[243] the smooth operation of the banking and financial system fits this definition.[244] The impact of the GFC has been seen on the global economy of a poorly functioning banking system, evidencing the ned for policy makers to get the structure of regulation correct; this is not necessarily more rules and regulations.

5.4 Evidence of a knee jerk approach?

The GFC caused governments, their central banks, and regulatory authorities to take action. The sight of queues of bank customers waiting to withdraw their money prompted governments to undertake a programme of regulatory reform to ensure there would be no repeat of the crisis, however, this reform was based more on a political need to do something, rather than a fully considered analysis of the need. Alcock noted that:

> "It is easy to forget in the immediate aftermath of scandals that extra regulation may achieve little beyond satisfying the call for something to be done and can cumulatively cost a lot even perversely increase the chances of future disasters."[245]

This is a salutary warning of the dangers of reacting too quickly without the time and space to undertake a thorough review of the issues. Tomasic notes that "legislation produced in great haste invariably tends to be criticised as being an overreaction" and this has been the outcome

[243] A I Ogus, Regulation: Legal Form and Economic Theory, (Oxford 1994), Clarendon Law Series,

[244] H McVea, Financial services regulation under the Financial Services Authority: a reassertion of the market failure thesis?, (2005) Cambridge Law Journal, 64(2), 413

[245] A Alcock, Are Financial Services Over-Regulated, (2003), Company Lawyer, 24(5), 132-138.

of the GFC, with a ‘knee jerk’ reaction to be seen to be doing something.[246] Since the crisis the sector has seen a new section 3A inserted into the FSMA 2000, explicitly covering systemic risk, a new Banking Act (2009) dealing with failing or insolvent banks, a new regulatory structure, removing the single regulator and replacing it with a ‘twin-peaks’ model, overseen by a Financial Policy Committee installed in the Bank of England with specific obligations to ensure financial stability. [247] Furthermore, the Financial Services (Banking Reform) Act 2013 requires retail banking operations to be ring-fenced from investment banking operations, or possibly vice versa, coming into force in 2019[248]. This is in addition to international efforts to improve bank and financial stability through issues such as capital adequacy regulation.[249]

However, the question remains, whether more regulation and more complex regulation is the answer? Baber posits that “financial legislation has become complicated”,[250]and this is likely to continue for some time into the future, with ring fencing of retail operations now enacted.[251]. He added that “the rule of law has many enemies. One of them is bad law”.[252] The ‘knee-jerk’ approach to bank financial services regulation will achieve exactly this, that a rush to be seen to be doing something, motivated by political considerations that will have an overall negative impact, storing up the same problems that affected the previous regulatory regimes. A concern with increasingly complex regulation is to how financial institutions deal with them. Where

[246] R Tomasic, Creating a template for banking insolvency law reform after the collapse of Northern Rock: Part 2, (2009) Insolvency Intelligence, 22(6), 81-88
[247] Financial Services Act 2012 amending the Financial Services and Markets Act 2000
[248] See A Hudson, Banking Regulation and the ring-fence, Compliance Office Bulletin, 2013, 107(Jun), 1-23. Hudson comments that there is ambiguity in what is being ring-fenced off from what.
[249] See Chapter 8.
[250] G Baber, A Critical Examination of the legislative response in banking and financial regulation to issues related to misconduct in the context of the crisis of 2007-2009, (2013) Journal of Financial Crime, JFC 20(2), 237

[251] Financial Services (Banking Reform) Act 2013
[252] G Baber, A Critical Examination of the legislative response in banking and financial regulation to issues related to misconduct in the context of the crisis of 2007-2009, (2013) Journal of Financial Crime, JFC 20(2), 237

the regulations and control mechanisms are complex regulators struggle to ensure compliance across the market sector. Hupkes adds that a consequence of the banking crisis will be "greater regulation", with consequences here having a negative connotation, with greater referring to the volume not the quality. [253] In a similar vein Chui, notes that there is "regulatory creep" indicating a concern that increasing regulation will achieve little in the long term other than to be seen to be doing something, evidencing more political decision drivers than one based on regulatory need. [254] A key outcome of this research is that the overall design of the regulatory structure is more important than individual rules and regulations.

A better way forward may well be to pare down the complexity of the regulation, not to deregulate, but to allow for greater transparency in the regulatory regime, by focusing on the overall architecture of the regulatory regime rather than a focus on the minutiae of regulation. [255] The call is not for a hands-off deregulatory approach allowing unfettered bank operations but for a structural design that allows regulators to provide a stable environment in which banks operate. This may have the result that powerful banking organisations will be prevented from hiding behind a thicket of unintelligible and unenforceable regulations. In addition to a stronger structural focus a stronger sanctions-based market abuse regime could fill the gaps. The evidence of the GFC is that no matter what the regulatory landscape is banks and the individuals that control and operate them will look to circumvent those rules; a stronger anti-abuse regime may have the deterrent effect that rules, and regulations do not[256]. A stronger focus on understanding why regulation is needed will provide a system that that is more capable

[253] E Hupkes, Regulation, self regulation or co-regulation, (2009), Journal of Business Law, 5, 427-446.
[254] Chui I H-Y, The interface between financial regulation and corporate governance, (2012), Company Lawyer, 33(3), 65
[255] Deregulate tends to have negative connotations of removing controls that are very often needed, linked often to a left versus right political debate.
[256] N Ryder, The Financial Crisis and White Collar Crime: The Perfect Storm (Edward Elgar 2014); N Ryder ed, White Collar Crime and Risk (Palgrave Macmillan 2018)

of preventing collapse. Collapse here refers to systemic collapse as opposed to individual firm collapse. Two key features of the GFC were that firms had become too big to fail (TBTF), and their interconnectedness where firms had grown so large and so interconnected with each other that regulators have little choice but to step in and rescue when faced with collapse.

5.5 Why is there such a focus on banks?

Banks are corporate entities like any other, however, when the reality of large-scale retail bank failure presented itself in the Autumn of 2007 the UK government felt that the application of existing corporate insolvency measures, through the Insolvency Act 1986 and the Companies Acts was insufficient, resulting in emergency legislation in the form of the Banking (Special Resolutions) Act 2008. Alexander alludes to why the UK government felt compelled to act:

> "Banks are important because they bring communities together by accepting deposits from savers and lending to borrowers to start businesses, buy houses, pay university fees, or engage in several other socially useful activities. In doing so, banks provide credit and liquidity for their customers which supports the economy. To do this effectively, banks must manage financial risks, including credit, market, liquidity, and operational risks, which if managed effectively, benefit society economically, but if mismanaged may result in costs for society. Banking regulation is therefore important to ensure that banks manage these risks efficiently and that they do not create social costs".[257]

Alexander sets out the important links between the provision of banking and bank regulation, emphasising that banks provide important and socially advantageous activities that benefit society, the failure of which can lead to significant negative outcomes for bank customers and

[257] K Alexander , Principles of Banking Regulation (Cambridge 2019)

due to the interconnectedness of the modern banking system that impact can result in wide ranging economic consequences.[258] Berger et al further note the importance of banks:

> "Banks play critical roles in the economy. They operate the payments system, act as a conduit for monetary policy, and are a major source of credit for households, corporations, and governments…Banks also create liquidity for the public on the balance sheet by transforming relatively illiquid assets such as loans into relatively liquid liabilities such as transactions deposits, and off-balance sheet through loan commitments and similar claims to liquid funds".[259]

The growth and importance of banks and banking is formulated on their role in financial intermediation. It is not an exaggeration to state that the economic development over the last 300 years is a product of the development of banking with particular focus on their intermediation services in generating liquidity which has provided the fuel for economic growth through business investment and more recently consumer finance. The Organisation for Economic Cooperation and Development (OECD) defines financial intermediation as:

> "…a productive activity in which an institutional unit incurs liabilities on its own account for the purposes of acquiring financial assets by engaging in financial transactions on the market; the tole of financial intermediaries is to channel funds from lenders to borrowers by intermediating between them."[260]

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[258] R Tomasic, Creating a template for banking insolvency law reform after the collapse of Northern Rock: Part 1, (2009) Insolvency Intelligence, 22(5), 65

[259] A N Berger, P Molyneux, J O S Wilson, Banking ins a Post-Crisis World, in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition, Oxford 2014)

[260] OECD Glossary of Statistical Terms; https://stats.oecd.org/glossary/detail.asp?ID=972#:~:text=Financial%20intermediation%20is%20a%20productive,lenders%20to%20borrowers%20by%20intermediating

Banks have long carried on these financial intermediation services by taking in deposits which can be recalled at any time, and lending long term, for example mortgages, based on those deposits, however, deregulation from the 1970's resulted in banks search for yield and profit and a move away from the basic intermediation with increased leverage rates to allow increased lending and other investment activity. [261]

At a more fundamental level the Cruickshank report into competition in banking noted that "banks operate at the heart of the modern economy" and this depth of engagement has increased since the report was published with banks increasingly important in preserving access to banking services avoid financial and social exclusion, but not necessarily though the traditional branch network. [262] Persons who do not have access to a bank account will pay more for basic services such as phone, energy, and many other essential services. Research illustrates [263] shows that 1.23m people are classed as 'unbanked', that is not having access to basic banking services such as a current account allowing for payments to be made by direct debit which can lead to a "poverty premium",[264] as many service providers offer better deals to those that pay using direct debit.[265] The importance of access to banking services has been highlighted during the Covid-19 pandemic, with the resulting lockdown and closure of shops forcing large numbers of consumers online for which access to a bank account is essential. [266]

[261] See D Pesendorfer, Goodbye neo-liberalism? Contested policy responses to uncertain consequences of the 2007-09 financial crisis, in K Alexander, R Dhumale, Research Handbook on International Financial Regulation (Edward Elgar 2012).
[262] D Cruickshank, Competition in UK Banking: A Report to the Chancellor of the Exchequer, (HM Treasury 2000)
[263] HM Treasury and Department for Work and Pensions, Financial Inclusion Report 2018-19 (March 2019)
[264] Ibid
[265] R Jones, Britons without a bank account pay a £485 poverty premium' The Guardian (Manchester 22nd April 2019) access at https://www.theguardian.com/money/2019/apr/22/britons-without-bank-account-pay-poverty-premium. accessed 22/10/19
[266] See E-commerce in the time of COVID-19: OECD Policy Responses to Coronavirus (COVID-19) http://www.oecd.org/coronavirus/policy-responses/e-commerce-in-the-time-of-covid-19-3a2b78e8/ accessed 27/11/20

This confirms the argument that banking, and the provision of banking services is a public good and the importance of the provision, and continuity, of banking services to the social and economic wellbeing of the country emphasising the importance that effective regulation is to banks and by extension banking services and by further extension to the wider economy. The continuity of banking services is essential to maintain economic prosperity, to provide the social capital that allows society to grow. [267] Regulation is the mechanism by which national governments manage the continuity of banking services. Ensuring that regulation is designed to achieve these goals is essential, however, the history of banking is littered with scandal and collapse followed by regulatory reform. The GFC "was the most serious economic disturbance in the post Second World War 2 era",[268] and provided the greatest stress event in the history of banking bringing the system to near collapse, with regulation failing to properly identify, mitigate and manage the ensuing financial crisis, and over a decade later the GFC still has an influence on opinion, policy and politics.[269] The GFC has played a central role in the direction and development of bank regulation since its emergence in 2007, reshaping the debate on why and how our banks are regulated.

5.6 What is regulation? The context

The starting point is what is regulation in context, however, it is a difficult starting point as there is "no single agreed meaning of the term, but rather a variety of definitions in usage", although regulation is a term used frequently in a range of contexts. [270] Regulation "is often

[267] See R Baldwin, M Cave, M Lodge, Understanding Regulation (2nd Edition, Oxford 2012)
[268] J Armour, Dan Awrey, P Davies, L Enriques, J N Gordon, C Mayer, J Payne, Principles of Financial Regulation (Oxford 2016).
[269] N Moloney, E Ferran, J Payne eds, The Oxford Handbook of Financial Regulation (Oxford 2015)
[270] See R Baldwin, M Cave, M Lodge, Understanding Regulation (2nd Edition, Oxford 2012)

spoken of as if an identifiable and discrete mode of governmental activity", highlighting a common theme that the starting point for regulatory intervention is within national governments. [271] The lack of a detailed definition is both inevitable and desirable. The breadth of areas that require some form of regulatory oversight means that a single definition cannot cover all possibilities. Environmental regulation will require a different set of outcomes than education, and in turn financial regulation will require yet further differences. The definition of regulation will ultimately depend on what the stated outcomes relevant to the sector being regulated needs.

Regulation is a complex subject and covers an incredibly wide range of activity encompassing a very wide range of industry sectors. Baldwin *et al*,[272] noted that "regulation has, … become a central form of state intervention" reflecting further on the commonly held position that regulation is primarily the exercise of governmental or state action with a view of controlling or governing a particular element of the economy.[273] This fact of control polarises opinion on regulation and itself creates a tension surrounding what regulation is and what it should be, and importantly how far regulation should pervade within a particular market sector.

The history of bank and financial markets regulation is also the history of the debate between controlled economic activity and unfettered free market operations with banks on the side of free markets.[274] The debate surrounding regulation and deregulation 'haunts' the bank and financial services sector and the history of regulation in this sphere is a study of the pros and

[271] R Baldwin, Martin Cave, Martin Lodge, Understanding Regulation: Theory, Strategy and Practice (2nd Edition, Oxford 2012).
[272] R Baldwin, Colin Scott, Christopher Hood eds, A Reader on Regulation (1998, Oxford).
[273] Economy here is used in the widest term that refers to the so called real economy covering all sectors such health, education, environmental and bank and financial services.
[274] See T Arthur, Do we have a free market in banking? (2011) Adam Smith Institute Blog, https://www.adamsmith.org/blog/tax-spending/do-we-have-a-free-market-in-banking

cons of regulation and deregulation, depending on the prevailing political landscape. It is clear that in respect of bank regulation political influence and even political dogma plays a key role in what the regulatory environment looks like, it was only the GFC that resulted in a different view emerging and the failure of the free market neo-liberal argument.[275]

Ogus notes on the nature of regulation that "the expression 'regulation' is frequently found in both legal and non-legal contexts. It is not a term of art, and unfortunately it has acquired a bewildering variety of meanings".[276] Selznick called it a "sustained and focused control exercised by a public agency over activities that are valued by a community".[277] At its most, a working definition can be seen as a set of rules created by legislative process controlled by an agency of government responsible for oversight with the backing of law, including the availability of potential sanctions. This is an impossibly wide definition when applied to the range of regulatory activities, in which some may not have the benefit of legislative creation and may even seem remote from government, and have no sanction mechanisms beyond negative reviews in a report.[278] However, the definition advanced here does reflect the position of bank and financial services regulation in which the origin and driving force behind the promulgation of regulations comes through a legislative process, and therefore, a political one. It is a feature of bank regulation that a government agency or authority is delegated with responsibility to carry out regulatory functions in line with the statutory provisions that provide the legal basis for such regulation, and that failure to comply with regulations can result in some form of sanction, dependent to the specifics of the failure.

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[275] D Pesendorfer, Goodbye neo-liberalism? Contested policy responses to uncertain consequences of the 2007-09 financial crisis in K Alexander, R Dhumale, Research Handbook on International Financial Regulation (Edward Elgar 2012)
[276] A I Ogus, Regulation Legal Form and Economic Theory (Oxford 1994).
[277] See R Baldwin, M Cave, M Lodge, Understanding Regulation: Theory, Strategy and Practice (2nd Edition, Oxford 2012).
[278] Ibid.

5.7 Why regulate banks?

There is no single answer to this question. Armour *et al*. state that the "primary purpose of regulation is to improve the functioning of that system" and that therefore the "design of financial regulation is…ultimately an exercise in economics-applying the analytical tools of economics to determine the legal and regulatory framework best suited to correcting the failures of the financial system". [279] The Prudential Regulation Authority further note that justification lies in the possible outcomes of not regulating noting that:

> "In the absence of prudential regulation, deposit-takers and investment firms would take more risk and be less safe and sound, with the financial system as a whole in consequence less stable, than is in the public interest".[280]

There are two ways to view this point; at first sight it would suggest that prudential regulation did not exist until the creation of the Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA), however, this is to ignore the fact that the Tripartite regulatory system had a prudential regulatory role. This leads to a second view, even with prudential regulation is in place this will not guarantee a stable environment without strong focus on wider policy level issues. [281] That regulation and economics overlap is undoubted and to an extent regulation is a sphere of economics in context, an element of applied economics.[282] The over reliance on established economic principles lies at the centre of the GFC with banks and

[279] J Armour, D Awrey, P Davies, L Enriques, J N Gordon, C Mayer, J Payne, Principles of Financial Regulation (Oxford 2016) Chapter 5.
[280] Bank of England, FSA, The Bank of England, Prudential Regulation Authority: The PRA's approach to banking supervision, October 2012
[281] Policy level here refers to government and legislative decision making process in control over the economy. For banks and financial services this also includes central banks who play a role in economic policy decisions particularly as central banks such as the UK's Bank of England have independent responsibility for setting interest rates.
[282] See R Baldwin, M Cave, M Lodge Eds, The Oxford Handbook of Regulation (Oxford 2012), Chapter 2.

regulators operating under the assumption of efficient and ultimately self-correcting markets.[283]

A fundamentally important question is why do we regulate banks and financial services, or more accurately what is the purpose of bank and financial services regulation; what is the outcome to be achieved? The thesis of this research is that understanding what the purpose of regulation is key to understanding what is to be achieved from regulation, and from this understanding authorities can design the optimal structure of regulation. Moloney picks up this point:

> "The traditional rationale for financial services and markets regulation is the correction of market failures related to asymmetric information and to externalities, notably systemic risks, in order to support market efficiency and efficient resource allocation".[284]

Banks operate within the financial system with Cranston *et al* setting out a useful statement on what regulation is looking to achieve:

> "Traditionally the focus of bank regulation has been on the protection of individual institutions stability from a depositors run and of depositors and deposit guarantee schemes from incurring losses in the event of bank failures. Another fundamental goal was the protection of taxpayers from a public bailout and from the kind of moral hazard that arises when public bank rescues are likely-and is still valid today. "[285]

[283] See Chapter 9
[284] N Moloney in R Baldwin, M Cave, M Lodge Eds, The Oxford Handbook of Regulation (Oxford 2012), Chapter 18. P437.
[285] R Cranston-Principles of Banking Law (3rd Edition, Oxford 2017).

This initial comment reflects the pre-GFC position, which focused on firm specific or micro-economic rationales for regulation. This means that the regulatory regime is designed to prevent failure of individual banks, and by extension prevent protection schemes from incurring losses as a result of a bank failure. They further note:

> "However, in recent years and especially since the Global Financial Crisis (GFC) the focus of bank regulation has substantially broadened to include (a) eliminating the too-big-to-fail institution, by, at the very least, making successful recovery possible, and failing that, facilitating orderly resolution; (b) substantially increasing capital cushions, and introducing liquidity requirements; and (c) enhancing the resilience of the financial system to withstand system wide-shocks".[286]

This better reflects the post crisis position, with a wider focus for regulators on systemic issues. However, the quote remains largely embedded in micro-prudential firm specific language. The primary difference is that the position here is the recognition that that "bank failures are rarely individual and self-contained events. They reduce externalities that threaten the stability of the financial system".[287] The externalities that are generated provide the underlying rationale for regulation. These externalities are linked to contagion related spill overs that result from the failure of a large bank. This interconnectedness results in a potential 'domino' effect of failure which in turn may lead to systemic disruption, which is the contagion of one bank's failure infecting other banks which could further lead to potential stress in the banking and financial system as a whole.

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[286] Ibid.
[287] Ibid.

It is clear from the pre-GFC regulatory position that there was a lack of understanding the nature of regulation in respect to its role with regards to systemic protection. The focus on the micro-prudential, firm specific position resulted in the regulatory authorities lacking the structure, tools and focus on what were the real issues with the way banks were operating, particularly in reference to the risk profiles that banks were taking. Thus, in the wake of the GFC the focus of what regulation should achieve has changed from a micro-prudential firm specific viewpoint to a more macro-prudential system wide approach. This addresses the design lacunae of associated with the regime created by the FSMA 2000.

There are several rationales to why regulate. In the broader context a primary rationale is based on the potential for widespread 'market failure', as Francis notes regulation is "justified because the uncontrolled marketplace will, for some reason, fail to produce behaviour or results in accordance with the public interest".[288] Behaviour is a difficult concept in the context of bank and financial services regulation. Regulation, at least in part, fulfils a behaviour management function in so much as it should set rules and standards within the regulated activity. As noted by Baldwin *et al*, regulation functions to restrict behaviour, preventing undesirable activity such as market abuse, a so called 'red light' concept.[289] They also note that regulation can have a 'green light' effect in that it can act in an enabling way, facilitating actions. In terms of financial services regulation this can be seen when applied to bank competition. The behaviour associated with the GFC can be reflected in the term 'casino banking' describing the approach to investment banking as analogous to gambling but a common problem with this is that gamblers often chase losses.[290] This can be seen in the

[288] J Francis, The Politics of Regulation (Oxford 1993).
[289] R Baldwin, M Cave, M Lodge, Understanding Regulation (2nd Edition, Oxford 2012)
[290] House of Commons Treasure Committee, Banking Crisis: dealing with the failure of the UK banks, Seventh Report of Session 2008-09 (2009) 1st <ay 2009 HC 416

collapse of Barings Bank when trader Nick Leeson sought to correct the losses he had made with wilder and wilder 'bets' eventually causing the failure of the bank.[291]

Tverskey and Kahneman note this as "loss aversion" in that "the displeasure of losing a sum of money exceeds the pleasure of winning the same amount"[292]and followed their work on prospect theory.[293] Prospect theory is a model of behaviour that explains how people make decision between alternatives that involve risk, noting that people are loss averse on the basis that losses are disliked to a greater degree than gains,[294] ultimately leading to behaviour where people are more willing to take risks to avoid a loss, [295]explaining why gamblers and bankers chase losses and can be used to explain behaviour in the CDS market. [296]

Regulation can provide the environment necessary to ensure new entrants have fair access to markets, however, the history of banking does not provide overwhelming evidence of this; a quick scan of the UK banking sector will show a small number of very large banks dominating the sector. Barriers such as high capital adequacy[297] rules make it difficult for new entrants to break through into the sector. This is a missed opportunity as far as UK bank and financial services regulation is concerned. The failure of UK regulation to fully facilitate market entrance by new organisations resulted in the growth of the megabank, the Globally

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[291] J Rodrigues, Barings collapse at 20: How rogue trader Nick Leeson broke the bank, The Guardian (Manchester 24th February 2015) https://www.theguardian.com/business/from-the-archive-blog/2015/feb/24/nick-leeson-barings-bank-1995-20-archive, last accessed 1/12/20.
[292] A Tversky, D Kahneman, Rational Choice and the Framing of Decisions (1986), The Journal of Business, Vol 59, No.4, Part 2, 251, 258.
[293] D Kahneman, A Tversky, Prospect Theory: An Analysis of Decision making under Risk (1979) Econometrica, Vol 47, No.2, 263.
[294] D Khaneman, Thining Fast and Slow (Kindle edition, Penguin 2012).
[295] Prospect Theory, Behavioural Economics.com, https://www.behavioraleconomics.com/resources/mini-encyclopedia-of-be/prospect-theory/, last accessed 10/1/21.
[296] Collateral Debt Swaps. See Chapter 6.
[297] What is Threat of New Entrants, Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/knowledge/strategy/threat-of-new-entrants/, last accessed 20/01/21.

Systemically Important Financial Institutions (G-SIFIs) that were at the centre of the GFC. [298] The Financial Conduct Authority (FCA) recently noted some general success in opening banking to new entrants, and work was ongoing to improve access there is however, significant work to be done. [299] In the context of the GFC and preventing another crisis the work on opening the banking sector to new entrants is of utmost importance. Increased competition in the banking sector will provide customers with greater choice and may have the effect of reducing their size, increasing their resolvability in times of stress. To support this., the Financial Conduct Authority has a statutory objective to promote effective competition.[300] A barrier to competition however rests on the regulatory capture theory and application to banks, where the regulator becomes a function of the regulator, supporting rules against new market entrants due to high entry and compliance costs.[301]

Alongside this a regulatory focus on allowing institutions to fail in a safe manner would have strengthened the overall regulatory rationale of ensuring the safety and soundness of the financial system. This again proves that understanding the why of regulation is vital to ensure that the correct regulatory structure is employed. The full range of argument of why regulate is beyond the scope of this research and has been discussed at length, such rationales include:

- Monopoly Power,
- Excessive Profiteering,
- Externalities,

[298] See A E Wilmarth, Taming the Megabanks: Why we need a new Glass-Steagall Act (Oxford 2020)
[299] R Baker, D Finlayson, D Mittendorf, K Raghaven, FCA Evaluation Paper 18/3: An evaluation of reducing barriers to entry into the UK banking sector (2018) FCA London December 2018, https://www.fca.org.uk/publication/corporate/ep18-3.pdf, last accessed 18/1/21.
[300] Financial Services Act 2000, S.1E
[301] See G J Stigler, The Theory of Economic Regulation (1971) The Bell Journal of Economics and Management Science, Vol.2, No.1, 3

- Information Asymmetry,
- Continuity of Services,
- Anti-Competitive activities,
- Protection of Public Goods,
- Inequality of bargaining power,
- Better Allocation of resources and
- Planning. [302]

While not all of these apply directly to the regulation of banks, many of them do. The corresponding list that can be directly applied to financial regulation and banks in particular will include:

- Protection of investors,
- Protection of consumers,
- System or stability,
- Market efficiency,
- Competition and
- Integrity.

It is difficult to put these into a hierarchy of priorities and it is clear that they are not mutually exclusive, however, the GFC has made it clearer that the primary rationale for regulation of banks is to prevent systemic collapse, which results in system stability or financial stability becoming a central feature of the strategy of national governments in deciding the regulatory

[302] R Baldwin, M Cave , M Lodge, Understanding Regulation: Theory, Strategy and Practice (2nd Edition, Oxford 2012)

structure. A stronger systemic focus will provide the environment for banks to continue to provide strong liquidity to commercial markets allowing for strong economic growth. The other goals are not relegated and to an extent are complemented by a stronger systemic risk focus, wherein a strong, safe, and stable financial system will allow a regulator to deliver on the other goals of a regulatory regime. In designing regulatory structures policy makers should focus on such architecture that creates the strongest systemically stable system which in turn will allow a simpler and more transparent regulatory regime to develop within that system.

The pre-crisis regulatory regime was tasked with four statutory objectives,[303] that covered the above list, however, there was no explicit objective that required the regulator, the FSA, to maintain financial stability, the closest objective being to maintain market confidence.[304] The GFC conclusively proved that banks play a central role in the smooth functioning of the economy, providing essential services to individuals and businesses, and the GFC came dangerously close to bringing the entire banking system down, which would have resulted in catastrophic impact on the global economies. The willingness of government to rescue retail banks in trouble reinforces this fact; the possibility of such a bank collapsing presents governments with unpalatable outcomes of significant negative impacts on individual depositors, businesses, and the wider economy. The failure of the pre-crisis regulatory regime to prevent the impact of a global economic event such as the sub-prime crisis set out the weaknesses of the approach to regulation in the years preceding its emergence. [305]

[303] Sections 3-6 Financial Services and Market Act 2000. See Chapter 4
[304] Section 3 Financial Services and Markets Act 2000.
[305] See Chapter 6

Banks are special, they are not like other entities resulting in the need for a specific type of regulatory regime.[306] They play a central role in the economy, “channelling money from savers to borrowers”, they provide maturity transformation services turning short term deposits into long term loans, based on leveraging those deposits to be able to make sufficient loans to grow.[307] This makes them inherently unstable, and technically insolvent. Banks operate on a premise that not all depositors, not even a majority will withdraw their money at the same time. The situation where large numbers of depositors withdraw deposits at the same time is termed a bank run, with the potential for the collapse of the bank as a result of insufficient liquidity and/or capital; this was seen in the case of the collapse of Northern Rock.[308] Additionally banks pose significant other dilemmas to regulatory authorities. Banks are powerful corporate entities in much the same way as other corporate entities such as large manufacturing, pharmaceutical, or service companies, and in the same way they are prone to stresses within their market sectors.

5.8 The Economic Theory of Regulation, the GFC and the future of regulation.

A detailed analysis of the entire scope of regulation as a broad subject and beyond the scope of this research; the impact and stratification of regulation across such a wide range of societal activities provides a wide and rich literature on the subject with different goals and priorities

[306] R Tomasic, Corporate rescue, governance and risk taking in Northern Rock: Part 2, (2008) Comp Law, 29(11), 330; R Tomasic, Creating a template for banking insolvency law reform after the collapse of Northern Rock: Part 2, (2009) Insolvency Intelligence, 22(6), 81

[307] H Borchgrevink, Y Sovik, B Vale, Why Regulate, (Staff Memo Norge Bank 2013)

[308] See Al Brummer, The Crunch: The Scandal of Northern Rock and the Escalating Credit Crisis (Random House 2008. Technically Northern Rock did not fully collapse as it was effectively nationalised by the UK government to prevent the impact on its customers that a collapse would have resulted in.

attached to the specific area under regulation.[309] Posner[310] noted that one of the main theories of economic regulation is public interest theory which posits that regulation is provided based on a demand for correction of market inefficient market practices.[311] A second and key theory that creates issues for financial regulation is the "most promising"[312] theory; 'Economic Theory of Regulation'[313] posits that regulation is not driven by public interest priorities but by the interests of interest groups.[314] As Baldwin[315] et al note the theory is built on the premise that the parties involved are focused on maximising their own interests. Peltzman, as one of the architects of the theory notes:

> "Politicians, like the rest of us, are presumed to be self-interested maximisers. This means that interest groups can influence the outcome of the regulatory process by providing financial or other support to politicians or regulators".[316]

A key component to develop from the economic theory of regulation is 'Capture Theory'.[317] This is particularly important in an analysis of the pre-crisis failure of the regulator to deal with the emerging issues in banks and the financial system as a whole.

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309 See A I Ogus, Regulation: Legal From and Economic Theory (Oxford 1994); R Baldwin, C Scott, C Hood, Regulation (Oxford 1998); R Baldwin, M Cave, M Lodge, Understanding Regulation: Theory, Strategy and Practice (Oxford 2012).
310 R A Posner, Theories of Economic Regulation, (1974) Center for Economic Analysis of Human Behaviour and Social Institutions, NBER Working Paper Series, Working Paper No.41
311 A I Ogus, Regulation: Legal From and Economic Theory (Oxford 1994); R Baldwin, C Scott, C Hood, Regulation (Oxford 1998); R Baldwin, M Cave, M Lodge, Understanding Regulation: Theory, Strategy and Practice (Oxford 2012).
312 R A Posner, Theories of Economic Regulation, (1974) Center for Economic Analysis of Human Behaviour and Social Institutions, NBER Working Paper Series, Working Paper No.41
313 G J Stigler, The Theory of Economic Regulation (1971) The Bell Journal of Economics and Management Science, Vol.2, No.1, 3
314 Ibid
315 R Baldwin, M Cave, M Lodge, Understanding Regulation: Theory, Strategy and Practice (2nd Edition, Oxford 2012)
316 S Peltzman, M E Levine, R G Noll, The Economic Theory of Regulation after a Decade of Deregulation (1989) Brookings Papers on Economic Activity. Microeconomics, Vol 1989(1989), p1, 1
317 The theory is often ascribed to George Stigler, a Nobel prize winning economist. See G Stigler, The theory of economic regulation, (1971) The Bell Journal of Economics and Management

Capture Theory posits that “as a rule regulation is acquired by the industry and is designed and operated primarily for its benefit”.[318] Armour *et al* note that it “refers to the process by which a regulated industry influences the incentives of policymakers in pursuit of its own self-interest”:[319] They further note:

> “The concept of regulatory capture proceeds from the view that regulation is a valuable service-imposing various costs (such as direct and indirect taxes and conferring various benefits (in the form of implicit and explicit subsidies), which regulated industries can acquire for their private benefit. In effect, the idea is that ‘captured’ regulators cease to be agents of society at large and rather become faithful agents for the industries they regulate”.[320]

Simply put the theory claims that regulatory authorities become dominated by or subservient to the interests of the organisations or industry that they have regulatory responsibility for. Capture theory can be seen reflected in the pre-crisis regulatory regimes across global financial systems. This theory reflects the political issues and considerations associated with regulation and the ability of national governments to impose effective regulation on industry sectors. This is particularly evident in banks and financial services. The history of regulation in this area shows strong political influence over the design and structure of regulation.

[318] G Stigler, The theory of economic regulation, (1971) The Bell Journal of Economics and Management Science, Vol.2, No.1 (Spring 1971), p3, 3
[319] J Armour, D Awrey, PDavies, L Enriques, J N Gordon, C Mayer, J Payne, Principles of Financial Regulation (Oxford 2000), 560
[320] Ibid

This political influence in the design has played a central role in the failure of regulation to achieve its goals and to provide the protection that regulation is designed to deliver. The overall design of the UK regulatory structure has with each iteration been impacted by the political landscape of the UK at the time of implementation. The history of UK regulation is one that mirrors the politics of the time rather than be an independent check and balance on the actions of banks, organisations, and individuals.

The regulatory structures employed by UK regulatory authorities are a process of compromise between what the government of the day can achieve and what the banks and the financial services sector has been willing to endure. This is classic regulatory capture. The evidence for this can be seen in the compromise regulatory structures that evolved over the past 30 years. The revolution in economic reforms that followed the Conservative party victory in the 1979 general election evidence such capture. The shift in emphasis away from 'Keynesian' economic principles to more market-based forces was itself a product of 'capture' by interest groups, among them the global banking industry. [321] The momentum for deregulation from the mid-1970s reached a zenith with the election of Margaret Thatcher in 1979 in the UK, and Ronald Reagan in 1980 in the US. This new political landscape shaped the regulatory regime that was to follow. Significant deregulation of financial markets in the UK were enacted by the Financial Services and Markets Act 1986 which brought forth widescale liberalisation of the UK financial sector. In the US the pressure to remove structural barriers such as the Glass-Steagall Act of 1933 gathered pace before its final repeal in 1999.[322]

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[321] This is in reference to John Maynard Keynes who advocated a demand led macroeconomic approach which characterised much of the post World War II era up until the mid 1970's and the collapse of the Bretton Woods agreement precipitated in part by the mid 1970s energy crisis.
[322] Gramm-Leach-Bliley Act 1999

Political change created strong momentum for further deregulation that would ultimately lead to the GFC as deregulation led to innovation; innovation that lacked sufficient oversight by regulation and had little or no social value, beyond liquidity generation and yield growth.[323] Alongside the deregulation of financial services that the Financial Services Act 1986 ushered in a new era of regulation for financial services. The new regulatory regime created a myriad of regulatory agencies to oversee specific areas of the economy. However, the key feature of the new regulatory regime was, that although operating under a statutory footing, it was in effect a regime based on self-regulation. This self-regulatory regime evidences a compromise between the deregulatory forces of the new economic thinking advocating a more hands-off approach and a need to strengthen investor protection. It is important to note that the regulation of banks at this time remained with the Bank of England, however, it is possible to claim that the regulatory capture theory is evident here also. The 'cosy' relationship that the Bank had with the banking industry and its position as Lender of Last Resort made it a 'servant' of the regulated rather than the regulator itself.

The capture theory of regulation can again be seen in the regulatory regime that followed the election of 'New Labour' following the general election in May 1997. Once again political considerations played a significant role in the design of the structure of regulation in the UK, with the implementation of a single consolidated 'super' regulator – The Financial Services Authority (FSA). The key feature of this regulatory reform was that regulatory responsibility for banks moved from the Bank of England to the new FSA.

[323] Turner Review: A Regulatory Response to the Global Banking Crisis (March 2007), FSA London

The 1997 reforms that resulted in the consolidated single regulator model via the FSMA 2000 were heralded as necessary to deal with a range of financial scandals blamed on the inadequacies of the 1986 regime, however, once again political expediency resulted in a failed regulatory process. The 1997 reforms have been described as light touch[324] and lauded as one of the reasons that London is one of the major financial services centres in the world.[325] This light touch regime however, reflected the political need that the government needed to be able to advance it economic agenda. As a result, the GFC can be considered as result of the economic theory of regulation and regulatory capture in particular. The political needs of the sitting government prevented an independent and strong regulatory process from emerging ultimately leading to missed opportunities in understanding the pressures that had built up within the financial system and the fact that banks had dramatically mispriced the risks that they were taking.

