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Regulatory experiences in the UK and the Nordic
countries: a review of the literature

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Abstract: Since deregulation in the 1980s, all advanced countries have gone along the same route increasingly shaping their financial regulations according to principles and theoretical models set out by global standard setters. Structural fragilities, failures of regulators, and short-sighted supervisors are characteristics most of them share as the heated theoretical debate about the lessons coming out of the recent crisis has shown. However, specific differences between countries are still important, especially as regards the economic, cultural, and political differences which have given rise to dynamic interactions between regulation, the shaping of financial systems, the business models used by financial firms, and the degree of financial deepening.

In the literature on financial regulation, the experience in the UK and in Nordic countries represents two particularly important chapters.

Banking and financial regulation in the UK has traditionally been taken as a model for the rest of the world. Many of the most hotly debated questions in the literature regarding the bases of financial regulation – such as discussion between rules-based and principles-based regulation, the related issue of light-touch versus heavy-touch regulation, the relations between central banking and prudential supervision, and the different institutional regulatory architectures – have started with developments in British financial regulation.

The crises of Nordic countries during the early 1990s, classified as being among the “Big Five” in the history of financial crises from the post-War period, are stark confirmation of

the difficulty for regulators and supervisors of dealing with the risks which arise during the transition from tightly regulated to competitive and internationally open financial systems. On the other hand, the regulatory solutions for crisis management adopted by the Nordic countries are still considered as one of the few examples of successful crisis resolutions, in terms of comprehensive and in-depth interventions and appropriate balancing of systemic fiscal costs with moral hazard.

The present work is divided into two parts: the first presents an overview of the literature during the main stages of the development in banking regulation in the UK from the 1970s to date; the second part is an analysis of the main literature concerning the regulatory implications of the 1990s crises – in Finland, Norway, and Sweden – from when they broke out until their resolution.

Key words: financial regulation, banking regulation, deregulation, bank crisis management and resolution, United Kingdom, Nordic countries

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Part I

Financial regulation in the United Kingdom: a review of the literature

1. Introduction

Before the current financial crisis, the UK financial regulatory system had an extraordinarily high international reputation. "The U.K. financial stability policy framework is at the forefront internationally in many respects... The quality and effectiveness of financial sector supervision in the U.K. is strong in the banking and securities area" (IMF, 2003, pp. 9-11). With such a reputation as this, the United Kingdom has exerted considerable influence over the years on financial regulation, both at world level – with the particularly incisive participation of British supervisors in the work of the Basel Committee on Banking Supervision (BCBS) – and within the European Union.

The first Basel Accord came about mainly as a consequence of joint initiatives by the Bank of England and the Federal Reserve System. With only few changes this framework introduced a previous agreement between the two countries, codifying at international level the Capital Adequacy model adopted in 1980 by the Bank of England. Indeed in the years after Basel I in 1988, capital requirement was often defined in the literature as the "Cooke Ratio," after Peter Cooke, Chairman of the Basel Committee, who at the time served as the highly respected Head of Banking Supervision of the Bank of England (Bank of England, 1987 a) and b); Hall, 1989; Kapstein, 1991; Hall, 1992). With new international standards, the UK regulatory system was also destined to undergo profound changes. However, the UK was ready before other countries to take leadership in coordinating regulatory responses to the challenges thrown up by the spread of international banks. Starting in the early 1980s, London began to speak on behalf of international concerns trying to prevent systemic collapses caused by banking globalisation. The definition of common approaches and standards also became a way for international banking centres to compete against one another, and London's position as the key global financial marketplace became crucial (Picciotto and Haines, 1999). As Moran shows in his clear analysis (1991) of the UK

“financial revolution” during the 80s, Britain’s skill in influencing global financial regulation was always seen as a source of comparative advantage.

The same sort of things can be said for the relationship between the UK regulatory model and the EU one. By the late 1970s, many reforms to the British regulatory system arose out of the need to comply with European Union Directives. The traditional British antipathy to the expansion of EU law governing banks and financial markets can be seen clearly in many documents (HM Treasury, FSA, and Bank of England, 2005). Nevertheless, this only became an important characteristic of the UK regulatory policy after the crisis (Turner, 2009, p. 102; HM Government, 2013). A stylized interpretation of financial regulation policy throughout the EU before the credit crisis is that, whereas France and Germany were pushing for a tighter and more harmonised financial regulation, the UK was moving in the opposite direction. Actually, the important advances in the EU financial regulatory framework between 1999 and 2005, in the context of Financial Services Action Plan, had been broadly encouraged and supported by the UK. “As the EU’s only large market-based economy and with London being the location of one of the world’s most significant capital markets, during this period the UK enjoyed a position of considerable influence over the EU financial services regulatory policy design. In the boom market conditions before the global financial crisis, the success of the City of London was used in at least two ways in EU regulatory debate – to promote the British view as being the one to emulate in order to achieve similar triumphs, and to resist alternative proposals that, by not being informed by such extensive practical experience of shaping regulation to fit vibrant capital markets, risked causing wanton damage to a prized economic assets that benefitted Europe as a whole. A strong emphasis in EU policy in the early 2000s on facilitating the development of US-EU financial markets further strengthened the British position because UK regulation, a system familiar to the large US banks that had major European operations based in London, seemed to offer the approach most easily adaptable to a transatlantic environment” (Ferran, 2012, p. 11). In contrast with the stereotype which came about after the crisis, which saw in net opposition the “Anglo Saxon” financial model and regulatory approach, and the one in force

in continental Europe,¹ British regulatory philosophy profoundly influenced the shaping of EU financial regulation, especially during the period of Great Moderation before the crisis (Quaglia, 2010).

The factors which contributed to modifying the structural characteristics of the British banking system – especially from the early 1980s onwards – were seen in many EU countries, especially on the continent. The *laissez faire*-based Basel regulatory approach contributed in no small measure to reducing the differences between structures and between regulatory models used throughout financial systems in the EU. However, there can be no doubt that the transformation of the banking system due to the shift to market-based finance and the internationalisation of financial markets were much more prominent in the UK than in other countries (Mullineux, 2012; Hardie and Maxfield, 2013).

With the establishment of the universal banking model after the 1986 Big Bang, financial system in Britain assumed a countenance, which was very different from that little community of bankers, which made up that quintessentially British culture of the City of London. Interactions between the regulatory model and the financial structure, seen throughout all countries, take on a peculiar characteristic in the UK; this was due to the central importance always given to the target of promoting and consolidating London as a global financial centre. This important role has been – and in many ways continues to be (Carney, 2013) – the basis for many regulatory reforms introduced in the United Kingdom, especially from the 1980s onwards.

Unlike the United States, the British system has never placed any limits on the allowable business of financial institutions and, in particular, has never placed any barriers whatsoever upon the entry of high-street banks into investment banking. This is why, even though the UK is referred to as a market-based system like the US (Allen and Gale, 2001), this classification does not fully explain the specifics of the British financial system, or the characteristics, which led to its development. Banking is an extremely important segment of the British economy. As a proportion of the national economy, banking in Britain was, in

¹ Whyte (2011) states that “[h]owever absurd British paeans to light touch regulation seem now, there were more in common between Britain and the rest of Europe in the run-up to the financial crisis than is often recognised.”

2010-2011, second only to Switzerland among the G20 economies, and much more important than the US. Banking sector assets as a per cent of GDP totalled around 520%, partly as a reflection of the international character of its banking sector. Foreign banks hold nearly half of all UK banking assets, while British-owned banks have over half of their assets outside the country. UK banks have the largest global share of cross-border banking business in the world. The UK is also one of the most important centres for private and investment banking. The UK share of assets in the global shadow banking system (including hedge funds, money market funds and structured investment vehicles) was estimated in 2010 as around 13% of the total, much less than the 40% in the US (The CityUK, 2012). With the expansion and globalisation of the City, the largest UK banks have established themselves as major global players in securities markets and in markets for foreign exchanges and derivatives (Bank of England, 2010). With intermediation on the wholesale markets between financial counterparties greater than intermediation between household savers and corporate borrowers, the British banking system has become the typical model for so-called market-based banking, the intrinsic fragility of which was bound to emerge during the crisis (Adrian and Shin, 2010; Hardie and Maxfield, 2013).

The U.K. approach to financial regulation was an important driver of London's position as a global financial centre. Although during the 1970s the UK abandoned the self-regulation system in force before City globalisation, the implementation of the later statutory regime retained many of the traditional characteristics of the old regime (Tomasic, 2010). Until the financial crisis, the superiority of light-touch, principles-based approach to financial regulation was claimed as key factor in the success and international prestige of the British system (Furse, 2006). According to this approach, the purpose of financial regulation must be to "facilitate economic activity in the private sector, and to promote wealth creation by providing a framework of rules within which economic actors can operate confidently. In our view that means, as far as possible, a light touch. It argues for an approach based on the principle that market participant can do what they want unless we say that they can't, rather than that they can only do what we say they can." (Davies, 1997, p. 111). Many theoretical and empirical articles spoke of this greater efficiency in terms of the collective

benefits of market-friendly regulation. The flexibility given by the discretionary implementation of principles by supervisors allowed the rapid adaptation of rules to market changes and consumer needs; the reliance upon market discipline and stronger models of governance of financial institutions helped optimise individual risk-taking and the efficient allocation of resources, thus encouraging stable growth at aggregate level (Llewellyn, 1999; Rajan and Zingales, 2001; Beck, Demirgüç-Kunt and Levine, 2003; Barth, Caprio and Levine, 2004). It is no surprise that the principles-based approach to financial regulation was also considered by the banking industry has a model for “better regulation” (IIF, 2006). The effects of the crisis in Britain have shown the failure by the supervisory authority to enforce the broad discretionary powers allowed by principles-based regulation. The association between light- touch regulation and the vulnerability of financial systems has now been largely accepted not only by comparative studies into which institutional factors contributed to the crisis (Tonveronachi, 2010; Dalla Pellegrina and Masciandaro, 2011), but by British regulators themselves (Turner, 2009). After the crisis, the view that focused on economic benefices arising from the growth of the financial sector, has been radically reconsidered (Haldane et al, 2010; Beck et al, 2014): as Turner clearly argues (2010), some of the activities performed by the UK financial sector do not provide any economic value and are not welfare enhancing. It is, however, not clear, whether the broad UK regulatory reforms brought in to deal with the crisis can be seen as a radical departure from previous policies and practices (Lastra, 2013).

The purpose of this first Part is to present a review of the literature on the UK financial regulatory system. This review will refer to the main developments in the British regulatory system, starting with the early 1970s and focusing mainly on banking regulation. The term “regulation” is used to describe the regulation/supervision system, because the border between regulatory and supervisory tasks is blurred due the large rule-making powers delegated by informal tradition and/or by law to supervisory bodies. In the second section, I shall analyse the passage from self-regulation to statutory supervision. The third section will illustrate discussion about the process of deregulation during the 1980s, which culminated with the so-called Big Bang. The fourth part deals with reforms to institutional

architecture and the creation of a single regulator. In the fourth section, we shall look briefly at those regulatory reforms brought in after the crisis and analyse the most important writings about retail banking ring-fencing, that peculiarly British solution to solve the crucial issue of too-big-to-fail. Finally, I should like to draw a few conclusions.

2. From self-regulation to statutory supervision

Towards the end of the 1960s, the UK banking sector consisted of three main groups: deposit banks, dominated by the London clearing banks and the discount houses; the secondary banks, a mixed sector including the foreign and overseas banks, the accepting houses, subsidiaries and associates of the deposit banks, set up for Eurodollar market access, the investment or merchant banks; and other deposit-taking institutions (the so-called "fringe banks"); and the building societies and saving banks, specialised in mortgage lending. Deposit banks were the fulcrum of UK domestic retail banking. They played the main part in operating the UK payment system. Because of their role in providing the money transmission services, they maintained high ratios of cash reserves and liquid assets to gross deposits by convention and by official prescription. The required minimum ratio for liquid assets (set at 28% at the end of the 1960s) was satisfied mainly by money lent out at call and short notice, largely Treasury bills and commercial bills. Beyond these requirements, funds were either invested in securities, mainly gilt-edged stock, or were lent in the form of advances. The ability of deposit banks to expand advances was constrained not only by liquidity requirements but also by direct controls on lending applied by the government, mainly in order to oblige them to provide finance for the public sector. The role of discount houses was to provide a link between the deposit banks and the Bank of England, by serving as a channel for the interchange of bank funds as well as providing access to the Bank of England as a lender of last resort. They were the major operators of the sterling money market. The secondary banks accounted at the end of the 60s for about one third of total deposits in the UK. They were predominantly engaged in wholesale activity, in the underwriting and placement of securities in the international markets, asset management, and financing the property market. Their liabilities were mainly large money

market deposits, both in sterling and in foreign currencies, these coming mainly from overseas residents (the Eurodollar market), time deposits and short-term notes (Bank of England, 1968; Bank of England, 1969; Revell, 1973).

Until the Banking Act of 1979, the UK had no overall banking law. Although this role was not formally recognised to it, the Bank of England was generally accepted as the authority responsible for banking supervision and prudential regulation. The Bank's role as supervisor in terms of the degree of supervision and the range of institutions covered had developed "naturally," as market changes had arisen and was very narrowly focused on the operational need of central banking (Bank of England, 1975; Bank of England, 1987c). There was not even any general-purpose definition of what comprised a "bank." Instead, there were many statutory instruments, according to which specific aspects required official authority or certification, and several lists of institutions were regarded as "banks" for purpose of different Acts. There were therefore no entry controls based upon prudential criteria: instead, there was a process of "progressive recognition" by the Bank of England and by the community of banks, similar to a "cursus honorum." As Hall explains (1999, p. 4), the later "status ladders" could be climbed by banks as their reputation and financial expertise grew. For the investing public, "certification" arising out of the registration of a bank in one of the various lists published by the Bank of England provided some degree of assurance on the quality of services offered. Comparing this certification system with the licensing one, which became law in the UK with the 1979 Banking Act, Goodhart (1989, p. 211) asserts that one advantage of the first system was to encourage banks in the process of "learning by doing." This virtue was in line with the informal practitioner-based regulatory approach of the Bank of England, according to the theory whereby gradual incorporation of banks into the system, associated with their aspiration for recognition, would set up the conditions for transferring banking authority from banks with a higher status to those with a lower status, and thus the opportunity for existing institutions to observe and penalise any deviant conduct.

