GOVERNANCE OF GLOBAL FINANCIAL MARKETS

The recent financial crisis proved that pre-existing arrangements for the governance of global markets were flawed. With reform underway in the US, the EU and elsewhere, Emilios Avgouleas explores some of the questions associated with building an effective governance system and analyses the evolution of existing structures. By critiquing the soft law structures dominating international financial regulation and examining the roles of financial innovation and of neo-liberal policies in the expansion of global financial markets, he offers a new epistemological reading of the causes of the Global Financial Crisis.

Requisite reforms leave serious gaps in cross-border supervision, in the resolution of global financial institutions and in the monitoring of risk originating in the shadow banking sector. To close these gaps and safeguard the stability of the international financial system, an evolutionary governance system is proposed that will also enhance the welfare role of global financial markets.

EMILIOS AVGOULEAS holds the chair of International Banking Law and Finance at the Law School of the University of Edinburgh. He was previously the Professor of International Financial Markets and Financial Law at the University of Manchester. He also holds a number of visiting professorships and has written extensively in the wider field of financial law and economics, behavioural finance and financial regulation, and EU financial services law.

INTERNATIONAL CORPORATE LAW AND FINANCIAL MARKET REGULATION

Corporate law and financial market regulation matter. The Global Financial Crisis has challenged many of the fundamental concepts underlying corporate law and financial regulation; but crisis and reform has long been a feature of these fields. A burgeoning and sophisticated scholarship now challenges and contextualizes the contested relationship between law, markets and companies, domestically and internationally. This Series informs and leads the scholarly and policy debate by publishing cutting-edge, timely and critical examinations of the most pressing and important questions in the field.

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The Law, The Economics, The Politics

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In loving memory of my father Evangelos

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FOREWORD

Walter Bagehot's classic, *Lombard Street*, was his response to the financial crisis sparked by the collapse of the Overend Gurney bank and to what he saw as the enormity of the potential liabilities of the City of London, which accompanied its great wealth. He wrote: '[W]e must examine the system on which these, great masses of money are manipulated, and assure ourselves that it is safe and right'. Professor Avgouleas has penned an equally authoritative study of the background to the financial crisis which began in 2007 and the ameliorative steps subsequently taken. He too inquires whether the system is now 'safe and right'. The answer is not totally reassuring as regards the international operation of the world's financial giants and the financial revolution they have spawned. In his view what is necessary is a new system of global financial governance, underpinned by an umbrella international treaty.

But this is to anticipate. The detailed and careful analysis which precedes Professor Avgouleas's conclusion begins with a lucid account of the structures and operation of financial markets, identifying their contribution to economic growth but also highlighting their risks and instabilities. Market phenomena such as bubbles and herding feature regularly but in the modern age there have also been developments such as derivatives transactions and shadow banking. That leads to a cogent dissection of the crisis itself and what proved to be the frail machinery available to handle it, not least in its cross-border dimensions. The context of the crisis, as Professor Avgouleas explains, was what he characterizes as the financial revolution of the preceding decades – liberalized markets, technological advances and financial innovation, all accentuated by a public policy shot through with neo-liberalism. On reading Professor Avgouleas's account of this financial revolution, one draws the obvious parallel with the Industrial Revolution and correlative financial change of Bagehot's day. The financial revolution, misunderstood and badly managed, was fertile ground for a crisis when coupled with factors such as the excessive rent-seeking by those associated with finance, their lobbying against effective capital requirements and other prophylactic regulation, and their promotion of a climate where 'light touch' regulation was the order of the day.

Professor Avgouleas then turns to international financial governance, with a thoughtful history of the Bretton Woods settlement in practice, and of the measures following the Asian Crisis of the late 1990s and the Global Financial Crisis a decade later. As would be expected, the IMF and the constellation of Basel institutions, such as the Financial Stability Board (née Forum) feature prominently. The role of state-to-state groups like the G-20 is also traced. The weaknesses in standard setting and its enforcement post-Asian Crisis are explored, in particular the Basel II standards for bank capital, which in their formulation were captured by the industry. Basel II is also illustrative of the drawback to the soft law approach to international financial regulation. The meat of Part III of the book is Professor Avgouleas's outline and critique of post-Global Financial Crisis measures at national, regional (European Union) and international levels. The reasons for the differences in approach are touched on, as is the constitutional background to the new European Supervisory Authorities and supervisory colleges. Fraught issues are explained such as the countercyclical buffer in Basel III. The reform of the 'too-big-to-fail' financial institution and the new resolution regimes are deservedly given extensive treatment.