A further instance of regulatory capture is where regulatory authorities recruit former bankers to work in regulatory roles and vice versa, where banks employ former regulators.[326] This "revolving door" of staff is in part useful as it provides the regulator with access to experts in their field, but there is significant disadvantage associated with such actions.[327]Banks are powerful corporate entities and will offer remuneration packages considerably more generous that regulatory authorities can afford, leading to a paradox

[324] The Turner Review: A Regulatory Response to the Global Banking Crisis (March 2007), FSA London

[325] M Cole, The Seventh Annual AA Sommer Jr Lecture on Corporate, Securities & Financial Law: The UK FSA Nobody Does it Better, (2007) Fordham Journal of Corporate & Financial Law, 12 Fordham, J. Corp & Fin L. 259-281

[326] For example Mark Carney the Former Governor of the Bank of England was a senior manager at Goldman Sachs see https://www.bankofengland.co.uk/about/people/mark-carney/biography accessed 3/12/20. Henry Paulson Jr the former US Treasury Secretary was the former Chairman of Goldman Sachs before being appointed to the US Treasury and was in post when the GFC emerged. https://home.treasury.gov/about/history/prior-secretaries/henry-m-paulson-jr-2006-2009

[327] J Armour, D Awrey, P Davies, L Enriques, J N Gordon, C Mayer, J Payne, Principles of Financial Regulation (Oxford 2016)

[328]where persons working for the regulator will not want to be seen as over officious or penal in approach for fear of being unemployable in the future. While Amour *et al* note that "outright regulatory corruption is…mercifully rare" this more subtle version of capture may prevent a regulator from achieving the required goals. [329] Linked to this is the relative financial position of the regulator the regulated. Banks are able to employ large numbers of with Lloyd's bank alone reporting over 63000 employees as at the end of 2019;[330] by contrast the Bank of reports around 3,000 employees with responsibility for over 1,700 banks and associated financial institutions. [331] This disparity between just one bank and the total number of staff at the regulator evidences the challenges of effective bank and financial services regulation in the UK.

The post GFC crisis reforms are again, in large measure, as result of political considerations. George Osborne as the shadow chancellor of the exchequer was critical of the 1997 regulatory processes and was swift to undertake a reform package following the conservative/liberal democrat election victory of May 2010. It is more difficult to argue that the 2010 reform package displayed evidence of 'capture' due to the environment that pervaded at the time. The new government was insulated by a public demand to punish banks that had led the global economy into recession and armed with this governments were able to propose strong and intrusive regulation, with the UK for example, announcing an end to 'light touch regulation' and wholesale reform of the structure. The period

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[328] Paradox here can also refer to the fact that it is in the general interest that banks are strong, and to achieve this strength they have grown in size, however, this also means that they become too big to be allowed to fail.
[329] Ibid, p93
[330] Lloyds Banking Group Annual Report and Accounts 2019 https://www.lloydsbankinggroup.com/assets/pdfs/investors/annual-report/2019-download-links/2019_lbg_annual_report.pdf
[331] Bank of England, Working at the Bank: An Introduction. https://www.bankofengland.co.uk/-/media/boe/files/careers/workingatthebank.pdf accessed 4/12/20: Note that this figure includes the Bank of England, the Financial Policy Committee and the Prudential Regulation Authority, but excludes the Financial Conduct Authority.

immediately following the GFC allowed national governments some political manoeuvrability in reforming regulation relatively free from pressure.[332] This allowed the government to propose and enact wide ranging reforms.

Alexander[333] notes further evidence of regulatory capture at the international soft law level where pressure from banks and finance associations lobbied the Basel Committee to incorporate less stringent capital adequacy requirements,[334] allowing banks to more market-sensitive risk measurement models resulting in them holding lower levels of regulatory capital. A key outcome of the GFC is the lack of high-quality capital, regulatory capital, held by banks as the GFC unfolded, leaving the global banking system undercapitalised which in turn led to a liquidity crisis. As Alexander posit the failure of the Basel II regulatory capital adequacy requirements encouraged banks to increase their leverage levels which when the GFC emerged led directly to the failure of banks, for example Lehman Brothers.[335]

5.9 Regulatory approaches

In choosing how to approach regulation three primary options, namely rules-based approaches, risk-based approaches, and principles or outcomes-based approaches.[336] A rules-based approach requires the regulated to follow a set of rules developed, promoted, and enforced by the regulator. The feature of rules-based regulation is the setting of a complex body of rules

[332] Turner Review: A Regulatory Response to the Global Banking Crisis (March 2007), FSA London
[333] K Alexander, Principles of Banking Regulation (Cambridge 2019)
[334] This refers to rules imposed on banks to hold specific volumes and types of capital as buffers to manage the effects of crises. This is discussed further in Chapter 8.
[335] The Basel II accords are a set of rules from the Basel Committee on Banking Supervision based in Basel, Switzerland outlining the volume and type of capital a bank should hold. While not binding the Basel measures are seen as a globally recognised standard and through national and supra-national measures they are usually transposed into law. See The Capital Requirement Directive IV.
[336] R Baldwin, C Scott, C Hood, Regulation (Oxford 1998)

and regulations that prescribe the way in which the regulated entities carry on their activities. Rules based regulatory systems require significant regulatory resources to ensure compliance, which are characterised by quite intrusive regulatory supervision. Risk based regulation achieves its aims by targeting those activities that are recognised as the highest risk to achieving the overall aims of regulation as applied to a specific sector under regulation. Outcomes or principles-based regulation takes a broader approach focusing on broadly outlined rules and principles which outline a set of standards to be achieved from regulation, a set of outcomes. Outcomes based regulation looks at what is to be achieved from regulation.

5.10 The FSA and its approach to regulation.

Chiu and Wilson reflect on the scale of the role that the FSA was undertaking in taking responsibility for multiple regulatory objectives, alongside a much-expanded workload now that a single consolidated regulatory model was legislated for bringing the regulation of financial services under a single authority and adding bank regulation to the FSA's regulatory responsibilities. [337] The size and complexity of the UK banking and financial system made reliance on a prescriptive rules-based approach. While the FSA had been called the "most powerful quango since the Stasi"[338]it would not be large enough or powerful enough to be able to act as a rules-based regulator, lacking sufficient resources to ensure and enforce what would have been a massive body of rules.

The new regulator chose a risk-based approach, wherein the FSA would prioritise how it would approach regulation based on the level of risk that the regulated sector posed, with a particular

[337] I H-Y Chiu, J Wilson, Banking Law and Regulation (Oxford 2019)
[338] C McCarthy, "The new McCarthyism" The Telegraph, London 6th April 2003. The Stasi were the feared secret police that permeated East German society.

focus on firm specific supervision and regulation. In respect of its intended approach the FSA declared in its introductory document that "its aim is to be a world-leading regulator, respected for its effectiveness, integrity and expertise both at home and abroad", further noting that "if we achieve that aim we will contribute to the maintenance of London's competitive position and to our consumer protection duties," and that "our goal is to maintain, orderly and clean financial markets and help retail consumers achieve a fair deal". [339] The FSA claimed they would do this in a number of ways:

- Getting a fair deal for consumers,
- Improving industry performance,
- Flexible and proactive regulation and
- Maximising our effectiveness.

There is no mention of financial stability in the way the FSA proposed in its new approach to regulation, the way in which they will discharge their regulatory obligations. [340] The focus of the regulatory approach is skewed toward consumer protection alongside protecting London's position in the global financial markets.

The FSA's approach was risk based and "they developed a new operating framework, designed to identify the main risks to our statutory objectives as they arise and to plan how to address these risks in line with the new regulatory approach. The framework is thus the bridge linking the statutory objectives and out regulatory activities".[341] As Sergeant, the then managing director, regulatory processes and risk directorate noted:

[339] A new regulator for the new millennium, Financial Services Authority, January 2000, p11
[340] Earlier in the 'a new regulator for a new millennium it notes the statutory objectives of the FSA with Section 3 being noted as preserving stability.
[341] A new regulator for the new millennium, Financial Services Authority, January 2000, p11p.14.

> "…a single financial regulator makes possible a single system of risk-based regulation under which resources are directed to those issues, firms and consumers which pose the greatest risk or opportunity when judged against the regulator's objectives of protecting consumers, promoting public awareness, maintaining confidence and reducing financial crime".[342]

A primary advantage of the risk-based approach and a reason that the approach was taken was the relative lack of resources available to the FSA. Risk-based approaches taken by the FSA reflects that it lacked sufficient resources to apply a rules-based approach; the size and complexity of the UK bank and financial services sector made the risk-based approach attractive to the new regulator. Chiu and Wilson note that FSA used this opportunity to roll out a new approach to regulation to unify the overall approach to regulation and supervision that had been fragmented under the FSA 1986 regulatory regime. [343] The FSA set out the approach it planned to take:

> "The Financial Services Authority's (FSA) risk-based approach to regulation is designed to provide a transparent operating framework under which it will be clear what priorities have been set, and how and why they have been set up; and in which consumers firms, politicians, academics etc. will be able to influence the allocation of resources and the intensity of regulatory effort"[344].

[342] C Sergeant, Risk-based regulation in the Financial Services Authority (2002) Journal of Financial Regulation and Compliance, Vol.10, No,4, 329, 329
[343] I H-Y Chiu, J Wilson, Banking Law and Regulation (Oxford 2019)
[344] C Sergeant, Risk-based regulation in the Financial Services Authority (2002) Journal of Financial Regulation and Compliance, Vol.10, No,4, 329, 329

To achieve this the FSA developed the Advanced, Risk-Responsive Operating framework, or ARROW approach to risk identification which was designed to consider the possible adverse effects created by financial institutions and the likelihood of those adverse effects arising. As is now known the ARROW system of risk-based regulation failed to achieve its aims. This is particularly evident in the case of Northern Rock which was subject to the ARROW process even though the bank was regarded as high impact which ARROW was designed to cover, noting:

> "Full ARROW risk assessments are an integral part of this supervisory process; they are intensive stocktakes of individual firms and are supplemented by several other monitoring techniques. We have designated Northern Rock and more than a hundred comparable businesses as high-impact firms".[345]

The deficiencies of the risk-based approach are evident in how ARROW is applied with the regulation and supervision of Northern Rock exposing the key failings. Northern Rock's insolvency came in the middle of its regulatory assessment period, with the next assessment due in January 2009, following its January 2006 assessment, a period of three years. This is a long time in a dynamic marketplace for what is termed a high-impact firm. Northern Rock was clearly an institution that was running risk and needed stronger supervision from a stronger regulator within a stronger regulatory structure and was reflected in the report into the Northern Rock failure:

[345] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.

> "The FSA has acknowledged that there were clear warning signals about the risks with the Northern Rock's business model, both from its rapid growth as a company and from the falls in its share price from February 2007 onwards. However, insofar as the FSA undertook greater 'regulatory engagement' with Northern Rock, this failed to tackle the fundamental weakness in its funding model and did nothing to prevent the problems that came to the fore from August 2007 onwards. We regard this as a substantial failure of regulation"[346]

This is failure, but it is a failure of the overall regulatory structure rather than the regulations themselves. While adopting a risk-based approach the FSA was also charged with the development of specific rules under which the regulated should follow. To discharge its regulatory options the FSA created a vast array of rules and guidance to be placed in a 'Handbook' accessible to the regulated sector which acts as a manual for those regulated bodies. In this way the FSA operated under a hybrid risk-based and rules-based approach to regulation. In April 2007, the FSA announced a move to principles-based regulation to complement the risk-based approach.[347]

5.11 Conclusion

The above has set out the basis upon which to analyse the options for the regulation of banks in the UK. The chapter shows that the primary reason for regulating is to maintain financial stability. The chapter explores the debate surrounding the rationale for regulation in the context of banks, noting that banks cannot be treated like ordinary companies due to their importance

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[346] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1., p24

[347] S Bazley, The Financial Services Authority, risk-based regulation, principles based rules and accountability (2008) Journal of International Banking Law and Regulation, 23(8) 422

and interconnectedness that has the potential of creating a domino effect that could result in the collapse of the banking system with negative outcomes on the real economy. The chapter explores the issue of the regulatory approaches available to bank regulators. The chapter provides the basis for why banks are regulated and sets the context for the next chapter which analyses the regulatory system in place when the GFC emerged in 2007. An understanding of issues relevant to the rationale for bank regulation provides the analytical basis to understand the regulatory structure that was in place and to further understand the reforms that followed the GFC. The overall analysis shows that complex and opaque regulatory systems create information asymmetries that allow banks to avoid regulation. However, it is also clear that regulatory structures alone cannot prevent banking crises. Bank regulation will only be effective if the macroeconomic environment provides a safe and sound system for banks to operate; this was not in place in the years prior to the emergence of the GFC. The preceding chapters have provided the framework in which regulation operates and analyse the overall rationales for regulation with reference to theory. The chapters that follow will analyse these issues in practice by evaluating the role regulation played in the emergence of the GFC and the reform agenda that followed, starting with a look at the perceived causes. The evidence shows that the lack of attention to elements analysed in the conceptual framework and failure to fully understand the rationales led to a regulatory system that was insufficiently robust to protect the economy from external shocks.

Chapter 6. The Global Financial Crisis: Causes and Effects

6.1 Introduction.

The Global Financial Crisis (GFC) saw unprecedented actions by national governments and their agencies to protect their respective economies. This rationale for the change in approaches to supervision and regulation and the increased debate on the structure, purpose and the even the philosophy of how we control financial institutions emerged from the GFC. From the event that unfolded in the late summer of 2007 and throughout 2008, with the severity of the impact seen in the autumn of 2008 with the collapse of US investment bank Lehman Brothers,[348] the near collapse of several other senior financial institutions such as Bear Stearns, Merrill Lynch and AIG.[349] The crisis continued into 2009 resulting in the US government providing $700bn of support through the Troubled Asset Recovery Programme (TARP).[350] In the UK the impact of the impending crisis was felt a year earlier with the collapse of the Northern Rock Bank in the Autumn of 2007, and the subsequent rescue of Halifax Bank of Scotland (HBOS), the Royal Bank of Scotland (RBS) and Lloyds Banking Group.[351] This chapter will analyse the causes, effects and impact of the GFC leading to sweeping reforms of banking regulation across the globe. However, the approach to the debate and regulatory reform has missed a key point. The reforms and structural changes were a 'knee jerk' reaction to be 'seen to be doing something' and full and detailed analysis of the need, the philosophy of

[348] B Chu, Financial Crisis 2008: How Lehman Brothers helped cause 'the worst financial crisis in history', The Independent (London 12th September 2018); https://www.independent.co.uk/news/business/analysis-and-features/financial-crisis-2008-why-lehman-brothers-what-happened-10-years-anniversary-a8531581.html, last accessed 25/01/21

[349] N Mathiason, Three weeks that changed the world, The Guardian (Manchester 28th December 2008), https://www.theguardian.com/business/2008/dec/28/markets-credit-crunch-banking-2008, last accessed 25/02/21

[350] Department of the Treasury, TARP Programmes; https://www.treasury.gov/initiatives/financial-stability/tarp-programs/pages/default.aspx,

[351] The rescue of Lloyds Banking Group was a result of the merger with HBOS facilitated as part of the Banking (Special Provisions) Act 2008. The financial distress that HBOS was under infected Lloyds following the merger.

regulation, was not properly undertaken. Understanding the causes of the GFC is fundamental to understand the 'why regulate' question and to be able to ascertain the optimal design structure for the regulation of banks.

6.2 The Causes of the Global Financial Crisis – Some Background

There is a broad spectrum of literature[352] on the causes of the GFC and many focus on specific elements such as the US sub-prime mortgage collapse,[353] the rise of innovative financial products that lacked true social utility[354], the role of the Credit Ratings Agencies[355], and bank and financial regulation itself.[356] However, it is clear from the analysis that will follow that there is no single factor that can be identified as the specific cause of the crisis, instead a broad range of connected issues can be identified as the cause, or contributing to the cause, that, when brought together, created the deepest financial crisis since, possibly deeper, that the Great Depression.[357] As Goodhart states "it is difficult for a single person to put together a completely coherent story of everything that has happened".[358] The chapter will show that a number of interrelated factors caused the GFC. However, what emerges as one common element at the heart of the crisis is the failure of macro-economic policy prevailing in the years prior to 2007, and that this provided the environment in which the other factors evolved. The macro-economic policy failure provides the conduit through which the other factors present in

[352] See C AE Goodhart, The Regulatory Response to the Financial Crisis, (2009 Edward Elgar); Engel and McCoy, The Subprime Virus (2017 Oxford); See Chapter 3
[353] K C Engel and P A McCoy, The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps (Oxford 2011)
[354] See A Turner, The Turner Review: A regulatory response to the global banking crisis (FSA London March 2009)
[355] J De Haan, F Amtenbrink, Credit Ratings Agencies, in S Eijffinger, D Masciandaro, Handbook of Central Banking, Financial Regulation and Supervision: After the Crisis (Edward Elgar 2011)
[356] Ibid
[357] See the 'Pecora Committee' hearings into the 1929 financial 'crash' and subsequent bank crisis and great depression. https://www.senate.gov/about/powers-procedures/investigations/pecora.htm
[358] C AE Goodhart, The Regulatory Response to the Financial Crisis, (2009 Edward Elgar), 9

the run up to the crisis were able to infect the global financial industry; the policy created the mechanisms that would allow the individual elements to create a perfect storm. The chapter will look at the key identified components that when considered together can be regarded as causative agents of the crisis. The individual factors alone would not have caused the crisis but with misguided macro-economic policy drivers they created a critical mass that triggered the largest economic event since the Wall Street crash of October 1929, itself a precursor to the banking crisis of the 1930s and the subsequent Great Depression.[359]

6.3 The Causes – An Analysis

The scale, impact, and fallout from the GFC have continued to be felt long after the individual failures and near failures of some of the oldest and best-known financial institutions. In the US, the GFC starting point begins with the failure of Lehman Brothers[360], although emergence of what would become the GFC was seen over a year earlier when several financial institutions began announcing difficulties in being able to value their investments, leading to a credit crunch and then credit crisis followed the UK bank Northern Rock being nationalised after getting into trouble in August 2007[361]. The GFC is in effect a chain of events that emerge from the late summer of 2007 and unfold through 2008. In fact, the GFC is a product of misplaced economic policy since the 1970's when pressures to deregulate and liberalise financial markets first emerged from the economic crisis of the early 1970's.[362] It is impossible

[359] J K Galibraith, The Great Crash 1929 (First Published 1954, Penguin 1992)
[360] B Chu , Financial Crisis 2008: How Lehman Brothers helped cause 'the worst financial crisis in history', The Independent (London 12th September 2018); https://www.independent.co.uk/news/business/analysis-and-features/financial-crisis-2008-why-lehman-brothers-what-happened-10-years-anniversary-a8531581.html, last accessed, 36/01/20
[361] S Boyd, BNP Paribas Freezes Funds as Loan Losses Roil Markets, Bloomberg (9th August 2007); https://www.bloomberg.com/news/articles/2007-08-09/bnp-paribas-freezes-funds-as-loan-losses-roil-markets, last accessed 26/01/21
[362] K J Stiroh, Diversification in Banking, in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014)

to blame the GFC on a single action, but instead to analyse a number of interrelated policy and economic actions that created an environment that would eventually cause the near collapse of the financial system. It is equally clear that the failure to appreciate the impact of this wider economic policy debate led to an inadequate regulatory structure at the macro-economic level so that the market liberalisation that fuelled economic growth since the Second World War was managed in a sustainable way. A further deregulatory measure that often gets missed in the analysis of the GFC is the demutualisation of the building societies by virtue of the Building Societies Act 1986, allowing for building societies to compete with banks, many of which, like Halifax would merge with mainstream banks.[363]

As noted above, fundamental to an understanding of the cause of the GFC is the deregulation and market liberalisation that pervaded banking since the 1970's.[364] The direction of travel following the Wall Street Crash of 1929 was to sever the links between retail investment banking, with this staying place through the Second World War. The economic reconstruction programme that resulted from the Bretton Woods conference[365] ushered in a period of demand led economic growth. However, this situation came under stress in the early 1970's in what Galbraith termed the "dim years"[366] when conflict in the Middle East and the rise of OPEC forced rising energy prices on the global economy, at the same time the US economy could no longer support the system, with the cost of the Cold War and the Vietnam War putting significant pressure on the US economy.[367] The Bretton Woods agreement had linked the

[363] A Samuels, New Law for building societies: Building Societies Act 1969 (1987) Conveyancer and Property Lawyer, Jan-Feb, 36
[364] Ibid
[365] The Bretton Woods conference was a meeting that took place in July 1944 at the Mount Washington Hotel in Bretton Woods, New Hampshire with representation from 44 nations to discuss post war economic reconstruction. The key outcomes of the conference can be seen in the International Monetary Fund (IMF), and the International Bank for Reconstruction and Development, which would later become the World Bank. : https://www.worldbank.org/en/about/archives/history/exhibits/bretton-woods-monetary-conference
[366] J K Galbraith, The World Economy Since the Wars: A Personal View (1995 Mandarin), 204
[367] IMF, The end of the Bretton Woods System (1972-81), https://www.imf.org/external/about/histend.htm

price of gold to the US dollar, however, in August 1971 the US administration of President Richard Nixon temporarily suspended the dollars convertibility into gold, and by the spring of 1973 major global currencies began to float against each other signalling an end to the Bretton Woods system that had created steady economic growth since the end World War Two, ushering a new era and a refocus on economic thought in what Pesendorfer,[368] called a "neo-liberal counter revolution" against Keynesianism.[369] From the collapse of the Bretton Woods system the forces for deregulation increased on the basis that political interference in economic activity presented negative outcomes and that the economic crisis of the early 1970's was a result of bad policy, including the Bretton Woods process and not market failure. The clamour for deregulation is premised on free markets and low regulatory 'intrusion', and that open and free markets with full information flow will ensure strong economic growth. From the early 1970's until the emergence of the GFC the regulation of financial markets and services, is evidenced by a process of steady deregulation, however, it cannot be said to be completely deregulatory in nature. Regulatory action and development reforms have continued through the period since the end of Bretton Woods, particularly in response to crises; the UK Financial Services and Markets Act 2000 in response to the scandals of the 1980's and 1990's and the US Sarbanes-Oxley Act in response to the Enron Collapse being key examples.[370] The reality that emerges from the deregulation process is that a failure to fully or properly deregulate financial markets created a 'half-way-house' in which may have been counter-productive in controlling the exponential growth in financial services innovations where information asymmetries were maintained by a partially deregulated market place. As such it is clear that

[368] D Pesendorfer, Goodbye neo-liberalism? Contested policy responses to uncertain consequences of the 2007-09 financial crisis, in K Alexander and R Dhumale, Research Handbook on International Financial Regulation (2012 Edward Elgar)
[369] Keynsianism refers to the work of John Maynard Keynes (1883-1946), an English economist active in the post WWII era. His 'General Theory of Employment and Interest and Money' was influential on economic though and government policy in the years following the war and played a prominent role in the Bretton Woods Conference. https://www.britannica.com/biography/John-Maynard-Keynes
[370] Classic Financial and Corporate Scandals, https://projects.exeter.ac.uk/RDavies/arian/scandals/classic.html

regulation itself played a part in the crisis, failing to ensure market efficiency or sufficient systemic protections.

Rajan[371] states that "technological change, market liberalisation, and institutional change have combined to expand access to credit risk sharing opportunities",[372] in what Turner [373] termed an "interplay between macro-economic imbalances"[374] that had built up in the years preceding the crisis, and "financial market developments and innovations"[375] since the development and growth of securitisation. This captures the essential characteristics that provided the environment for the GFC, creating the 'atmospheric conditions' for the 'perfect storm' that was to come. Arora[376] notes that in the 20 years prior to the GFC, the traditional view of bank operations as one based heavily on a dependence of retail deposits which was transformed into one that became increasingly reliant on the originate to distribute model.[377] Arora's comments note the change in what we understand banks to be in the 21st Century, from the simple deposit, savings, and lending operations to global financial conglomerates of today. Banks have come a long way from the notion we saw in the popular BBC sitcom Dad's Army, where the platoon commander is also the local bank manager who knows each of the bank's customers refusing to cash a £10 cheque for a customer as he did not know them.[378] This is not the bank we would recognise from the modern UK high street where it is very unlikely that the manager will know

[371] R G Rajan, Has Financial Development made the world riskier (2005) NBER Working Paper 11728
[372] ibid
[373] The Turner Review: A Regulatory Response to the Global Banking Crisis (March 2009), FSA London.

[374] Ibid
[375] Ibid
[376] A Arora, Banking Law (2014 Pearson)
[377] O Akseli, Was securitisation the culprit? Explanation of legal processes behind the creation of mortgage-backed subprime securities, in O Akseli, J Gray, A Campbell, Financial Regulation in Crisis? The Role of Law and the Failure of Northern Rock (Edward Elgar 2011)
[378] Dad's Army, (Columbia Pictures 1971)

all their own customers and the range of financial services products offered vastly outnumber those available in the 1940's.[379]

6.4 The US Sub-Prime Mortgage Crisis

> "The astonishing thing about the subprime crisis is that something so small wreaked so much havoc. Subprime loans started out as just a pocket of the US home loan market, then mutated. Like a virus into a crisis of global proportions".[380]

One of the most often cited reasons for the GFC is the collapse of the US Sub-prime mortgage market[381]which itself was caused by the US housing crisis. Prime rate financial products are those offered at the normal market rate, whereas subprime refers to a loan that is usually offered at higher interest rates and additional charges than products termed prime. Subprime loan products reflect a different market price of a particular product than linked to prime products, with such loans usually offered to customers that are ineligible for prime rate products, often due to having a weak, poor credit history, or no credit history. Such loans are offered at a higher rate to reflect the potential higher default rates of lending to customers with a poor credit history.

[379] Arora, Banking Law (Pearson 2014)
[380] K C Engel and P A McCoy, The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps (Oxford 2011), 13
[381] For a masterly account of the subprime crisis see K C Engel and P A McCoy, The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps (Oxford 2011)

Sub-prime is not to say that there is anything illegal or immoral with the product itself, and it is important to note that sub-prime lending is an important source of credit for those that cannot access main-stream financial services. Sub-prime lending provides credit to individuals and organisations that may struggle to access loans and other financial services products for a range of reasons and as such are very important vehicles allowing access to financial services otherwise denied. There is, however, a price to pay for this access; sub-prime products are more expensive than so called ‘prime’ financial products often charging higher rates of interest and increased administration charges. Subprime financial lending is an important feature of the financial services landscape as they provide much needed credit. This allowed many people to buy an incredible range of products and fuel the economy with the largest of these being home ownership. The importance of subprime lending to an understanding of the GFC is based on the homeownership explosion funded in part by subprime lending, which provided the fuel for the GFC. The need to support the securitisation process created a market for mortgages with the OECD[382] estimating that the size of the sub-prime mortgage market had reached $1.3trillion by 2007 with further $1trillion in the Alt-A mortgage market.[383]

Sub-prime and similar lending practices themselves did not create the GFC, but the selling of sub-prime financial products to ordinary consumers and the sub-prime market securitisation market created by financial institutions in their search for yield and profit to fuel investment growth through securitisation played a significant role in the emergence of the crisis. For the sub-prime lending market to create the GFC it needed other factors; in particular poor and misguided macro-economic policies that allowed the major global financial institutions to

[382] A Blundell-Wignall, The Subprime Crisis: Size, Delevering and Some Policy Options https://www.oecd.org/daf/fin/financial-markets/40451721.pdf
[383] Alt-A mortgages fall in between prime and sub-prime mortgage lending.

create risk while thinking that it was effectively risk free. The reality of the GFC ultimately lay in the hands of governments, regulators, central banks, and the global financial institutions. Financial innovation creates liquidity acting as the lubricant for the global financial system and the global economy, but the search for ever more yield by the banks created an unsustainable environment based on a flawed process, which ultimately collapsed. In simple terms the real issue was not in the subprime mortgage market itself, but the securitisation of sub-prime loans to 'feed' the 'Wall Street'[384] investment banks like Lehman Brothers[385].

6.5 Fraud and the Subprime crisis

Fraud has been a key debate point in the cause of the GFC. Hudson[386] cites the fraudulent mis-selling of domestic mortgages to sub-prime borrowers, targeting and encouraging customers with little or no credit history leading and no realistic hope of maintaining payments; leading to the creation of a property bubble that eventually burst on the realisation that many borrowers could not afford their repayments once their initial 'teaser' rates had ended, with Acharya and Richardson noting that there is "universal agreement that the fundamental cause of the crisis was the combination of a credit boom, and a housing bubble"[387]. Tomasic stating that a culture of euphoria in finance has clouded our view of financial fraud, and did in respect of the GFC, following a "haphazard" approach.[388] Lewis[389] notes examples of fraudulent

[384] 'Wall Street' is used here to denote investment banking generally and refers to Wall Street in New York, the centre of the US banking sector. The term is used in part pejoratively to refer to a group of financial institutions that were at the heart of the GFC and have been subject to significant criticism for the part they played in the GFC. Technically the bank does not have to be quartered or even present on Wall Street.
[385] Lehman Brothers were not the only 'Wall Street' investment bank involved in the securitisation of subprime mortgages, most if not all had some exposures such as Bear Stears, Morgan Stanley, Chase Manhatten, Merril Lynch to name a few. Lehman is chosen here as the ultimate example and remains the largest corporate insolvency in history.
[386] A Hudson, The Law of Finance (2013, 2nd Edition, Sweet and Maxwell)
[387] V V Acharya and Matthew Richardson, Causes of the Financial Crisis, (2009, Critical Review, 21:2-3, 195), 195
[388] R Tomasic, The financial crisis and the haphazard pursuit of financial crime (2011), Journal of Financial Crim, vol.18, No.1, 7, 7
[389] M Lewis, The Big Short:Inside the Doomsday machine (Kindle Edition Penguin 2011)

activities of mortgage brokers at the height of the sub-prime boom, knowingly completing mortgage applications for unsuitable customers, including multiple applications for persons with very low income, the so called no income, no job, no assets loans, better known as NINJA loans. These loans are typically offered to a borrower with very little due diligence on the part of the lender to verify the borrower's ability to pay.[390] Ryder[391] undertakes a detailed analysis of the role fraud took in reference to subprime lending practices with a clear conclusion that the GFC is a product of financial crime. Fraud[392] was an undoubted feature of the crisis but again, the failure is a product of an environment that allowed banks to develop such products purely designed to allow them to take advantage short term profit growth opportunities.[393]

It is clear that fraud played a role in the subprime crisis, but much of this fraud was perpetrated at the mortgage broker level, those selling mortgage products to ambitious perspective homeowners, however the GFC is also a consequence of banks' increasing appetite for these mortgages to feed the securitisation process,[394] and that while fraud emerged from within the sub-prime mortgage market this was not necessarily the cause of the GFC itself, rather it was a consequence of a problematic macro-economic policy that pervades the period running up to the crisis. Linked to the fraud argument is the clear greed that the securitisation process created. On their own securitisation and sub-prime lending are useful financial vehicles but linked with

[390] https://corporatefinanceinstitute.com/resources/knowledge/credit/ninja-loan/#:~:text=A%20NINJA%20Loan%20(No%20Income,the%20applicant's%20ability%20to%20repay.
[391] N Ryder, The Financial Crisis and White Collar Crime (2014 Edward Elgar)
[392] For a comprehensive analysis of the Financial Crisis and the fraud and criminal issues see N Ryder, The Financial Crisis and White Collar Crime (2014 Edward Elgar)
[393] See the US Fraud Enforcement and Recovery Act 2008, the only law to state that the crisis was caused by fraud; N Ryder The Financial Crisis and White Collar Crime: The Perfect Storm (Edward Elgar 2014)
[394] O Akseli, Was securitisation the culprit? Explanation of legal processes behind the creation of mortgage-backed subprime securities, in O Akseli, J Gray, A Campbell, Financial Regulation in Crisis? The Role of Law and the Failure of Northern Rock (Edward Elgar 2011)

new and innovative financial products designed only to drive the search for yield and liquidity, insufficiently controlled problems surfaced.

6.6 The Rise of Universal banking:

Herring and Carmassi, note an issue that pervades the GFC debate; specifically the development of banks that are so large they have a potential impact beyond their own insolvency, either on the domestic economy or where the institution is so large on the global banking system and economy, and following the GFC "these issues surged to the top"[395] reflecting on that fact that some financial institutions have become so large they were too big to fail, and if they did fail they would indeed impact the stability of the financial system and the real economy.[396]

The reason for this can be traced back to the growth of the conglomerate corporate entity defined as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors "banking, securities, insurance"[397]; or universal banking which Benston simply defines as "financial institutions that may offer the entire range of financial services".[398] The GFC has shown that the growth of these organisations has become a problem for regulators in so much that they developed into institutions that are too big for authorities to be allowed to fail. Deregulation and market liberalisation play a further role in the development of such

[395] R J Herring, J Carmassi, Complexity and Systemic Risk, in A N Berger, P Molyneux, J O S Wilson, The Oxford Handbook of Banking (2nd Edition Oxford 2015), 77
[396] Ibid
[397] BIS, The Supervision of Financial Conglomerates, (July 1995) A Report by the Tripartite Group of Bank, Securities and Insurance Regulators, https://www.bis.org/publ/bcbs20.pdf, last accessed 25/01/21
[398] G J Benston, Universal Banking, (1994) The Journal of Economic Perspectives, Vol.8, No.3, 121, 121

institutions, particularly in the US where such operations were not permitted in law until the repeal of Glass-Steagall in 1999.[399]

Morrison considered that for individual firms the economies of scale created by the universal banking modes provided enhanced efficiency, but also noted that the wider shift to universal banking came at a cost of "heightened systemic fragility" and that "large universal banks would prove too central to the operation of the economy to be allowed to fail, so that a moral hazard problem would arise between banks shareholders who gain from taking too much under-priced risk, and regulators , who use taxpayers funds to pick up the costs of excessive risk taking".[400] Morrisons comments here accurately describe the issues and problems that universal banking caused with respect to the GFC, the creation of which led to the too big to fail paradox, institutions that have become so big and important that they effectively hold regulators and central banks to ransom. To prevent another crisis such banks, need to be resolvable or allowed to fail, however, banks that BIS/FSB would categorise as G-SIB simply cannot fail.

<u>6.7 Financial innovation</u>

A further GFC driver is financial innovation. Turner in his review of the FSA and the crisis clearly identifies financial market innovation as a root cause singling out the search for yield a driving force behind such innovation,[401] "that was predicated on the belief that by slicing, structuring and hedging, it was possible to create value, offering investors combinations of risk, return and liquidity which were more attractive than those available from direct purchase of

[399] Gramm-Leach-Bliley Act 1999
[400] A D Morrison, Universal Banking in A N Berger, P Molyneux, J O S Wilson, The Oxford Handbook of Banking (2nd Edition Oxford 2015), 129
[401] A Turner, The Turner Review: A Regulatory response to the global banking crisis (FSA London 2009), March 2009

underlying credit exposures".[402] Cranston et al note the irregularity and unpredictability of innovation and that "it can sweep all in front of it when it bursts forth", which neatly characterises what happened. Frame and White take this further in citing Paul Volcker as stating that ATM machines are the most important financial innovation that he had seen, but only after he had highlighted the innovations of credit default swaps and collateralised debt obligations "which took us right to the brink of disaster".[403] They further cite Paul Krugman who noted that financial innovation should strike fear into investors hearts. The development of innovation ran hand in hand with market liberalisation[404] and is a feature of bank deregulation over the past 50 years and is a response to attempts to regulate. The issues raised in this thesis reflect the continuing game that played out between regulators and the regulated at an operational and political level and this is particularly true in the development and use of financial innovation in the pursuit of regulatory avoidance.