Traditionally, banking supervision was of merely secondary importance for the Old Lady of Threadneedle Street: "it was an unexciting and largely dormant issue" (Bank of England,

1975b, p. 365). In the context of a very critical reconstruction of the model of self-regulation put in place after the 1973-75 crisis, Metcalfe (1986) notes that the “acceptance of the spirit of self-regulation and awareness of penalties of misconduct supposedly would made the banking system self-equilibrating. The Bank of England’s supervisory role could, therefore, be minimal. The light touch of moral persuasion, rather the heavy hand of law, was all that was needed.” According to Goodhart and Schoenmaker (1993, p. 2), before the crisis of the fringe banks in 1973-75, “the idea that the Central Bank should have a formal duty to inspect and to give regulatory orders to the other commercial banks would have been anathema both to those banks and to Central Bank.”

In a cartelised banking system, financial stability was “naturally” granted because there was so little competition. The banking community – the “club of banks”, as Goodhart defines it (1989, p. 180) – voluntarily accepted “guidance and advice” from the Bank of England because, as a “manager of the club,” it had the indispensable role of guaranteeing, during any crisis, liquidity support as the lender of last resort, and organising any rescue operations which may have been necessary, the costs of which would then be shared around the other banks in the “club.” The functions traditionally performed by the Bank of England in crisis management and resolution were, according to Goodhart, at the very basis of its informal powers as bank supervisor². Goodhart and Schoenmaker (1993, p. 3) would later use the well-known motto “he who pays the piper calls the tune” to represent this approach.

In the U.K., the traditional opposition between rules and discretion in designing supervision was thus understood as self-regulation as against statutory regulation. The first was justified by voluntary acceptance by those being regulated, and the second by statutory instrument. According to Goodhart (1989, p. 201), this distinction has often been exaggerated when analysing the British model, given that “all regulation will need to be

² The issue of moral hazard was traditionally considered less important in the UK than in other countries, e.g. the USA, because of the limited insurance cover traditionally given by the UK deposit insurance scheme, even after the reforms brought in with the 1979 Banking Act. According to Goodhart (1989, p. 212), “the terms of the insurance are so constrained, with large co-responsibility, low maxima and limits on maximum contributions, that the cost to the participants of the scheme would also seem to be strictly limited. Indeed, overall, it would seem to be a scheme with limited objectives, limited cost and, perhaps, limited justification.”

practitioner-based.” Goodhart considers as mainly naive all discussion about the “capture” of the supervisory agency by the industry to be regulated. The fundamental issue of public accountability of the supervisory body has no place in the model of “clubs” set out in Goodhart’s seminal analysis of UK self-regulation (McGuire, 1993).

Revell (1975) defines the supervisory approach of the Bank of England in that period as “vicarious participation” in the management of supervised banks to stress the participative and discretionary nature of UK supervision.³ Opposition to detailed statutory systems was based, according to Gardener (1986), upon a “market-oriented approach,” more worried about non-stifling initiatives and innovation, which was particularly good at guaranteeing competitive advantage for the City of London at both European and world level.

In 1971, the new credit control policy brought in by the Bank of England with its document *Competition and Credit Control* (Bank of England, 1971), began the financial deregulation and liberalisation process (Goodhart, 2014). It prepared the groundwork for the later abolition of traditional segmentation in the banking system and the disappearance of credibility in self-regulation insured in the past by the “club of banks” and by informal dialogue with the Bank of England. The episode of the fringe banks crisis (1973-1975) was not only an unintended consequence of deregulation, but also proof that informal supervision, based upon belief about banking and market self-discipline, had turned out to be lax and inefficient supervision. In an international context of rising inflation, generalised floating exchange after the fall of Bretton Wood and fast movements of capital arising out of the recycling of oil surpluses, the abolition of quantitative controls on lending and of the clearing banks’ cartel on interest rates powered an enormous expansion of intermediation on the wholesale market between primary and secondary banks. The consequent speculative property market bubble paved the way for the crisis of the fringe banks, unsupervised by the Bank of England because they were not recognised as banks (Bank of England, 1974; Reid, 1986; Metcalfe, 1986). Faced with such a serious crisis, which risked

³ The Bank of England recognised that this expression described very well the U.K. supervisory system “based on the belief that a bank is only as good as its senior management and that it is more useful to seek to influence a bank’s policy from the top than try to monitor its procedure from the bottom” (Bank of England, 1975b, p. 369).

becoming systemic, the Bank of England organised a large-scale rescue operation (the Lifeboat) for several failing fringe banks with the help of the clearing banks. The cost of this crisis for the Bank of England has never been revealed, because it acted in full independence without ever having to ask any sort of authorisation from the Treasury. Its refusal to use the deposit protection scheme⁴ was explained as a way of avoiding government intervention in managing the crisis. This episode clearly demonstrate the firm will of the Bank of England – subject as it was to the Treasury in implementing monetary policy – to remain independent of the government in her supervisory and crisis management role (Reid and Kynaston, 2003). With no public finances needed to save banks, public accountability of the “Bank of banks” would have been considered as excessive government interference in the free market (McGuire, 1993). The same degree of autonomy was exercised in August 1974, when the Bank extended its supervision to all banks and became the supervisor of the banking system as a whole “not as result of careful consideration and public debate but as a result of a spontaneous reaction to a crisis which [the Bank of England], as a central bank, [was] able to respond to” (Bank of England, 1987c, p. 381). Wilson (1977) stresses that, in the mid-1970s, increased exchange-rate risks for banks and large imbalances in international payments forced the Bank of England to intensify its surveillance of foreign banks with branches in London, and to require their parent banks an acknowledgment of their “moral responsibility” to support the foreign affiliates in any difficulties.

However serious it may have been, the fringe banks crisis would never have been enough on its own to overcome resistance by the Bank of England and banks to the shift from self-regulation to a statutory system (Cooke, 1986). The deciding factor was the requirement upon the UK to comply with the First Banking Directive 1977, which imposed the formal licensing of deposit-taking institutions operating in Britain. With the Banking Act 1979, the duty and the right of the Bank of England to perform micro-supervision over all banks were placed on a firm statutory basis. The Act explicitly lays down the requirement of supervision

⁴ Before the Banking Act 1979, in the UK deposit insurance, brought in with the Protection of Deposits Act 1963, was managed by the Department of Industry and Trade, with the purpose of providing protection for consumers of financial services (Hall, 1999, p. 4).

as a form of protection for savers (but does not mention banks or shareholders). The task of reaching stability in the overall financial system was undertaken by the Bank of England in its role as the central bank (Goodhart, 1989). A formal list was given of the financial institutions to be subject to Bank of England control, and every bank wishing to operate on the market needed to be authorised and to comply with certain criteria regarding legal form, prudence, and management judged sufficient by the Bank of England.

All banks would be required to contribute to the new Deposit Protection Scheme, managed by the Deposit Protection Board, a separate statutory body at the Bank of England, which was substantially unfunded (except for a modest one-off contribution paid when authorisation was given) and which would cover Sterling deposits by residents and non-residents. According to Goodhart and Schoenmaker (1993) this giving responsibility for managing deposits to the Supervisory Authority was something the Bank of England actively wanted as a guarantee of its independence from the government, and was one of the most controversial points of the Banking Act 1979, because this solution could easily generate moral hazard with both banks and depositors.

Even though the Banking Act gave extra formality and transparency to the British banking supervision system, its main effect – as Gardener states (1989) – was “more evolutionary than revolutionary.” The Bank of England style of supervision, based upon dialogue and flexibility, did not disappear, especially in its dealings with those banks with which it had enjoyed a trusted relationship for many years. To this end, the Bank sponsored the creation of a two-tier system of authorisation and supervision: the “recognised banks” and the “licensed deposit-taker institutions.” Only the first group would be able to call themselves “banks.” They enjoyed a high reputation and standing in the financial community, and continued to be subject to the same regime of non-statutory supervision in force before 1979. The second tier included all other deposit-taking institutions, for whom, as suggests McGuire (1993), the measures laid out in the Banking Act 1979 had been mainly drawn up. The licensed banks were therefore subject to a more careful supervision by the Bank of England, according to criteria which were more specific and more demanding than those required by the European Directive (Lee, 1979; Hall 1999). Many authors (including Norton,

1991 and Quinn, 1991) agree that, in spite of a more formalized approach to banking supervision necessary to bring Britain in line with the European Directives, the informal manner of banking supervision applied in the United Kingdom did not really change after the Banking Act 1979 (and the same is also true for the Banking Act 1987).

The 1984 crisis at Johnson Matthey Bankers (JMB), which was a fully recognised bank, showed up the limits of this two-tier system of authorisation. JMB was a banking subsidiary of one of London's largest bullion dealers: the systemic risks which its insolvency could have given rise forced the Bank of England to rescue the bank. As the Bank openly stated, during this rescue operation it acted as a central bank in the interests of systemic stability and not as a supervisor, where the failure of a non-viable bank ought to have been accepted as positive so that the moral hazard could be avoided (Bank of England, 1987c). Discussions on potential conflicts of interests between central banking and banking supervision – which would become a constant in the development of institutional supervision architecture in the UK – began with the JMB affair.

The JMB affair forced a revision of the Banking Act 1979, leading to the Banking Act 1987 (Bank of England, 1984; Hall, 1999). The new Banking Act did not make many substantial amendments to the 1979 Act; it merely confirmed depositors' protection as the main purpose of banking supervision. It also replaced the two-tier authorisation system by a single list of authorised institutions, and widened supervisory powers given to the Bank of England (especially for approving prospective shareholders and to require information from institutions and their officers, managers, controllers and external auditors). In order to assist the Bank in the fulfilment of its duty, the Act granted important statutory powers to the Bank of England Board of Supervision. New provisions were brought in regarding the role of auditors, who were authorised to disclose information to the Bank of England without contravening their duty of confidentiality to clients.⁵

With the new Banking Act 1987, the Bank of England wanted to continue enjoying those powers she had been granted, with no limits placed upon its discretion when applying

⁵ The right of auditors to communicate with the Bank of England was replaced by a duty to do so only in the aftermath of the BCCI affair. As Hall (1999) and McGuire (2003) stress, for day-by-day supervision the Bank of England traditionally preferred not to use the inspection-based approach, and instead went for an analysis of reports by external auditors.

them. The prudential criteria which banks had to comply with to be authorised to operate (adequate capital, liquidity, provisions, accounting records and internal controls etc.) were defined, not by applying the same precise rules to all banks, but rather by “Statements of Principles,” periodically updated through negotiations between the Bank and commercial banks (Bank of England, 1988).

“That the Banking Act says little about the standards we require banks to observe is deliberate vagueness. To specify in legislation the way in which capital and risk should be measured; how various financial instruments should be treated; the control systems banks should use; the amount of capital they should have; and so on: all that detail would be both clumsy and inflexible. In some minds, of course, flexibility is only one step away from weakness and inconsistency. We remain convinced, however, that flexibility is essential to effective and fair supervision. To apply capital ratios, exposure triggers and all the other tools of supervisory control in a rigid, mechanical fashion, with no regard to the particular balance of each bank's business or the experience of its management, would be to impose on banks an inappropriate degree of regimentation. What is more, it could also do damage to the banking system as a whole: too great a degree of uniformity would tend to create a banking community less well able to withstand systemic shocks, just as a genetically homogeneous population can be vulnerable to disease. So, while the principles we follow and the measurement techniques we use are now applied equally to all banks, we do not regard uniformity in their precise application as a desirable objective. Banks are individual and should be treated as such” (Bank of England, 1987c, p. 382). The “quality of management,” rather than adherence to prescribed prudential rules, was still the nebulous benchmark for the judgment of supervisor.

3. The Big Bang and financial deregulation

As Plender states (1999), the Big Bang is the best term to define two significant deregulation measures: the abolition of monopolised fixed commission on securities transactions and the removal of barriers to foreign entry into the stock exchange that until then had been constituted as a “private club.” These reforms, according to their strongest

critics and their most enthusiastic supporters, were considered as emblematic of Mrs Thatcher's Conservatism. According to Miller (1989), they contributed to turning London into one of the engines of financial globalisation and, at the same time, they radically altered the financial landscape in the UK.

The removal of foreign exchange controls in October 1979, mostly undertaken to strengthen the role of the City in the world's financial markets, had exposed the domestic financial system to international competition. The Big Bang was the deliberate response of the government and the Bank of England to the competitive threat coming from changes to the structure of international market securities, and by the progressive lowering of home bias in the portfolio holdings by British residents.

Traditional segmentation in the British banking system in its three main sectors, commercial retail banks, investment (or merchant) banks and UK offices of foreign banks was already in decline since the 1970s. According to Blair (1994), this tendency – which was only emphasised by the Big Bang – did not actually start with deregulation because there had never been any rules in the UK covering allowable activities for banks: it was a spontaneous trend towards rationalising and transforming management models, encouraged by the authorities and by the Bank of England in particular, especially direct to give a competitive advantage to clearing banks. Indeed, clearing banks had progressively increased their share of medium and long-term finance, and were increasingly providing investment banking services, mainly in corporate financial advice, capital issue facilities, investment management, and loan syndication. The blurring of boundaries between the various segments of the financial services market had accelerated, especially after Competition and Credit Control came into force. In the same way, Hingham and Thompson (1993) remark that UK financial deregulation brought in after the Big Bang did not come about with the abolition of restrictions upon the business open to financial institutions, but rather from the disappearance of market entry barriers to home-based and international competitors. Restrictions upon conducting securities business by banks were not the consequence of any legal regulations (such as the Glass-Steagall Act in the United States), but rather of the rule book for members of the Stock Exchange to protect them against

competition: fixed minimum commissions; the single capacity rule, which required there to be a separation between brokers and the so-called jobbers (dealers and market-makers); the requirement that brokers and jobbers should be independent and not part of any financial group; the exclusion of all foreign from stock exchange membership⁶.

