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Kern Alexander
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Introduction

We shape our buildings; thereafter, they shape us.

Winston Churchill

This book analyses how the principles of banking regulation, including the regulatory standards, norms and legal frameworks, develop and interact with the institutional and organisational structure of banking. The fractional reserve banking system discussed in Chapter 2 allows the banking system collectively to create and allocate credit – which means they decide who gets access to scarce economic resources. This means that banks have control over the redistributive process in the economy and as a result have become essential to the political settlement of a country. Banking regulation reflects the very nature of this settlement.

The global financial crisis of 2007–2008 has been the subject of much debate and analysis. The causes of the crisis have been attributed to over-expansive monetary policies in developed countries which led to property and share price bubbles in the United States, the United Kingdom and many other countries. Most large banks and financial institutions failed to measure and manage the risks to which their highly leveraged balance sheets were exposed. Regulators and supervisors also played a role by failing to require that banks hold adequate levels of capital while also failing to detect the serious liquidity exposures of financial institutions in the wholesale funding markets and the large build-up of leverage in the financial system. Few observers paid attention to systemic risks which had arisen from global macroeconomic imbalances and a substantial increase in leverage and debt across the financial system. Bank regulatory capital models were heavily dependent on risk-weightings of assets on bank balance sheets, which were based on historic default and loss data that were inadequate for estimating the institution's future credit, market and liquidity risks or for estimating systemic risks across the financial system. Moreover, banks and their interconnected financial agents and institutions in the wholesale capital markets devised and traded complex collateralised debt obligations and credit default swaps that contributed significantly to systemic risk. Also, accounting standards impeded adequate provisions and valuation of assets when wholesale markets suddenly collapsed.

In addition, the crisis management measures of regulators and central banks failed to manage the fallout from the crisis. Central banks, including the Bank of England and the

Board of Governors of the Federal Reserve, were slow to recognise dangers from the collapse of confidence in inter-bank markets in mid to late 2007. In August 2007, the Bank of England refused to provide the British bank Northern Rock with lenient lending terms after the bank, which was solvent at the time, had lost access to the wholesale funding markets.[1] A few months earlier, in March 2007, at a time when US mortgage loan defaults were increasing sharply and when mortgage lenders were going out of business, Federal Reserve Chairman Ben Bernanke testified before the US Congress that '[t]he impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained'.[2] Similarly, William Poole, former President of the Federal Reserve Bank of St Louis, stated in late 2007 that '[m]y own bet is the financial market upset is not going to change fundamentally what's going on in the real economy'.[3] This suggests that UK and US central bankers had very little, if any, understanding of the risks that were threatening the financial system nor how to respond to a crisis once it began.

The regulators of the world's most sophisticated banking and financial markets failed to learn the lessons from previous banking crises in Japan and Scandinavia in the early 1990s and from the Asian financial crisis of the late 1990s, including that banking sector losses must be recognised early and sometimes separated from viable assets in so-called 'bad' banks.[4] Market panic and the collapse of confidence in counterparties should have triggered faster official guarantees. For instance, it was not until December 2007 after the crisis had intensified that the US government established the Term Auction Loan Facility, the first in a series of government-subsidised loans to the financial sector. Later, US authorities failed to pre-empt the collapse of Lehman Brothers in 2008 or to limit the fallout, while most European states had inadequate legal frameworks to allow the restructuring of their largest and most systemically important banks.

The fall of Lehman Brothers demonstrated that in an increasingly interconnected world, a localised economic shock (such as a market or institutional failure) can affect financial institutions and markets in other countries, even causing the global financial system to collapse like a row of dominos. Such a chain of failures that threatens all or part of the financial system epitomises 'systemic' risk. Prior to the global financial crisis, regulators

