

The Foundations and Future of Financial Regulation

Financial regulation has entered into a new era, as many foundational economic theories and policies supporting the existing infrastructure have been questioned following the financial crisis. This book offers a timely exploration of financial regulation in the aftermath of the crisis in order to map out the future trajectory of regulation in an age where financial stability is being emphasised as a key regulatory objective.

The book is split into four sections: the objectives and regulatory landscape of financial regulation; the regulatory regime for investor protection; the regulatory regime for financial institutional safety and soundness; and macro-prudential supervision. The analysis ranges from theoretical and policy perspectives to comprehensive and critical consideration of financial regulation in the specifics. The book focuses on the substantive regulation of the UK and the EU, within a global context, making comparisons where relevant with the US. Running through the book is the consideration of the relationship between financial regulation, financial stability, institutional structures in the UK, EU and US, and the responsibility of various actors in governance.

This book offers an important contribution to the critical analysis of the role of financial regulation, market discipline and corporate responsibility in the financial sector, and on the roles of regulatory authorities. It will be of interest to academics and students of banking and finance law and comparative economics.

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The Foundations and Future of Financial Regulation

Governance for Responsibility

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Iris H-Y Chiu**

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Part 4

Macro-prudential supervision

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14 The rise of macro-prudential supervision

Macro-prudential supervision has become a key aspect of financial regulation in the UK, EU and globally in the aftermath of the global financial crisis.¹ Wolf defines macro-prudential supervision as ‘oversight of the financial system as a whole’² and as different from the chiefly ‘micro-prudential’ approach taken in financial regulation up until the global financial crisis. Pre-crisis, banking and financial regulation focused on individual institutional soundness in terms of capital adequacy and conduct of business. This ‘micro-prudential’ approach is now regarded as inadequate:³ central banks and regulators need to have an overall picture of the build-up of risks in the financial system as a whole⁴ and to consider the linkages and connections between financial institutions in the assessment of risks. Macro-prudential supervision, providing a bird’s-eye view of the financial system as a whole, is better placed to support the regulatory pursuit of financial stability.⁵

- 1 FSA, ‘The Turner Review: A Regulatory Response to the Global Banking Crisis’ (March 2009) www.fsa.gov.uk/pubs/other/turner_review.pdf accessed 3 January 2013, 83; G30 Working Group on Macroprudential Policy, *Enhancing Financial Stability and Resilience: Macroprudential Policy, Tools and Systems for the Future* (Washington, DC: Group of Thirty 2010). See also the discussion in Mads Andenas, ‘Harmonising and Regulating Financial Markets’ in Mads Andenas and Camilla Andersen (eds), *Theory and Practice of Harmonisation* (Cheltenham: Edward Elgar 2012), 14, and Jan J Dalhuisen, *Transnational and Comparative Commercial, Financial and Trade Law*, vol III (5th edn, Oxford: Hart Publishing 2012), ch 2.
- 2 Martin Wolf, ‘Seven Ways to Fix the System’s Flaws’ *Financial Times* (London, 23 January 2012).
- 3 FSA, ‘The Turner Review: A Regulatory Response to the Global Banking Crisis’ (March 2009) www.fsa.gov.uk/pubs/other/turner_review.pdf accessed 3 January 2013, 83, viz. ‘The lack of such a [macro-prudential] perspective, and the failure to specify and to use macro-prudential levers to offset systemic risks, were far more important to the origins of the crisis than any specific failure in supervisory process relating to individual firms. Getting macro-prudential analysis and tools right for the future is vital’.
- 4 For example, FSA, ‘The Turner Review: A Regulatory Response to the Global Banking Crisis’ (March 2009) www.fsa.gov.uk/pubs/other/turner_review.pdf accessed 3 January 2013, 83. Markus K Brunnermeier and others, *The Fundamental Principles of Financial Regulation* (Geneva Reports on the World Economy, London: Centre for Economic Policy Research 2009) define macro-prudential supervision as an overview of the factors that may affect financial stability in general.
- 5 European Union Committee, *The Future of EU Financial Regulation and Supervision* (HL 2008-09, 106-I), para 22.

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The EU and UK have institutionalised new regulatory infrastructures in order to carry out macro-prudential supervision. A suite of new regulatory techniques, many of them pre-emptive in nature,⁶ is also being developed for macro-prudential supervision. This part will examine the nature of macro-prudential supervision and how it is purported to be carried out. The authors will, however, raise certain concerns regarding the bureaucratic powers behind macro-prudential supervision and the technocratic nature of such supervision.

The purpose of macro-prudential supervision is:

[T]o contribute to the prevention or mitigation of systemic risks to financial stability in the [European] Union that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth.⁷

Macro-prudential supervision is, in essence, a supervisory framework or approach to monitoring systemic risk concerns.⁸

In order to monitor systemic risk concerns, the macro-prudential regulator needs to be supplied with a comprehensive range of information to facilitate the understanding and analysis of systemic risk in financial markets. Chapter 15 will discuss the exponential expansion in regulatory powers to collect information from the financial services sector and markets for the purposes of prudential supervision or systemic risk monitoring. Further, in order to develop the toolkit for macro-prudential supervision, both the UK and EU have established new bodies with a dedicated macro-prudential mandate but closely connected to the central bank; they are the UK Financial Policy Committee⁹ (FPC) and the EU's European Systemic Risk Board (ESRB).¹⁰ Chapter 16 will explore how the new bodies work and Chapter 17 will critically discuss concerns that may arise with respect to the new bodies, particularly in relation to issues of accountability and technocracy.

6 Priya Nandita Pooran, 'Macro-prudential Supervision – A Panacea for the Global Financial Crisis?' (2009) 3 *Law and Financial Markets Review* 534.

7 European Parliament and Council Regulation (EU) 1092/2010 of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board [2010] OJ L331/1 (ESRB Regulation 2010), art 3(1).

8 G30 Working Group on Macroprudential Policy, *Enhancing Financial Stability and Resilience: Macroprudential Policy, Tools and Systems for the Future* (Washington, DC: Group of Thirty 2010); Claudio Borio, 'Towards a Macroprudential Framework for Financial Supervision and Regulation?' (February 2003) BIS Working Paper http://papers.ssrn.com/sol3/papers.cfm?abstract_id=841306 accessed 21 March 2013; Committee on the Global Financial System (Bank of International Settlements), 'Macroprudential Instruments and Frameworks: A Stocktaking of Issues and Experiences' (May 2010) CGFS Paper No 38 www.bis.org/publ/cgfs38.pdf accessed 21 March 2013.

9 HM Treasury, *A New Approach to Financial Regulation: The Blueprint for Reform* (Cm 8083, June 2011).

10 Established by the ESRB Regulation 2010.

Eriksson-Zetterquist¹¹ argues that a flurry of ‘organisation’ often occurs after a catastrophe, when existing institutions are seen as inadequate to prevent or manage the catastrophe.¹² However, the salience of the new institution must be tested once the dust of the catastrophe settles. Although macro-prudential supervision and its institutions have been quickly established, this part will critically analyse whether these institutions are likely to remain salient.

Macro-prudential supervision is intended to deal with systemic risks at a broad level. The EU Regulation establishing the ESRB in 2010 widely casts systemic risks as:

... a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. All types of financial intermediaries, markets and infrastructure may be potentially systemically important to some degree.¹³

The sources of risk to be monitored for the purposes of macro-prudential supervision are wide-ranging and this immediately raises the question of whether regulators are able to deal with such a wide and potentially indeterminate range of risks. Joosen¹⁴ argues that indeterminacy in the scope of regulation is generally adverse to the framing of clear regulatory objectives, as regulators do not have specific indicators to focus on, entailing either inaction or discretionary and arbitrary judgements in the execution of their functions. The breadth and potential indeterminacy of the sources of systemic risk to be monitored is a recurring theme in our critical discussion of macro-prudential supervision in this part. We argue that such breadth and potential indeterminacy has resulted in the establishment of wide powers for regulators in terms of information collection and the development of macro-prudential tools. Further, the central banks (within which the FPC and ESRB are nested) seem to be embarking on bold and novel developments and this phenomenon may suggest that macro-prudential supervision is more than a new regulatory mandate for financial regulators. Macro-prudential supervision may actually be a form of general economic management importing more intervention by central banks.

11 Ulla Eriksson-Zetterquist, ‘Risk and Organising: The Growth of a Research Field’ in Barbara Czarniawska (ed), *Organising in the Face of Risk and Threat* (Cheltenham: Edward Elgar 2009), 9.

12 Other aspects of the suboptimal outcomes of crisis driven regulation are developed in Mads Andenas, ‘Who is Going to Supervise Europe’s Financial Markets’ in Mads Andenas and Yannis Avgerinos (eds), *Financial Markets in Europe: Towards a Single Regulator?* (The Hague: Kluwer Law International 2003), xv. The point is also made that only in the immediate post-crisis period will reactive measures be adopted: when the floodgates holding restrictive measures back burst, industry is no longer able to block reform effectively. Later on, with order re-established, reform may again be effectively blocked by industry.

13 ESRB Regulation 2010, art 2(c).

14 Bart PM Joosen, ‘The Limitations of Regulating Macro-Prudential Supervision in Europe’ (2010) 25 *Journal of International Banking Law and Regulation* 493.

15 Information collection and surveillance in macro-prudential supervision

15.1 Introduction

Enriques¹ has rightly pointed out that the trajectory of post-crisis regulatory reform will proceed along the lines of expanding the scope of regulation and overhauling existing regulation in order to compensate for perceived regulatory gaps. As the crisis has revealed a lack of regulatory discernment concerning unregulated parts of the financial sector (such as alternative investment funds),² as well as complex financial transactions and linkages (particularly in derivatives transactions on the over-the-counter markets),³ post-crisis reforms have therefore provided for the expansion of reporting to regulators by the financial services sector and through public disclosure.⁴ Extensive information surveillance hence forms the backdrop to macro-prudential supervision. Extensive information surveillance may be necessary, as surveillance for signs of systemic risk requires an approach that is open-minded, given the protean qualities⁵ of systemic risk. In the words of the Financial Stability Board:

The identification and availability of relevant data is critical for assessing systemic risk and calibrating policy responses. Improving information and data collection frameworks . . . is important to help authorities better

- 1 Lucas Enriques, 'Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's View' (2009) 30 *University of Pennsylvania Journal of International Law* 1147.
- 2 James Crotty, 'Structural Causes of the Global Financial Crisis: A Critical Assessment of the "New Financial Architecture"' (2009) 33 *Cambridge Journal of Economics* 563.
- 3 Dan Awrey, 'The FSA, Integrated Regulation, and the Curious Case of OTC Derivatives' (2010) 13 *University of Pennsylvania Journal of Business Law* 1.
- 4 Iris H-Y Chiu, 'Transparency Regulation in Financial Markets - Moving into the Surveillance Age?' (2011) 3 *European Journal of Risk and Regulation* 303, discusses the changing nature of regulation following the global financial crisis from transparency to surveillance.
- 5 Referred to in Eilis Ferran and Kern Alexander, 'Can Soft Law Bodies Be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board' [2010] *European Law Review* 751.

understand interconnections within the financial system and common exposures to shocks that can lead to system-wide stress.⁶

Enhanced regulatory disclosure will support the budding surveillance structure in national, EU and international financial supervision. At the same time, the general level of transparency and disclosure to investors and the public has also increased, although it is doubted that investors may be enrolled into surveillance roles for the purposes of macro-prudential supervision.⁷ Post-crisis, the role of transparency has arguably changed, from that of empowering the market to observe and discipline, to that of empowering regulators to discern and supervise.⁸ Goodhart,⁹ however, doubts that the pre-crisis levels of information were insufficient. He opines that what was lacking was macro-prudential supervision and tools to deal with potential macro-prudential issues.

Transparency has long been an ideological foundation for financial regulation as it facilitates market discipline. Brandeis' famous quote, 'Sunlight is said to be the best of disinfectants', underlies the disclosure regime in US securities regulation since the 1930s. Financial markets are replete with sophisticated counterparties who may be in a position to exercise market discipline: counterparties to structured product, credit and derivative transactions; underwriters and issuers; gatekeepers such as auditors, rating agencies and stock exchanges; institutions and investment managers; issuers and analysts. There is potential for different actors, in this wide 'regulatory space',¹⁰ to exert discipline upon one another, creating a multi-faceted structure of private market-based governance.¹¹ Werbach terms this structure as a 'poly-opticon', where multiple actors may have the capacity to observe and influence each other's behaviour in unexpected ways. Such market-based governance is diffuse but pervasive in nature.¹² In the securities law reform carried out by the EU since the Financial Services Action Plan 1999, disclosure regulation

6 Financial Stability Board, 'Intensity and Effectiveness of SIFI Supervision: Progress report on implementing the recommendations on enhanced supervision' (27 October 2011) www.financial-stabilityboard.org/publications/r_111104ec.pdf accessed 5 March 2013, 17.

7 Iris H-Y Chiu, 'Transparency Regulation in Financial Markets - Moving into the Surveillance Age?' (2011) 3 *European Journal of Risk and Regulation* 303.

8 Iris H-Y Chiu, 'Transparency Regulation in Financial Markets- Moving into the Surveillance Age?' (2011) 3 *European Journal of Risk and Regulation* 303

9 Charles AE Goodhart, *The Regulatory Response to the Financial Crisis* (Cheltenham: Edward Elgar 2009), 30.

10 Colin Scott, 'Analysing Regulatory Space: Fragmented Resources and Institutional Design' [2001] *Public Law* 329.

11 Houman B Shadab, 'Counterparty Regulation and Its Limits: The Evolution of the Credit Default Swaps Market' (2009/10) 54 *New York Law School Law Review* 689, reviews the reliance on counterparty discipline especially in the wholesale sector and points out the regulatory gaps. See also Iris H-Y Chiu, 'Enhancing Responsibility in Financial Regulation – Critically Examining the Future of Public-Private Governance Parts 1 and 2' (2010) 4 *Law and Financial Markets Review* 170 and 286, for a comprehensive review of mixed regulatory strategies prior to the global financial crisis.

12 Kevin Werbach, 'Sensors and Sensibilities' (2007) 28 *Cardozo Law Review* 2321.

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has also been embraced in many aspects of securities regulation. Prospectus disclosure for issuer products acts as a disinfectant against issuer fraud in investment markets, whether wholesale or retail. Continuous disclosure by issuers (including ad hoc disclosure of price-sensitive information under Article 6 of the EU Market Abuse Directive or, where the US is concerned, as an obligation to avoid fraud-on-the-market) has further been imposed to support the efficient allocation functions of the secondary investment market.¹³ Disclosure regulation is extended to collective investment products – such as UCITS in the EU, non-UCITS collective investment schemes in the UK,¹⁴ structured complex products (e.g. asset-backed securities) in the US Regulation AB – as well as to intermediary regulation under the EU Markets in Financial Instruments Directive ('MiFID'). The MiFID and its supplementary Regulation¹⁵ have also imposed mandatory price transparency for large investment firms acting as 'systematic internalisers', electronic trading platforms and traditional stock exchanges. In sum, the retail investment market is well covered by product, intermediary and market transparency.

However, the global financial crisis has shown that the assumption that market discipline is facilitated by transparency and is self-sustaining should be questioned.¹⁶ For example, Mendales argues that sophisticated investment banks and institutions failed to discern the quality of structured products, such as collateralised debt obligations, because of insufficient disclosure of relevant matters as well as poor judgement.¹⁷ Further, even sophisticated parties, such as credit rating agencies, involved in rating the complex collateralised debt obligations lack comprehensive information regarding underlying loan assets.¹⁸ In the post-crisis era, market discipline has been shown to be weak¹⁹ as market actors do not use information effectively and the adequacy of transparency is itself in doubt. The post-crisis explosion of transparency reforms is not based on further

13 Milton H Cohen, "'Truth in Securities' Revisited' (1966) 79 *Harvard Law Review* 1340.

14 FCA Handbook (as of 30 April 2013, formerly FSA Handbook) COLL 1.2, 4.

15 Commission Regulation (EC) 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive [2006] OJ L241/1.

16 Timothy A Canova, 'Financial Market Failure as a Crisis in the Rule of Law: From Market Fundamentalism to a New Keynesian Regulatory Model' (2009) 3 *Harvard Law and Policy Review* 369; John W Head, 'The Global Financial Crisis of 2008–2009 in Context—Reflections on International Legal and Institutional Failings, "Fixes," and Fundamentals' (2010) 23 *Pacific McGeorge Global Business & Development Law Journal* 43; Evan N Turgeon, 'Boom And Bust For Whom?: The Economic Philosophy Behind the 2008 Financial Crisis' (2009) 4 *Virginia Business and Law Review* 139.

17 Richard E Mendales, 'Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix it' [2009] *University of Illinois Law Review* 1359.

18 Claire A Hill, 'Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?' (2010) 71 *University of Pittsburgh Law Review* 585.

19 Benton E Gup, 'Market Discipline: Is it Fact or Fiction?' (August 2003) <http://ssrn.com/abstract=449841> accessed 22 March 2013.

stimulating market discipline, but based on empowering public regulatory authorities to carry out regulatory surveillance and supervision.

'Surveillance' may be understood as a process for creating visibility by the collection and analysis of myriad data, in order to identify matters of interest relevant to policy or politics.²⁰ Older ideas of surveillance include Bentham's Panopticon where total transparency is achieved in a hypothetical prison by having a centrally placed prison guard watch everything happening in prison cells.²¹ Typical conceptions of surveillance may involve CCTV cameras watching social and civic life. In the Panopticon, the transparency further causes the watched to internalise the knowledge of being watched, entailing a behaviour of compliance. In Foucault's terms, '[the Panopticon is] at once surveillance and observation, security and knowledge, individualisation and totalisation, isolation and transparency'.²² However, contemporary understandings of surveillance pertain to the element of bureaucratic control.²³ The enhanced informational empowerment of regulators in the UK and EU for the purposes of macro-prudential supervision is arguably designed for surveillance.

