The legal response to the recent financial turmoil: policy and regulatory initiatives to enhance the stability of the global and the European financial system

Christos Vl. Gortsos
Associate Professor of International Financial Law,
Panteion University of Athens,
Secretary General, Hellenic Bank Association

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A. Basic assumptions

1. The view that the financial system functions without the existence of regulatory or supervisory framework – or that it is self-supervised does not correspond to the reality

2. The neoclassical model on which the modern financial system is based includes the possibility of market failures, in particular:
   - the existence of information asymmetry, and
   - the occurrence of negative externalities

The objective of the regulatory intervention is to address them

A. Basic assumptions

3. In the developed economies the existing regulatory intervention in the financial system consists of strict rules that seek to ensure the following policy requirements:

- Ensuring the stability of the financial system as a whole and of its specific sectors and infrastructures (banking sector – capital markets – insurance markets – payment systems, clearing and settlement)
- Ensuring the effectiveness of capital markets and investor protection
- Ensuring the effectiveness of payment systems
- Ensuring the protection of consumers of financial services
- Combating the financial crime

B. The existing international architecture of the monetary and financial system

1. International monetary system

- global system of floating foreign exchange rate
- regional monetary unions
- pegging – monetary crises

B. The existing international architecture of the monetary and financial system

2. International financial system

2.1 The law-making process:

- rules are produced by international organisations and standard-setting *fora* with the participation of national central banks and supervisory authorities (see below diagram) – the predominant role of the Financial Stability Forum and (as of recently) of G-20
- rules of international soft financial law with strong indirect mechanisms of enforcement **–** the predominant role of the International Monetary Fund

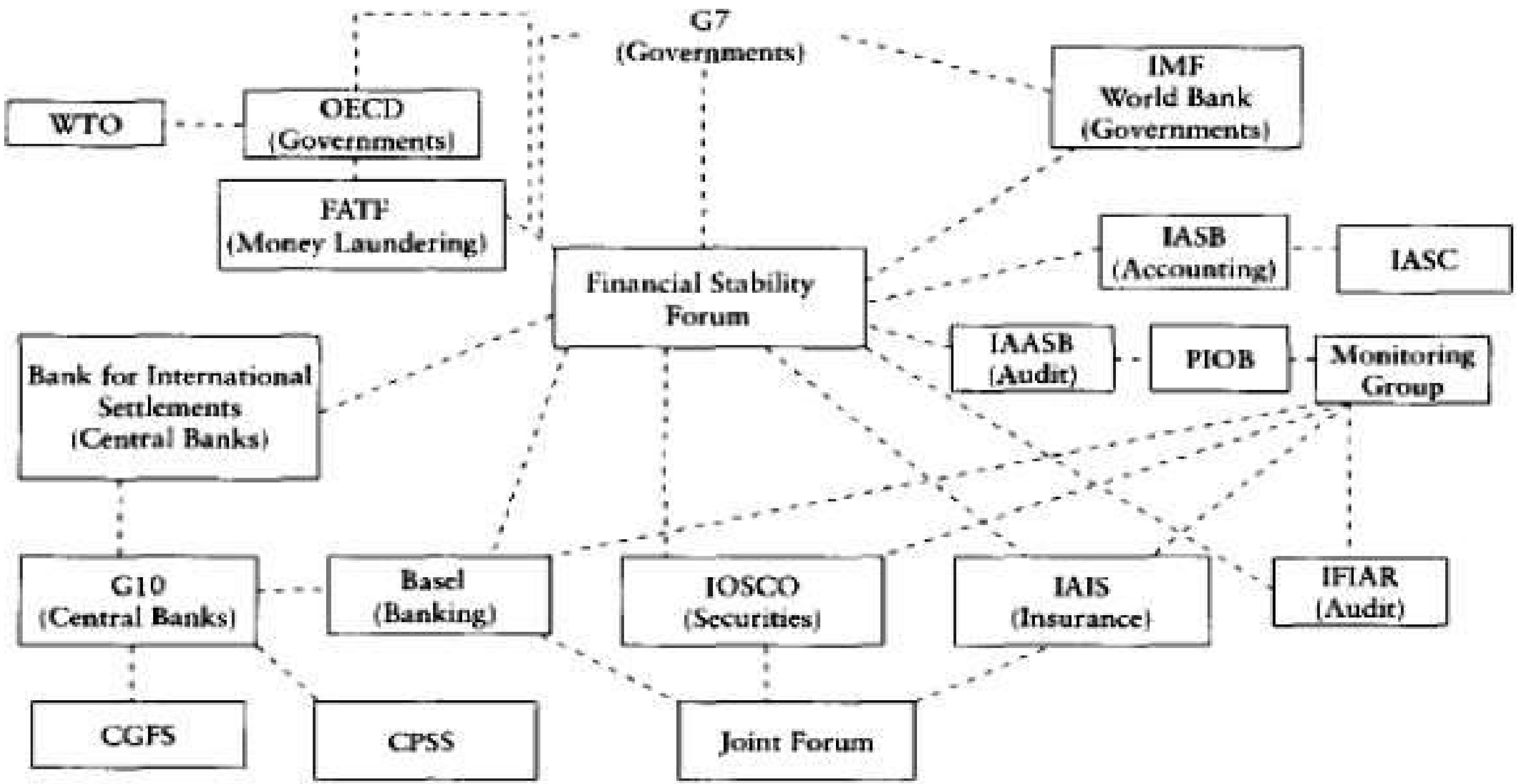
2.2 «Supervisory framework»