1 See House of Commons Treasury Committee, 'The Run on the Rock' (2008) 38ff.
2 See Federal Open Market Committee of the Board of Governors of the Federal Reserve System, Transcript of Minutes of Meeting of 7 August 2007 (Federal Open Market Committee meeting transcript, Board of Governors of the Federal Reserve System 2018) www.federalreserve.gov/monetarypolicy/files/FOMC20070807meeting.pdf accessed 3 January 2018, with Ben Bernanke stating after the crisis had begun, '[m]y own feeling is that we should try to resist a rate cut until it is really very clear from economic data and other information that it is needed', and he went on 'I'd really prefer to avoid giving any impression of a bailout or a put, if we can.'
3 See Poole W, President of the Federal Reserve Bank of St Louis, stating '[m]y own bet is the financial market upset is not going to change fundamentally what's going on in the real economy', Binyamin Appelbaum, 'Days Before Housing Bust, Fed Doubted Need to Act', *New York Times* (New York, 18 January 2013) www.nytimes.com/2013/01/19/business/economy/fed-transcripts-open-a-window-on-2007-crisis.html accessed 3 January 2018.
4 See Fujii M and Kawai M, 'Lessons from Japan's Banking Crisis – 1991–2005', in Alexander K and Dhumale R (eds), *Research Handbook on International Financial Regulation* (Edward Elgar 2012), 259, 284.

focused almost entirely on 'micro-prudential' regulation: correcting market failures that threaten economic efficiency at the level of the individual firm, such as by maintaining competition, protecting investors against fraud and other abuses, preventing standard externalities, and preserving the viability of individual banks and other financial institutions. The crisis revealed that regulation must also focus on correcting market failures that cause systemic risk both from within the banking sector and from the broader financial system. Such regulation is often called 'macro-prudential'.

In the relatively few years since the crisis, no overall conceptual framework has emerged for designing a macro-prudential regulatory regime to control financial market failures that cause systemic risk. In some cases, macro-prudential regulation – as exemplified by the US Dodd-Frank Act and European legislative reforms – remains constrained by its predominant focus on standard externalities caused by individual banking institutions but without adequate focus on the market failures across the financial system that create systemic risk. And although it is now apparent that both financial institutions and financial markets can be triggers and transmitters of systemic risk, macro-prudential regulation in its current form rarely addresses the systemic risks that arise from the regulatory arbitrage that results in the business of borrowing and lending and the trading of risky financial instruments that increasingly takes place in the so-called shadow banking markets.

A large part of the problem is that regulators and policymakers view macro-prudential regulation in an *ad hoc* manner – as a collection of 'tools' in their regulatory 'toolkit'. This results in either overly specific regulatory proposals without realistic guidance as to their application or use, or overly broad propositions that provide no concrete regulatory guidance at all. Furthermore, the misapplication of these tools – such as stricter restrictions on leverage and credit growth – may be as likely to increase financial risk-taking, however, as to control it. At an October 2015 US Federal Reserve conference, regulators themselves recognised that 'policymakers have made little progress in figuring out how they might actually' prevent another financial crisis and that both monetary and macro-prudential policies are not really effective.[5]

This book argues that to develop a coherent and consistent approach to banking regulation the regulator's objectives must be clear and guided by certain principles that aim to correct the fundamental types of market failures that undermine banking sector stability and threaten the legitimate interest of bank customers, depositors and investors and other stakeholders who depend on the banking sector for their economic livelihood. It also attempts to build on recent academic and policy-based literature that analyses the need to design a more coherent regulatory framework that links the objectives and theory of micro-prudential regulation and macro-prudential regulation.[6] Indeed, Ingves (2011) has identified the need to have a better conceptual framework that strikes a balance between macro-prudential regulation and micro-prudential regulation: both are necessary

5 See Appelbaum B, 'Skepticism Prevails on Preventing Crisis' *New York Times* (New York, 5 October 2015).
6 See Brunnermeier M, Crockett A, Goodhart C, Persaud A and Shin H, *The Fundamental Principles of Financial Regulation* (Princeton University Press 2009).

for maintaining financial stability and the conditions for sustainable economic growth.[7] But other principles of regulation such as accountability and transparency that aim at protecting bank customers and investors are also important and should be recognised in the analysis.