This is a book of great scholarship. The wealth of learning is astonishing. It is drawn from a range of disciplines as varied as finance theory, economics, international relations and law. Not everyone will agree with the solutions proffered. In one sense they appear radical but a contextual reading reveals that, like most sensible reforms, they build on what has gone before. Anyone pondering the way forward for global financial governance will need to engage with the considerations Professor Avgouleas advances, based as they are on the mature reflections of a leading authority. The book deals with matters which concern ordinary people; as Professor Avgouleas notes, it is they who have reaped the consequences of the international havoc wrought by the Global Financial Crisis in terms of job losses and economic hardship. Deliberation by public policy makers on the contents of the book will inevitably lead them to conclude that vested interests cannot be allowed to continue with 'business as usual'.

Sir Ross Cranston FBA

PREFACE

The collapse of Lehman Brothers was just the high point of a crisis that started in mid-2007 and continues until this day. This came to be known as the Global Financial Crisis (GFC). Policy-makers, regulators, the industry, academics and other stakeholders throughout the world have been grappling with its root causes and consequences on a daily basis for the past four years. The Eurozone debt crisis is only its latest manifestation/transformation in a dramatic chain of events that has also led to the near collapse of the world's biggest financial institutions and their costly public rescues, a major economic recession and heavy over-indebtedness for most Western countries.

Many of the questions raised following the eruption of the GFC have been answered only in part. Therefore, one of the biggest challenges this work has faced was the possibility of fashioning a new epistemological reading of the causes of the GFC. This new reading had to build on those causes of the GFC that have already been well explained, such as, for instance, trade imbalances, misaligned incentives and unsustainable debt accumulation. But it also had to try to identify the missing link that allowed those causes to be correlated in open global markets with catastrophic consequences.

The eruption of the GFC showed that the preceding regulatory frameworks in the US and the EU were more or less built on sand, when it came to crisis management, especially cross-border crisis management. In addition, the global financial architecture of the pre-crisis era, largely based on a thick network of soft law bodies, lacked the institutional capacity required to deal with a cross-border financial crisis. The rules and standards of those bodies were built on flawed assumptions, which, especially in the case of capital standards, allowed financial institutions to over-leverage their balance sheets operating on a perilously thin equity base. They also did not take into account system-wide developments. Thus, capital adequacy standards intensified rather than contained asset bubbles that in most cases precede financial collapses. Other failures and loopholes clearly observed in the system in the pre-GFC era were narrow representation, lack of accountability and a significant failure to address the problems created by the integration of global financial markets, including issues of regulatory coverage. National, regional and international regulatory systems, largely informed by neo-liberal ideology, left outside of any meaningful public oversight the global OTC derivatives markets and the shadow banking sector, namely, the two most important laboratories/sources of financial innovation and generators of interconnectedness.

A gigantic reform effort is underway in the US, the EU and globally trying to address the aforementioned loopholes in order to minimize systemic risk and contain the impact of the 'too-big-to-fail' institution. Requisite reforms have also led to the establishment of a number of new systemic regulators and financial supervisors at all levels. The mandate of these bodies is often complex and their effectiveness remains unverified. Nonetheless, it is beyond doubt that most of these reforms are in the right direction and will close major loopholes in the regulation and supervision of global finance. However, this effort is bound to be undermined by the absence of formal global governance structures dealing with: (1) the supervision of large cross-border financial institutions, so-called Globally Systemically Important Financial Institutions (G-SIFIS); (2) the resolution of large cross-border financial groups; (3) the extension of global supervisory oversight to the shadow banking sector; and (4) the building of knowledge-based standard-setters for international finance that would closely co-operate and supervise the most effective of the existing soft law bodies, such as the Basel Committee on Banking Supervision, on a legally binding basis.

