Preface

It has been ‘A Hard Day’s Night’*

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The sub-title to this part of the book could have been – *What have we learned since the demise of Lehman Brothers?* The question, however, could not actually have been that short as we would have needed to add something about the number of investment banks that had to convert to become US holding companies, the re-nationalization of Fannie Mae and Freddie Mac, the death and then resurrection of AIG, the collapse of the Icelandic banking system, the overhauls of financial regulation in the UK, US and much of Europe, the Greek debt tragedy, and of course, we would need to list the extraordinary measures that governments took around the world to prop up their banking systems through explicit guarantees that contributed to the ballooning of government fiscal deficits. Instead, we think that The Beatles’ 1964 tune *A Hard Day’s Night* is more appropriate. While some of us might remember the lyrics better than others, the words go a long way in describing the recent global financial crisis. For some, people have been ‘. . . *working like a dog*’, or not working at all, trying to save their homes from a short sale or foreclosure. For others, they are finally seeing conditions in financial markets improving as low interest rates and quantitative easing are helping to boost the real economy and improving bank profitability; leading managers and traders to long for a return to large bonuses and the prospects of acquiring bargain-priced vacation homes in exotic locations. Perhaps it is not much more than a natural evolution of the capitalist system.

By and large, policymakers and regulators have not been ‘. . . *sleeping like a log*. . .’ (as the song goes), as many of them have awoken with what seems to be a terrible hangover. Some of those mornings-after were brought about through bank managers taking excessive risks or an evaporation of confidence, while others are suffering after following advice or the spin of people like Bernie Madoff, R. Allen Stanford and Marc Dreier – fraud artists who were not ‘playing by the rules’.¹ As well, central bankers had

been warning about systemic risk issues for some time but the vagueness of the term and the low probability that a financial system would fail to function kept attention to the issue largely to gatherings of central bankers at meetings of the Bank for International Settlements (BIS) or around the board table of the International Monetary Fund (IMF).

The 2010 Banking Law Symposium held in April 2010 focused on the issue of managing systemic risk in detail. We have collected in this book research on the global financial crisis by leading scholars, policymakers and practitioners. It is clear from the analysis that there was no single cause of the crisis. If that were the case, dissection of the issues might be relatively straightforward. Instead, we are left with considering a number of issues and learning from mistakes that were made in our economic systems. David Harvey, the noted social theorist, for example, in his *You Tube* lecture on *The Crisis of Capitalism* suggests six points that should be considered.² First, he offers human frailty by picking up on points made by Alan Greenspan that investors were under delusions and greed played a key role in the behaviour of Wall Street. Second, there were institutional failures and regulators were found ‘asleep at the switch’ as the shadow banking system grew very large and outside their purview. Third, the capitalist system might well be inherently unstable and we need to remind ourselves of the teachings of Keynes. Fourth, there are deep-seated cultural differences noting that the Europeans saw the early stages of the crisis as ‘. . . having nothing to do with us’ because the origins were linked to the US fascination for homeownership and the excesses caused by the deductibility of mortgage interest. Fifth, argument raised by Fox News that there was too much regulation and much of it was of the wrong sort. Lastly, a key issue that was missed was an understanding of systemic risk linkages between financial stability and government guarantees, regulation of the financial sector and sovereign risk.

PART I: SYSTEMIC RISK: ‘*TICKET TO RIDE*’

The first part of the Symposium started with a discussion of systemic risk. In his keynote remarks to the Symposium Jean Pierre Sabourin, a leading authority on deposit insurance, noted that the implementation of extraordinary measures, including blanket government deposit guarantees, has helped to prevent the global economy from sinking into an economic abyss. Such measures can lead, however, to inefficiencies, erode market discipline and encourage moral hazard by distorting incentives. What is often not considered, Sabourin noted, is charging banks for the privilege of the application of a full guarantee and plans to transition out of such

guarantees are often left too late. What happens is that the banks will believe that governments will always step in to bail them out – ‘too-big-to-fail’; an issue that was examined in great detail throughout the Symposium and one that will be on the minds of policymakers for some time to come. We are grateful to Charles Enoch for summarizing in the Foreword to this book the nature of the discussions during that event. The crisis was inevitable, and we had to have a *ticket to ride* the storm – reminiscent of another Beatles tune.