6.8 Securitisation

Financial innovation reached its zenith with the development of securitisation. The 'explosion' in sub-prime mortgage lending is an undoubted key contributor to the emergence of the GFC, however, as with most of the debate surrounding the causes of the GFC it cannot be analysed in isolation. Key to understanding the GFC and the role that sub-prime lending had in fuelling the conditions for the GFC is to understand the securitisation process that grew up in the decades prior to 2007/8. A better understanding of the subprime mortgage contribution is not to look at the issue from the mortgage customer perspective, but instead for the investment banking view. In a final analysis the subprime issue can be interpreted as a push/pull

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402 Ibid, 14
403 W S Frame and Lawrence J White, Technological change, Financial Innovation and Diffusion in Banking in A N Berger, P Molyneux, J O S Wilson, The Oxford Handbook of Banking (2nd Edition Oxford 2015), 271
404 K Alexander, Principles of Banking Regulation (Cambridge, 2019)

phenomenon. There was as much pulling from 'Wall Street' banks as there was pushing from mortgage customers. Demand for 'bundles' of mortgages to create investment capable derivatives surged in the "overheated market conditions that characterised the housing bubble"[405] with "a tremendous increase in the size of securitisation markets"[406]from the early 1990s.[407] The 'rampant' securitisation of sub-prime loans was the 'straw that broke the camel's back' in respect of the GFC. Global prosperity in the post-World War Two era has developed as a result of innovation in financial services that provided increased lines of liquidity to both individuals and companies, Securitisation of existing and long used financial products was one, if not the key element of these innovations, used as a risk-sharing and refinancing technique since they first appeared in the 1970s.[408] Securitisation is not a new phenomenon and used correctly provides for increases in flow of liquidity that in turn provides ongoing liquidity for economic growth. The ideal product for this innovation was mortgages. Mortgages have long been a mainstay for banks and other credit institutions as they are large loans repaid over extended time periods, resulting in significant financial benefits for credit institutions. The problem for credit institutions is the maturation period of such loans. While many mortgages are redeemed early, the typical maturation period for a UK mortgage is 25 years, and though a profitable process overall, it takes many years to realise those profits. The only way to grow loan availability, yield and profitability is through economies of scale, continually growing to meet internal and external growth targets.[409] This can be described as organic growth and links with Kay's 'narrow banking'[410] theory of credit institutions engaging in a narrow range of

[405] L Allen, A Sunders, Risk Management in Banking, in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014, 175
[406] B Casu, A Sakisyan, Securitisation, in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014, 354
[407] Ibid
[408] R Cranston, E Avgouleas, K van Zweiten, C Harem T can Sante, Principles of Banking Law (3rd edition Oxford 2017)
[409] The negative outcome from this is the creation of the too big to fail institution.
[410] J Kay, Narrow Banking: The Reform of Banking Regulation, (2009), Johnkay.com; https://www.johnkay.com/2009/09/15/narrow-banking/,

activities such as deposits and loans, with riskier investment banking only available through specialist institutions. This model would allow institutions to fail without the need for public bailout. To overcome the slow growth credit institutions turned to securitisation, defined by Casu et al as:

> "Securitisation is a structured process that involves a bank transforming its (usually) illiquid assets, traditionally held until maturity, into marketable securities by pooling these assets and transferring them into a special purpose vehicle (SPV), a bankruptcy-remote entity that in turn finances the purchase through the issuance of securities backed by the pool (generally referred to as asset-backed securities or ABSs)"[411]

As an over-simplification, securitisation is a capital financing[412] process of bundling up or "pooling"[413] financial products as a new product with the payments passing through to the purchases of the securities, designed to efficiently allocate risk.[414] However, a truth behind securitisation is that they were employed in part to move assets off balance sheet and therefore avoid capital regulation oversight.[415] Cranston *et al* note:

> "In principle, securitisations are an ingenious mechanism to spread risk and reduce financing costs, especially for small and medium-size borrowers, which are thus afforded greater access to capital. It may also be utilised for risk transfer purposes or

[411] B Casu, A Sakisyan, Securitisation, in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014, 354
[412] Goodhart C AE, The Regulatory Response to the Financial Crisis, (2009 Edward Elgar)
[413] A Jobst, What is Securitization, IMF, imf.org/external/pubs/ft/fandd/2009/09/pdf/basics/pdf accessed 23/04/2020
[414] Goodhart C AE, The Regulatory Response to the Financial Crisis, (2009 Edward Elgar)
[415] K Alexander, Principles of Banking Regulation (Cambridge)

to obtain relief from regulatory capital requirements by moving assets off balance sheet".[416]

Securitisation evidences the growth in financial innovation that resulted from the liberalisation of markets. While banking has always looked for innovation to drive growth, the development of securitisation was a significant leap in the development of innovative investment vehicles. Of importance in the above quote is that it alludes to the use of such innovation to avoid regulation where possible with reference to the avoidance of capital regulation rules and by using SPV's to remove the assets from their balance sheets. By 1994 Schwarcz[417] notes that the US Securities and Exchange Commission opined that asset securitisation was "becoming one of the dominant means of capital formation in the US"[418] and that this was the case globally as an "…innovative approach to financing that has taken the country, and begun to take the world by storm".[419] It is clear from the GFC fallout that this was the case; the rise in securitisation and the increasing complexity and lack of transparency paired with poor understanding, supervision and regulation led to an out of control financial services industry increasingly utilising innovation to generate capital and liquidity. In short securitisation circumvents the problems with the time lag in banks maturity transformation process, allowing the bank to offload and bet paid much earlier on its mortgage lending.

[416] R Cranston, E Avgouleas, K van Zweiten, C Harem T can Sante, Principles of Banking Law (3rd edition Oxford 2017), 16

[417] S L Schwarcz, The Alchemy of Asset Securtization, 1994, Stanford Journal of Law, Business and Finance Vol 1, 133

[418] Ibid

[419] Ibid

Securitisation of assets is not new phenomenon and can be traced back to the South Seas Company and the South Sea Asset Bubble of 1720,[420] but the securitisation process that was the basis of the GFC can be traced back to the 1970's.[421] As with sub-prime loans there is nothing intrinsically wrong with securitisation and the pooling of assets to create further tradeable assets. Innovation that drives capital and liquidity growth is of wide economic benefit but innovation without control and without understanding or properly managing the risk profile can and did lead to failure.

In this context, Jobst[422] notes that securitisation started in 1970s with the bundling of residential mortgages by US government backed agencies. These tentative steps were further followed by other assets that generated income becoming securitised, followed over the next four decades by increasing ranges of income producing assets. There is a wide literature on the securitisation process itself, the IMF notes that it is essentially a two-step process, usually known as the 'originate' to 'distribute model'. In the originate phase, credit institutions that have advanced loans identify the assets that they want to bundle together, selling the bundled assets to a special purpose vehicle (SPV) usually set up by the same financial institution created to purchase the bundled loan asset. The process removes the loans from the originating institution. The second or distribution phase, the SPV issues tradeable, interest-bearing securities which are sold on thus financing the purchase from the originator with investors receiving fixed or floating rate payment from the cash flows generated by the assets in the bundle. Very often the originator administrates the loans in the bundle and passes what? on for a fee to the SPV. Jobst notes the

[420] GP Gilligan, The Origins of UK financial services regulation, (1997) Company Lawyer, 18(6), 197

[421] R Cranston, E Avgouleas, K van Zweiten, C Harem T can Sante, Principles of Banking Law (3rd edition Oxford 2017)

[422] A Jobst, What is Securitization, IMF, imf.org/external/pubs/ft/fandd/2009/09/pdf/basics/pdf accessed 23/04/2020

advantages of the process is that it "represents an alternative and diversified source of finance based on the transfer of credit risk (and possibly also interest rate and currency risk) from issuers to investors".[423] However, the problem is that the risk was poorly understood, but much more fundamentally, the drive for yield resulted in risk being ignored. In the UK Northern Rock utilised the 'originate to distribute' model alongside borrowing from the wholesale money markets to fund its operations and it was the seizing up of these processes that precipitated the GFC causing Northern Rock to fail.

The initial use of securitisation was relatively straightforward based on a narrow range of assets, chief among them being mortgages, commonly referred to as mortgage-backed securities (MBS) with other securities referred to more broadly as asset backed securities (ABS). Providing there is a stable flow of money through the securities, in essence the loans and mortgages are being paid by the individual or organisation that took out the loan, there is little to criticise. Securities that comprise high quality prime mortgages can be regarded as relatively safe, and in a growing and successful economy these innovative securities provide a good mechanism to generate capital liquidity.

The problem with the model is that there are only so many 'prime' customers who have higher quality credit ratings and who therefore are unlikely to default on repayments. This presented a problem for financial institutions that needed a flow of loans to generate the ABS and MBS securities. Statistics show that sub-prime mortgage lending rose from $180bn in 2001 to $625bn in 2005.[424] This exponential growth was the result of the securitisation needs of the

[423] Ibid
[424] A Hudson, Law of Finance (2nd Edition Sweet and Maxwell 2013)

big financial institutions. When the ability to originate 'prime' loans dried up the banks moved into the sub-prime loan market to continue the securitisation process. In place of 'prime' lending sub-prime was used to fill the gap, and this was potentially a huge source of funds, but of course the default risk within the sub-prime lending market carries much more significant risk, a risk that materialised as the GFC. It is a corollary that higher risk lending leads to higher default rates, but this risk was generally ignored in the creation of the financial engineering that fuelled the crisis.

The securitisation process continued to develop throughout the 70s, 80s, 90s and early 00s, with increasing sophistication. The relatively simple ABS and MBS backed securities evolved into much more complex and 'engineered' securities that purported to transfer and spread risk, but which ultimately did not. Securitisation based on ABS and MBS was the mainstay of this process until the early 2000' when a "second wave" [425]of securitisation emerged, based on a security called the Collateralised Debt Obligation (CDO), as Casu and Sarkisan note:

> "CDOs are securitisation vehicles that depart from the traditional securitisation model towards the creation of instruments backed by fewer but larger and more heterogeneous assets, including huge yield binds, leveraged loans, and tranches of other securitisations".[426]

[425] B Casu, A Sakisyan, Securitisation, in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014

[426] Ibid, 359

The CDO is a complex structured asset backed security split into tranches of different securities ranked by credit risk, frequently named senior, mezzanine and junior, with the junior tranche carrying the most risk and with the lowest credit rating. There is no accident that the increase in volume of CDOs mirrors the growth of sub-prime mortgage lending rising from $30bn in 2003 to $225bn in 2006.[427] As new 'prime' loan origination slowed, banks turned to sub-prime originators to take their place. In itself this does not present a problem, as we have noted the value of sub-prime lending generally, the problem is the way in which the origination process developed. The key point for the securitisation process to continue is the need for people to take out mortgages and in sufficient numbers to continue to 'feed' the securitisation machinery. Bailey *et al* point to the alchemy behind the CDO, distinguishing them from MBS securities whose assets consisted of real mortgage payments, whereas CDO's "were the securities that collected those mortgage payments; in a sense CDO's "re-securitised" existing security".[428]

A second credit derivative that played a significant role is the Credit Default Swap which transfers the credit risk of a debt instrument from one party to another.[429]In a simple way CDS can act as a type of insurance against a particular event, even without an insurable interest, for example a CDS can be taken out against the potential default of a CDO. Alexander and Eatwell note the meteoric rise in CDS contracts rising from $1000bn in 1986 to $516000bn by 2007 further noting that the CDS market was at the centre of the GFC when Lehman Brothers collapsed in 2008.[430]Avgouleas further reflects on this outlining that "CDS trading created a

[427] M N Baily, R E Litan, M S Johnson, The Origins of the Financial Crisis, (2008) Fixing Finance Series, Brookings Institution, November 2008; https://www.brookings.edu/wp-content/uploads/2016/06/11_origins_crisis_baily_litan.pdf
[428] Ibid
[429] K Alexander, J Eatwell, A Persaud, The nature of modern credit markets, banking and financial innovation, in K Alexander, R Dhumale, Research Handbook on International Financial Regulation (Edward Elgar 2012)
[430] K Alexander, J Eatwell, in K Alexander, R Dhumale, Research Handbook on International Financial Regulation (Edward Elgar 2012)

complicated chain of linked exposures" with the resulting making it impossible to assess counterparty risk.[431]He noted that the "collapse of a major financial institution dealing in those markets could potentially lead to severe domino effects, and-in an extreme scenario-to the complete unwinding of the CDS market", which is what happened when Lehman Brothers collapsed followed shortly afterwards by the biggest player in the CDS market American Insurance Group (AIG).[432]

An important issue in respect of the development of innovative finance techniques is linked to the way in which these products were marketed to investors. Fundamental to the failure to control the growth of risk is the part played by the credit ratings agencies. The role of the credit ratings is to provide a rating on a range of products and institutions based on an analysis of possible default of the investment product. Casu and Sarkisyan[433] highlight the central role that credit ratings agencies play in the securitisation process and the part they played in in underpinning the crisis noting that positive ratings were attached to structured products with "significant errors",[434] misrepresenting the risks associated with the mortgage-backed securities they were providing ratings for. The credit ratings agencies were responsible for exacerbating the mispricing of assets by failing to fully understand the risk profiles that the products and institutions were engaged in; in what Adrian et al refer to as "neglected risk", failing to fully factor in the possibility of declines in aggregate housing prices[435]

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[431] E Avgouleas, Regulating Financial Innovation in N Moloney, E Ferran, J Payne eds, The Oxford Handbook of Financial Regulation (Oxford 2015)
[432] Ibid.
[433] B Casu, A Sarkisyan, Securitization in The Oxford Handbook of Banking, A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014
[434] Ibid
[435] T Adrian, A B Ashcraft, V Cetorelly, Shadow Bank Monitoring in Oxford Handbook, A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014p393

A key criticism, however, in respect of credit ratings agencies is the conflict-of-interest issues displayed in that the ratings agencies operation. A fundamental flaw in the system is that the credit agency fees are paid by the institutions[436] that are issue the securities; the Issuer pays model however, Goodhart[437] notes that the credit ratings agencies are part of the "Pantheon of Villains" upon which the GFC is blamed, providing positive AAA [438]credit ratings for structured products such as CDO's making them look like safe investments, even when default rates within them were starting to rise. Goodhart posits that the allegation of conflict is partially misplaced, a pint supported by Sinclair but the role that the credit ratings agencies played in the mispricing of risk.[439]

The demand for mortgages to feed the securitisation process was always going to lead to fraudulent practices without sufficiently robust oversight mechanisms, and the simple mathematics that at some stage the system would run out of individuals taking out mortgage loans. On the face of it large portions of the system are analogous to an elaborate and legal pyramid or Ponzi scheme, requiring the bottom of the pyramid to be refreshed to ensure that payments at the top continued.

As the securitisation process required more mortgages, the increase in fraud followed and continued to grow throughout the period preceding the GFC. Increasingly, mortgage providers were providing loans to individuals and others who could not afford them, with brokers using a range of methods to avoid the rules in place. In addition, mortgage origination firms used an

[436] T J Sinclair, Credit Ratings Agencies and the Global Financial Crisis (2010) Economic Sociology_the European electronic newsletter, Vol12. Iss 1, 409. https://www.econstor.eu/bitstream/10419/155956/1/vol12-no01-a2.pdf
[437] C AE Goodhart, The Regulatory Response to the Financial Crisis, (2009 Edward Elgar)
[438] AAA credit rating is the highest possible rating which would indicate a low level of default probability.
[439] C AE Goodhart, The Regulatory Response to the Financial Crisis, (2009 Edward Elgar)

array of incentives to get people to take out mortgage loans without providing detailed information on the consequences of default. One such mortgage product often cited as an example of the kind of mortgage product that caused problems is the 'teaser rate' mortgage. This is a popular product in many jurisdictions in which a home loan is offered at lower rates than what? over a period and then rises to normal rates at a set time. This kind of loan product is useful in allowing individuals to borrow money and buy homes which would they not normally be able to afford. This is the reason for the exponential growth in sub-prime lending in the years up to the GFC. Again, it needs to be noted that these products in principle are useful and beneficial but in the years prior to the increasing use of fraudulent practices to sell mortgage loans they created an asset bubble. The pressure to sell loans to bundle on to the banks for securitisation, leading to increased remuneration packages leading to further inappropriate lending practices continued to create the bubble in the period prior to the crisis.

The system's collapse was triggered by the bursting of the US property market. It is trite that in a growing economy people pay their debts, but it is also trite that in an economic downturn the default rates increase. This is precisely what happened to create the conditions necessary for the GFC. The US economy took a downturn resulting in job losses resulting in failure to make repayments resulting in default, and with increasing default rates came collapse. The scale of the mortgage mis-selling came to light as the rates of default emerged, which in turn resulted in the collapse in value of the CDOs and the near collapse of the global economy.

Akseli[440] asks whether securitisation was the "culprit"[441] and argues that it was not. He argues that it is capable of being "a clear and efficient financing mechanism",[442] but what was unclear was why the combination of sub-prime bubble bursting and increased securitisation led to such

[440] O Akseli, Was Securitisation the culprit? Explanation of legal processes behind creation of mortgage-backed sub-prime securities, in J Gray and O Akseli, Financial Regulation in Crisis? The Role of Law and the Failure of Northern Regulation, (2011, Elgar Financial Law Series, Edward Elgar)
[441] Ibid, p11
[442] Ibid

a severe financial crisis, leading to a failure of several financial institutions.[443] As noted earlier, securitisation is a valuable mechanism to generate capital and liquidity and a point Okseli makes in his argument, however, this is overly simplistic. Undoubtedly, securitisation is a useful mechanism and has had enormous benefits raising “critical finance”[444] but it was a culprit at least. The product and process were not to blame but the application and use of the product was it fuelled growth but allowed unparalleled and uncontrolled expansion.

Turner[445] takes a partially contradictory view. Turner places, inter alia, the rise in financial innovation at the heart of crisis, noting that while securitisation had been around since the 1930s, from the mid-1990s the system saw “explosive growth in both scale and complexity”.[446] He characterised the period as displaying financial innovation with little or no social value. The period in the years preceding the GFC displayed unprecedented financial engineering leading to the creation of a range of complex and innovative financial products in the chase for yield.

6.9 Macro-economic misalignment

The sub-prime loan securitisation collapse and the US property market bubble bursting have long been blamed for the crisis, but this did not happen in a vacuum. As has been noted above, sub-prime lending and securitisation as products and processes have significant benefits to economies. The question becomes why did they become toxic and how did they lead to the largest financial collapse since the 1930s? There is no single reason. Instead, there is an

[443] V Acharya and Matthew Richardson, Causes of the Financial Crisis, (2009,) Critical Review, 21:2-3, 195
[444] Ibid
[445] ATurner, The Turner Review, A regulatory response to the global banking crisis, FSA, March 2009.
[446] Ibid

umbrella reason for the GFC, namely the economic environment that drove policy makers and the financial industry forward since the 1970s and the introduction of securitisation. In simple terms, Diamond and Rajan[447] opined that global central banks operated an "extremely accommodative monetary policy"[448] leading to low interest rates which ignited the demand for housing. Hudson notes the macro-economic issues in the lead-up to the crisis with an excessive amount of cheap money available to increasing proportions of the population, noting that the combined impact of cheap money and exponential growth in sub-prime lending led to inflationary pressures which were relieved by interest rates rises, which then in turn led to increasing levels of mortgage defaults. Carmassi et al add further support in positing that lax monetary policy was in the primary reason while also noting the compounding effect of regulatory failure by allowing, and even encouraging excessive leverage.[449]

The lead organisation at the heart of the crisis was the US Federal Reserve, and the policies of the US Federal Reserve Board chaired by Alan Greenspan, in what Melvin and Taylor[450] termed the "greatest financial dislocation since the Great Depression of the 1930's"[451]. Indeed, Greenspan has often been cited as the individual at the heart of the crisis, with the application of the so-called Greenspan Put. Armour *et al*[452]note that prior to GFC the focus of regulation was on the firm specific micro-prudential regulatory environment and that by developing a regime that looked to ensure individual banks were safe and sound, the system could be

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[447] D W Diamond and Raghuram G Rajan, The Credit Crisis: Conjectures about Causes and Remedies, 2009, American Economic Review: Papers and Proceedings, aeaweb.org/articles.php@doi=10.1257aer.99.2.606
[448] Ibid
[449] J Carmassi, D Gros, S Micossi, The Global Financial Crisis: Causes and Cures (2009) Journal of Common Market Studies, Vol 47 No.5, 977,

[450] M Melvin and M P Taylor, The Global Financial Crisis: causes, threats and opportunities. Introduction and Overview (2009, Journal of International Money and Finance, Vol 28), p1243.
[451] Ibid
[452] J Armour, D Awrey, P Davies, L Enriques, J N Gordon, C Mayer and J Payne, Principles of Financial Regulation (2016, Oxford).

managed also.[453] This paradigm can no longer be accurate in the post-GFC climate, and the focus now needs to move to the macro-prudential environment in which the micro-prudential environment operates. The focus on micro-economic issues was naïve in the pre-crisis banking sector and it was clear that poor macro-economic management would have a negative effect on banks. The interconnectivity of banks which has further increased as a result of globalisation provided clear signs that banks do not operate within the silo of micro-prudential confines. This lack of understanding by national authorities provided the culture and environment that led to the GFC, and while the actions of individual banks, individual bankers and the boards of banks hold significant responsibility it is the decisions of the central bankers and national treasury departments that allowed this position to evolve.

As Black[454] posits, "the crisis revealed significant blind spots in the regulators vision"[455] and something missing here were seeking to understand the build-up of risk within the system.[456] This is because of the focus on the micro-prudential environment looking at the firm specific activities, whereas the challenge is to understand the interrelationship between macro-economic developments at the global and national level and then understand the impact on the stability of individual financial institutions. This could be called the macro-micro economic prudential link which seemed to have lacked focus during the years leading up to the GFC, which Black argues was either ill-understood or significantly under-emphasised.[457]

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[453] Ibid
[454] J Black, Restructruing Global and EU Financial Regulation: Character, Capacities, and Learning in E Wymeersch, K J Hopt, G Ferrarini, Financial Regulation and Supervision: A Post-Crisis Analysis (Oxford 2012) et al
[455] Ibid
[456] Ibid
[457] Ibid

A further contribution to the GFC was the lack of understanding of the risk profiles that banks undertook. In the micro-economic environment, failure did not seem to be a possibility. The economic conditions of the 'great moderation' were seen as capable of continuing in perpetuity and that the efficient market hypothesis[458] and belief in economic rules would ensure that while corrections would occur over time, there would be no complete collapse. Famously, Gordon Brown, when Chancellor of the Exchequer, proclaimed that there would be no more boom-and-bust economics, however, the reports into the failures of Northern Rock, RBS and HBOS clearly identify that the institutions did not understand their risk profiles, and did not have sufficient risk identification and risk management processes.

This failure to understand risk was clear in the business models employed by banks, in particular Northern Rock. Northern Rock displayed a classic expansionary business model designed to provide year on year growth. By the end of 2006, the value of its assets had grown to over £100 billion, up from a little under £16 billion nine years earlier.[459] Like many of the statistics that pervade the GFC discussion, the near exponential growth rates across a wide range of activities should have triggered a discussion around the potential bursting of bubbles, yet it seems that the belief in economics ensured that risk was ignored.

The issue, however, was not with growth but with the mechanisms employed to achieve that growth. Northern Rock achieved this by departing from traditional banking methodologies. Instead of adopting to borrow money on wholesale markets and employing the 'originate to

[458] See Chapter 5
[459] House of Commons Treasury Committee, The run on the Rock, Fifth Report of Session 2007-08, Volume 1, HC 56, 26th January 2008; Tomasic, R. 'Corporate rescue, governance and risk taking in Northern Rock: part 2' (2008) The Company Lawyer 29(11), 330

distribute' model with their loan book, they accessed funding based on securitisation of their mortgage book through a special purpose vehicle based in Jersey, named Granite. This dramatic change in the funding method of the institution allowed it to grow rapidly in the period following demutualisation allowing it to become the sixth largest mortgage lender in the UK.[460] The problem with this funding model was that it left the bank without sufficient resources when the "market dislocation" took place following BNP Paribas announcement in the summer of 2007, leading to a global credit crunch and then crisis, resulting in the impossibility for Northern Rock to "finance their wholly illiquid assets".[461]

These products were designed to spread and diversify risk, but it was clear that this failed and, as Turner finds, the securitised credit and the "vast majority"[462] of the losses had not been transferred to end investors, "but on the books of the highly leveraged banks and bank-like institutions"[463].

6.10 Shadow Banks – The impact of the non-banks.

> "If it looks like a duck, quacks like a duck, and acts like a duck, then it is a duck – or so the saying goes"[464]

[460] Ibid
[461] Ibid
[462] A Turner, The Turner Review: A regulatory response to the global banking crisis, (2009) The Financial Services Authority, London, March 2009.
[463] Ibid
[464] L E Kodres, What is Shadow Banking, (20013) Finance and Development, IMF, June 2013, https://www.imf.org/external/pubs/ft/fandd/basics/pdf/kodres-shadow-banking.pdf

An amplifying issue for the GFC was the rise of the so-called shadow banks. Shadow banks are not truly banks but are financial institutions that operate outside the banking and regulatory system[465] yet provide what would be considered financial intermediation services such as credit and liquidity maturation in a similar manner as banks. The rise of the shadow bank mirrors the rise of financial innovation, and the emergence of the term runs close to the debate on the causes of the GFC. The term shadow banking is credited to Paul McCulley to describe the activities of a set of financial institutions that operated out sider the strict regulatory environment associated with banking, noting that:

> "Unlike conventional regulated banks, unregulated shadow banks fund themselves with uninsured short-term funding, which may or may not be backstopped by liquidity lines from real banks. Because they fly below the radar of traditional bank regulation, these levered up intermediaries operate in the shadows without…. deposit insurance"[466]

This quote raises several important issues. It suggests that a significant contributor to the GFC did not originate within the regulated bank sector, the tipping point came from the unregulated sector. The rise of shadow banking was specifically designed to avoid regulatory oversight and exposed a hole in the regulatory approaches in the years prior to the GFC. Shadow banking growth further evidences the overall failure of governments and regulators to fully understand the environment that banks were operating in, as Krugman notes:

[465] Financial Stability Board https://www.fsb.org/wp-content/uploads/c_130129y.pdf
[466] P McCulley, The Shadow Banking System and Hyman MInskey's Economic Journey, (2009) Insights into the Global Financial Crisis: Economic Theory and Philosophy, The Research Foundation of CFA Institute; https://www.cfainstitute.org/-/media/documents/book/rf-publication/2009/rf-v2009-n5-15.ashx

> "As the shadow banking system expanded to rival or even surpass conventional banking in importance, politicians and government officials should have realised that they were re-creating the kind of financial vulnerability that made the Great Depression possible-and they should have responded by extending regulations and the financial safety net to cover these new institutions. Influential figures should have proclaimed a simple rule: anything that does what a bank does, anything that has to be rescued in crises the way banks are, should be regulated like a bank"[467]

This further evidences the political influence over the regulatory environment, and the failure of governments to provide an overall environment that allowed banks to operate within a safe and sound banking sector. Krugman is stating that any organisation that operates as a bank should be subject to the same level of regulation, however, this is not strictly necessary and while some control over the innovative products that were directly responsible a stronger overall control and understanding of the macroeconomic issues that led to the GFC would have allowed the shadow banking industry to carry on without impacting the mainstream. One possible outcome is that a stronger macroeconomic framework would have slowed the overall growth of shadow banking keeping them within manageable boundaries.

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[467] P Krugman, Out of the Shadows, New York Times (New York June 18th 2009); Turner A, The Turner Review: A regulatory response to the global banking crisis, (2009) The Financial Services Authority, London, March 2009., last accessed 21/01/21

Alexander notes that increasing the regulatory burden on traditional banks will generate regulatory arbitrage and increase the drive for shadow banking.[468] The option is therefore, to regulate shadow banking, but this is a complex process as many transactions that operate within this sphere are private contracts rather than investor purchased products which creates additional regulatory challenges.

Shadow banking emerged in direct opposition to regulation as a means of circumventing the burdens of a complex regulatory environment. This evidences a further problem with regulation where the regulated will always look to evade what they see as burdensome regulation that prevents unfettered growth. Regulation has a cost in direct financial terms and through opportunity cost. Regulated firms will need staff to manage compliance with regulations and any form of regulation will create a friction in their operations. The rise of the shadow bank alongside the increase in innovation created a non-regulated sector that was ultimately under the control of the regulated institutions that would put the whole system under stress. The prime example of the impact of shadow banking on the global banking system was the activities and near collapse of American Insurance Group (AIG) which as a result of its involvement in the CDS market required an $85 billion bailout by the US government.[469]

This proves that firm specific microeconomic approaches were wrong and the most effective method to regulate the shadow banking sector is to provide an overall macroeconomic

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[468] K Alexander, J Eatwell, A Persaud, The nature of modern credit markets, banking and financial innovation, in K Alexander, R Dhumale, Research Handbook on International Financial Regulation (Edward Elgar 2012)

[469] On the 16th September 2008, the day after Lehman Brothers was allowed to fail, The US Federal Reserve announced that the Federal Reserve Bank of New York was to provide $85 billion revolving credit facility to prevent total collapse. See W K Sjostrom, The AIG Bailout, (2009) 66 Wash & Lee L.REV, 943

environment in which innovation can thrive, but without the contagion related spillages that characterised the GFC.

6.11 Conclusion

This chapter has provided an overview of the prominent reasons for the emergence and impact of the GFC, however, individually these issues were not the cause, but aggregated they amplified an environment that nurtured risk taking. This is investigated in more detail in Chapter 4, but the true underlying cause of the GFC was the economic environment that banks operated in the decades prior to the GFC. Carmassi et al note:[470]

> "The massive financial instability of 2007-08 was, in the main the result of lax monetary policy. Regulation compounded this error by allowing and encouraging excessive leverage and maturity transformation by banks. Innovation did contribute to reckless credit expansion and investments but without lax money and excessive leverage, reckless bets on asset price increases would not have been possible. Therefore, a repeat of this instability could be avoided by correcting these two policy faults. There is no need for intrusive rules constraining non-bank intermediaries and financial innovation. The main message is keep it simple"[471]

Goodhart notes that a major feature in assessing the causes of the GFC is the mispricing of risk, however, this mispricing error was created as a result of the overall economic environment in

[470] J Carmassi, D Gros, S Micossi, The Global Financial Crisis: Causes and Cures (2009) Journal of Common Market Studies, Vol 47 No.5, 977,
[471] Ibid

place. The aggregate effect of bank innovation to fuel growth played a significant part, but the failure of poor over economic control

What emerges from the above discussion is that the cause of the GFC cannot be laid at the foot of a single actor or issue, a combination of factors came together over an extended period that 'erupted' in 2007 and continued through until 2009. However, what is clear is that in the absence of a single causative agent, it was the build-up of forces in the nearly five decades since the end of the Bretton Woods Accords. The processes of deregulation and market liberalisation opened up financial markets to a period of sustained innovation in a macroeconomic environment that promoted risks, namely historically low interest rates for a sustained period. This suggests the GFC is product of misaligned policy drivers rather than the failure of specific regulations; in essence the regulator and central bank was unable to deal with the factors that created the conditions necessary for crisis, in an environment that promoted moral hazard, itself a product of the regulatory regime. The outcome of this is that more and increasingly complex regulation is a barrier to financial stability and as a result of this the focus should be on macroeconomic and macroprudential policy areas, rather than the minutiae of regulation. A strong overarching and transparent regulatory regime is the only way to ensure stability, one that embraces the possibility of individual firm failure with senior management sanctions a real possibility. One question that will always remain unanswered is what the actual impact of would allowing Northern Rock to fail and what would that impact have been. The chapter has explored the debate around how the GFC emerged, and to a large extent to blame. The conclusion is that the GFC was not the result of a single identifiable element but instead of a correlation of interconnected processes. What does emerge from the chapter is the political drivers creating a macro-economic environment that encouraged risk allowed the other components to amplify their impact. The next two chapters analyse the regulatory regimes before and after the impact of the GFC.

Chapter 7- A Critical analysis of the part the regulatory architecture played in the Global Financial Crisis 2007/8

7.1 Introduction

This chapter will critically asses the part that pre-crisis regulatory and supervisory architecture played in the global financial crisis (GFC) and to assess the contribution that an ineffective regulatory structure made to the near collapse of the global financial system.[472] Whether it was a collapse of the global financial system is a matter for debate, with maybe a more accurate characterisation being a near collapse of the 'western' financial system focused around the G20 group of nations.[473] What does emerge is that while the GFC may not have had direct impact on all nations, its economic impact was and continues to be felt globally, further impacted by the global SARS-2 pandemic.[474] This chapter begins by briefly looking at the history of bank and financial services regulation in the United Kingdom (UK), with a focus on the period following the Financial Services Act 1986, the so called 'Big Bang'[475] and the look at the reforms introduced by the Financial Services and Markets Act 2000 (FSMA 2000). The chapter adds to the overall premise of the thesis that the regulation of banks and the wider financial services industry is prone to political influence that is more focused on dogma than regulatory needs. This analysis adds to the lacuna in the literature that fails to fully link political decisions and regulatory structure.

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[472] Western financial system would be widely defined to include G20 nations, most of which were impacted by the GFC.
[473] OECD, https://www.oecd.org/g20/.
[474] OECD, Tackling Coronavirus (Covid-19): Contributing to a global effort. https://www.oecd.org/coronavirus/en/.
[475] LCB Gower, "Big Bang" and City Regulation, The Modern Law Review, 51(1) 1-22.

In the period since the GFC, there has been widespread criticism of the role that the regulatory agencies played in the crisis, to the point that they were, at least in part, a cause of the GFC itself, with the post GFC focus on wholesale reform of the structure.[476] Additionally, there has been wide scale criticism of the legislation and regulations applied by UK and global regulatory agencies; that they were inadequate to protect the global economy from the GFC. While some of the criticism is fair, to allocate blame to the legislation[477] alone is to take a narrow view of the issues that presented themselves to the UK and global authorities in the period preceding the GFC. Regulations are only as effective as the regulator, but what the GFC proved is that the environment in which regulations and the regulator operate are an important consideration and that to apportion blame to the regulator and the regulations is to ignore the true underlying conditions and causes that allowed the GFC to develop.[478] What emerges from the debate into the GFC is that no regulator or regulatory system faced with "arguably the greatest crisis on the history of finance capitalism"[479] could have been able to prevent the GFC. However, a more focused regulator operating within a stronger regulatory structure would have been better placed to manage the impact of the GFC on the financial system. Furthermore, the only real way to have prevented the GFC would have been stronger overall economic policy to control the excessive risk taking by the financial institutions that were at the centre of the GFC. In the UK, errors in regulatory design driven by political motivations played a role in developing a regulatory approach that was unable to deal with the multiple vectors of attack that the GFC presented. As noted in Chapter 6 there is no single individual cause, but instead multiple causative agents operating in a weak macro-economic environment created the aggregate effect of regulatory failure leading to the GFC, however, what emerges from the

[476] A key conclusion of this thesis is that wholesale reform was undertaken without full consideration and was based on political objectives rather than true regulatory rationales.
[477] In the thesis legislation and regulation are in part the same issue with legislation providing the necessary legal underpinning for the existence of regulations.
[478] See Chapter 6 for an analysis of the causes of the GFC.
[479] A Turner, The Turner Review: A regulatory response to the global banking crisis, FSA London, March 2009.

analysis that political decisions played a significant role in the failure of the regulatory design process.

7.2 A changing landscape

The UK regulatory structure has undergone considerable change in the past four decades[480] since the FSA 1986 ushered in a new era of deregulated markets, facilitating enormous growth in both the size and complexity of the UK financial services sector, reaching £132bn or 6.9% of total economic output in 2018, 49% of which was generated in London, supporting 1.1m jobs nationwide, and contributing £29bn in tax revenue for the tax year 2017/18.[481] Understanding the pre-crisis regulatory position provides an understanding of the failings of the regulatory process and of economic policy that allowed the conditions for the GFC to develop and failed to mitigate its impact. An understanding of the role of the that the FSA 1986 played prior to the enactment of FSMA 2000 illustrates how and why the legislation and the regulator, the Financial Services Authority (FSA) failed to take sufficient action to insulate the UK economy from the emerging GFC. It is clear from an analysis of the regulation and regulatory actions that the regulator failed to meet its statutory obligations as set out in the FSMA 2000,[482] that set out in section 3 of the Financial Services and Markets Act 2000 to maintain market confidence; that it was “asleep on the job”.[483]

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480 For a look at the history of financial services regulation in the UK see G Gilligan Historical Touchstones in the Regulation of the Financial Services Sector: The Evolution of Financial Services Regulation (1992) Journal of Financial Regulation and Compliance, Vol.1, No1, 63.

481 House of Commons Library, Research Briefing; Financial Services: Contribution to the UK economy, 31st July 2019,https://commonslibrary.parliament.uk/researchbriefings/sn06193/#:~:text=In%202018%2C%20the%20financial%20services,6.9%25%20of%20total%20economic%20output.&text=Luxembourg's%20financial%20service%20sector%20was,%2C%203.1%25%20of%20all%20jobs.

482 Sections 3-6 FSMA 2000.

483 House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.

The FSA 1986 was a result of a wide-ranging review carried out by Laurence Gower,[484] in what Black[485] referred to as the "first experiment"[486] in UK regulatory approaches, framing it as "self-regulation with a statutory mandate".[487] The focus of the review and subsequent legislation was to regulate the carrying on of investment business, with the regulation of banks remaining with the Bank of England. The clear rationale for the Act was to create a new legislative framework to regulate a burgeoning securities and investment market, driven in part to cover the privatisation of the nationalised industries and the increased engagement with personal financial products such as pensions and personal equity plans. A further driver in the growth of the UK financial services sector was because of political[488] ambition by the then Conservative government. The flaw in the reform was the focus on investor protection rather than a wider look at the growing importance of the macro-economic pressures building up due to general market liberalisation. The fact that bank supervision and regulation was not higher up the priority list for reform evidence a misguided understanding of where the risks were being generated; it was from the banking and the non-bank shadow banks that the GFC emerged.

A further flaw in the regulatory design was the clear direction of travel chosen by the Conservative government emphasising a return to a more neo-liberal economic tradition with a stronger focus on the operations of the free market, with an avowed move away from the Keynesian focused demand led economic tradition that had emerged in the post-war era.[489] The FSA 1986 represents a decade of changing economic thought and to a large extent, and in

[484] LCB Gower, Review of Investor Protection, Report, Cmd 9215 (1984).
[485] J Black, Regulatory Styles and Supervisory Strategies, in The Oxford Handbook.
[486] Ibid, 219. This is not the first experiment but refers to an emphasis shift in the approach to financial services regulation.
[487] Ibid, 219.
[488] This further evidence the political influences that pervade bank and financial services regulation,
[489] A reference to John Maynard Keynes the celebrated British economist.

part it represented the UK regulatory response to that changing economic thought pervading western economies, banking, and financial services from the end of the Bretton Woods era, with stronger emphasis on free market neo-liberal theories. [490] One of the centrepieces of the liberalisation was in the market for company securities. The London Stock Exchange is a long established securities market and to maintain and grow its position the government decided on a legislative path that would open UK financial markets to global exposure, with what was labelled the 'Big Bang' reforms set out in the FSA 1986 as the vehicle to give effect to those reforms. [491] These reforms brought wholesale deregulation[492] of the UK financial sector allowing increased competition and allowing large US banks to take over their smaller UK equivalents. This resulted in the UK financial markets no longer being referred to as a 'gentleman's club', but as a truly international financial centre. The deregulation that followed this period would play a significant role in the development of the conditions that facilitated the emergence of the GFC.