The first part of the book covers Chapters 1–5. Chapter 1 provides a general discussion of the banking business and its origins and evolution in modern financial markets. It considers the historic differences between commercial banks and other deposit-taking institutions, such as savings banks/building societies and credit unions, by explaining when and why they were created and what functions they serve. The evolution of the banking business has often responded to regulatory changes. For instance, the chapter discusses how the primary economic function of banking – credit intermediation – has evolved in response to financial innovation, such as securitisation, and regulatory changes that resulted in bank disintermediation – alternative forms of credit – outside the formal regulated banking sector. It also discusses the role of banks in payment systems and the implications for systemic risk and competition, while exploring how banks use low-margin lending to attract other higher-margin business, such as underwriting. The chapter will also discuss the advantages and disadvantages of direct and indirect finance and the role of technology. Also discussed is the importance of bank organisational structure and how different organisational structures have evolved in different jurisdictions.

Chapter 2 discusses the main theories and institutional models of banking regulation, including how asymmetric information within banks and across the financial system can result in moral hazard and adverse selection, thereby leading to negative externalities that can undermine financial stability. The chapter considers some of the main theories of regulation, including public interest and capture theories. It traces the recent development of prudential regulatory concepts and supervisory practices and the move from a primarily micro-prudential supervisory perspective to a macro-prudential perspective that focuses on risks across the financial system and the role of banks in payments systems. Regulation has to do with rule-making, while supervision involves monitoring institutions' compliance with regulatory rules and enforcement by imposing sanctions. The chapter discusses the economic importance of banks and the importance of effective regulation to curb the costs of banking failures and crises. The evolving regulatory concepts are also relevant for understanding the different institutional models of banking regulation (e.g. Twin Peaks, sectoral or mixed approach) and the advantages and disadvantages of certain models. In this regard, the national institutional models will be analysed in terms of their interaction with regional (i.e. EU ESAs/ESRB/SSM) and international institutional structures, with particular focus on the Financial Stability Board and G20 policy framework. The experiences of different jurisdictions, including the US, UK, Australia, China and EU, will be considered.

Chapter 3 analyses global policy developments in banking regulation and the role of international soft law norms and standards, with particular focus on the Basel Committee

7 See Ingves S in Brunnermeier et al. (n 6), 96.

on Banking Supervision and the Core Principles for Banking Supervision and the importance of the financial stability objective in international banking regulation. The chapter discusses the role of the Financial Stability Board (FSB) in fostering macro-prudential regulatory practices and its important influence on the development of bank resolution regimes. It also discusses how the FSB coordinates its responsibilities with the G20 and the International Monetary Fund in promoting international standards to safeguard financial sector stability.

Chapter 4 analyses bank capital regulation and risk management. The chapter discusses the role of regulatory capital and how the risk management function is essential for calculating the bank's regulatory capital. It will also discuss the evolution of bank capital and liquidity requirements under Basel II and Basel III, and how Basel III adopts stricter regulatory capital and risk governance standards. It will also provide critical discussion of the risk-weights used by banks to calculate regulatory capital and how reliance on risk-weighting has come to be perceived as a major weakness in prudential regulation. It discusses the application of higher capital requirements to so-called Systemically Important Financial Institutions (SIFIs) and the systemic risks they pose. The chapter also addresses the amendments to Basel III (so-called 'Basel IV') that were adopted in 2017 which, among other things, reduce the extent to which banks can rely on their internal risk-weightings to calculate regulatory capital. Moreover, the chapter will also discuss how risk management has evolved from a micro-prudential approach to assessing risks to a macro-prudential approach that focuses more on the stability of the financial system and the inter-linkages and operations of the financial system.

Chapters 5 will analyse the law and regulation of bank corporate governance and how governance processes for banks have undergone greater formalisation since the financial crisis of 2007–2008. Governance reforms are a response to pre-crisis breakdowns that led to excessive risk-taking in bank lending and derivatives trading and to criminal activity in the case of LIBOR manipulation and other market abuse. The chapter will provide a comprehensive discussion of the unique governance issues associated with banks arising from the inherent complexity of bank business models and their risk profile. It will provide an understanding of the duties and responsibilities of directors and the behaviour required from them and well-functioning boards. Inadequate credit assessment was identified as a key contributor to the banking crisis and governance issues in relation to risk will receive attention in this chapter.