15.2 Expansion in regulatory powers for information collection

There is an overall increase in regulatory reporting in micro-prudential and risk management matters for the financial sector generally. As systemic risk could be triggered by institutional failure, institution-based micro-prudential and risk management information are of key importance to regulators and are now subject to enhanced reporting obligations. The EU European Markets and Infrastructure Regulation 2012 (EMIR) has also introduced an increase in trade and price reporting over a comprehensive range of markets.

In terms of micro-prudential information, financial institutions now need to report liquidity management, stress testing results, the management of leverage, the design of remuneration packages and risk management generally, in addition to capital adequacy reporting that was the mainstay of pre-crisis micro-prudential reporting.

Capital adequacy reporting and large exposures reporting will be enhanced and standardised across the EU.²⁴ Liquidity reporting has by and large been rolled

20 David Lyon, 'Editorial. Surveillance Studies: Understanding Visibility, Mobility and the Phenetic Fix' (2002) 1 *Surveillance and Society* 1.

21 Discussed in James Theodore Gentry, 'The Problem of Monitoring Private Prisons' (1986) 96 *Yale Law Journal* 353.

22 Michel Foucault, *Discipline and Punish: The Birth of the Prison* (1977), 249, as quoted in Neil Selwyn, 'The National Grid for Learning: Panacea or Panopticon?' (2000) 21 *British Journal of Sociology of Education* 243.

23 Elia Zureik, 'Review: Surveillance Studies: From Metaphors to Regulation to Subjectivity' (2007) 36 *Contemporary Sociology* 112.

24 See European Banking Authority, 'EBA Consultation Paper on Draft Implementing Technical Standards on Supervisory reporting requirements for Institutions (CP 50)' (London, 20 December

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out across the UK financial sector. Banks, building societies and banking groups with investment outfits are now required to carry out intra-day liquidity assessments, to report any deviations to the regulator and to submit remediation plans for these deviations.²⁵ Alternative investment funds regulated in the EU will also have to establish liquidity plans²⁶ and report to their respective national regulators.²⁷ UCITS managers will also have to implement liquidity risk management processes but reporting does not seem necessary.²⁸ Stress testing procedures and results are now also part of the regulatory reporting landscape. The UK requires all financial sector firms whose assets under management (or fee or commission income or assets and liabilities)²⁹ are above certain prescribed thresholds to be subject to regular stress testing carried out in-house, and such results may be requested by the regulator.³⁰ UCITS are also subject to regular stress testing obligations but again not reporting.³¹ Credit rating agencies, regulated directly by the European Securities Markets Authority (ESMA), are required to regularly back-test the validity of their models and assumptions, and to report back-testing results to ESMA.³² Alternative investment funds, too, are required

2011), beefing up Pillar 3 in the Basel II Accord regarding disclosure and 'Update on the Technical Standards on Supervisory Reporting Requirements' (London, 15 March 2013) as well as various consultation papers on the reporting of leverage and liquidity ratios and asset encumbrances and exposures. See European Banking Authority, 'EBA Consultation Paper on the Data Point Model related to the Technical Standards on Supervisory Reporting Requirements for Leverage Ratio' (London, 18 March 2013); 'EBA Consultation Paper on the Data Point Model related to the Technical Standards on Supervisory Reporting Requirements for Liquidity Coverage and Stable Funding' (London, 18 March 2013); 'EBA Consultation Paper on Draft Implementing Technical Standards on Asset Encumbrance Reporting' (London, 26 March 2013); 'EBA Consultation Paper on Supervisory Reporting for Forbearance and Non-Performing Exposures' (London, 26 March 2013)

- 25 FSA, 'Strengthening Liquidity Standards Including Feedback on CP08/22, CP09/13, CP09/14' (October 2009) PS 09/16 www.fsa.gov.uk/pubs/policy/ps09_16.pdf accessed 6 March 2013; PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) BIPRU 12.
- 26 European Parliament and Council Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2011] OJ L174/1 (AIFM Directive), art 16, to be fully transposed by July 2013.
- 27 AIFM Directive, art 24.
- 28 Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depository and a management company [2010] OJ L176/42 (UCITS Commission Directive 2010), art 40(3).
- 29 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 20. The thresholds are: assets under management or administration of at least £10 billion (or the equivalent amount in foreign currency); or total annual fee and commission income arising from its regulated activities of at least £250 million (or the equivalent amount in foreign currency); or assets or liabilities of at least £2 billion (or the equivalent amount in foreign currency).
- 30 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SYSC 20.2.7.
- 31 UCITS Commission Directive 2010, art 40(2).
- 32 European Parliament and Council Regulation (EU) 513/2011 of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies [2011] OJ L145/30, art 22a.

to report leverage levels to the national regulator to facilitate monitoring for systemic risk concerns. These reports may include, for example, a breakdown of leverage, the five largest sources of borrowed cash or securities for each managed AIF and the fund's internal assessments of appropriate levels of leverage.³³ UCITS are also required to report to the national regulator at least annually concerning their exposure to derivative instruments on the over-the-counter market. This information must reflect a true and fair view of the types of derivative instruments used for each managed UCITS, the underlying risks, the quantitative limits and the methods that are chosen to estimate the risks associated with the derivative transactions.³⁴ As the remuneration policies of financial sector employees may affect risk management,³⁵ the disclosure of remuneration information in connection with risk management and quantitative information has been required of all banks, building societies, investment firms³⁶ and alternative investment funds.³⁷ Further, regulatory authorities in the EU require recovery and resolution plans to be submitted by financial firms,³⁸ in order to assist in the supervisory oversight of the firms.

The conception of systemic risk as emanating from a high impact market shock has also shaped regulatory reforms that relate to increasing regulatory demands for market data. Market-wide information has to be monitored and submitted to national regulators, primarily by market providers. Following the global financial crisis, the EU enacted a Regulation on short selling that compels short sales to be disclosed, so that enhanced data may be required for regulatory surveillance in adverse circumstances in the financial sector.³⁹

Under the EU Markets in Financial Instruments Directive 2004 (MiFID),⁴⁰ the explosion in trade data that must be disclosed is based on improving investor choice and execution on competitive markets. MiFID ushered in comprehensive

33 AIFM Directive, art 24(4).

34 UCITS Commission Directive 2010, art 45.

35 Guido Ferranini and Maria C Ungureanu, 'Executive Pay at Ailing Banks and beyond: A European Perspective' (2010) 5 *Capital Markets Law Journal* 197, 202; European Parliament and Council Directive 2010/76/EU of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies [2010] OJ L329/3 (Capital Requirements Directive 2010), art 22(1), Section 11, Annex V.

36 PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) BIPRU 11.5.18ff.

37 AIFM Directive, art 13.

38 Commission, 'Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate' COM(2011) 453 final; Financial Services Act 2010 (UK), s 139B; FSA, 'Recovery and Resolution Plans' (August 2011) CP 11/16 www.fsa.gov.uk/pubs/cp/cp11_16.pdf accessed 22 March 2013.

39 European Parliament and Council Regulation (EU) 236/2012 of 14 March 2012 on short selling and certain aspects of credit default swaps [2012] OJ L86/1, arts 5–9, 18–19.

40 European Parliament and Council Directive 2004/39/EC of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive

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price transparency regulation, ordering offer and transaction details on most markets to be made transparent. Systematic internalisers in a liquid stock must disclose quotations and closed transactions. Moreover, the Commission Regulation 2006 that supplements the primary Directive further sets out the disclosure levels expected of electronic trading platforms and stock exchanges for pre-trade and post-trade transparency.⁴¹ In the wake of the global financial crisis, increased reporting of trade data is required, but the purpose of such enhanced transparency is to assist regulatory supervision rather than market discipline.

Proposed reforms further require market data on regulated markets, electronic trading facilities and 'organised trading facilities' to be disclosed.⁴² The term 'organised trading facilities' is likely to capture all forms of trading activity that are not simply ad hoc and irregular, leaving 'over-the-counter' or bilateral arrangements to be very narrowly defined. The range of market data collection is set to expand with the broadening of the scope of MiFID to cover more markets. The European Commission is looking at repealing MiFID to make way for a new Directive and Regulation. The new Directive proposes to usher in more risk management regulation for market operators, requiring them to monitor markets and report regularly on disorderly trading behaviour and market abuse, as well as reporting traders' aggregate positions on a weekly basis. The Directive will also impose reporting and risk management requirements on firms carrying out algorithmic trading.⁴³ The Regulation⁴⁴ will further enhance the handling of trade information by facilitating consolidation of information services in the form of consolidated tapes. The EMIR, which was passed in June 2012, compels standardised over-the-counter derivative instruments to be centrally cleared, requires market data to be reported by such derivatives trading markets and increases the categories of instruments for which trade data needs to be reported, including in systemic internalisation. Trade data returns will greatly increase, presumably to assist in information surveillance by regulators.

At the international level, surveys of economic outlook and financial stability have always been carried out (e.g. by the International Monetary Fund (IMF) and

2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L145/1 (Markets in Financial Instruments Directive, MiFID).

41 Commission Regulation (EC) 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive [2006] OJ L241/1, arts 17, 21ff, 27.

42 Commission, 'Proposal for a Regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories' COM(2011) 652 final.

43 Commission, 'Proposal for a Directive of the European Parliament and the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (recast)' COM(2011) 656 final.

44 Commission, 'Proposal for a Directive of the European Parliament and the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (recast)' COM(2011) 656 final.

Organisation for Economic Development (OECD))⁴⁵ and specific issues in the financial sector have been surveyed and reported by international organisations (such as the Bank for International Settlements,⁴⁶ the Financial Stability Board⁴⁷ and the European Banking Authority).⁴⁸ Such international surveys and reports could provide a bird's-eye view of macroeconomic conditions and useful insight that may feed into macro-prudential supervision. However, Davies and Green write from experience that international data has seldom fed into the UK Bank of England's financial stability reviews.⁴⁹ Post-crisis, will there be more resolve to use information from international surveys in the information surveillance carried out at the level of the national regulatory agency?

Regulators are increasingly equipped by legislation to obtain extensive amounts of information, but the link between the collection of more information and effective macro-prudential supervision still has to be established. How information will be analysed and used to inform policymaking or supervisory decisions is key to macro-prudential supervision. The following will discuss the challenges in effective analysis and use of the extensive regulatory information that may be collected.

15.3 The challenges in information surveillance at national and EU levels

We argue that there are inherent difficulties in the management of regulatory data collection in order to achieve the extensive information surveillance needed to support macro-prudential supervision. First, national regulatory agencies, such as the PRA and FCA in the UK, would be subject to challenges in terms of aggregating and mapping vast amounts of regulatory information, as well as identifying granularity and using such regulatory information meaningfully. Second, it will be argued that the expansive data reported to national regulatory agencies may

45 Kumiharu Shigehara and Paul E Atkinson, 'Surveillance by International Institutions: Lessons Learnt from the Global Financial Crisis' (June 2011) OECD Working Paper No 860 <http://ssrn.com/abstract=1859669> accessed 23 March 2013, discussing how disparate reports such as the OECD's Economic Outlook reports for countries and the IMF's global financial stability and world economic outlook reports could be fed into a more integrated systemic risk monitoring system.

46 For example, the global liquidity survey found in Committee on the Global Financial System (Bank of International Settlements), 'Global Liquidity – Concept, Measurement and Policy Implications' (November 2011) CGFS Paper No 45 www.bis.org/publ/cgfs45.pdf accessed 23 March 2013.

47 Such as the quarterly thematic review of compensation practices at large financial institutions.

48 Such as the EBA's data collection exercise for remuneration information in banks. See European Banking Authority, 'EBA Guidelines on the Remuneration Benchmarking Exercise (EBA/GL/2012/4)' (London, 27 July 2012); European Banking Authority, 'EBA Guidelines on the Data Collection Exercise regarding High Earners (EBA/GL/2012/5)' (London, 27 July 2012).

49 Howard Davies and David Green, *Banking on the Future: The Rise and Fall of Central Banking* (Princeton, NJ: Princeton University Press 2010), 66–67.

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be disconnected from macro-prudential supervision, whether at the UK or at the EU level.

In order to achieve the ambitions of macro-prudential supervision, information surveillance to support macro-prudential supervision needs to be broad-based. However, a broad range of disparate information must be aggregated in order for it to be meaningful for analysis. The aggregation of information needs to take place at several levels: first, institution-specific information needs to be aggregated; then aggregated institutional information must be aggregated in order to provide a sectoral picture. Sectoral information should also be aggregated with the aggregated information of other sectors. However, it is also important that unaggregated information be nimbly used, compared or 'composited'⁵⁰ with other information to create indicators that may be useful. This flexibility may be important as systemic risk may manifest itself in dynamic forms of structural vulnerability. In sum, macro-prudential regulators have to maintain a balance between being able to aggregate information in order to achieve a bird's-eye view and being sensitive to disparate information signals that may raise concerns per se. Schwarz is also concerned about the per se complexity of information reporting by institutions: such reports may themselves be too complex, as they may be based on risk management models and assumptions that are highly difficult to evaluate.⁵¹

We suggest that given the organisational structure of the national regulators in the UK, there are limits to their ability to respond to the gargantuan needs of information management.

15.3.1 Information aggregation and mapping

This subsection discusses the potential difficulties in information management due to the organisational structure of the UK regulators. The Prudential Regulation Authority (PRA) in the UK is responsible for the micro-prudential supervision of major banks and financial institutions. It is derived from the Prudential Business Unit at the former Financial Services Authority (FSA), which was departmentally structured along sectoral lines.⁵² This means that the regulatory reporting in micro-prudential and risk management relating to banks and building societies go to one department, while reports from alternative investment funds or investment firms go to other departments. It is surmised that the sectoral structuring of

50 See, for example, discussions on how composite indicators can be constructed in Bank of England and Financial Services Authority, 'Instruments of Macro-prudential Policy' (December 2011) Bank of England Discussion Paper www.bankofengland.co.uk/publications/Documents/other/financial_stability/discussionpaper111220.pdf accessed 3 December 2012, 33; Anna Maria Agresti, Patrizia Baudino and Paolo Poloni, 'The ECB and IMF Indicators for the Macro-Prudential Analysis of the Banking Sector: A Comparison of the Two Approaches' (November 2008) ECB Occasional Paper No 99 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1144486 accessed 23 March 2013.

51 Steven L Schwarz, 'Regulating Complexity in Financial Markets' (2009) 87 *Washington University Law Review* 211.

52 See www.fsa.gov.uk/pages/About/Who/Management/Retail/index.shtml.

departments will not be dramatically changed after the establishment of the PRA, as the former FSA has already operated with a twin peaks model while preparing for the structural changeover to the PRA and the Financial Conduct Authority (FCA) since 2011.⁵³ The organisation of departments by sectoral responsibility could give rise to challenges in information aggregation across departments. Further, each department may expand in order to cope with the expansion of information surveillance. This means that each department may have plenty of unaggregated information to monitor and manage, as there will be volumes of micro-prudential information per institution, in terms of liquidity, stress testing, capital adequacy, large exposures and remuneration reporting. Can such information be meaningfully aggregated *per* institution? The Financial Stability Board has mentioned that different pieces of micro-prudential information from a financial institution may not be well-aggregated by the institution itself and suggests that financial institutions develop enterprise-wide systems to put together risk profile information.⁵⁴ Can one depend on regulators to do this job?

Even if institution-specific micro-prudential information is aggregated for each financial institution, will institution-specific information be aggregated with that of other institutions to present a sectoral picture? Significant work is likely to be required to put sectoral information together. Although the Prudential Business Unit at the FSA had a department that deals with banking groups in order to capture systemically important financial groups' risk profiles, the Banking Group department may not be able to capture links that are outside a group structure, such as derivative and swap exposures. There are likely to be further challenges in aggregating sectoral information, such as in information from the banking sector with information from the investment firm sector. The PRA suggests that it will endeavour to integrate work of departmental supervisors and risk specialists, and will ensure that key supervisory messages are passed on to senior management.⁵⁵ But the question remains open as to whether there is adequate regulatory capacity to construct a cross-sectoral and sufficiently macro-level database of intelligence. The Financial Stability Board has found that most national regulators face difficulties in hiring sufficiently talented personnel to manage their albeit slightly increased resources and generally feel that there is inadequate supervisory talent in carrying out the task of effective macro-prudential supervision.⁵⁶

53 FSA, 'Delivering a Twin Peaks Approach in the FSA' (6 Feb 2012) at www.fsa.gov.uk/library/communication/pr/2012/012.shtml.

54 Financial Stability Board, 'Intensity and Effectiveness of SIFI Supervision: Progress report on implementing the recommendations on enhanced supervision' (27 October 2011) www.financialstabilityboard.org/publications/r_111104ee.pdf accessed 5 March 2013, 6–7.

55 Bank of England (Prudential Regulation Authority), 'Our Approach to Banking Supervision' (May 2011) www.bankofengland.co.uk/publications/Documents/other/financialstability/uk_reg_framework/pr_approach.pdf accessed 6 March 2013, 12.

56 Financial Stability Board, 'Intensity and Effectiveness of SIFI Supervision: Progress report on implementing the recommendations on enhanced supervision' (27 October 2011) www.financialstabilityboard.org/publications/r_111104ee.pdf accessed 5 March 2013, 8–9.

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While regulators may be able to cope with the needs of information aggregation by hiring more personnel and making each department bigger and more resourced, the tendency for departmental differentiation is inherent to bureaucracies⁵⁷ and this itself may undermine the regulator's ability to achieve effective aggregation of information. Individual departmental growth may lead to more specialisation within each department and the extent of integrated perspectives that can be achieved across departments may become more limited.

Further, micro-prudential and risk management reports may be collated with other forms of regulatory data on market transparency or investor protection, for example. Liquidity information from institutions combined with market data may present a more complete picture of whether some assets are likely to maintain their liquid status in stressed times. Further, information that is made available in the public domain, such as valuation of hedge funds for the purposes of investor protection, may provide information on the risk profiles of certain hedge funds. If information-mapping exercises were carried out in more reflexive ways, they could generate unexpected insights into correlations and links that may be important in systemic risk monitoring, realising the ambitions of macro-prudential supervision.