We begin in Part I with an examination of Systemic Risk by reviewing investor behaviour up to the dawn of the financial crisis in 2007. Richard J. Rosen notes that that period was marked by a rapidly expanding array of structured securities – bonds issued as part of a securitization process. Those securities were very complex and difficult to evaluate even for financially sophisticated investors. Nonetheless, the market grew and over time investors often based decisions on the credit ratings provided by agencies such as Moody’s, Standard and Poor’s and Fitch. While those agencies have a long track record of evaluating securities, it is probable that the intermediaries involved in issuing structured securities took advantage of overconfidence and (rational) inattention particularly when the agencies continued to give them high ratings. Rosen does not ask whether regulators contributed to the problems that led to the crisis.

Jack Selody then looks squarely into the eyes of systemic risk in Chapter 2 and asks: what constitutes the nucleus of a modern financial system and what makes it vulnerable to failure? He argues that it is the cluster of financial markets and supporting infrastructure that coordinates the activity of financial institutions. Selody maintains that the most significant aspects of the proposed regulatory reforms will not remedy this vulnerability because the principal systemic risk is the fragile liquidity of the core markets as they lack adequate risk-proofing. He believes that the reforms being discussed will raise costs in the regulated sector, push financial activity to the unregulated sector, and thereby create greater system vulnerability over time. A solution to this problem is offered through measures that keep markets liquid during institutional insolvency and by risk-proofing the core infrastructure. There are good reasons to support his hypothesis as evidenced by the progress made in risk-proofing the large-value payment systems and foreign exchange clearing systems.

We now better understand that the absence in several jurisdictions of specialized resolution tools has given a rise to additional costs. Sebastian Schich, in Chapter 3, notes that the result of an inability to close problem banks effectively has been an expansion of government guarantees. The costs associated with such measures have been substantial and seen in many ways particularly in the forms of large and growing contingent fiscal

liabilities as well as distortions to competition and incentives. To mitigate such problems risk-based premiums need to be specified, with premium adjustments consistent across borders. Appropriate premiums – be they charged *ex ante* or *ex post* – should ensure a fair distribution of risks and costs, and discourage activities that tend to contribute to systemic risk. Schich concludes his analysis by noting that systemic risk is an externality and surcharges would be appropriate to the extent that they induce financial institutions to internalize more fully this externality.

Rightly so, there was considerable discussion during the April 2010 Symposium on the US. Gillian G. H. Garcia points out in Chapter 4 that ‘forbearance in the US for larger institutions appears to be more permanent and is being enshrined in an enlarged safety net’.³ It is carried out for instance, by merging one troubled large bank into another slightly less-troubled large bank so that the resulting entity is ‘far-too-big-to-be-allowed-to-fail’. Hopefully, forbearance will not become a permanent government response under the financial sector reforms that have already been enacted in the UK and that are proposed for the US. Failed institutions avoided prompt corrective action (PCA) restraints by artificially maintaining their well-capitalized status, sometimes with supervisory assistance, almost until they failed. Garcia notes that their supervisors had not deployed their discretionary powers to discipline them.⁴

In Chapter 5, Jean Roy, Rima Turk-Ariss and Yenni Redjah examine the question as to why the Canadian banks performed so well during the global financial crisis. They found in a comparison of Canada and the US that the behaviours of the respective banks were strikingly different. Whereas massive government intervention was needed in the US to bail out the financial system, the Canadian government did not have to inject capital in any banks and none failed. Investors themselves were aware of the difference in risk between the two systems as the Value at Risk of the stocks of major banks in the US was twice as big as those of Canadian banks. They conclude that a more conservative Canadian culture seems to form the basis for the stability of the Canadian financial system.

The global financial crisis has forced a re-examination of risk transmission in the financial sector and how it affects financial stability. Risk management concentrates on the analysis of risk at the level of the individual institution and system-wide. In Chapter 6, Dale F. Gray and Andreas A. Jobst illustrate how contingent claims analysis (CCA) can be applied to improve systemic financial sector risk management. They propose a new framework (‘Systemic CCA’) developed to estimate the magnitude of contingent liabilities from the financial sector under systemic distress assumptions. This aggregation technique generates an estimate of the joint market-implied contingent liabilities by combining the individual

risk-adjusted balance sheets of financial institutions and the dependence between them. The Systemic CCA does not only quantify the magnitude of potential risk transfer to the government but also helps indicate the contribution of individual institutions to contingent liabilities over time depending on their size and interconnectedness.

The political fallout from taxpayer-supported bank bailouts has caused governments to consider the implementation of levies on the financial services industry. John Snape analyses, in Chapter 7, the defensibility of the UK proposal for a tax on the balance sheets of banks. His work explicitly recognizes that both the timing and the context of such a proposal are crucially important. The City of London, though weakened by the financial crisis, is still highly influential, and this presents the government with a difficult policy dilemma. However, revenues from the City's financial services can no longer fund the public services, and the dominant neoliberal theories of taxation are increasingly under pressure from a more political strand of liberal egalitarianism. In these terms, the levy does indeed make sense, but, as stated, timing and context is everything, and all this may quickly change.

