Introduction

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> *'Feasts to which many contribute may excel those provided at one man's expense.'*
>
> Aristotle, *The Politics*

Although the synoptic perspective of a single author is often preferred by critics to the collective expertise of an edited book, Aristotle's authority nonetheless can be invoked to justify a collective work on a topic as complex and wide-ranging as international financial market regulation. Indeed, a comprehensive study of international financial regulation would necessarily involve a multi-disciplinary analysis of the economic, financial, legal and political issues that have so perplexed academics, policymakers and practitioners since the global credit and financial crisis began in August 2007. Any such analysis would be lacking if it did not address how the prudential regulation of financial markets requires continuous adaptation to the evolution of financial markets themselves: in instruments traded, in institutional structures, and in the degrees of integration of national and international markets. In the past decade the speed of change has accelerated. This has been particularly evident in the recent financial crisis that was precipitated in 2007 by the sub-prime mortgage problems in the United States. The resulting liquidity crisis in wholesale funding markets transformed itself into a solvency crisis for many institutions and countries while spreading to Europe and throughout the world. In terms of institutions and market structures, these events demonstrate the power of contagion in today's increasingly integrated financial markets. In terms of policy analysis, it demonstrated that modern risk modelling does not adequately represent the behaviour of market participants – behaviour that, in the face of extreme events, tends to dramatically alter the correlations on which most risk modelling is based. In terms of policy implementation, it demonstrated that regulation, supervision, and financial crisis management have not kept pace with changing markets and, in some cases, have exacerbated some negative aspects of those changes.

Accordingly, this book analyses how financial markets and institutions have changed over the past three decades, and the role of law and regulation in responding to those changes. Indeed, it is an important theme of this book that law and regulation have not responded adequately to the changing structure of financial markets: legal and regulatory frameworks have had an overriding and disproportionate focus on reducing transaction costs between market participants so that they can enter into an increasing array of complex transactions with the expectation of greater returns but also with greater risks, most of which have been externalised, or shifted, on to society at large. Regulation and private contracting have essentially permitted private parties to reap huge gains from private risk-taking while socialising the losses. Public law and regulation have failed to control the socialisation of these risks. This failure to control systemic risks stems in part from regulators and policymakers failing to address the changing *systemic* characteristics of the international financial system that has become characteristic of international regulatory developments in recent years. It was certainly a characteristic of the amended version of the Basel Capital Accord known as Basel II,[1] surely the most important practical expression of the contemporary theory of international financial regulation. And via Basel II, and now Basel III, it has become a significant characteristic of the Capital Requirements Directive,[2] and, indeed of several of the regulatory initiatives now being taken by the IMF, the World Bank, and the Financial Stability Board.

Efficient risk-management by firms is a fundamental component of competitive success in today's financial markets. It also makes an important contribution to general market stability – in normal times. However, in the face of extreme events (even 'moderately' extreme events) rational risk-management by individual firms may precipitate a macro-economic reaction that is destabilising, can place those firms in jeopardy, and result in a general welfare loss. The classic example is a bank run. A depositor at a particular bank would be willing to leave funds on deposit, but believes that other depositors are likely to react to an adverse event by withdrawing their funds, forcing the bank to call in loans or sell securities and suffer losses, perhaps even suspending payments. Consequently, a rational investor will seek to be the first to withdraw funds at the first sign of serious trouble. Hence all withdraw their funds as rapidly as possible when there are adverse developments resulting in a 'run'. A run on one particular bank necessarily affects the perception of the liquidity of other banks and the run spreads to other, nominally solvent, banks.[3] More formally, whilst a depositor may be certain about the probability of suffering a liquidity shock, the depositor cannot be certain about the probability that his or her shock will occur early or late relative to others. In other words, depositors cannot be sure where they will be in the queue to withdraw funds. The result is the rush to withdraw (Caballero and Krishnamurthy, 2006, 8).