The successful mapping of information may also be affected by the regulatory architecture in place. In the UK, micro-prudential and risk management information will be reported mainly to the PRA and market data will be collected by the FCA. Any mapping of information will therefore depend on the extent of inter-agency coordination. The PRA and the FCA have a formal Memorandum of Understanding covering regular information exchange and coordination in view of the financial stability objective.⁵⁸ The two agencies will be jointly responsible for the administration of the Financial Services Compensation Scheme, in charge of the deposit guarantee and investor compensation schemes in the UK. They will also institute formal arrangements for supervising large financial groups. Further, there are formal requirements for the two agencies to exchange views and consult each other whenever new rules are made by either agency. These arrangements⁵⁹ will facilitate inter-agency cooperation on specific matters.

57 The classic Weberian bureaucracy, as Weber argues that a bureaucratic organisation is defined by its 'purely technical superiority over every other form' and provides 'precision, dispatch, clarity and familiarity with documents, continuity and discretion, uniformity, rigid subordination, savings in friction in material and personal costs'. See WG Runciman (ed), *Weber: Selections in Translation* (Eric Matthews tr, Cambridge: Cambridge University Press 1978), 350. The pervasiveness of Weberian analysis is affirmed in Clifford I Nass, 'Bureaucracy, Technical Expertise and Professionals: A Weberian Approach' (1986) 4 *Sociological Theory* 61. See also the grand organisational theories of work distribution and control in Talcott Parsons' work; for example, Talcott Parsons, *Structure and Process in Modern Societies* (New York: The Free Press 1960), 59–96.

58 See Draft Memorandum of Understanding (MoU) between the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) (November 2012) www.bankofengland.co.uk/financialstability/Documents/overseeing_fs/fca_pra_draft_mou.pdf accessed 11 April 2013.

59 Financial Services Act 2012 amending the Financial Services and Markets Act 2000 by inserting sections 3E to 3Q.

However, will these arrangements foster greater integration of information management and the development of perspectives across the two agencies?

Organisation literature suggests that the effectiveness of information coordination between agencies is likely to be affected by how the objective for coordination is defined. Where coordination is defined with clear and narrow objectives,⁶⁰ it may be more easily achieved, as agencies know what they are bringing to the table. They can devote a reasonably predictable amount of resources to achieve coordination. However, if coordination is of an open-ended nature, the agencies involved in the network of coordination may each succumb to the 'free-rider' tendency⁶¹ and let others do the work. The legislative framework instituting the PRA and FCA contains a mixture of defined shared objectives and more open-ended coordination, such as information exchange for the purposes of financial stability. The PRA and FCA may be more incentivised to focus on the defined aspects of their coordination, than on the more difficult and open-ended aspects. We suggest that it may not be easy to achieve effective and nimble information sharing across the two agencies.

At the EU level, the European Supervisory Authorities – the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) – have all been asked to put in place a permanent capacity to monitor and respond to systemic risk.⁶² The three authorities will assist the macro-prudential supervisor in the EU, which is the ESRB. The three authorities will likely rely on information relay from national regulators, as they do not collect information themselves, except in the case of ESMA when directly regulating credit rating agencies.⁶³ The quality and quantity of information relayed to the three authorities will depend on how national authorities have analysed and aggregated the raw information they receive.⁶⁴ However, the EBA is rolling out standard reporting templates for

60 Greg L Stewart, 'A Meta-Analytic Review of Relationships Between Team Design Features and Team Performance' (2006) 32 *Journal of Management* 29; Jia Hu and Robert C Liden, 'Antecedents of Team Potency and Team Effectiveness: An Examination of Goal and Process Clarity and Servant Leadership' (2011) 96 *Journal of Applied Psychology* 851.

61 Casey Rowe, 'The Effect of Accounting Report Structure and Team Structure on Performance in Cross-Functional Teams' (2004) 79 *The Accounting Review* 1153.

62 European Parliament and Council Regulation (EU) 1093/2010 of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC [2010] OJ L331/12 (EBA Regulation 2010), arts 1(i), 22–24; European Parliament and Council Regulation (EU) 1094/2010 of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC [2010] OJ L331/48 (EIOPA Regulation 2010), arts 8(1)(i), 22–24; European Parliament and Council Regulation (EU) 1095/2010 of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC [2010] OJ L331/84 (ESMA Regulation 2010), arts 7(1)(i), 22–24.

63 However, it is noted that the EBA carried out its own research among European banks in the preparation of its systemic risk monitoring report. See EBA, *Report on Risks and Vulnerabilities of the European Banking System* (July 2012) and (January 2013).

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all Member States in respect of capital requirements, large exposures and other micro-prudential and remuneration reporting.⁶⁵ Such templates could force national regulators to engage in the required information aggregation and mapping where relevant. However, with 27 national authorities to deal with, it is queried whether the EBA's templates will prove overly standardised, failing to capture local nuances or highlight different issues that may be salient to different Member States.⁶⁶

Nevertheless, the regulatory architecture at the EU level is also organised in a sectoral manner. It is therefore queried whether European authorities will be able to map Member State information per sector and across sectors at the EU level to monitor for signs of systemic risk. It is to be noted that the systemic risk report prepared by the Joint Committee for the three European authorities show that a genuine effort is put into aggregating information and even across sectors.⁶⁷ However, the three authorities need to have adequate recognition for granularity and pockets of issues that may be relevant to different Member States or groups of Member States.

In late 2012, political agreement was secured for the European Banking Union or the Single Supervisory Mechanism. The Single Supervisory Mechanism empowers the European Central Bank (ECB) to carry out micro-prudential supervision, for all euro area banks in the EU with at least €30 billion in assets or assets whose value represents one-fifth of a Member State's gross domestic product.⁶⁸ Non-euro area Member States may choose to participate in the Single Supervisory Mechanism and the UK has indicated its willingness to opt in. We are of the view that the Single Supervisory Mechanism is likely to create a differentiated tier of legal integration⁶⁹ for euro area and non-euro area

64 Roberta S Karmel, 'The Future of the Securities and Exchange Commission as a Market Regulator' (2009) 78 *University of Cincinnati Law Review* 501. Commenting on the US information counterpart (Office of Financial Research) that will assist the macro-prudential supervisor (Council for Financial Stability Oversight), Karmel indicates that the quality of analysis will be key to the quality of macro-prudential supervision.

65 European Banking Authority, 'Update on the Finalisation and Implementation of the Standards on Supervisory Reporting' (31 July 2012) www.eba.europa.eu/News—Communications/Year/2012/Update-on-the-finalisation-and-implementation-of-t.aspx accessed 23 March 2013; European Banking Authority, 'Update on Supervisory Reporting Requirements for Liquidity and Leverage Ratio' (20 December 2012) www.eba.europa.eu/News—Communications/Year/2012/Update-on-supervisory-reporting-requirements-for-l.aspx accessed 23 March 2013.

66 The systemic risk reports produced by the EBA have thus far been highly aggregated, perhaps an achievement in the face of information aggregation and mapping challenges. However, it may perhaps lack adequate granularity. See EBA, *Report on Risks and Vulnerabilities of the European Banking System* (July 2012) and (January 2013).

67 *Joint Committee Report on Risks and Vulnerabilities in the EU Financial System* (13 March 2013) at www.esma.europa.eu/system/files/jc-2013-010_jc_rsc_joint_risk_report_2.pdf accessed 11 April 2013.

68 Alex Barker, 'Eurozone Agrees Common Bank Supervisor' *Financial Times* (London, 13 December 2012).

participating banking sectors. The ECB will administer the micro-prudential and risk management information reports from banks subject to the Single Supervisory Mechanism and may also impose its own requirements. It remains to be seen to what extent the ECB's role may result in deviations from the EBA's development of the single rulebook for the EU. As the ECB becomes the main repository of micro-prudential information (submitted by financial institutions subject to its supervisory mechanism), it is queried whether the EBA's information aggregation function will be affected. Moreover, marginalisation of the EBA could occur if the ECB works closely with the ESRB in its macro-prudential supervision as the ESRB is nested within the ECB. The dynamics between the ECB, ESRB and EBA may affect how any information aggregation and mapping is carried out.

Nevertheless, it may be argued that aggregating and mapping information across agencies at the national or EU level is not an insurmountable problem if regulators are able to develop technologically sophisticated systems to manage the data at both levels. Information technology experts argue that information technology systems could be constructed to pool together diverse sources of information to be shared, achieving information integration.⁷⁰ However, the ability of such technological systems to deliver 'integrated data' may be heavily influenced by the policy and social environment of the agencies involved, affecting data definition and semantic translation.⁷¹ Human qualitative assumptions necessarily underlie the work of data integration systems and would affect the quality of information aggregation and mapping. Having data integration systems in place may assist in the information management process, but they cannot replace the human qualitative assumptions that are necessary for determining how aggregation and mapping should take place. The qualitative judgements may be affected by institutional ethos and dynamics with other institutions at the EU level, as well as between EU level institutions and national regulators. Williams⁷² and Bamberger⁷³ also warn against excessive reliance on automated generation of signals for regulatory attention.

Policymakers already recognise the challenges faced by regulatory bodies to meet the massive informational needs of macro-prudential supervision. Hence, much of the aggregation of information is to be done by the financial sector itself. Financial institutions have to aggregate institution-specific information⁷⁴ and markets have to prepare aggregate information⁷⁵ on trade data by the week or

69 Mads Andenas and Iris H-Y Chiu, 'Financial Stability and Legal Integration in Financial Regulation' (2013) *European Law Review* 335.

70 Theresa A Pardo and others, 'Modeling the Social & Technical Processes of Interorganizational Information Integration' (37th Hawaii International Conference on System Sciences, Hawaii, 31 January 2004).

71 Mysore Ramaswamy, 'On the Phenomenon of Information Dilution' (2006) 7 *Issues in Information Systems* 289.

72 Mysore Ramaswamy, 'On the Phenomenon of Information Dilution' (2006) 7 *Issues in Information Systems* 289.

73 Kenneth A Bamberger, 'Technologies of Compliance: Risk and Regulation in a Digital Age' (2009/10) 88 *Texas Law Review* 669.

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on market monitoring data, such as market abuse monitoring.

Delegating aggregation to the financial sector may mean running the risk of the financial sector introducing its own perspectives, embedded within the presentation of aggregated information. Such a presentation may be self-serving, unless the process and form of aggregation can be strictly prescribed. However, prescription may also become outmoded. Any form of 'delegated governance' to the private sector may entail a principal-agent problem.⁷⁶ Hence, regulators may need to put in place checks in terms of process-based supervision and perhaps consider commissioning ad hoc independent audits⁷⁷ into the reporting processes in financial institutions and markets.

15.3.2 The regulatory objectives relating to data collection

This section suggests that information surveillance undertaken by regulatory agencies may not feed into the macro-prudential supervision framework if the information collected is regarded as irrelevant to the objective of macro-prudential supervision.

There are different pieces of empowering legislation for collecting various types of information. Each may be couched in different terms, targeting different objectives and perspectives. If regulatory agencies interpret regulatory reporting narrowly within the objectives of the empowering legislation, the regulatory treatment of information collected may not be relevant to macro-prudential supervision. For example, the UK FCA will be setting up a Research Unit⁷⁸ for monitoring market and product trends in order to be informed of any risks to consumer interests that may require early regulatory intervention. Such information surveillance is pursuant to the consumer protection objective, which may

74 Financial Stability Board, 'Intensity and Effectiveness of SIFI Supervision: Progress Report on Implementing the Recommendations on Enhanced Supervision' (27 October 2011) www.financialstabilityboard.org/publications/r_111104ee.pdf accessed 5 March 2013, 7.

75 Commission, 'Proposal for a Directive of the European Parliament and the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (recast)' COM(2011) 656 final; Commission, 'Proposal for a Regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories' COM(2011) 652 final.

76 Discussed in relation to price transparency regulation in Iris H-Y Chiu, 'Delegated Regulatory Administration in EU Securities Regulation' (2007) 40 *International Lawyer* 737.

77 The UK regulator is looking at more regular dialogue with the audit industry in order to enhance its own information surveillance, e.g. PRA and FCA Handbooks (as of 30 April 2013, formerly FSA Handbook) SUP 3.8; FSA, 'Code of Practice for the Relationship between the External Auditor and the Supervisor' (May 2011) FG11/09 www.fsa.gov.uk/pubs/guidance/fg11_09.pdf accessed 5 January 2013. The Financial Stability Board has also recommended that regulators establish richer dialogue with auditors in order to better monitor institution risk, see Financial Stability Board, 'Intensity and Effectiveness of SIFI Supervision: Progress Report on Implementing the Recommendations on Enhanced Supervision' (27 October 2011) www.financialstabilityboard.org/publications/r_111104ee.pdf accessed 5 March 2013, 13.

78 Financial Conduct Authority, 'Journey to the FCA' (October 2012) www.fsa.gov.uk/static/pubs/other/journey-to-the-fca-standard.pdf accessed 25 March 2013, 41.

assist in preventing consumer scandals and crises. Although the information may also be relevant to systemic risk monitoring, in terms of the risk profiles of assets for example, such information surveillance is more likely to feed into the objectives of the FCA, which revolve around consumer protection, than be regarded as relevant for systemic risk monitoring and macro-prudential supervision.

Although information surveillance has increased, it is uncertain how much intelligence will feed into macro-prudential supervision if information surveillance serves narrowly defined regulatory objectives administered by different departments. Further, narrow perspectives on information collection at the national level will affect the quality of information relayed to the three European authorities. Information surveillance undertaken by national regulators pursuant to specifically defined regulatory objectives could become disconnected from national macro-prudential supervision and even more so from EU-level macro-prudential supervision.

At this juncture, it may be useful to carry out a comparison with the macro-prudential supervision regime in the US, based on the reforms undertaken in the US Dodd-Frank Act 2010.⁷⁹ The Act provides for the establishment of a macro-prudential supervisor and centralised intelligence and information surveillance agency for the financial sector. In the US, the new Financial Stability Oversight Council established under the Dodd-Frank Act is responsible for systemic risk oversight.⁸⁰ The Council is a cross-sectoral committee consisting of all the relevant sectoral regulators such as the Securities Exchange Commission (SEC) and the Commodities and Futures Trading Commission as well as the Consumer Financial Protection Bureau and the Secretary of the Treasury. Under section 112, the Council is tasked with identifying risks to the US financial system and to financial stability, and with promoting market discipline. These objectives are to be achieved through the collection and analysis of information by the newly established Office of Financial Research. The Office's analysis may then inform monitoring, supervision, discipline, rule-making and other regulatory action.⁸¹

The Office of Financial Research is established to collect, use, analyse and share data. It is expressly provided that the Office will have a data centre as well as research and analysis capacity.⁸² The Office is also financially supported by a Financial Research Fund.⁸³

The Dodd-Frank Act contains a gamut of data collection powers. Although not all data collection is expressly stated to pertain to systemic risk oversight, nor is it all directly relevant to the new Financial Stability Oversight Council, data collected by the SEC must be reported to the Council, Congress and Senate under sections 961-4 and, hence, the Office can access regulatory reports submitted by

79 Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank Act), Pub.L. 111-203.

80 Dodd-Frank Act (US), s 111.

81 Dodd-Frank Act (US), s 112.

82 Dodd-Frank Act (US), ss 153, 154.

83 Dodd-Frank Act (US), s 155.

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the SEC to the Council. The data collection powers target firms as well as markets. The Act now abolishes the status of exempt private investment advisers for hedge funds and requires them to register with the SEC. Section 404 authorises the collection of data pertaining to fund management and assets under management. Credit rating agencies are also subject to mandatory disclosure of their ratings methodologies, due diligence and performance, thus enabling public comparison. They are also required to report annually to the SEC in order to facilitate supervision of internal control management and management of conflicts of interest.⁸⁴ Product providers of asset-backed securities are subject to enhanced disclosure to the SEC under section 942. Corporate issuers are also subject to enhanced disclosure of directors' and employees' trade and hedging activities,⁸⁵ and corporate governance arrangements.⁸⁶ Sections 727 and 766 compel all swap transactions on or off exchange to be publicly reported or reported to the Commission where no swap data repository is relevant. Data collected by exchanges, which may also act as swap data repositories, may be open to inspection by the SEC. As for data directly reported to the Financial Stability Oversight Council, section 620 requires all investment banks to report the state of their activities and management for a one-off comprehensive review. The Council may also require collection of data from central counterparties and clearing and settlement facilities under section 809.

The most significant point of comparison is the Office for Financial Research, a centralised and dedicated information surveillance agency directly supporting the macro-prudential supervisor. It remains to be seen if the Office of Financial Research can overcome the inherent difficulties in information aggregation and mapping discussed above, but at least the regulatory objective of the Office is to treat all information as intelligence for surveillance purposes. In the UK and EU, information surveillance is largely added on to the existing regulatory functions of national regulators and may be subsumed under those specific regulatory functions.

15.4 Concluding remarks

As the G30 report on macro-prudential supervision puts it, 'Comprehensive macro-prudential oversight requires regular and periodic fully integrated reviews of the entire financial system, which is technically demanding and possibly very costly for both public supervisors and the private institutions they oversee'.⁸⁷ Such integration begins at the level of information collection by the national regulator. Information integration must be carried out at many levels: within departments, across departments, between national agencies and European authorities.

84 Dodd-Frank Act (US), s 932.

85 Dodd-Frank Act (US), s 955.

86 Dodd-Frank Act (US), s 972.

87 G30 Working Group on Macroprudential Policy, *Enhancing Financial Stability and Resilience: Macroprudential Policy, Tools and Systems for the Future* (Washington, DC: Group of Thirty 2010).

Moreover, there is a need to establish frameworks for information aggregation and mapping with sufficient open-endedness and reflexivity in order to discern signals in the myriad of information collected. This is potentially a complex and difficult project, as paradigms for understanding information⁸⁸ and frameworks for analysis will have to be established and will need to address the requirements of reflexivity and manageability. Moreover, difficulties will be compounded where information analysis is undertaken across agencies or national boundaries. In the UK and EU, besides these inherent difficulties in managing information surveillance, we have suggested that there is a potential gap between the various regulatory objectives of information surveillance and those of systemic risk monitoring. Information collection serves other more specifically defined regulatory purposes, as administered by the national regulators, and may not feed directly into macro-prudential supervision.