- absence of supranational supervisory authorities – the principle of “decentralisation”

2.3 Regulatory framework:

- Rules adopted by different standard-setting *fora* for the satisfaction of certain requirements of regulatory intervention

The global financial regulatory/supervisory structure



C. The existing European architecture of the monetary and financial system

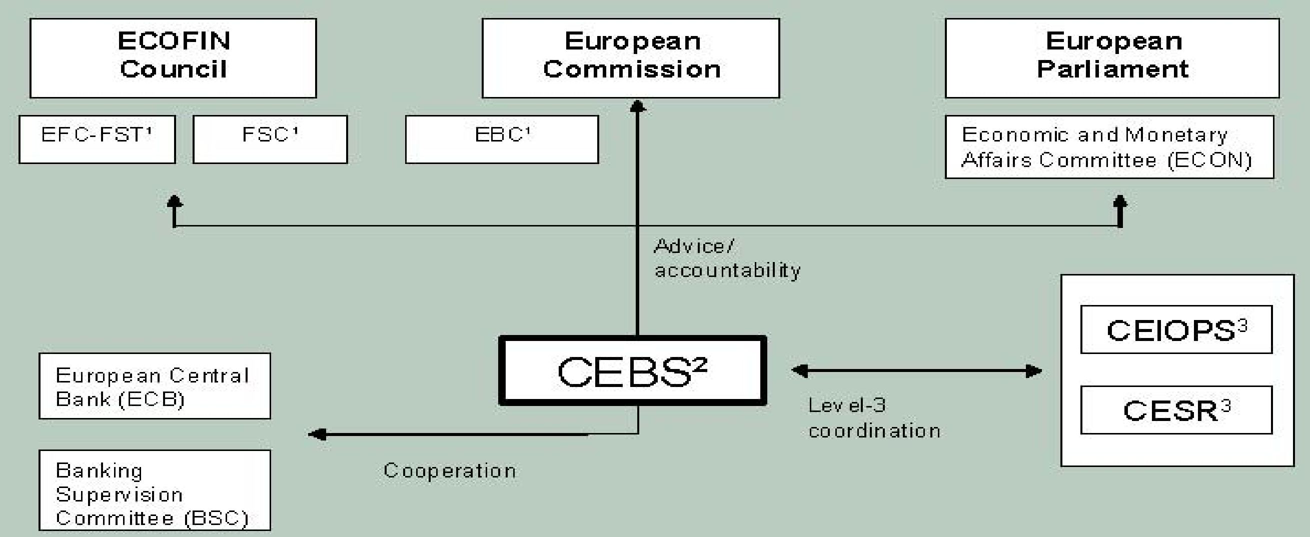
1. European monetary system: regional monetary union

2. European financial system

2.1 Law-making process: three levels of law-making process (Lamfalussy process)

- basic legal acts (Co-decision procedure: European Parliament – Council (EcoFin))
- implementing measures (European Commission with the assistance of regulatory committees and structured pan-european networks with the participation of sectoral supervisory authorities (CEBS – CESR – CEIOPS), see below the diagram)
- Soft law rules: CEBS – CESR – CEIOPS