PART II: THE SOVEREIGN CRISIS – A GREEK TRAGEDY, AN ICELANDIC MELTDOWN AND THE IRISH SWEEPSTAKES – WHAT IF ANYTHING DO THEY HAVE IN COMMON?

The global financial crisis promoted a debt crisis throughout most of Europe. The first group of countries to undergo a debt crisis included Portugal (with public debt levels of 76.8 per cent of GDP), Ireland (64 per cent), Greece (115.1 per cent), and Spain (53.2 per cent).⁵ The total amount of government debt outstanding for those countries was USD1726.9 trillion. With average growth rates for them ranging between 0.7 per cent and 2.6 per cent it will take decades to see debt-to-GDP levels return to pre-crisis levels. Foreign banks were exposed to USD236.2 billion of public and private debt in Greece with nearly one-third of that debt held by French banks. A Greek collapse became a major contagion (the spreading of a very harmful disease or practice) concern that spread across Europe and beyond.

There has always been a direct link between banks and the risk exposure of governments. Governments seek to limit their risks through prudential regulation and limits on coverage of insured deposits in member institutions. At the same time, banks hold substantial sums of sovereign debt; when governments run into financial difficulty so can the banks. That

problem was seen clearly in France when Credit Agricole reported huge losses in its international business due to a continuing problem in a Greek bank subsidiary.⁶

The Greek authorities might be correct in their determination not to restructure its debt. This is so because a restructuring would imply a default – something that EU members would not allow to happen due to the undermining effects on the euro. However, we use different titles of The Beatles' songs to try to explain how to cope with the current scenario: *If you've got trouble* and *In spite of all the danger* Greece cannot *Carry that weight*, they have to embark in *Fixing a hole* and *Getting better*, they are experiencing problems *Here, there and everywhere*. Therefore, a possible option is a debt re-profiling (a voluntarily exchange offer prior to default). In other words, the main difference between a debt re-profiling and a debt restructuring is the timing when the exchange offer is performed. A debt re-profiling can help ease part of the Greek pressure of the internal devaluation by reducing their debt servicing burden. Greece should take advantage of the liquidity that has been provided by the European Monetary Union (EMU) and IMF to do an orderly debt re-profiling which will not trigger the credit default swaps linked to the Greek bonds.

The link between the financial crisis and the sovereign debt problem is examined in the next three chapters. In Chapter 8, Arnór Sighvatsson and Gunnar Gunnarsson focus on Iceland's situation noting that the entire financial system failed. In so doing it contributed to a collapse of Iceland's currency, which depreciated by 60 per cent from 1 September 2008 until capital controls were instituted on 28 November 2008. Although the scale of the twin crisis was without precedent they note that the build-up of unsustainable macroeconomic imbalances and misalignments in asset prices followed a typical pre-crisis pattern described in the literature. Lax risk management and low perceived risks based on optimism about the future prospects of the booming economy made the financial institutions and the private sector far too willing to assume imprudent risks. Financial institutions overextended themselves not only domestically but particularly abroad. The large scale of the cross-border and cross-currency operations of the banks became problematic as their principal lender of last resort, the Central Bank of Iceland, could only provide them with liquidity in domestic currency and that made them particularly vulnerable to a run on their foreign liabilities.

In ancient Greece, tragedian Euripides during his stage plays at the peak of a tragic moment used a '*Deus ex Machina*' (Act of God) as a means to solve the plot. The question is whether there is such an Act of God for what is unfolding for the Greek economy to sustain the country through the rough waters that it is currently experiencing. In Chapter 9, Ioannis

Kokkoris, Rodrigo Olivares-Caminal and Kiriakos Papadakis discuss the difficulties of membership in the EMU, with a particular focus on Greece and the implications of an internal devaluation. They also discuss how debt re-profiling can help to support the mechanisms of fiscal rehabilitation and external financing at the sovereign and corporate level.

The Greek case is further explored in Chapter 10. Lee C. Buchheit and Mitu Gulati draw on the lessons learned from sovereign debt restructurings of the modern era, and underscore that it can easily be understood that a sovereign debt crisis can be a painful experience for both the debtor and its creditors. Indeed, a mismanaged sovereign debt crisis can be a catastrophically painful experience. The authors suggest that success could be found in structuring a transaction that would be an exchange offer – new bonds of the Hellenic Republic would be offered for the Republic's existing bonds. The terms of the new bonds would determine the nature and extent of the debt relief that the transaction would provide to Greece. Exchange offers have been the norm for sovereign debt restructuring of middle-income countries since the 'Brady Plan' implemented in 1990. The terms of the 'new' Greek instruments would be a function of the nature and extent of the debt relief the transaction is designed to achieve. At one end of the spectrum there might be a simple 're-profiling' of existing bonds (or some discrete portion of them such as bonds maturing over the next three to five years) involving a deferral of the maturity date of each affected bond. At the other end of the spectrum there could be a transaction designed to achieve a significant net present value (NPV) reduction in the stock of debt.

