European Financial Regulations – Post Crisis
Banking and Capital Markets Regulations, What?
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Key Points:

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This article accordingly considers the case for Financial Regulations in financial markets, post crisis by reference to a selection of recent interpretations and cases involving European Union regulations.

The presentation also makes reference to a limited number of cases in other jurisdictions in which those regulations are a measure of the sorts of complicated financial disputes that may arise again in the future.

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This presentation reviews the current knowledge on the various tradeoffs regarding public policies towards systemic financial and corporate sector restructuring. It discusses empirical findings that consistency in the framework adopted for bank and corporate restructuring is the key factor for success, although often missing.

This consistency may cover many dimensions but entails, among others, ensuring that there are sufficient resources for loss-absorption and that the financial sector firms will face an appropriate framework of sticks and carrots for restructuring.

To assure the sustainability of restructuring, deeper structural reforms will be necessary, which often will require that political economy factors are considered up-front.

The use of rules has three dimensions:

1. rule-formation,
2. rule-application (or rule-following); and
3. rule-enforcement.

It simply signifies the expediency and economy of avoiding enforcement by bringing a legal action in front of the courts, where compliance can be achieved with less radical and more informal means.

What is important is that the power of the regulatory authority to promulgate (broadcast) legal rules and put them into practice is always licensed by the Rule of Law either by virtue of a statutory instrument (e.g. the FSMA 2000 or the FSA 1986 as the case may be) duly passed by the Parliament or ad hoc to the extent in which the judiciary acknowledges this practice as lawful.

The term `(financial) regulation’ refers to the body of legal rules, regulations and administrative requirements established by public authorities or self-regulatory bodies as well as to its application and enforcement.

European Financial Regulations – Post Crisis
Reports about misconduct in the financial sector are seemingly endless.
Misconduct is wide-ranging and varied—from abusive practices in mortgage securities and commodities markets to manipulation of foreign exchange and interest rates.
Truly, the reports suggest an ethical crisis in finance. A major complaint is about the lack of serious efforts to hold to account executives that engaged in misconduct or were in leadership positions at the banks. The events call into question the adequacy of the current arrangements for ensuring integrity in the financial sector, at the institutional and individual levels.

There is a role for regulatory ethics in promoting integrity and accountability in financial markets. But what regulations and what codes? Do we need to regulate financial corporations or their directors? Nonetheless, wrongful conduct reported against banks is across-the-board and diverse.

**Following are major classes of misconduct:**

- **Mortgage-related** issues, at both ends:
  1. Practices adopted for selling mortgage securities to investors;
  2. Foreclosure procedures in dealing with delinquent mortgage repayments.

- **Transactions in non-financial markets**—for example, Commodities Futures
  - Interest rate manipulation (LIBOR)
  - Manipulative practices in foreign exchange markets
  - Questionable regulatory arbitrage practices in foreign jurisdictions

A common refrain is that there was insufficient understanding of the risks in credit derivatives.

Is there an ethical aspect to the decision to take up business in credit derivatives without adequate knowledge and awareness? Was there an ethical failure when executives, through their actions, imposed on the banks risks they did not fully appreciate? How can you regulate that?

Financial regulation is a prime candidate and Finance is a highly complex field, mastered only by a small class of people. As a result, if one accepts that the interests and preferences of states and regulators are taken into consideration, we can conclude that this class plays an influential role in constructing these interests and preferences.

There is an incentive to construct interests and preferences in a way that favours laissez-faire regulation, as indeed many of them have for the last two to three decades. There is this segment of corporate finance structure that enjoys the benefits of lax financial regulations, reaped in the form of enormous bonuses for its executives prior to the crash, while its costs are distributed across a
broad spectrum of people who lack the expertise to scrutinise the regulators’ actions.