88 Augusto de la Torre and Alain Ize, 'Regulatory Reform: Integrating Paradigms' (2010) 13 *International Finance* 109, arguing that diverse paradigms for understanding financial sector trends are important, such as through the lens of collective welfare paradigms as well as the dominant agency paradigm.

16 The regulatory architecture for macro-prudential supervision in the UK and EU

In the UK, the Financial Policy Committee (FPC) is tasked with macro-prudential supervision. In the EU, the European Systemic Risk Board (ESRB) is designated to carry out macro-prudential supervision. The dedication of specific bodies to carry out macro-prudential supervision shows the political will to make macro-prudential supervision credible. However, the two dedicated bodies mentioned above are formalised networked structures bringing together a range of regulatory agencies. The networked structures underlying the FPC and ESRB seem to promise a supply of intelligence, dialogic perspectives and debate to support the difficult task of macro-prudential supervisors. This chapter will examine whether the architecture of these structures is in fact optimal for the future of macro-prudential supervision.

16.1 UK

In April 2013, the UK discarded its single regulator structure in the form of the Financial Services Authority (FSA) in favour of a twin peaks model featuring the micro-prudential regulator, the Prudential Regulation Authority (PRA), and the conduct of business regulator, the Financial Conduct Authority (FCA).¹

Further, a macro-prudential supervisor in the form of the FPC has been established.² The FPC is an inter-agency body chaired by the Governor of the Bank of England and has significant Bank representation alongside Treasury representation. The Chief Executive of the FCA is also a member of the FPC. The FPC is a sub-committee of the Court of Directors, to which the Bank of England is customarily accountable.

The FPC is empowered to take macro-prudential measures in respect of the financial services industry in general and not limited to specific persons. Such measures may take two forms: specific directions to the PRA or FCA to take

¹ Based on HM Treasury, *A New Approach to Financial Regulation: The Blueprint for Reform* (Cm 8083, June 2011) and the Financial Services Act 2012.

² Financial Services Act 2012 amending the Bank of England Act 1998 by inserting new sections 9A to 9V.

certain macro-prudential measures whose categories are specified in legislation;³ or recommendations to the PRA or FCA to take specific regulatory action, which the PRA and FCA must comply with or otherwise explain. The FPC is also tasked with producing two general financial stability reports for public disclosure each year. Being a high-level committee, the FPC is unlikely to have its own information surveillance capacity and will rely on the members in its networked structure for intelligence and analysis. The FPC will receive input from the PRA and FCA but the Bank's representation indicates that the FPC will also be informed of economic outlook analyses by the Bank. The Treasury's representation may bring to the table broader policy outlooks as well.

Although the FPC is essentially a networked structure, the authors suggest that it is likely to be dominated by the central bank. This will affect the character and trajectory of macro-prudential supervision. Some commentators are of the view that macro-prudential supervision is highly related to the central bank's monetary stability role and hence it is natural for macro-prudential supervision to be an extension of central banking functions.⁴ Other commentators,⁵ however, are of the view that macro-prudential supervision should not be dominated by the central bank, as the central bank may have other conflicting objectives. Further, central bank dominance in macro-prudential supervision may give rise to certain assumptions about the sources of systemic risk – that it emanates largely from the banking sector, for example – and such assumptions may not be well founded. There are some early signs that much systemic risk monitoring carried out by the FPC is focused on the banking sector, but this may simply be the result of the impact of the European sovereign debt crisis which is directly felt by many banks. There are also some signs that the preferred toolkit in macro-prudential supervision in the UK is balance sheet-based (i.e. micro-prudential tools and other capital tools, such as capital conservation and countercyclical buffers, as recommended in Basel III). These early signs of the nature of macro-prudential supervision suggest that macro-prudential supervision is largely focused on the micro-prudential health of banking institutions. Such an emphasis could arguably be due to the regulatory architecture underlying the FPC.

3 Bank of England and Financial Services Authority, 'Instruments of Macro-prudential Policy' (December 2011) Bank of England Discussion Paper www.bankofengland.co.uk/publications/Documents/other/financialstability/discussionpaper111220.pdf accessed 3 December 2012, 8.

4 Luis Garicano and Rosa Lastra, 'Towards a New Architecture for Financial Stability: Seven Principles' (2010) *Journal of International Economic Law* 597; Jaime Caruana, 'The Challenge of Taking Macroprudential Decisions: Who Will Press Which Button(s)?' (Speech at 13th Annual Banking Conference, Chicago, 24 October 2010); John Gieve, 'A Better Plan for Bank of England Governance' *Financial Times* (18 December 2011).

5 Eilis Ferran, 'The Break-up of the Financial Services Authority' (2011) 31 *Oxford Journal of Legal Studies* 455; Nicholas Dorn, 'Accountability in Prudential Regulation of Financial Markets: A Response to HM Treasury's 2011 Consultation Paper, "A New Approach to Financial Regulation"' (April 2011) <http://ssrn.com/abstract=1822142> accessed 26 March 2013.

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In the networked representation in the FPC, the PRA and Bank of England arguably share common objectives. The PRA is a subsidiary of the Bank of England, chaired by the Governor of the Bank of England, while the PRA Chief Executive is Deputy Governor of the Bank for financial stability. The governing body of the PRA is appointed by the Bank, with Treasury approval, and hence the PRA may not be independent of Bank perspectives. The government views the PRA as a necessary complement to the Bank of England's financial stability oversight, viz. 'Locating the PRA within the Bank of England group is a reflection of the important role it will play in protecting financial stability. Its core objective will be to promote the safety and soundness of the firms it regulates'.⁶ It is likely that, due to organisational structure and common objectives, the PRA may be able to achieve greater integrated information surveillance with the Bank. This could mean that information surveillance brought to the table by the PRA and Bank may form the bedrock of FPC deliberations, thereby pointing the way for macro-prudential supervision. Further, the Bank undertakes its own surveys (i.e. the Bank of England's biannual *Systemic Risk Survey*, which asks compliance and risk management officers in the financial sector what they consider to be high impact risks for the UK financial system). The Bank therefore carries out its own information collection and analysis and seems not to rely on information mapping with its other non-Bank partners in the FPC. It is queried whether the FCA, with its suite of different objectives, and the Treasury, with its wider economic objectives, are observers or active information suppliers in the FPC. If the FPC is dominated by information surveillance provided by the Bank and the PRA, the FCA may play a more peripheral role even if it is represented at the FPC.

The PRA has stated that it will adopt a judgement-based approach in its micro-prudential supervision role, considering both the risks of institutional failure and wider economy issues.⁷ This approach is said to be in sync with the pre-emptive nature of macro-prudential supervision.⁸ If the Bank becomes alert to any potential financial stability issue, the Bank may consider managing the issue

6 HM Treasury, *A New Approach to Financial Regulation: The Blueprint for Reform* (Cm 8083, June 2011), para 1.32 and the Financial Services Act 2012.

7 Bank of England (Prudential Regulation Authority), 'Our Approach to Banking Supervision' (May 2011) www.bankofengland.co.uk/publications/Documents/other/financialstability/uk_reg_framework/pr_a_approach.pdf accessed 6 March 2013, 9.

8 G30 Working Group on Macroprudential Policy, *Enhancing Financial Stability and Resilience: Macroprudential Policy, Tools and Systems for the Future* (Washington, DC: Group of Thirty 2010); Financial Stability Board, 'Macroprudential Policy Tools and Frameworks: Update to G20 Finance Ministers and Central Bank Governors' (14 February 2011) www.bis.org/publ/othp13.pdf accessed 26 March 2013; Committee on the Global Financial System (Bank of International Settlements), 'Macroprudential Instruments and Frameworks: A Stocktaking of Issues and Experiences' (May 2010) CGFS Paper No 38 www.bis.org/publ/cgfs38.pdf accessed 21 March 2013. Priya Nandita Pooran, 'Macro-prudential Supervision – A Panacea for the Global Financial Crisis?' (2009) *Law and Financial Markets Review* 534; Eddy Wymeersch, 'The Institutional Reforms of the European Financial Supervisory System, An Interim Report' (January 2010) Ghent University Financial Law Institute Working Paper No 2010-01 <http://ssrn.com/abstract=1541968> accessed 26 March 2013.

at the lowest level of micro-prudential supervision before moving the issue to the FPC's table. Hence, the PRA, in response to micro-prudential information received from financial institutions or stress-test reports, may be able to act preemptively in its supervisory relationship with those institutions, introducing various balance sheet and micro-prudential measures (such as extra capital charges, amendments to recovery plans, or requiring that contingent capital instruments be issued).⁹ Such early intervention may be carried out by the PRA and could be regarded as a form of macro-prudential supervision using micro-prudential tools. In this way, many 'macro-prudential' issues could end up being managed by the Bank (including the PRA) as a whole and not being raised at the FPC level.

In principle, the FPC may exercise its powers by recommending or directing the PRA or FCA to carry out various measures in relation to balance sheet, terms and conditions in transactions and market structures.¹⁰ It is arguable that there is a preference for balance sheet or micro-prudential regulation in the implementation of macro-prudential supervision, although an emphasis on micro-prudential regulation would fly in the face of post-crisis critique¹¹ that has pointed out the inadequacies of micro-prudential regulation. However, we suggest that the FPC may prefer balance sheet tools, chiefly administered by the PRA, than transaction intervention tools, which may have to be co-monitored with or monitored by the FCA. Balance sheet tools that are more micro-prudential in nature have also been further developed, especially under Basel III, and hence there is perhaps greater willingness to engage with these, as leakages from regulatory arbitrage may be mitigated given the international convergence towards Basel III. Policymakers prefer a predefined and narrow set of what may be termed as macro-prudential measures. The pre-definition of macro-prudential measures is preferred so that they do not themselves become 'unexpected' policy output responsible for a systemic episode. The Interim FPC has indicated a preference for an initial narrow set of macro-prudential tools in order to subject them to experimental use and evolution over time.¹² These preferences arguably tend to converge on balance sheet tools, as these have been well used since the international convergence of capital adequacy regulation under the Basel I capital accord. There appears to be a greater reluctance to intervene in transactional terms (such as loan-to-value mortgages or loan-to-income credit arrangements), as such restrictions may crudely and unduly interfere with the market-driven

9 Samuel G Hanson, Anil K Kashyap and Jeremy C Stein, 'A Macroprudential Approach to Financial Regulation' (November 2010) Chicago Booth Research Paper No 10-29 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1708173 accessed 26 March 2013.

10 Bank of England and Financial Services Authority, 'Instruments of Macro-prudential Policy' (December 2011) Bank of England Discussion Paper www.bankofengland.co.uk/publications/Documents/other/financialstability/discussionpaper111220.pdf accessed 3 December 2012, 17ff.

11 FSA, 'The Turner Review: A Regulatory Response to the Global Banking Crisis' (March 2009) www.fsa.gov.uk/pubs/other/turner_review.pdf accessed 3 January 2013, 83.

12 Interim Financial Policy Committee, 'Record of the interim FPC meeting held on 20 September 2011' www.bankofengland.co.uk/publications/records/fpc/pdf/2011/record1110.pdf accessed 26 March 2013.

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allocation of resources.¹³ Market structure tools are dominated by EU-level regulation¹⁴ and hence the FPC may see balance sheet tools as being the preferred range of tools to use. A preference for balance sheet tools is likely to promote PRA-Bank leadership on the FPC.

The likely domination of the Central Bank's perspective may arguably be observed in the deliberations of the interim Financial Policy Committee in 2011 and 2012. An Interim Financial Policy Committee was set up pending legislative formalisation for the FPC in 2013 and the records of its quarterly meetings are publicly available. The records do not show inter-agency discussion and present the consolidated recommendations agreed upon by the FPC, as addressed to the then FSA. The records of meetings in 2011¹⁵ and 2012¹⁶ show overwhelming concern for bank-related issues (including capital positions due to sovereign debt stress, liquidity and leverage matters), although there is also some concern that residential mortgage foreclosures be limited to prevent systemic impact on consumers. Although banking sector issues loom large in the FPC minutes, it is nevertheless premature to conclude that the FPC focuses excessively on the banking sector in monitoring systemic risk.

We suggest that the economic context in the UK and EU – where there is concern about banking sector weaknesses, due to exposures to weakly performing sovereign debt in the EU – and the preference for a narrow set of balance sheet-based tools¹⁷ will characterise macro-prudential supervision in the UK for the immediate future. This trajectory may be due to concerns about the parameters of responsibility and accountability, or may be due to assumptions made about the sources and nature of systemic risk. Although the networked nature of the FPC could allow it to take a more inductive approach to systemic risk monitoring, it appears, at least for now, that a narrower view of systemic risk monitoring is

13 Bank of England and Financial Services Authority, 'Instruments of Macro-prudential Policy' (December 2011) Bank of England Discussion Paper www.bankofengland.co.uk/publications/Documents/other/financialstability/discussionpaper111220.pdf accessed 3 December 2012, 25ff.

14 Such as the centralisation of derivatives trading with central counterparties and centralised clearing, see European Parliament and Council Regulation (EU) 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories [2012] OJ L201/1 (European Market Infrastructure Regulation 2012).

15 Interim Financial Policy Committee, 'Record of the interim FPC meeting held on 16 June 2011' www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2011/record1106.pdf accessed 26 March 2013; Interim Financial Policy Committee, 'Record of the interim FPC meeting held on 20 September 2011' www.bankofengland.co.uk/publications/records/fpc/pdf/2011/record1110.pdf accessed 26 March 2013; Interim Financial Policy Committee, 'Record of the interim FPC meeting held on 23 November 2011' www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2011/record1112.pdf accessed 26 March 2013.

16 See, for example, Interim Financial Policy Committee, 'Record of the interim FPC meeting held on 22 June 2012' www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2012/record1207.pdf accessed 26 March 2013.

17 Bank of England and Financial Services Authority, 'Instruments of Macro-prudential Policy' (December 2011) Bank of England Discussion Paper www.bankofengland.co.uk/publications/Documents/other/financialstability/discussionpaper111220.pdf accessed 3 December 2012.

taken, which revolves around Bank perspectives. It will be important to see how the FCA brings its views and intelligence on product and market developments to bear. Further, it should be considered whether the Ombudsman service can be separately represented at the FPC, in order to provide intelligence on consumer market issues, as systemic risk issues can also arise from consumer product markets.

16.2 EU

As mentioned earlier, the EBA, EIOPA and ESMA have all been tasked with establishing a permanent capacity to monitor and respond to systemic risk.¹⁸ Systemic risk is defined as relating to ‘any particular financial institution’,¹⁹ and more broadly as any risk of disruption in financial services caused by an impairment in any or all parts of the financial system, which affects the financial sector, real economy, or both.²⁰ The three authorities are to assist the ESRB in monitoring systemic risk, by establishing qualitative and quantitative indicators to facilitate the judgement of the ESRB in deciding whether any systemic risk action (e.g. warnings) ought to be taken.²¹ Together, the three authorities also form a committee for inter-agency coordination. The three authorities, the Joint Committee and the ESRB, together, form the framework for comprehensive macro-prudential supervision in the EU and the European System of Financial Supervision (ESFS).²² The ESFS is essentially a networked structure as well.

The networked structure of the ESRB and the three European authorities seems optimal to capture the monitoring needs of macro-prudential supervision. However, we suggest that it is more likely that the ECB is at the forefront of financial stability. Although the ESRB is a network consisting of the three European authorities and central bank representation, the ESRB is likely to be dominated by the ECB and central bank perspectives as the ECB and national central bankers comprise 29 of its 37-strong General Board.²³ We predict that

18 European Parliament and Council Regulation (EU) 1093/2010 of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC [2010] OJ L331/12 (EBA Regulation 2010), arts 1(i), 22–24; European Parliament and Council Regulation (EU) 1094/2010 of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC [2010] OJ L331/48 (EIOPA Regulation 2010), arts 8(1)(i), 22–24; European Parliament and Council Regulation (EU) 1095/2010 of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC [2010] OJ L331/84 (ESMA Regulation 2010), arts 7(1)(i), 22–24.

19 EBA Regulation 2010, art 1(5); EIOPA Regulation 2010, art 1(6); ESMA Regulation 2010, art 1(5).

20 EBA Regulation 2010, art 22; EIOPA Regulation 2010, art 22; ESMA Regulation 2010, art 22.

21 European Parliament and Council Regulation (EU) 1092/2010 of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board [2010] OJ L331/1 (ESRB Regulation 2010), art 16.

22 ESRB Regulation 2010, art 1.

23 ESRB Regulation 2010, art 6.

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the ESRB's main role will be to act as a platform for high-level information exchange between the three European authorities, the ECB and national central banks, but not necessarily as a macro-prudential decision-maker. We are of the view that the ECB will take on the management of financial stability issues more pre-eminently than the three European authorities who are tasked with the groundwork of systemic risk monitoring. As the ECB takes over unified micro-prudential banking supervision of euro area banks and banks in non-euro area participating countries (in the form of the Single Supervisory Mechanism), the ECB's perspective on institutional fragility and risk may become dominant in defining systemic risk issues. Pending the finalisation of the Single Supervisory Mechanism, the ECB is already at the forefront of financial stability issues, such as sovereign debt and bank crises in euro area Member States.²⁴

Although the EBA, EIOPA and ESMA are responsible for monitoring and responding to systemic risk,²⁵ the role of the three European authorities is to provide information in order to feed into decision-making by the macro-prudential regulator.

The three European authorities have pursuant to their systemic risk monitoring role, issued sectoral reports on a semi-annual basis²⁶ to provide EU-level perspectives on key trends and risks in the banking, securities and insurance sectors. The commitment to issuing these publicly available reports manifests the authorities' commitment to systemic risk monitoring. However, the authors are concerned that the three European authorities' approach to systemic risk monitoring may be very much coloured by their focus on market and legal integration.