At the centre of the FSA 1986 regulatory regime was the innovative use of a private company exercising regulatory powers,[493] the Securities and Investment Board (SIB).[494] However, the 1986 reforms, stopped short of introducing a full statutory regulatory architecture. This embraced the then political thinking of bringing in more private sector engagement with a broad range of public activity yet showing a reticence to take a fully statutory position. As MacNeil posits the "Self-regulatory ethos…was deeply ingrained in the financial sector",[495]

[490] See Chapter 6 for a brief background on the Bretton Woods Conference of. 1944.

[491] The London Stock Exchange traces its origins back to 1689. Londonstockexchange.com accessed 3rd June 2020.

[492] See D Pesendorfer, Goodbye neo-liberalism? Contested policy responses to uncertain consequences of the 2007-09 financial crisis in K Alexander and R Dhumale eds, Research Handbook on International Financial Regulation (2012) Edward Elgar,

[493] E Lomnicka, Making the Financial Services Authority Accountable, JBL, 2000, Jan 65-81.

[494] The SIB formed the core of the new Financial Services Authority.

[495] I Macneil, The Future for Financial Regulation: The Financial Services and Markets Bill, 1999, MLR, 62(5) 725-743.

and while 'Big Bang' was a significant change, putting the self-regulation regime on a "statutory footing"[496] was the way forward key elements of self-regulation were retained. This evidences a half-way house approach to regulatory reform which did not fully meet the needs of investors or the financial services industry.

7.3 The Failure of the Financial Services Act 1986 - Enter the Financial Services and Markets Act 2000

A centrepiece of the then Labour government's reform agenda focused on bank and financial services.[497] The FSA 1986 had been 'dogged' with financial scandals, which have been frequently cited as evidence of a need to overhaul the regulation of financial services in the UK.[498] Scandals such as The Bank of Credit and Commercial International (BCCI),[499] the Maxwell Pensions scandal[500] and Barlow Clowes,[501] were given as primary reasons for a need to reform. There was undoubted political capital made from the scandals and they were used as examples of political failure by the FSA 1986 regulatory regime as part of an election campaign by the opposition, but also as political failure of the then Conservative government. The difficulty with using scandals as drivers of reform is that it is difficult to see how any regulatory system and any regulatory body can prevent all scandals; it is a feature of every regulatory iteration that some form of fraud will arise, where the scandals are used to drive a political agenda. The political period between 1979 and 2010 encompass two such regulatory

[496] *Ibid*.
[497] See M Taylor, Financial Services and Markets Act 2000 – I (2000) Amicus Curiae Issue 30 September 2000, 3
[498] E Ferran, Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model (2003) Brooking Journal of International Law, Vol.28 Issue 2, 257.
[499] See N Passos, The Genesis of the BCCI Scandal (1996) Journal of Law and Society, Vol.23, No.1, 57.
[500] See B Spalek, Exploring the impact of financial crime: A study looking into the effects of the Maxwell Scandal upon the Maxwell pensioners (1999) International Review of Victimology, Volume 6, Issue 3, 213-230.
[501] See S Toms, Financial Scandals: A Historical Overview (2019) available at Researchgate.net https://www.researchgate.net/publication/332754261_Financial_scandals_A_historical_overview

iterations and both were impacted by financial fraud. One of the key functions of any regulatory system is to prevent fraud; a clear indication of this is seen in early iterations of financial services regulation such as the Prevention of Fraud (Investments) Act 1939 and re-enacted in 1958,[502] which was explicitly catered for with a statutory obligation for the FSA by virtue of section 6 of the FSMA 2000, but to expect such a system to insure against such eventualities is impossible.[503] There has always been financial scandal and fraud in financial markets and this has continued through the FSMA 2000 regulatory regime and through the reforms made since 2010, and such frauds continue to be a feature of banking.[504] The nature of financial crime and in particular the nature of financial criminals makes complete eradication impossible to achieve and as such represents a weak basis for wholesale reform. Bank and financial regulation must deal with financial fraud, but the focus must be on overall financial stability that can withstand the fallout from even large-scale frauds. The failure associated with the GFC was that a large part of the system, the sub-prime mortgage securitisation process could be classed as an elaborate but legal Ponzi[505] scheme, created by macro-economic policy failure linked to interest rate levels remaining consistently low for extended periods of time.[506]

Prior to the 1986 reforms, Alcock noted the existence of a high degree of self-regulation through four bodies: the Stock Exchange for securities dealing, the Society of Lloyds focusing on insurance, the Takeover Panel with responsibility for setting the terms and expectations surrounding mergers and acquisitions, and the Bank of England who as the lender of last resort

[502] See M Taylor, Financial Services and Markets Act 2000 – I, (2000) Amicus Curiae, Issue 30, 3.
[503] For a discussion and analysis of section 6 see Ryder, N. 'The Financial Services Authority, the Reduction of Financial Crime and the Money Launderer – A Game of Cat and Mouse', (2008) Cambridge Law Journal, 67(3), 635-653.
[504] N Megaw, The UK's slow-burn £50bn banking scandal, The Financial Times (London 10th September 2019); https://www.ft.com/content/f74af4b0-d31d-11e9-a0bd-ab8ec6435630, last accessed 23/01/21.
[505] Named for Charles Ponzi, an American fraudster who gave his name to a financial pyramid investment scheme. See https://www.wsj.com/articles/the-original-ponzi-schemer-11602778470
[506] For a more detailed discussion of the association between the 2007/2008 financial crisis and fraud see Ryder, N. *The Financial Crisis and White Collar Crime: The Perfect Storm?* (Edward Elgar, 2014).

retained responsibility for bank supervision.[507] At this time there was relatively little statutory provision in respect of bank and financial regulation.[508] The regulatory model adopted by the FSA 1986 was characterised as self-regulation within a statutory framework,[509] with the legislation setting out the framework delegating specific regulatory functions to specified regulatory bodies. However, the self-regulatory delegated model created an accountability deficit. In a technical sense the Department of Trade and Industry (DTI) was the responsible regulatory authority, however, it delegated primary responsibility to the SIB, which in turn delegated regulatory functions, through the setting up and creation of rules to a range of Self-Regulating Organisations (SROs) and Recognised Professional Bodies (RPBs) to carry on the specific regulatory functions over a particular financial services sector, with a key example of an RPB being the Law Society for England and Wales. Initially there were five primary SROs, the Securities Association (TSA), the Association of Futures Brokers and Dealers, (AFBD) the Investment Management Regulatory Organisation (IMRO), the Life Assurance and Unit Trust Regulatory Organisation (LAUTRO) and the Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA),[510] creating a complex structure to the regulation of financial services. Note that the Bank of England and therefore supervision and regulation of the banking sector remained outside this structure, as did Lloyds of London and the insurance market.

[507] It is interesting to note that Alcock refers to the regulators as “clubs”, even calling the Stock Exchange as a “Private Members Club”. See A Alcock, The Financial Services and Markets Act 2000: A Guide to the New Law (Jordans 2000).
[508] A Alcock, The Financial Services and Markets Act 2000: A Guide to the New Law (Jordans 2000).
[509] I MacNeill, The Future for Financial Regulation: The Financial Services and Markets Bill (1999) Modern Law Review, Vol 65(5), 725;.E Ferran, Examining the United Kingdom’s Experience in Adopting the Single Financial Regulator Model (2003) Brooking Journal of International Law, Vol.28 Issue 2, 257
[510] See S S Miller, Regulating Financial Serices in the United Kingdom – An American Perspective, The Business Lawyer, (1989), Feb 1989, Vol 44, No2 (February 1989) p323-364.

By the end of the life of the 1986 regulatory regime the list of primary SROs was reduced to the Securities and Futures Authority (SFA), the Investment Management and Regulatory Organisation (IMRO), and the Personal Investment Authority (PIA), but without any change to the process of banking and insurance regulation. This still left a complex regulatory environment where unit trusts required authorisation by the SIB, whose management came under the responsibility of the IMRO, yet were sold by PIA authorised members.[511] At this time the Bank of England retained authority for the banking sector. As Blair *et al* note, prior to the Banking Act 1979 the UK lacked formal supervision of the banking sector and while the Bank of England Act 1946 contained provisions to issue directives, the Bank of England exercised its powers "of moral suasion", preferring informal networks to guide the banking sector rather than formal legislative direction, based on its traditional position as lender of last resort.[512] The overall approach of the Bank of England seems to be based on its place at the centre of the banking network rather than as a formal structured regulator. The regulatory gravitas of the Bank of England and its management allowed it to stay close to the banking sector, to keep 'its finger on the pulse'. The reforms that would follow would move the Bank of England to the side-lines of bank regulation, creating a 'turf war' between regulators instead of their supposed working together.

The FSA 1986 represented a compromise position between the government and the banking/financial services sector, the need to improve investor protection and the political environment that pervaded. The compromise position was complicated by the prevailing political environment of financial liberalisation, with strong emphasis on deregulation,[513] not

[511] A Alcock, The Financial Services and Markets Act 2000: A Guide to the New Law (Jordans 2000).
[512] M Blair, L Minghella, Michael Taylor, Mark Thriepland & George Walker, Blackstones Guide to the Financial Services and Markets Act 2000 (Blackstone Press 2001).
[513] D Harvey, A Brief History of Neoliberalism (Kindle Edition, Oxford 2005).

only in the financial services sector, but across most economic and social spheres.[514] The search for compromise creates a risk that important issues could fall between the cracks of the system. Blair *et al* note that the proposal in the Gower report to create a US style Securities and Exchange Commission (SEC), supported by the opposition, was rejected in favour of the statutory self-regulation model noted above, stating that "the need to reassure a sceptical, and sometimes hostile, City community meant that the government stressed the self-regulatory element in the new system".[515] The compromise reflects the inability of governments to develop an effective regulatory regime, based more on what can be achieved politically rather than what is required from the regulatory process, the why factor. The compromise in the 1986 reforms further evidences regulatory capture theory where rather than the regulation meeting the precise requirements of society and the economy, it is only permitted to go as far as the self-interest of the regulated will allow.[516] This is the regulatory compromise that pervades and undermines regulation and created the environment that allowed the mechanics of the GFC to develop, and further evidences the point that regulation is capable of contributing and amplifying regulatory failure and firm and systemic collapse. The compromise position created by the 1986 legislation further evidences the changing political environment of the 1980s and the uncertainties of the increasing growth of liberal economics and its influence over economic thought.

Macneil noted a "dissatisfaction" with the workings of the self-regulation model, that there was a poor working relationship between the regulators, and that a change to a wholly statutory regulatory structure was required to ensure that UK financial services remained at the forefront

[514] Ibid.
[515] M Blair, L Minghella, Michael Taylor, Mark Thriepland & George Walker, Blackstones Guide to the Financial Services and Markets Act 2000 (Blackstone Press 2001).
[516] See Chapter 5.

of global financial services.[517] The process of financial market liberalisation and the focus on deregulation had significantly changed the landscape of bank and financial services in the UK, from an active financial centre to a global player. The 1986 reforms operating alongside major social and political change resulted in what may be termed a 'financialisaton' of society.[518] Many more people, became consumers of financial services products. Traditionally people had opened bank accounts, current and savings accounts, and had used banks for loans, in particular mortgage loans, but by the end of the 1980s an increasing number of people were engaging with a wide range of financial services products such as pensions, personal equity plans and other investments. A major change came in the form of share ownership as thousands of people applied for shares in the newly privatised public companies, referred to as "popular capitalism".[519]

7.4 New Labour and Reform

The first action of the new 1997 Labour government was to announce a complete overhaul of the way financial services were to be regulated, and "with little fanfare and even less criticism"[520] the old regime was swept away. Black refers to this as "the second experiment – integrated regulation",[521] and with Sarker referring to it as "the most fundamental shake-up of the UK's regulation of the financial services in a decade".[522] This betrays a fundamental

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517 I MacNeill, The Future for Financial Regulation: The Financial Services and Markets Bill (1999) Modern Law Review, Vol 65(5), missing page numbers here.

518 See P Mader, D Mertens, N van der Zwan eds, The Routledge International Handbook of Financialization (Routledge 2020).

519 R Seymour, A Short history of privatisation in the UK: 1979-2012, The Guardian (Manchester, 29 March 2012) https://www.theguardian.com/commentisfree/2012/mar/29/short-history-of-privatisation accessed 7/12/20.

520 E Lomnicka, Reforming UK Financial Services Regulation: The Creation of a Single Regulator, (1999) Journal of Business Law, Sep, 480.

521 J Black, Regulatory Styles and Supervisory Strategies, in in N Moloney, E Ferran, J Payne eds The Oxford Handbook of Financial Regulation, (Oxford 2015).

522 R L Sarker, Reform of the Financial Regulatory System, 1998, Company Lawyer, 19(1), 11-13.

problem with the approach to regulation in the UK, in that regulation seemingly needs reform approximately every ten years, not as a result of a cyclical economic process, but as a result of failure to prevent the specific events that regulation is supposed to protect against.[523] This is what Spicer *et al* noted as a "regulatory spin cycle"[524] with policy makers responding with new and more detailed regulation, which after a period of time is watered down and ineffectively enforced and often repealed, laying the foundations for future crises. This makes reaction a feature of regulatory reform, and the 'spin cycle' nature reflects the difficulties in creating a stable regulatory platform; the dynamic nature of financial services and the political machinations to achieving a regulatory compromise result in a less than optimal regulatory structure. Largely missing from this debate is that the reforms are not merely a response to failure but also a product of the political drivers, with the failures amplified for political capital.

The debate is replicated in the US also. The US response to the GFC was legislated largely through the Dodd-Frank Wall Street Modernisation Act 2010, however, almost immediately it was challenged, even as being unconstitutional and since its enactment it is received significant criticism from the right wing of US politics and its provisions eroded by the Trump administration since 2017.[525] The response from the new labour government was to amend the FSMA 2000, which had placed the regulation of financial services on a fully statutory footing, however, the more momentous change preceded FSMA 2000 and came in Part III of the Bank of England Act 1998 with the news that the regulation of banks would be transferred to the

[523] One problem is that staff turnover in the financial services industry is traditionally quite high and as such institutional memory is myopic with little memory of the past embedded into the management structures. In addition the remuneration packages are traditionally very generous and incentivise failure.
[524] A Spicer, D Lindley, JP Gond, S Mosonyi, Z Jaser, E Marti, H Peterson, A Edwards, Cultural Change in the FCA, PRA & Bank of England: Practising What They Preach?, 2016, Report from New City Agenda, 2006, www.newcityagenda.co.uk/wp-content/uploads/2016/10/NCA-Cultural_Change_in_regulators_report.pdf.
[525] J Pramuk, Trump signs the biggest rollback of bank rules since the financial crisis, CNBC, May 24th 2018.https://www.cnbc.com/2018/05/24/trump-signs-bank-bill-rolling-back-some-dodd-frank-regulations.html accessed 7/12/20.

recently renamed SIB, the Financial Services Authority. [526] The core of the reform was the employment of the consolidated regulatory model based around a single regulator, the FSA, however, the change in the regulatory regime for banks seems to try to fix a problem that did not exist.

There is little or no theoretical support to choose one regulatory structure or model over another. As Norton notes that "no…absolute or otherwise clear compelling criteria exist…in determining the choice between single or multiple, functional regulator (or, for that matter for an 'umbrella' regulation within which functional regulation occurs).[527] While the UK moved from a self-regulatory model within a statutory framework to a fully statutory consolidated model, the US has long adopted a multi-agency approach, with responsibility for regulation delegated to an agency with supervisory oversight of a particular element of the financial services sector. The US regulatory structure is in stark contrast to the UK approach, and maintains a fragmented system even after the GFC, however, to try and provide some measure of additional coordination the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 created the Financial Stability Oversight Council (FSOC), which acts as a council of regulators including experts under the auspices of the Treasury Secretary. Even with the inclusion of the FSOC the US remains a fragmented regulatory system, with a range of federal level regulators responsible for their part of the financial system. For depository institutions such as banks this includes the Office of Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve, the US Central Bank. Regulation of credit unions vests with the National Credit Union Administration (NCUA). For

[526] Bank of England Act 1998, ss21-30.
[527] J T Norton, Global Financial Sector Reform: The Single Financial Regulator Model Based on the United Kingdo, FSA Experience – A Critical Reevaluation, (2005) The International Lawyer, Spring 2005, Vol.39, No.1, p15-52, at 19.

the securities and commodities markets the regulators are the SEC and the Commodity Futures Trading Commission (CFTC). In addition, there are a range of further federal regulators, firstly covering government sponsored enterprises, namely the Federal Housing Finance Agency (FHFA), the Farm Credit Administration (FCA) and the Consumer Financial Protection Bureau (CFPB).[528] This is an opposite approach to that implemented by FSMA 2000, yet the US financial system was the origin of the GFC through the sub-prime crisis and was adversely affected by it. That both the multi-agency structure and the single unitary structure of regulation failed to achieve the stated aim of financial stability would suggest that the answer lies somewhere else.

The failure of the regulatory system has been cited as one of the causes for the crisis. Key to measuring the success of the FSMA 2000 regulatory process lay in the four statutory objectives provided by the legislation of maintaining market confidence,[529] improving public awareness,[530] protecting consumers[531] and reducing financial crime.[532] The statutory obligations set out a benchmark on how the regulator was to operate, and to be scored against on failure. The objectives stated:

3 Market confidence

(1) The market confidence objective is: maintaining confidence in the financial system.

[528] Who Regulates Whom? An Overview of the US Financial Regulatory Framework, Congressional Research Service, March 2020; https://fas.org/sgp/crs/misc/R44918.pdf accessed 9/12/20.
[529] Section 3 FSMA 2000
[530] Section 4 FSMA 2000
[531] Section 5 FSMA 2000
[532] Section 6 FSMA 2000

(2) “The financial system” means the financial system operating in the United Kingdom and includes—

(a)financial markets and exchanges;

(b)regulated activities; and

(c)other activities connected with financial markets and exchanges.

4 Public awareness

(1) The public awareness objective is: promoting public understanding of the financial system.

(2) It includes, in particular—

(a)promoting awareness of the benefits and risks associated with different kinds of investment or other financial dealing; and

(b)the provision of appropriate information and advice.

(3) “The financial system” has the same meaning as in section 3.

5 The protection of consumers

(1) The protection of consumers objective is: securing the appropriate degree of protection for consumers.

(2) In considering what degree of protection may be appropriate, the Authority must have regard to—

(a)the differing degrees of risk involved in different kinds of investment or other transaction;

(b)the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity;

(c)the needs that consumers may have for advice and accurate information; and

(d)the general principle that consumers should take responsibility for their decisions.

(3) “Consumers” means persons—

(a)who are consumers for the purposes of section 138; or

(b)who, in relation to regulated activities carried on otherwise than by authorised persons, would be consumers for those purposes if the activities were carried on by authorised persons.

6 The reduction of financial crime

(1) The reduction of financial crime objective is: reducing the extent to which it is possible for a business carried on—

(a)by a regulated person, or

(b)in contravention of the general prohibition,

to be used for a purpose connected with financial crime.

(2) In considering that objective the Authority must have regard to the desirability of—

(a)regulated persons being aware of the risk of their businesses being used in connection with the commission of financial crime;

(b)regulated persons taking appropriate measures (in relation to their administration and employment practices, the conduct of transactions by them and otherwise) to prevent financial crime, facilitate its detection and monitor its incidence;

(c)regulated persons devoting adequate resources to the matters mentioned in paragraph (b).

(3) “Financial crime” includes any offence involving—

(a)fraud or dishonesty;

(b)misconduct in, or misuse of information relating to, a financial market; or

(c)handling the proceeds of crime.

(4) “Offence” includes an act or omission which would be an offence if it had taken place in the United Kingdom.

(5) “Regulated person” means an authorised person, a recognised investment exchange or a recognised clearing house.

These statutory obligations were described by Howard Davies, the first Chairperson of the FSA, as the “capstone” under which the FSA is required to discharge its functions, and in a way that is compatible and which it considers most appropriate to meet those objectives.[533] These statutory objectives represented a significant departure from the regime it replaced in setting out in law statutory objectives for the regulator. This provided the advantage that the regulator had a known and published set of criteria that it could refer to in discharging its functions. The disadvantage of setting out such provisions in law is that they potentially create a defensive approach to operations.

[533] G Bevers, The Accountability of the Financial Services Authority under the Financial Services and Markets Ac 2000, Company Law, 2001, 22(7), 220-222.

Achievement of the regulatory regime created by the FSMA 2000 centred on the employment of the consolidated regulation model with the legislation putting in place a single unitary regulator, often referred to a single “super regulator,[534] even as a “regulatory monster”.[535] This regulator emerged from the SIB as the FSA, a single agency responsible for the entirety of financial services regulation and supervision in the UK, a ‘one-stop-shop’ financial regulator. The reforms involved a two stage process, starting with the transfer of bank supervision from the Bank of England to the FSA and culminating with N2, the operational date for the completion of the reforms and the FSA to take control of UK bank and financial services regulation.[536] While unitary regulation was not new, having been implemented in Scandinavia,[537] the concept of a single supervisory and regulatory regime had never been tried out on such a large and complex financial system as the UK, in particular London, making the decision to apply this thinking a bold experiment in the face of traditional thinking.

One of the ambitions for the new regime was that it would be cost efficient alongside regulatory effective to encourage foreign investment.[538] This is the wrong focus for a regulator. While an efficient regulator is important, cost efficiency should not be of central importance, it must first and foremost discharge its functions correctly and achieve it aims, and specifically its statutory obligations. Additionally, it should not be the role of the regulator to attract inward investment. A competent regulator will provide the environment for its market sector to attract

[534] A Alcock, The Financial Services and Markets Act 2000: A Guide to the New Law (2000) Journal of International Banking Law, 16(6), 167, 167.
[535] A Alcock, A Regulatory Monster, (1998) Journal of Business Law, Jul, 371, 371.
[536] N2 was set as Midnight 30th November 2001.
[537] Blair et al, Blackstone’s Guide to the Financial Services and Markets Act 2000, OUP.
[538] E Lomnicka, Reforming UK Financial Services Regulation: The Creation of a Single Regulator, (1999) Journal of Business Law, Sep, 480.

investment on the basis that the financial services industry is safe and sound, however, conversely an over regulated sector will deter inward investment due to increased costs and increased friction in doing business. Sarker noted that the FSA had estimated the annual costs of regulation at £50m, however, by 2016, this was estimated to have risen to £1.2bn.[539]

In hindsight, experimenting with such a radical change in the form and method of regulation was ill advised with such a complex economy and financial system with other options, the half-way house available, indeed the 'twin peaks' regulatory structure that was brought in following the 2010 General Election was part of the debate before the consolidated model was adopted. Blair *et al* note that the desire to create a single statutory regulator may have been linked to the Labour party's desire to achieve such a body at the time of the Gower review and in the time preceding the FSA 1986.[540] This point emphasises the theme that clearly emerges from any analysis of the development of a regulatory regime, specifically the impact of political machinations on the decision-making process. Political thinking plays a role in designing and implementing a regulatory and supervisory regime for financial services and that a desire to win elections plays a further and significant part. The danger with such an approach is that it clouds considered analysis and application, preventing a clear path to achieving the stated aims of financial services regulation. The political 'interference' in designing the correct financial regulatory architecture played its part in preventing regulation from identifying the upcoming crisis and mitigating its effects. It is clear from analysis that financial services regulation should be designed around the aims and rationales of regulation as applied to the activity that

[539] Spicer et al, Cultural Change in the FCA, PRA & Bank of England: Practising What They Preach?, 2016, Report from New City Agenda, 2006, www.newcityagenda.co.uk/wp-content/uploads/2016/10/NCA-Cultural_Change_in_regulators_report.pdf. Last accessed 30/06/2020.
[540] I MacNeill, The Future for Financial Regulation: The Financial Services and Markets Bill (1999) Modern Law Review, Vol 65(5), 725.

needs regulatory control and intervention, avoiding subjective application based on political ideology.

In addition, it was ill advised that the design of the unitary regime was to be applied to the entire range of financial services activity, including bank regulation. McNeil notes the move from a myriad of self-regulatory organisations that characterised the FSA 1986 process to a single regulator, the FSA, which by itself would have been a significant development for the UK financial sector, but by including the regulation of banks under the single regime created a step too far.[541] Instead, a more incremental approach to unitary regulation would have been a more considered approach, creating a single regulator for investment protection, market conduct and financial education and allowing the Bank of England to continue with the supervision and regulation of banks. It is not disputed that the financial market liberalisation of the second half of the 1980's and throughout the 1990's required a stronger bank supervision scheme and as such it would have been a requirement to strengthen the Bank of England's powers in respect of supervision. This would have allowed the new FSA as a consolidated regulator to embed itself within the financial services sector, and to allow the Bank of England as a central bank and lender of last resort, with its expert knowledge in the field to apply itself to the banking sector, where the primary stresses that led to the GFC were building. This in effect would be the twin peaks system that emerged from the new conservative government following the 2010 general election and which was the expected model in 1997. Whether this would have been able to prevent or militate the impact of the GFC is impossible to state definitively but such a radical regulatory structure being applied to the size and complexity of the UK financial system did not.

[541] Ibid.

7.5 The Failure: Regulations, Regulator or the inevitable?

In August 2007, the global financial markets ground to a halt. BNP Paribas, announced the closure of three of its funds on the realisation that it could no longer accurately price the assets in the investment funds.[542] This action led to similar announcements from other financial institutions exposed to the innovation and financial engineering that has pervaded the financial services industry since the 1970s.[543] In turn, the actions of credit institutions created significant friction in the availability of inter-bank credit, which was commonly referred to as the 'credit crunch',[544] resulting in contractions in the business and consumer credit markets. This in turn led to a credit crisis that precipitated the GFC that "threatened the very fabric of the financial system and ultimately the entire economy".[545] In February 2008, Northern Rock was nationalised,[546] following months of feverish attempts to rescue it. Nationalisation was the only option to rescue a bank that would have ultimately failed with significant fallout for customers and the wider economy. The collapse of Northern Rock was not an isolated incident. The credit crunch that had now evolved into a banking crisis resulted in government support for the Royal Bank of Scotland by way of a partial bailout and the Halifax Bank of Scotland by way of a government facilitated takeover by Lloyds Bank,[547] which following the takeover required similar assistance, with the UK government buying 81% and 43.4% respectively of these UK banks.[548]

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542 S Kar-Gupta, Y Le Guernogou, BNP Freeze $2.2 bln of funds over subprime, Reuters (9th August 2009); available at https://www.reuters.com/article/us-bnpparibas-subprime-funds-idUSWEB612920070809, accessed 25/01/21.
543 See Chapter 4.
544 M N Baily, R E Litan, M S Johnson, The Origins of the Financial Crisis (2008), Fixing Finance Series, Paper 3, November 2008; https://www.brookings.edu/wp-content/uploads/2016/06/11_origins_crisis_baily_litan.pdf.
545 HR Cohen, Preventing the Fire Next Time: Too Big To Fail, 2012, Texas Law Review, Vol 90, 1717-1743.
546 House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.
547 These were not the only failures or near failures. Bradford and Bingley a building society that could trace its origins to 1851 collapsed in September 2008 after rescue attempts failed with part of the bank sold to Santander and the remainder, mainly toxic assets taken over by the government's asset management vehicle.
548Bank Reforms, how much did we bail them out and how much do they still owe, The Guardian (Manchester 2011) http://www.theguardian.com/news/datablog/2011/nov/12/bank-bailouts-uk-credit-crunch#data accessed 6/02/15.

A responsive regulatory regime focused on the true underlying rationales of regulation would have been better placed to see the impending stresses in the financial markets and act accordingly, in liaison with other authorities. The issue revolves around two questions; firstly, was there a failure of regulation; and secondly, was there a failure of the regulator? The central tenet of blame is levelled at the out-of-control US sub-prime mortgage market in the USA, resulting in an enormous property bubble, which eventually burst, and that in turn this activity was used to support the US investment banking systems thirst for securitisable assets. The collapse of the US house price and sub-prime mortgage bubble was primarily a US issue,[549] which ultimately infected the UK and global banking sector due to the interconnectedness of banks and markets, leading to almost catastrophic systemic failure. The banks noted above were not directly involved in the US sub-prime mortgage markets, although Northern Rock was heavily involved in securitisation of its mortgage book. The failure of Northern Rock and rescue of HBOS and RBS evidences the fact that wider issues associated with weak regulatory control were responsible for the GFC. The FSMA 2000 reforms were designed to avoid the fraud and scandals that characterised the 1986 regime, placing all the responsibility for bank and financial services regulation in one authority to avoid issues created by the complexity of a myriad of regulators. The key regulatory question is why did the GFC impact on the UK so severely when the underlying cause of the GFC was the US sub-prime mortgage bubble and when UK banks were not directly involved in the sub-prime lending market?

Much of the blame in the UK is placed at the foot of the regulatory regime in the UK, namely the FSMA 2000 and the unitary regulator, the FSA. Verrill, notes that a common factor in in bank failure is regulatory mistake, highlighting that warning signs are ignored or swept under

[549] For a comprehensive discussion and analysis of the Sub-prime collapse see K C Engel and P A McCoy, The Subprime Virus (Oxford 2011).

the carpet, querying why a second tier lender, considerably smaller than its well-known competitors, was able to corner 19 per cent of the UK mortgage market in 6 months.[550] A point that was further explored by the UK Treasury Committee in their scathing report on the failure of Northern Rock, 'The Run on the Rock'.[551] It is difficult to believe that the warning signs were swept under the carpet, however, it would seem that they were at best missed or misinterpreted. Of concern with the regulatory regime is the fact that the warning signs of an overheating economy and a rapidly expanding property bubble were evident in the early years of the 21st Century yet it seems that little was done to prevent its impact.

The collapse of Northern Rock was the first real test of the consolidated regulatory system, the first test for the single 'super' regulator. The FSA had been operating for seven years gaining insight, knowledge, and experience of its remit. The issue seems to be that the focus on the FSA was on its function as a consumer watchdog rather than a regulator of banks. While carrying on regulatory functions such as approvals and authorisation, it is notable that the searchlight of the FSA was focused on consumer protection and market participant integrity. Regarding its relatively new function of bank regulation there was not the same outward evidence of activity as was the case with its other regulatory activities, leading former Chancellor of the Exchequer Lord Lawson to say, "at the time of the Northern Rock I went onto the FSA's website and clicked 'what we do'. In no place did it mention banking supervision. Which was very honest indeed, since that's precisely what they hadn't been doing".[552] While a media friendly soundbite, this criticism is mirrored in the FSA's analysis of

[550] L Verrill, Regulation Hits the Rocks, Insolvency Intelligence, 2008, 21(1) 16.
[551] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.
[552] City Diary Telegraph, The Daily Telegraph (London 30th October 2008).

the failure of Northern Rock,[553] RBS[554] and HBOS.[555] The FSA's approach to regulation and its focus on micro-prudential, firm specific regulation was criticised as failing or failed, and that its overall approach to prudential regulation was inadequate.[556]

As a bank Northern Rock was subject to regulation and supervision by the FSA and did so via its ARROW (Advanced, Risk-Responsive Operating framework). As Gray notes ARROW is a regulatory mechanism that analyses the risk posed by an individual institution against the FSA's statutory objectives,[557] and are "intensive stocktakes of individual firms supplemented by a number of other monitoring techniques".[558] In hindsight the FSA admitted that it was wrong to have awarded a low default probability from the ARROW process,[559] even though it was classed as a high impact firm by the FSA.[560] The criticism of the regulators handling of Northern Rock is supported by the House of Commons Treasury Committee in the 'Run on the Rock' Report. Here, the Committee provided a scathing attack on the performance of the FSA and stated that the regulator:

553 House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.
554 House of Commons Treasure Committee, the FSA's report in the failure of RBS, HC 640, 19th October 2013
555 Parliamentary Commission on Banking Standards, An Accident Waiting to Happen: The failure of HBOS, HL Paper 144, HC 705, 4th April 2013.
556 The Tripartite Review: A review of the UK's Tripartite system of Financial Regulation in relation to financial stability, March 2009. Hereafter known as the Sassoon Report.
557 J Gray, Financial Regulation Before and After Northern Rock in J Gray and O Akseli eds, Financial Regulation in Crisis: The Role of Law and the Failure of Northern Rock (Edward Elgar 2011).
558 House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.
559 J Gray, Financial Regulation Before and After Northern Rock in J Gray and O Akseli eds, Financial Regulation in Crisis: The Role of Law and the Failure of Northern Rock (Edward Elgar 2011).
560 House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.

> "…was asleep on the job…A very clear signal of a bank running a big risk is rapid expansion. Northern Rock was giving that signal quite clearly; it really is remarkable that [the FSA] missed it".[561]

This is a damning indictment of the FSA from an influential House of Commons Committee and reflects the comments of Verrill in respect of ignoring or missing the signs if the approaching GFC.[562] The report concluded that the FSA missed the signs that the Northern Rock Bank was running a high-risk business strategy. Northern Rock's balance sheet had grown more than six-fold between 1997 and 2006,[563] largely based on its aggressive mortgage business. The problem was the method employed to fund such dynamic growth as it relied on borrowing from wholesale markets and through securitisation of its residential mortgage book through its offshore special purpose vehicle, Granite, which Northern Rock's former CEO stated accounted for 50% of the bank's funding.[564] It is not difficult to see how, when the global financial markets seized up, the so-called "dislocation";[565] Northern Rock got into trouble. The financial institution adopted the 'originate to distribute' funding model that resulted in problems for many US mortgage providers, which relies on enough new mortgages to support the funding model. This leads to an upward spiral of aggressive growth as the bank must originate enough loans to ensure its own survival. As seen in the US, when orthodox and less risky prime products have become saturated in the market there is a need to move to more innovative and inevitably riskier products. This characterises the explosion in sub-prime

[561] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1., Para 37.
[562] Above n.79
[563] Ibid, Para 12
[564] R Tomasic, Corporate Rescue, governance and risk taking in Northern Rock, Part 2, 2008, Company Lawyer, 29(11), 330-337
[565] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1., para 15

lending in order to fuel the “originate to distribute” model which eventually resulted in large-scale mortgage applications.

In Northern Rock’s case, one such innovative product was the so called ‘Together Loan’.[566] This mortgage loan offered a loan to value ratio of 125%, which in simple terms means that there is an immediate 25% negative equity position for borrowers. There can be no doubt that this “racy” mortgage product was designed specifically to entice consumers to take out Northern Rock mortgages, an essential requirement by the bank if they were to continue growth using the financing model in place.[567] The obvious corollary is that where an economic downturn emerges, one of the first economic sectors to contract quickly is the housing market and the price of housing, with the associated drop in value. With properties already in 25% negative equity, this presents significant issues of borrowers and lenders. The additional impact for Northern Rock is that the number of mortgage applications will fall in an economic downturn having a significant negative impact on the originate to distribute model, and the significant knock on to Northern Rocks funding model. Without a sufficient flow of new mortgages to ‘originate’ and without sufficient capital and liquidity buffers, Northern Rock became increasingly reliant on borrowing in the wholesale lending market to continue operations. When the so-called ‘credit crunch’ emerged, the wholesale lending market evaporated causing Northern Rock to fail.[568]

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[566] See A Brummer, The Crunch: The Scandal of Northern Rock and the Escalating Credit Crisis (Random House 2008.
[567] Ibid p11.
[568] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.