In recent decades, however, the structure of financial markets has changed, shifting from a bank-based to a market-based financial system (Hendricks, Kambhu and Mosser, 2006) with banking now following an 'Originate, Rate and Relocate' model. Financial intermediation has moved from institutions into markets and, as a consequence of this disintermediation, financial crises are now manifest in markets rather than institutions. Accordingly analytical interest has moved from bank runs to 'market gridlock' as a source of systemic risk.[4] The market oriented systemic crisis results from a breakdown in the functioning of markets for traded assets. It may be triggered, for example, by a sharp decline in the price of one asset that sparks a widespread sell-off in the general rush for liquidity. Again, in more formal terms, the individual agent knows the probability of a shock, but does not know the probability of being able to trade with the market counterparties on whom his or her liquidity depends. Not knowing, and being averse to uncertainty, the agent, and all other agents, has a collective bias toward liquidity (Caballero and Krishnamurthy, 2006, 15). The collective rush for liquidity produces the market gridlock characteristic of market based systemic crises. It is important to note that a relatively small event can produce this gridlock in very large markets.

FINANCIAL RISK-TAKING IS A CONCERN OF PUBLIC LAW AND POLICY

Financial risk-taking is a concern of public law and policy because associated with the risk-taking actions of individuals there are externalities; i.e. costs and benefits accruing to the society that are *external* to the calculations of the individual investor, and not accounted for in the market place. A major financial failure imposes costs on society going far beyond the losses suffered by the immediate investors. In an economy where there are important externalities, competitive markets will be socially inefficient. The task of public law and policy, in this case of financial regulation, is to attempt to mitigate these market failures.

Financial externalities are particularly potent because they are transmitted *macroeconomically*. Financial markets are markets for stocks of current and future assets, the value of which today is dependent on the expectation of their future value. To the extent that expectations are shared, any factor that leads to a general shift in expected future values will have an immediate impact on financial markets, and on the major macro-financial variables, such as the interest rate and the exchange rate. So the failure of a single firm can, by influencing expectations, have an influence not only on its immediate counterparties, or even just on firms dealing in similar products, but also, through its impact on expectations, on financial markets as a whole and then, via the interest rate or the exchange rate, the contagion may spread to the whole economy.

Yet despite the presence of externalities and potential contagion, a peculiarity of market expectations is that they can be remarkably stable (or tranquil) for substantial periods of time, even when underlying real circumstances might be decidedly unpropitious. Periods of tranquillity defined by stable expectations and stable market confidence may sustain the illusion that, despite evidence to the contrary, financial markets are truly reflecting a strong and balanced real economy. The shattering of that illusion, however, can be catastrophic, leading to a sudden loss of investor confidence that can, without any visible means of support, plunge financial markets over the cliff edge and into the abyss.

One of the tasks of financial regulation therefore is to keep markets away from the cliff edge, and when they rush over, to ensure that the damage to the economy as a whole is minimised. The contributions in this volume consider financial regulation in this light and relate it to other important areas of financial law, regulation and governance. The book is divided into five parts. Part I analyses the changing structure of global financial markets involving the disintermediation of banks and how regulation failed to respond adequately to the resulting financial innovations that sowed the seeds of the global credit and financial crisis that began in 2007 and spread to become a sovereign debt crisis in Europe in 2011. This part explains how financial innovation in the form of securitisation and complex financial instruments allowed banks and other market participants to shift financial risk to counterparties in multiple jurisdictions and considers what level of regulation is needed to bring more transparency for investors in understanding the risk they are taking on when investing in these financial products. Chapter 2 examines how inadequate legal frameworks allowed an excessive build-up of risk in the shadow banking sector. In this chapter, Tom Burns analyses the structure of the so-called shadow banking system as one that was largely based on private law. It was unable to cope with a liquidity crisis because of its inherent defects. Unfortunately, these defects were not fully appreciated by the banking regulators during the development of this parallel banking system. The chapter goes on to argue essentially that the private law system (left to its own devices) became too complex and opaque and began to underprice credit risk. It was thinly capitalised, had no lender of last resort and had a tendency to produce serious conflicts of interests. The privately regulated shadow banking system was therefore in poor condition to withstand a liquidity crisis. The chapter highlights the importance of developing adequate public law principles of financial regulation to support existing private law doctrines which proved inadequate in controlling and mitigating the damages created by excessive financial risk-taking.