Ireland has recently been faced with a sovereign debt crisis. Although the Irish distress started slightly before the Greek tragedy it was quickly overshadowed by the magnitude of the latter and underestimated by the rapid response of their authorities in adopting a series of austerity measures to tackle a very delicate situation. The crisis was the result of an expansion of credit resulting from a real estate bubble which was burst by a credit crunch. Apparently, Ireland has run out of its four-leafed shamrocks and the crisis that was temporarily put on the back-burner regained notoriety on the cover of the specialized press due in part from mounting pressure from bondholders fearing for their return and the €7 billion rescue plan put in place in 2009 to help the Allied Irish Bank and Bank of Ireland and the recent nationalization of Anglo Irish Bank in the amount of €34 billion. The Chilean government also put the entire Irish funds industry on a watch-list out of concern for Irish sovereign debt.⁷ For those of us old enough to remember the world-famous Irish Sweepstakes that helped finance the building of Irish hospitals in the 1930s and later, we might very well be seeing some form of a comeback – but this time as a

way to finance budget deficits. Is this a return of the Irish sweepstakes but without the horses?

PART III: ADDRESSING THE PROBLEM OF 'TOO-BIG-TO-FAIL'

We, along with many others for that matter, have noted that national governments were required to intervene in many ways, given the depth of the financial crisis. For example, in the US, price declines in the residential housing markets contributed to heavy losses at Fannie Mae and Freddie Mac – something in excess of USD225 billion. Interestingly, both of them were created as government-initiated agencies; but when the crisis hit they exhausted their capital from guaranteeing loans on single-family homes and the market looked to the government to backstop the agencies.⁸ The lesson from that experience is clear as markets gladly accept the profits from such entities but will look to the authorities if failure is imminent. Contrary to that Beatles song '*... when I am home everything seems alright ...*' – clearly that has not been the case as Fannie and Freddie have contributed to the hangover being experienced by US taxpayers especially those that do not own homes or now have negative equity positions.

In Part III, we focus on the issue of 'too-big-to-fail' (TBTF) through the work of some leading experts. The recent crisis has caused policymakers to become much attuned to the issue of TBTF and its various derivations – 'too-big-to-save', 'too-big-to-close', etc. – subjects that were previously debated mainly by economists. Beginning in early 2008, an evaporation of liquidity began to have serious consequences for many large banks and non-bank financial institutions and the lack of lending spread and severely damaged major manufacturers such as General Motors and Chrysler. Starting with Bear Stearns unravelling in March 2008, a succession of large and complex financial institutions experienced funding crises that led to either their failure, conservatorship, or forced acquisition; sometimes by or through a government. But, the most severe blow came from the bankruptcy on 15 September 2008 of the USD600 billion investment bank Lehman Brothers, a firm regarded by the authorities not as TBTF but instead 'too-big-to-bail out'. That event was soon followed by the collapse and acquisition by the Federal Reserve Board of American International Group (AIG). The line from a Beatles' tune – '*... with a little help from my friends ...*' – seemed to be getting lots of play on Wall Street!

Geoffrey Wood with Ali Kabiri note in Chapter 11 that competition authorities, and many economists for that matter, usually apply a definition of competition which is frequently misleading in practice and always

mistaken in principle. When that is understood it becomes clear that the approach taken to financial regulation is misconceived. Wood examines an alternative approach which may lead to a financial system which is stable, efficient, and innovative. His chapter draws out an interesting comparison between banks and grocery stores – both are quite necessary to function in modern-day life. Wood's argument is that focus on the stability of the individual firm is misguided. Rather, policymakers should be more concerned about the stability of the industry. This is, however, merely reinforcing an existing and well-supported argument. The key point of his chapter is that industry stability matters for banking, and firm stability does not.