The Eurozone debt crisis entered its critical phases after the completion of the manuscript. As a result, it is not given full consideration in the book. A weak and severely under-capitalized banking sector is again at the heart of the problem, making several of the obvious solutions, such as large-scale sovereign debt restructuring, unsustainable. Arguably, developments in the Eurozone give additional force to one of the central arguments of this book as regards the need for impartial and effective supra-national governance structures to regulate and supervise global markets and especially large cross-border financial institutions, strengthening the force and effectiveness of ongoing regulatory reforms.

The writing of this book started at the beginning of my study leave in September 2008. A week later Lehman Brothers collapsed and any meaningful writing effort paused for at least two years. In the meanwhile, the world of global finance changed forever. The scholarly and policy-making analysis of global markets and of the global financial crisis that has emerged since 2008 has been fragmented but yet in many cases it has been of peerless quality. In addition, the bulk of relevant analysis has been immense and probably beyond the ability of a sole researcher to read, save understand, what was said there. At the same time, reform was taking shape in a number of areas, especially the regulation of systemic risk and 'too-big-to-fail' institutions, at rapid pace and at all levels: national, regional, international. As a result, keeping up with developments became an impossible task and the idea of dropping the project altogether came to my mind several times. Nonetheless, the immense challenges the modern world presents are inextricably tied up with the good workings of global finance, which since 2007–8 seems to have fallen into a state of irremediable disrepair. Thus, the desire of joining other (much more influential) voices in offering an analysis and possibly a workable first solution to the problem was one of the reasons that kept me going. My mother's great example of fortitude in the face of personal loss and her unfailing support was the second major reason. The third was the encouragement, support and immensely helpful advice I received from very distinguished scholars. Charles Goodhart has frequently shared his invaluable insights with me and shed light on many areas of global markets and their regulation that looked incomprehensive. This work would have been much poorer without being able to 'drill' into his vast well of knowledge in the field of global markets and global finance reform. Joe Norton, one of the founders of international financial regulation as a distinct academic discipline, proved to be the mentor and friend only the most fortunate ever have in their academic lives. In email after email Joe gave me constructive advice, sense of direction, access to his work and incredible emotional support following the death of my father in March 2010. Steven Schwarcz, one of the giants of modern financial law, not only was the kindest of hosts during my stay at Duke Law School, but also has been a good friend and colleague, who has provided inspiration with his original scholarship and work ethic. Eilis Ferran, one of the founders of this series, and a scholar of the highest order in the field of corporate and financial law, was both very supportive in the planning stages of this book and a source of rational and constructive advice during the research and writing stages. Cambridge University Press editor, Kim Hughes with her strict adherence to deadlines constantly reminded me that this book, like any other, should have a completion date and for everything that comes next there is always the possibility of a second edition. I am immensely grateful to all of them.

Special thanks must go to Sir Ross Cranston for finding the time to read the manuscript and provide the foreword for this book. I am also grateful for his advice about the timing and contents of this book and his invaluable insights on global financial reform. Once again it has been an immense privilege to be able to benefit from discussions with Sir William Blair on various aspects of this book.

I had immensely informative and constructive discussions on various parts of this book with a number of distinguished scholars and good friends, especially Douglas Arner, Lawrence Baxter, Ross Buckley and Heracles Polemarchakis. Doug, Larry, Ross and Heracles repeatedly gave me access to their unpublished work and dedicated hours of email and face to face discussions to our mutual effort to understand the whirlwind developments unfolding in front of our eyes and make (scholarly) sense of them. I am deeply indebted to all of them. Similarly I am indebted to my Manchester colleagues, Dora Kostakopoulou and William Lucy, for similar discussions and much appreciated editorial advice. I have also held very stimulating discussions with colleagues from other UK universities and especially Iain MacNeil, Joanna Gray and Dalvinder Singh. I am grateful to them for sharing with me their insights and scholarly work. The same applies to Eva Hupkes of the FSB for kindly giving me access to her unpublished work.

I would also like to thank all the academics and students that have attended my lectures and seminars on several themes of this book in the past three years at the Universities of Oxford, Cambridge, Duke, Copenhagen and Hong Kong. The participants of the conference 'Greening Humanity', held in Athens at the Eugenides Foundation in October 2010, and especially my colleagues in Manchester and co-organizers of this conference John Harris and Jon Sulston (Nobel Prize, Med. Sci., 2002), have taught me a great deal about the moral dilemmas facing our modern world and its multi-faceted challenges. Discussions with them and with OLMMOG are responsible for planting into my mind one of the central ideas of this book.