The European financial regulatory/supervisory structure



EBC European Banking Committee
EFC Economic and Financial Committee
FSC Financial Services Committee
FST Financial Stability Table
CEIOPS Committee of European Insurance and Occupational Pensions Supervisors
CESR Committee of European Securities Regulators

[1] Finance ministries
[2] Supervisors and Central Banks
[3] Supervisors

C. The existing European architecture of the monetary and financial system

2. European financial system (cont.)

2.2 «Supervisory framework»

- absence of European supervisory authorities – the principle of “decentralization”
- rules for the allocation of competences between national competent authorities
- rules of cooperation between national competent authorities

2.3 Regulatory framework:

- structured system of rules of financial law with respect to all the abovementioned requirements of regulatory intervention

D. The current financial turmoil

Basic assumptions

- distinction between “crisis” (e.g. US and United Kingdom) and turmoil (e.g., Greece),
- distinction between rescue and recovery plans
- the function of the monetary system: enhancement of the liquidity in the economy / liquidity trap
- differentiation of interest rates / interbank market
- regulatory developments in order to address the specific reasons of the financial turmoil

E. The responsiveness to the current financial turmoil

1. The current financial turmoil is due to **specific reasons** and the regulatory intervention has to address them via **adequate instruments**

2. **The financial turmoil is due mainly to problems relating to:**
   - the extent of the use (and not the use as such) of the "originate and distribute model"
   - the extent of leverage mainly by investment banks
   - the capital adequacy framework
   - the operation of Credit Rating Agencies
   - the conditions of trading in certain categories of financial instruments
   - the evaluation of financial transactions
   - the management of liquidity risk
   - the scope for regulatory arbitrage

E. The responsiveness to the current financial turmoil

3. Three main objectives of the regulatory reform already undertaken or under preparation:

- regulatory intervention on issues which were not at all or partially regulated (e.g. CRAs) in order to address some of the reasons underlying the financial turmoil
- reinforcement of the existing regulatory framework where it has not been proved completely adequate (e.g. enhancement of transparency requirements)
- adoption of “temporal” measures in order to address certain immediate adverse effects of the financial turmoil (e.g. recovery plans, guarantee measures)

E. The responsiveness to the current financial turmoil

4. Issues arising with respect to the initiatives already undertaken or under preparation

4.1 Differences with the crisis of 1929

4.2 Review of the objectives of the deposit guarantee schemes: protection of retail depositors vs. ensuring systemic stability

4.3 Market failure vs. public sector failure

E. The responsiveness to the current financial turmoil

4. Issues arising with respect to the initiatives already undertaken or under preparation (cont.)

4.4 The adequacy of regulatory intervention:

- risk of (provisory) overregulation
- emphasis on the effectiveness of regulatory intervention
- different treatment of “systemic important” providers of financial services
- the adequate horizon of the regulatory intervention: handling the “time inconsistency problem”

II. Towards a “brand” New International Financial Architecture (NIFA)

A. Elements of a “brand” new international financial architecture

1. International monetary system

- The choice not to return to an international system of fixed exchange rate *à la* Bretton Woods
- Reinforcing of regional monetary unions

2. International financial system / Institutional framework: two alternatives

- Amendments to the governance of international organisations and international *fora* – International Monetary Fund – G-7
- The creation of an “International Financial Organization” (the model of the World Trade Organization)

B. The supervisory framework

1. The option of creating of a fully-fledged supervisory authority

- Rather impracticable to envisage the creation of such an authority in terms of political realism
- There is, anyway, no precedent

The creation of such a fully-fledged supervisory authority would require:

- the creation of an international organisation,
- *with a global participation (in order to avoid regulatory arbitrage)*,
- based on an international convention

B. The supervisory framework

1. The option of creating of a fully-fledged supervisory authority (cont.)

The signatory parties to the international convention would assign to such a fully-fledged supervisory authority the power to:

- exercise the supervision of their national financial institutions and markets (or, at least, of those considered as “systemically important”),
- issue binding legal norms on their regulation, and
- impose sanctions on these financial institutions.

B. The supervisory framework

2. The need for enhancement of international supervisory cooperation

- The global supervisory reform should mainly assess the possibility of enhancing international supervisory cooperation mainly through the effective operation of "**colleges of supervisors**" for globally active financial institutions (and in particular banking groups).

- The Financial Stability Forum strongly encourages the adoption of protocols for establishing supervisory colleges for each of the major global financial institutions. Colleges will improve information exchange and cooperation in addressing cross-border issues and will strengthen the authorities' responsiveness to risks.