**EU Response to The Financial Crisis:**

1- The response of the EU to the ramifications of the 2008 Financial Crisis encapsulated 40 legislative proposals which brought radical changes to the EU financial sector regulatory framework. For political purposes, European and American governments as well as others around the world were anxious to show their voters that prompt action is taken to make the financial sector pay for its actions.¹

The sheer scale of the reforms meant that the financial sector regulatory framework contained an equal scale of weaknesses and loopholes.

2- One immediate result of the new regulatory frameworks is the establishment of yet another supervisory agency, namely the European Supervisory Agencies (ESAs) in 2011. However, those agencies were hampered since inception by fundamental weaknesses including primarily lack of authority, insufficient independence over the shape and effectiveness of primary legislations including the flexibility even to propose corrections to legislative errors or non-operative legislations.

3- Broad range and huge number of legislative reforms was introduced ESA’s hastily post 2008 and flaws were noted for example in certain rules and directives for example in:
- Alternative Investment Fund Managers Directives (AIFMD),
- in provisions for bank remunerations in the Capital Requirements Directives (CRD IV), and the contentious plans for Financial Transactions Tax.

As a result to the latter, smaller financial firms and mid-size financial services providers have been disproportionately affected by the Capital Requirement Directives which caused a significant increase in their operation costs which placed them in the risk of having to fold up leaving only the too-big-to-fail institutions as sole players and manipulators of the market.

4- **Bail-in vs. Bailout:**

- A bail-out is when outside investors rescue a borrower by injecting money to help service a debt. Bail-outs of failing banks in Greece, Portugal and Iceland were primarily financed by taxpayers.

- By contrast, a bail-in, a term **first popularised** in the pages of *The Economist*, forces the borrower's creditors to bear some of the burden by having part of the debt they are owed written off. (In the case of Cyprus, the creditors in question were bondholders, and depositors with more than €100,000 in their accounts.) At the height of the financial crisis, governments avoided resorting to bail-outs out of concern that it might cause panic among the creditors of other banks; even the bondholders of Irish banks were initially spared. But as time has passed, and the cost of government bail-outs has risen, the appeal of asking private-sector investors to take a hit has increased. Ironically, it was one such bail-in—the restructuring of Greek government debt—that led to the problems faced by the Cypriot banks, which were big holders of Greek bonds.

The two different methods of accomplishing the goal vary greatly. Bail-outs are designed to keep creditors happy, while bail-ins are ideal in situations where bail-outs are politically difficult or impossible, and creditors aren’t keen on the idea of a liquidation event. The new approach became especially popular during the European Sovereign Debt crisis.

Most regulators had thought that there were only two options for troubled institutions in 2008 - taxpayer bailouts or a systemic collapse of the banking system. But, bail-ins soon became an attractive third option to recapitalize troubled institutions from within; by having creditors agree to rollover their short-term claims or engage in a restructuring.

**But why would the creditors agree to that?**

It is essential to segregate who is regulated and beneficial under the deposits protection schemes (Bailout) and who isn’t: Bailout is for banks that are classified as deposit takers and not investment firms/banks which are not allowed to accept deposits, hence not protected. E.g. Lehman went belly up because The Fed was not obligated to interfere to bailout an investment firm such as Lehman. Merrill was politically bailed out through obliging B of A into an acquisition.

The scale of the problem became clearer when it was found out that deposit takers are invested in products sold to them by the Big Investment Boys of Wall Street and London City. The biggest scam is that when a deposit taker is not allowed to act as investment firm, they went out and bought themselves an investment bank:

a- Bailout policies were initially designed to protect depositors: Which depositors? How about investors? Is it not true that bailout
represents a commitment by the state to protect its population of depositors?

b- Will bail-in really address Moral Hazard Issues if bailout created it, supposing?

c- It is recognized that the issuance of bail-in debt instruments may raise the cost of funding for financial institutions, nevertheless the removal of explicit bail-out programs is believed to eliminate moral hazard and lead to greater market disciplines. It should be noted that Capital Requirement Directives and Regulations as well as the Banks Recovery and Resolution Directives are designed to reduce and mitigate the effects of a failure of a financial institution. Such regulations in their current form are only designed to contain risk rather than eliminate it. (Paragraph 110 House of Lords Report)²

5- The problem of ’too-big-to-fail’ is still not addressed and taxpayers are still at risk of having one of those big and complex institutions failing.