In writing this book I have also incurred a number of institutional debts. First, I would like to acknowledge the generous financial support I have received from the UK's Arts and Humanities Research Council (AHRC) by means of a study leave research grant. I would also like to thank Manchester Law School and its then Head of School Andrew Sanders for granting me a year-long study leave upon re-joining the law school. I would also like to thank Duke Law School and its Dean David Levi for hosting me as a Global Capital Markets Fellow during the

AY 2008-2009. Last but not least I would like to thank the production team at Cambridge University Press and especially Sarah Roberts for their great work in turning my manuscript into the book you hold in your hands.

The book considers global financial developments up to 20 July 2011 and discusses regulatory proposals issued until that date with only minor updates for follow ups. Furthermore, every effort has been made to state the law as it stood on 30 June 2011.

ABBREVIATIONS

ABCP	Asset Backed Commercial Paper
ABS	Asset Backed Securities
AIFMD	Alternative Investment Fund Managers Directive
AMH	Adaptive Markets Hypothesis
BCBS	Basel Committee on Banking Supervision
BHC	bank holding company
BIS	Bank for International Settlements
BoE	Bank of England
CBO	Collateralized Bond Obligations
CBRG	Cross-Border Resolution Group
CCP	central counterparty
CDO	Collateralized Debt Obligation
CDS	Credit Default Swap
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CFTC	Commodity Futures Trading Commission (US)
CLN	Credit Linked Note
CLO	Collateralized Loan Obligation
CoCo	Contingent Capital Instrument
CRA	credit rating agency
CVA	credit valuation adjustment
EAD	exposure at default
EBA	European Banking Authority
EBRD	European Bank of Reconstruction and Development
ECB	European Central Bank
EIB	European Investment Bank
EIOPA	European Insurance and Occupational Pension Authority
EL	Expected Loss
EMH	Efficient Market Hypothesis
ESA	European Supervisory Authority
ESFS	European System of Financial Supervisors
ESMA	European Securities Markets Authority

ESRB	European Systemic Risk Board
EU	European Union
EWS	Early Warning System
FANNIE MAE	Federal National Mortgage Association
FATF	Financial Action Task Force on Money Laundering
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board (US)
FREDDIE MAC	Federal Home Loan Mortgage Corporation
FSA	Financial Services Authority (UK)
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSD	Financial Sector Development
FSF	Financial Stability Forum
FSOC	Financial Stability Oversight Council
FSSA	Financial Sector Stability Assessment
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
G-20	Group of 20
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GSE	Government Sponsored Enterprise
G-SIFI	Globally Systemically Important Financial Institution
IAASB	International Auditing and Assurance Board
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IASCF	International Accounting Standards Committee Foundation
IBRD	International Bank for Reconstruction and Development
IFAC	International Federation of Accountants
IFI	International Financial Institutions
IFS	International Financial Standard
IIF	Institute of International Finance
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRB	Internal Ratings Based Approach
ISDA	International Swaps and Derivatives Association
ISMA	International Securities Market Association
ISSB	International Standard Setting Body
LCFI	Large Complex Financial Institution
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
MBS	Mortgage Backed Securities
MDGs	Millennium Development Goals

MOU	Memorandum of Understanding
NAV	net asset value
NIFA	New International Financial Architecture
NSFR	Net Stable Funding Ratio
OBSE	off-balance sheet entity
OECD	Organisation for Economic Co-operation and Development
OLA	Orderly Liquidation Authority
OTC	Over the Counter
PCA	Prompt Corrective Action
PD	probability of default
PSE	Public Sector Entity
RMBS	Residential Mortgage-Backed Securities
ROSC	Reports on the Observance of Standards and Codes
RWAs	risk-weighted assets
SDRs	Special Drawing Rights
SEC	Securities and Exchange Commission (US)
SIFI	Systemically Important Financial Institution
SIV	Special Investment Vehicle
SPE	Special Purpose Entity
SPV	Special Purpose Vehicle
TARP	Troubled Assets Relief Program
TRN	Transnational Regulatory Network
TRS	Total Return Swap
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
WTO	World Trade Organization