The three European authorities have evolved from networked committees whose main role was to assist the European Commission in establishing technical legislation to support primary legislation on the integration of EU financial markets.²⁷ The three European authorities are heavily involved in legislative reform: the EBA in the legislative implementation of Basel III in the form of the fourth Capital Requirements Directive (recast) and the Recovery and Resolution Directive; the EIOPA in the implementation of the Solvency II Directive on micro-prudential regulation for insurance firms; and ESMA in reforming the Markets in Financial Instruments Directive, the Transparency Directive and the Market Abuse Directive, as well as drafting technical supporting legislation for recently enacted post-crisis legislation such as the Regulation for Credit Rating Agencies and the Alternative Investment Fund Managers Directive. Hence, it is likely that the three agencies will consider legal integration as a key means to address systemic risk issues. This approach may seem plausible, as legal integration offers

24 For example, see Ben Rooney and Chris Isidore, 'ECB loans out €529.5 billion to European banks' *CNN Money* (New York, 29 February 2012) http://money.cnn.com/2012/02/29/markets/ecb_bank_loans/index.htm accessed 27 March 2013.

25 EBA Regulation 2010, art 3; EIOPA Regulation 2010, art 3; ESMA Regulation 2010, art 3.

26 See, for example, EBA, Report on Risks and Vulnerabilities of the European Banking System (July 2012) and (January 2013); ESMA, Trends, Risks and Vulnerabilities (January 2013).

27 Niamh Moloney, 'The Lamfalussy Legislative Model: A New Era for the EC Securities and Investment Services Regime' (2003) 52 *International and Comparative Law Quarterly* 499.

a platform for many issues to be considered and discussed at a pan-European level, contemporaneously dealing with systemic risk concerns. We are concerned where there may be a conflict between objectives, the European authorities are likely to favour market and legal integration as they are deeply ingrained in the workings of the authorities²⁸ and hence macro-prudential supervision may be viewed through the lens of these objectives. Systemic risk monitoring across the EU may reveal realities that are difficult for the European supervisory authorities to grapple with, given its market integration and regulatory convergence objectives. In the EU, the reality is that certain countries are more connected to others, such as German and French banks in Eastern European countries and the UK's exposure to Ireland (which exceeds that of other Member States). The 'systemic risk' signals at the EU level may more correctly be described as pockets of signals that are geographically concentrated. However, the systemic risk reports of the three European authorities present information without any reference to possible pockets of issues that may require different treatment.

Nevertheless, can it be argued, contrary to the discussion above, that the three European authorities have carried out EU-wide systemic risk monitoring and have taken proportionate actions so far? For example, the sovereign debt crisis in the euro area has prompted the EBA to carry out numerous stress tests in order to survey the soundness of European banks in general. The credibility of these stress tests has been criticised,²⁹ but the EBA has nevertheless made a micro-prudential/macro-prudential move to increase all European banks' core tier one capital base to 9 per cent of risk-weighted assets.

Further, the Joint Committee of the three authorities³⁰ may also have a significant role in monitoring systemic risk. The remit of the Joint Committee relates to financial conglomerates, accounting and auditing, micro-prudential analyses of cross-sectoral developments, risks and vulnerabilities for financial stability, retail investment products, measures combating money laundering, information exchange with the ESRB, and developing the relationship between the ESRB and the three authorities. Although the remit is wide, the Joint Committee has in early 2013 published its first report³¹ on EU-wide risks and vulnerabilities, manifesting its commitment to systemic risk monitoring in a cross-sectoral fashion. The report derives its findings from EU-level data and such data, supplied by the three European authorities, appears to be highly aggregated.

28 Niamh Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: More Europe or More Risks?' (2010) 47 *Common Market Law Review* 1317.

29 James Wilson, 'German regulator attacks stress tests' *Financial Times* (London, 7 June 2011) concerning the July round in 2011. The need for further stress tests a few months on into the sovereign debt crisis was again criticised in Patrick Jenkins and Ralph Atkins, 'European banks have €115bn shortfall' *Financial Times* (London, 8 December 2011), on the basis that the capital shortfalls assessed by the EBA keep changing.

30 EBA Regulation 2010, art 54; EIOPA Regulation 2010, art 54; ESMA Regulation 2010, art 54.

31 *Joint Committee Report on Risks and Vulnerabilities in the EU Financial System* (13 March 2013) www.esma.europa.eu/system/files/jc-2013-010_jc_rsc_joint_risk_report_2.pdf accessed 11 April 2013.

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The report highlights the common risks for the Union but is not an exhaustive list of risks.³² Although a genuine effort to grapple with EU-wide risks and presenting a EU-level perspective, it remains uncertain how pockets of differences may be dealt with and whether there may be individual Member States whose problems could become systemically significant. Further, the report highlights national fragmentation as being an EU-level risk to be dealt with.³³ The authors therefore remain concerned about whether the relationship between market and legal integration and financial stability is perceived excessively through the lens of unwavering support for market and legal integration³⁴ and wonder if the Joint Committee and the three European authorities may be overstating the panacea qualities of legal integration.

16.3 Concluding remarks

Going forward, we suggest that macro-prudential supervision, although officially reposed in the FPC in the UK, is likely to be dominated by the central bank's perspectives. In the EU, the macro-prudential responsibility of the ESRB supported by the three European authorities may also become more dominated by the ECB. The Single Supervisory Mechanism under the ECB may become the home of micro- and macro-prudential supervision in the EU. In this respect, there may be similarities between the UK's approach to macro-prudential supervision at the national level and the approach taken at the European level. We, however, advocate caution in regarding market and legal integration as an essential platform upon which to manage systemic risk in the EU.

One remaining point is that the ideology of macro-prudential supervision is highly pre-emptive in nature. We might even say that the rise of macro-prudential supervision, however carried out, is a key illustration of the movement of financial regulation into new ideological territory. The next chapter will discuss how the post-crisis regulatory architecture in the UK and EU will cope with changes in financial regulation towards a more pre-emptive and public-interest character.

32 *Joint Committee Report on Risks and Vulnerabilities in the EU Financial System* (13 March 2013) at page 3, www.esma.europa.eu/system/files/jc-2013-010_jc_rsc_joint_risk_report_2.pdf accessed 11 April 2013.

33 *Joint Committee Report on Risks and Vulnerabilities in the EU Financial System* (13 March 2013) at pages 12–14, 16–17, www.esma.europa.eu/system/files/jc-2013-010_jc_rsc_joint_risk_report_2.pdf accessed 11 April 2013.

34 See Mads Andenas and Iris H-Y Chiu, 'Financial Stability and Legal Integration in Financial Regulation' (2013) *European Law Review* 335.

17 The pre-emptive approach in financial regulation and the accountability of regulatory authorities in the UK and EU

The determination to embrace new regulatory approaches has been clearly articulated by policymakers and regulators in the post-crisis era. The UK PRA will embrace a pre-emptive and judgement-based approach,¹ which the FCA will also adopt, in order to bolster consumer protection.² The judgement-based approach in regulatory supervision is essentially pre-emptive in nature and allows regulators to take intervening actions before problems have actually occurred. This approach allows regulators to make judgements as to the likely consequences instead of acting *ex post facto*. The judgement-based approach is very much in line with the change in the character of financial regulation away from facilitating market discipline and towards providing the public good of consumer protection or financial stability. Hence, the judgement-based approach is supported by changes to the capacity and powers of regulators. It is important to look into the nature of regulators' accountability and to discuss how this may affect the trajectory of financial regulation.

Although the judgement-based approach to regulation requires more preventive forms of supervision, such as vetting and inspections, regulators are unlikely to be able to carry out the same intensive supervision for all supervised entities due to constraints on resources. The judgement-based approach is therefore likely to be risk-based, meaning that entities regarded as having riskier profiles or as likely to cause more harm upon failure may be subject to more intensive supervision. The PRA seems to indicate that its approach in supervision will be based on assessing the stability risk that each firm poses to the overall financial system and supervisory engagement is likely to be commensurate with the level of risk

1 Bank of England (Prudential Regulation Authority), 'Our Approach to Banking Supervision' (May 2011) www.bankofengland.co.uk/publications/Documents/other/financialstability/uk_reg_framework/pr_a_approach.pdf accessed 6 March 2013; endorsed by the HM Treasury in HM Treasury, *A New Approach to Financial Regulation: The Blueprint for Reform* (Cm 8083, June 2011).

2 Martin Wheatley, 'My Vision for the FCA' (Speech at the British Bankers' Association, London, 25 January 2012); Financial Conduct Authority, 'Journey to the FCA' (October 2012) www.fsa.gov.uk/static/pubs/other/journey-to-the-fca-standard.pdf accessed 25 March 2013, 25, 41.

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identified.³ This sounds strikingly similar to a risk-based approach that prioritises regulatory attention for 'higher risks'. Further, the FCA is also likely to engage in a risk-based approach given its fourfold classification of firms (based on scale and consumer base) for the purposes of determining supervisory intensity.⁴ However, the judgement-based approach means that regulators are likely to take earlier intervention instead of waiting for market discipline to apply.

It may be argued that the judgement-based approach will be undermined if a risk-based approach to regulation continues to be taken. This is because a risk-based approach makes assumptions about risk and about the likely impact of risk materialisation, assumptions that may be mistaken from the outset or become misplaced over time. As the judgement-based approach is pre-emptive in nature, perhaps regulators should be more willing to question assumptions and adopt approaches that ensure that supervision is adequate for all supervised entities. Black and Baldwin⁵ suggest that 'lower risks' may over time become volatile and unstable through accumulation or through changes in context, thus warranting some regulatory attention. Nevertheless, the PRA will also examine the risk management and governance contexts of firms in assessing the risks they pose, so its approach seems to include a kind of responsiveness by keeping an eye on 'lower risks' as suggested by Black and Baldwin. The FCA⁶ has also indicated that it will engage in proactive surveillance and research to inform itself of signals and risks that may warrant pre-emptive action. The PRA and FCA may be indicating the adoption of a modified risk-based approach that is more dynamic in nature in order to ensure the judgement-based approach is a success.

The increased capacity and powers of financial regulators to make pre-emptive judgements may raise the question of whether such judgements are sound and accountable. One concern is that these judgements will be made by groups of technocrats that are insular, and financial regulation and supervision could in time take on an elitist character. This chapter will argue that the post-crisis character of regulatory agencies, whether in the UK or EU, is likely to become more technocratic and may be in danger of becoming too insular and elitist in the future.

Where regulatory agencies engage in more intelligence, surveillance and information analysis, they are likely to become technocratic bureaucracies.⁷ This is because financial, economic, legal and technological expertise are required to

3 Bank of England (Prudential Regulation Authority), 'The PRA's Approach to Banking Supervision' (October 2012), www.fsa.gov.uk/static/pubs/other/pr-a-approach-banking.pdf accessed 28 March 2013, 16ff, 31ff.

4 Financial Conduct Authority, 'Journey to the FCA' (October 2012) www.fsa.gov.uk/static/pubs/other/journey-to-the-fca-standard.pdf accessed 25 March 2013, 27ff.

5 Julia Black and Robert Baldwin, 'When Risk-Based Regulation Aims Low: Approaches and Challenges' (2012) 6 *Regulation and Governance* 2.

6 Financial Conduct Authority, 'Journey to the FCA' (October 2012) www.fsa.gov.uk/static/pubs/other/journey-to-the-fca-standard.pdf accessed 25 March 2013, 41ff.

7 Technocracy is defined as 'the government (or control) of society by scientists, technicians, or engineers-or at least the exercise of political authority by virtue of technical competence and

sort and analyse the intelligence and the professionalisation of staff characterises the role and work of the agency as technocratic. In this respect, national regulators (such as the PRA and FCA) and the three European authorities assisting the ESRB may develop into technocracies. Technocracy is not necessarily a drawback, as technocracy is often associated with focused problem-solving, greater objectivity and independence.⁸ However, commentators have warned about technocratic decision-making being more politically powerful⁹ because of the necessary difficulties surrounding the questioning of expert judgement. We therefore need to look into whether the new regulatory architecture in the UK and EU has adequately addressed issues of accountability in relation to the making of pre-emptive technocratic judgements in financial regulation and supervision.

First, it is queried whether the technocratic character of regulatory agencies renders them insular and inward-looking. This could be a concern as pre-emptive powers may be exercised so as to affect transactional and market freedoms, and the wisdom of pre-emptive judgements may be questioned if such judgements are made in an insular manner. Harfield, commenting on the Serious Organised Crime Agency in the UK, has observed that agencies with intelligence capacity tend to be 'shielded from public scrutiny'¹⁰ and maintain an aura of remoteness. Insularity may be useful for sensitive decision-making, shielded from unnecessary interference, but could also result in mistakes that follow narrow-minded and linear paths of inquiry. The UK Serious Fraud Office's mistakes in relation to investigations against Vincent Tchenguiz in light of the collapse of Icelandic bank Kaupthing in 2009 may have been due to insular mindsets and blinkered decisions made by its officers.¹¹

17.1 The accountability of UK and EU regulators

In the UK, the FCA is subject to input accountability and *ex post* accountability. Input accountability refers to the channels of participation maintained by the FCA for outside stakeholders in the form of consultation for policy proposals. *Ex post* accountability refers to the political accountability of regulators through reporting and engagement with the government and Parliament, as well as judicial scrutiny of regulatory decisions.

expertise in the application of knowledge' in John Gunnell, 'The Technocratic Image and the Theory of Technocracy' (1982) 23 *Technology and Culture* 392 at 392.

8 See Steven Brint, 'Rethinking the Policy Influence of Experts: From General Characterizations to Analysis of Variation' (1990) 5 *Sociological Forum* 361, 366.

9 Steven Brint, 'Rethinking the Policy Influence of Experts: From General Characterizations to Analysis of Variation' (1990) 5 *Sociological Forum* 361; Miguel Angel Centeno, 'The New Leviathan: The Dynamics and Limits of Technocracy' (1993) 22 *Theory and Society* 307.

10 Clive Harfield, 'SOCA: A Paradigm Shift in British Policing' (2006) 46 *British Journal of Criminology* 743, 755.

11 For example, the Serious Fraud Office's mistakes relating to enforcement against Vincent Tchenguiz, see Kate Mackenzie, 'SFO Admits Tchenguiz Case Errors' (*FT Alphaville*, 23 February

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In terms of input accountability, the FCA is required to maintain four panels of stakeholders:¹² the Practitioner Panel, the Markets Practitioner Panel, the Small Business Practitioner Panel and the Consumer Panel. It was initially envisaged at the draft stages of the Financial Services Bill 2012 that the PRA may institute and consult panels as and when it is perceived to be necessary, and so there is no formalisation of external stakeholder relationships. This has given rise to criticism in the press¹³ regarding concerns over the PRA's accountability in its important role of micro-prudential supervision. The PRA's lack of formal commitment to stakeholder scrutiny reinforces the concerns surrounding insularity, which may be undesirable given that the PRA and the Bank of England are likely to dominate macro-prudential supervision and pre-emptive measures in micro-prudential regulation. The final Financial Services Act 2012 has now provided for the PRA to be subject to a duty to consult a Practitioner Panel and a duty to consider its representations.¹⁴

On *ex post* accountability, the FCA will institute a formal complaints mechanism and will also be subject to the scrutiny of the Upper Tribunal if its decisions against regulated persons are referred to the Tribunal. The FCA may be subject to judicial review but the scope of review is highly limited given the extensive powers and discretion conferred by legislation.¹⁵ The PRA will similarly be subject to Tribunal scrutiny.¹⁶

In terms of reporting accountability, the FCA has perhaps the most extensive accountability regime, inherited from the FSA, with channels of accountability to the Treasury, the Parliament, the aforementioned stakeholder panels and the general public through public reporting and annual public meetings.¹⁷ However, the PRA, under the umbrella of the Bank of England, is accountable only to the Court of Directors. Although the Bank of England is accountable to the Court of Directors, which is further scrutinised by an Oversight Committee,¹⁸ the PRA is not directly accountable to the Oversight Committee and its accountability

2012) <http://ftalphaville.ft.com/2012/02/23/893851/sfo-admits-tchenguiz-case-errors/> accessed 28 March 2013.

12 Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012), ss 1N–1Q.

13 Donia O'Loughlin, 'Consumer Panel: PRA should consider consumer representations' *Financial Times Advisor* (London, 25 January 2012).

14 Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012), ss 2M and 2N.

15 *BBA v FSA* [2011] EWHC 999 (Admin), [2011] ACD 71; *R (Griggs) v FSA* [2008] EWHC 2587 (Admin), [2009] ACD 28.

16 See FSA, *Complaints against the Regulators* (March 2013) www.fsa.gov.uk/static/pubs/policy/ps13-07.pdf accessed 11 April 2013.

17 Eva Lomnicka, 'Making the Financial Services Authority Accountable' [2000] *Journal of Business Law* 65. See for a comparison, Julia Black and Stéphane Jacobzone, 'Tools for Regulatory Quality and Financial Sector Regulation: A Cross-Country Perspective' (2009) OECD Working Paper on Public Governance No 16 <http://ideas.repec.org/p/oec/govaaa/16-en.html> accessed 4 April 2013.

18 Bank of England Act 1998 as amended by the Financial Services Act 2012 by inserting section 3A.

therefore lies primarily to the Bank, and to the Court of Directors that oversees the Bank. On the whole, the PRA is more remote from political and public accountability compared to the FCA's exposure to input accountability and forms of public scrutiny. The difference in accountability regimes may suggest that more accountability is deemed necessary in the realms of consumer protection and transactional supervision (the FCA's remit), but is seen as less relevant to the delivery of financial stability as a public good. This may, however, allow the micro-prudential and macro-prudential supervisors in the UK to become relatively more insular and perhaps elitist.