Foreign securities firms, especially American, Japanese and Swiss, did business in London, but not on the UK domestic securities' markets (from which they were excluded because of the Stock Exchange rules), but in the Euro-market. The City, thanks to the Euro-market, was still a major international centre, although it was split into two artificially divided segments: major international business was dominated by large foreign institutions, and the small domestic market, on the other hand, was dominated by under-capitalised British institutions. Especially after the abolition of foreign exchange controls, the weakness of the domestic financial services industry had made their reform inevitable, to avoid the risk that on the domestic securities market the City became a sclerotic second-class financial centre in a world of rapid change, and that the most lucrative deals were closed by foreign investors or tended towards other international financial centres such as New York, Tokyo, or Frankfurt (Bank of England, 1985; Gower, 1988; Lawson, 2006).

With the Big Bang, the ownership rules were amended to allow single non-member (national or foreign) to own 100% of capital of a member-firm; minimum commissions were abolished and dual capacity was introduced.⁷ Although the Big Bang deregulated the stock market, its impact on the structure of the British financial system was enormous and very rapid. By late 1986, half of the over 200 Stock Exchange member firms joined American, British, and European finance groups, banks, or investment companies. "In one-step change banking and securities business was combined within newly established financial conglomerates and the separation of these activities which had characterized the UK

⁶ Given that, unlike other countries (such as the USA), there was no large over-the-counter market in domestic securities in the UK, membership of the Stock Exchange was a necessary requirement to provide services as a broker or a dealer (Gower, 1988).

⁷ Peeters (1998) states that, actually, the Government only required members of the Stock Exchange to dismantle the minimum commission system, in stages, by October 27, 1986 (date of the Big Bang). The single capacity rule, required by self-regulation to avoid conflicts of interest, became unsustainable without fixed commissions. With the introduction of negotiated commissions, dual capacity was admitted. To reach a suitable scale, member firms had to have free access to outside capital. This, in turn, forced the Stock Exchange to change the ownership rules.

financial services industry for three hundred years or more was abandoned” (Dale, 1992, p. 107).

The removal of barriers between business sectors which in the past had been kept separate meant that the whole regulatory structure needed to be reorganised. As stated by Gower (1988), the scholar who more contributed to the new system, the Financial Services Act (FSA) 1986, the second leg of Big Bang, came into force to deal with different objectives than the Big Bang. The original purpose of the FSA was to draw up conduct-of-business regulation of the securities industry for the protection of investors. In 1981 a series of financial scandals showed that the existing regulations for fraud prevention and against conflicts of interests by investors had become obsolete and more or less ineffective (Pimlot, 1985).⁸ In addition to fighting financial crime and to protect the reputation of the City, the intention was to adjust the legal regime of the investment industry to European law, designed to further the process of harmonisation of company and securities law throughout the EEC.⁹

The FSA, as also the Banking Act of 1979, was a classic example of prudential re-regulation following on from structural deregulation. Blair (1994, pp. 95-96) highlights that the FSA was the result of a compromise between pressure from the industry, which was afraid of over-regulation, and the setting up of a control body very like the American SEC on the one hand, and, on the other, pressure from both the general public and Parliament, who were afraid that industry interests would prevail over consumer protection by eliminating those rules which, in the past, had protected them against conflicts of interest. The regulatory system which came about was “too complicated both in terms of structure and in terms of the body of regulatory law itself... Experience has shown just how difficult is to devise a system which does not over-regulate the industry, but at the same time does not under-protect the investors. It is doubtful that the right balance has been achieved.”

⁸ Basically, the Prevention of Fraud (Investment) Act was consolidated in 1958 to take account of a few minor amendments made from time to time, but it remained substantially the same as the 1939 Act.

⁹ Directives 79/279/EEC, 80/390/EEC, and 82/121/EEC imposed disclosure obligations for the initial listing of stock, ongoing disclosures requirements of listed companies, and to each member state to have a “competent authority” to enforce the necessary requirements. For an analysis on the impact of these European Directives concerning the securities and banking industries, see Creaven (1992).

The FSA brought in a prohibition on working in the investment business without prior authorisation. Banking activity, at least the taking of deposits and making credit, was subject to control by the Bank of England; its securities, underwriting, corporate finance, and investment management business were subject to the FSA.¹⁰ A new regulatory body was set up, the Securities and Investment Board (SIB), with Chairman and Board Members jointly nominated by the Treasury and the Governor of the Bank of England, but incorporated as a private company. With such an ambiguous legal status, the SIB was conceived as the watchdog of the system rather than as the body which licensed and directly regulated the investment firms. The chain of public accountability of the SIB was limited by its nature as a private body, financed by levies on market participants. The Treasury was the Government Department with responsibility for regulation of the financial services industry; however, it did not exert this control directly but by delegating powers to the SIB.

The differences between this system and, for example, the American SEC, are very clear,¹¹ as were concerns about reassuring the industry with a “practitioner-oriented” regulatory system. Consistently with the principles of self-regulation, licensing functions were primarily assigned to the so-called “Self-Regulatory Organisations” (SROs), trade organisations which had to be recognised by the SIB. These SROs, financed and managed by subsidiary companies, acted as second-level regulators of their shareholders, in line with their own rule book, drawn up according to a set of model rules developed by the SIB. The regulatory style was therefore “self-regulation within a statutory framework.” Moran (1988) states that, in spite of the government’s declared intent to ensure higher levels of

¹⁰Clearing banks, gild-edged market makers and all financial institutions listed by the Bank of England operating on the wholesale money market, the exchange market, and on the bullion market, were not required to be members of SROs, usually compulsory for an investment business. According to Peeters (1988), these exceptions were an attempt at minimising regulatory overlaps by adjusting the boundaries of supervisory responsibility.

¹¹ Indeed, the SEC was set up according to a Statute which laid down its powers, answered to Congress, and whose board members were appointed for five years by the US President upon the advice and with the consent of the Senate. The SEC is government funded, and its budget must be approved by Congress. As the Bank of England notes (1986, p. 72), the institutional differences between SEC and SIB reflect the cultural differences between the two countries, and in the UK these are the consequence of a long tradition of regulation by consensus. “Our experience suggests that a practitioner-oriented system can achieve all that a lawyer-oriented one can achieve, and more besides.”

competitiveness, to protect the industry from political control, and to keep regulation simple and informal, this reform actually gave rise at the same time to powerful corporatist institutions (the SROs), a growth of political intervention in the industry, and more formality and complexity in regulation.

The prudential issues arising from the fusion of banking and securities business are the most critical aspect of the reform. The financial conglomeration deriving from changes to ownership rules brought about a real structural revolution in the UK finance system, the dangers of which the Bank of England understood perfectly well partly because the change came about so rapidly (Bank of England, 1985). In a speech in October 1986, the Governor of the Bank of England set out his fears. "What would be the consequences of the failure of an undercapitalised investment house? Contracts could be reneged upon; stock could be dumped on the market, and these developments alone might well threaten the viability of other intermediaries. There will be firms that are part of conglomerate groups; their difficulties could well split into the other markets. It is unlikely, given the large sums involved and the position of the banks in the payment system, that commercial banks could remain wholly immune. Banks may be vulnerable because they have built up large exposures to securities businesses (whether or not associates). Those with subsidiaries engaged in securities business will also feel the practical obligation (based on market expectations) to their securities subsidiaries far in excess of the amounts of facilities granted. Such considerations may mean that a bank within a financial conglomerate may be particularly exposed to contagion and a loss of confidence" (taken from Dale, 1992, p. 108). The approach implemented by the UK with the Financial Services Act 1986 and the Banking Act 1987 began to look like a sort of functional regulation. Under the functional approach, each type of business has its own functional regulator and supervisor. If a financial group were engaged in banking and securities activities, the SIB was responsible for regulating and controlling business authorised under the Financial Services Act 1986 and the Bank of England was responsible for supervising the banking activities of the group authorised to undertake such activities under the Banking Act 1987. Faced with the possibilities of contagion, a crucial policy issue was, as Dale (1992, p. 108) reminds us, whether to put in

place strict firewalls of the kind imposed in the U.S. The criterion implemented by UK supervision of banks' general securities business was based upon the assumption that risks were inseparable, and the policy should be that a parent bank had a moral obligation to stand behind its subsidiaries to cover losses, even beyond the requirements of their limited liability (Bank of England, 1985b). The division of responsibility of supervisory tasks between the Bank of England and the SIB depended upon group structure. A bank's securities business was supervised by the bank regulator if conducted by the bank itself, and by the securities regulator if conducted by a separately-incorporated securities subsidiary. In the first case, the bank was subject to SIB regulation mainly in terms of the rule of conduct for investor protection, and the Bank of England became the "lead regulator," responsible for overall safety and soundness oversight. In the second case, the SIB was responsible for solvency in the subsidiary and cooperation with the Bank of England, as the consolidated supervisor, came under "supervisory colleges."

The main rationale of this solution, as Gower (1988) explains, was that a single technically expert regulator would have applied consistent rules to same activity, regardless of the entity in which it was conducted. Under this approach, at least in theory, regulatory arbitrage should have been avoided.

Discussions about the advantages and disadvantages of these separate supervisory approaches are still ongoing today (Group of Thirty, 2008). At the time, the UK regulatory arrangements after the Big Bang were judged by some as the best model to be implemented to deal with the challenges caused by increasing integration between different sectors in the financial industry. Others, though, considered them as a solution not consistent with the regime in which risks are assumed to flow freely between different parts of the group. Peeters (1988) argues that the UK statutory-backed self-regulation organized along functional lines contains good incentives for encouraging cooperation between separate regulators in the exercise of their function and powers. According to his conclusions, the British example is an argument in favour of a repeal of the Glass-Steagall Act in the USA. Thinking along the same lines, Friedman and Fries (1982) argue that a functional supervision approach – such as the one implemented in the UK – not only is

more efficient in terms of financial stability, but provides a mechanism for creating a “level playing field.” Schooner and Taylor (2003), after approval was given to the Gramm-Leach-Bliley Act in 1999, assert that financial modernisation in the UK after the removal of structural constraints which divide financial markets, became an incentive and an example for regulatory modernization in the United States. Kay and Vickers (1988), on the other hand, state that conduct regulation as set out in the FSA was not compatible with prudential regulation, because the objectives of investor protection are not necessarily consistent with the objectives of safety and soundness for banks. Gower (1988, p. 21) also recognises that the main problem with the system brought in by the FSA is that large financial institutions are subject to control by several regulators, each of which has different objectives and regulatory styles: the Bank of England “still prefers to regulate informally by a raising of the Governor’s eye-brows which is clearly not the way intended by SIB. There will need to be close collaboration between the Bank and the SIB notwithstanding that their view may diverge since Bank’s inclination will be to protect depositors and SIB’s the, possibly conflicting, interest of investors.” A more critical position is taken by Dale (1992, p. 111 ss.), who stresses a crucial problem with implementing functional regulation, i.e. the way the Bank of England supervised multi-function banking groups.¹² Interpretation by the Bank of England of its requirement to provide consolidated supervision, as set out in European law with the Consolidated Supervision Directive of 1983¹³, was actually very peculiar, even though this was due to the vagueness of the rules in the Directive itself (Hall, 1999, p. 101). According to the Bank, consolidated supervision did not require the consolidation of financial statements of different entities belonging to a group. “In order to minimise duplication and possibly conflicting supervisory requirements, the banking supervisors will have regard to the supervision carried out by other UK supervisory authorities... The presumption must be that the supervisor of, for example, a

¹² The main tool for avoiding contagion between different parts of the group were the rules covering large exposure; although they were in line with the Large Exposure Directive (91/121/EEC), they were still much less stringent than those for non-bank clients. The purpose of these rules was not to limit financing by the parent bank to its subsidiaries, but to ensure that any such financing was granted at market conditions (Hall, 1999, p. 109).

¹³ Directive 83/350/EEC

securities company is the best judge of the adequacy of its capital. The Bank will not generally expect to have to make an independent quantitative assessment of the capital adequacy of group companies which are subject to detailed supervision by other UK supervisory authorities... The Bank will not, therefore, normally require group companies undertaking an investment business and supervised by another supervisory body to be included within the bank's consolidated statistical returns..." (Bank of England, 1986b, p. 85). The limits of such a lax approach to consolidated supervision will be clearly seen in the years to come, especially after the collapse of Barings, and will be a powerful argument in favour of a single regulator as brought in by the Blair government in the late 1990s.

4. The single Mega-Regulator

Financial regulation during the 1980s and early 1990s is the story of a system which was undermined by financial scandals, and these had vast repercussions on public opinion and seriously damaged the reputation of the supervisory agencies, especially the Bank of England. Fragmentation of an institutional structure gave rise to the problem of ensuring proper supervision for multi-function financial institutions, which depended very much upon the efficiency of information sharing and upon cooperation between the various agencies.

The BCCI crisis was the first time in which the 1980s reforms could be tested at national, European, and world level. The central question raised by the collapse of BCCI was "why it took so long time for its problems to be detected and acted by banks regulators?" (Shadow Financial Regulatory Committee, 1991). Although the regulatory authorities in many countries, including the US and the UK, were clearly worried about BCCI long before it actually collapsed, as can be understood from the fact that an international supervisory college was established, this voluntary mode of cooperation proved to be ineffective. The collapse of the BCCI proved that the BIS Concordat needed to be strengthened, and that the same arrangements laid down by the European Community for sharing responsibility

between parent and host countries would have to be revised.¹⁴ The great responsibility incumbent upon the Bank of England has been clearly pointed out by Herring (1995, p. 7). He reminds us that, according to the Basel Concordat, responsibility for consolidated supervision over the BCCI group was up to Luxembourg. However BCCI did not actually conduct any sort of banking in Luxembourg, and Luxembourg did not offer the group any deposit insurance or lender of last resort facilities. “[Luxembourg] lacked the resources to monitor the worldwide operations of BCCI. It urged the Bank of England to accept the responsibility [of the consolidated supervision of the group] because the operational headquarters for the BCCI group and its largest branch network were in Britain. The Bank of England, however, was unwilling to accept the burden of supervising the global operation of a bank that it did not charter.”