The next part covers Chapters 6–10. **Chapter 6** analyses deposit guarantee schemes and bank recovery and resolution frameworks. It considers the importance of depositor protection regulation with a particular focus on UK and EU regulations and comparison with the United States. The inadequacy of deposit protection schemes in Europe became apparent during the crisis and led to substantial reforms of bank deposit guarantee regulation in the European Union. The UK's experience with depositor guarantee reform will be discussed along with a case study involving the bank run on Northern Rock in 2007. The conceptual basis of deposit guarantee schemes is analysed along with the position of the depositor as an unsecured creditor. The different types of deposit guarantee schemes (e.g. risk-based) and pre-pay versus post-pay will be compared. The chapter will consider whether bank deposit guarantee schemes are complementary to achieving regulatory objectives and the relationship between deposit guarantee schemes and bank resolution. The chapter also reviews the main resolution tools in several jurisdictions and the main principles of bank resolution adopted by the Financial Stability Board. It also considers the Dodd-Frank Act's resolution framework and the operation of the US Organised Liquidation Authority. The importance of the bail-in principle is discussed in the context of the EU Bank Resolution and Recovery Directive and the legal and regulatory issues raised by the bail-in tool. It also analyses the requirements for total loss-absorbent capital on the bank's capital structure and operations.

Chapter 7 discusses structural regulation of banks and why this has become important for achieving regulatory and resolution objectives. The chapter will discuss the conceptual basis of structural regulation and how it has been applied in some countries. It compares the main structural regulatory approaches – the UK, France, Germany and the US – and how they are designed to meet regulatory objectives and their impact on bank governance. In particular, the UK Banking Reform Act 2013 requires that banking groups with more than £25 billion in deposits segregate their retail banking operations and payment services into a separate subsidiary subject to higher capital requirements and different governance arrangements than the rest of the banking group, while allowing other subsidiaries in the group to engage in risky proprietary trading and other trading and investment activities. The UK's so-called ring-fenced banking regime has significant implications for the governance and strategy of the UK banking group, but does not apply to non-UK banking groups that operate retail branches in the UK. The chapter concludes that the use of different structural regulatory approaches across jurisdictions has important implications for the regulatory level playing field in Europe and internationally.

Chapter 8 analyses the regulation and law of bank mis-selling of financial products with particular focus on the sale of risky financial products and investments to non-professional customers and how the EU, UK and US legal and regulatory frameworks have been called into question because of widespread mis-selling. The legal concept of the duty of care is discussed and how it impacts bank management and decision-making regarding the design of retail financial products. It also discusses recent developments in EU regulation (e.g. MiFID II) that require banks to create organisational structures to review the development of financial products and to ensure that products and sales processes are suitable for bank customers. **Chapter 9** addresses the growing regulatory challenges for banks regarding misconduct risk and financial crime. The chapter reviews the large number of fines imposed on many banks post-crisis for misconduct in their business practices and the extent of administrative liability for banks and bankers who engage in market abuse including manipulation of benchmarks such as LIBOR. It also considers the criminal law investigations of the UK Serious Fraud Office of many international banks for manipulating LIBOR and related criminal investigations and trials which led to both convictions and acquittals for LIBOR manipulation.

Chapter 10 analyses the growing regulatory concern with shadow banking. Shadow banking has been described as another form of bank disintermediation – that is, maturity transformation, borrowing short and lending long – outside the formal regulated banking sector. The risks associated with shadow banking will be discussed and evaluated. The chapter suggests that regulators should take a functional approach to finance which would involve them identifying what functions the banking system performs (i.e. maturity transformation) and attempting to promote the benefits of the function while curbing the externalities associated with financial risk-taking. The chapter will also consider the potential new risks that post-crisis regulatory reforms may be spawning as they relate to bank trading of derivatives and their involvement in derivatives clearing houses.