At the EU level, the three European authorities are also subject to input accountability as they are assisted by a 30-strong stakeholder group¹⁹ (appointed by the ESA Boards of Supervisors following nomination by the relevant stakeholders), which changes every three years. The stakeholder groups are modelled on the Market Participants Consultative Panels of the Lamfalussy Committees.²⁰ The ESRB is also assisted by the 15-strong Advisory Technical Committee.²¹ The largest group of appointees to the European authorities' stakeholder groups are industry and market representatives, followed by academics who are considered to be experts in their field. The Commission and the ESAs are required to consult the stakeholder groups on regulatory action in the framework of the ESAs' Regulations. There are four stakeholder groups: the Banking Stakeholder Group, the Securities and Markets Stakeholder Group, the Insurance and Reinsurance Stakeholder Group and the Occupational Pensions Stakeholder Group.²²

The ESRB's Advisory Technical Committee is also made up of experts. Where *ex post* accountability is concerned, the three authorities are subject to appeals to a Board of Appeals before which Member States or private legal persons may disagree with an authority's decision.²³ The Board is composed of independent representatives from the three authorities, Member State regulators and experts from the private sector.²⁴ The Board must publish its decisions with reasons and its decisions may be appealed and referred to the European Court of Justice.²⁵

Where reporting accountability at the EU level is concerned, the three European authorities are accountable to the Commission and Council in their

19 EBA Regulation 2010, art 37; EIOPA Regulation 2010, art 37; ESMA Regulation 2010, art 37.

20 The Lamfalussy Committees, at the request of the European Parliament, incorporated within their structures the so-called Market Participants Consultative Panels (MPCPs), composed of stakeholders with interests in financial regulation, see Eilis Ferran, *Building an EU Securities Market* (Cambridge: Cambridge University Press 2004), 84.

21 ESRB Regulation 2010, art 12.

22 Following the requirements of EBA Regulation 2010, art 37.6, ESMA Regulation 2010, art 37.6 and EIOPA Regulation, art 37.7, the SGs have adopted their own rules of procedure by a majority of two thirds of their members.

23 EBA Regulation 2010, art 60; EIOPA Regulation 2010, art 60; ESMA Regulation 2010, art 60.

24 Sir William Blair, 'Board of Appeal of the European Supervisory Authorities' (2013) 24 *European Business Law Review* 165.

25 EBA Regulation 2010, art 61; EIOPA Regulation 2010, art 61; ESMA Regulation 2010, art 61.

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legislative standard setting activities,²⁶ and accountable generally to the Parliament and to the Council.²⁷ The ESRB is nested within the ECB, but it is subject to separate accountability to the Parliament and the Council and is required to present its annual report to both institutions.²⁸ The Chair of the ESRB may also be called upon by Parliament and Council to attend annual hearings or ad hoc hearings held when situations of widespread financial distress occur in the EU.²⁹ The accountability channels of the three European authorities and the ESRB are confined to the EU level and must certainly seem remote to the public. Again, it may be argued that the relative remoteness of the three European authorities and the ESRB protects the independence of technocratic judgement. Under the Single Supervisory Mechanism, the ECB will be subject to input accountability through the mechanism of the Bank Supervisory Board³⁰ where national authorities are represented for decision-making purposes. It has been proposed, in order to overcome issues of democratic deficit and inadequacy of accountability, that the ECB be made more directly accountable to Member States by appearing in national Parliaments if requested to do so.³¹ In terms of reporting accountability, the ECB is accountable to the Council and Parliament by way of an annual report.³²

The ECB will further be accountable to the European Parliament and the Parliament may set up committees of inquiry to scrutinise the work of the ECB if an issue of concern arises. The ECB's supervisory decisions may also be subject to appeal, to a Board of Appeal comprising five independent experts³³ and ultimately to the European Court of Justice.³⁴

European administrative law also provides certain control or accountability mechanisms, including individual remedies in judicial review or tort actions. The duty of the ESAs to give reasons is one such accountability mechanism. EU law imposes on EU decision-makers a duty to give reasons for their actions. This duty is clearly stated in Article 296 TFEU: 'Legal acts shall state the reasons on which they are based and shall refer to any proposals, initiatives, recommendations, requests or opinions required by the Treaties.' Article 41.2 of the Charter of Fundamental Rights of the EU includes further administrative law guarantees

26 EBA Regulation 2010, arts 10–17; EIOPA Regulation 2010, arts 10–17; ESMA Regulation 2010, arts 10–17.

27 EBA Regulation 2010, art 3; EIOPA Regulation 2010, art 3; ESMA Regulation 2010, art 3.

28 European Parliament and Council Regulation (EU) 1092/2010 of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board [2010] OJ L331/1 (ESRB Regulation 2010), art 19.

29 ESRB Regulation 2010, art 19.

30 European Parliament, 'Report on the proposal for a Council regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (COM(2012)0511 – C7-0314/2012 – 2012/0242(CNS)) (Proposed ECB Regulation)' A7-0392/2012, art 19.

31 Proposed ECB Regulation, recital 34.

32 Proposed ECB Regulation, art 17.

33 Proposed ECB Regulation, art 15a.

34 Proposed ECB Regulation, art 15b.

under the heading 'Right to good administration'. In the ESA Regulations, the general EU administrative law duty to give reasons is applied to three main types of decisions: those addressed to Member State regulators or to individual financial institutions in instances of breaches of EU law, emergency situations or settlement of disagreements. The duty applies to decisions with binding effects. It does not apply to all decisions adopted by the ESAs as most are not binding. Under Articles 17, 18 and 19 of the ESA Regulations, the ESAs must explain the reasons for their action. This may facilitate appeals and judicial review.

The duty to give reasons is related to transparency and access to documents, which also may facilitate accountability. The 2001 Regulation on public access to documents of the Parliament, the Council and the Commission will apply.³⁵ The duty to give reasons and to provide access to information go further than in English administrative law and will also have an impact on the work of domestic regulators.

Judicial scrutiny of regulatory decisions will secure compliance with the principle of proportionality, which is the EU law test of review of administrative action and of legislation.³⁶ This, too, is generally assumed to go further than in English law and will have an impact on the work of domestic regulators.

Next, we consider if there is accountability in the form of regulatory or supervisory liability to affected groups of the public. The limitations of deposit guarantee may cause uncompensated depositors to shift residual losses onto the public sector via liability claims against the State or the supervisory authority in case of bank failure. However, the ECJ in the *Peter Paul* case³⁷ refused to find that national regulators should be subject to *Francoovich* liability³⁸ in prudential supervision. National law provides for different forms of statutory immunity (e.g. Italy, Germany and, in an extreme form, the UK), liability under more stringent conditions than usual (e.g. France, where *faute lourde* is gradually being replaced by the general criteria of public responsibility) and liability without special liability criteria such as gross negligence (e.g. at least until recently, the Netherlands).³⁹ The law regarding liability towards regulated financial institutions themselves is even more divergent (see Chapter 6 on liability for credit rating agencies). The current transformations in EU banking law and financial market regulation may increase pressure for a reconsideration of national liability rules. As different liability regimes create different market conditions and different levels of consumer protection in the domestic market, a fundamental European debate seems overdue.

35 European Parliament and Council Regulation (EC) 1049/2001 of 30 May 2001 regarding public access to European Parliament, Council and Commission documents [2001] OJ L145/43.

36 See Paul Craig, *EU Administrative Law* (Oxford: Oxford University Press 2012), chs 19, 20.

37 Case C-222/02 *Peter Paul and others v Germany* [2002] ECR I-9425.

38 Joined Cases C-6/90 and 9/90 *Francoovich and Bonifaci v Italy* [1991] ECR I-5357.

39 Mads Andenas and Duncan Fairgrieve, 'Misfeasance in Public Office, Governmental Liability and European Influences' (2002) 51 *International and Comparative Law Quarterly* 757; Mads Andenas, 'Liability for Supervisors and Depositors' Rights – The BCCI and the Bank of England in the House of Lords' (2000) 3 *Euredia* 383.

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The current institutionalisation raises new questions of liability for EU institutions and the reach of EU liability for national institutions involved in financial market regulation.⁴⁰ The tendency for legislators, and for courts, is to limit tort law or administrative responsibility, as there is no desire to open up the floodgates of financial liability, the extent of which may be difficult to assess. On the other hand, the consequences for accountability of limiting court review and liability are also difficult to foretell, in particular for supervisory institutions with a high degree of independence as in the present case.⁴¹ In our view, general principles of EU tort law or administrative responsibility should apply to financial market regulators and the case for statutory restriction of such liability has not yet been made.

17.2 Addressing accountability deficits or weaknesses

We suggest that, generally speaking, financial regulators in the UK and EU are subject to comprehensive channels of *ex post* political accountability but judicial scrutiny and input accountability seem to be relatively weak.

One concern is that regulators in the UK and EU subscribe only to an insular form of input accountability. We query whether the stakeholders welcomed to provide input need be experts in finance and financial regulation and whether this means that wider stakeholder participation is non-existent or severely limited. If technocratic regulators consult expert stakeholders, will both groups be subject to similar frames of mind and groupthink? For example, the Bank of England's biannual *Systemic Risk Survey* targets the industry's compliance professionals and there seems to be a tendency to seek input only from recognised experts. It is arguably disconcerting – given the breadth of systemic risk and the potentially broad-based effects systemic risk in the financial sector may have on the general economy – that the stakeholder base for assisting regulators in their new pre-emptive regulatory approach seems to be industry-centred or narrowly confined to experts. As systemic risk consequences often result in real economy disruptions and cost, a wider constituency base may quite legitimately be interested in such pre-emptive policymaking. It is also noted that the EBA's semi-annual risk outlooks have also been prepared on the basis on surveys of European banks.⁴² The engagement of technocratic regulators with expert stakeholders may form a closed network that could become rather insular and elitist.⁴³ Although such

40 Phoebus Athanassiou, 'Financial Sector Supervisors' Accountability: A European perspective' (August 2011) ECB Legal Working Paper No 12/2011 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1807174 accessed 9 April 2013.

41 See Larisa Dragomir, *European Prudential Banking Regulation and Supervision: The Legal Dimension* (Abingdon: Routledge 2010); Mads Andenas, 'Liability for Supervisors and Depositors' Rights – The BCCI and the Bank of England in the House of Lords' (2000) 3 *Euredia* 383.

42 EBA, Report on Risks and Vulnerabilities of the European Banking System (July 2012) and (January 2013).

43 John Gunnell, 'The Technocratic Image and the Theory of Technocracy' (1982) 23 *Technology and Culture* 392.

characteristics may protect or reinforce the independence of regulators' decision-making, the expansion in regulatory powers to include pre-emptive judgements should perhaps be accompanied by more and wider forms of input accountability.

Further, Barth, Caprio and Levine⁴⁴ caution that regulators should not become too familiar with the regulated, as this may result in capture or, to a lesser extent, a form of complacency or blindness to problems that need to be addressed in the industry.

We query whether the mechanisms of accountability in the UK and EU will reinforce the characterisation of financial regulation and regulators as technocratic, insular, remote and elitist. This problem applies even more so at the global level where international financial regulation, discussed in the subsequent chapter, is concerned. Some commentators⁴⁵ argue for a range of stakeholders to be drawn into the regulatory space. As such, they may play the role of 'gatekeepers', providing intelligence to regulators, acting as whistleblowers⁴⁶ and disciplining the industry. These 'gatekeepers' could be professionals involved in internal controls, audit and legal compliance and whose professional stature and expertise could be leveraged upon to supply a form of governance to check on industry behaviour. Omarova,⁴⁷ for example, argues that regulators should constitute public interest councils represented by independent stakeholders who would provide advisory services to regulators and be accountable to Parliament. However, the representation of stakeholders also means that diverse interests may be able to 'lobby' policymakers. Policymakers and regulators need to be aware of the potential informational advantages that can be obtained through contact with stakeholders, bearing in mind stakeholder agendas. Barth, Caprio and Levine⁴⁸ suggest that an independent Sentinel agency should be established to be accountable to Parliament and to periodically review the efficacy of financial regulation. However, it remains uncertain how the Sentinel would avoid the influence of lobbies that affect parliamentarians. We are of the view that the expanded powers of regulators need to be matched with increased accountability, particularly to the wider public. As regulatory powers have been expanded to further the public good of financial stability, financial regulation has moved closer to social needs. Much more thought needs to be given to the regulatory design of participation, accountability and inclusion in order to adopt more diverse forms of governance and responsibility. Scott suggests that different areas of regulation could evolve into 'regulatory regimes' represented by diverse groups

44 James R Barth, Gerard Caprio Jnr and Ross Levine, *Guardians of Finance: Making the Regulators Work for Us* (Cambridge, MA: MIT Press 2012).

45 Shann Turnbull, 'Streamlining Prudential Regulation with Self-enforcing Co-regulation' (2006) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=979531 accessed 9 April 2013.

46 Heidi Mandanis Schooner, 'Private Enforcement of Systemic Risk Regulation' (2010) 20 *Creighton Law Review* 101.

47 Saule T Omarova, 'Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation' (2011) 37 *Journal of Corporation Law* 621.

48 James R Barth, Gerard Caprio Jnr and Ross Levine, *Guardians of Finance: Making the Regulators Work for Us* (Cambridge, MA: MIT Press 2012).

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of stakeholders, including public-led authorities, the market and public interest groups. Such regimes could provide a blueprint for designing the governance roles of various actors and the accountability of regulators, and may prevent regulatory capture by experts in the industry.⁴⁹ In such regimes, perhaps the Occupy movement,⁵⁰ which has been endorsed by Bank of England official Andy Haldane, could find a voice to provide input to regulators at the UK and EU levels.

We would also like to suggest that accountability for the UK FCA, PRA, FPC, the three European authorities, the ECB as the Single Supervisory Mechanism and the ESRB could be further improved by adopting a form of regulatory 'stress testing', accompanied by public reporting of the results. We suggest that regulators could stress-test their regulatory capacity against worst-case scenarios of multiple firm failures and other internal or external factors that may affect supervision and the quality of pre-emptive action. Regulators may also need to stress-test against the unintended consequences of the deployment of various pre-emptive regulatory tools, of a regulatory decision not to intervene as compared to an erroneous judgement, etc. Legislation could also provide for the regulatory agencies to carry out stress testing on a mandatory basis before the introduction of pre-emptive regulatory measures. We suggest that the adoption of a stress-testing methodology for self-review and reflection at regulatory agencies would be beneficial and would go beyond the cost/benefit analyses that are customarily appended to policy and rule-making proposals. Regulatory procedures could also be required to be audited periodically, beyond the current legislative power to review efficiency⁵¹ (in the use of resources), which applies to the PRA and FCA. Such audits may be especially necessary at the EU level, as there does not appear to be a mechanism for review of efficiency as applicable in the UK.

Finally, we argue that accountability mechanisms for regulators need especially to be strengthened in times of crisis management and resolution. Crisis resolution may entail significant fiscal cost, arbitrary decision-making in apportioning bail-in losses and severe economic consequences for a broad base of stakeholders without going through channels of broad-based input or reporting accountability. It may be argued that regulatory authorities need to act quickly and that avoiding undue delay is in itself a way of delivering the public good of financial stability.⁵² However, the nature of pre-emptive judgements made in a crisis is more critical

49 Colin Scott, 'Regulating Everything: From Mega- to Meta-Regulation' (2012) 60 *Administration* 61.

50 <http://occupyeconomics.org/>, accessed 11 April 2013.

51 Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012, ss 1S, 2O.

52 Dalvinder Singh, 'UK Approach to Financial Crisis Management' (2011) 19 *Transnational Law & Contemporary Problems* 868; Fabio Recine and Pedro Gustavo Teixeira, 'The New Financial Stability Architecture in the EU' (November 2009) Paolo Baffi Centre Research Paper No 2009-62 <http://ssrn.com/abstract=1509304> accessed 9 April 2013; Guido Ferrarini and Filippo Chiodini, 'Regulating Multinational Banks in Europe: An Assessment of the New Supervisory Framework' (April 2010) ECGI Law Working Paper No 158/2010 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1596890 accessed 9 April 2013.

in terms of their cost, their implications and their long-term consequences. The social discontent concerning the handling of the global financial crisis – in the form of Occupy protest movements⁵³ and media reports⁵⁴ on losses suffered by the taxpayer because of bailouts and the social fallout from the resolution of two Cypriot banks in early 2013 – revolve around the question of whether more robust forms of input and reporting accountability are necessary, even in times of crisis. We are of the view that the Commission's Proposal for a Recovery and Resolution Directive does not provide the accountability required to accompany the commitment of Member States to *ex ante* crisis resolution agreements, fiscal burden sharing, and *ex post* bilateral arrangements. International and European developments are excessively focused on the achievement of credible coordination and commitment to crisis management and burden-sharing frameworks. But as financial crises result in social cost, the wider public needs to have a voice in the developments of these arrangements and frameworks. The accountability of national and EU authorities, as well as international organisations involved in this area,⁵⁵ is highly undeveloped.

17.3 Concluding remarks

Policymakers in the UK and EU took the opportunity in the heat of the crisis to credibly endow themselves with increased powers.⁵⁶ This may have been more difficult to achieve in the absence of a crisis. Hence, the post-crisis deliberations must balance the needs of financial stability as a public good provided by new and expanded regulatory powers with the needs of credible accountability. However, it may be argued that as far as international developments go, regulating for financial stability will only become more remote and elitist. The next chapter examines this further.

53 The Occupy London and Occupy Wall Street movements.

54 Louise Armitstead, 'Northern Rock sold to Virgin Money "at a loss"' *The Telegraph* (London, 17 November 2011); 'RBS doubles annual loss in 2011, fourth since bailout' *BBC News* (23 February 2012) www.bbc.co.uk/news/business-17128477 accessed 9 April 2013.

55 See, for example, critical analysis by Miles Kahler, 'Defining Accountability Up: The Global Economic Multilaterals' (2004) 39 *Government and Opposition* 132.

56 Eric A Posner and Adrian Vermeule, 'Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008' (2009) 76 *University of Chicago Law Review* 1613.

18 The international framework for financial regulation

18.1 Introduction

This chapter does not purport to deal comprehensively with the volume of international developments in financial regulation to date, as myriad literature can be found on this issue.¹ In light of the challenges surrounding macro-prudential supervision at the national and EU levels, we intend to discuss the potential for international supervision and coordination given the international significance of certain financial institutions and the international dimension of monitoring systemic risk.