The Treasury Committee identified two potential signals of the "vulnerability of Northern Rock", a bank growing at such a fast rate,[569] Gray[570] commenting that in a ten year period it became the eighth largest UK bank and the fifth largest mortgage lender; and a fall in the share price in comparison with other banks, alongside the June 2007 profit warning.[571] The FSA itself "acknowledged that there were clear warning signals about the risks associated with Northern Rock's business model, both from its rapid growth as a company and from the falls in its share price from February 2007".[572] It is clear that investors were having doubts about Northern Rock from this date as reflected in the downward trend of its share price; however, the regulator seemed to hesitate:

> "…insofar as the FSA undertook 'greater regulatory engagement' with Northern Rock, this failed to tackle the fundamental weaknesses in its funding model and did nothing to prevent the problems that came to the fore from August 2007 onwards. We regard this as a substantial failure of regulation".[573]

The Treasury Committee regarded that as a substantial failure of the regulator in applying the regulation. The focus of the Committee to this point had been the way in which the FSA undertook its statutory duties, indeed the Committee did not feel the need to dismantle the

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[569] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.
[570] J Gray, Financial Regulation Before and After Northern Rock in J Gray and O Akseli eds, Financial Regulation in Crisis: The Role of Law and the Failure of Northern Rock (Edward Elgar 2011).
[571] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.
[572] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.Para 42
[573] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.42.

regulatory structure in place, only that it needed strengthening.[574] This suggests that what occurred can be more accurately characterised as a failure of the regulator rather than the regulations, or the legislation that creates and empowers the regulation. An analogy can be drawn with air crash investigations; was the crash a mechanical failure of the aircraft, the regulations, or was the crash caused by pilot error, the regulator or supervisor? The comments of the Treasury Committee suggest that the failure to control the oncoming effects of the crisis was because of a human failure, albeit a collective failure of the FSA, and the other integral components of financial services and bank regulation in the period preceding the GFC. Verrill noted further support for this position:

> "Commentators believe it worked badly, with the authorities forced into a series of late and hasty decisions. A more alert regulator may have recognised some time ago that Northern Rock's way of running its business made it particularly vulnerable to changes in wholesale money market conditions. But there is no evidence that it issued any warning until Northern Rock's board acknowledged it could no longer run its own affairs and was looking for a rescue bid".[575]

This further points to an issue with the regulator failing to perform its function. The FSA had the tools, it had the statutory and operational responsibility, but failed to properly use the tools and discharge its obligations with sufficient skill to the supervision and regulation of banks. In the FSA's own review of its performance, it's then Chairman Lord Turner noted that the "era

[574] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1., p4. See also Conclusions and Recommendations Para 53.
[575] L Verrill, Regulation Hits the Rocks, Insolvency Intelligence, 2008, 21(1) 16

of light touch regulation is at an end".[576] However, the legislation never purported to bring a light touch regulatory regime, nor did the FSA specifically announce that it planned to take such an approach, in fact the opposite was the case with the 'fanfare' that accompanied the introduction of the consolidated regulator concept talking in terms of bringing in world class regulation to the UK financial services sector; nothing suggested a 'light touch regime'. [577]

This 'light touch' approach was the result of internal decision-making processes at the highest level, and it is likely that this was because of political pressure from an understanding that to be able to deliver their agenda the government would need the banking community. The incoming Labour government knew that they would struggle to achieve their policy aims without the financial services industry and needed to reassure the sector that they would not be a party and government of micro-management control. The light touch approach was, however, the one promoted and implemented by the FSA. Margaret Cole, a former head of enforcement at the FSA, noted that such an approach had helped London become a "leading centre for mobile capital", further evidencing that the approach of the regulator was misplaced at the material time.[578] The regulator was blinded to the role that it needed to play in the time preceding the GFC. The promotion of London as a global financial centre and operating a regulatory and supervisory regime designed to facilitate this the FSA proved unable to prevent or slow the impact of the GFC.

[576] Turner Review: A Regulatory Response to the Global Banking Crisis (March 2009), FSA London.
[577] A New Regulator for a New Millennium, The Financial Services Authority, London.
[578] M Cole, The Seventh Annual AA Sommer Jr Lecture on Corporate, Securities & Financial Law: The UK FSA Nobody Does it Better, (2007) Fordham Journal of Corporate & Financial Law, 12 Fordha, J. Corp & Fin L. 259. Repetition of journal.

This brings into question who regulates the regulator and who picks up if the regulator fails to perform as required. Concerns surrounding the accountability of the new consolidated regulatory model surfaced even before the new system became operational. The structure of the new regime leaves a gap between the regulator and government oversight. The FSA was a company limited by guarantee that stood on its own in respect of its operational duties. In theory HM Treasury created policy and had oversight over the FSA, but the structure left open the fact if anything went wrong the regulator itself would be the relevant authority to blame. As such there was no true regulator for the regulator, other than through usual performance measurements set by senior Treasury personnel. The difficulty is that with respect to the GFC it may not have been possible to see the failure of the regulator in this instance. The environment created by the US sub-prime crisis and the pressures that built up in the global financial system were unprecedented and it would be very difficult to understand whether any regulatory structure would have fared any better.

There was an accountability gap between government and the regulator, and the regulator failed to discharge its full statutory obligations. However, the GFC was not only a failure of the regulator, it was not only a failure at the firm level microeconomic stage, but largely a system wide macroeconomic level. The regulatory failure did not just occur at the operational, day-to-day, level under the direction of the FSA but at the policy level. It is difficult to see how HM Treasury as the policy setter could effectively regulate the operational regulator, the FSA, when it was itself failing to fully appreciate the impact of the emerging pressures in the financial markets. The regulatory failure that allowed the GFC to develop was both at micro and macroeconomic level, but it is evident that the failures at the macroeconomic level created an environment in which the FSA could not have done much more that it did. A stronger macro level control that managed the overall environment may have allowed the FSA as the operational regulator to have more effectively discharged their statutory obligations.

Northern Rock was not an isolated incident evidencing wider failure that the FSA was not meeting its statutory duty[579] in respect of the banking sector. The stresses building up in the UK banking system were noted much earlier than the months prior to August 2007. With respect to HBOS, the Parliamentary Commission on Banking Standards (PCSB) noted in 2004 that FSA felt:

> "The group's growth had outpaced the ability to control risk. The Group's strong growth, which was markedly different than the position of the peer group, may have given rise to 'an accident waiting to happen'."[580]

The PCBS noted that "neither the FSA nor HBOS followed through on the implications of this characterisation"[581] HBOS failed on 1st October 2008 when it was forced to accept emergency liquidity assistance from the Bank of England, by which time a taxpayer backed, government facilitated takeover by Lloyds Banking group had been announced, taking place on 16th January 2009[582]; however, the scale of the problems at HBOS resulted in the bailout of Lloyds itself just a month later.[583] HBOS, like Northern Rock was reliant on wholesale funding which dried up when the credit crunch first emerged in the late summer of 2007 and like Northern Rock the

[579] To maintain market confidence – something missing here?
[580] Parliamentary Commission on Banking Standards, An Accident Waiting to Happen: The failure of HBOS, HL Paper 144, HC 705, 4th April 2013. Para 1.
[581] Ibid.
[582] Ibid.
[583] E Dunkley and P Jenkins, How Lloyds came back from the brink, Financial Times (London 18th May 2017, https://www.ft.com/content/34e57e76-3a87-11e7-821a-6027b8a20f23.

real problem was one of liquidity, but with the onset of the GFC and the lack of affordable credit all actions to reduce its reliance on wholesale funding came too late to stave off the need for action. Again, the failure of UK regulatory authorities to mitigate wider pressures due to the micro-economic approaches of UK regulation surface in the case of HBOS.

Verrill's argument that the regulatory authorities missed the warning signs is important[584]. The evidence shows that both Northern Rock and HBOS were displaying obvious signs that they were running risky business models with inadequate controls. Both institutions were pursuing an aggressive expansion policy with insufficient safeguards and insufficient regard for potential outcomes, with a focus on maintaining this growth based on borrowing in the wholesale financial markets. A second observation is that, not only did they fail but in fact ignored their own internal warning signs in the pursuit of yield.[585] This would be of greater concern as it would be a clear breach of the regulators statutory duty notwithstanding that it would be contrary to the rationale of regulation as a system of governance, it would have the impact of nullifying UK financial services regulation at its point of contact and possibly prove that political interference may have played a central role in the GFC's impact. A further example of regulatory failure to take action is in respect of the Royal Bank of Scotland (RBS), noting that by its own admission again that the FSA's approach in supervising and regulating banks was "inadequate".[586] As the House of Commons Committee stated "the FSA report paints a picture of a regulator severely unbalanced and with an insufficient focus on prudential

[584] L Verrill, Regulation Hits the Rocks, Insolvency Intelligence, 2008, 21(1) 16.
[585] In addition to the GFC exposing problems with the structure of regulation it also exposed problems with internal management and governance of banks leading to wideranging reviews into the corporate governance of banks. Wheatley Review.
[586] House of Commons Treasure Committee, the FSA's report in the failure of RBS, HC 640, 19th October 2013, para 11.

issues”,[587] even given that “statutory independence was accorded to the FSA to enable it to both offer constructive challenge to establish dogma and to resist political pressure”.[588]

These factors do not suggest a failure of the regulations, but instead they point to a failure of the applications of the regulations by the FSA. How the legislation is applied to the task is the responsibility of the regulator and a misapplication of the regulations is likely to lead to failure, which is what occurred. An analysis of this issue is possible by looking at the initial actions taken by UK policy makers to the emerging crisis. In the immediate aftermath of the failure of Northern Rock, HBOS, RBS and Bradford & Bingley, the UK government announced an amendment to the FSMA 2000 with the insertion of a new statutory obligation[589] focusing on financial stability. The failures of Northern Rock, RBS and HBOS expose significant failings within the UK regulatory system that laid open the UK economy though its banking system to the excesses of the financial liberalisation.

7.6 The FSA, only one part of the chain of failure

The FSA was not the only party to ignore, miss, or fail to appreciate the signs; the Bank of England had noticed stresses building up within the banking system because of the funding models employed. In a 2008 speech to the British Bankers Association (BBA), the Deputy Governor of the Bank of England Sir John Gieve noted that in the July 2006 Financial Stability Report there were warnings of “UK banks increasing dependence on wholesale funding” and[590] in April 2007:

[587] Ibid. para 22.
[588] Ibid. para 22.
[589] Section 1 Financial Services Act 2010. Should always be Financial Services Act 2010, s. 1.
[590] J Gieve, Speech to the British Bankers Association 12 Annual Supervision Conference, October 2008.

> "If UK banks were unable to securitise existing assets, new lending would need to be financed through other wholesale sources, which may be difficult or costly to access during time of stress".[591]

This scenario was the one that played out later in the autumn of 2007. This proves evidence of an ineffective supervisory and regulatory approach and provides further evidence that the tripartite regulatory regime failed in its purpose. The Bank of England had concerns over the funding models used by major banks, however, it failed to communicate such concerns to the FSA. This is contrary to the Memorandum of Understanding in place between the tripartite authorities to communicate with each other. It is surprising that banks were not a greater focus of the regulator. Tomasic notes "banks are special" and "not like other companies".[592] The nature of banking and the importance of banks to society results in a need to treat them in a different manner to other corporate structures, while ensuring that they are also seen as corporate structures. Regulating and supervising banks is a challenging task. When large companies run into trouble there is significant noise regarding job losses and economic impact, however, when banks run into trouble the noise is amplified exponentially. Support for failing industrial companies does exist, for example the introduction of the car scrappage scheme to protect jobs in the automotive industry,[593] but the scale of intervention in respect of banks is unprecedented. There will be political fallout when large companies fail,[594] the spike in unemployment figures causes politicians to take a deep breath, but there are wider societal

591 Ibid.

592 R Tomasic, Corporate Rescue, governance and risk taking in Northern Rock, Part 1, 2008, Company Lawyer, 29(10), 297-303

593 D Milmo and T Webb, Budget 2009: car industry welcomes scrappage scheme, The Guardian (Manchester, 22nd April 2009), https://www.theguardian.com/uk/2009/apr/22/budget-scappage-scheme-welcomed

594 FT Collectionsm Carillion's Collapse: risk and failure, The Financial Times https://www.ft.com/content/2cab2ac2-fb83-11e7-9b32-d7d59aace167

issues at play when a bank fails. It is evident that we witness considerably more detailed debate when a bank is in trouble that most cases of corporate failure, only the largest of corporations would merit the kind of debate that bank failure does. Governments are much more willing to step into bailout banks than corporations. The search for yield created a dangerous and ultimately destructive downward spiral, as evidenced by the US sub-prime mortgage market.

The risk of systemic failure is why bank regulation and supervision are different. The "contagion related spillages from national, regional and global crises are the downside of financial globalisation".[595] This is a known in respect of banking, however, as noted by the House of Commons Treasury Committee and the PCBS, the risks were known, and were known for some time. Hoggarth *et al* found in a study of the costs of banking system instability, cumulative output losses incurred during crisis periods are roughly 15-20% on average of annual GDP.[596] Banks are so closely interconnected that failure of one bank may result in the failure of more; the worst-case scenario being a complete collapse of a country's banking system with a possible knock on to the global banking system, leading to another great depression. This was played out in respect of the interbank lending rates rising,[597] and term lengths shortening, known as the credit crunch. This is potentially very damaging for institutions reliant on short term funding and securitisation. This risk always existed in fractional reserve banking as institutions lend long and borrow short, reliant on deposits and

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[595] R Bollen, European regulation of payment services – the story so far, 2007, Journal of International Banking Law and Regulation, 22(9), 451-468

[596] G Hoggarth, R Reis, V Saporta, Costs of banking system instability: Some emprircal evidence (2002) Journal of Banking Law and Finance, 826

[597] Unknown at the time was the incidence of large scale manipulation of the key interbank lending rate LIBOR. See J McBride, Understanding the Libor Scandal, (Council on Foreign Relations 12th October 2016), https://www.cfr.org/backgrounder/understanding-libor-scandal

low loan default rates to fund growth. The search for yield led financial institutions to undertake increasingly risky activities, and increasingly risky ways of funding growth.[598]

Faced with pictures of people queuing around the block to withdraw deposits from Northern Rock prompted the government to take the bank into public ownership, and to increase the deposit insurance protection from £33,000 to £50,000, and eventually to guarantee all deposits, and to make this information widely available. It is interesting that in the US Lehman Brothers was allowed to fail, while in contrast US authorities facilitated the takeover of Washington Mutual by JP Morgan[599] followed by the rescue of Citigroup.[600] The difference being that Lehman was not a retail bank but an investment bank; the desire to protect consumers being the focus of policy drivers in this area. What emerges from the failures is the different nature of the GFC as it applied in different jurisdictions, in particular between the US and the UK. The US failure is clearly linked to risky investment banking decisions based on a range of products that were originally designed to diversify risk which due to poor risk management and an all-out desire for profit led to the collapse or near collapse of several US banking's most historic names, namely Lehman Brothers, Bear Stearns, and Merrill Lynch. These institutions, however, are generally classified as investment banks with little or no retail activity. Due to the conglomeration and the dominance of universal banking methodologies in the USA, the knock-on effect of risky investment activities was also felt on retail banks. In the UK the pattern was a little different where the failed institutions were very much part of the high street, or retail banking tradition. Names such as Halifax, RBS which owned the Nat West Brand,

[598] A Turner, The Turner Review: A Regulatory Response to the Global Banking Crisis (March 2009), FSA London
[599] Sidel et al, WaMu is seized, sold off to JP Morgan, in largest failure in US banking history, Wall Street Journal, 26th Septemebt 2008, wsj.com, full URL needed here and for foonote 265.
[600] Enrich et al, US agrees to rescue struggling Citigroup, Wall Street Journal, 24th November 2008, wsj.com

and Northern Rock are common features of the UK high street representing a different profile than in the US.

7.7 Risks in international banking

Alexander notes that studies have identified the systemic risks inherent in international banking.[601] These include, global systemic risks to the world financial system; safety and solvency risks that arise from imprudent lending and trading activity; and risks to depositors through lack of adequate insurance. All of these emerged through the GFC. The sub-prime mortgage collapse in the US created the global risk, or more accurately fuelled the engine that created risk, with US banks overexposed to the increasing numbers of loan defaults, and imprudent lending practices such as teaser rates in the US and the 125% loan to value Together mortgage in the UK,[602] coupled with securitisation and complex financial engineering, added to underlying weaknesses, and the ticking time bomb went off when they found that they could no longer fund day to day banking activities. This put the institutions themselves in precarious positions, risking depositors' savings, leading to 'a run'. Over exposures to risk and the failure to understand and manage that risk may precipitate a financial crisis that could result in bank runs, with Northern Rock a classic outcome. As Alexander notes:

> "Systemic risk is therefore a negative externality that imposes costs on society at large because financial firms fail to price into their speculative activities the full costs associated with their risky behaviour".[603]

[601] K Alexander, D Eatwell, R Dhumale, Global Governance of Financial Systems (Oxford 2006)
[602] See A Brummer, The Crunch: The Scandal of Northern Rock and the Escalating Credit Crisis (Random House 2008.
[603] K Alexander, D Eatwell, R Dhumale, Global Governance of Financial Systems (Oxford 2006), 133

This shows that systemic risk represents one of the fundamental aspects of the bank and financial services industry. The regulator and by extension the regulatory authorities were aware of the risks, they were known and identifiable, yet failed to take appropriate action to mitigate the effects.

7.8 Failure and the consolidated model

There were significant concerns with the proposals for single consolidated model among academic commentators. Alcock had noted that the danger in the new regulatory regime was a possible misunderstanding of the previous process.[604] Alcock opined that the there was a wide belief that the previous process of self-regulation had been the root cause of the scandals that had pervaded the FSA 1986 regulatory regime, but that there was fear that the 1997 reforms would impose an "inappropriately high level of standardised regulations on the whole financial services sector";[605] something they were not used to. Alcock's analysis focuses on the protection of consumers and lacks the focus on systemic risk issues, which were the underlying cause of the GFC. The consumer protection focus was born from the scandals that affected consumers, whereas past banking failures such as BCCI and Barings tended to centre around commercial institutions with minimal impact on public consumers; the impact of commercial banking failure is usually felt over the longer term and behind the scenes.

Accountability was a clear concern with the new regulator from the start and was borne out in the impact of the GFC. Lomnicka had noted possible dangers with the FSA's "enormous size"

[604] A Alcock, A Regulatory Monster, (1998), Journal of Business Law, Jul, 371
[605] Ibid.

and its "wide scope and its monopoly position".[606] She noted that proper management structures would be needed to avoid "bureaucratic problems associated with its size"[607]. At its inception, the FSA had 2,000 employees and would be responsible for supervision and regulation of around 10% of the UK GDP.[608] Alcock focused on the size of the regulatory responsibilities of the FSA, taking on direct responsibility for 10,000 financial services firms. He questioned why such a regulatory monster was being created in the UK.[609] This analysis misses a central point. The FSA was not large enough to competently take on the role required of it. On the face of it 2,000 employees sounds a big number but when set in the context of regulating a market sector worth nearly 10% of the UK economy it is a very small number. Both Alcock and Lomnicka are correct to be concerned with the creation of a bureaucratic friction, but the correct balance must be struck. Both commentators note the enormity of task that the reforms brought, particularly with the addition of supervision and regulation of banks added to the workload of the FSA, but then criticise its size. It is evident that there was widespread misunderstanding of what was needed from bank and financial services regulation. The focus was on firm specific actions to prevent individual failure, rather than focusing on the interconnections between them to prevent systemic failure, notwithstanding that from the outset the FSA stated that its role was not to guarantee against failure.[610] This is an important point that further evidences the regulatory failure of the FSMA 2000 regime, and further points to the why regulate question. The FSA stated that it was not aiming for a zero-failure approach, but this seems only to be directed at investment banking where retail banking activities were not affected. Where retail customers would be affected the actions of the regulatory authorities would suggest an approach closer to zero failure, but this was based on the possibility of

[606] E Lomnicka, Reforming UK Financial Services Regulation: The Creation of a Single Regulator, (1999) Journal of Business Law, Sep, 480
[607] Ibid
[608] A Alcock, A Regulatory Monster, 1(998), Journal of Business Law, Jul, 37
[609] Ibid
[610] FSA, New Regulator for a New Millennium.

systemic collapse. What is missing from the FSA's early pronouncements is sufficient depth of engagement on systemic protections. The commentary on its statutory objective of maintaining market confidence lacked focus on the systemic nature of that objective.

7.9 The FSA – not truly a single regulator

While the FSA was the single super-regulator with operational responsibility for regulation and supervision, it is misnomer to state that they acted, or failed to act, alone. Indeed, it is inaccurate to fully characterise the UK regulatory regime as a consolidated, single regulatory process. At no point was there actually a single regulator, but instead a tripartite regulatory structure involving multiple high-level institutions was in place. The FSA discharged its functions within this tripartite relationship alongside the Bank of England and HM Treasury. None of the authorities acted with sufficient strength to prevent the spread of contagion of the GFC 'perfect storm' that impacted the banking industry and the wider economy. Banks may have been able to weather an ordinary storm, but what emerged in the second half of 2007 was much more than an ordinary storm. It is unclear whether any regulatory system would have fared better at preventing or lessening the impact of the GFC and that even if a twin-peaks regulatory architecture had been in place there is no guarantee that it would have been effective. However, a more alert, a more proactive and more forceful regulator would have been able to temper the severity of the GFC.

The tripartite regime and the way in which it operated has come in for the strongest criticism. The way in which the tripartite authorities operated is an underlying reason why the regulatory regime failed. That the FSA as the lead organisation was chief architect of the regulatory failure is difficult to dispute by failing in its appreciation and application of its regulatory objectives, with particular emphasis on systemic risk within the banking system. The problem emerges from the issue that when you have three organisations in charge, it is likely that no-one is in control. It is apparent that each of the tripartite authorities abrogated responsibility to the others, or at least did not fully understand their role within the structure. Indeed, the structure would seem to obscure the roles, responsibilities, and accountability of each authority, and that it comprised an "uncomfortable straddling of roles" between the tripartite authorities.[611]

The Memorandum of Understanding between the authorities was meant to ensure that each authority understood its role within the regulatory structure. What emerged was clear evidence of poor operational communication between authorities preventing them from discharging their functions effectively, possibly due to political interference. Tomasic adds that the tripartite arrangement did not support the engagement of a timely and effective response to the crisis as it emerged.[612] The evidence may suggest a form of 'turf war' between the tripartite authorities that fostered a form of competition between organisations that should have been coordinating and cooperating with each other.

7.10 FSA and the realisation of an incorrect focus

The evidence to suggest that the regulatory structure erred in its approach can be found in the early responses to the GFC. The initial response to the crisis was the enactment of legislation to allow the UK authorities to take Northern Rock into temporary public ownership by virtue

[611] A Hudson, Law of Finance, (Sweet and Maxwell 2009)
[612] R Tomasic, Corporate rescue, governance and risk-taking in Northern Rock: Part 1 (2008, Company Lawyer, 29(10); R Tomasic, Corporate rescue, governance and risk taking in Northern Rock: Part 2, (2008) Comp Law, 29(11), 330

of the Banking (Special Provisions) Act 2008, followed by placing this on a permanent footing through the Banking Act 2009. The Banking Act 2009 provided UK authorities with a range of resolution options with a view to either avoiding the collapse of a bank by facilitating a buyout by another bank,[613] transfer to a Bank of England bridge bank,[614] or temporary public ownership,[615] alongside additional measures to take a bank through a modified form of administration.[616] The key concern for the Banking Act 2009 is depositors, not merely creditors, which has become the focus of traditional administration and insolvency processes. Until the 2008 Special Provisions Act the only insolvency mechanism available to banking authorities were those available to companies in general as provided for in the Insolvency Act 1986 (as amended). By its very nature, insolvency occurs as a result of corporate failure, that in a technical sense the corporation's assets are no longer sufficient to meets its liabilities and unlikely to be capable of doing so, and therefore, the failure of the organisation is unlikely to leave it with sufficient assets to repay creditors for goods and services advanced. Banks are corporations in many senses and are subject to company law, however, banks are also different. Banks will have creditors in the same way as ordinary corporations, but they also have a special kind of creditor, depositors. The difficulty is that under ordinary insolvency provisions bank depositors, the customers, would have been treated as ordinary unsecured creditors. That the UK did not have provisions to deal with bank insolvency was a serious lacuna in the UK government's corporate governance strategy, which would have allowed the relevant authorities to have acted more quickly than they were able.

[613] Section 11 Banking Act 2009
[614] Section 12 Banking Act 2009 – see above how to cite legislation.
[615] Section 13 Banking Act 2009
[616] Part 3 Banking Act 2009

The government tasked the new FSA chairperson Lord Turner[617] to review the FSA's performance putting forward several recommendations. His review called for a systemic approach and a more intrusive and stronger supervisory approach from the FSA, one that focused more on systemic risk, including recommendations on quality and quantity of capital. His review in turn led to a White Paper, Reforming Financial Markets published in July 2009. The primary proposals being a new Council for Financial Stability to replace the Standing Committee, strengthening the governance arrangements and enhancing the FSA's power, announcing how the regulator was to reform it approaches its regulatory functions. The White Paper states:

> "It is clear from the global scale of this financial crisis that there needs to be a major reform of the way that banks are managed and regulated".[618]

Key to the proposals was the announcement of the intention to legislate to provide the FSA with an explicit financial stability objective, stating that "the FSA has no specific objective for financial stability, although maintaining stability is a fundamental component of maintaining confidence in the financial system".[619] This reform was unnecessary with a statutory objective to maintain financial stability already contained in the FSMA 2000, providing further evidence that it was a failure of the regulator rather than the regulations; the FSA as supervisor and regulator failed to spot the crisis and failed to act. The rush to insert a new objective echoes the concerns of Alcock in that the government, dealing with the fallout of bank failure in a regulatory regime designed by them, needed to be seen to be doing something. The focus of the new thinking in the immediate aftermath was clearly one of 'get tough', of hitting the

[617] Turner Review: A Regulatory Response to the Global Banking Crisis (March 2009), FSA London
[618] HM Treasury, Reforming Financial Markets (White Paper, Cm 7667 July 2009)
[619] Ibid

financial sector with an overall stronger regulatory response, echoing Hupke's' comments in respect of the consequences.[620]

That this was a knee jerk, 'seen to be doing something' action is evidenced in the FSA's 'A New Regulator for A New Millennium',[621] the document that introduced the FSA to the financial services sector, where it states:

> "Market confidence is fundamental to any successful financial system; only if it is maintained will participants and users be willing to trade in financial markets and use the services if financial institutions".[622]

It further states:

> "Maintaining this confidence involved in our view preserving both actual stability in the financial system and the reasonable expectation that it will remain stable".[623]

This is achieved through:

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[620] E Hupkes, Regulation, self regulation or co-regulation, (2009), Journal of Business Law, 5, 427

[621] FSA, A New Regulator for A New Millennium, FSA, London.

[622] Ibid

[623] Ibid

> "Preventing material damage to the soundness of the UK financial system caused by the conduct of or collapse of firms, market or financial infrastructure".[624]

This proves that the macro-economic focus of regulation was a consideration that the FSA was undertaking some time before the GFC and yet failed to understand the overall impact. These words are contained in the section outlining the operation of section 3 FSMA 2000. This suggests that the FSA did have an obligation to protect the stability of the financial system, and therefore, to watch for systemic failure. By its own admission the FSA's objectives are "focused on consumers",[625] proving that the regulator applied an incorrect regulatory focus that caused them to insufficiently understand to take appropriate action:

> "The FSA will aim to maintain a regime that ensures as low an incidence of failure of regulated firms and markets (especially failures which have a material impact on public confidence and market soundness) as is consistent with the maintenance of competition in the markets. This in turn requires careful evaluation of the probability of any collapse, and its likely impact on the financial system".[626]

This further shows that the FSA had a statutory objective to monitor systemic risk and consequently a responsibility for financial stability. This provides further evidence that it was

[624] Ibid
[625] Ibid
[626] Ibid

not the regulations that caused the problem but failure to apply them by the regulator. The public commentary on section 3 suggests that the FSA had a statutory obligation to ensure that there were sufficient levels of market confidence to ensure investor protection and stability, and that market confidence by its nature included market stability. This would be achieved by managing systemic risks that could have an impact on the UK economy, arguably on, confidence, flows from the other, stability, and vice versa.

It is surprising that this financial stability focus was missed. There was a four-and-a-half-year period between the policy announcement and the N2 operational date, providing sufficient time for the regulator to fully understand its statutory obligation. A clear problem seems to revolve around a confusion of what Section 3 of the FSMA was supposed to do. The problem stems from the section itself which focuses on maintaining confidence but does not specifically note financial stability and this lack of direct reference to stability created a 'blind spot' in the regulator's viewfinder. It is likely that there was an assumption that the section covered the financial stability element. The gap in the regulatory application only surfaced following the post GFC analysis.

At the time of the passage of the Bill there was discussion on the need for a more specific and direct financial stability objective. Alcock noted the concerns of the Joint Committee on Financial Services in their first report on the Bill, when the question of whether Section 3 would cover systemic risk issues were raised. The Joint Committee report noted that systemic risk was not mentioned specifically which is understandable on a plain text reading of the section. The objective contained in the section refers to maintaining confidence in the financial system which Alcock felt that, while not specifically referring to stability, the objective must cover systemic risk. Blair *et al* noted “in view of the overarching importance attached to the systemic stability objective of regulation it is, perhaps, surprising that is only implicit in the market confidence objective”.[627]

The Joint Committee wanted the section amended to read “maintaining confidence in the soundness of the financial system”[628] and “should be expanded to include a reference to the management of systemic risk in collaboration with the Treasury and the Bank of England”. Blair et al[629] added that government ministers were not “persuaded”[630] by this argument, notwithstanding that there were over 1,500 amendments during the passage of the Bill; they claimed that the Memorandum of Understanding between the tripartite authorities sufficiently covered the issues, and that section 3 would do the job[631]. In hindsight it seems evident that that the Memorandum of Understanding hindered the operation of the regulatory authorities. The lack of understanding that the market confidence objective was also the market stability objective provides evidence of why the FSA has come in for so much criticism following the nationalisation of Northern Rock, as was noted in the House of Commons Treasury Committee report, The Run on the Rock.[632]

A further issue with the pre-GFC regulatory system was also noted as the new regulator came on stream, namely accountability. Mistry[633] noted a concern of the move from the delegated

[627] Ibid
[628] Joint Committee for Financial Services and Markets, First Report, HC 328-II, 14th May 1999, para 45.
[629] M Blair, L Minghella, M Taylor, M Thrieplan, G Walker, Blackstones Guide to the Financial Services and Markets Act 2000 (2001 Blackstone Press)
[630] Ibid
[631] Ibid
[632] House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.
[633] Hiren B Mistry, The Loss of Direct Parliamentary Control. Does That Mean a Financial Services Regulator Without Accountability, 2001, Company Law, 22(8), 246-248.

accountability present in the FSA 1986 system, whereby the regulatory powers were the responsibility of the relevant Secretary of State who then delegated those powers to the myriad of individual regulators, however, under the FSMA 2000 the regulatory powers are conferred directly on the FSA, removing the direct link to Parliament. Mistry satisfies this concern by noting that it was the regulator that took responsibility for failures and not the minister. In addition, the FSMA 2000 structure can increase accountability at the FSA as it was placed directly at the heart of the regulatory structure, creating a clear separation of duties and responsibilities between HM Treasury and the FSA. Further, as part of the tripartite system, HM Treasury operated as a component of the overall regulatory structure and had the power to remove or appoint the entire governing board of the FSA. While these created lines of accountability, it still exposes an overall accountability gap. The regulatory structure is, at least in part, a process driven by political considerations and as such there should be some line of accountability to the policy makers.

7.11 Bank Resolution: The Banking (Special Provisions) Act 2008 and Banking Act 2009

In the UK the last true run on a bank was during the Overend Gurney collapse in the latter half of the nineteenth century.[634] The UK retail banking sector has otherwise generally been an example of stability, and while mergers and takeovers have occurred in the post-war years, failure has not been a feature, save for some individual bank failures such as BCCI and Barings, but without the kind of systemic fallout characterised by the GFC. The banking crisis of 2007-9 provided clear evidence that the UK had a serious deficiency [635] in how it responded to banks

[634] R Sowerbutts, the demise of Overend Gurney, Bank of England Quarterly Bulleting, 2016, Q2, https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2016/the-demise-of-overend-gurney.pdf?la=en&hash=04B001A02BD5ED7B35D4FB3CF1DDC233A1D271BD, last accessed 1/12/20

[635] I MacNeill, The trajectory of regulatory reform in the UK in the wake of the financial crisis (2010), European Business Organisation Law Review, 11(4), 483

and a banking system under severe stress, what is often termed 'crisis management'.[636] The traditional position whereby the Bank of England as lender of last resort could step in quietly with liquidity support was no longer an available mechanism as a result of the transparency requirements of the FSMA 2000, and in any event the scale of the crisis as it emerged through 2007 was such that it was arguable that lender of last resort facilities were insufficient to meet the needs of the banking system as a whole, with some total support to the banking sector in the region of £1 trillion.[637] The issue faced by the regulator and by the government with regard to Northern Rock, and other banks was that of a bank about to fail, that is to become insolvent, and what provisions existed to deal with such an outcome.

Why did the regulatory authorities not let banks fail in the same way in which failure of the corporate form is seen as a normal part of the business cycle? Faced with the failure of Northern Rock, why did the government step in to rescue what was a relatively small bank.[638] The reason is reiterated by Tomasic[639] when he notes "banks are special"[640] and unlike other companies[641]. He posits that access to the essential services provided by banks means that governments cannot allow such entities to fail, including smaller operations such as Northern Rock. However, the only real option open to the authorities at the time was the standard corporate insolvency regimes available under the Insolvency Act 1986 and the Companies Act Year , in particular administration and winding up; however, these mechanisms are focussed

[636] I MacNeill, The trajectory of regulatory reform in the UK in the wake of the financial crisis (2010), European Business Organisation Law Review, 11(4), 483, 495
[637] M King, Speech to Scottish Business Organisations (2009) 20th October 2009
[638] See history of Northern Rock O Akselu, J Gray, Andrew Cambell, in J Gray, O Aksely eds, Financial Regulation in Crisis (Edward Elgar 2011); see also House of Commons Treasure Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.
[639] RTomasic, Corporate rescue, governance and risk-taking in Northern Rock: Part 1 (2008) Company Lawyer, 29(10)
[640] Ibid
[641] Ibid

on creditor interests and not depositor concerns.[642] By using the existing insolvency regime it will lead to an instance where the company is placed in suspended animation,[643] even if this is only temporary; such a suspension of the organisation's operation would have had a significant impact on the bank's customers, preventing access to current accounts and ATM facilities, in effect the cutting off of banking services which would have significant impact on individuals and business organisations.

The lack for a bank specific insolvency mechanism was a serious lacuna in the law in the period immediately prior to the crisis. Undoubtedly this was because such wide-ranging tools were not deemed necessary. While bank failures are not uncommon, and the history of banking is replete with instances of bank collapse or near collapse, it is arguable that authorities had not faced a bank insolvency of this nature in the modern era. The significant difference, as Tomasic notes, is that the largest occurrences of bank failure happen in the investment banking sphere, with BCCI and Barings cited as examples. [644] However, even these are exceptional examples as the failure in these two institutions was the result of wide-spread fraud and other illegal activity in the former and the actions of a single, poorly controlled trader in the latter. Collapses such as Johnson Matthey, BCCI and Barings would have a limited effect on both the economy as a whole and on individuals.[645] While these were major collapses in their own right the impact was containable, they were not sufficiently large enough institutions and were not as interconnected to create the contagion related spill overs that characterise the GFC. It is also evident that even in the relatively short time between these failures and the GFC banking had

[642] See R Goode, Principles of Corporate Insolvency Law (4th edition, Sweet and Maxwell 2011)
[643] The process for Administration under the Insolvency Act 1986 is to put in place a moratorium on credit claims while a solution is worked out
[644] R Tomasic, Corporate rescue, governance and risk-taking in Northern Rock: Part 1 (2008, Company Lawyer, 29(10)
[645] Classic Financial and Corporate Scandals, https://projects.exeter.ac.uk/RDavies/arian/scandals/classic.html, last accessed 12/01/21

changed. The increasing use of innovative financial products and the increasing use of financial engineering techniques and technology in financial services and beyond has changed the way in which banks search for yield. The collapse of Northern Rock, even though a relatively small player,[646] would have a significant impact on many what may be termed 'ordinary people'. Given the changing nature of banking, especially in relation to their interconnectedness, the impact of bank collapse is considerably more severe than in the past. Northern Rock's growth was not based on organic sound business practices, but on the use of innovative products that on the face of it reduced risk, but in effect had the opposite effect, and in addition to support this growth even further Northern Rock relied on wholesale inter-bank lending to support its day-to-day operations. Northern Rock was an example of an aggressive expansionary agenda within financial institutions that did not understand the risk profiles they were developing.

In *United Dominions Trust v Kirkwood,*[647] and Commissioners of the *State Savings Bank of Victoria v Permewan, Wright & Co,*[648] Denning MR and Isaacs J respectively laid out what could be described as the traditional approach to banks and banking, namely accepting customer deposits, and providing cheque accounts that can be drawn on them, and lending to others based on a reasonable leverage rate on those deposits. This notion of the nature of banking is one that would no longer be recognisable on the modern high street, and while the above forms a core element of a bank's operation it now only forms a part of what a bank will offer. It is no exaggeration to describe the modern retail or high street bank as a 'one-stop-shop' for financial services, providing a wide range of financial services and products to their

[646] House of Commons Treasury Committee, The Run on the Rock, Fifth Report, Session 2007-8, Volume 1.
[647] [1966] 2 QB 431
[648] (1915) 19 CLR 457

customers, such as personal investment planning, insurance, and estate planning. In addition, the modernisation of banking processes has led to the exponential rise in the use of debit cards, contactless payment, and a wide range of electronic banking options. Use of cheques and cash has been declining steadily over the last few decades, resulting in increased reliance on banks and particularly banking services as increasing numbers of bank customers move to online banking.[649]

This change in banks and how they are perceived by society changes the nature on how they should be viewed when they are under stress. The impact that a bank under stress or an insolvent bank will have a wide-ranging impact on customers. The failure of a retail bank means the inaccessibility of several key bank operations; ATM machines will cease to operate, cheques will not clear, direct debits and standing orders will not process and salary payments will not be made and received. This does not just impact the individual customer but will have wider economic and socio-economic issues also. The impact on small business will be just as significant, if not amplified, as funding access and access to funds will impact on the business and employees equally. The issues identified in the preceding paragraphs outline why measures used in past bank failures were not suitable for the crisis that presented itself in the second half of 2007. The wider impact resulting from the failure of a retail/high street bank required a stronger and more flexible set of measures that could be provided by the lender of last resort or from corporate insolvency provisions under the Companies Acts[650] or Insolvency Act 1986, including the more rescue-based additions of the Enterprise Act 2002.