The final part of the book covers Chapters 11–15. **Chapter 11** explores the meaning of risk culture and its contribution to bank governance and responsibility. Systemic failures and the perception of a widespread culture of misconduct in UK, European and US banking practices have led to a number of high-profile investigations into the culture of banking. The chapter will discuss international initiatives to regulate risk culture in banking and financial institutions and recent developments in EU regulation. Among G20 countries, the UK has taken the lead by introducing a Senior Manager's Certification Regime that attempts to enhance ethics and risk culture in British financial institutions. Regulatory reforms are also built on the initiatives of industry and professional bodies, such as the Banking Standards Board, FICC Market Standards Board and the Chartered Banker Professional Standards Board, to enhance banking culture and professional standards. The chapter will conclude by considering what further organisational and regulatory initiatives can support the maintenance of ethical behaviour and responsible attitudes that will induce bank employees to engage in higher ethical standards and appropriate levels of risk-taking in the future.

Chapter 12 considers recent developments in financial technology and its potential to transform the banking business and related regulatory challenges. The chapter reviews recent regulatory and legal developments in open banking and how it may transform the banking business by allowing third-party data firms to have access to bank customer data and to offer them a multitude of financial services. This could lead to the unbundling of the banking industry and could have important ramifications for regulation and policy. The chapter also discusses the growing importance of digital currencies and Bitcoin, and whether this is causing disintermediation in the banking sector. The chapter further considers how certain international initiatives are promoting fintech solutions to support the spread of digital financial technologies in order to increase financial inclusion. It also discusses some areas of regulation that can support the establishment of responsible digital practices to protect financial customers and improve financial literacy and awareness so that digital financial products are better understood by end users.

Chapter 13 analyses recent developments in financial policy that have put environmental sustainability on the regulatory reform agenda. This chapter addresses how environmental sustainability is related to banking regulation and how banks have incorporated sustainability objectives into governance and strategic objectives.

Chapter 14 analyses the growing use of administrative sanctions and civil liability imposed on banks for breaching prudential regulatory standards and rules. It analyses the administrative sanctions regime under EU and US law and discusses the administrative process and legal principles and standards that regulators must comply with in order to impose administrative and regulatory sanctions on banking institutions and their employees. Administrative and constitutional law are relevant for the analysis of how regulatory sanctions and the importance of the proportionality principle are vital for understanding how the EU and UK go about enforcing financial regulation. Similarly, US regulatory authorities are constrained by the constitutional principle of due process in applying and enforcing regulatory standards. The importance of the European Convention of Human Rights' protection of property rights is essential for understanding the scope of authority of regulators. Indeed, the legal foundation of financial regulation and the administrative law principles (e.g. proportionality) that apply to its enforcement are an important focus. The principles governing regulatory investigations and enforcement are essential for understanding how bank compliance strategies can be used to support risk management and overall bank governance.

Chapter 15 concludes by summarising the overall themes and major regulatory issues of the book; it considers the impending challenges of building a more effective banking regulatory regime and some of the important issues raised by recent regulatory reforms. It identifies future prospects, challenges and tensions in developing an effective regulatory and policy framework. The chapter also considers some of the different approaches to banking regulation adopted by the European Union, the United States and some other jurisdictions, and whether these differences are significant enough to hinder the development of an effective cross-border banking framework to control systemic risks and achieve other regulatory objectives.

Also discussed are the implications for banking regulation of the Brexit negotiations and how some of the mooted principles of regulation emerging from the Brexit debate are relevant for international banking regulation. In particular, future market access between the UK and EU – for cross-border banking in the context of Brexit – will likely be governed by a trade agreement that contains the regulatory principles of equivalence and/or parity. Also, the chapter suggests that important future developments in banking regulation will involve efforts by regulators and bankers to manage environmental and social risks and to understand the extent that sustainability risks can constitute material financial risks. Indeed, understanding the linkages between environmental sustainability and social inclusion risks and the banking sector will be a major challenge for regulators.