After the collapse of BCCI, the whole UK banking regulatory framework began to be disputed (Kinsella, 1992). An Official Enquiry, chaired by Lord Justice Bingham, was set up. The Bingham Report (1992) dedicated many pages to a comparison between the efficiency of the British supervisory approach, which mostly depended upon dialogue with management and prudential returns by external auditors, and the American approach, based upon on-site inspections by a corps of professional examiners. The Report reached the conclusion that the traditional supervisory style of the Bank of England based upon trust, frankness, and a desire to cooperate, had not been shown as inferior to the American style, although traditional British supervisory methods were not up to the task of coping with sophisticated frauds. However, when it moved on to discuss the basic problem – i.e. whether a radical re-shaping of regulatory responsibility was needed – the inquiry gave a negative response. The option of transferring bank regulatory responsibility from the central bank to an independent body was expressly rejected. The Bank of England, although it realised the need to give more powers to bank inspectors, quoted the conclusions of the

¹⁴ The Second Banking Directive assigns responsibility for supervising soundness and solvency of a bank to the chartering country, but places responsibility for providing deposit insurance with the host country. This diversion of responsibility undermines incentives for effective supervision. The post-BCCI Directive 95/26/EC gave greater powers to the host country in its dealings with overseas banks seeking entry. In particular, the host country was allowed to prohibit corporate structures which prevent supervision, and to prevent banks from opening subsidiaries in “suspect” jurisdictions.

Bingham Report as further proof of the superiority of its own more flexible, discretionary approach (Bank of England, 1992).

After the collapse of BCCI, the years 1991-93 saw another crisis in the small banks segment: in three years, almost a quarter of all small banks collapsed due to liquidity and profitability problems associated with greater dependence upon wholesale funding (Logan, 2001). Then in 1995 came the collapse of Barings. The Bank of England was responsible as lead supervisor for the group as whole. The internal inquiry organised by the Board of Banking Supervision (Bank of England, 1995) confirmed that, in spite of difficulties in discovering this fraud in time due to a lack of internal controls and limited supervision by functional regulators, there had been large gaps in providing consolidated supervision by the Bank of England: the worst thing was the improper application of rules covering large exposures and lack of rigour in applying prudential rules on a consolidated basis¹⁵.

As well as these banking crises, there were also numerous serious crimes or large-scale violations of conduct of business standards, including the most serious of all, the pension missselling scandal, which hit a vast number of retail clients. The need, widely accepted by politicians of all colours, for enhanced protection of consumers of financial services in the UK was actually, according to Black and Nobles (1998), one of the key factors in the reforms brought in by the New Labour government when they came to power in. These financial scandals accentuated increasing public and banking dissatisfaction not only with banking supervision, but with the whole regulatory framework, considered to be excessively costly, inefficient and plagued by inconsistencies, with overlaps but also gaps. As predicted by Borio and Filosa (1994), the blurring of boundaries between banking, securities, and the insurance industry, which arose from the conglomeration of financial institutions and the loosening of functional restrictions, had made the regime inadequate. Diversified financial groups were subject to multiple authorisation and supervisory requirements applied by specialist functional regulators. Briault (1998, p. 13) underlines that in 1998 eight UK financial institutions were authorised to conduct all five of the main regulated activities (deposit-taking, insurance, securities and corporate finance, fund

¹⁵ This functional regulatory model was not up to the task, especially because there were no real measures for cooperation between relevant regulatory bodies, as stated by Hall (1999, p. 189).

management, and advising on or selling investment product to retail customers); a further thirteen were authorised for four of these activities and over fifty were authorised to conduct three out of the five. This contrasted with the situation of twenty years before, when the largest UK financial institutions were typically confined to just one, or at most two, of these activities (Dale and Wolf, 2003). Structural changes to the UK financial services sector, accelerated by Big Bang and other deregulation measures – including the Building Societies Act 1986¹⁶ – inevitably raised the question of the appropriate allocation of responsibilities between different supervisors.

Lastra (2003) points out that an important role in the UK regulatory reforms of the late 1990s can be seen in the influence of European law, which was based upon the universal banking model. In particular, the Capital Adequacy Directive¹⁷ set the minimal capital requirements for market risk using the same criteria for credit institutions and investment firms: in the UK it posed the question of how a level playing field for banks and securities firms could be maintained if this Directive were to be implemented by different functional regulators. Generally speaking, the total volume of European Directives in the field of financial regulation required UK regulators to assume tasks and meet formal standard well beyond those traditionally assumed (Jackson, 2005).

Parallel to discussions about the Bank of England's performance as a banking regulator, consensus was being reached by politicians and economists about giving the central bank monetary policy independence, "regarded as a practical consequence of new economic orthodoxy in which monetary policy is the main instrument for delivering price stability" (Ferran, 2003, p. 6; Martijn and Samiei, 1999).

A few days after the election of the Blair government in May 1997, the new Chancellor of the Exchequer Gordon Brown announced the main planks in the new reform programme: monetary policy independence was to be given to the Bank of England, and responsibility for banking supervision was to be transferred from the Bank to a new and strengthened SIB, which would also be given direct responsibility for the regulatory regime covered by

¹⁶ This statutory measure introduced important amendments to this sector, which had previously been very strictly regulated, allowing building societies to compete with joint stock banks in retail financial products (Hall, 1999).

¹⁷ The CAD (93/6/EEC)

Financial Services Act 1986¹⁸. The two-tier regulatory system of SIB and self-regulating organisations were to be replaced by a single regulator. The targets and outlines of this reform were explained by the Chancellor: “It has long been apparent that the regulatory structure introduced by the Financial Services Act is not delivering the standard of supervision and investor protection that the industry and the public have the right to expect... Simply reforming the Financial Services Act 1986 is not enough in itself. In today’s world of integrated global financial markets, the financial services industry transcends geographical and political boundaries and the regulatory responses must meet this challenge. The United Kingdom financial services industry needs a regulator which can deliver the most effective supervision in the world... ...There is therefore a strong case for bringing the regulation of banking, securities and insurance under one roof.”¹⁹

Responsibility for regulation and supervision of all parts of the finance industry were thus given to the SIB, which was now renamed the Financial Services Authority (FSA).

A Memorandum of Understanding (MoU) between the Treasury, Bank of England, and FSA was approved, which laid down everyone’s responsibilities, the chain of public accountability and what cooperation was required in emergency situations, under the Tripartite Standing Committee (Bank of England 1998a and 1998b). According to the MoU, the Bank of England was to guarantee monetary and financial stability. The FSA was to be given licensing powers and prudential supervision on banks, building societies, investment firms and insurance companies, the supervision of market conduct, and regulatory policy in matters of prudential supervision and market conduct. The Treasury was to be politically

¹⁸ Nobody can be surprised that, right from the start, the Central Bank was firmly against giving up any of its supervisory powers. The official response of the Bank of England in a press release, issued on the same day that the reform was announced, was diplomatic but resolute: “We have never argued that banking supervision for the purpose of depositor protection must necessarily be undertaken in the central bank. We have recognised that changes in financial markets are blurring traditional distinctions between bank and other financial intermediaries. Nevertheless, banks remain of special systemic importance, because of their unique role of providers of liquidity, to both depositors and borrowers, including their central role in payments and settlements, and because their resulting unsecured exposures each other make them particularly vulnerable to contagion from elsewhere in the system. For these reasons it will continue to be important under the new arrangements that the central bank is able to monitor, through the new regulatory body, the financial condition of individual institutions, as well as that of the system as a whole.” (Bank of England 1997, p. 23). Davies, who was to become the first FSA chairman, took the same line (Davies 1997 e 1997b).

¹⁹ The Chancellor’s Statement to the House of Commons 20 May 1997, available at <http://www.publications.parliament.uk/pa/cm199798/cmhansrd/vo970520/debtext/70520-06.htm>

responsible for regulation, and had to be informed of any emergencies that might cause wider economic disruption or when public support for specific operations might have been required. It was jointly responsible with the Bank of England and the FSA for deciding when the Treasury needed to be alerted. The Financial Services and Market Act 2000 (FSMA), which replaced the Financial Services Act 1986, completely ratified this new setup and replacing self-regulation with a new, fully statutory system.

According to the FSMA, the FSA was to be given four objectives: ensuring market confidence, i.e. prudential regulation,²⁰ promoting public understanding of the financial system, guaranteeing consumer protection, or the conduct of business and market regulation, and preventing and punishing financial crime (money laundering, fraud, market abuse etc.). In carrying out these purposes, the FSA was required to follow principles of good regulation as set down in law: efficiency and economy, i.e. the need to use their resources in the most efficient and economical way; the responsibility of management of authorised institutions; the proportionality principle, according to which regulation must set down duties proportional to the advantages it intends to bring about; the need for regulation not to be a hurdle to financial innovation, considered as a value to be promoted; the need to maintain the UK's competitive advantage on international financial markets; the principle whereby regulation must not distort competition between the authorised institutions (Blair, 1999).

The wide debate which accompanied this reform covered two major theoretical issues, the separation between supervision and monetary policy, and the principles of the single regulator model. In spite of the many overlaps between these profiles, I shall present the various articles in the literature separately, for greater clarity.

Separation between monetary policy and banking supervision

At a theoretical level, the interactions between central banking and banking supervision are clear: the central bank is concerned about the safety and soundness of the banking system for the implications it may have on the payments system, on the transmission of monetary policy, and on the cost of the crisis for fiscal stability. Banking supervision, for its part, is

²⁰ For a detailed analysis of the legal aspects of banking supervision under the FSMA, see Singh (2007, pp 45 et seq.).

concerned about the effects that the lending of last resort policy and the variability of interest and exchange rates may have on the liquidity, profitability, and solvency of individual banks. The balance between information flows, on the one hand, and conflicts of interests and objectives on the other, arising out of these interactions, is still hotly debated, and is conditioned by institutional, political, and market features in various countries (Lannoo, 1998; Carmichael, Fleming and Llewellyn, 2004).

Goodhart and Schoenmaker (1993 and 1995) show that issue of conflicts between the objectives of monetary policy and those of supervision, as far as adequate interest rates are concerned, is not empirically documented in an unambiguous way, either for Britain or for other countries. In an empirical analysis on several countries, they identified a few cases where the concern of a central bank for the solvency of its banks has been a major factor in an expansionary monetary policy. Possible conflict between regulatory and monetary objectives depends largely on the structure of banking and financial systems. The more such a system involves intermediaries financing maturity mismatch positions through the wholesale market, the greater such dangers of conflict are likely to be. The empirical analysis offered by these authors on the ways different countries dealt with crises showed that there is indeed a conflict between moral hazard and systemic stability, but they argue that this is inevitable in an open, market-driven system: as such, it cannot be resolved by institutional rearrangements, but must be internalised within a single authority. On the other hand, they also affirm that the main traditional argument in favour of mixing these two functions, i.e. the target for a central bank of ensuring that the costs of systemic crises are not passed on to taxpayers, has become less important with the passage of time because, with the increasing complexity of financial institutions, such costs inevitably require fiscal support. This is said to be an argument in favour of handing supervision over to an independent authority. At the same time, according to Goodhart and Schoenmaker (1998, p. 145), the increasing risk of having to ask for taxpayers' money to rescue banks explains why, after such adverse reputational effects of large supervisory failure as the BCCI affair, the very guidelines followed by the Bank of England have changed: "Whereas in the earlier years it regarded the regulation and prudential supervision as a natural, core

function, more recently it has come to view the possible devolution of this function to some other official agency with some equanimity, or even relief.”

Conversely, Di Noia and Di Giorgio (1999) admit that data on inflation rates and banking profit levels in those countries where the central bank has a monopoly on banking supervision do not give easy answers about the suitability of institutional separation. However, the authors claim that there are several factors which support belief in separating monetary policy and banking supervision other than the traditional ones about conflicts of interests. Given that it would be pointless to have a deposit insurance agency without any supervisory powers, it would be preferable, to avoid problems with moral hazards, to give both banking supervision and deposit insurance management to an agency separate from the central banks. Additionally, in countries such as the UK where the monetary liabilities of banks are relatively slight, specialisation by banks has gradually fallen, and this justifies a common regulatory agency for all segments in financial management. If this agency is the central bank, expectations of the kind of “too central-bank-supervised to fail” (p. 19) institutions could arise, and moral hazard problems could emerge. However, according to the authors the main argument in favour of separating the two functions is the problem of costing accountability: paying for supervision by seignorage and compulsory reserves, as is the case with a central bank, seems rather inefficient. Hawkesby (2000) remarks that separation between central banking and prudential supervision had been decided as a counterbalance to the independence granted to the Bank of England in implementing monetary policy, to avoid an excessive concentration of powers. He stresses the importance of synergies between central banking and banking supervision as a consequence of information about the health of the banking industry acquired by the central bank in managing the control of payments and settlement systems. Hawkesby maintains that entrusting the Bank of England with the supervision of global financial stability, in line with the MoU, has however left the field very unclear. No definition of financial stability is given in the MoU in practical terms, and there is a danger of duplicating functions as a prudential systemic supervisor and central bank, given the importance of systemic banks in the British financial system. Meyer (1999), a Federal Reserve System

governor, considers that Westminster has made “a mistake” in separating monetary policy and macro-financial stability from supervision, because of the important systemic implications of supervisory and regulatory policies. Since the ways in which markets operate are not fully understood, something which could only come about with long experience and day-to-day interaction with the banks, the ability of a central bank in managing systemic crises could be severely compromised. Abrahams and Taylor (2000) state, on the contrary, that arguments in favour of print together monetary policy and banking supervision are less convincing in financial systems such as Britain, which is dominated by financial conglomerates, in which banking is only one of the many financial activities. Continuing to give supervisory powers to the central bank may raise expectations that the lending of last resort be used to protect all creditors of financial groups, thus increasing problems of moral hazards associated with those financial institutions which are too big to fail. Hadjiemmanuil (2002) agrees that full consolidation in UK financial supervision was the necessary response to inefficiency in the previous functionally fragmented regime. With this in mind, he says that if the combination of monetary and direct supervisory functions within the central bank were unavoidable, this would significantly constrain the choice of regulatory structure for the broader financial services industry. The central bank's necessary involvement in banking regulation would turn it into the only possible candidate for the role of cross-sectorial regulator. However, there is little reason to believe that the informational advantages or economies of scope that central banks may enjoy in relation to the prudential supervision of banks also extend to the supervision of non-banking institutions, especially insurance companies. The transfer to central bank, whose primary concern is with monetary and macroeconomic issues, of the responsibility not only for prudential, but also for conduct-of-business issues, would be even less plausible. Accordingly, the acceptance of arguments for the absorption of banking supervision in the central bank would effectively exclude a move towards the full consolidation of financial regulation.