In Chapter 3, Professor Edward Kane analyses how the incentives of regulators and politicians were misaligned and were a major influence allowing banks to engage in excessive risk-taking, and that regulatory reform requires that financial supervisors have enhanced training and stronger incentives to control risk-taking in the financial sector. His discussion is mainly focused on the failed regulatory and supervisory practices in the US and how the policies designed to promote home ownership encouraged borrowers and lenders alike to operate with a perilously high degree of leverage. For borrowers, the value of the subsidies that they could derive both from tax deductions for mortgage interest and from federal programmes supporting mortgage credit increased with the amount they borrowed. For lenders, federal programmes supported the securitisation of home mortgages by offering cheap or even unpriced guarantees and by making it possible for banks to avoid capital requirements on mortgages that they chose to securitise. The SEC and bank supervisors did not require institutions either to estimate or to hold capital against the risk they were originating. Professor Kane's chapter also addresses the ethics of supervision and regulatory rules and the market for regulatory services and its imperfections.

Part II examines bank capital adequacy regulation and its effect on bank behaviour, and risk measurement approaches under Basel II and III and the challenges they pose for bank governance and regulation. In Chapter 4, Isaac Alfon, Isabel Argimon, Patricia Bascuñana-Ambrós examine some of the important influences that cause banks to hold regulatory capital in excess of the minimum requirements. They review hypotheses about how decisions on capital are taken and how they affect the 'buffer' between actual capital and the regulatory requirement. The hypotheses come from the literature and from interviews with policy makers, supervisors and practitioners. They argue that the amount of capital held by banks and building societies depends on risk management, market discipline and the regulatory environment, not simply on the regulatory minimum requirement. For example, UK financial regulation included an individual capital requirement which was one of several tools available to supervisors as part of the supervisory review process under Basel II and III. Using both quantitative and qualitative approaches, the authors provide evidence on which the hypotheses hold in the UK. They find that regulatory requirements affect the amount of capital held by banks and by building societies. Chapter 5 extends the discussion of capital adequacy regulation to risk measurement for expected loss under Basel II and III. In doing so, Gianluca Riccio draws on the flexibility permitted in Basel III to use ratings and loss given default methodologies along with ratings to build a sound model for measuring expected loss when data are unreliable. In Chapter 6, Dr Andrew Cornford discusses the impact of Basel II and III on trade finance and suggests that Basel III may limit the capacity of banks to finance cross-border trade, especially in developing countries.

Part III turns to the inter-relationship between European institutions and the growing integration of EU financial markets. It does so by examining the institutional structure of European financial regulation and supervision and the role of the European institutions during the recent financial crisis that involved substantial state bailouts of European banks and the legality and policy implications of this under the EU state aid regime. Professor David Mayes, in Chapter 7, examines the gaps in the EU home country control regime prior to the establishment of the three new European Supervisory Authorities and how it lacked effective cross-border coordination between home and host supervisors and inadequate crisis management procedures. Klaus Ilmonen discusses in Chapter 8 the evolution of the EU financial services action plan and the Lamfalussy framework and whether it was sustainable to achieve EU financial integration objectives. Although the chapter was written before the 2009 De Larosiere report, it nevertheless provides an important framework of analysis to show how the EU regulatory regime should be evaluated over time. In Chapter 9, Dr Costanza Russo analyses how EU state aid rules have been applied to financial institutions in the crisis. Since October 2008, European Member States have been implementing recapitalisation and guarantee plans to support the banking sector. Such plans, although different, are based on common principles agreed at the level of the EU Ministers of Finance, stating that they should be limited in scope and time, that State involvement must be confined to the minimum, that shareholders should bear the consequences of intervention and that Governments should protect competition. In light of the special circumstances of the financial crisis, the European Commission has provided guidance to show how state bail out plans can be compatible with EU state aid rules. This chapter examines the main characteristics of the most important European Member States measures, and argues that the role of the State appears to be more than 'temporary' and less than 'profitable' for the taxpayers. Her overall argument is not optimistic: the bailouts have resulted in serious moral hazard and, the Commission's 'compatibility decisions' may lead to a new financial market structure where competition has been seriously hindered and where the involvement of the State in banks' capital and governance may not end as soon as the Commission wishes.