  A review of these arrangements will be undertaken in 2009 once enough experience has been gathered.

C. The regulatory framework

- The main regulatory measures which have already been undertaken or are under preparation relate to the following issues:

    - Enhancement of the capital requirements framework

    - Enhancement of liquidity risk management

    - Ensuring adequate valuation of financial instruments

    - Dealing with Systemically Important Financial Institutions (SIFIs)

    - Specific measures in the capital markets

Enhancement of the capital requirements framework

Basel Committee on Banking Supervision

Actions:

- **Enhancements to Basel II**

  The Basel Committee's proposals seek to strengthen the 3 pillars of Basel II.

  In particular, the Basel Committee proposes strengthening the risk capture of the framework by requiring, among others, a higher capital charge for "re-securitisation" or increased capital for liquidity lines extended to support ABCP conduits (pillar I), strengthens the requirements of pillar II and revises the existing pillar III requirements, among others, on securitisation exposures in the trading book and in valuation with regard to securitisation exposures

III. Towards a new European Financial Architecture

A. Elements of a "new" European financial architecture

1. European monetary system

- Redetermination of the objectives of the ESCB (?)
- Limitation of the institutional independence of the ECB (?)
- Policy of collaterals for the provision of liquidity

2. European financial system / Institutional framework

- Broader: review of the European Economic Governance
- Review of the Lamfalussy process

B. The supervisory framework

1. **Enhancement of the European supervisory framework of the financial sector** / European Commission

Action:

The European Commission has set up a High-Level Expert Group (de Larosière Group) to examine:

- How the supervision of European financial institutions and markets should be best organized to ensure the prudential soundness of institutions, the orderly functioning of markets and thereby the protection of depositors, policy-holders and investors;
- how to strengthen European cooperation on financial stability oversight, early warning mechanisms and crisis management, including the management of cross border and cross sectoral risks;
- how supervisors in the EU's competent authorities should cooperate with other major jurisdictions to help safeguard financial stability at the global level.

B. The supervisory framework

2. The option of creating a single supranational, European financial supervisory system

The main argument in favor of such a structure:

It represents one of the options to effectively supervise and regulate pan-European, “systemically important” financial conglomerates, due to the threats they are posing to the stability of the European financial system.

B. The supervisory framework

2. The option of creating a single supranational, European financial supervisory system (cont.)

Two main alternatives (taking as a starting point the current structure of the European monetary and financial system):

- establishing a “European System of Financial Supervisors” – outside the European Central Bank (the “ECB”), based on the existing three so-called “Level 3 Committees” (i.e., CEBS, CESR and CEIOPS) established by the Commission according to the proposals of the Lamfalussy Report (see below under a), or
- activating para. 6 of article 105 of the Treaty establishing the European Communities (the “Treaty”), according to which the ECB could become, even though under constraints, a European financial supervisory authority (see below under b).

B. The supervisory framework

2. The option of creating a single supranational, European financial supervisory system (cont.)

In principle, in either case the following eight (8) issues need to be addressed:

- the necessary extent of amendments of the Treaty,
- the institutional structure of the system,
- the material coverage of its supervisory powers in the financial system (banking sector – capital markets sector – insurance sector),
- the personal coverage of its powers (which categories of financial firms and groups would be subject to supervision and by whom),

B. The supervisory framework

2. The option of creating a single supranational, European financial supervisory system (cont.)

- the extent of its regulatory powers,
- its decision-making bodies, their composition and their competences,
- the independence of its constituents, the decision-making bodies and the persons appointed therein, and
- its overall embedment within the existing institutional structure of the European Union/Community.

B. The supervisory framework

(a) The establishment of a "European System of Financial Supervisors" (ESFS) – outside the European Central Bank

General assessment:

- a legally demanding and time consuming option,
- but still a more straightforward solution for the effective supervision of European financial conglomerates (under current Treaty provisions – article 105.6)

C. The regulatory framework

The main regulatory measures which have already been undertaken or are under preparation relate to the following issues:

- Enhancement of the capital requirements framework
- Enhancement of liquidity risk management
- Dealing with Systemically Important Financial Institutions (SIFIs)
- Ensuring adequate valuation of financial instruments
- Review of the regulatory framework of Credit Rating Agencies
- Enhancement of transparency in financial markets and securitization process
- Specific measures in the capital markets