The consolidation of supervisory functions

Inefficiencies in the UK functional supervision model were accepted by most people, even before reforms were made. Much more controversial was the institutional structure implemented to overcome these inefficiencies. Although, as Briault claims (1999), countries such as Norway, Denmark, Sweden, and Japan had already gone down this route before the UK, and that other countries such as Australia were going to abandon previous functional supervisory models, no country had such broad regulatory powers in terms of coverage, scope, and discretion as was seen with the Financial Services Authority (Llewellyn, 1999). When compared with the regulatory agencies of advanced countries, the FSA was an anomaly in business-regulated diversity terms and breadth of functions, which included both prudential and conduct-of-business regulation. No other integrated financial regulator had been set up in any country with a financial system as internationally important as the UK, and most of them had a predominantly prudential focus (Taylor and Fleming, 1999).²¹ In the following years, as Jackson states (2005), the perceived successfulness of the UK model of consolidated supervision inspired many jurisdictions in the European Union and around the world to opt for this model.

Two alternatives have been at the centre of academic and policy-making attention. The first involved the alignment of regulatory responsibilities on an objective-based line, with the creation of two main cross-sector authorities, one responsible for prudential regulation of all financial institution and the other in charge of conduct-of-business regulation. The second involved the creation of a single financial regulator with cross-sector jurisdiction and comprehensive objectives, the so-called “mega-regulator.” Taylor (1995), probably the first supporter of the objective-based approach in financial regulation by means of the so-called Twin Peaks model, argues that a single regulator without a clear and well-defined mandate is in danger of becoming a bureaucratic monster. The institutional architecture of financial regulation ought to be objective-based: objectives and culture of prudential

²¹The FSMA 2000 set up the Financial Compensation Scheme, which united and replaced the various schemes existing for banks, building societies, insurance companies, and securities and investment firms, previously managed by separate regulators. The FSA was entrusted with managing the single compensation scheme, which made no distinction in coverage terms between depositors, policy holders, and investors (Schooner and Taylor, 2003, p. 332).

regulation are different, and may be in conflict with the conduct of business. Goodhart (1996) too is in favour of regulating by objectives, according to the contrast between micro prudentially focusing on investor protection and macroprudential focusing on systemic stability. Goodhart et al (1998, p. 152 et seq.) state that the alleged economies of scale which are expected from a monopolist regulator would be difficult to achieve, and there is a risk that conflict between various regulatory cultures (systemic, prudential, and conduct-of-business) may be difficult to reconcile or that one of them may be given undue powers. They also stress the problem of reputational contagion, i.e. the danger of regulatory failure compromising the reputation of an entire system and not just a part of it. They recommend the objective-based approach, where financial institutions are institutionally regulated for prudential purposes and functionally regulated for the purpose of business conduct. Llewellyn (1999) critically analyses the flexible, discretionary system of regulation used by the FSA. He affirms that the “contract regulation” model, as against a precise regulatory requirements approach applied to all regulated firms, is in line with the flexible and differentiated FSA approach to prudential regulation, which has the duty of minimising regulatory costs. According to such an approach, “the regulated firm self-selects its own regulation but within strict constraints set by the objectives and principles laid down by the regulator. Once the regulator has agreed with each firm how the objectives and principles are to be satisfied, a contract exists between the regulator and the regulated firm. The contract requires the firm to deliver on its agreed standards and procedures, and sanctions apply in the case of non-performance on the contract” (p. 49). According to Abrams and Taylor (2000), one disadvantage of the British mega-regulator is the number of targets, from systemic risks to fraud protection for individual advisers. “Indeed, rather than improving accountability, the creation of a unified regulator might diminish it because of the difficulty of designing a single set of objectives for it. As a result, its statutory responsibilities may be vague and ill-defined, which in turn give rise to problems of holding the regulatory agency to account for these activities (p. 17). Hadjiemmanuil (2000) stresses that not only has the UK brought in a single financial regulator, but also a single regulation. The FSA’s public powers include authorisation and the ongoing supervision of

financial intermediaries, the investigation of suspected misconduct, the intervention in problem institutions, the imposition of administrative sanctions, and the prosecution of breaches of the regulatory regime where these constitute a criminal offence. Its powers extend to the vetting, regulation of conduct and sanctioning of misconduct of an individual carrying on certain key function within authorised financial institutions. In carrying out these functions, the powers of the FSA go well beyond the application of statutory norms in specific cases: they include very broad and mostly discretionary policy and rule-making powers. Procedural safeguards are envisaged as a counterbalance for these vast rule-making powers – i.e. a requirement to make open consultations and to carry out cost-benefit analyses when a certain rule may bring about a rise in regulatory costs.

Nevertheless, Hadjiemmanuil outlines that “the bias of procedural constraints is in the direction of light, rather than intrusive regulation” (p. 184).

Dale and Wolf (2003) maintain that the speciality of banks, in the sense of being uniquely exposed to systemic risks, has disappeared, because their activities and risk exposures have become intermingled with non-banking activities. They give a positive assessment of the single regulator model, because it is the best way of applying prudential policy, i.e. “the importance of aligning the remit of the regulation with the risk management function of regulated organisations, so that in the case of centralised risk management of diversified activities, the regulator perspective is the same as that of management.” Commenting on the early years of the FSA, Ferran (2003) stresses that the peculiarity of the UK single regulator approach can be seen in the fact that the UK associated an integrated legal framework with the institutional arrangement for financial regulation. The FSA tried to gain credit as a single regulator, not only in its appearance but also in its essence, by emphasising its new integrated approach to regulation, the single risk-based approach to be used for all sectors, markets, and regulated firms. The risk-based approach to financial regulation means identifying hazards by the regulatory targets set by regulated firms, and dealing with such hazards by using the formal and informal tools placed at its disposal: in practical terms, these regulatory and supervisory measures are proportional to the hazards affecting both regulated corporations and regulatory objectives. Ferran then goes

on asserting that, as a consequence of this approach, the FSA gradually focused less on prudential supervision and more on the conduct of business. Jackson (2005) comes to more or less similar conclusions. He analyses the differences between the financial regulatory regime in the United States under the Gramm-Leach-Bliley Act and the UK under the FSMA. After comparing budget and staffing levels and regulatory enforcement actions by supervisory authorities in the two countries in 1998-2001, he states that the FSA allocates resources and applies more severe regulation to rule making and oversight of the securities industry, whereas in the USA more resources are dedicated to the control and regulation of depository institutions. He analyses the organisational structure of the FSA and, in particular, the division between market integrity functions (to be understood as the supervision of systemic risks) and consumer protection functions. According to Jackson, this structure is a manifestation of the FMSA's twin goals of achieving an extremely high level of protection of the integrity of markets, but it applies a lighter touch in the field of consumer protection. In many aspects, the UK crisis experience confirmed such an assessment.

The regulatory reforms, which the UK adopted after the crisis, recognise that the behaviour and the culture within banks played a major role non only in the 2008-2009 financial crisis but also in the conduct scandals such as the attempted manipulation of Libor, which undermined public trust both in the banking system and in supervisory authorities. At the same time, also the effectiveness of the protection of the integrity of the market was, however, dramatically overvalued. "One of the overriding issues ...is that many of the factors that contributed to systemic failure, with implications for the integrity of the markets, were at a more micro level considered to be efficient. For whatever reason, supervisory agencies across jurisdictions were preoccupied whit the adherence to rules that appeared to make sense at the level of individual institutions, but made less sense in the face of major shocks both to individual institutions and to the financial system as a whole. ...This would seem to have been the case in the United Kingdom, where the FSA appears not to have been concerned with systemic risk, whilst the Bank of England, though

acknowledging its responsibility for systemic regulation, had no supervisory contact with the banks” (Kern et al, 2007).

5. Retail ring-fencing as part of the UK response to the financial debacle of 2007-2008

The UK system, which was considered to be an international model for efficient regulation until the mid-1990s, showed its weaknesses during the financial crisis which hit Britain from 2007 on. The FSA, which had been “often cited by regulated entities as a model of an efficient and effective regulator, not only because its streamlined model of regulation, but also because it adheres to a series of ‘principles of good regulation’, which centre on efficiency and economy, the role of management, proportionality, innovation, the international character of financial services, and competition” (Group of Thirty, 2008, p. 29), was strongly criticised both inside and outside the UK.

The crisis showed up many regulatory failures in the legal systems of many advanced countries whose regulatory framework drew inspiration from the principles of market-friendly micro prudential regulation set out by the Basel Committee (Tonveronachi 2001; Caprio, 2013). The UK situation is particularly striking, especially in the light of the prestige its regulatory system had acquired throughout the world, and the seriousness and depth of the crisis itself. As one may read in the UK Financial System Stability Assessment undertaken by the IMF in 2011 (IMF, 2011), “The past four years have witnessed a crisis of unprecedented proportions in the UK financial sector and its regulatory framework (p. 5)...The crisis revealed major fault lines in the UK financial sector and its regulatory framework. The heavy reliance on market discipline and the assumption of a wide dispersion of risk proved to be inadequate (p. 6). ...Serious deficiencies in risk measurement were revealed by the crisis, as were the shortcomings in supervisors’ ability to identify and rectify those deficiencies (p. 39)”.

The specificity with which the crisis was seen in the UK conditioned both the analysis of its causes and the regulatory measures adopted to deal with it. The failures of Lehman and the Icelandic banks brought to light the contrast between keeping London as a world financial centre and the vulnerability which such a situation gives rise to because of difficulties with

having fully integrated supervision at global and European level. Especially in its dealings with Europe, the need was increasingly felt in the UK for some greater national focus to safeguard taxpayers against the cost of cross-border bank failures (Turner Review, 2009). These same issues are at the basis of the UK proposal to solve the problem of banks which are too-big-to-fail: “One of the reasons for ring-fencing is to allow international standards to apply to the wholesale/investment banking business of UK banks [where they tend to be global], while higher standards apply to UK retail banking [where markets tend to be national in scope].” (Vickers Report, p. 28).

The main UK regulatory responses to the crisis were the Banking Act 2009, the Financial Services Act 2012, and the Financial Services (Banking Reform) Act 2013. Their implications are still largely unknown, not just because much secondary regulation still has to become law, but also because of the many foreseeable changes which will have to be made to bring the system into line with new European regulations (Black and Hopper, 2012).

The Banking Act 2009 brought in the UK Special Resolution Regime (SRR) for failing banks, and filled a legal gap which became apparent with the difficulties encountered in finding an early resolution for the Northern Rock crisis in 2007. The UK SRR framework was mainly inspired by the approach of other countries, especially the USA (Brierley, 2009).

The Financial Services Act 2012, which came into force in April 2013, radically changed the institutional architecture brought in during the reforms of the late 1990s. The FSA was abolished and three new financial regulators created. At the same time, the Bank of England returned to centre stage in UK financial regulation – the Governor's eyebrows are back – but this has been balanced by the clear pre-eminence of the Treasury in crisis management. The approach of the single regulator has been replaced by a “Twin Peaks” model, amended by the insertion of the “macroprudential peak.” The Bank of England is now responsible for protecting and enhancing the stability of the UK financial system. The Financial Policy Committee (FPC), a semi-independent committee inside the Bank of England, is responsible for the macro-prudential regulation of the UK financial industry. Its function is identifying and monitoring systemic risks and take actions to reduce them, including making directions and recommendations to the other supervisory authorities. The

Prudential Regulation Authority (PRA), created as a subsidiary of the Bank of England, is responsible for micro-prudential prudential regulation and supervision of banks, insurers and investment firms considered “systemically important.” The Financial Conduct Authority is the organisation that has taken the legal status of the FSA and a significant portion of its previous functions: its function is protecting and enhancing confidence in financial services and markets, protecting consumers, and promoting competition; it is the regulator responsible for the conduct of business of all financial firms.²² (Conway and Edmonds, 2012).

For the third time in twenty years, the institutional architecture of financial regulation in the UK has been completely redesigned. No system has lasted more than twelve years since 1986. As Black and Hopper point out (2012, p. 20), this reform, like those which came before it, “has been driven by a combination of crisis, as markets outpace regulatory structures, and political opportunism, as each significant change in political administration brings the desire to distance itself from the old.” In such an important reform, addressing “execution risk” is perhaps the most important challenge for the British financial authorities (FSB, 2013).

The Financial Services (Banking Reform) Act 2013 was passed in December 2013; secondary legislation is expected to be completed by 2015, and it will probably not come into force before 2019. With several non-marginal innovations, this Act implements the main recommendations of the UK Independent Commission on Banking (ICB), set up in 2010 to make recommendations for creating a more stable and competitive basis for UK banking in the longer term. The proposals drawn up by the Commission in its final report (Vickers Report, 2011) are based upon the principle whereby the right policy approach for UK banking stability requires both structural reform and greater loss-absorbing capacity. The structural reforms are intended to bring together two main targets: first, to solve the too-big-to-fail problem, making it easier and less costly to resolve banks that get into trouble and credibly restricting the reach of public creditor guarantees to insured

²² The Financial Services Act 2012 partly amends the Banking Act 2009, extending the ability of the relevant authorities, i.e. the PRA, the FCA and the Treasury, to place some “systemically important entities” (mainly investment firms and central counterparty clearing houses) under the special resolution regime.

depositors; second, to help insulate retail banking from external financial shocks, including by reducing problems arising from global interconnectedness. These goals, according to the ICB, are “wholly consistent with maintaining the UK’s strength as a pre-eminent centre for banking and finance, and are positive for the competitiveness of the UK economy. They [will] also contribute to financial stability internationally, especially in Europe. The international reform agenda – notably the Basel Process and European (EU) initiatives – is making important headway, but needs to be supported and enhanced by national measures” (Vickers Report, p. 7).