Chapter 10 compares how the EU and Japan regulate foreign direct investment and examines the financial stability implications. The key analytical and policy question examined is whether multinational companies and their overseas investment need to be regulated at the national and/or at the international level, in order to address market failures and to enhance their potential contribution to world welfare. The chapter examines, from a developing country perspective, two kinds of regulatory regime: first, the current regime based on national autonomy, and second, a regime proposed by the European Union and Japan at the WTO in 2005 but which was rejected, but would have instituted fresh global rules of the game which would have effectively allowed multinationals unfettered freedom to invest where they like, whenever they like, how much and in what products.

Part IV analyses the relatively unrecognised area of central clearing of derivatives. In Chapter 11, Chryssa Papathanassiou analyses how central counterparties (CCPs) mitigate counterparty risk and thus are conducive to financial stability. The chapter examines the legal structure and principles that undergird CCPs. It argues that a CCP is useful, in a risk mitigation sense because it serves (1) as a coordinator administering the default procedures of derivative counterparties; (2) according to clear and transparent rules; and (3) for multiple products and markets. The CCP's default coordination procedures may prove useful during periods of market stress and is an element missing in bilateral netting. Chapter 12 focuses on the role of clearing houses in reducing systemic risk and related issues that apply to settlement institutions. Related legal issues are analysed as well with respect to the doctrine of novation and how it governs transactions involving counterparties and clearing houses. This chapter was written just as the crisis was beginning in 2007 and analyses the financial stability role that CCPs can play in OTC derivative smarkets. CCPs are an important part of the G20's regulatory reforms that attempt to reduce systemic risk in the over the counter (OTC) derivative markets. The chapter suggests that although proposed regulatory reforms will require that many standardised OTC contracts be cleared in CCPs, this may create a concentration of risk in CCPs and thus potentially create a new financial stability threat.

Part V examines the interaction between regulatory institutions and markets and the determinants of the institutional design of financial supervision along with issues of global governance in the operations of the International Monetary Fund, and other international financial institutions. Chapter 13, entitled 'Lessons from Japan's Banking Crisis', surveys the economic policy issues and financial regulation developments involving the Japanese banking crisis in the 1990s. Professor Mariko Fujii and Dr Masahiro Kawai examine the Japanese government's response to the financial crisis in the 1990s and how Japanese authorities failed to recognise the severity of the crisis, which developed slowly, and lacked an adequate legal framework for bank resolution. They argue that policy measures adopted after the 1997–1998 financial crisis, supported by a newly established comprehensive framework for bank resolution, were more decisive at a later stage. Japan's experience suggests that it is vital for a government not only to recapitalise the banking system but also to provide banks with adequate incentives to dispose of troubled assets from their balance sheets, even if that required the government to mobilise regulatory measures to do so, as Japanese authorities did in 2002. Economic stagnation can cause new nonperforming loans to emerge rapidly, and deplete bank capital. The authors conclude that if the authorities do not address banking sector problems promptly, the crisis will be prolonged and economic recovery substantially delayed.

Chapter 14 examines the determinants of the institutional design of financial supervision at the national level. Professor Donato Masciandaro assesses five different theories concerning the determinants of financial supervision architectures: (1) the market view emphasises the role of the structure of the financial system in determining the policymaker's choices; (2) The institutional view stresses the role of the existing rules of the game in explaining the features of supervisory design, with particular attention to the role of central bank; (3) The legal view highlights the influence of the legal tradition of a jurisdiction in shaping the design of the financial architecture of supervision; while (4) the political view emphasises the role of the public governance standards; (5) The geography view claims the existence of a direct link between countries' geographical position and features of financial supervision design. The empirical analysis was performed with ordered logit and probit functions on a dataset of 89 countries and provides support for the institutional view.