The reader should come away from this book with a deeper understanding of the objectives and function of banking regulation and its vital importance to our economy and society. Financial regulation cannot simply eliminate the market failures that threaten banking stability and bank customers, depositors and investors. In a market-based financial system where most decisions on the allocation of capital are based on the pursuit of private gain, financial crises will be inevitable. The book will show instead how a shift in focus in traditional banking regulation towards a more macro-prudential perspective can nonetheless reduce the risks associated with market failures and reduce the impact of crises when they occur. To achieve this, banking regulation should be designed to operate both *ex ante*, based on a coherent and consistent application of certain regulatory measures or tools, and *ex post*, by stabilising parts of the financial system afflicted by systemic shocks and reducing the impact of those shocks. This book attempts to elucidate the main principles and standards that guide regulators in fulfilling their tasks.

1

The Business of Banking

History, Function and Organisational Structure

Table of Contents

INTRODUCTION

1.1 This chapter provides an overview of the banking business and its origins and evolution in modern financial markets. It discusses the historical development of banking in medieval and early modern Europe and how certain restrictions on banking, such as usury, led to innovations in the banking business and in ways to manage risks. The chapter also analyses the primary *economic* function of banking – credit intermediation – and how financial innovation, such as securitisation, has facilitated bank disintermediation and other forms of credit provision outside the formal regulated banking sector. Finally, it examines the organisational structure of banks and banking groups and how different organisational structures evolved in different jurisdictions and with different strategic objectives.

I THE ORIGINS OF BANKING

1.2 In ancient societies, the temple was usually the location for much of what we would associate today with the banking business. Indeed, sanctuaries and temples in ancient Greece served to provide safe custody for bullion and other valuables.[1] In Mesopotamia, borrowing and lending took place at the temple,[2] while in Jerusalem temples served as fora for money dealers to trade currencies and to take deposits and make loans with interest. The money trading business within temples and their precincts provided a sense of security for traders and an effective system of regulation and dispute resolution. For example, the temples in Jerusalem were known as centres of money changing as depicted in biblical passages.[3] The first codified restrictions on lending and borrowing included the prohibition on usury and guarantees of privacy rights for parties to loan transactions as set forth in the Code of Hammurabi between 2084 BC and 2081 BC.[4]

1.3 The term 'bank' derives from the medieval Italian *banco*, which denoted a merchant's bench in a marketplace. The bench would often serve as a place where merchants and money dealers would agree loans, and if a merchant defaulted on a loan or other obligation the money dealer was entitled to break the bench in front of the merchant.[5] This was the origin of the term 'bankruptcy'. During the Middle Ages, bankers came to play an important role in providing innovative forms of finance to supply credit to monarchs, merchants and traders. For example, some of the large Florentine and Siennese banks founded around 1250 were family-owned (i.e. by the Bardi, Peruzzi and Acciaiuoli families) and played an important role in providing loans to merchants and traders across Europe in the eleventh and twelfth centuries.[6]

1.4 In the thirteenth and fourteenth centuries, the prohibition on usury restricted how Christian bankers could be repaid for loans. Indeed, usury had been considered an odious practice in antiquity. In the *Politics*, Aristotle described usury 'as a most hated sort' of wealth

1 See Kurke L, *Coins, Bodies, Games, and Gold: The Politics of Meaning in Archaic Greece* (Princeton University Press 1999). See also Von Reden A, *Exchange in Ancient Greece* (Duckworth 1995) and E. Cohen E, *Athenian Economy and Society: A Banking Perspective* (Princeton University Press 1992).
2 See Millett P, *Lending and Borrowing in Ancient Athens* (Cambridge University Press 1991). See also Duggan A and Lanyon E, *Consumer Credit Law* (Butterworths 1999).
3 See the Book of Matthew 21:12–13.
4 Maloney R, 'Usury and Restrictions on Interest-Taking in the Ancient Near East', 36 Catholic Biblical Quarterly, 1, 1–20, 4–7. See also Thier A, 'Money in Medieval Canon Law', in Fox D and Ernst W (eds), *Money in the Western Legal Tradition* (Oxford University Press 2016).
5 See Tyree AL, *Banking Law in Australia* (5th edn, Butterworths 2005), chapter 2.
6 Hunt E, *The Medieval Supercompanies: A Study of the Peruzzi Company of Florence* (Cambridge University Press 1994), 38.