The international framework for financial regulation has arguably led to standard-setting, with the Basel Committee at the Bank for International Settlements (BIS) leading the global standards in micro-prudential regulation since 1988;² the International Organisation for Securities Commissioners (IOSCO) leading standard-setting for cross-border offering of securities³ and credit rating agency disclosures, etc;⁴ and the Financial Action Task Force (FATF) setting international standards on money laundering.⁵ The International Monetary Fund (IMF) has played a key role in ensuring convergence of banking regulatory standards by implementing the Basel Core Principles⁶ in its Financial Sector Assessment Programme.⁷ The Programme assesses individual countries for compliance with the Core Principles, in particular countries receiving IMF

1 For example, see Benton E Gup, *The New Financial Architecture: Banking Regulation in the 21st Century* (London: Praeger 2000); Barry Eichengreen, *Toward a New International Financial Architecture: A Practical Post-Asia Agenda* (Washington, DC: Institute for International Economics 1999); Kern Alexander, Rahul Dhumale and John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (Oxford: Oxford University Press 2006); Douglas Arner, *Financial Stability, Economic Growth, and the Role of Law* (New York: Cambridge University Press 2007).

2 www.bis.org/bcbs/about.htm accessed 10 April 2013.

3 www.iosco.org/library/pubdocs/pdf/IOSCOPD81.pdf accessed 10 April 2013.

4 www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf accessed 10 April 2013.

5 www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf accessed 10 April 2013.

6 www.bis.org/publ/bcbs30a.pdf, and updated as of 2012, see www.bis.org/publ/bcbs230.pdf accessed 10 April 2013.

financial assistance. Standard-setting at the international level may create a more level playing field and reduce regulatory arbitrage that exacerbates systemic risk. However, the setting of common standards does not mean that financial sector risks have been definitively reduced. International supervision is necessary to monitor the implementation of standards, any unintended consequences and changing practices in the international financial landscape. Supervisory coordination at the international level has however not achieved significant substantive development.

18.2 International supervisory coordination

For internationally active banks, the Basel Committee has encouraged consolidated and adequate supervision by home and host regulators since the Concordat of 1975,⁸ which has been revised several times since.⁹ However, actual home-host coordination is largely left to bilateral arrangements on information exchange and supervision. Although a multilateral framework for home country control¹⁰ exists in the EU flanked by supporting host country supervision,¹¹ the effectiveness of the framework has been questioned in the wake of the global financial crisis. Legislative amendments were introduced in 2009 to boost host country supervision for significant bank branches.¹² Home country control is also the dominant framework in EU securities¹³ and investment firm supervision.¹⁴ The

7 www.imf.org/external/NP/fsap/fsap.aspx accessed 10 April 2013.

8 Committee on Banking Regulations and Supervisory Practices, *Report to the Governors on the Supervision of Banks' Foreign Establishments* (1975) www.bis.org/publ/bcbs00a.pdf?noframes=1 accessed 10 April 2013.

9 Bank for International Settlements, *Principles for the Supervision of Banks' Foreign Establishments* (May 1983) www.bis.org/publ/bcbsc312.pdf accessed 10 April 2013; Bank for International Settlements, *Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishments* (July 1992) www.bis.org/publ/bcbsc314.pdf accessed 10 April 2013; Joint Working Group (Basel Committee and the Off-Shore Group of Supervisors) *Supervision of Cross-Border Banking* (October 1996) www.bis.org/publ/bcbsc315.pdf accessed 10 April 2013.

10 European Parliament and Council Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions [2006] OJ L77/1 (Capital Requirements Directive 2006), art 40.

11 Capital Requirements Directive 2006, arts 29–31, 41–43.

12 European Parliament and Council Directive 2009/111/EC of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management [2009] OJ L302/97 (Capital Requirements Directive 2009), art 42a.

13 European Parliament and Council Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2003] OJ L345/64 (Prospectus Directive), art 21; European Parliament and Council Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities [2009] OJ L302/32 (UCITS recast Directive), arts 19–21.

14 European Parliament and Council Directive 2004/39/EC of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive

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limitations of home country control have, however, been exposed in supervising international financial groups and meeting specific host country needs where cross-border entities operate. In this section, we will highlight the issues of international supervisory coordination and crisis resolution as being the most current and pertinent discussions in international financial regulation.

International supervisory coordination is intended to close any gaps in the patchwork of national supervision that may be taken advantage of by financial firms that have cross-border operations. Whether in international banking – the best practices for which were laid down in the Concordats of 1975 and 1983, and supplemented in 1992 and 1996 – or in the home country control frameworks adopted in the EU as mentioned above, supervisory coordination has largely depended on voluntary information exchange and engagement between national regulators. Lomnicka notes¹⁵ that, in relation to the EU, the partnership of home-host regulators in cross-border supervision may not adequately deal with two problems. The first is the home country's slowness to address problems not on its shores and the second is the host country's concern to impose its own regulatory regime so that it may maintain control over the protection of its own constituents. In the EU, host authorities' concerns have found their way into legislation, allowing host countries to impose reporting duties,¹⁶ restrictions for 'general good' purposes,¹⁷ and intrusive supervisory measures for 'significant branches'¹⁸ and 'precautionary' situations.¹⁹

At the international level, some home country regulators have not provided adequate cross-border supervision, as in the case of the failure of Luxembourg-based international bank BCCI in 1990, while others have applied extra-territorial powers with perhaps excessive zeal, such as the US. Piccioto and Haines²⁰ are of the view that:

It is hard to avoid the conclusion that these ramshackle co-operation arrangements are far from adequate to maintain oversight over financial markets which, even if they remain substantially local in their roots, are globally interlinked by the ability of a substantial number of financial agents to engage in many types of transactions in and across all markets.

2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L145/1 (Markets in Financial Instruments Directive, MiFID), arts 31–32, 56–62.

15 Eva Lomnicka, 'The Home Country Control Principle in the Financial Services Directives and Case Law' (2000) 11 *European Business Law Review* 324.

16 Capital Requirements Directive 2006, art 29; Markets in Financial Instruments Directive, art 61, for example.

17 Capital Requirements Directive 2006, art 31.

18 Capital Requirements Directive 2009, art 42a.

19 Capital Requirements Directive 2006, art 30; Markets in Financial Instruments Directive, art 62, for example.

20 Sol Piccioto and Jason Haines, 'Regulating Global Financial Markets' (1999) 26 *Journal of Law and Society* 351.

Brummer²¹ argues that, in the case of the US, international supervisory coordination has been used as a platform for states to exercise extra-territorial powers, particularly where US supervision of securities matters and market abuse are concerned. The dynamics of supervisory coordination, left largely free to evolve through bilateral relations, may be highly unpredictable.

18.3 Post-crisis initiatives in international financial regulation and supervision

Post-crisis, the Basel Committee and the Financial Stability Board (FSB) have led the way in recommending how international supervisory coordination should improve. They are in favour of instituting supervisory colleges. The FSF Working Group on Market and Institutional Resilience (FSF WG) has now identified the large banking groups in need of effective international supervision and instituted supervisory colleges for them.²² The Basel Committee guidelines²³ also propose to formalise the loose home-host supervisory arrangements concerning cross-border entities, by instituting home country leadership and encouraging best practices for the structure and division of responsibilities in colleges. Colleges are also expected to adopt operational guidelines for information exchange such as documenting minutes of meetings, ensuring a common approach to information sharing and implementation of agreed outcomes, and maintaining a detailed checklist of risks to monitor. Colleges also need to agree on the implementation of stress-testing models, and engage in the sharing of findings upon the conduct of stress testing. Colleges are also responsible for jointly meeting the banking group that they are responsible for overseeing. Colleges are in general encouraged to bring the spirit of macro-prudential supervision to the table and to engage in joint crisis management where necessary. In relation to global SIFIs, the Financial Stability Board proposes²⁴ that Crisis Management Groups be established for each SIFI so that a group of specified regulators would be able to engage with each SIFI regarding recovery plans and cross-border resolution possibilities and issues.

The Basel Committee and FSB recommend that regulators adopt a set of best practices including regulatory convergence in national crisis resolution regimes and contingency recovery plans, and cooperation with each other in information

21 Chris Brummer, 'Territoriality as a Regulatory Technique: Notes from the Financial Crisis' (2010) 79 *University of Cincinnati Law Review* 499.

22 Financial Stability Forum, 'Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience: Update on Implementation' (2 April 2009) www.financialstabilityboard.org/publications/r_0904d.pdf accessed 10 April 2013.

23 Basel Committee on Banking Supervision, *Good Practice Principles on Supervisory Colleges* (Basel: BIS 2010) www.bis.org/publ/bcbs177.pdf accessed 10 April 2013.

24 Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (October 2011), para 8ff, at www.financialstabilityboard.org/publications/r_111104cc.pdf accessed 9 May 2013.

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exchange, planning for orderly resolution and burden sharing.²⁵ The Financial Stability Board's Principles in particular specify the types of information that should be shared, such as recovery plans prepared by firms, firms' stress-testing results and risk profiles, and information regarding linkages and connections for each systemically important firm. The Board also recommends the development of common databases and regular annual meetings for colleges. Further, national resolution authorities should refrain from unilateral actions without consultation and should attempt to achieve coordinated understandings without jeopardising the needs of resolution.²⁶ Van Meerten and Ottow²⁷ argue that supervisory colleges should perhaps be directly responsible for the exercise of supervisory or enforcement powers, and this could perhaps make international supervision more institutionalised and effective. However, this may mean that national powers of supervision would have to be exercised through the college where internationally significant financial institutions are concerned. Would this unduly fetter national discretion and can colleges be sufficiently responsive to urgent needs? On the other hand, this could mean that the responsibility for providing the public good of financial stability in globally linked markets will be instituted at a suitably global level,²⁸ and this could be superior to relying on the goodwill of cross-border coordination. But the idea of moving supervisory powers upwards to be exercised by an entity beyond the state level could give rise to questions of accountability and democratic deficit.

One school of thought is of the view that the potential for effective international supervision and crisis resolution would be realised if international institutions were more directly responsible and able to exercise powers over financial institutions that have international operations. This school of thought perceives the reason for the hitherto lacklustre performance of international coordination as due to the loose bilateral frameworks in international supervision. Even with the new supervisory colleges, international supervision is still carried out via networks, albeit with slightly enhanced formalities and clearer mandates. Could it be argued that international frameworks are not likely to be effective, unless they are formally instituted and endowed with distinct personalities, mandates and powers? If so, do we need new financial authorities or should we make existing international organisations more integrated and robust?

25 Basel Committee on Banking Supervision, *Report and recommendations of the Cross-border Bank Resolution Group* (Basel: BIS 2010) www.bis.org/publ/bcbs169.pdf accessed 10 April 2013; Financial Stability Forum, 'FSF Principles for Cross-border Cooperation on Crisis Management' (2 April 2009) www.financialstabilityboard.org/publications/r_0904c.pdf accessed 2 March 2013.

26 Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (October 2011), para 7ff, at www.financialstabilityboard.org/publications/r_111104cc.pdf accessed 9 May 2013.

27 Hans van Meerten and AT Ottow, 'The Proposals for the European Supervisory Authorities: The Right (Legal) Way Forward?' (2010) 1 *Tijdschrift voor Financieel Recht* 5.

28 See also Claire R Kelly and Sungjoon Cho, 'Promises and Perils of New Global Governance: A Case of the G20' (2012) 12 *Chicago Journal of International Law* 491.

18.4 Global supervisory institutions

A number of commentators call for greater cohesiveness between existing international bodies such as the IMF, Basel Committee, FSB (both part of the Bank for International Settlements, the BIS), IOSCO and the World Bank, to combine their expertise in surveillance and to formalise a form of macro-prudential supervision at the international level. Davies²⁹ argues that since a good number of international organisations have surveillance programmes and capacity, there is potential for them to join up their platforms and engage in high-level international macro-prudential surveillance. Arner and Buckley³⁰ also argue that as macro-prudential risk monitoring is highly connected to international financial and trade liberalisation, international organisations are well-placed to monitor the broader issues of trade, economic development and overall financial stability. Hence, perhaps the OECD and the WTO³¹ should form part of the international framework for developing a cohesive view of international capital flows, economic development, macro-prudential supervision and financial stability.

However, Shigehara and Atkinson have pointed out the weaknesses in international organisation surveillance: analyses tend not to be well-integrated with the domestic economic specifics of individual countries and distinct conclusions that could amount to warning signals are rarely provided.³² A number of commentators are of the view that what international organisations can do collectively in collaboration is limited. Brummer³³ is of the view that it is not easy to achieve a coherent global division of labour among a diversity of international organisations and that international organisations are in any case unlikely to be able to do more than produce enabling pieces of soft law such as they are currently doing. Further, Giovanoli³⁴ also opines that international organisations have well-entrenched mandates and operational structures and are only likely to work as loose confederations. Hence, the issues experienced with international coordination among national regulators will not be different where international organisations working together are concerned. Porter³⁵ has, however, argued that there

29 Howard Davies, 'Global Financial Regulation After the Credit Crisis: Policy Implications' (2010) 1 *Global Policy* 185.

30 Douglas Arner and RP Buckley, 'Redesigning the Architecture of the Global Financial System' (2010) 11 *Melbourne Journal of International Law* 1.

31 Régis Bismuth, 'Financial Sector Regulation and Financial Services Liberalization at the Crossroads: The Relevance of International Financial Standards in WTO Law' (2010) 44 *Journal of World Trade Law* 489.

32 Kumiharu Shigehara and Paul Atkinson, 'Surveillance by International Institutions: Lessons from the Global Financial and Economic Crisis' (June 2011) OECD Working Paper No 860 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1859669 accessed 10 April 2013.

33 Chris Brummer, 'How International Financial Law Works (And How It Doesn't)' (2011) 99 *Georgetown Law Journal* 257.

34 Mario Giovanoli, 'The Reform of the International Financial Architecture after the Global Crisis' (2009) *New York University Journal of International Law & Politics* 81.

35 Tony Porter, 'Public and Private Authority in the Transnational Response to the 2008 Financial Crisis' (2011) 30 *Policy and Society* 175.

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is encouraging leadership from the BIS, in terms of the Basel Committee and the FSB, and hence there could be a coherent coordinated approach among international organisations with the BIS acting as a nucleus.

Some commentators prefer the establishment of a totally new global authority to respond to contemporary financial stability needs. They call for either the establishment of an international financial authority with specific mandates, such as crisis resolution, or the creation of a new mandate for an existing body, such as the IMF, as a centralised international financial regulator. The rationale for centralising some form of financial regulatory authority at the international level is largely based on the inability of states to deal with some international financial institutions whose scale of operations and risk may outstrip the regulatory capacity and resources of any one state.³⁶ As early as 2001, Eatwell and Taylor recommended a World Financial Authority to undertake authorisation of internationally active financial institutions, to supervise them and exercise direct enforcement powers.³⁷ However, such a strong form of centralisation is opposed by commentators who argue that it may introduce excessive technocratic uniformity in financial regulation, amplifying errors and suboptimal approaches.³⁸ Further, such centralisation may also be dominated by the hegemony of countries that enjoy dominance in financial regulatory development.³⁹ Avgouleas⁴⁰ proposes a four-tier system where micro-prudential standard setting is internationally centralised by the Basel Committee, macro-prudential supervision is centralised at a global level, and two further distinct mandates are created for an international financial policymaking body and a crisis-resolution body. Such a system supports a great degree of centralisation but allows international responsibility to be managed by four discrete agencies. This may appeal to commentators who are concerned about the concentration of power in one internationally constituted but unelected body.

Other commentators propose less comprehensive forms of centralisation, pointing out that only key areas that will truly benefit from centralisation, such as crisis resolution and macro-prudential supervision, should be managed at the international level. Such an approach may be able to strike the balance between the need to ensure financial stability as an international public good, while minimising the transfer of powers away from democratically elected governments to unelected and remote technocratic bodies at the international level.

36 Geoffrey RD Underhill, 'Markets beyond Politics? The State and the Internationalisation of Financial Markets' (1991) 19 *European Journal of Political Research* 197.

37 John Eatwell and Lance Taylor, *Global Finance at Risk: The Case for International Regulation* (New York: The New Press 2001).

38 Nicholas Dorn, 'The Governance of Securities' (2010) 50 *British Journal of Criminology* 23; Christian Tietje and Matthias Lehmann, 'The Role and Prospects of International Law in Financial Regulation and Supervision' (2010) 13 *Journal of International Economic Law* 663.

39 Manuela Moschella, 'Back to the Drawing Board: The International Financial Architecture Exercise' (2010) 17 *Review of International Political Economy* 155; Ben Thirkell-White, 'The International Financial Architecture and the Limits to Neoliberal Hegemony' (2007) 12 *New Political Economy* 19.

40 Emiliós Avgouleas, 'Why Global Finance needs an Institutional Big Bang' (Berle IV Symposium, London, 14–15 June 2012).

Pan⁴¹ is of the view that an international financial agency with international surveillance powers should be formed and should have technical expertise and sufficient resources to serve the purposes of international supervision and crisis resolution of internationally significant financial institutions. Ocampo⁴² is also of the view that an international outfit focused on international supervision and crisis resolution would be superior to ad hoc decision-making led by the political leaders of the G-20 or G-30 and would have a permanent capacity to respond to supervisory issues. Such an outfit could also potentially house an international debt or bankruptcy court, as sovereign debt issues may affect financial stability significantly. Avgouleas⁴³ is of the view that a world financial authority could have limited jurisdiction over internationally important financial institutions alone and thus need not disturb the fabric of national regulation and supervision of institutions that do not have the same impact. On a more limited scale, Lastra and Garicano⁴⁴ and Eichengreen⁴⁵ support the resolution of internationally important financial institutions at a centralised and international level. Eichengreen, in particular, supports a global system to address systemically important failures, sovereign bankruptcy and emergency liquidity assistance as international crisis resolution, if left uncoordinated, could result in states scrambling for the remains of a failed financial institution in order to satisfy liabilities to its constituents, resulting in disorderly resolution, beggaring thy neighbour actions and perhaps prolonged disruption to financial markets overall.⁴⁶ However, can there be an internationally centralised crisis management system without antecedent macro- or micro-prudential supervision? Will the centralisation of authority at an international level result in future mission creep in more and more areas?