A technique is proposed in Chapter 12 as a way to wind down the operations of large complex financial institutions (LCFIs) when they become insolvent. The proposal is that those firms produce 'living wills'. George G. Kaufman notes that those kinds of documents will achieve an orderly resolution of LCFIs whose resolution might otherwise be disruptive with higher private and societal costs than necessary. The idea is 'to focus advance attention of both a firm's management and its regulators on problems that may arise in the unwinding of the firm when insolvency threatens including: accurately inventorying all assets and liabilities, identifying all counterparties, and giving full recognition to the complexity of organization structures across both separately chartered subsidiaries and different cross-border and structural jurisdictions'.⁹ Such information should reduce the likelihood of pitfalls and make winding down more efficient and lessen the need for policymakers to consider the firm TBTF with all the inefficiencies associated, including the likely use of taxpayer funds.¹⁰ Knowing how to unwind an LCFI may well make regulators more willing to do so.

Arthur E. Wilmarth Jr., in Chapter 13, points out that TBTF remains 'the great unresolved problem of bank supervision', and that the current financial crisis has proven, once again, that TBTF institutions 'present formidable risks to the federal safety net and are largely insulated from both market discipline and supervisory intervention'. This is because TBTF institutions 'pursue riskier and opaque activities and . . . increase their leverage, through capital arbitrage, if necessary, as they grow in size and complexity'.¹¹ Wilmarth proposes five reforms designed to prevent excessive risk taking by LCFIs and to shrink TBTF subsidies in the US financial system so as to strengthen current statutory restrictions on the growth of LCFIs. Those steps would strip away many of the safety net subsidies that are exploited by LCFIs and would subject them to the same type of market discipline that the capital markets have applied to commercial and industrial conglomerates over the past 30 years. Financial conglomerates,

Wilmarth maintains, have never demonstrated that they can provide beneficial services to their customers and attractive returns to their investors without relying on safety net subsidies and massive taxpayer-funded bailouts. It is long past time for LCFIs to prove – based on a true market test – that their claimed superiority is a reality and not a myth.

The German experience with TBTF is examined by Jens-Hinrich Binder in Chapter 14. He notes that Germany is proceeding with an overhaul of its bank insolvency regime.¹² The key policy objective is to avoid the need for further bailouts of systemically important institutions; be it on the grounds of their size or because of their interconnectedness with other market participants. Binder discusses the constraints on the German approach and whether this very policy objective can realistically be achieved. The chapter also identifies the treatment of close-out and netting arrangements as a major obstacle to the successful procedural treatment of LCFI insolvency. The author observes that while Anglo-Saxon banks are perceived to be the villains of the piece, German banks are in reality the Achilles' heel of the European banking system as they are undercapitalized.¹³ A related issue, of course, is that the European banks have been heavily involved in financing sovereign deficits.

Ioannis Kokkoris, in Chapter 15, comments that different types of laws affect the conditions or environment of competition between EU member states. The notion of competition law as a national interest corresponds with the growth of competition law systems in many liberal and democratic sovereign states. The provision of state aid is a contentious issue during a financial crisis as states will be inclined to maintain the viability of the financial sector by providing state aid to the banking industry. State aid, he concludes, must be addressed to meet the challenges of a competitive economy.

PART IV: CROSS BORDER – DID ANYONE MENTION BURDEN-SHARING?

Robert R. Bliss and George G. Kaufman examine, in Chapter 16, the issue of failing LCFIs, noting that they may not be efficiently resolved by either existing domestic bankruptcy or bank insolvency resolution regimes. While some are banks and others have bank-like characteristics, their size, complexity, interconnectedness, international stature, and the scope of the potential externalities suggest that such closures could generate severe problems. Accordingly, such solutions might require a hybrid approach drawing on the most suitable elements of both existing regimes. In the second part of their chapter, they look at the problems that

arise in resolving holding companies and, in particular, those companies that operate across countries. Some suggestions are offered for partially mitigating these problems through marginal changes in existing national insolvency laws and corporate structures. Their approach may be more feasible than achieving a broader coordinated change of laws governing LCFI insolvencies in different jurisdictions.

Rosa M. Lastra and Rodrigo Olivares-Caminal note that consolidated supervision has become a premise for global banking as LCFIs increasingly expand the range of their services offered in several countries. The authors note in Chapter 17 that the financial crisis has shown consolidated supervision not to be enough; it needs to be aligned with a more effective resolution process. Although efforts are underway, with both the IMF and the Basel Committee on Banking Supervision Cross-Border Bank Resolution Group working to develop a cross-border resolution framework,¹⁴ the lack of an effective consolidated resolution framework poses a challenge to the future of global banking and finance. Soon, they hope, policymakers will focus on risk-proofing their financial system safety nets and put in effective treaty-like mechanisms to share the burden when cross-border banks fail.