The approach to the structural reform adopted by the ICB is retail ring-fencing²³, which brings in the universal banking model, but places very severe limits on the magnitude and the nature of the commingling of retail and investment banking within a single entity. In a long examination of the advantages of universal banking, the ICB says that retail ring-fencing is better than any hypothetical full separation, because it is less costly for banks, allows customers to source banking services from a single provider, and, finally, because the benefits of diversification might allow the bank to still transfer capital between its different arms (Vickers Report, 2011, 8, 89-90). According to the ICB recommendations, all core retail activities whose continuous provision is imperative and for which customers have no ready alternative should be ring-fenced, , i.e. the taking of deposits from and providing lending and credit services to, individuals and SMEs. Ring-fenced banks should be a separate legal entity and their subsidiaries should only provide permitted retail services. Insured deposits of the ring-fenced bank should have priority in the event of failure.²⁴ The aim of insulating UK retail banks from external shocks and diminishing problems for resolvability of financial interconnectedness imply that what the ICB defines as prohibited activities cannot be carried out inside the ring-fence: any retail or wholesale services outside the European Economic Area; any services, other than deposit-taking and payment services, to financial counterparties; trading book activities (not only proprietary

²³ The definition of ring-fencing used by the ICB is different from the ring-fencing applying to cross-border banks, which arise out of regulatory restrictions on intra-group cross-border asset transfers, aimed at preventing undue influence by a foreign parent on its subsidiaries or at protecting the interests of minority shareholders and creditors of subsidiaries (Cerrutti et al., 2010).

²⁴ In insolvency and in resolution all insured deposits should rank ahead of other unsecured creditors.

trading in the Volker rule sense). Other banking services – including taking corporate deposits, issue loans to large non financial organisations, securities underwriting and provision of hedging services to clients - should be permitted (but not required) within the ring-fence. The stringent capital requirements for ring-fenced proposed by the ICB should have the purpose of making UK retail banks better able to absorb losses without recourse to taxpayer money in the event of a crisis. The Commission recommended that large UK ring-fenced banks ²⁵should have a minimum equity capital as 10% of risk-weighted asset (RWA), accordingly tighter leverage caps, and quantified as 17-20% of RWA the required primary loss-absorbing capacity (i.e. long-term uninsured debt subjects to bail-in powers) for large UK ring-fenced banks and UK headquartered global systemically important banks. The Financial Services (Banking) Reform Act 2013 took on many recommendations made by the ICB, although there were many significant exceptions (HM Treasury, 2012). As John Vickers, Chair of the ICB, pointed out in his comments on the Bill, the Act leaves Government with too much scope to redefine the location and the high of the ring-fence discretionally. For instance, Government decided that ring-fenced banks could have counterparties and hold assets outside the EEA, provided that this did not create a barrier to resolution. “This is a questionable relaxation of the ICB recommendation.” (Vickers 2012, p. 17). An important concession was also made to UK-based G-SIBs, for which the government decided that, so long as such a bank can show that any non-UK operations do not pose a risk to UK financial stability²⁶, the requirement of a primary loss-absorbing capacity of at least 17% of RWA will not apply to those non-UK operations. Also, the government has not accepted the ICB recommendation that banks subject to enhanced capital requirements should have correspondingly enhanced leverage ratios (Vicker, 2013,

²⁵ A ring-fence bank is defined as large by the ICB if its RWAs-to-UK GDP ratio is 3% or above. The additional capital requirement over the 7% required as a minimum by Basel III (3% for the large, smaller for smaller ring-fenced banks) is what the ICB defines as a “ring-fenced buffer.” To this must be added the Basel III countercyclical buffer (up to 2.5% of RWA). The ICB also suggests that regulators be given the discretion to impose a further “resolution buffer,” which may require banks to have up to 3% of RWA of additional equity (or other loss-absorbing capacity) if they are not readily resolvable. In total, the minimum equity capital of a large ring-fenced bank could be as much as 15.5%, according to the ICB.

²⁶ Such a bank could evidence this through producing a robust credible plan for the resolution of foreign operations separate from the resolution of its UK operations. As Reynolds argues (2012), this is thought to benefit banks such as HSBC, whose corporate structure consists of separate subsidiaries for its operations in various markets globally.

p. 6, n. 7). Perhaps more importantly, the government did not accept the Parliamentary recommendation on the so-called “electrification” of ring-fencing, which would define, in statute and from the start, what legal and operational links should be permitted between ring-fenced bank and its wider corporate group, without prejudice to the general principle whereby the transactions between the ring-fenced bank and its wider corporate group must be conducted on an arm’s length basis (Edmonds, 2013; Parliamentary Commission on Banking Standards, 2013).

According to Acharya (2011), ring-fencing may be a useful way of insulating commercial banking against those risks which have no real social use. Acharya also points out that retail ring-fencing will not stop those risk-taking incentives inside the ring-fenced commercial banks, such as mortgage lending, corporate loans and personal loans, which have caused the greatest losses after the credit crunch. The higher capital requirements specified by the ICB are no guarantee of sufficient solvency, given that assets considered to be low-risk under prudential regulation (e.g. mortgages) may produce speculative bubbles and give rise to systemic hazards. Vèron (2011) adds that the tighter prudential regulation required by the ICB for retail banks ought to correct the previous “financial mercantilism” by British supervisors, i.e. their tendency to encourage the global expansion of their big domestic retail banks by using only light-touch supervision. Chow and Surti (2011) argue that supervisory authorities will find it difficult to ensure institutional compliance on limits on market and counterparty risks and on intra-group subsidisation, needed to ensure isolation and continuity of the ring-fenced operations. It is easy to see that banks have many incentives to break these limits, because they reduce the allowed risk management strategies and increase the costs of providing banking services. Compared with the Volker rule, retail ring-fencing has however the advantage of allowing diversification gains, albeit in a limited degree: the opinion of the authors is that this ought to reduce the risk that activities outside the ring fence move towards a shadow banking system. According to Haldane (2012), all proposals for structural reform – such as the Volker rules, UK ring-fencing, and the Liikanen Plan – could improve the financial stability in two ways: during a crisis, by avoiding cross-contamination between the more hazardous investment banking

and retail banking; in normal times, by allocating resources better from a social perspective. This allocation advantage, which can only come about at the cost of reducing the benefits of cross-subsidiarisation which universal banks now enjoy, might be compromised if there is no full separation of capital and cultures between commercial banking and investment banking. Viñals et al. (2013) compares the main structural measures proposed by the US (the Volker rule), the UK, and the EU (Liikanen Expert group) as part of their banking reforms. The nature and scope of the separation is significantly more severe under the Volker rule. While US banks cannot run prohibited business lines anywhere in their global corporate structure, all European proposals permit banking groups to run business lines proscribed for depositor institutions within the group. Under either the UK or Liikanen proposals, activity restrictions are not imposed on the non-ring-fenced affiliates. The consequence is that the British ring-fencing model and the European model promote resolvability at the level of the retail bank, but not necessarily at a group level. Moreover, the UK approach is only nationally focused and does not compel the group to ring-fence retail operations in other jurisdictions.

Less closely examined, but probably much more important, are the foreseeable effects of ring fencing on organisational models for cross-border banks. Tonveronachi (2013) outlines that UK ring-fencing can be understood as a “defensive strategy” to protect national deposit insurance; reference to the trauma caused by the Icelandic banking crisis can be clearly understood, and this may bring about a deglobalisation in banks and the abandonment of any regulatory playing field as set out in international prudential standards. In the same way, Gambacorta and Van Rixtel (2013) maintain that structural regulatory proposals aim at protecting depositors and cut the cost of the official safety net within home country jurisdiction. In particular, the Vickers solution seeks to restrict government support to retail banking and payment services within the European Economic Area. However, structural reforms may contribute to a fragmentation of banking markets along national lines, reinforcing the trends towards multinational banking, characterised by banks largely matching assets and liabilities in subsidiaries operating in multiple jurisdictions. The size and the direction of amendments to global banking organisational

models in various jurisdictions will depend mostly upon the size of the funding gaps they have in other host countries.

Conclusions

The crisis has thrown doubt on several key aspects of the British regulatory paradigm which, especially since the 1980s, had been seen at international level and in Europe as a successful model to be imitated. In the UK, as in other countries, a new direction has been looked for financial regulation. As the Turner Review (2009, p. 38-39) recognised, the global financial crisis challenged on both theoretical and empirical grounds the existing regulatory philosophy and the intellectual assumptions of efficient, rational, self-correcting markets on which it was based.

Until the financial crisis, the superiority of light-touch, principles-based approach to financial regulation was claimed as key factor in the success and international prestige of the British system. The association between light-touch regulation and the vulnerability of financial systems has now been largely accepted by the same British regulators. It is not clear, however, whether the broad U.K. regulatory reforms brought in to deal with the crisis can be seen, in this regard, as a radical departure from the previous practice.

At the same time, perhaps paradoxically, the crisis has shown the difficulties which the British model has in reconciling itself with regulatory and institutional reforms in Europe. The post-crisis EU regulatory approach involves putting in place stricter and better-matched rules for all operators, and a greater centralisation in the supervisory approach. For the UK, the greater emphasis on achieving a pan-European uniformity in supervision and regulation with a more prescriptive and a longer and more harmonised rule-book risks compromising the traditional country's ambition to shape the European legislation in line with its own national interests. "Policy-makers in most areas of supervision and regulation need to work out what is best for the UK, not the lowest common denominator of what can most easily be agreed internationally. There is nothing inherently optimal about an international level playing field in regulation. There may be significant benefits to the UK as a financial centre from demonstrating that it can establish and adhere to standards above

the international minimum. A stable legal and regulatory environment, supporting a more secure financial system, is likely to attract new business just as ineffective or unnecessary bureaucratic regulation is likely to deter it. The UK's ability to make necessary reforms to financial regulation risks being constrained by the European regulatory process, which is developing rapidly as Eurozone countries move towards banking union. Some new financial regulation across the EU may be desirable as a support for the Single Market. However, there are at least two dangers for the UK. The first is that the prescriptive and box-ticking tendency of the EU rules designed for 27 members will impede the move towards the more judgemental-based approach being introduced in the UK in response to past regulatory failures. The second is that some EU regulations may limit the UK's regulatory scope for unilateral action. This could mean moving at the speed of the slowest ship in the convoy. This is a risk that UK, as a medium-sized economy hosting one of the world's two important financial centres, cannot afford. " (Parliamentary Commission on Banking Standards 2013, par. 36-37).

Significant contrasts were seen in the emphasis given to reforms designed to solve the too-big-to-fail problem. The British retail ring-fencing model, which forces retail banks to hold more capital than required by Basel III, is not in line with the different characteristics of banks in continental Europe because, although many of them are large global banks, the concentration of retail banks is much lower than in Britain.

The duty of mandatory capital surcharges that will exceed levels set by European law (the "gold-plating rule" in Euro-legal jargon), even though possible at statutory level, goes against the European approach which favours greater harmonisation.

The refusal of the UK to join the Banking Union is the latest proof of the dilemma which the British feel about the Single Market of financial services. As things stand, it is difficult to tell whether this position will cause greater difficulties either for Europe, because effective financial integration without the City of London goes against its original plans for unity (Schoenmaker, 2012, p.11), or for the UK, which feels the need to protect itself against an increasing "Continental Shift" in European financial regulation (Open Europe, 2011).

Part II

The Nordic crises of the 1990s and their regulatory implications: an overview of the literature

Introduction

The Nordic financial crises began in the early 1980s, when financial deregulation and increased access to international markets activated a boom-burst cycle.

As the theory predicts (Fisher 1933; Minsky 1977; Allen and Gale 1999), and as the history of financial crises has shown (Kaminsky and Reinhart 1999), many assets bubbles and burst associated with banking and currency crises –as the Nordic crises were – are preceded by financial liberalisation. Increased competition in financial services, the removal of cross-border restrictions on capital flows, and financial innovations triggered a sharp credit boom and gave rise to increased financial fragility. The latter was amplified by inadequate prudential banking supervision, lax accounting rules and practices, distorted tax incentives that strongly favoured an expansion of debt financing that turned out to be unsustainable. Macroeconomic external and internal shocks created the conditions for the burst and the emergence of the crisis (Drees and Pazarbaşıoğlu, 1995).

It has been said that the Nordic banking crises were due to “bad banking, bad policies and bad luck” (Berg 1998, p. 206). Actually, given the inherent instability of financial systems, the recent crisis has shown that, in an environment of financial deregulation, it is very difficult for the various players, bankers, regulators and supervisors, borrowers and investors, to lean against the wind. The Nordic crises are a good illustration of such a view. For this reason, the conviction is growing today that, leaving market forces free to innovate, the management and resolution of financial crises is probably even more important than their prevention.

The main objective of crisis management and resolution policies is to re-establish the financial intermediation processes upon which the economy depends for an efficient allocation of capital, and to accomplish this objective at minimal costs. To limit the costs of banking crises, governments can use various mechanisms, mainly aimed at restoring

banks' financial health and investors' confidence in the financial systems. These mechanisms usually reallocate wealth towards banks and away from taxpayers (Calomiris et al, 2004). For this reason, they face a key trade-off. Public support of banks can reduce the risk of a credit crunch and major economic disruptions, but entails two kinds of costs. Direct costs include taxpayers' money that is spent on bank financial assistance. Indirect costs include distortions to incentives that may result from encouraging banks and investors to abuse government protection. These distortions may worsen market discipline and incentive risk-taking, creating the premises for a new crisis in the future. The Nordic countries' successful experience in crisis management and solution shows that several economic, regulatory and political prerequisite can help in different ways to minimize these distortions.