18.5 Conclusion

In reality, the post-crisis changes made to international financial regulation architecture are modest. The Financial Stability Board has taken the lead with responsibility for global standards of financial stability and is working with the Basel Committee on micro-prudential and macro-prudential supervision. However, the Board's current stance seems to be that of recommending frameworks

41 Eric J Pan, 'Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks' (2010) 11 *Chicago Journal of International Law* 243.

42 José Antonio Ocampo, 'A Development-Friendly Reform of the International Financial Architecture' (2011) 39 *Politics and Society* 315.

43 Emiliós A Avgouleas, 'Financial Regulation, Behavioral Finance and the Global Financial Crisis' in Robert W Kolb (ed), *Lessons from the Financial Crisis* (Hoboken, NJ: John Wiley, 2010).

44 Luis Garicano and Rosa Lastra, 'Towards a New Architecture for Financial Stability: Seven Principles' (2010) 13 *Journal of International Economic Law* 597.

45 Barry Eichengreen, 'Out of the Box Thoughts About the International Financial Architecture' (May 2009) IMF Working Paper No 09/116 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1415173 accessed 10 April 2013.

46 See the discussion in Chapter 2 on the action taken by Iceland and the UK in the wake of the Icelandic banking failure.

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and best practices. It is not in a position to assume a form of macro-prudential supervision at a global level and does not have a mandate to coordinate international crisis resolution as such. On the one hand, there seems to be a need for robust international financial regulation that goes beyond soft law standard-setting and networked coordination. On the other hand, the empowering and centralisation of international financial regulation may be resisted as being remote, elitist and lacking in accountability.

There is a role for global initiatives⁴⁷ to deal with public goods at a high level (climate change, poverty, conflict, international crime and money laundering) and, post-crisis, a call for emphasis to be placed on financial stability.⁴⁸ However, where public goods become global public goods, their provision may be subject to policymaking in international organisations whose accountability may be relatively weak and whose operations remain remote and opaque. These cautions have been voiced by Kaul and others⁴⁹ who argue that the characterisation of global public goods should be undertaken with scrutiny and caution. Further, they suggest that developments in the provision of global public goods should take into account the need for adequate representation of the diverse public so that global public goods do not become elitist, removed from national or local needs and hijacked by the interpretations of the internationally powerful states or epistemic communities. The global provision of public goods, such as financial stability, continues to be fraught with problems of representation, coordination, distribution and equity. It remains to be seen whether the characterisation of financial stability as a global public good and the developments in enhanced international coordination led by the FSB will strike the right balance between centralisation and decentralisation, or will evolve towards a new international financial regulatory architecture in due course.

47 Douglas Arner and RP Buckley, 'Redesigning the Architecture of the Global Financial System' (2010) 11 *Melbourne Journal of International Law* 1; Howard Davies, 'Global Financial Regulation after the Credit Crisis' (2010) 1 *Global Policy* 185; Martin Wolf, 'Seven Ways to Fix the System's Flaws' *The Financial Times* (London, 23 January 2012).

48 For example, the centralised standard-setting and surveillance carried out by the World Health Organisation for global health issues has been much affirmed. See Jennifer Prah Ruger, 'Global Functions at the World Health Organisation' (2005) 330 *British Medical Journal* 1099.

49 Inge Kaul and others (eds), *Providing Global Public Goods: Managing Globalization* (New York: Oxford University Press 2003).

19 Conclusion

The rise of financial stability as a public good has led to a resurgence in regulatory power in financial markets. Financial stability has always been recognised as one of the objectives in financial regulation. Cranston¹ identifies the maintenance of 'systemic stability' as a public good that 'financial regulation' can provide. Individual firms will not take collective action to protect the financial system as a whole² and thus generate a classic market failure that the state is ultimately called upon to correct.³

As Kaul and others argue, 'Public goods theory often lags behind rapidly evolving political and economic realities'.⁴ In financial regulation, there is an additional reason for this: the academic community was overwhelmingly pro-industry and facilitative of market-based governance in the pre-crisis years.

In this book, we have provided a critical account of the key reforms in financial regulation which further the objective of financial stability and we have questioned whether financial regulation has fundamentally changed in nature.

The resurgence in regulatory power has to contend with the reality that regulators are far from being the only suppliers of governance in financial regulation.⁵ Kaul and others⁶ argue that modern public goods such as financial stability

1 Ross Cranston, *Principles of Banking Law* (2nd edn, Oxford: Oxford University Press 2003), 66ff.

2 Steven Schwarcz, 'Systemic Risk' (2008) 97 *Georgetown Law Journal* 193, 206.

3 Paul A Samuelson, 'The Pure Theory of Public Expenditure' (1954) 36 *Review of Economics and Statistics* 387. The correction of market failure brings with it the concomitant risk of moral hazard. In economic literature, the lesson of moral hazard has been described with the words 'less is more'. Professor Stiglitz states: '[T]he more and better insurance that is provided against some contingency, the less incentive individuals have to avoid the insured event, because the less they bear the full consequences of their actions', see Joseph E Stiglitz, 'Risk, Incentives and Insurance: The Pure Theory of Moral Hazard' (1983) 8 *The Geneva Papers on Risk and Insurance* 4, 6.

4 Inge Kaul and others, 'Why Do Global Public Goods Matter Today?' in Inge Kaul and others (eds), *Providing Global Public Goods: Managing Globalization* (New York: Oxford University Press 2003), 3.

5 Helmut Wilke, *Governance in a Disenchanted World* (Cheltenham: Edward Elgar 2009) argues that it is not possible for states to do so.

6 Inge Kaul and others, 'Why Do Global Public Goods Matter Today?' in Inge Kaul and others (eds), *Providing Global Public Goods: Managing Globalization* (New York: Oxford University Press 2003), 11.

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arise from the complexities and interconnections caused by liberalisation and the expansion of private transactional freedoms. Hence, financial stability is a 'framework'-type public good which is enjoyed by all in order to further private aspirations and utility. The intrinsic transactional nature of financial sector activity means that the regulatory space is replete with diverse actors. Kaul and others point out that these diverse actors, including regulators, are all responsible for the production and consumption of the same public goods. Hence, the role of the state as an exclusive producer is outdated; the state's role is more that of a 'public visible hand'. The authors view the development of post-crisis financial regulation in the EU and UK as very much an extension of a new 'public visible hand'.⁷ However, the rise of this 'public visible hand' is countered by the dispersion of responsibility for governance in the new landscape. The regulated industry, which led the way in delegated and self-governance in the pre-crisis years, has been criticised for catering excessively to self-interest and supplying minimal or weak forms of governance.

Post-crisis, the industry remains an important actor in governance in financial regulation. Indeed, its leadership and authority in governance, stemming from its superior knowledge and lobbying power, is unlikely to be easily replaced. This seems to confirm Meyer and Drori's theory⁸ that governance will be dominated by knowledge-based, epistemic actors, most often collectively organised in rational forms. The post-crisis reforms show that regulators are strategically pitting other sophisticated participants and gatekeepers against the industry to encourage the emergence of more responsible forms of governance.

The quality of governance emanating from these 'alternative experts' (institutional shareholders, auditors and even credit rating agencies) remains to be seen. It may be argued that these 'other experts' are in the same industry and of the same mould and therefore unlikely to challenge industry practices.⁹ Further,

7 See the legal scholarship on regulatory law in the EU: Hans-W Micklitz, 'The Visible Hand of European Regulatory Private Law: The Transformation of European Private Law from Autonomy to Functionalism in Competition and Regulation' (2009) 28 *Yearbook of European Law* 3; Bruno de Witte and Hans-W Micklitz (eds), *The ECJ and the Autonomy of the Member States* (Cambridge: Intersentia 2012), 349; Fabrizio Cafaggi and Horatia Muir Watt, *Making European Private Law* (Cheltenham: Edward Elgar 2008); Fabrizio Cafaggi and Horatia Muir Watt (eds), *The Regulatory Function of European Private Law* (Cheltenham: Edward Elgar 2009); Roger Brownsword and others (eds), *The Foundations of European Private Law* (Oxford: Hart Publishing 2011).

8 Gili S Drori and John W Meyer, 'Global Scientization: An Expanded Environment for Organization' in Gili S Drori, John W Meyer and Hokyu Hwang (eds), *Globalization and Organization* (Oxford: Oxford University Press 2009); Gili S Drori, 'Governed by Governance' in Gili S Drori, John W Meyer and Hokyu Hwang (eds), *Globalization and Organization* (Oxford: Oxford University Press 2009).

9 Smith and Walter observe that 'gatekeepers', such as institutional investors and auditors, fail to keep corporations in check as their discipline is dull and plagued by conflicts of interests. See generally, Roy C Smith and Ingo Walter, *Governing the Modern Corporation* (Oxford: Oxford University Press 2006).

Cowton¹⁰ and Coffee¹¹ warn of the perverse self-interested motivations driving various experts. Hence, the quality of their governance may need to be monitored too.

In this book, the authors also note the concentration of governance in the hands of select groups and sound a warning against the development of elitism in financial regulation. One should not forget the strong post-crisis social criticism (e.g. the Occupy movements). McCormick¹² also argues that the engagement of wider civil society may be crucial to changing the weak ethical culture in banks and financial institutions. Social action that is based on values, justice and sentiment is not in any way less legitimate or valid than the epistemic or knowledge-based rationales supporting contemporary governance, as described by Meyer and Drori.¹³

In an age where the internet is able to bring together diverse voices and provide platforms that defy hierarchical structures and limitations on access to epistemic communities, new avenues can be explored to empower non-knowledge-based stakeholders. Blogs and wikis can bring together disparate individuals, and Wu¹⁴ has argued that collective action (such as disaster relief action) could be organised through blog participation and volunteer leadership. Further, many individuals are driven by honesty and genuine concern in the face of important social issues, so the galvanising of social voices via blogs and wikis has a lot of potential, despite some setbacks (e.g. the role of Facebook in fuelling the London riots of summer 2011). Further, McCormick also argues that there are many non-epistemic communities that have a voice and ought to be engaged with as a matter of wider governance: civil society groups, such as non-governmental organisations, the media, women's groups, faith-based organisations, think-tanks, business development organisations and academic institutions.¹⁵ In this respect, Kaul and others are of the view that as global public goods affect many, the many should be systemically enrolled in the production process.¹⁶ The possible alienation of the

10 Christopher J Cowton, 'Governing the Corporate Citizen: Reflections on the Role of Professionals' in Jesús Conill, Christoph Luetge and Tatjana Schönwälder-Kuntze (eds), *Corporate Citizenship, Contractarianism and Ethical Theory* (Surrey: Ashgate 2008).

11 John C Coffee Jr, *Gatekeepers* (Oxford: Oxford University Press 2002) generally.

12 Roger McCormick, 'Towards a more Sustainable Financial System: The Role of Civil Society Parts 1 and 2' (2012) 6 *Law and Financial Markets Review* 129 and 200.

13 Gili S Drori and John W Meyer, 'Global Scientization: An Expanded Environment for Organization' in Gili S Drori, John W Meyer and Hokyu Hwang (eds), *Globalization and Organization* (Oxford: Oxford University Press 2009); Gili S Drori, 'Governed by Governance' in Gili S Drori, John W Meyer and Hokyu Hwang (eds), *Globalization and Organization* (Oxford: Oxford University Press 2009).

14 Irene Wu, 'Using Blogs and Wikis for International Collective Action: Disaster Response to the Boxing Day Tsunami in 2004' (2010) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1644005 accessed 12 April 2013.

15 Roger McCormick, 'Towards a more Sustainable Financial System: The Role of Civil Society Parts 1 and 2' (2012) 6 *Law and Financial Markets Review* 129 and 200.

16 Inge Kaul and others, 'Why Do Global Public Goods Matter Today?' in Inge Kaul and others (eds), *Providing Global Public Goods: Managing Globalization* (New York: Oxford University Press 2003), 6.

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broader social dimension may perpetuate a form of elitism in governance, which could affect the substantive purposes of financial regulation. Governance capacity is now diffused among more actors (e.g. investors, custodians, gatekeepers, such as auditors, and the mighty financial industry itself).¹⁷ The diffusion is arguably well-known but the definition of governance capacity depends on empirical observation of the incentives driving these actors and discussion of how regulatory design may influence their incentives.¹⁸ There seems, however, to be a certain reluctance to move towards wider stakeholder participation in the policy development of financial regulation; this is a weak feature of post-crisis reforms.

This book also argues that the rhetoric surrounding the 'public visible hand' of regulatory resurgence is perhaps stronger than the actual achievements of the new substantive reforms. Chapters 6 and 7 point out that although the EU has ushered in sweeping reforms to subject hitherto unregulated sectors (such as credit rating agencies and alternative investment fund management) to regulation, these regimes have focused largely on well-trodden investor protection issues and rather than dealing more closely with systemic risk. Chapters 12 and 13 also show that micro-prudential regulation and risk management are subject to meta-regulation and still very much dependent on firm implementation, although it is intended that regulatory supervision should become more intensive.

It may be argued that the change in the tenor of regulatory supervision to one of pre-emption and judgement-based supervision allows regulators to take more discretionary action based on public interest objectives. For example, Chapter 11 has discussed structural reforms as being a highlight of pre-emptive and public interest-based regulation in order to mitigate the catastrophic social consequences of SIFI failure. Part 4 also shows that regulatory resurgence in the rise of macro-prudential supervision empowers central banks to utilise a wider and more pre-emptive suite of regulatory tools to safeguard financial stability. However, pre-emptive judgements in this area are not free of mistakes and not necessarily free of possible negotiation with the regulated in the supervisory process.

The post-crisis landscape shows that responsibility for governing the financial sector and managing its risks – which have far-reaching effects upon the real economy – remains diffuse. Regulators have reinvigorated the public good narrative of financial stability but many substantive law reforms continue down well-trodden paths and truly revolutionary reforms (such as structural separation) are still works in progress.

17 Helmut Wilke, *Governance in a Disenchanted World* (Cheltenham: Edward Elgar 2009) argues that this is ideal given the nature of the financial sector as a sophisticated and complex knowledge-based system.

18 Dino Falaschetti and Michael J Orlando, *Money, Financial Intermediation and Governance*: (Cheltenham: Edward Elgar 2008), arguing that understanding incentives in regulatory design is of paramount importance. Smith and Walter however warn that private commercial interests generally go against the incentives required to achieve sound forms of 'governance' and discipline, see generally, Roy C Smith and Ingo Walter, *Governing the Modern Corporation* (Oxford: Oxford University Press 2006), 19; Ulrich Beck, *World At Risk* (Ciaran Cronin tr, Cambridge: Polity Press 2009).

Beck predicts that in a world of ‘organised irresponsibility’, a transnational cosmopolitan movement will arise to challenge private spheres of responsibility to become more cognisant of and accountable to social demands. However, in the post-crisis era, the rupture of such ‘organised irresponsibility’ has not taken place. The financial sector continues to operate at a sophisticated distance from the social platform. This may be due to the stronghold on power that the industry has maintained over governance¹⁹ or it may be due to the inherent ‘ungovernability’²⁰ of such a sophisticated and complex sector (i.e. the sector is not easily penetrable unless equipped with the relevant expertise). The regulators’ increased partnering in governance with other sophisticated parties in the financial sector (such as institutional investors or custodians) is likely to perpetuate an elitist circle of participation. Moreover, this limited circle could affect the way ‘financial stability’ is understood and managed.²¹ There is likely to be continued exclusion of the social sphere from governance, which is not ideal. Any social discontent outside of the relatively impervious financial sector system is a symptom of the artificial closing of systemic boundaries of participation. Such boundaries may be forced open in due course when confronted with normative arguments.

Responsibility for the future of financial regulation is a contested space featuring the interests of different stakeholders. As the rise in the importance of the objective of financial stability has refashioned the ‘public visible hand’ in finance, the opportunity for ‘financial stability’ to be conceptually developed to factor in social needs should also not be wasted. The regulator’s ultimate responsibility should be to restore social utility, accountability and credibility²² in the global financial system.

19 Beck has also more recently claimed that the euro crisis has precipitated a transformation of European governance: ‘Thus the threat to the euro has uncovered a novel, autonomous source of legitimation of a form of political action that aims at the political transformation of society and politics as found hitherto in the nation state. The conflict between supporters of nation-state orthodoxy, who wish to keep politics within the existing rules, and the Europe builders, who advocate rule changes, is fed by the clash between actions that are “illegitimate but legal” and those that are “illegal but legitimate” and whose legitimacy is derived from the urgent need to ward off imminent dangers. This emergency politics is illegal to the extent to which it undermines existing nation-state democracy. The impending catastrophe empowers and even forces the Europe builders to exploit legal loopholes so as to open the door to changes that are in fact ruled out by national constitutions or European treaties.’ Ulrich Beck, ‘Europe at risk: the cosmopolitan turn’ (‘Debating Europe’ conference, European University Institute, Florence, 31 October 2012), presenting the analysis in Ulrich Beck, ‘The Cosmopolitan Perspective: Sociology of the Second Age of Modernity’ (2000) 51 *British Journal of Sociology* 79.

20 Mark Mazower, ‘Europe Raises Spectre of Ungovernable World’ *The Financial Times* (London, 25 May 2012).

21 Capture of regulators and the regulatory process is subject to new analysis and theorising. See, for instance, Stephen P Croley, *Regulation and Public Interests: The Possibility of Good Regulatory Government* (Princeton, NJ: Princeton University Press 2008). The crisis is taken into account in the most recent literature: Stephen P Croley, ‘Beyond Capture: Towards a New Theory of Regulation’ in David Levi-Faur (ed), *Handbook on the Politics of Regulation* (Cheltenham: Edward Elgar 2011); Daniel Carpenter and David Moss, *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (Cambridge: Cambridge University Press 2013).

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