6- Regulatory Arbitrage by banks:
Inconsistency in rule-books opens the door for “regulatory-arbitrage” across borders especially in international transactions. Since different types of assets have different risk profiles, CAR primarily adjusts for assets that are less risky by allowing banks to "discount" lower-risk assets. The specifics of CAR calculation vary from country to country, but general approaches tend to be similar for countries that apply the Basel Accords.

7- Shadow Banking Regulations:³
The “shadow banking system” can broadly be described as “credit intermediation involving entities and activities outside the regular banking system”. According to one measure of the size of the shadow banking system, it grew rapidly before the crisis, from an estimated $27 trillion in 2002 to $60 trillion in 2007, and remained at around the same level in 2010.

The term started to be used widely at the onset of the recent financial crisis, reflecting an increased recognition of the importance of entities and activities structured outside the regular banking system that perform bank-like functions (“banking”). These entities and activities provide credit by themselves or through a “chain” that transforms maturity or liquidity, and builds up leverage as in the regular banking system. They also typically rely on short-term

² Supra note
³ The term “shadow banking” is not intended to cast a derogatory tone on this system of credit intermediation. However, the FSB has chosen to use the term “shadow banking” as this is most commonly employed and, in particular, has been used in the earlier G20 communications.
funding from the markets, such as through repos and asset-backed commercial paper (ABCP).

8- There has to be a clear shift towards a resourceful and centric interpretation approach to the use of rules: what is rule or regulation are designed to illuminate, prevent or allow? The prime objective has been the control and management of the interpretive project that makes possible the use of rules, rather than the production of self-contained and static regulatory requirements that is bound not to be followed. If a bank seeks to have an offshore branch or performs a transnational acquisition of another financial institution, it requires the approval of its own domestic regulators. So the regulator is in fact granting an approval to a bank to acquire another offshore bank in a jurisdiction that will allow the mother bank to avoid or bypass the regulations.

Conclusion:

Churchill once said:
If you produce ten thousand rules on a single matter, you shall destroy all respect of the law.

In plain English, if you want to produce rules, then produce rules that can be performed by the ruled population and that can be “complied with” on the performance side.

It suggests that the constructive theory of producing rules and regulations is preferable to the communicative practice because it is better able to accommodate two fundamental intuitions about the practice and interpretation of the rules. First, the perception that the resolution of producing rules in the regulatory framework, must be the outcome of a genuine and reciprocal commitment to the public conception of justice, rather than the product of mistake and prevention.

There are three arenas that suggest researchers may need to shift from explaining the strengthening of official international standards to analyzing their weakening in the post-crisis world. The latter task will require scholars to devote more analytical attention to a wider set of international regulatory outcomes, including “informal regulatory convergence”, “regulatory fragmentation”, and especially “cooperative transnational regulatory decentralization”.

Governing Finance analyze the interplay at the domestic level between regulators, elected policymakers, financial industry groups, and other societal actors. Globalization and Finance is concerned more with the influence of trans-governmental networks of
regulators and transnational non-state actors such as banks themselves.

Second, the suspicion that contradictory practice of regulatory interpretation must not be conducted by using inefficient process of issuing new rules and regulations but by making changes to all three pillars of bank regulations:

1- only common equity should be recognized as capital for regulatory purposes;
2- risk weighing of assets should be abandoned; and
3- capital requirements should be assigned on an institution-by-institution basis

This process is to be performed according to a regulatory standard for prompt and corrective action incorporated into a monitoring dynamic approach.

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