Chapter 15 addresses weaknesses in the international financial institutions and the challenge of coordinating policy to prevent liquidity crises. Dr Anastasia Nesvetailova discusses the effect of liquidity illusions on public policy and how international institutional theory can shed light on the causes of financial crises and the efforts of governments to manage these crises. In Chapter 16, Xenia Roduner addresses the concept of governance as it relates to the International Monetary Fund. She applies governance theories to a range of institutional arrangements ranging from formal international organisations to trans-governmental networks and less formal international standard setting bodies. She links these theories of governance to theories of human rights, especially with respect to the concept of fairness. She examines the concept of fairness as it relates to decision-making in the International Monetary Fund and in particular applies her analysis to the system of voting power on the IMF Executive Board. In so doing, she considers constitutionalist theory to analyse fairness in IMF decision-making and also suggests that human rights principles are relevant for assessing the fairness, accountability and efficiency of decision-making in the IMF and World Bank.

Iftekhar Hasan and Maya Waisman analyse in Chapter 17 the phenomenon of the underpricing puzzle in initial public offerings (IPOs) of companies which are established and operate in one jurisdiction but which conduct their IPO in another country. Although the characteristics of this underpricing puzzle have received substantial attention in the literature, very little is known about the success and failures of IPOs of companies performing primarily in one market but opting for going public in a different country. The authors analyse the short-term performance of the Israeli IPOs and compare it with that of local US as well as other foreign IPOs. The number of Israeli IPOs in the US was greater than the combined number of IPOs in the US of all other non-US companies between 1985 and 2000, excluding Canada. Using the sample of 728 US, 61 Israeli and 78 other foreign firms, the authors demonstrate substantially lower underpricing by Israeli IPOs compared to the rest of the sample. A formal panel logit regression analysis is employed to confirm this finding.

Chapter 18 examines the role of financial taxes in the regulatory reform debate and the practicability of implementing a financial transaction tax in globalised financial markets with centralised clearing and settlement. The authors suggest that proposals by the EU Commission and some EU states for a financial transaction tax are flawed because they will lead to significant distortions and circumvention in global financial markets. In Chapter 19, Dieter Pesendorfer critically analyses the neo-liberal paradigm that has governed the design of financial regulation and argues that recent regulatory reforms have failed to address the market failures that caused the global credit and financial crisis. He suggests that a post neo-liberal framework based on the precautionary principle and other theories from environmental regulation are needed to rebuild a more effective international financial regulatory regime.

An important theme running throughout most of these chapters has been the recognition of the intellectual failure of market-based regulatory frameworks such as Basel II that dominated official thinking over the past two decades. The market-based approach to financial regulation has generally concentrated to an excessive extent on microeconomic risk, which has utilised risk sensitive techniques that, in the face of extreme events, can exacerbate systemic risks, with the potential to precipitate a crisis. Essentially, financial policymakers and regulators have failed to incorporate systemic risks into the design of regulatory institutions and of risk management. The major lesson to be drawn from the current crisis is that a rebalancing is urgently needed. An important aspect of this rethink is determining the right balance between liberalised and liquid financial markets and adequate legal and regulatory controls to curb the systemic risks that arise from excessive financial risk-taking. This recalibration of international financial regulation to take account of systemic risks is now taking place at the Financial Stability Board, in coordination with the International Monetary Fund, and under the watchful eye of the G20. Nevertheless, these regulatory reforms impinge on other areas of economic and social policy and, as some authors argue, raise human rights issues as well. The contributions – from across the disciplines of law, economics, finance and political economy and international studies – provide insightful analyses of the difficult issues and challenges that face the governance and operation of globalised financial markets.

NOTES

1. Basel Committee on Banking Supervision, Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version (June 2006).
2. The Council and European Parliament formally adopted the Capital Requirements Directive on 14 June 2006. The Capital Requirements Directive comprises Directive 2006/48/EC and Directive 2006/49/EC. See Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) OJ L 177, 14.6.2006, p. 1; and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) OJ L 177, 14.6.2006, p. 201.
3. Before the introduction of deposit insurance in the twentieth century, bank runs were common in Europe, the UK and the US. In the late nineteenth century there was approximately one major bank run every decade. During the National Banking Era in the United States (1863–1914), there were five major bank runs: 1873, 1884, 1890, 1893, and 1907.
4. The banking collapses of the German IKB and the UK's Northern Rock were the result of market gridlock, not of a bank run. In the case of Northern Rock the bank run was not a *cause* of Northern Rock's difficulties, but a *result* of the funding crisis in wholesale capital markets and of the preliminary response of the authorities.