In Chapter 18, Larry D. Wall, María J. Nieto and David G. Mayes note that the European Union has been facilitating the growth of cross-border banking groups with considerable success. But, the job is not yet done as bank supervision remains the responsibility of national supervisors. The authors propose an alternative that would retain the most important advantages of full centralization of chartering and supervision only for those cross-border groups that are systemically important to the EU. All other banks would retain national chartering and supervision. Their chapter explores the idea of an EU-level supervisor that could supervise all systemically important cross-border banking groups without requiring an opt-in by the bank's home country. In this respect, the European supervisory system would work somewhat like that in the US which has long operated under a dual bank chartering system that allows banks to choose between charters issued by the federal government and charters issued by the state government.

PART V: PRUDENTIAL REGULATION – NO AMOUNT OF BANK CAPITAL IS ENOUGH IF IT IS NOT USED WISELY!

The head of the European Central Bank noted recently that central banks have had to undertake a number of measures without 'ever forgetting their

medium and long-term goals of price stability and, at times, they have had to ask what will happen in the next week; in the next day; or even in the next few hours'.¹⁵ During the months and years ahead Jean-Claude Trichet suggests that the challenge will be to manage the 'excesses and imbalances accumulated over the previous decades by households, firms and financial institutions – notably the expansion of debt, the build-up of risk and the increase in leverage'.¹⁶

Since the road to improved bank capital ratios appears to run through Basel, George A. Walker outlines the many twists and turns that led to the proposals of the Committee on Banking Supervision. He notes in Chapter 19 that banks were strongly criticized for holding low capital and liquidity levels immediately before the crisis. That, of course, prevented them from absorbing subsequent losses as the crisis unfolded. Central banks and finance ministries were then forced to inject substantial amounts of market liquidity and bank capital to re-stabilize the markets. He examines the main papers issued by the Basel Committee following the crisis. Some conclusions are drawn with regard to the effectiveness of the emerging new capital and liquidity reserve framework. Walker does not see the end of the road is actually in sight. Instead, it is a new process of adjustments and validation. Basel II and III represent significant advances on Basel I. All of this must simply be incorporated into a larger new macro- and micro-prudential oversight and control framework.

In Chapter 20, Imad Moosa, takes a step back to explore where we are now with the new Basel III requirements. First of all, he observes that the full implementation of Basel II would not have reduced the impact of the financial crisis – far from it given the wholesale lack of attention needed to manage liquidity risk. Notwithstanding the introduction of a number of measures to improve the stability of banks, the Basel III framework is still seen as wanting on a number of fronts that can equally destabilize the financial system; namely, the lack of consideration to regulatory arbitrage, the continued reliance on internal models, and the different treatment of bank and non-bank activities. Overall, the chapter questions whether international standards are the appropriate route to stability emphasizing the need for a more domestic focus as the US has sought to do.

PART VI: COUNTRY CASE STUDIES – THERE IS NO 'COOKIE-CUTTER' APPROACH THAT CAN BE OFFERED

The 2010 Banking Law Symposium provided an opportunity to review policies, practices and indeed success in some countries. It would be very

difficult and beyond the scope of this book to produce a complete assessment of each system around the world – that task is being left to future historians. But, some important lessons have been learned regarding cooperation and coordination. The need to better manage systemic risk and the problem surrounding the increase in moral hazard that emerged during the crisis is an issue of paramount importance.

In Chapter 21, Dalvinder Singh places the US reforms introduced with the implementation of the *Dodd-Frank Act 2010* in a historical context and he analyses the resistance to architectural reform in the US. The new Act like many of the predecessors for regulatory reform has been built on the existing institutional framework with micro regulatory reform. Notwithstanding this, the new legislation certainly brings better oversight over banks and non-bank systemic risk, given the reluctance to co-operate between bank and non-bank supervisors.

John Raymond LaBrosse and James F. McCollum examine in detail the safety net arrangements in Canada in Chapter 22. They conclude that the system has many features that work extremely well. Its success in managing through the financial crisis has also been assisted by the healthy state of the Canadian banking system at the beginning of the Great Recession. While high marks can be given to the Canadians, they should not rest on their laurels. Two important gaps in the financial safety net have been identified. The first concerns a means to integrate the prospective national securities regulator into the safety net and the second deals with a need to develop a policy to locate responsibility for financial system stability within the safety net. The fact that Canada uses a continuous improvement process to update its banking legislation every five or ten years should soon lead to proposals that will be watched intensively by many other countries.