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[649] The Decline of cash in the UK – in Charts, BBC News Online, 6th June 2019); https://www.bbc.co.uk/news/business-48544695, last accessed 10/10/20; While there is still undoubted support for having a physical branch network there is increasing use of online banking.

[650] At the time of the Northern Rock failure the Companies Act 2006 had received Royal Assent, but much of the Act had not yet come into force.

When the trouble at Northern Rock emerged it quickly became clear to authorities that they did in fact need a wider range of measures to deal with a bank that was failing, measures needed to bring a bank into public conservatorship, or more accurately nationalisation. The initial response to this was delivered via the Banking (Special Provisions) Act 2008 which gave the UK government the necessary tools to allow the nationalisation of the Northern Rock, and later the Bradford and Bingley building society.[651] The Act allowed the Financial Services Authority (FSA) the power to nationalise the Northern Rock on the basis of maintaining systemic stability[652] and protecting the public interest[653] where financial assistance had been provided by HM Treasury initially through the Bank of England and then more directly.[654] Section 3 of the Act provided HM Treasury to transfer the shares of the Northern Rock to an entity controlled by HM Treasury,[655] with HM Treasury announcing on 22nd February 2008 that all shares had been acquired by virtue of the Act.[656] To five effect to this the government set up UK Financial Investments Limited, a company with HM Treasury as sole shareholder to manage the assets of Northern Rock and the other banks that were given assistance during the GFC; subsequently becoming part of UK Government investments in March 2018.[657]

The Banking (Special Provisions) Act 2008 was not designed to be a permanent solution, the timeline between introduction to Parliament and Royal Assent was a mere 48 hours giving insufficient time to fully scrutinise such a significant provision, that has the power to effect

[651] A Arora, 'Banking Law' (Pearsons, 2013)
[652] Banking (Special Provisions) Act 2008, Section 2(2)(a)
[653] Banking (Special Provisions) Act 2008, Section 2(2)(b)
[654] A Arora, 'Banking Law' (Pearsons, 2013)
[655] UK government vehicle to take over NR.
[656] Anu Arora, 'Banking Law' (Pearsons, 2013)
[657] https://www.gov.uk/government/organisations/uk-financial-investments-limited, last accessed 21/01/21

individual property rights in such a draconian way.[658] The Act's sunset clause[659] provided for the Act to lapse on 21st February 2009 and replaced by the provisions of the Banking Act 2009, which had received Royal Assent on 12th February 2009. The Banking Act 2009 places the UK's bank resolution mechanisms on a permanent footing, providing regulatory authorities with what Arora[660] terms a "regulatory toolkit"[661] of options to resolve a bank in distress. The Act provides several options to a bank that is facing insolvency, although insolvency itself is a last resort. The focus of the 2009 legislation is on rescue and resolution and is triggered when a regulated institution[662] fails or is likely to fail to meet certain threshold conditions set out in the legislation,[663] key being lack of appropriate resources, including but not limited to financial. Singh notes, however, that the primary reason for bank failure will be mismanagement within the senior management group.[664] This argument when applied to Northern Rock, HBOS and RBS resonates, confirmed by the FSA reviews of the failures, with the decisions of the boards at all three of these institutions creating the culture and environment that led to their full or partial failure. It is clear from the GFC that this was a factor, the actions and poor understanding of the risk associated with such actions resulted in banks' inability to respond to the wider negative economic events emerging in the timelines immediately preceding the GFC.

The resolution measures available rank in order on the basis of their ability to rescue the troubled financial institution, as defined in section 2 of the 2009 Act, namely those institutions

[658] R Tomasic, The Rescue of Northern Rock: nationalisation in the shadow of insolvency (2008) Corporate Rescue and Insolvency, August 2008; http://www1.lexisnexis.co.uk/2008/magazines/articles/CRI.pdf, last accessed 23/01/21
[659] Section 2(2) Banking (Special Provisions) Act 2008
[660] A Arora, 'Banking Law' (Pearsons, 2013), 124
[661] R Tomasic, The Rescue of Northern Rock: nationalisation in the shadow of insolvency (2008) Corporate Rescue and Insolvency, August 2008; http://www1.lexisnexis.co.uk/2008/magazines/articles/CRI.pdf, last accessed 23/01/21
[662] Part 1 Banking Act 2009
[663] Section 7 Banking Act 2009; The General conditions.
[664] D Singh, The UK Banking Act 2009, pre-insolvency and early intervention: policy and practice (2011) Journal of Business Law, 1, 20

having Part 4A permission by virtue of the FSMA2000, but excluding building societies,[665] credit unions and certain other institutions specified by HM Treasury.[666] The undoubted focus of the Banking Act 2009 is the change in attitudes to depositors in stark contrast to the traditional insolvency measures available when Northern Rock ran into trouble. Instead of treating bank depositors as ordinary unsecured creditors, the focus of the 2009 provisions is to elevate the depositors to a status akin to preferential creditors protected above all others. This reflects the notion that banks are special and cannot be treated the same as traditional corporate entities. [667]

The resolution mechanisms comprise a number of options triggered on failure or likely failure to meet the noted thresholds, with the last resort being temporary public ownership – nationalisation.[668] The first of the options is arguably the one that regulatory authorities hope will be the one that is used, namely the facilitation of a private sector purchase of a troubled bank, similar to that which led to HBOS becoming part of the Lloyds Banking Group.[669] Clearly this is the preferred option as it has the least impact on potential systemic failure, and would suggest that the institution in question is fundamentally sound at its core and with some efforts the substantial 'rump' of the institution will survive in the medium to long term. It is worth noting that in advance of this event it is likely the Bank of England will have been involved in its role as Lender of Last resort (LoLR), with some liquidity support to the troubled institution having been in place in advance of the triggering the resolution mechanism. The

[665] Covered in part by Section 84 Banking Act 2009.
[666] RTomasic, Creating a template for banking insolvency law reform after the collapse of Northern Rock: Part 2, (2009 Insolvency Intelligence, 22(6), p81). Interestingly Tomasic notes that so called shadow banks are not covered by the legislation yet they were arguably a major contributor to the GFC.
[667] R Tomasic, The Rescue of Northern Rock: nationalisation in the shadow of insolvency (2008) Corporate Rescue and Insolvency, August 2008; http://www1.lexisnexis.co.uk/2008/magazines/articles/CRI.pdf, last accessed 23/01/21
[668] Section 11 Banking Act 2009
[669] Lloyds TSB seals £12bn HBOS rescue, The Financial Times (London 18th September 2008)

trigger is pulled when the bank, with Lender of LoLR support, will not be able to resolve itself and some other intervention is the only real option. The second resolution mechanism is to create a bridge bank within the Bank of England and transfer the assets of the failed institution to that bridge bank.[670] This mechanism is to be used where the failure is of a more significant level than the previous mechanism where the state of failure is so severe that it is unlikely to attract a private sector purchaser until considerable restructuring has taken place in the failed institution. The aim of this mechanism is that the restructured organisation will be sold to a provide sector purchaser.

Chiu and Wilson[671]refer to the Banking Act provisions as the 'pioneering piece of legislation on bank crisis management and resolution"[672] which was then followed by provisions in the US by Title II of the Dodd-Frank Act 2010, and the creation of the Orderly Liquidation Authority.[673] The UK bank resolution system created by the Banking Act 2009 created the template for European harmonisation on crisis management and resolution, supported by the work of the Financial Services Board (FSB) which introduced the "Key attributes of effective resolution regimes for Financial Institutions" [674] in 2011 which were the template for the EU's Bank Recovery and Resolution Directive 2014[675] to which the UK amended the Banking Act 2009 by means of the Bank Recovery and Resolution Order 2014.[676]

[670] Section 12 Banking Act 2009
[671] I H-Y Chiu, J Wilson, Banking Law and Regulation (Oxford 2019)
[672] Ibid, 605
[673] Dodd-Frank: Title II – Orderly Liquidation Authority
[674] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011) https://www.fsb.org/wp-content/uploads/r_111104cc.pdf, last accessed 24/01/21
[675] Directive 2014/59/EU
[676] SI .2014/3329

7.12 Bail-in

The latest addition to the resolution mechanisms is contained in Section 12A[677] of the Banking Act 2009, as a result of the BRRD, namely the Bail in option which involves shareholders being divested of their shares, creditor clams being cancelled with the shared then being transferred to affected credits where appropriate, or the shares can be transferred to a potential purchaser.[678] As Alexander notes that bail-in provisions are "intended to address the moral hazard problems of so-called too big to fail financial institutions and the unfairness of having taxpayers subsidise excessive private sector taking".[679] Chiu and Wilson[680] envisage that the bail-in tool will be utilised where the troubled bank can be recapitalised within the resolution mechanisms processes, further referring to the process as a form of "private sector burden sharing".[681] It seems clear that the intention of bail-in is to be used prior to the other resolution mechanisms available so that resolution of the bank can take place as an 'internal matter' as much as is possible. As noted above Bail-in is a tool specifically directed at the too big to fail paradox associated with SIB institutions, making the first port of call the shareholders, not the taxpayers as was seen in the bailout phase.

The resolution mechanisms that have emerged are of fundamental importance to the regulatory debate and the issue of systemic risk, with the addition of the bail-in tool a very useful addition. In dealing with the too big to fail paradox dealing with the orderly insolvency of a bank is the first and most essential step. A strong proactive resolution scheme supported by a dynamic

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[677] Inserted via Schedule 7 Financial Services (Banking Reform) 2013 and Article 20 The Bank Recovery and Resolution Order 2014 SI2014/3329

[678] HM Treasury, Bail-in Powers implementation; https://www.gov.uk/government/consultations/bail-in-powers-implementation-including-draft-secondary-legislation/bail-in-powers-implementation

[679] K Alexander, Principles of Banking Regulation (Cambridge 2019)

[680] I H-Y Chiu, J Wilson, Banking Law and Regulation (Oxford 2019)

[681] Ibid, 642

responsible resolution authority will allow a simplified regulatory structure to emerge with greater transparency as a corollary.

7.13 Conclusion

The above discussion shows that it is difficult to place the blame solely on UK legislation from preventing the collapse of the US housing market from infecting the UK banking industry. The criticism has primarily focused on how the regulator operationalised those regulations and, from the evidence, the regulator was found wanting. It is clear from the Parliamentary committee reports, and academic commentary, that the criticism has been levelled at the FSA as the single regulator and the tripartite regulatory regime within which it operated, putting in doubt that a single regulatory regime existed. The evidence suggests that there was no catastrophic failure of the regulations themselves, instead pointing to a failure of application of the regulations as originally designed by policy makers which, if properly applied, may have at least softened the severity of the GFC in the UK. The evidence suggests that the architecture of bank and financial services in the UK was operated in such a way as to make it difficult for the detailed regulation to be applied effectively. The tripartite system employed prevented clearly defined lines of authority from developing so that in effect no one part of the regulatory structure was clear as to their role, leading to initial delays followed by haste. For a single regulatory system to have prevailed, all parties within the system should have been provided with clear guidance of the role they were to play within the system, especially the role required of them in times of regulatory crisis. In addition, the FSA should have been provided with clear guidance, with the other regulatory authorities having knowledge, that it was the lead authority with overall responsibility for regulation and supervision of the financial services sector.

The evidence that emerges from the crisis does not suggest a reason for wholesale changes to the structure, but for a full and frank reflection of what happened and for lessons to be learned. The HM Treasury Select Committee did not feel that wholesale changes should follow and that there was no pressing need for significant amendments to the single regulatory process and architecture. In internal review, the FSA identified many of its failings and looked at strategy to avoid repetition? It identified that a 'light touch' regulatory culture had emerged following the creation of the FSA and implementation of the FSMA 2000, probably because of the political environment in which the regulator found itself. This was contrary to the concerns expressed prior to FSMA 2000 enactment where it was felt that a new regulator with strong ambitions to avoid the failures of the past would need to bring a heavy hand to establish credentials.[682]

The tripartite system lacked clarity of purpose, with each authority failing to understand the specifics of their role within the system. The regulatory approach was micro-focused, that is it focused on individual firms rather than the system, the macro-focus. The FSA was very inward-looking in its approach to regulation to be able to meet its overall regulatory and statutory obligations. It seems evident that a turf war of sorts had developed between two key elements of the tripartite system, the FSA, and the Bank of England. The Bank of England had been the central component of the UK financial system regulatory architecture with a strong

[682] A Alcock, A Regulatory Monster, (1998) Journal of Business Law, Jul, 371,

and integrated relationship with the banking sector, and banking culture. The expansion of financial services products available to a wider range of the population than ever before required a new form of protection, a consumer protection regulator. While the FSA became the single regulator the Bank of England remained the lender of last resort. This potentially caused confusion and animosity between the two lead regulators, in addition to the political fallout from removing supervision from the Bank of England. The failure of the Bank of England's approach is a failure of the tripartite regime generally in that there was poor communication between the relevant authorities at key times when there was opportunity for action. The authorities were aware of signs that should have led to a conclusion that banks were are at risk, but the inefficiency of the regulatory system resulted in a weak response.

The conclusion from analysis of the regulatory architecture in the period preceding the failure of Northern Rock is that the government missed an opportunity to develop a more comprehensive and effective regime. The regulation did not fail overall, the regulator did. It did not have sufficient focus on micro-prudential regulation supervision of systemically important financial institutions and did not appreciate its responsibility at the macro-prudential level, to ensure systemic stability. In hindsight it may have been appropriate to have left bank regulation and lender of last resort in the same institution, the Bank of England. With its function of interest rate setting and micro and macro prudential responsibility as well as liquidity responsibility, this would have provided a more holistic approach to supervision and regulation. This would be closer to the twin-peaks regime discussed prior to choosing the consolidated model and the structure introduced by the new coalition government following the May 2010 General Election.

The difficulty in the post-crisis debate is to separate out from the background the actual reasons for such widespread failure, or more accurately why the regulatory architecture in place failed to insulate the UK economy against the effects of the collapse of the US property bubble[683]. The position so far in this chapter has been looking to understand whether it was the regulations, or the regulator that failed to perform as expected and needed, with both elements being a product of the FSMA 2000; the regulator owing its existence, authority, and power to create the detailed regulation held within the complex legislative provisions of the statute. At this stage it is useful to note the environmental issues in which the regulator operated and whether a more general failure to control the environmental issues, the macro-economic policy, left the regulator with an impossible task. While this explored elsewhere it is essential to note the free macro-economic environment that prevailed in the immediate time preceding the GFC. It is clear from the reform programme that followed the General Election of May 2010 that blame has been apportioned to both the regulator and the legislation, with subsequent significant reforms made. This criticism has led to a rush to reform the legislation and the regulatory architecture that may not have been required or needed further analysis and consideration. The programme of reform that continues 10 years after the 2010 General Election was a 'knee jerk' reaction to a public and media clamour to 'do or seen to be doing something', again driven by political ambition and ideology rather than a socio-economic analysis of what regulation should achieve and provide. This, therefore, casts doubt on whether the new structures and new regulators brought in following the GFC event will have any greater chance of success than predecessor regimes.

[683] K C Engel, P A Mcoy, The Subprime virus: Reckless Credit, Regulatory Failure, and Next Steps (Oxford 2011),

The chapter identifies a missing debate in the literature, namely identifying the link between the need for reform of regulation and the political influence that affected the design of the instant regulatory structure. It is clear from the analysis that need is often outweighed by political viewpoint, not only of the incumbent government but of wider economic thought and only when need becomes the priority will regulation meet its overall goal. The following chapter analyses the reforms that followed.

Chapter 8 The Post-crisis regulatory structure – A Knee Jerk Reaction?

8.1 Introduction

This chapter will critically analyse the structural regulatory reforms that have been implemented and any that remain to be implemented since the emergence of the global financial crisis (GFC). This chapter is anchored by the United Kingdom (UK) general election of May 2010 and focusses on the proposals made by the Conservative party in opposition and the reforms brought forward because of winning that election. Chapter 7 dealt with the initial reforms of the previous government, however, there is a cross reference of discussion and analysis between chapters 7 and 8. The key theme that emerges is a continuation of a 'knee jerk'[684], politically charged, reaction to the impact of the GFC and the subsequent widespread economic fallout,[685]with the UK economy shrinking 6% between the first quarter of 2008 and second quarter of 2009, the period of impact of the GFC, and taking the economy five years to return to the pre-crisis size.[686] The actions by policy makers was to react to the failure by calls for wholesale changes to regulation, without sufficient analysis of how the incumbent regulatory structure operated within the overall macroeconomic regulatory environment. The chapter will analyse those regulatory changes with reference to the question of why regulate to understand what the optimal structure should be. As with the pre-crisis the literature fails to fully analyse the links between regulatory design and political decision-making processes with

[684] See Chapter 5 for further discussion on the knee jerk response
[685] See W Grant, G K Wilson, The Consequences of the Global Financial Crisis: The Rhetoric of Reform and Regulation (2012 Oxford) ; K Hopkins, Signs of Recession: The impact on Britains real economy, The Guardian (Manchester, 13th October 2008); https://www.theguardian.com/business/2008/oct/13/economics-creditcrunch, last accessed 10/12/20
[686] Office for National Statistics, The 2008 Recession 10 years on, https://www.ons.gov.uk/economy/grossdomesticproductgdp/articles/the2008recession10yearson/2018-04-30, last accessed 12/01/21

the thesis seeking to fill that void. The chapter structure outlines the key issues raised by the reform debate and process.

8.2 The political environment

As noted in Chapter 7 the reforms to bank regulation and supervision that have taken place over that past 30 years have been driven by a political need [687] to be seen to be doing something, a response to the 'clamour of the electorate' to reform what many saw as a broken regime that failed to insulate the UK economy from external pressures and from poor risk judgements by global and domestic banks respectively. It was shown in the previous chapter, the government led by the Prime Minister, Gordon Brown had enacted some initial reforms to strengthen the regulatory regime that had come in for so much criticism.[688] Lord Turner who had taken over the chair of the Financial Services Authority announced the end of 'light touch' regulation,[689] and the implementation of an enhanced supervisory scheme for banks,[690] alongside the enactment of the Banking Act 2009 and the insertion of a financial stability objective into the Financial Services and Markets Act 2000 (FSMA 2000).

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[687] See for example E Ferran, The Break up the Financial Services (2011) Oxford Journal of Legal Studies, Vol31, No.3, 455

[688] Inserted Section 3A in the Financial Services and Markets Act 2000 giving the regulator a statutory obligation to ensure financial stability. It is argued in this thesis that the existing Section 3 already covered this requirement.

[689] A Turner, The Turner Review: A regulatory response to the global banking crisis, (2009) The Financial Services Authority, London, March 2009. See also L Elliot, Our touch will be heavier. We have to focus on the risks, The Guardian (Manchester 17th October 2008), accessed 17/10/08

[690] Ibid; See also S Crown, Turner Review and its impact on the future of banking, (2009) Journal of International Banking and Finance Law 5 JIBFL, 243

The general election of May 2010 brought the Conservative party led by David Cameron to power, in coalition with Nick Clegg's Liberal Democrats, and this signalled an extensive, if not revolution in regulatory reform of banks.[691] While in opposition George Osborne, as Shadow Chancellor, had signalled an intention to replace the single regulator in a tri-partite structure and tasked Sir James Sassoon with undertaking an independent review of the tripartite system of regulation.[692] The key result of the report is that the tri-partite regime failed[693] in its primary role and that a new view was needed. It is arguable that the Sassoon[694] report acted as a catalyst, inter alia, for the change that came following the 2010 general election and George Osborne's elevation to Chancellor of the Exchequer.[695]

8.3 The Rise of the Peaks – The new structure emerges

Chapter 7 illustrated that the focus of the regulation and supervision of banks and financial services prior to the GFC was based around the consolidated single regulator model providing overall responsibility for all supervisory and regulatory activity, operating within the tripartite system. The single regulator was the Financial Services Authority (FSA), supported by the other two signatories to memorandum of understanding within the tripartite system, the Bank of England, and HM Treasury.[696] The obvious rationale behind this structure was that all the expertise and experience required to effectively regulate and supervise the financial system can

[691] Rawlings P, Bank Reform in the UK: Part II – Return to the Dark Ages (2010) International Corporate Rescue, 10, While it may have been heralded as extensive and revolutionary much of the reform measures have been discussed for a number of years, Taylor M, Twin Peaks; a regulatory structure for the new century (1995), Centre for the Study of Financial Innovation.
[692] The Tripartite Review: A review of the UK's Tripartite system: A review of the UK's Tripartite system of financial regulation in relation to financial stability: Preliminary Report, (2009), The Conservative Party March 2009.
[693] See Chapter 7
[694] A Sparrow, Conservatives call for radical reform of financial regulation, The Guardian (Manchester 9th March 2009), last accessed 21/01/21
[695] P Rawlings, Bank Reform in the UK: Part II – Return to the Dark Ages (2010) International Corporate Rescue, 10
[696] Reference

be located within these three bodies. The FSA was to be the face of the regulatory regime, supported by the other two members of the tripartite system, through the communication process set out in the memorandum of understanding.[697]

A key conclusion from the research is that there are two clear primary aims of regulation, firstly there is the need to manage systemic risk so as to ensure overall financial stability is maintained within the system, in which the structure of regulation will dictate the approach that the regulators take to that process; and secondly it should protect consumers from certain actions of financial services providers and the actions of individuals within the financial services industry.[698] However, no matter what the structure or architecture of the regulatory regime is, if the regulators either do not have the correct tools or do not use the tools they have correctly then it is of little consequence what the structure actually is, whether it is twin peaks, single super regulator, or multiple regulatory bodies responsible for a single element of the system[699].

The initial responses to the crisis was the enactment of bank resolution provisions, initially though the Banking (Special Provisions) Act 2008 and subsequently the Banking Act 2009,[700] followed by an amendment to the FSMA 2000 to include a specific statutory objective giving the FSA responsibility for financial stability,[701] notwithstanding that such an explicit objective was dismissed during the passage of the Financial Services and Markets Bill.[702] The

[697] See Chapter 7
[698] The systemic risk function is the primary rationale for bank regulation. Other regulatory rationales will be met only if they operate within a safe, sound and stable system.
[699] As evidenced in the USA.
[700] See Chapter 7
[701] By insertion of Section 3A into Financial Services and Markets Act 2000
[702] See argument in Chapter 7

consolidated super-regulatory regime has been the subject of intense criticism,[703] and its operation within the tripartite regime was largely blamed for the failure to spot, communicate and prevent the global financial crisis from having the impact that it did have on the UK financial system and subsequently the UK economy.[704] The newly elected Conservative/Liberal Democrat Coalition government from the 6th May 2010 proposed significant reform to the single regulatory model, in effect its abolition.[705] The reforms were in fact a package that originated, not in the coalition government, but from Conservative Party policy worked out while in opposition;[706] it is difficult to really see the input from the Liberal Democratic Party coalition partner in the reforms, largely mirroring the pre-election promises of the Conservative shadow chancellor, George Osborne, and on becoming the chancellor of the Exchequer in May 2010 the programme of reform of the structure of bank and financial services regulation was quickly implemented. These reforms and the speed in which they were brought forward evidence the 'knee jerk' approach to amending the regulatory system in place during the GFC and were implemented too hastily, based on political expediency rather than from a full analysis of what was needed from the regulatory regime. As noted in Chapter 8 the post crisis regulatory system was the least open to regulatory capture theory[707] on the basis that public opinion was firmly of the belief that the banks were responsible for the GFC and were

[703] The Tripartite Review: A review of the UK's Tripartite system: A review of the UK's Tripartite system of financial regulation in relation to financial stability: Preliminary Report, (2009), The Conservative Party March 2009.
[704] K Hopkins, Signs of Recession: The impact on Britains real economy, The Guardian (Manchester, 13th October 2008); https://www.theguardian.com/business/2008/oct/13/economics-creditcrunch, last accessed 10/12/20
[705] A Sparrow, Conservatives call for radical reform of financial regulation, The Guardian (Manchester 9th March 2009), last accessed 21/01/21
[706] The Conservative Party, From Crisis to Confidence: Plan For Sound Banking: Policy White Paper (2009) Conservative Party, https://conservativehome.blogs.com/files/planforsoundbanking.pdf, last accessed 21/01/21 The Tripartite Review: A review of the UK's Tripartite system: A review of the UK's Tripartite system of financial regulation in relation to financial stability: Preliminary Report, (2009), The Conservative Party March 2009.
[707] See Chapter 5

calling for tougher measures, providing political 'cover' for far reaching regulatory reform which allowed such regulatory reform to proceed apace.[708]

The core of the reform proposal was the abolition of the consolidated regulatory model and replace with a 'twin-peaks' regulatory structure, in stark opposition to the previous governments intention in its report of responses to its Seventeenth Report of Session 2007-08, stating that "the Government remains firmly committed to its regulatory model, with the Financial Services Authority (FSA) as a single regulator of the financial system".[709] The premise underpinning twin peaks is the separation of two key components of supervision and regulation, namely prudential regulation, focussing on ensuring the safety and soundness of the system within which the regulated entities operate; and conduct regulation, focussing on the conduct of persons, firms and markets within the system to ensure that not only that there is safety and soundness within the markets but that they operate in a clean fashion and can be trusted by users and wider society. The individual peaks are therefore prudential and conduct as regulatory concepts.

Twin peaks is not a new concept developed following the crisis however, and the concept was proposed during the reform debate leading up to the enactment of the FSMA 2000,[710] but dismissed in favour of the consolidated model. This was a mistake. The decision to implement the consolidated model around a super regulator arguably missed an opportunity to create a

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708 G Baber A Critical Examination of the legislative response in banking and financial regulation to issues related to misconduct in the context of the crisis of 2007-2009, (2013) Journal of Financial Crime, JFC 20(2), 237

709 House of Commons Treasury Committee, Banking Reform: Government and Financial Services Authority Response to the Committee's Seventeenth Report of Session 2007-8; Fourteenth Special Report of Session 2007-8, HC 1131, 27th October 2008.

710 M Blair, L Minghella, M Taylor, M Thrieplan, G Walker, Blackstones Guide to the Financial Services and Markets Act 2000 (2001 Blackstone Press)

regulatory architecture that would have been more effective in preventing the global financial crisis fallout, and while the consolidated model had been implemented elsewhere,[711] it had not been tried on a scale equivalent to the UK financial system.[712] It is clear that the size of the UK financial markets was too large for the consolidated model experiment; to properly supervise and regulate, and that adding bank regulation to such a large and complex financial sector added to the challenge. The perfect storm for regulatory failure was then added to by misguided macroeconomic control policies[713] which allowed risk to build up within the system without a sufficient release valve.

Twin peaks is a name or description for what is a theoretical concept to deal with the risks posed by regulatory failure in the financial markets. Twin peaks as a concept is specifically designed to avoid the issues that emerged in the crisis and that the single consolidated model failed to prevent from infecting the UK financial system. The clear problem with the consolidated model is that it while it provided a single authority for the supervision and regulation of banks and all other financial services products and providers, it lacked sufficient specialisation and focus in relation to the specific elements of supervision and regulation, which particularly evident in respect of bank regulation and the GFC, with transfer of bank regulation from the Bank of England to the FSA created a knowledge gap in the with respect bank operations and supervision, removing the long established networks between the UK central bank and the UK banking sector. Twin peaks is not an entirely new concept in bank regulation and was not in 1997 when the single regulator model was being planned. The twin

[711] Such as Scanindavia; See J T Norton, Global Financial Sector Reform: The Single Financial Regulator Model Based on the United Kingdo, FSA Experience – A Critical Reevaluation, (2005) The International Lawyer, Spring 2005, Vol.39, No.1, p15-52
[712] Ibid
[713] See Chapter 4

peaks system was developed by Taylor in two papers published in 1994[714] and 1995[715] respectively, and was at one point seemingly favourite to be adopted as the regulatory model in the UK.[716] At the core of Taylor's argument is that the UK regulatory system failed to match both the pace of change and innovation that was taking place within the financial services sector, a point that he noted again in 2009 when revisiting his original argument.[717] In reality this battle between regulation and financial services innovation has 'raged since the beginning of banks, has always been the case, and still pervades. The pace of financial services innovation, both in product development and operations is 'breath-taking' and the scale of financial engineering that banks and bank-like entities undertake is potentially unmanageable. This is what in some measure Turner[718] was referring to in his review of the actions and failures of the FSA following the crisis when he spoke of financial innovation with little or no social value.[719] The development of products and processes that began with deregulation in the 1970's[720] led to further and faster innovation in the search for yield, with less emphasis on the social utility of such products and increasing focus on driving internal growth only.[721] 'Light touch' regulation coupled with a relaxed macro-economic environment with historically low interest rates provided the catalyst for the GFC.

[714] A Hilton, UK financial supervision: a blueprint for change, (1994) Centre for the Study of Financial Innovation; J T Norton, Global Financial Sector Reform: The Single Regulator Model Based on the United Kingdom FSA Experience – A Critical Reevaluation (2005) The International Lawyer, Vol.39, No.2, 15
[715] M Taylor, Twin Peaks; a regulatory structure for the new century (1995), Centre for the Study of Financial Innovation.
[716] Outlook: The FSA, The Independent (London 23rd October 2011), https://www.independent.co.uk/news/business/outlook-the-fsa-1185702.html, last accessed 21/01/21
[717] M Taylor, Twin Peaks Revisited…a second chance for regulatory reform
[718] A Turner, The Turner Review: A regulatory response to the global banking crisis, (2009) The Financial Services Authority, London, March 2009
[719] Ibid
[720] See Chapter 4
[721] A Turner, The Turner Review: A regulatory response to the global banking crisis, (2009) The Financial Services Authority, London, March 2009

Taylor argued for a "reconfiguration"[722] around two specific regulatory roles, namely systemic stability, and consumer protection, given institutional operational reality by the creation of two regulatory commissions, a Financial Stability Commission, and a Consumer Protection Commission. Taylor argued that the benefits of twin peaks are clear in that it would eliminate regulatory duplication and overlap, which was a feature of the regulatory system in place prior to the FSMA 2000,[723] bringing in regulatory agencies with clear roles and lines of authority, achieving greater levels of transparency. It is important to note that Taylor's original paper was focused on the perceived failings of the regulatory regime of the Financial Services Act 1986 (FSA 86), and his criticism is of the "multiplicity of agencies"[724] that characterised the post 86 regime.[725] There is little argument now that the self-regulatory regime within a weak regulatory structure was not sufficient for the scale of upheaval that the deregulatory measures that culminated in the FSA 86 brought to the UK financial services industry. It is, however, worth restating at this point that the regulation for banks remained firmly with the Bank of England.

Taylor revisited his original hypothesis in 2009,[726] in the wake of the GFC and the performance of the single regulatory model. In this paper, Taylor restates the central themes of a twin peaks regulatory model of one based on stability and prudence as one strand of the regulatory regime and consumer protection as a second strand. With respect to the argument there is nothing in the twin peaks model of supervision and regulation that the consolidated single regulator model could not achieve with some modification, rather than a wholesale change to the regulatory system.

[722] Michael Taylor, Twin Peaks; a regulatory structure for the new century (1995), Centre for the Study of Financial Innovation
[723] Financial Services Act 1986; See Chapter 7
[724] Michael Taylor, Twin Peaks; a regulatory structure for the new century (1995), Centre for the Study of Financial Innovation
[725] Ibid
[726] Ibid

The evidence suggests[727] that the FSA was primarily a conduct regulator and largely fits in the second of the proposed peaks, having a strong focus on consumer protection, not least through a statutory objective.[728] Some of the criticism levelled at the FSA was that it was over-focussed on conduct issues and did not pay sufficient attention to its role as a prudential supervisor and regulator of banks.[729] The introduction of the Financial Policy Committee as a systemic oversight body and placed within the structures of the Bank of England will, it is hoped, provide the necessary systemic management tools not available during the crisis. [730] The failure of policy makers in developing a systemic oversight authority with explicit wider economic responsibility was an error when developing and implementing the tri-partite system. An analysis of the twin peak's structure reveals the problems with the consolidated model, or at least with the size of the task given to the consolidated model employed in the UK. The attractiveness of the consolidated model is based on the one-stop-shop for supervision and regulation of the entire range of financial services industry, including banks. The corresponding problem is the lack of focus on certain elements of the regulatory regime at key moments. Some of this comes from the rationale to create the consolidated single super regulator, and the rationale for the single super regulatory regime.

[727] See Chapter 7
[728] Section 5 FSMA 2000 the Protection of Consumers
[729] House of Commons Treasury Committee, The run on the Rock, Fifth Report of Session 2007-08, Volume 1, HC 56, 26th January 2008
[730] HM Treasury, Reforming Financial Markets (White Paper, Cm 7667 July 2009); https://www.bankofengland.co.uk/about/people/financial-policy-committee

The FSMA 2000[731] was a product of political ideology formed while New Labour was in opposition, conceived to deal with the financial scandals that haunted the regulatory regime created by the FSA 1986. The Collapse of BCCI and Barings Bank, and the Maxwell Pensions fraud provided the rationale to overhaul the structure of the regime. The attractiveness of placing all the elements of supervision and regulation under one roof and within one management structure was obvious. The system it replaced, a self-regulatory approach within a statutory framework, was a hybrid model that was unworkable over the long term. The problem with self-regulation is that it is prone to regulatory capture,[732] with an eventuality that the regulator becomes the servant to the regulated body master. It is an oft quoted maxim that self-regulation is no regulation and is analogous to the cat looking after the pigeon loft. While good intentions will provide solution in the short to medium term, the long-term outlook would not meet the needs of the industry. The deregulatory pressures brought about because of the Financial Services Act 1986 would make self-regulation unworkable and thus unsustainable.

In contrast the twin-peaks regulatory structure provides for a clearer delineation of regulatory responsibilities, one focussing on prudential actions and one on conduct. The UK model introduced by the Financial Services Act 2012 provides for prudential supervision and regulation of the larger, systemically important financial institutions to be the responsibility of the prudential peak, while other smaller institutions and the conduct of firms, markets and people are the remit of the conduct peak. This means that some prudential supervision and regulation in the UK is performed by the conduct regulator, leaving the named prudential regulator to focus on institutions that present the greatest systemic risk. Both supervisory and

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[731] Ferran argues that political motivations pervade the debate; Ferran, E The Break up the Financial Services (2011) Oxford Journal of Legal Studies, Vol31, No.3, 455
Financial Stability Board https://www.fsb.org/wp-content/uploads/c_130129y.pdf See chapter 7
[732] See Chapter 5

regulatory bodies operate within the micro-prudential regulatory environment that is their focus is on firm specific activities and risks, but with one peak focused on the larger systemically important financial institutions it is clear to see a more systemic approach being taken within the new structure. In the UK the prudential peak is manged by the Prudential Regulation Authority (PRA)[733] and the conduct peak by the Financial Conduct Authority (FCA).[734]

The new twin-peaks regulatory structure employed in the UK is a modified form Taylors original approach,[735] and while the prudential and conduct peaks are in place, sitting on top of them, or more accurately across them is a further level of regulation. This high-level regulation is provided by the Financial Policy Committee (FPC) described as fulfilling the role of a single focused body responsible for ensuring the overall stability of the system, and that no such role was performed in the previous regime.[736] The FPC is a macro-prudential regulatory body, specifically aimed at systemic oversight, allowing the 'peaks' to concentrate on the micro-prudential, firm and markets specific issues. The role of the FPC is to look for and forewarn of the exact dangers that precipitated the GFC. To this aim the FPC is a valuable addition to the regulatory environment as it is clearly arguable that the macro-economic environment played a significant if not the significant role in creating the conditions in which the micro-economic actors were able to operate. The establishment of the FPC reflects the rationale that bank regulation should be more focused on ensuring systemic stability than individual bank stability, although it is clear in the present model of banking that one is a direct correlation of

[733] https://www.bankofengland.co.uk/prudential-regulation
[734] https://www.fca.org.uk/
[735] M Taylor, Twin Peaks; a regulatory structure for the new century (1995), Centre for the Study of Financial Innovation.
[736] HM Treasury, A new approach to financial regulation: Blueprint for reform, (June 2011) Cm8083,
, para 1.25

the other. This corresponds with the too big to fail phenomenon, the failure to deal with provides that a single bank failure will have systemic impact.