The purpose of this Part is to present a review of the literature of the regulatory implications of Nordic crises. The second section presents a brief description of the Nordic crises. The third section analyses common trends and national specifics in banking deregulation of the Nordic countries as described in the literature. The fourth section presents the various solutions adopted to solve the crisis in the three countries, and the debate about their respective effectiveness. In the fifth, some brief conclusions will be presented.

2. A stylised description of the Nordic crises.

A systemic banking crisis hit Norway, Sweden and Finland in the period between 1988 and 1994. Reinhart and Rogoff (2008, p. 5) list the crises in Finland, Norway, and Sweden among the "Big Five Crises" which came about after the War: "protracted large scale financial crises that are associated with major declines in economic performance for an extended period."

The three crises appear, to some extent, quite similar in their cause, timescale, and for the way they were managed. All three were twin crises, i.e. banking and currency crises²⁷,

²⁷ All three Nordic countries, like most small open economies, maintained a fixed exchange rate at the time of financial liberalisation. In 1991, the reference currency basket was replaced with a peg to the ECU (the virtual currency created in preparation for the coming of the euro).

which, as the seminal work of Kaminsky and Reinhart (1999) show, are generally closely linked in the aftermath of financial liberalisation. The rapid growth of bank lending, an increase of asset prices, poor risk analysis and weak control systems within the banks, and inadequate regulation and supervision were the main drivers which left the banking systems in these three Nordic countries structurally vulnerable to the macroeconomic shocks which came about in the period between the 1980s and the early 1990s (Llewellyn, 2002). The experience of Sweden and Finland adds further proof that banking and currency crises reinforce one another: currency collapse undermines an already ailing banking system; a banking crisis causes a loss of confidence on international markets and feeds an exodus of capital and balance-of-payment problems (Englund and Vihriälä, 2009, p. 95-96). Nevertheless, the Nordic crises were three separate episodes, because in the early 1990s little cross-border banking took place between these Nordic countries (Borio et al, 2010). Norway was the first in the sequence: the crisis began in 1988 and became systemic in 1991²⁸, several years after the peak of the business cycle. It was not as severe as those in Sweden and in Finland and, in comparison with these, had a more limited international dimension (BCBS 2004; Vale, 2004; Honkapoja, 2009; Stigum, 2010). In Norway, the abandonment of quantitative credit restrictions took place in 1984-1985, but already at the end of the 1970s, after the deregulation of foreign currency exposures,²⁹ major commercial banks gained better access to international money market funding. During the early 1980s, the housing market was deregulated and house prices increased; in the same time, a boom in commercial properties began. High oil prices in 1979-1985, expansionary fiscal policies, and increased investment spending in the petroleum industry favoured a dramatic increase in private consume and real investments. The positive international business cycle reinforced the high growth rates in internal demand, and an increase in commodities and real estate's prices. In this environment, credit expansion was rapid. Deregulation

²⁸ There is no consolidated agreement about the year when the Nordic crises began and when they reached their peak. My references shall be to the dates used by Kaminsky and Reinhart (1999).

²⁹ Banks were required to maintain a zero net position between the Norwegian Krona and foreign currency; however, starting in 1978, the position was measured as net exposure in the spot market and on the forward market for overseas currencies. This new rule allowed banks funding part of their domestic lending in Norwegian Krona via short-term capital flows from abroad (Steigum, 2010; BCBS 2004).

produced an aggressive competition for market share in the credit market, mainly after the abolishment of the regulation of new branch establishment. Banks competed amongst themselves and with non-banking financial institutions, which had been more lightly regulated.

The aggressive growth strategies of the two major commercial banks – Norske Creditbank and Christiania Bank³⁰ – stimulated herding behaviour in the smaller commercial and savings banks, which copied the aggressive lending practices of the two large banks. The turn-around of the boom came in 1986 with the decline of oil prices. The Norwegian Kroner was devalued, restrictive fiscal and monetary policies were introduced, and the economy went into recession during the first half of 1988. In 1988-90, several small banks failed due to credit losses and were merged with larger solvent banks. The severity of the crisis worsened in late 1990, when the rise in interest rates applied by Germany after reunification deepened the recession and worsened the weak condition of banks.³¹ In December 1990, the crisis began to strike the larger banks and the bank's own guarantee funds were effectively depleted. The situation continued to worsen, peaking in the autumn of 1991, when the second and the fourth largest banks lost their entire capital due to sustained huge credit losses. At this point the crisis became systemic. In 1991, the major commercial banks, accounting for more than half the market, were in trouble, with loan losses which amounted to 2.8% of GDP (Borio et al, 2010). Between 1991 and 1992, the three largest commercial banks were nationalised. During 1993, macroeconomic conditions in Norway improved. After the Kroner started to float in December 1992, interest rates fell rapidly and banks' loan losses decreased. By the end of 1993, the crisis was effectively over.

The Finnish and Swedish crises were much more serious than Norway's, and involved a greater international dimension (Kaminsky and Reinhart, 1999).

³⁰ Only these two commercial banks were operating nationwide, with a combined market share of approximately 30%. In addition, there were three large regional banks and several small local banks (Vale, 2004).

³¹ According to Steigum (2009), without this shock from outside the Norwegian banking crisis in 1991-92 would probably not have happened.

In Sweden, the rapid development of financial markets had already begun by the late 1970s after the partial abolition of capital controls (Englund, 1990). During the 1970s, growing fiscal deficits and a restrictive monetary policy forced the banks to concentrate their assets in fixed-interest government and housing bonds. Loans to households and business were increasingly channelled outside the banking system, via finance companies and other institutions of a growing grey market, largely financed by the banks themselves. In the early 1970s, the Swedish banking system consisted of fifteen large and medium-sized commercial banks (one of which was state-owned), and several savings and cooperative banks. The globalisation of Swedish industry, with large companies becoming increasingly active internationally, and banking deregulation promoted, mainly in the early 1980s, a large consolidation process, which included commercial and savings banks (Frisell and Noréus, 2002)³². In the early 1980s, the interbank market, the market for derivative instruments and forward markets in foreign currencies were rapidly taking hold.³³ The money market facilitated circumventing the quantitative lending regulation, which was then abandoned in the mid-1980s, in a period when Sweden experienced a protracted economic up-turn.

Demand for mortgages accelerated, stimulated by high inflation rates and the tax system, which favoured household leveraging. Property prices rose quickly facilitating borrowing. Since nominal interest rates in Sweden were relatively high compared to other countries, when foreign exchange restrictions were lifted, the amount of loans granted in foreign currencies greatly increased (Englund 1999). Banks funded these loans denominated in foreign currency mainly on the international interbank market: this led to large maturity mismatch in loans and funding in foreign currency (Englund and Vihriälä, 2009). Around 1990, the period of strong economic growth ended. The impact of tighter monetary policy in Germany, associated with speculative attacks against the Krona, and the recession in

³² Following the banking restructuration which was implemented during the crisis, at the end of the 1990s Sweden had one of the industrial world's most concentrated bank markets (Frisell and Noréus, 2002).

³³ According to Englund (1990), the early 1980s also saw a great increase in stock exchange transactions. The great profits associated with the rapid growth of financial markets caused political concerns and led in to the introduction of special taxes on transactions in share (1984) and money market (1989). Sweden decided to abandon the financial transaction taxes in 1990-91 (Pomeranets, 2012).

export contributed to Sweden's distress. After the great drop in collateral values, in 1991 several finance companies were the first to experience distress. Problems in the finance companies sector, largely funded by banks, gradually extended to the whole banking system. As the weakening of the economy and the property market continued, banks incurred increasingly larger losses, mainly in property loans. In the autumn 1991 two of the largest banks were no longer able to fulfil regulatory capital requirements, and needed bailing out. During the spring of 1992 another large bank went bankruptcy, forcing to treat banking problems as a systemic crisis. The European ERM crisis in 1992 deepened the banking crisis. With the increase in interest rates set by the Riksbank³⁴ (the Swedish Central Bank) to defend the Krona, non-performing loans began to rise causing large bank losses³⁵. In November 1992 the fixed parity with the ECU was abandoned and the Krona fell more than 20%. With the worsening of the crisis, access by domestic banks to international financial markets was cut back severely and the risk of foreign lenders refusing to roll over short-term credit lines became concrete (Englund and Vihriälä, 2009). Massive public support and a blanket guarantee of bank liabilities were issued, with immediate effects on international confidence. Already in February 1993, the depreciation of the Krona halted and in the following months a net improvement in financial indicators showed that the crisis was over.

Finland experienced the most severe crisis and the most dramatic and lasting economic recession of the three Nordic countries.

In Finland, deregulation of the financial markets started in the early 1980s, but in 1980 the foreign currency market was already developing, with Finnish banks allowed to cover commercial forward positions. The abolition of exchange controls in 1985-1986 allowed the private sector to borrow freely from overseas. This improved the availability of debt financing from sources other than domestic banks. Starting in the mid-1980s, due also to

³⁴ As Jonung (2009) points out, real after-tax interest rates increased also because of the far-reaching tax reform of 1990-91, dubbed the "tax reform of the century," which significantly reduced the tax deductibility of mortgage rates.

³⁵ According to Andersson and Viotti (1999), during the crisis the credit losses of the seven largest banks, which accounted for approximately 90% of the banking market, amounted to 12% of the Swedish GDP. According to Borio (2010), loan losses in 1992, the peak year of the crisis, amounted to 3.8% of the GDP.

the exceptionally favourable macroeconomic conditions, overseas borrowing was widely used, with more than half of this financing intermediated by banks. The Finnish banking system comprised five major banking groups and two large groups of savings and cooperative banks, each group owning a commercial bank that acted as 'central bank' for individual savings and cooperative banks. Before the abolition of interest rate controls, competition was practised mostly by building large branch networks: consequently, in the early 1980s, the banking industry evidenced a substantial excess capacity and weak profitability (Nyberg and Vihriälä, 1993). The liberalisation of the domestic credit market and foreign exchange transactions gave rise to steady growth in credit, helped also by tax incentives for borrowing.³⁶ As in Sweden, in Finland the share of corporate debt denominated in foreign currency grew considerably and the banks became highly dependent on foreign money market funding. This was especially true for large savings banks and their commercial bank affiliates (Englund and Vihriälä, 2003; Englund and Vihriälä, 2009). Honkapohja (2009, p. 19) shows that the external debt-to-GDP ratio for Finland increased from 17% to 50% between 1986 and 1991, increasing in the same period from 19% to 28% in Sweden.

The end of the boom came in Finland in 1990. Real interest rates rose considerably, due to the tighter monetary policy in Germany and the defence of the Finnish Markka against speculative attacks. The Finnish crisis precipitated in 1991 with the collapse of the Soviet Union, which brought about a dramatic quick decrease in exports to Russia, previously a major importer of Finnish goods. In the late summer, the commercial bank owned by savings banks (Skopbank) recorded large credit losses and needed capital infusion from the Bank of Finland³⁷. From 1992 the banking crisis became systemic and several banks asked for public capital support. In August, the government announced that the stability of the Finnish banking system would be safeguarded in all circumstances and issued a

³⁶ As Nyberg and Vihriälä (1993) explain, in Finland tax incentives to borrow were strong. Equity capital was heavily taxed, relative to debt, which was the cheapest form of external finance for companies. Furthermore, household interest expenses could be deducted from taxable income at a high marginal tax rate. Finally, the interest earnings of banks were partially tax exempted.

³⁷ Englund and Vihriälä (2009, p. 99) state that by the end of 1989 the Bank of Finland and the Bank Inspectorate had already put under special surveillance Skopbank, whose Director committed suicide shortly afterwards.

blanket guarantee of all bank liabilities. Fixed exchange parity became unsustainable, and in September 1992 the Bank of Finland allowed the Markka to float. The depreciation of the currency helped the recovery in 1993, which was mainly export-led (Englund and Vihriälä, 2009). The banking crisis came to an end in 1994, but its effects on the economy continued for several years: unemployment rates, which had reached 16% in 1993, remained high, usually somewhere above 10%, until the early 2000s (Honkapohja, 2009).

Sandal (2004, p. 83-84) presents detailed data comparing the duration and the seriousness of the crisis in the three Nordic countries: cumulative fall in real GDP was 10.4% in Finland (1990-93), 5.3% in Sweden (1990-93), whereas in Norway GDP hardly fell at all. Finland had also the largest loan losses in the peak year of the crisis (4.4 % of GDP) and the largest cumulative fall in bank lending. The recovery of the banking sector took more time in Finland than in the other two countries: whereas the banking sector in Norway and in Sweden returned to profitability just two years after the peak of the crisis, it took four years in Finland.

3 Banking deregulation in Nordic Countries in the 1980s: common trends and some national specifics

Up to the early 1980s, the banking systems in Finland, Norway, and Sweden were heavily regulated. According to Drees and Pazarbaşıoğlu (1995), this regulation shared common principles and objectives: the priority was not ensuring financial stability, but rather maintaining low and stable interest rates and, especially in Norway and in Sweden (Englund, 1990; Berg and Eitrheim, 2009), channelling subsidised credit into housing and the government. For Sweden, Ingves and Lind (2008, p. 22) point out that “[d]e facto public guarantees were provided for mortgage loans and for investment in real estate.” Interest rate ceilings, quantitative lending regulation, and foreign exchange controls were in effect in the Nordic countries until the late 1970s and early 1980s³⁸.

³⁸ In Finland, deposit rates were also strictly regulated until the early 1990s. As Englund and Vihriälä (2009) outline, from the mid-1980s onwards, Finnish banks were however authorised to issue wholesale certificates of deposits on the free money market.

Restrictions on the volume of bank lending were imposed primarily by means of reserve requirements in Norway, and bond investment obligations in Sweden. In Finland credit was controlled indirectly, because there was no interbank market and bank refinancing at the central bank was subject to quotas (Tarkka, 2009).