In Chapter 23 Ganiyu Ogunleye looks at how the crisis unfolded in Nigeria. Since Nigeria's economy is largely crude-oil dependent it is vulnerable to external shocks and fiscal policy tends to be pro-cyclical. Ogunleye notes that a resilient financial safety-net requires macro-economic stability; mutually reinforcing monetary and fiscal policies; effective regulation; effective depositor/investor protection and sound governance of banking institutions. To what extent has Nigeria attained these imperatives? Perhaps, the jury is still out. But, given Nigeria's vulnerability to external shocks, maintaining macro-economic stability has been a daunting challenge to policymakers. Islamic finance has been experiencing tremendous growth and Islamic assets have reached \$750 billion.

The financial crisis felt in Malaysia is reviewed by Khairuddin Hj Arshad in Chapter 24. He notes that the nature of the Islamic bank–customer relationship appears to have made a significant difference.

Indeed, the expansion of global Islamic finance demonstrates its viability and resilience. Those developments have drawn significant interest from global regulators in the role and relevance of Islamic finance-based Shariah principles.

In the final chapter John F. McEldowney notes that financial risk and its assessment is at the centre of various global reform strategies aimed at addressing shortcomings in the regulation and reform of financial institutions. In reference to the UK, McEldowney notes that the tripartite system of financial regulation to achieve financial stability has come under intense criticism and public scrutiny. He proposes that a precautionary principle is required in any future regulatory strategy and that risk management requires transparency and effective accountability if it is to gain public confidence and address the needs of investors. Adopting a precautionary principle is important but even it cannot guarantee that no bank will ever fail which suggests that the response of legislators should be more strategic and systemic in defining the public interest and managing risk. Setting the correct regulatory balance between adequate loans to ensure market growth, financial stability and systemic risk assessment is likely to be a major challenge that is best addressed by the application of the precautionary principle.

Throughout the crisis, governments have been called upon to play an increasingly active role in backstopping banks, LCFIs, insurance companies, financial systems and industries that found their roots in capitalism. In our view five distinct areas of attention have emerged. First, the matter of ‘too-big, too-complicated, too-complex, etc. to-fail’ has received considerable attention. Second, financial system safety nets have been found to be in need of some attention and possibly major restructuring. Third, despite decades of attention on setting capital rules at an international level, more focus is required on risk management and supervisory practices. Fourth, for decades governments have been under-pricing guarantees they have provided to the banking sector and more appropriate arrangements need to be developed. Finally, the global financial crisis has put a number of sovereigns at risk (of downgrades or even default).

CONCLUDING REMARKS: GOING FORWARD – *HELP! OR ‘HERE COMES THE SUN’*

At this point we might be thinking of another old Beatles tune – *Help!* ‘... help me if you can I’m feeling down . . .’ Maybe not as we are beginning to see more signs of hope which might suggest an alternative Beatles song forecasting sunnier days ahead. For the first time since the trauma of the

Lehman Brothers failure data compiled by the BIS indicates that cross-border lending by banks is returning. In a recent report it commented that ‘global banks boosted lending outside their national borders by USD700 billion, or 2.1 per cent, to USD33400 billion in the first quarter of 2010’.¹⁷ ‘The balance sheet repair of the global banking system continues apace’, said Huw van Steenis, a banking analyst at Morgan Stanley. He noted that ‘the dominant story of the first half of the year was the credit recovery in northern Europe and the US’. Does this mean that the process of de-globalization that we have witnessed is coming to an end?

Another question that is before economists is whether the US economy is about to enter a period of very sluggish growth or a double dip recession. If it is the latter the Chairman of the Federal Reserve Board of Governors has indicated that the monetary authorities will use every tool at their disposal to prevent it – QE2 has set sail, but it is not a *Yellow Submarine*! The Obama Administration has added that it will propose a major infrastructure spending initiative to bring down the high rate of unemployment.

Bank capital levels are improving through concerted efforts of bank supervisors to re-establish control and banks have been forced to undergo stress tests so that supervisors can better understand the impact of less than favourable scenarios. At the same time, there are persistent worries about German and French banks particularly regarding their capital levels and sovereign debt exposures.¹⁸ However, there are hopeful signs in the sphere of banking as profits of US banks appear to be returning to pre-crisis levels. The TBTF problem might now be less of a concern as some of the largest banks are emerging as smaller versions of their former selves. This is being done by shedding unprofitable business lines and/or certain divisions like proprietary trading have been moved out of regulated entities or given a home in an offshore jurisdiction.

In the sovereign area: Icelanders are returning to their boats and probably finding fishing to be a much less stressful activity than trying to compete as an international financial centre; Greece has not yet collapsed owing to support provided by its euro-zone partners along with assistance from the IMF; blanket deposit guarantees are in many jurisdictions set to be reduced; and General Motors has returned to the equity markets. Unless the demand for credit improves there is a danger that banks will again run up their risk curves and start lending in search of yield.