The FPC provides a platform to monitor and act on systemic issues as they are identified, and to allow high level action to cascade through the banking system. That the FPC stands as a systemic monitoring operation suggests that the implementation of such a regulatory body would have been sufficient in the aftermath of the GFC. The decision to discard the previous consolidated model in favour of twin peaks was one that was taken in haste, politically driven, and one that would have benefitted from a more focused and thoughtful approach. The new coalition government announced their intention to implement the twin-peak reforms as quickly as possible,[737] but a stepped approach to the reform may have provided a more rounded view. If the consolidated regulatory model had some form of macro-prudential oversight, then the issues that were argued as being missed[738] by the regulator before the GFC may have been picked up and dealt with effectively. This again provides evidence that the reform process was significantly influenced by political rationales.

The evidence from the criticism levelled at the FSA and the tri-partite regime that there was a lack of effective macro-prudential oversight. While it is arguable that the Bank of England should have fulfilled this function the lack of a clearly articulated role resulted in a weak approach to the wider economic environment and its impact. The lack of clarity in the memorandum of association ensured that the roles within the tri-partite system were ill defined at best, however, there is also the possibility that, at least to some degree, a turf war between

[737] HM Treasury, A new approach to financial regulation: Blueprint for reform, (June 2011) Cm8083,
[738] House of Commons Treasury Committee, The run on the Rock, Fifth Report of Session 2007-08, Volume 1, HC 56, 26th January 2008

the new and old regulator had surfaced.[739] There is no specific evidence of turf wars beyond anecdotal commentary[740] and as the Bank, within the tri-partite system, had responsibility for macro-economic issues it must bear some responsibility for the impact of the GFC alongside the FSA. If the Bank of England had been provided with the same authority now granted to the FPC then an earlier response to the emerging crisis may have prevented the full impact of the GFC on UK banks and economy. The very conditions that led to the GFC are what the FPC and similar macro-prudential regulators are designed to look for, and work with the micro-prudential regulators to ensure firms do not make the same errors.

8.4 Twin Peaks – Panacea or not?

Whether the UK implementation of the peaks structure will prevent a repeat of the GFC is a matter for time. While the UK experimented with the consolidated regulatory model other jurisdictions took the opportunity to structure their financial services sector differently. The twin peaks structure was adopted by Australia and the Netherlands, and other European countries in a range of forms and versions,[741] with varying degrees of success. The application of twin peaks in Australia is held out as an example of successful operation, Hawtrey asking "why have Australian banks been so remarkably resilient, [742] " a question additionally asked by Hill[743]. Australia implemented a twin peaks approach following the 1996 Wallis Commission in 1998,[744] one year after the enactment of the FSMA 2000 that ushered in the consolidated single regulator model in the UK. Lui and Hawtrey both note that Australian

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739 G Parker, B Masters, FSA Chief fears turf war with Bank, The FT (London 23rd June 2009)
740 Ibid
741 Michael Taylor, Road From Twin Peaks, Connecticut Insurance Law Journal, (2009), Vol 1:16, p61-96
742 K Hawtrey, The Global Credit Crisis: Why Have Australian Banks Been So Remarkably Resiliant? (2009) Agenda, Vol 16, No.3, 95
743 J G Hill, Why did Australia fare so well in the global financial crisis, in E Ferranm N Noloney, J G Hill, J C Coffee, The Regulatory Aftermath of the Global Financial Crisis (Cambridge 2012)
744 A Lui, Single or Twin? The UK financial regulatory landscape after the financial crisis of 2007-2009 (2102) Journal of Banking Regulation, 13(1), 24

banks withstood the GFC better than the UK,[745] with Hawtrey commenting that "the stability of the banking sector in Australia contrasts sharply with the US and UK"[746] further noting there was no a "true taxpayer bailout of a private commercial bank in the wake of the Global Financial Crisis".[747] While the resilience shown in Australia provides support for the UK implementation of twin peaks, with respect overall conclusions cannot be drawn due to the differing size and importance of the respective banking sector. In the EU the Netherlands had implemented a twin peaks regulatory structure in 2002 which "worked well during the crisis, as decisions were able to be made in timely manner…in part because of laws permitting information sharing", with "clear divisions of powers and responsibilities were instrumental in achieving effective coordination between key institutions during the crisis", [748] In stark contrast to that in the UK, however, the Dutch financial sector was significantly affected by the GFC and significant funds were made available to banks by the Dutch government.[749]

Regarding the UK implementation of the twin peaks approach the true resilience will not be understood until the system is faced with the same levels of stress that accompanied the GFC, however, the experience of Australia and the Netherlands provide a solid basis for optimism that the new structure will fare better, primarily based on improved communication between regulatory authorities which failed so badly in the UK. [750] The evidence from Australia and

[745] Ibid
[746] K Hawtrey, The Global Credit Crisis: Why Have Australian Banks Been So Remarkably Resiliant? (2009) Agenda, Vol 16, No.3, 95, 95
[747] Ibid, 97
[748] International Monetary Fund Country Report No.11/208, Kingdom of the Netherlands: Publication of Financial Sector Assessment Program Documentation – Technical Note on Financial Sector Spervision: The Twin Peaks Model (2011), International Monetary Fund Washington DC. https://www.imf.org/external/pubs/ft/scr/2011/cr11208.pdf, last accessed 21/01/21
[749] D Jolly, The Netherlands to Provide $13 Billion to the ING Group, The New York Times (New York, 12th December 2008) https://www.nytimes.com/2008/10/20/business/worldbusiness/20ing.html, last accessed 22/01/21
[750] Bank of England, The Financial Crisis – 10 years on: What happened and what has been done since?, https://www.bankofengland.co.uk/news/2018/september/the-financial-crisis-ten-years-on

the Netherlands provides evidence for Born *et al's* argument that there is "evolving role of communication as a policy instrument".[751] The inclusion of the FPC as a macro-prudential regulator provides the UK implementation of twin peaks with an oversight body and with bank supervision delegated to a subsidiary body of the Bank of England a stronger system of regulation and supervision should emerge.

8.5 The Structure of Banks and Separation of Banking Activities - The Creation of the Ring Fence

Twin peaks was the first iteration of the new government's post-crisis reform package. While the implementation of the UK's twin peaks structure was proceeding the government continued to review regulatory requirements, with further proposals for reform forthcoming.[752] These further reforms focus on the structure of banks and banking services and proposed legislation to create a form of separation between the retail and investment businesses of banks, entitled ring fencing in the UK.[753] The proposals would create a ring fencing of banking activities deals directly with the structure of banking with a significant impact on how banks undertake their business activities, as Schwarcz note "ring fencing can best be understood as legally deconstructing a firm in order to more optimally reallocate and reduce risk".[754] With the criticism levelled at the banking sector for creating the GFC and causing the subsequent recession the government took the opportunity to explore additional regulatory measures while the political and social environment permitted, operating in an environment absent capture

[751] B Born, M Ehrmann, M Fratzscher, How should cenral banks with a financial stability objective? The evolving role of communication as a policy instrument in S Eijffinger, D Masciandaro, Handbook of Central Banking, Financial Regulation and Supervision: After the Financial Crisis (Edward Elgar 2011)
[752] Banking Reform: delivering stability and supporting a stable economy (2012) HM Treasury/BIS, June 2012, Cm8356
[753] Ibid
[754] S L Schwarcz, Ring Fencing (2013) 87 S.Cal REV 69 in A E Wilmarth, Narrow Banking as a Structural Remedy For The Problem of Systemic Risk: A Commnet on Professor Schwarcz Ring Fencing, (2014), 88 S.Cal Rev 1, 1

theory.[755] Hudson usefully defines the distinguishing features of retail and investment banking with the former meaning "a bank which conducts traditional banking business with ordinary members of the public…[which] involves taking deposits, making loans, providing payment cards…and so forth" and the latter as an amalgam of three different types of business which are not retail to including, "investment advice, investment products and investment intermediation,…providing corporate finance services…and proprietary trading on its own account". [756]

The concept behind ring fencing is, like many of the concepts applied to regulation, not new. Following the fallout from the Wall Street Crash, the subsequent banking crisis resulting in the Great Depression the US enacted the Glass-Steagall Act in 1933, emerging from the Pecora commission's[757] investigation into the banking crisis, with specific provisions to provide for separation of banking practices. The legislation prevented banks from engaging in both retail and riskier commercial or investment banking activities; with a relatively simple rationale behind Glass-Steagall being to separate activities classed as carrying risk, such as trading in investments, from the more traditional retail, customer focussed activities, with institutional failure having limited impact. An important underlying rational to this is that financial institutions like other corporate entities should be allowed to fail. Corporate failure is a normal part of the business cycle, firms are incorporated, they trade and if unsuccessful they fold. Any corporate failure will have impact, on jobs as employees are laid off, and in a wider sense on the creditor base who advance goods and services, with particular impact on the large group of unsecured creditors who themselves may face insolvency as a result of another organisations

[755] See Chapter 5
[756] A Hudson, Banking Regulation and the ring-fence (2013) Compliance Office Bulletin107 (June), 1, 4
[757] D Moss, C Bolton, E Kintgen, The Pecora Hearings, (2009) Harvard Business School, https://www.hbs.edu/faculty/Pages/item.aspx?num=32063, last accessed 12/01/21

failure. This is particularly the case in respect of larger corporate failures where large numbers of secured creditors are involved. The key is that the impact of corporate failure should have as little wider repercussion as possible, but failure must be possible.[758]

In the early stages of the post GFC reform debate the possibility of reinstating the structural separation of banking activity returned to the agendas of governments and their regulatory authorities. The focus of blame on risky activity focused the debate on regulatory reform based on splitting up the capabilities of financial institutions to engage in such risk bearing activities, leading to calls for a range of options designed to prevent such risk infecting markets, some going as far as calling for a return to full separation.[759] The options available range from full structural separation, similar to Glass-Steagall requirements, to maintaining the status quo, which was not really an option given the scale of the GFC, and given the political environment the new government were not going to maintain the same system that led to the crisis. As Kay notes the Glass-Steagall approach had become outdated by the time of its repeal by the Clinton administration in 1999 due to the evolution within global banking which had "increased [in] scope and complexity". [760] In addition the full structural separation of retail and commercial banking was not a feature of the UK or European banking system and as such there is little momentum for such separation.

[758] Fear of failure is a key element. Knowing that failure is a possibility should impact on decision making in that knowing that failure is an option will prevent the riskiest activity. See work by Kahneman and Tverskey. See chapter 4 on moral hazard and the fact that regulation of banks created an insolvency remote environment as the result of the too big to fail paradox,
[759] For a detailed and scholarly analysis of this issue see A E Wilmarth, Taming the Megabanks: Why we need a new Glass-Steagall Act (2020 Oxford)
[760] J Kay, Narrow Banking: The Reform of Banking Regulation, 15th September 2009

At the other end of the debate is the return to what John Kay terms “Narrow Banking”.[761] Narrow banking as a concept will be familiar to older generations and the traditional notion of what a bank is and what a bank does. Kay states that “Narrow banking implies the creation of banking institutions focused on the traditional functions that the financial system offers to the non-financial economy.” He goes on to outline the kind of activities that a Narrow Bank would provide and that only institutions specialising in these activities could describe themselves as banks:

- “Payments systems (national and international), for institutions of all sizes
- Deposit taking, from individuals and small and medium-sized enterprises”.

Under this proposal only narrow banks would be granted permission to accept deposits from the public, with a maximum deposit amount,[762]and only narrow banks would be able to access the major payment systems such as BACS and CHAPS. In addition, only narrow banks would qualify for deposit protection schemes.[763] Kay opined that such narrow banks may engage in limited lending activity such as mortgage lending and small business loans, but not have a monopoly on such activity. Additionally, Kay felt that these narrow banks would be able to operate within larger banking and financial services groups or other corporate groups, but on the other hand some may be stand-alone independent entities. Interestingly Kay noted that such banks would not be subject to supervision but would be subject to regulation in respect of compliance with the rules governing the operation of such entities.

[761] Ibid
[762] Ibid; Kay notes a figure of no more than £50,000
[763] Ibid

The creation of narrow banks is clearly attractive in the light of the GFC. Banks that could only have operated within very narrow confines would not have run into the trouble that banks like Northern Rock, HBOS and RBS faced, and if such an entity were to come under the stress of potential insolvency it would be easier to resolve with limited wider impact. It is clear from Kay's proposal is that a narrow bank that was failing could transfer its depositor base and other activities to another narrow bank easier than when the GFC hit. However, the narrow banking idea was never likely to be the primary option for authorities looking to reform regulation and how banks operate. Banks and banking have moved on significantly and the economy's interaction with banks and the services they provide would make the narrow bank unattractive to modern consumers who use their bank for the whole range of financial services. The availability of one-stop-shop banking and financial services providers, allowing them to find the products and services they need is attractive to consumers in contemporary society. Some consumers will shop around but many will undoubtedly be happy with the ability to get their financial services needs from one place, especially where that place is their primary banking option. At the core of the debate surrounding banking activity separation is the prevention of risk bearing activities from risking the operations of the financial institution itself. The GFC was a crisis caused by risk, by people and organisations failure to understand risk and understand the risk inherent in financial engineering. The post crisis debate has in part centred on how to manage the risk so that it does not infect the institution.

Unlike that which has been enacted in the UK, Glass-Steagall provided for complete separation of investment and retail banking activities to the extent that they cannot be carried out by the same corporate entity. As Blair et al notes the UK did not enact measures that mirror the provisions in the Glass-Stegall Act the UK system could be characterised as "highly fragmented and compartmentalised", the need for Glass-Steagall undoubtedly seemed less certain.[764] Glass-Steagall was at the centre of a relatively[765] stable banking system for 60 years until its repeal in 1999, replaced by the Gramm-Leach-Bliley Act, legislation that bowed to deregulatory pressures that had built through the 1970s and 1980s. As Ciro and Longo note, the system that had been developed following the great depression has been "eroded by state withdrawal from the economy" and the effect of this has made "excessive risk-taking in financial markets commonplace".[766] There is strong circumstantial evidence that the removal of the separation boundaries played a significant part in amplifying the impact of the GFC and the comments of Ciro and Longo would suggest that the removal of the legal separation between investment and retail banks would support this view. With the erosion and eventual repeal of Glass-Steagall the lobbyists for deregulation achieved their aim in liberalising banking practices within the US, thus creating the conditions for pressure to build up within the financial system, a bubble that burst with damaging consequences during the GFC. The undoubted rationale for banking activity separation is risk management. By only allowing certain entities to carry on certain banking activities, systemic risk will be manged more efficiently. A correlation of this is that regulating the risk created within banking will be easier as targeting regulation at specific identified risk will be easier. The lack of understanding of risk was a clear failure during the GFC.

[764] M Blair, L Minghella, M Taylor, M Thrieplan, G Walker, Blackstones Guide to the Financial Services and Markets Act 2000 (2001 Blackstone Press)

[764] Such as Scanindavia; See Norton J T, Global Financial Sector Reform: The Single Financial Regulator Model Based on the United Kingdo, FSA Experience – A Critical Reevaluation, (2005) The International Lawyer, Spring 2005, Vol.39, No.1,15

[765] Relatively is used here to denote the fact that banking failures, crises and scandals are a common feature of banking, however, unlike the GFC these events rarely impact the global banking system in the same way that the GFC did.

[766] Tony Ciro and Michael Longo, The global financial crisis: causes and implications for future regulation: Part 2 (2010, Journal of International Banking Law and Regulation), 25(1), p9

The origins of the UK decision to implement a ring fence is the report from the Independent Commission on Banking,[767] more commonly referred to as the Vickers report after the report's chair, Sir John Vickers to look at issues relating to the too big to fail paradox and with competition in banking, the remit:

> "…will look at the structure of banking in the UK, the state of competition in the industry and how customers and taxpayers can be sure of the best deal. The Commission will come to a view. And the Government will decide on the right course of action".[768]

The final report was published in September 2011 with one of the key recommendations for a "retail ring fence" to be implemented across the UK banking landscape.[769] The Commission considered how best to manage the interactions and possible risk between retail banking and investment banking. The report had a two-pronged focus, loss absorbency through capital and liquidity measures,[770] and structural reform predicated on separation between retail and investment operations of banking organisations. The Commission considered and dismissed total separation, concluding that a ring fence around a banks retail option was the better course of action. This undoubtedly reflected the development of banking that had emerged through the 20th Century. The growth of conglomerate banking providing a one-stop shop for financial

[767] Independent Commission on Banking: Final Report; Recommendations, September 2011, https://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf, last accessed 1/12/20
[768] House of Commons Library, The Independent Commission on Banking: The Vickers Report, Standard Note SNBT 6171, 30th December 2013, researchbriefings.files.parliament.uk
[769] Chapter 3 Vickers Report Independent Commission on Banking: Final Report; Recommendations, September 2011, https://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf,
[770] See Chapter 8. For further discussion on capital regulation and loss absorbency provisions.

services had become the norm and to require complete structural separation would have taken huge effort to achieve. Ring fencing provided a sold half-way house between the status quo and full separation. In the aftermath of the GFC banks were blamed for the crisis, and the resulting recession that followed. Politically it was relatively easy to criticise banks and their senior management teams with little political fallout, but there would only be so far that politicians could push the banks before any real push back, and as such ring-fencing provided a middle ground, allowing large banking groups to survive but putting some limitations on how the operate, with specific focus on the riskier activities.

With stability at the centre of the ICB proposal it acts as an attempt to deal with the too big to fail (TBTF) paradox that had been a feature of the GFC. One of the key advantages of ring-fencing deals with the TBTF issue head on in that "it would make it easier and less costly to sort out banks if they got into trouble, by allowing different parts of the bank to be treated in different ways" where "Vital retail operations could be kept running while commercial solutions – reorganisation or wind down – were found for other operations. [771] It would help shield UK retail activities from risks arising elsewhere within the bank of wider system, while preserving the possibility that they could be saved by the rest of the bank", and very importantly "…in combination with higher capital standards it could curtail taxpayer exposure and thereby sharpen commercial disciplines on risk taking".[772] In simple terms ring fencing will allow failed banking operations to close, on the basis that maintaining retail banking is one of the fundamental outcome of regulation. Regulation must ensure that liquidity generation can continue in a safe and sound environment, however, innovation carries risk, but this risk must not be allowed to interrupt retail banking operations. Retail banking operations include current

[771] Independent Commission on Banking, Interim Report: Consultation on Reform Options, April 2011, 3
[772] Ibid

account banking, savings, and lending, in addition to efficient payment systems and operation of the ATM network. All these activities are essential to a modern economy and the loss of them would create potential hardships by removing access to funds for citizens and resulting payment failure. As noted by the ICB in its interim report “retail customers have no effective alternatives to their banks for vital services; hence the imperative to avert disruption to the system for their continuous provisions”,[773] that is in contrast to wholesale and investment banking customers who “generally have greater choice and capacity to look after themselves”.[774]

The policy aim of ring fencing was to “insulate critical banking services from shocks elsewhere in the financial system; and make it easier to preserve the continuity of those services, while resolving financial institutions in an orderly manner and without injecting taxpayer funds”.[775] The government claimed that this would “preserve the many benefits of modern banking, but will substantially reduce the perceived implicit guarantee that derives from the presumption that government will be compelled to step in to support failing banks”.[776] The issue that caused so much trouble and is inextricably linked to the GFC is the issue of proprietary trading, put simply trading on its own account. Banks generally act as principal in virtually all transactions but this kind of activity is very broad and is generally part of a bank as corporate entities ordinary market position.[777] The proprietary trading that caused so much difficulty is that which has been termed ‘casino banking’ or ‘pure’ proprietary trading, described as: “…the bank using its capital for its own account to generate profits (and risk taking losses) from

[773] Independent Commission on Banking, Interim Report: Consultation on Reform Options, April 2011, 3
[774] Ibid
[775] White Paper: Banking Reform: delivering stability and supporting a sustainable economy, June 2012, Cm 8356
[776] Ibid
[777] Proprietary Trading, Third Report of Session 2012-13, Parliamentary Commission on Banking Standards, HL Paper 138, HC 1034

illiquid inventory, disconnected from customer activity, then that is 'pure' proprietary trading".[778] When coupled with huge leverage levels this created the giant holes in banks' balance sheet. Banks used their own capital and borrowed more to increase yield potential and therefore profits, setting up dedicated operations and hedge funds to achieve this.

In the US the Dodd-Frank Act of 2010 incorporated the Volcker Rule, named after former Treasury Secretary Paul Volcker, which prohibits banks from undertaking proprietary trading. In the EU the High-Level Expert Group on structural reforms, known as the Liikanen reforms after its chair Erkki Liikanen proposed a form of ring fencing that falls between the US and UK reforms, although these have since stalled. As a model the ring fence operates as a prohibition on activity in so much that it compels a bank holding group to separate certain activities into different entities, that is to separate retail banking operations into one legal entity and commercial or wholesale banking activities into another. The ring fence was introduced by the Financial Services (Banking Reform) Act 2013 which received Royal Assent on 18th December 2013.[779] In a similar fashion to the Financial Services Act 2012 that created the twin peaks regulatory structure, the 2013 Act reforms banking regulation by making amendments to the core Financial Services and Markets Act 2000. In line with the White Paper the Act only mandates a single core activity of accepting deposits,[780] in the UK or elsewhere, with the possibility of secondary legislation providing for HM Treasury to add further regulated activities to this list.[781]

[778] Ibid
[779] https://www.legislation.gov.uk/ukpga/2013/33/introduction/enacted
[780] Section 142B(2) FSMA 2000 as inserted by the Financial Services (Banking Reform) Act 2013
[781] Section 142B (5) FSMA 2000 as inserted by the Financial Services (Banking Reform) Act 2013

This clearly links with the impact of the GFC. The potential impact on ordinary depositors is the primary reason that Chancellor Alistair Darling stepped in to save Northern Rock by nationalisation. The impact of ordinary insolvency measures would have treated the depositor base as ordinary unsecured creditors, and while the Financial Services Compensation Scheme would have compensated most Northern Rock's depositors the delay in paying such compensation would undoubtedly have had a significant negative impact on many. Even with the Chancellor of the Exchequer announcing a guarantee of all bank deposits it was too late for Northern Rock. The impact of the bank's failure on ordinary depositors was too unpalatable for government forcing them into action. Any impact on access to deposits and access to funds will have a stronger negative impact on people from lower socio-economic backgrounds who do not have significant savings to support themselves while access to their accounts is disrupted. This can lead to problems in receiving wages and salaries and making payments such as car loan repayments and mortgage payments.

To support the core activities the legislation also refers to "core services" that ring fenced banks must provide, these being "facilities for accepting deposits or other payments into an account which is provided course of carrying on the core activity of accepting deposits; facilities for withdrawing money or making payment from such an account; overdraft facilities in connection with such an account".[782] Again this clearly attempts to deal with potential outcome of a failed bank on its depositor base and the resulting fallout.

The ring fenced is designed to ensure continuity of provision of core activities and services vital to the citizens of the country, to ensure the continuity of the provision of services that

[782] Section 142C (2) (a)(b)(c) FSMA 2000 as inserted.

lubricate the economy. Increasingly the lack of access to banking services such as a bank account creates significant difficulties for individuals and families and those that lack access to bank account services will pay more for goods and services and are in danger of financial exclusion and with those affected having to pay a £485 per annum poverty premium, reflecting that suppliers of every day services such a telecommunications offer discounts and better deals to those that pay by direct debit, and in addition those that lack access to basic banking services have fewer and usually more expensive options when attempting to access credit.[783] It is for this primary reason that governments will intervene in a failing retail bank. Again, this is linked to political decision that no government can afford politically to allow a retail banking institution to fail thus alienating voters. Key to understanding the impact and possible effectiveness of the ring-fence is its scope[784]. The scope of the ring fence is linked to the "mandated services"[785] that can only be provided by ring fenced banks, these are "core activities"[786] on which households and small businesses depend.[787] The proposal is a radical departure from the evolution of bank regulation in more recent times. The contemporary thinking that led to the consolidated regulatory model was that increasing consolidation of banking and financial services should be met with similar consolidation in the regulatory and supervisory environment.

Further the implementation of a twin peaks structure may cause some conflict with the ring fence operation. The twin peaks approach is premised on the division of regulatory functions

[783] R Jones, Britons without a bank account pay a £485 poverty premium', The Guardian, 22 April 2019, accessible at theguradian.com. The article notes that up to 1.2million UK citizens are 'unbanked' and may be paying a 'poverty premium'.
[784] A Hudson, Banking Regulation and the ring-fence (2013) Compliance Office Bulletin107 (June), 1
[785] R Jones, Britons without a bank account pay a £485 poverty premium', The Guardian, 22 April 2019, accessible at theguradian.com. The article notes that up to 1.2million UK citizens are 'unbanked' and may be paying a 'poverty premium'.
[786] Financial Services (Banking Reform) Act 2013 Section 4 (1) which inserts a Part 9B into the Financial Services and Markets Act 2000.
[787] Explanatory Notes to the Financial Services (Banking Reform) Act 2013

relevant to regulatory aims. The ring fence option can further sub-divide these regulatory requirements as banking groups will be required to divide their activities into entities providing the core activity and core services, while prohibited activities will have to be delivered from a separate entity. How will both entities be supervised and regulated? The ring fence has the potential to create increased complexity within the new regulatory structure and put pressure on the regulator. The PRA for larger institutions will now have to responsibility for two financial services entities within the single bank holding group. One clear issue with the ring fence is the level of discretion that banking groups had in setting the structure of the new retail entity. The legislation does not mandate the specifics of what sort of entity may carry out such activities as mortgage lending. Some will place such activities within the ring fence alongside the core activities such as retail deposit taking, while other banking groups may not. This discretion allows banking groups to take different approaches to the way in which they restructure the group to meet the ring-fencing requirements. To prevent the ring fence from failing the legislation requires the PRA to make rules to ensure the effectiveness of the ring fence by maintaining the separateness of the RFB from the rest of the group. To achieve this the relationship between the RFB and other parts of the group should be limited, that the RFB should be sufficiently capitalised and have sufficient liquidity to withstand stress, from other parts of the group, in addition the RFB should not be financially dependent on other groups. The most important issue is that the RFB should have a corporate governance and management structure that is able to act independently of the parent group.

The strength, or height of the ring fence will be critical in whether the system will work, and whether in reality it can maintain separateness from the overall group.[788] Until tested it is impossible to understand how the ring fence will really function but one query will be the extent of the true separation of the entities within the group will be, and whether in the face of significant stress and possible insolvency the regulator may 'drop the fence'. The difficult scenario is if the investment banking arm within the banking group came under stress. In response to questioning from the Parliamentary Commission on Banking Standards the government noted that:

> "A ring fence does not make banks resolvable. Without wider reforms, it is possible that a ring fence bank would simply result in one too big to fail bank becoming two such banks, the failure of either of which would require taxpayer support to avoid major disruption".[789]

Wetzer expressed concerns regarding how the corporate governance structures of the new regulatory architecture will work. [790] For the ring fencing of retail banking services to meet its objectives there needs to be clear operational lines within the banking group. Wetzer notes that to ensure that any discretion exercised in setting up the RFB the regulatory framework adopts at least three regulator-based "gap filling strategies", namely flexible legal structures allowing regulators to respond to changing circumstances. Secondly, the regulator has power to impose

[788] Bainbridge A, Shearer D, Atkinson J, Gray K & Lovegrove S, Legislative Comment: The Banking Reform Act 2013, (2014), Compliance Officer Bulletin, 114(Mar), 1

[789] Banking Reform: a new structure for stability and growth, HM Treasury/Department for Business Innovation and Skills, February 2013, Cm 8545

[790] T Wetzer, In Two Minds: The Governance of Ring-Fenced Banks, Journal of Corporate Law Studies, available at https://ssrn.com/abstract=3325292

group restructuring with the ultimate sanction of full separation as a possibility; referred to as ring fence electrification. The third of the gap filling measures is achieved through supervision to ensure compliance with the rules.

While the ring fence is brought in via primary legislation, the Act provides for updates to be affected via secondary legislative processes; it is envisaged that the addition of additional core activities and services would be via this route. The most flexible and possibly most controversial process would be via the use of rules as set forth by the PRA. Given the lack of success of the FSA rule making powers in managing risk profiles there is some danger that PRA rule making display the same lack of effectiveness.[791] The final of the gap filling measures is supervision to ensure compliance with the rules. Whether this is achievable is doubtful given the overall complexity and lack of transparency within banking generally. Effective supervision failed in the period prior to the GFC.

The most important of the gap filling measure is the so-called electrification element. As noted, electrification refers to the regulator's ability to enforce complete separation of the RFB from the parent entity.[792] This undoubtedly is reliant on the previous two gap fillers providing the regulator with the evidence to undertake such action. This is an extreme measure that will have significant ramifications for the parent banking group, including severe reputational damage. Obviously, this is a last resort but whether such an action is realisable in reality is doubtful. To trigger such an action will require real 'muscle' and will power on the part of the regulator and

[791] Bank of England, The Bank of England, Prudential Regulation Authority: Our Approach to Banking Supervision (May 2011)
[792] Bainbridge A, Shearer D, Atkinson J, Gray K & Lovegrove S, Legislative Comment: The Banking Reform Act 2013, (2014), Compliance Officer Bulletin, 114(Mar), 1-32

will need to be supported by the political will power of the incumbent administration. Undoubtedly any such move by the regulator will face resistance from the banking group subject to such action, and it is likely that the banking group will exercise its judicial review rights when faced with a regulator mandated breakup of the group.

The ring fence will only be effective if the strength of the ring fence is sufficient to achieve its policy aims. The fence must be sufficiently strong and high enough to withstand pressures during times of stress. As stated, the RFB entity must have sufficient capital and liquidity to withstand such stresses, however, capital and liquidity impacts of group profits, it is money that is not earning profit. The other quandary for the parent group is what happens when the investment arm is under stress, the capital and liquidity tied up in the RFB could be used to support the investment arm but waiting for PRA and HM Treasury approval to access such funds may take too long to help.

The other danger with ring fencing is linked to timing. In the immediate aftermath of the GFC there was significant political will to reign in the excesses of the banks and bankers. The legislative provisions that have delivered the structural reforms were enacted at a time when legislators and regulators were able to challenge the powerful banks and their lobby operations without significant pushback. This was not going to be a permanent state with the banking industry always likely to gain more political power as time moved on. A key problem with banking regulation has always been the institutional memory deficit. This refers to a feature of financial services where there is failure to remember failure. Financial Crises are a common and recurring occurrence, in part as participants move on or simply forget the causes and impact of the last crisis; there is seemingly a belief that it cannot happen again. The further we move away from the GFC timeline and further away that the mistakes remain in the mind of the participants the same mistakes are likely to reappear

The report set out several advantages to such separation, noting the cost benefits of sorting out failing institutions.[793] A key reason for separation outlined in the report is the protection it provides for continuity of what may be classed as essential banking services, for instance a basic current account with debit card and cheque book, a basic savings account and access to small scall lending. Continuity of banking services is one of the underlying key elements that bank regulation aims to achieve with the associated rationale that underpins separation in ensuring that basic banking services can be maintained while resolution mechanisms are triggered for an institution in distress, without the need for recourse to lender of last resort support or taxpayer funded bailout. The reliance on access to banking services in the UK in the form of debit cards, direct debit, ATM access and other services means that failure of access to these services can create significant disruption and cause hardship. The banking service continuity rationale links closely with the primary aim of achieving financial stability, being not only important as an economic stabilisation factor but a key measure in maintaining financial and social exclusion,[794] which itself can support economic growth and stability.

The continuity of banking services links to wider issues with banking regulation and correlates with the debate on issues such as moral hazard and the too big to fail debate[795], ensuring such continuity means that regulators and governments will continue to need to bail out banks that

[793] Independent Commission on Banking: Final Report; Recommendations, September 2011, https://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf, last accessed 1/12/20, p.24
[794] Ibid
[795] See Chapter 4

fail as the impact of such failure could have potentially catastrophic consequences for individuals, organisations, and the wider economy, particularly the most vulnerable. The evolution of banking services in the UK has meant that access to such services has become essential to ensuring socio-economic growth in across the UK;[796] lack of access to banking services long cited as reasons for socio-economic decline in areas,[797] and so complete loss of such services even for a limited period is a strong rationale for separation of banking activities.

The difficult issue for policy makers is to ascertain what form the separation should take to achieve the stated stability aims. The Glass-Steagall Act required complete separation of banking practice to the point that the activities subject to the separation must be carried out by different business entities, so that there should be no cross-contamination of stress between retail and investment banking, they are fully separated[798]. This allows the failure of an investment bank to have no impact on retail banking beyond the economic impact that any bank failure would bring. The essential outcome is that retail customers would still have access to banking services as normal, although it would be envisaged that access to credit will be restricted as liquidity levels in the financial system would dry up, as evidenced in the early phase of the GFC as investment banks struggled to accurately value their funds, leading to the so called ‘credit crunch’ followed by the full-blown crisis that emerged in the final quarter of 2008.

In contrast to the provisions of Glass-Steagall, the Vickers approach was not to recommend full separation, instead opting for a ring fence within which the retail operations of banking

[796] Financial inclusion report 2018-19, HM Treasury, Department for Work and Pensions, March 2019
[797] Ibid
[798] A W Wilmarth, Taming the Megabanks: Why we need a new Glass-Steagall Act, (2020 Oxford)

groups would be carried out by a separate subsidiary within the wider banking group.[799]This was an error and missed opportunity impacted by probable political considerations. The issue of capture theory in regulation is explored in chapter 5, however, the theme of political influence over regulatory structure pervades this research. Ring-fencing provides a compromise position between the status quo of bank regulation which has operated largely within a free market ethos, and Glass-Steagall type restrictions placing banks under tight control. The Vickers proposals, and subsequent legislative provisions were a 'half-way house' between these two options. This generates two views to the value of the ring-fencing proposal. The first is, as stated, that this was a missed opportunity to deal with several factors. The evidence would point to full separation as being a significant factor in safer banking practices, and the repeal of Glass-Steagall can be traced as a major deregulatory factor leading to the amplification of the impact of the GFC[800]. Full separation of activities, split between completely different entities with different ownership, management and controls would ensure that stresses in the investment bank would not impact on access to most banking services in the retail bank, and that disruption would be limited. Limiting the separation to subsidiaries of a parent banking group brings inherent risks. This approach begins to address the too big to fail paradox that banks need to be able to fail, The effectiveness of the ring fence will depend on the strength of the ring fence itself, especially dependent on how porous the ring fence will be in times of stress, with a particular emphasis on any stress the banking group comes under, making a key consideration with the Vickers subsidiary model ring fence is how to ensure that if the investment arm of the banking group runs into trouble what impact will this have on the retail arm. It is difficult to envisage in this model that the failure of the investment arm will have no impact on the retail operation. A further key consideration is whether the complete

[799] Independent Commission on Banking, Interim Report: Consultation on Reform Options, April 2011
[800] A W Wilmarth, Taming the Megabanks: Why we need a new Glass-Steagall Act, (2020 Oxford)

failure of the investment arm will mean failure of the parent group and whether the retail group can survive the failure of its parent organisation. For the ring fence proposal to succeed, the nature of the subsidiary will need to be such that it can survive beyond the collapse of its parent. It is clearly possible that the subsidiary will be able to operate but the potential collapse of its parent will put significant stress on the retail arm, and the ability to resist calls to support the failing operation financially will need to be strong or risk the viability of the retail arm itself. Complete separation would achieve this.

The second issue is whether such a ring-fence is required. An analysis of the pattern of failure in the UK may not provide sufficient evidence for the separation argument. The key trigger in the UK was the closure of the BNP Paribas funds linked to the US housing bubble bursting based on the subprime mortgage crisis triggering the credit crunch restricting interbank lending which precipitated the resulting failure of Northern Rock. [801] Would the existence of ring-fenced banks have prevented the failure of Northern Rock? As Brandt *et al.* suggest from their study there is a link between banking crisis contagion and structure of the banking network. [802] Ring fencing as a policy strategy is designed to prevent such crisis contagion, its focus is on stability, however, this can only be effective where the separation is sufficient to prevent contagion and the UK model does not adequately provide evidence that this will be the case. The UK government asserts that ring fencing will support financial stability by supporting an easier resolution of banks in trouble. [803] [804] The key aim of what the Bank of England calls

[801] S K-Gupta, Y L Guernigou, BNP freezes $2.2 bln of funds over subprime (Reuters 9 August 2009), https://www.reuters.com/article/us-bnpparibas-subprime-funds-idUSWEB612920070809, last accessed 20/11/20

[802] O De Brandt, P Hartmann, J-L Peydro-Alcalde, Systemic Risk in Banking after the Great Financial Crisis, inA N Berger, P Molyneux, J O S Wilson, (2nd Edition, Oxford 2015)

[803] https://www.gov.uk/government/publications/ring-fencing-information/ring-fencing-information Accessed 20th Feb 2018

[804] https://www.fca.org.uk/consumers/ring-fencing Accessed 20th Feb 2018

structural reform is the protection of consumers of banking services from emerging shocks elsewhere in the group,[805] with a secondary aim of ensuring that where failure occurs the cost of such failure does not fall on the taxpayer. The aims of ring-fencing are laudable, and prevention of the taxpayer bailout requirement is now an important policy aim, but in a comparison with the crisis that unfolded through 2007 and 2008 with systemic shocks at the centre of the crisis; faced with a similar situation in the future, the strength of the ring-fence would be the test of the structure, whereas full separation would have provided that strength.