Much was learned about TBTF during the crisis but actually more was learned about ‘too big to close’. Indeed, 2008 will be recalled as an important year in the twenty-first century as it saw the acquisition of Bear Stearns by JP Morgan facilitated by lending by the Federal Reserve Bank of New York; the bankruptcy of Lehman Brothers – a firm ‘too-big-to-bail’ out; the determination of two government sponsored entities

– Fannie Mae and Freddie Mac – as being ‘too-big-to-be-allowed-to-fail’ into conservatorship by the Federal Housing Finance Agency; the acquisition by the Federal Reserve Board of AIG which was determined ‘too-big-and-too-interconnected-to-be-allowed-to-be-closed’, and the absorption of Merrill Lynch into the Bank of America. In 2009 and 2010 the attention turned to the sovereign arena, particularly to the Greek tragedy, the potential spill-over to Ireland, Portugal, Spain and the risks that it entail to the euro-zone, then to the implications of the US Federal Reserve ‘throwing dollars from a helicopter’ through QE2 and the currency wars that were fought in the lead-up to the Korea G20 Summit.

In the next few years discussions will continue on issues such as cross-border coordination, harmonization, burden sharing, failure resolution, the interactions between monetary policy and regulatory reforms, the need for better macro-prudential tools, crisis management and the use of government guarantees. There is indeed a full agenda that awaits us. Economic activity is expected to improve in many G20 countries and it is hopeful that the Great Recession will not be followed by the Great Disappointment or else we will not be ‘. . . *sleeping like a log*’ for a while yet, like the refrain from that old Beatles song. Instead, maybe *All You Need is Love*.

John Raymond LaBrosse
Rodrigo Olivares-Caminal
Dalvinder Singh
5 November 2010

NOTES

- * The reference to the Beatles songs throughout the introduction is for illustrative purposes only and these are all well known. All tracks credited to Lennon and McCartney except for *In spite of all the danger* to Harrison/McCartney and *Here comes the sun* to Harrison.
- 1. A truly excellent account of 21 tales of the new recession was published by *Vanity Fair* and included in a book entitled *The Great Hangover*, edited by Graydon Carter, Harper Perennial, 2010.
- 2. Please see <http://www.youtube.com/watch?v=26o22Y33h9s>
- 3. Please see Garcia, G.H., *The Troubled Asset Relief Program: Has Forbearance As Far As the Eye Can See Saved the US Economy?* (Chapter 4 in this volume).
- 4. Garcia, G.H., ‘Failing Prompt Corrective Action’, *Journal of Banking Regulation*, 2010, V.11, pp. 171–190.
- 5. *The Globe and Mail*, 1 May 2010, Business section, p. 7.
- 6. Please see ‘Greek Woes Hit Credit Agricole,’ <http://ftalphaville.ft.com/thecut/2010/08/27/327681/greek-woes-hit-cr>
- 7. Brown, John Murray, ‘Chile meeting on Ireland funds awaited’, *Financial Times*, 15 November 2010.

8. Please see <http://link.ft.com/r/VKY5JJ/C5NYI1/Y88YJ/BMN10H/GKJLMZ/KI/t?al=2010&a2=8&a3=27>
9. Kaufman, G.G., *Living Wills: Putting the Caboose before the Engine and Designing a Better Engine* (Chapter 12 in this volume).
10. Taxpayer support of the banking system in Europe through the financial crisis appears to have cost something close to 17 per cent of GDP. Please see Michel Barnier, found at <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/10/470&format=HTML&aged=0&language=EN&guiLanguage=en>
11. Ibid.
12. Federal Ministry of Finance, Discussion draft: Law on the restructuring and orderly resolution of credit institutions, on the creation of a Restructuring Fund, and on the prolongation of the limitation period for directors' and officers' liability.
13. Please see Plender, John, 'German banking weaknesses come to light', *Financial Times*, 7 September 2010.
14. The IMF is working on a proposed framework (principles) for cross-border resolution of financial crises. This proposed framework is subject to consideration of the Board (a resolution is expected soon). Also see Bank for International Settlements, Report and Recommendations of the Cross-Border Bank Resolution Group, March 2010 available at <http://www.bis.org/publ/bcbs169.pdf?noframes=1>.
15. Please see <http://www.bis.org/review/r100901a.pdf> at p. 1.
16. Ibid.
17. <http://www.ft.com/cms/s/0/9442c552-b91c-11df-99be-00144feabdc0.html?ftcamp=crm/email/201096/nbe/EuropeBusiness/product>
18. *The Economist*, 'Still in a Spin', 15 April 2010.