The structural reform effected by the creation of the ring-fence aims to ensure that so called core activities identified in the legislation with only accepting deposits being listed,[806] will be "operationally and organisationally separate"[807] from those riskier activities that were at the centre of the financial crisis, or in other words "economically and legally separate".[808] The legislation further sets out that that the ring fenced body may only carry on core services such as facilities for accepting deposits, withdrawing money and overdraft services in connection with such an account.[809] The key question is whether the level of operational and organisational separation will be sufficient to deal with systemic stresses such as those that emerged. Therefore, the success of these structural reforms will be predicated on the strength or height of the fence to ascertain how operationally and how organisationally separate they really are.

[805] https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/structural-reform. Accessed 20th Feb 2018
[806] Section 142B Financial Services (Banking Reform) Act 2013 which sets out as accepting deposits as the only listed core activity.
[807] https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/structural-reform
[808] Proposals for splitting retail and investment banks set out in white paper, editorial, Company Lawyer, (2012), 33(8), 237-238
[809] Section 142C Financial Services (Banking Reform) Act 2013

Responses to the proposals from the banking industry were not unsurprisingly warm, as Hill and Legere[810] noted, ranging from the defensive approach of accusing government and regulators of politically motivated actions in an environment when 'banker bashing' had very little political consequences to more measured responses focussing on the impact on economic activity from such proposals.[811] The anticipated cost of compliance or the implementation of the reform at around £4-5 billion also gave the banking industry cause for concern, and this at a time when bank capital adequacy ratios were under review with a view to increased levels of capital as buffers against systemic shock.[812] The alternative view is that the aim of the ring fence reform is ensure that riskier investment activities are only carried out by the entity outside the ring fence. One such activity is so called proprietary trading where the financial institution acts as principal in transactions. The traditional and typical model of banking is one where the institution transacts on behalf of its clients, instructed by clients, using client money, whereas proprietary trading focuses on bank profits independent of the customer focus.[813] In the years leading up to the GFC institutions increasingly started trading on their own account, proprietary trading, often borrowing to do so, running significant leverage ratios in the pursuit of yield. The traditional model of fractional reserve banking could not provide the profit levels being sought by institutions and trading on their own account was the obvious method. Proprietary trading by the largest institutions has been cited as one of the causes of the GFC[814] with bank trading desks exposing their companies to enormous risk profiles and was the "clearest expression of so called "casino banking".[815] It was proprietary trading in innovative products

[810] Jeremy Hill and Edite Legere, UK: financial services bill – Financial Services (Banking Reform) Bill – expect the unexpected. Legislative Comment (2013), Journal of International Banking Law and Regulation, 28(4) p47
[811] Ibid
[812] Ibid
[813] Proprietary trading, Parliamentary Commission on Banking Standards House of Lords, House of Commons, Third Report of Session 2012-13, HL Paper 138/HC1034
[814] Ibid
[815] Ibid, 9

fuelled by weak macro-economic leading to a housing bubble, itself caused by the activities in the subprime mortgage market.

In the ring-fenced bank model proprietary trading is prohibited by the retail entity situated inside the ring fence, only permitted by the investment arm outside it. In the US policy makers have taken a different approach, instead of focusing on structural reform such as separation, the US approach is to focus on the prohibition of proprietary trading itself through the so-called Volcker Rule, named after its author Paul Volcker, the former chairman of the US Federal Reserve Board. [816] The Volcker rule prohibits specified institutions from engaging in proprietary trading, along with becoming involved by way of some form of ownership in, or the sponsorship of a hedge fund. The primary function of the rule is to reduce the instances of banks trading on their own account using leverage to gamble on risky investments.

8.6 The US response

The US legislative response to the crisis was delivered through the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 hailed "as the most sweeping overhaul of US financial regulation since the 1930s".[817] Herring and Carmassi [818]refer to the legislation as "sprawling and complex"[819] running to 2319[820] pages culminating in 500[821] new rules. The Act established the Financial Stability Oversight Council (FSOC) to monitor stability of the

[816] Ibid
[817] Halligan L, Obama signs a bill that lets banks have US over a barrel once more, The Telegraph (26th July 2010)
[818] R J Herring, J Carmassi, Complexity and Systemic Risk: What's changed since the crisis in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014)
[819] Ibid
[820] Ibid
[821] Ibid

financial system [822] with a "clear statutory mandate that creates for the first-time collective accountability for identifying risks and responding to emerging threats to financial stability"[823] undertaking a similar role to the Financial Policy Committee (FPC) in the UK. Bliss[824] points out an important function of the FSOC is to promote market discipline, a key element missing in the pre-crisis era. In addition, the Act established a Consumer Financial Protection Bureau to "enforce existing consumer financial regulations and implement new consumer protections",[825]a role performed by the Financial Conduct Authority in the UK. Stiroh[826]notes that a key function of the legislation was to "impose new constraints on bank size and activities"[827] further noting that a focus on the act is to require "enhanced prudential standards such as higher capital and liquidity standards for the most significantly important banking companies",[828] prevent mergers and acquisitions that result in a combined liabilities that exceed 10% of the industry total,[829] and prohibit proprietary trading in line with the Volcker rule.[830] To address some of the issues that arose in respect of the subprime crisis the Dodd-Frank Act requires loan originators to hold 5%[831] of their securitisation deals to ensure that they have "skin in the game"[832]which is also replicated as part of the EU Capital Requirements Directive

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822 https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc, last accessed 23/01/21

823 US Department of the Treasury, What is the Financial Stability Oversight Council and what does it do, https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc/about-fsoc, last accessed 23/01/21

824 R R Bliss, Market Discipline in Financial Markets: Theory, Evidence and Obstacles in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014),

825 T A Durkin, G Ellihausen, Consumer Lending, in , in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014), 323

826 K J Stiroh, Diversification in Banking, in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014)

827 Ibid, 228

828 Ibid

829 Ibid

830 Ibid

831 W S Frame, L J White, Technological Change, Financial Innovation and Diffusion in Banking in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014), 283. See also B Casu, A Sarkisyam, Securitisation in , in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014)

832 Ibid.

(CRD II).[833] Of critical importance Deyoung[834] posits that “by far the most important regulatory reform contained in the Dodd-Frank Act is the ‘Orderly Liquidation Authority’ (OLA) granted to the FDIC”,[835] which enables the FDIC[836]to seize and resolve insolvent systemically important financial institutions without recourse to bailout. Deyoung further notes the likely course of action in such instances to include seize the insolvent entity, fire the senior management, impose 100% loss on shareholders, with further losses imposed on other creditors and bondholders and then place the remaining assets and liabilities in a temporary bridge bank.[837]

At first sight the Dodd-Frank Act looks to address the issues that prevailed in respect of the GFC, with a focus on attempts “to reduce risks to financial stability and limit potential problems such as moral hazard that maybe associated with very large financial firms”[838] and that “one possible outcome is pressure on the largest firms to reduce their size and limit their product diversity”.[839] The above commentary suggests that US approach looks to deal with the elements of the pre-crisis environment blamed for the crisis, however, as Engel and McCoy note, “the real strength of the law will depend on the regulators charged with writing and enforcing new rules under the law. In the worst case, regulators could refuse to write rules, as Greenspan did while heading up the Fed, or draft rules that are concessions to industry”, [840] reflecting the existence of regulatory capture theory, or, “they will adopt rules designed to

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[833] B Casu, A Sarkisyam, Securitisation in , in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014)
[834] Ibifd
[835] Ibif 845
[836] The Federal Deposit Insurance Corporation; https://www.fdic.gov/
[837] R Deyoung, Banking in the United States, in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014), 323
[838] K J Stiroh, Diversification in Banking, in A N Berger, P Molyneux, J O S Wilson eds, The Oxford Handbook of Banking (2nd Edition Oxford 2014), 228
[839] Ibid
[840] K C Engel, P A Mcoy, The Subprime virus: Reckless Credit, Regulatory Failure, and Next Steps (Oxford 2011),225

protect consumers, encourage industry innovation, and prevent another crisis".[841] Almost immediately the legislation came in for criticism with Halligan referring to the "inherent feebleness of this door-stopping bundle of statute and its lack of desperately needed substance".[842] Henry and Kotlikoff referred to the act as "a full employment act for regulators that addresses everything but the root cause of the financial collapse",[843] calling it a "dog's breakfast"[844] and claiming it fails to deal with the central problem of "Wall Street's ability to hide behind proprietary information to facilitate the production and sale of trillions of dollars in securities whose true values are almost impossible for outsiders to determine",[845] with Kotlikoff analogising that "the law is like being invited to dinner and served pictures of food".[846] Scott considered the relative pros and cons of the legislation, particularly noting the creation of the new resolution authority, however, he also noted a number of negatives, including criticism of the Volcker rule against proprietary trading on the basis that it may affect the competitiveness of US banks and that proprietary trading improve liquidity and diversify risk.[847] Wilmarth in a more recent analysis notes that the reforms have failed to remove the systemic risks presented by universal and shadow banks. He notes strong opposition from republican politicians and the banking industry lobby groups that at least weakened provisions that would have "imposed stronger restrictions on the size and activities of financial giants",[848] with particular venom reserved for the Orderly Liquidation Fund (OLF) as a "bailout fund",[849] resulting that all future resolutions will be dependent on loans from the US Treasury

[841] Ibid
[842] Halligan L, Obama signs a bill that lets banks have US over a barrel once more, The Telegraph (26th July 2010), last accessed 5/10/10
[843] J S Henry, L J Kotlikoff, Financial Reform, RIP, (Forbes 25th July 2010), last accessed 23/01/21
[844] Ibid
[845] Ibid
[846] Halligan L, Obama signs a bill that lets banks have US over a barrel once more, The Telegraph (26th July 2010), last accessed 5/10/10
[847] H S Scott, A general evaluation of the Dodd-Frank US financial reform legislation, (2010) Journal of International Banking Law and Regulation, 25(10), 477
[848] A E Wilmarth, Taming the Megabanks: Why we need a new Glass-Steagall Act (Oxford 2020) at 302
[849] Ibid, 303

department. As Wilmarth[850] further notes the administration of President Donald Trump undertook measures to "do a big number of Dodd-Frank"[851] with only a Democratic Party hold on the House of Representatives preventing further watering down of the legislation. It remains to be seen how far President Biden will look to strengthen Dodd-Frank, although Biden was the vice-president to Barak Obama when the latter signed the legislation on 21st July 2010. Klein notes one of his priorities will be to restore the power of the Consumer Financial Protection Bureau which the Trump administration had eroded, collecting only $8 in fines during the second quarter of 2020 compared to $12bn under its first directorship.[852] Wilmarth however, clearly feels that the US has failed to create legislation that will prevent another crisis similar to the GFC, noting:

> "In sum, our existing financial system-with its 'global doom loop' linking TBTF universal banks and run-prone shadow banks to heavily indebted governments and overcommitted central banks-poses an unacceptable risk of causing a global financial panic that could trigger a second Great Depression. We must adopt a completely different approach to have any realistic hope of preventing such a catastrophe"[853].

[850] Ibid
[851] Ibid, 311
[852] Klein A , Top 5 financial regulatory priorities for the Biden administration, (Brookings Institution) November 9th 2020, https://www.brookings.edu/opinions/top-5-financial-regulatory-priorities-for-the-biden-administration/, last accessed 24/01/20; see also A Ackerman, P Kiernan, Where Trump and Biden Stand on Financial Regulation, The Wall Street Journal (Washington DC October 16th 2020); https://www.wsj.com/articles/where-trump-and-biden-stand-on-financial-regulation-11602858855,last accessed 24/01/20
[853] A E Wilmarth, Taming the Megabanks: Why we need a new Glass-Steagall Act (Oxford 2020), 355

Further noting:

> "Our choice is clear-we must break up universal banks and shadow banks or they will continue to dictate our government's policies and control the future direction of our economy and society"[854]

8.7 Conclusion

The discussion in this chapter focuses on the reforms that followed the GFC and the election of the conservative government in May 2010. The evidence from the above analysis show that the reforms represent a politically motivated attempt to address the perceived issues with the previous regime's failures. It was clear that given the political influence that pervades bank and financial services regulatory architecture significant reforms would occur. However, was it wise to undertake such a radical change creating more and increasingly complex, transparent rules. The implementation of the ring fence is a step in the right direction for banking in the UK. To achieve the overall aim of bank regulation, to ensure systemic and therefore, financial stability banks must be allowed to fail without the concomitant knock-on effect to the wider economy. The position in the US where the crisis originated further evidences the difficulties in developing effective regulation in the face of political opposition. The tension between the banks and their political supporters on the right of the political divide continues to prevent regulation from achieving its lofty aims of providing financial stability. This further provides evidence that a pared back transparent regulatory structure is a key ambition for bank regulation, providing a relatively low regulatory system with strong macroprudential oversight.

[854] Ibid, 356

The FSOC in the US and the FPC in the UK provide an opportunity for releasing some of the regulatory burden while maintaining a strong and stable banking system, delivering financial innovation that provides societal benefits in the form of liquidity growth, mortgage lending at affordable rates, small business lending alongside broader commercial activity. The final chapter draws the research to a conclusion by returning to the central theme of the thesis of why regulate.

Chapter 9 - Conclusion

9.1 Introduction

The primary research question posed in the thesis is why regulate, supported by a further group of sub-questions designed to draw out the answer to why regulate. The initial sub-group were:

1. Why regulate and supervise banks?
2. Should we supervise banks at all?
3. Are we at a point where we should be looking to strip back regulation, not add to it?
4. If the answer is yes to supervise and regulate, what should that regulatory structure look like.

As noted in Chapter 1 as the research matured the question of why regulate crystallised into one where the rationales of regulation required understanding against an overall environment in which the regulation of banks operate, to include broader economic thought and a borad focus on the political drivers that play a central role in the design of regulatory processes.

The theme that emerges from that analysis is that the primary reason for why regulate should focus on financial stability as being the regulatory objective to be achieved. This focus was not evident in the pre global financial crisis (GFC) environment with little attention paid to macroeconomic and stability issues.[855] Key here is a stronger understanding of the capture theory of economic regulation. There was a tendency for the regulator to become 'captured' by the industry that it regulates, the GFC providing evidence of this with regard to the pre-

[855] D Reece, Financial Stability report is a reminder of how banks should be run, The Daily Telegraph (London 28th October 2008).

crisis environment, and specifically with lack of new market entrants.[856] For an effective regulatory system to develop the regulatory authorities must act independently of the regulated. Therefore, the thesis focuses on the regulation of banks in the United Kingdom (UK) using the GFC as the base line for analysis. The GFC provides the evidence by which the regulatory regimes may be scored against the overall rationales of regulation in the context of banks, which answers the initial and central research question set out in Chapter 1 of the thesis which was to understand why regulate?

Chapter 4 provides the conceptual framework in which regulation takes place analysing the key part that deregulation played in creating the environment that led to the GFC. The change in economic thought, moving away from interventionist policies, supported by political drivers changed the environment in which banks operated. This new regime promoted risk through innovation within an environment that became increasingly deregulated. Chapter 4 brings together a number of key elements that pervade the bank regulation debate, in particular moral hazard. Moral hazard will continue to prove the biggest challenge to bank and financial stability. Moral hazard posits that failure will be rewarded, or more accurately not punished for failure. The GFC created the biggest moral hazard in history with universal banks operating in a bankruptcy remote environment; operating on an assumption that they will be rescued if they face insolvency. The provisions of the Banking Act 2009 and subsequent developments in the Bank Resolution and Recovery Directive, with the addition of the bail-in option provide a welcome and necessary addition to the regulatory toolkit.[857] However, the existence of any form of insurance against failure will always create an environment of moral hazard. To ensure

[856] Stigler G J, The Theory of Economic Regulation (1971) The Bell Journal of Economics and Management Science, Vol.2, No.1, 3.
[857] 2014/59/EU

financial stability the effects of moral hazard need to be addressed and militated. In essence there must be an element of jeopardy, an element of uncertainty as to whether a regulator will step in. The resolution mechanisms are an important step in this process, however, ultimately banks must be allowed to fail in an orderly fashion, they must be allowed to fail as per other corporate entities, it is a fundamental part of the business cycle. The transfer operations in the resolution provisions should be set up to operate at speed to avoid disturbance to depositors, and the wider economy. The removal of moral hazard will create a modification of behaviour in the banking sector that will support the overall stability objective. The recommendation is that inherent bank safety nets are reviewed and that banks must be allowed to fail in an orderly manner, within a robust bank insolvency process that protects depositor interests.

Chapters 5 and 6 analyse the rationales for regulation and the perceived causes of the GFC. Chapter 5 investigates the framework underpinning the central research question of the thesis in respect of why banks may need regulation. Chapter 6 looks to focus the causes and analyses the combined issues of deregulation and political influence. The usual causes cited for the GFC lie with the United States (US) Sub-prime loan market and the subsequent bursting of the US housing market bubble that had built up in the decades preceding the GFC. The thesis, however, focuses on a different view in that the collapse of the US housing market and the failures within the sub-prime loan market were merely the end of the process. The chapter outlines the real cause which was the failure of the regulatory environment to fully understand the risk profiles created by prevailing economic thought. This failure was a result of the creation of an economic environment based on misplaced trust in economic theory that failed to work in the real world. The environment focused on deregulation of financial markets on the premise that they would self-correct, however, with the inherent information asymmetries creating imperfect markets self-correction was not possible. Ultimately regulation is a process of managing risk. Black posits that the regulator should identify its objectives and understand the risks that organisations within its sphere of responsibility may present to prevent it achieving those objectives.[858] This is a more challenging task with respect to bank regulation than may be initially apparent as banks operate in a dynamic and competitive environment.

Chapter 7 analyses the regulatory regime in place as the GFC emerged and in the years preceding it. The focus of the chapter is on the Financial Services and Markets Act 2000 (FSMA) and the operation of the Financial Services Authority (FSA). The chapter notes the perceived failure of both the FSMA and FSA alongside the so called tripartite regulatory regime. Again, the chapter notes that the design of the regulatory regime was focused on delivering political outcomes rather than outcomes based on regulatory need. Chapter 8 evaluates the reforms enacted following the GFC. In line with the central theme of the thesis the chapter notes that there was a rush to reform, a ‘knee jerk’ approach to updating the regulatory processes for banks. The chapter analyses the raft of legislation brought in to fix the perceived issues with the previous regulatory regime, but notes that the ‘knee jerk’ provided potentially provides little more than being seen to be doing something, again due to political rather than regulatory needs. The chapter notes the complexity of the new regulatory regime and laments the missed opportunity to provide a more transparent process capable of preventing a repeat of the GFC.

The obvious conclusion to draw from these two chapters is that effective regulation that meets the rationales provided for in Chapter 5 are difficult to achieve. This is as a result of the

[858] Black J, Regulatory Styles and Supervisory Strategies, in N Moloney, E Ferran, J Payne eds The Oxford Handbook of Financial Regulation, (Oxford 2015).

political considerations that pervade decisions on regulatory design. These political considerations are often accompanied by reliance on economic dogma to underpin political decision making. The GFC shows clear evidence of policy level failure to ensure a regulatory environment fit for purpose. The financial liberalisation and deregulation that emerged following the economic crisis brought with it a resurgence in free market economic neo-liberal thinking with bank regulation largely fitting in with this thinking. The development of financial innovation and the rise of securitisation operated within a liberalising market, largely encouraged by the governments of the day. The last three iterations of financial services regulation reform reflect this approach. The Financial Services Act 1986 set the UK financially regulatory system on the path of deregulation, opening up the UK financial market. The self-regulatory ethos of UK financial services regulation was largely maintained within a statutory framework, although created a complex and overlapping regulatory system, with the Bank of England retaining responsibility for the banking sector. The reforms enacted via the FSMA 2000 changed the course of UK financial regulation dramatically setting up a wholly statutory regime and a single consolidated regulatory system with the regulator subject statutory objectives. The reforms were as a result of political changes brought about by the 1997 general election and the perception that the financial services sector was beset with scandal. In addition to the creation of the single regulator structure the government transferred regulation of banks from the Bank of England to the FSA.

This was a mistake; the size and complexity of the UK financial services sector was too much for the new structure, and its focus on consumer protection issues resulted in a lack of focus on bank regulation and systemic stability. One of the first provisions to follow the emergence of the GFC was to add a statutory objective to maintain financial stability to the FSA's objectives, although such an objective already existed but had lacked focus, with insufficient time and resources dedicated to this issue. The bigger mistake was the missed opportunity to take up the opportunity to employ Taylor's twin peaks methodology, separating prudential and conduct regulation between two bodies.[859] This was, however, taken up by the new conservative government elected in 2010 which had criticised the failure of the consolidated model and advocated its abolition.[860] The reforms brought in a modified a twin peaks system, with the Financial Conduct Authority (FCA) taking the rump of the FSA's activities as a conduct and the Prudential Regulation Authority (PRA) having prudential regulation responsibility for large banks. A key modification from Taylor's model is the creation of the Financial Policy Committee to sit above the twin peak regulators with specific responsibility for monitoring the macroeconomic environment and systemic risk factors. This too was a mistake and evidences a knee-jerk political reaction to be seen to be doing something following the GFC. The development of a macroeconomic systemic responsible regulator was sufficient to ensure financial stability. The FSA had focused and become an experience conduct regulator, building experience. The decision to scrap the FSA at the first opportunity was hasty and lost the opportunity for lessons learned to be put into practice. The remaining issue revolves around the Bank of England and its role. It was a mistake of the FSMA 2000 to remove its responsibility for banks a role that it was ideally suited to as the lender of last resort. It is clear that bank regulation is best placed within the central bank.

[859] Taylor M, Twin Peaks; a regulatory structure for the new century (1995), Centre for the Study of Financial Innovation.
[860] P Rawlings, Bank Reform in the UK: Part II – Return to the Dark Ages (2010) International Corporate Rescue, 10

9.2 An alternative approach?

The thesis posits that the regulatory choices made since the 1970's have been clouded by a political focus largely based on a change in economic thought processes. The evidence provided in chapters 7 and 8 looking at the before and after comment on this link, noting a 'knee jerk' politically driven reaction to the emergence of the GFC. This is reinforced through the analysis in chapter 4 outlining the conceptual framework within which the regulation of banks applies. These chapters look to emphasise the contribution to knowledge made in the thesis in linking regulatory design to environment alongside politically driven decision making, which is lacking overall in the literature.

The FMSA 2000) provided the FSA with a statutory objective to reduce financial crime,[861] and while this covered fraud or dishonesty[862] and handling the proceeds of crime.[863] It also includes misconduct in, or misuse of information relating to a financial market.[864] To support this a new, innovative and novel market abuse regime was developed to fill gaps in the existing criminal law.[865]. The original market abuse provision was enhanced by the 2005 Market Abuse Directive which added to the list of actions caught by the regime.[866] The regime covers abuse in the market under three broad headings of market abuse, misuse of information and creating false and misleading impressions.[867] Following the GFC and as part of the reform measures the government enacted provisions to bring senior managers to account for causing the failure of

[861] Section 6 Financial Services Act 2000, See Chapter 7.
[862] Section 6(3)(a).
[863] Section 6(3)(c).
[864] Section 6(3)(b).
[865] M Filby, Part VIII Financial Services Act: Filling insider dealing's regulatory gaps (2004), Company Lawyer 23(12), 163; An Alcock, Market Abuse – the new witchcraft (2001), The New Law Journal, 151, 1398. See Part VIII FSMA 2000
[866] Given effect by the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2005, SI2005/381
[867] K Alexander, UK insider dealing and market abuse law: strengthening regulatory law to combat market misconduct in Bainbridge ed, Research Handbook on Insider Trading (Edward Elgar 2013).

a bank. Section 36 of the Financial Services (Banking Reform) 2013 creates the offence of causing a financial institution to fail, punishable on conviction to a maximum prison sentence of 7 years and a fine.[868] The provision allows for such a prosecution of a person in the position of a senior manager in respect of the failed institution on the basis that at the time they made the decision the manger was aware of the risk that the implementation of the decision may cause failure of the group institution and the conduct falls below what could be reasonably expected of a person in the senior managers position and that the implementation of the decision causes the failure of the group institution.[869]

The provision represents a 'nuclear' option that would operate on the unpalatable outcome of a bank failure, an option that no one would want to see; it is an option to be kept behind glass to be opened in time of emergency. For the purposes of Section 36 a bank is deemed to have failed if it enters insolvency, any of the stabilisation options in Part 1 of the Banking Act 2009, or the firm for the purposes of the Financial Services Scheme to be unable, or likely to be unable, to satisfy claims against the firm.[870] This definition of failure is useful in that it does not mean total collapse of the firm, but can include one of the stabilisation options to prevent failure, the decision that caused the firm to require the support of stabilisation options.[871] The Act does not specify if accepting liquidity support from the central bank also qualifies to trigger the provision, however, if the senior managers decision leads to the requirement to request support, the provision to apply. In addition, the Act should be modified to cover a wider range of errant activity, falling short of causing the bank to fail, which will be a rare occurrence. Part VIII FSMA is a setting standards provision designed to show the kind of behaviour that is

[868] Section 36(1) and (4)(b) respectively.
[869] Section 36(1) (a)(b)(c)(d).
[870] Section 37(9)(a)(b)(c), with insolvency defined in Section 37(10).
[871] The provision seems clearly to deal with actions of senior bankers such as Fred Goodwin, the head of RBS whose takeover of Dutch bank ABN AMBRO nearly led to the collapse of RBS.

expected from market participants.[872] In a similar vein the Section 36 offence should be expanded to include behaviour that would fall short of failure, with a set of thresholds set out in legislation that trigger criminal sanctions. A stronger deterrent effect will support a safe and sound banking system.[873] The lacuna that is identified in the thesis and noted at chapter 4 is that extreme risk taking was rewarded with bailout rather than punished through a robust sanctions scheme.

9.3 Challenges and The Way Forward.

The ultimate outcome of the thesis is to learn and understand the lessons from the GFC, to avoid repeating the mistakes of the past, and to avoid another GFC like event. The thesis has looked at several factors in relation to the causes of the GFC, the regulatory structures in place before and since, as well as the hidden forces that complicate the regulatory debate. However, at a fundamental level the failure to deal with the too big to fail paradox will remain the challenge for bank regulators and until regulators are fully able to do so the spectre of financial instability will remain. The G-SIB TBTF paradox and its link with moral hazard remains the biggest challenge to successful regulation of banks. The imposition of the ring fence was a step in the right direction, however, too many questions remain unanswered, especially with respect to the how strong the fence will be. A better approach will be to create the same form of separation seen in the US Glass-Steagall Act of 1933 which enforce in law the separation of retail and investment banking activities. The ring fence creates a 'soft' approach to this, but not does not mandate full separation, still permitting banking groups. The only true way to ensure that bank failure has limited impact on ordinary customer is for a full separation.

[872] A Haynes, Market Abuse: An analysis of its nature and regulation (2007) 28(11), 323.
[873] See Anon, Offence of reckless misconduct for senior bankers among amendments to Banking Reform Bill (2013), 34(12), 379.

Rawlings noted that the Future of Banking Commission advocated a breakup of banks which would lead to increase competition and remove the risky investment bank techniques that financial innovation has brought, leaving retail banks to undertake less risky activities such as deposit taking, lending and payments.[874]This would operate on similar lines to Kay's Narrow banking concept with retail high street banking offering limited services.[875] This would allow investment banking to continue to innovate to create and maintain liquidity, subject to systemic regulatory requirements.

9.4 Final Conclusion

The primary research question posed in the thesis is 'why regulate'? The thesis has shown that the fundamental rationale for regulation is to maintain financial stability, not only in the banking sector but stability for the economy with the avoidance of political influence an important factor. The stability requirement provides the key to why there is a need to regulate. This cannot be achieved in the current climate with banking groups that are too big to fail offering no option to regulatory authorities but to rescue banks in trouble. Former Bank of England Governor Mervyn King pointing out that "it is hard to see how the existence of institutions that are too important to fail is consistent with their being in the private sector".[876] An enhanced resolution system, a strong separation of retail and investment banking activities and a banking culture that allows failure, with potential for sanctions is needed to create effective banking provision in a safe and sound environment will provide benefits to financial stability. A simplification of the structure and application of regulation will allow this to emerge.

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[874] P Rawlings, Bank Reform in the UK: Part I – The Future of Banking Commission (2010) International Corporate Rescue, 3

[875] J Kay, Narrow Banking: The Reform of Banking Regulation, (2009), Johnkay.com; https://www.johnkay.com/2009/09/15/narrow-banking/, last accessed 4/12/20

[876] King M, Speech to Scottish Business Organisations (2009) 20th October 2009.

It is clear from the analysis that the reason why banks need regulation is predicated on the central role they play in economic activity and the impact on society. Modern banking provides essential services to industry and ordinary people and failure of a bank will have a significantly negative effect on both. The interconnectedness of banking amplifies the need. Effective regulation is needed to ensure that banks operate in a safe and sound manner proving vital services to the economy. Regulation is necessary but it should not be so complex that banks seeking high yields are not able run excessive risk portfolios that put the institution in danger of collapse. The thesis in analysing regulatory architecture notes that across the globe the GFC had significant impact on different styles of regulatory design, whether single consolidated model as in the UK, twin-peaks in the Netherlands or the more fragmented approach characterised by the US. This provides evidence that the whichever regulatory design is utilised the environment in which the regulator applies domestic and international law plays an equally important part. This is in addition to the application of individual provisions by the regulators. There is a need for a coherent and integrated approach to regulatory design that includes the overall regulatory architecture, the macro-economic environment, and the operation of the regulator.

As a final word the implementation of a twin-peaks regulatory system based on statutory obligations would have been preferable to the single consolidated model. This would have provided a more specialised regulatory structure providing for conduct and prudential regulation to vest with experts. The creation of the Financial Policy Committee with oversight responsibility for financial stability is to be lauded and provides the necessary high-level supervision of regulation that should prevent a repeat of the GFC. A key mistake made as part of the 1997-2000 reforms to was to remove the Bank of England as the primary regulator of banks, a point corrected by the 2010 reforms. Ultimately however, it is the overall macro-economic environment and the strength of character of regulators that will prevent a repeat of the GFC. The political driven design process creates a challenge for effective regulation, one that may result in missing the lessons from the past.[877]

[877] See above (n.2)

Appendix A - Brexit and Bank and Financial Services Regulation

On the 23rd June 2016 the UK voted in a referendum to leave the European Union (EU) which became effective at 11pm on 31st December 2020[878]. To manage the UK's exit the government enacted the European Union (Withdrawal) Act 2018 which effectively brings existing EU legislation into UK law. From the point of exit UK legislative development will solely be the remit of the UK Parliament and the devolved institutions. Brexit, as it is popularly known, will have a significant impact on the UK financial services system the exact nature of which is still uncertain, however, the early indications is that is that the deal may not match the access available under EU membership,[879] and "looks quite similar to a no deal as far as financial services are concerned".[880] The UK EU Trade and Cooperation agreement itself does not make provisions for financial services so access to EU financial markets will be based on compliance with individual jurisdictions and markets rules and regulations which will be more difficult following the loss of the EU banking passport which allows forms to operate banking services across the EU without the need for additional regulatory clearances.[881]

The exact impact of Brexit will be worked out in the years to come. Of key concern in respect of regulation is a fear that it will lead to a "bonfire of regulation"[882] and a new era of

[878] This was after a number of extensions had been negotiated see Commons Library Research Briefing, Brexit timeline: events leading to the UK's exit from the European Union, (UK Parliament House of Commons Library 6th January 2021), https://commonslibrary.parliament.uk/research-briefings/cbp-7960/ last accessed 16/1/21
[879] S Payne, C Giles, J Brunsden, Boris Johnson admits Brexit deal is limited for financial services, Financial Times (London 27th December 2020) https://www.ft.com/content/3c07d219-b20a-4315-9f17-badb10a5279b
[880] J Hogam, F Gillen, M White, J Lawless, D Murphy, A Farrell, E O Cuiv, H Beattie, Tony Spratt, The Brexit Deal: Impact on Financial Services (McCann Fitzgerald, Lexology 12th January 2021) https://www.lexology.com/library/detail.aspx?g=285b7f67-1116-40b5-b820-a8c0f0ddcfd2, last accessed 16/1/21
[881] S Hall, What does the Brexit Trade deal mean for financial services, (UK in a Changing Europe, 27th December 2020) https://ukandeu.ac.uk/what-does-the-brexit-trade-deal-mean-for-financial-services/ last accessed 16/01/21
[882] M Thomas. J Roslington, The UK Supervisory Regime in the Post-Brexit Environment, in J Herbst and S Lovegrove eds, Brexit and Financial Regulation (Oxford 2020). See also R Mason, Tory MPs suggest firms draw up list for bonfire of EU laws after Brexit, The Guardian (Manchester 7th December 2016), https://www.theguardian.com/politics/2016/dec/07/tory-mps-suggest-firms-draw-up-list-for-bonfire-of-eu-laws-after-brexit

deregulation. There has long been widespread concern over the cost and bureaucracy associated with EU rules and regulations negatively impacting the traditional ‘light touch’ approach of UK regulation with the UK financial services sector “built on an ethic of free trade” [883]which was a key factor in its success.

To maintain its global position and attract business, and therefore, contribute to the UK economy, the UK banking sector will lobby hard to reduce the regulatory burden on UK banks. To remain competitive globally UK banks may look to encourage regulatory arbitrage away from the EU and into London. It is unlikely that this can be achieved through capital adequacy reductions although the UK will no longer be subject to EU capital adequacy directive developments, although to attract market entrants this maybe an option. Thomas and Roslington note the concerns of UK “unilateral deregulation” but in doing this would risk the UK having to operate outside the work of the International Organisation of Securities Commission (IOSCO)[884] who have been influential in bringing together cooperation in securities trading, particularly in the years following the GFC.[885]

Thomas and Roslington further note that messages from the UK government suggest that they do not intend to follow a path of deregulation[886] , outlining that the then head of the Financial Conduct Authority (FCA) Andrew Bailey stated that “the UK did not intend to engage in a ‘race to the bottom on deregulation’, further noting that the “stakes were simply too high in terms of our public interest objectives”, further supported by comments from the then chair of

[883] Ibid, 175
[884] See https://www.iosco.org/about/?subsection=about_iosco
[885] Thomas M. Roslington J, The UK Supervisory Regime in the Post-Brexit Environment, in J Herbst and S Lovegrove eds, Brexit and Financial Regulation (Oxford 2020).
[886] Ibid

the Prudential Regulation Authority (PRA) warning against wholesale abandonment of regulation. These were drawn from comments made in 2017, however, by November 2020 it was clear that some accommodation in the relaxing of financial services regulation would be needed with Andrew Bailey, now the governor of the Bank of England signalling that "loosening financial regulations in an attempt to foster higher long term 'productive investment" may be required. Bailey further notes that "government's financial regulations were standing in the way", and while talking specifically about pensions and noting the importance to avoid "excessive leverage' and the use of corporate debt finance bank loans as the solution it is concerning that the twin impacts of Brexit and SARS-CoV-2 pandemic, a 'bonfire of regulation' is a distinct possibility.

This is cause of concern. The GFC was a product of deregulation over a prolonged period that allowed financial institutions to develop risky positions and any significant deregulatory measures risks a return to the conditions that allowed the GFC to develop. Of further concern with unilateral UK deregulation by the UK is the possibility of opening up a 'deregulation war' with other significant financial centres such as New York, Hong Kong, Tokyo, and the EU itself. A deregulatory move by UK authorities will undoubtedly lead to similar moves in other areas leading to a period of regulatory arbitrage which may result in destabilisation on a broader scale. The pressures for deregulation were already high and one of the many drivers behind Brexit, however, the additional financial pressures brought on by the SARS-Cov-2 Pandemic[887]will increase the voices for deregulation even further. The need to protect the UK financial services sector and maintain London as a leading centre for mobile capital will

[887] See J Wilson, The economic impact of coronavirus: analysis from Imperial experts, (Imperial College London, 13th May 2020), https://www.imperial.ac.uk/news/196514/the-economic-impact-coronavirus-analysis-from/ last accessed 16/01/21

increase the need for UK banks to operate in a friction free environment, which regulation creates.

The issue of the impact of Brexit and additional impact of the global health crisis present a challenge to the 'why regulate' question posed in this research. The central thesis of this research is that to effectively regulate banks and by extension financial services it is fundamental to understand the need of why we regulate, to understand the rationale behind putting in regulation in the first place. As has been noted in this research the primary focus should be on managing systemic risk to ensure financial and economic stability so that economic growth can take place, and search for bank profits needs to be a secondary aim to this. The threat of deregulation due to the twin Brexit and pandemic pressures may lead to the temptation to lose this point, to provide an environment where banks and other financial institutions are able to take advantage of the regulatory arbitrage opportunities discussed above. This will provide short term advantages to UK based banks and may attract banks to the UK in order to avail themselves of a deregulated supervisory system, however, this will inevitably lead to collapse. The short termism of the regulatory environment characterised in the years prior to the GFC evidence the need for regulation to take the long-term approach, to manage the system in such a way to avoid failure, but where individual institutions do run the risk of failure the environment should allow such failure in an orderly manner with minimum contagion to the system

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