Limits on credit expansion kept competition low, and profitability for banks was therefore relatively stable. Low interest rate ceilings promoted a “favourable selection” by implicitly excluding risky borrowing.

Before liberalisation, prudential regulation played a relatively minor role in the Nordic countries. With limits both on the amount of lending and on interest rates, banks had little incentive to take excessive risks.

Banking was a protected industry whose profitability was in fact granted by regulation. There were capital adequacy requirements, at least for commercial banks, but they were not deemed to be important in this relatively safe environment. In Finland, the regulatory capital-to-liability ratios of commercial banks were gradually relaxed in the 1960s, also giving the supervisory authority the power to reduce the capital requirements of individual banks temporarily below the legal 4% of total liabilities. For savings and local banks, the capital requirements were even lower.³⁹ The rationale for applying lower ratios for the local banks had been, as Englund and Vihriälä (2009) explain, that their lending was less risky than that of commercial banks. In Norway, formal capital requirements were only applicable to commercial banks and were particularly lax, because the Norwegian authorities permitted subordinated debt to cover a large share of regulatory capital. As Drees and Pazarbaşıoğlu (1995) show, by 1983 almost 40% of the capital of Norwegian commercial banks consisted of subordinated debt, 90% of which was raised in overseas currency.

While the opportunities for banks to extend credit were limited, incentives for increasing leverage were not significant. This changed dramatically under the deregulated environment, since capital requirements were not tightened until the early 1990s, when the Basel Accord was adopted (BCBS, 2004).

³⁹ The almost non-existent capital regulation of the saving banks was partially counter-balanced by some restrictions on their investment policy (Tarkka, 2009).

Both before and after liberalisation banking supervision was also gradually given low priority in the Nordic countries.⁴⁰ According to Englund and Vihriälä (2009), the resources devoted in Finland and in Sweden to financial supervision were small and supervisory agencies focused primarily on consumer protection. As BCBS (2004) states, most of the staff were lawyers who focused mainly whether the banks fulfilled their legal requirements. Not enough was done to change the skills and resources of the supervisory authorities in connection with deregulation. Also during the crisis, their role remained marginal. The same was true for Norway: the Parliamentary Commission who wrote a broad report about the banking crisis in 1998 stated that banking supervision functioned less than optimally in a situation characterised by deregulation, increased competition and strong credit growth (Berg and Eitrheim, 2009).

Financial deregulation began in the Nordic countries between the late 1970s and the early 1980s, in line with the developments seen during those years in all advanced countries (Edey and Hviding, 1995). The impact of deregulation on the competitive conditions and the behavioural responses of banks produced the conditions of financial fragility that emerged with the crisis; regulation and the supervisory authorities were unable to provide a suitable response to the risks and bank performance overvaluation that were already visible in the years immediately before the crises (Benink and Llewellyn, 1994). “When financial deregulation started in Finland, Norway and Sweden in the 1980s, financially-driven booms, busts and crises were unknown phenomena to policy-makers in the central banks and the ministries of finance, as well as to forecasters, to financial regulators, to the economics profession, to bankers and other actors in the financial system, and to the public at large. The thinking and thus the behaviour established by many decades of financial controls and

⁴⁰ In the Nordic countries, the central banks traditionally never had any responsibilities for banking supervision. In Finland, banking supervision before the crisis was handled by the Banking Supervision Office which was directly responsible for supervising commercial banks; for the savings and cooperative banks, it was assisted by two specific Inspectorates, formally subordinated, but in practice operating independently, in close relationships with the two banking groups. In Sweden there were two Inspectorates, one for banking and one for the insurance supervision, which after the crisis were merged into the Financial Supervisory Authority of Sweden. In Norway, an integrated financial supervisor had already been established in 1986, by merging the Banking Inspection Agency, the Broker Control Agency and the Norwegian Insurance Council into the Financial Supervisory Authority of Norway. Changes to the supervisory architecture adopted in the Nordic countries after the crisis are detailed by Taylor and Fleming (1999).

regulations continued unchanged, without an understanding that financial liberalisation was rapidly creating a new and financially more risky world that replaced the old risk-free environment” (Jonung, 2009, p. 308).

In the late 1970s, when inflation was high, restrictions placed upon the expansion of credit began to be seen as unsustainable and gave rise to increasing incentives for circumventing the regulations. A parallel credit market developed mainly in Sweden and Norway, apparently contributing to bank disintermediation. However, banks were not really bypassed, because they participated in the unregulated loan market through off-balance sheet activities, by guaranteeing and arranging grey-market loans, and channelling part of their lending through non-bank subsidiaries, such as the finance companies in Sweden. A large “shadow banking system” was on the rise, which meant a consequent worsening in credit selection policies and less efficiency in monetary policy. In reaction to the rapidly growing unregulated market, the authorities chose a progressive relaxation upon the restrictions on bank lending and funding (Drees and Pazarbaşıoğlu, 1995).⁴¹

One of the most interesting features of the process of financial deregulation in the Nordic countries was that it started by allowing banks to borrow freely from abroad: this happened, as we have previously seen, in Norway from the late 1970s onwards, and in Sweden and in Finland from the early 1980s. The consequence was a very tight dependence by the banks, especially in Finland and in Sweden, upon international wholesale funding. The consequent risks, made worse by the large number of loans in foreign currencies to domestic borrowers, households and corporations, were practically ignored by policymakers and the supervisory authorities (Englund, 1990; Tarkka, 2009; Berg and Eitrheim, 2009).

Credit limits and interest rates restrictions were progressively abandoned in the early 1980s and in the same year liquidity requirements were reduced or completely eliminated.⁴²

⁴¹ In Finland, where deposit rates remained strictly regulated until the early 1990s and interest payments on bank deposits were exempt from income tax, the banks retained a competitive advantage in the cost of funding: this may explain the relatively small role played by other financial intermediaries (Englund, 1990).

⁴² Starting from the late 1985, after the reduction of reserve requirements, the Norwegian bank sector was a net borrower at the central bank, and this position persisted even after the crisis. As Borio et al (2010) remind

According to several studies (Edey and Hviding, 1995; Drees and Pazarbaşıoğlu, 1995; Kaminsky and Reinhart, 1999; Englund and Vihriälä, 2009), financial liberalisation came to the Nordic countries as a major “shock,” to which the financial system responded quickly with a significant rise in lending and risk taking. “The higher risk taking was supported by strong incentives that in part stemmed from banks’ thin capitalization and from moral hazard due to explicit or implicit unlimited deposit insurance coverage and the expectation that no bank would be allowed to fail in case of a financial crisis” (Drees and Pazarbaşıoğlu, 1995, p. 18).⁴³

The lax regulatory framework prior of deregulation remained more or less unchanged, especially in Finland and Norway. As can be seen in a study by Halme et al (2000), in Finland the Basel Accord was incorporated into financial regulation in 1991, but with some notable exceptions. For example, revaluation reserves of fixed assets were treated as Tier I capital and loan loss reserves were unlimitedly included in Tier II capital. “The outcome was at least partially a result of a consensus-driven policy favoured by regulators and supervisors combined with the fact that those subject to regulation (banks) had a remarkable influence not only in the interpretation of current rules (law-taking) but also in the content of the legislative drafting (lawmaking).” (Halme et al, 2000, p. 56). As a consequence, capital adequacy rules and accounting practice on loan loss reserves in Finland generated warped incentives: instead of prudent risk-taking and reporting, efforts focused on finding artificial ways to meet the legal requirements. In Norway, as in Finland, accounting practices on asset valuation were lax, and the capital adequacy of many banks was insufficient to cover any large losses due to the rules on subordinated debt which enabled banks to increase their capital base without any rise in loss-absorbing capacity. According to several authors (Halme et al, 2000; Reinhart and Rogoff, 2008; Vastrup, 2009), the Danish experience in the turmoil of the early 1990s represents a counterfactual confirmation of the theory whereby financial deregulation does not necessarily mean an

us, financing to banks from the Central Bank both before and during the crisis was not pledged by any collateral.

⁴³ In the 1980s an explicit deposit insurance scheme existed only in Norway and in Finland. As Drees and Pazarbaşıoğlu (1995, p. 18) outline, in all three countries the central banks explicitly acknowledged that no bank would be allowed to fail.

increase in the vulnerability of financial systems, if the re-regulatory responses and supervisory practices are adequately designed to contain the risk-taking incentives of financial institutions. Denmark avoided a systemic banking crisis, even though in the early 1990 its financial system experienced considerable problems and was affected by the same European economic turbulence as its Nordic neighbours. This relative stability can be explained, among other things, by the fact that regulation was much harsher there. The EU capital requirements introduced in Denmark in 1992 were less stringent than its former requirements: for this reason, Danish banks were well capitalised when the crisis hit. Their accounting rules and practices are considered a good example of efficient rules. In general, Danish loan valuation rules were some of the strictest in the world (Halme et al, 2000, p. 57). This seems to be one of the main reasons why Denmark escaped a systemic banking crisis.

4. Different Models of Crisis Management and Resolution in the Nordic Countries.

As we have seen in the previous analysis, in the Nordic countries macroeconomic policies and prudential regulation did not operate effectively to prevent the crisis. Although financial deregulation had been a radical change for the Nordic economies, no adequate preventive measures were implemented during the boom years to stabilise the financial system, maybe because they were considered to be politically unpopular. As various writers have pointed out, resistance by banks to stricter regulation, and especially the failure to understand the growing risks of financial instability contributed to the failure to adopt adequate regulatory reforms and better supervision. During the 1980s, private sector borrowing in all three countries had risen considerably, and had thus become vulnerable to shocks. The fragility of banks had risen, due to the poor evaluation of borrowers, the weak capital base, and widespread access to foreign funding. From many points of view the Nordic banking crises were thus “accidents waiting to happen” (Sandal, 2004, p. 82).

Whereas in all three Nordic countries serious regulatory and supervisory failures were certainly the causes of the seriousness of the crisis, the solutions which they adopted for their resolution followed what would later be unanimously considered as best practices⁴⁴. Following both the frequent crisis episodes which arose in advanced and developing countries during the 1990s and especially the current crisis, several studies have investigated the best practices for crisis resolution, especially in the light of the experience in the Nordic countries (Dziobek and Pazarbaşıoğlu, 1997; Santomero and Hoffman, 1998; BIS, 1999; Calomiris et al., 2004; Hoggarth and Reidhill, 2004; Lumpkin, 2008; Mayes, 2009; Borio et al, 2010; White and Yorulmazer, 2014). For systemic crises, private resolution methods, theoretically considered the best option because they minimise fiscal costs and moral hazard problems, they are not feasible. Especially when the banks in distress are large, normal liquidation procedures may cause major disruptions to customers, fire-sale externalities, large direct losses to creditors, the loss of confidence in national and international investors, and enormous contagion phenomena. The use of public funds to bail out distressed banks always entails a trade-off between limiting the adverse impact on the real economy and creating distorted incentives which may jeopardise financial stability in the future. Furthermore, as the recent sovereign crisis in the euro area shows, public bailouts may trigger a vicious loop between bank and sovereign crises. Strict conditions and restrictions imposed in exchange of public support, associated with a transparent and strict assessment of losses, can help to contain moral hazard, even if it is hard for them to eliminate the problem completely. With systemic crises, the objective of minimising fiscal costs is not always easy to reach, especially if private insurance funds are not sufficient and there are no legal rules which allow the sharing of costs, not only among shareholders and managers but also uninsured creditors, or if these rules cannot be applied without triggering a contagion.

The solutions adopted by the Nordic countries to manage and solve their systemic banking crisis involved many different types of public intervention. Indeed, one of the main

⁴⁴ As Mayes (2009b, p. 4) notes, crisis management policies in the Nordic countries “in some respects were too successful and have led people to believe that crises can be solved quickly and with little or no costs to the taxpayers.”

characteristics of these Nordic crises was that so many of the largest banks incurred losses of such a dimension that they could not be covered without some large government intervention.

There is wide agreement that these interventions were successful in limiting both the costs and the duration of the crises (Drees and Pazarbaşıoğlu, 1995; Berg, 1998; Allen and Gale, 1999; Hoggarth and Reidhill, 2004; Borio et al, 2010). In all three crises, problems were recognised early and the authorities swiftly intervened without exercising forbearance. Widespread political consensus supported the actions needed to restore confidence in the banking system. Only a few months after the crisis was recognised as systemic, a wide range of measures was announced and implemented. No Nordic country, with the partial exception of Norway, had already in place a legal framework to deal with failures of systemically important banks. However, specific new rules and institutions were quickly passed. In all three Nordic countries, the authorities considered as a priority to identify the losses quickly, and to allocate them to the previous shareholders. They showed particular commitment in ensuring that the losses were booked correctly and transparently. In all three countries, the sine qua non for government capital injection was that banks' equity be written down according to losses, determined by severe evaluations, also tightening accounting practices. Finally, as Borio et al (2010) stress, in the Nordic countries the need to re-establish conditions for sustainable profitability in the long term, by reducing excess capacity and promoting operational efficiency, was also considered a priority. Conditions for public interventions therefore included balance sheet contraction, disposal of branch network, and cost-cutting measures. In very few cases did the authorities in Nordic countries close problem banks and liquidate their assets. Generally, governments permitted banking operations to continue without interruptions. Avoiding any interruption in banking services was a major concern for governments. According to Berg (1998), they considered it essential not only to protect the payment system and limit a domestic credit crunch, but also to maintain foreign banks' confidence in the national banking systems. According to Claessen et al (2004), the high quality of institutions of the three Nordic countries – measured in the six dimensions of democracy, political stability, rule of law,

bureaucratic regulation, government effectiveness, and low corruption – contributed to reducing the fiscal outlay of crisis resolution and to contain the economic costs of the crises. In general, fraud was a negligible issue in the three Nordic crises (Vale, 2004). Although the three Nordic countries had in common the above features, the strategies used to handle the crises were fairly different. The main divide runs, as several authors (Berg, 1998; Sandal, 2004; Mayes, 2009) argue, between Norway, on the one hand, and Sweden and Finland on the other.

In Norway, the first part of the crisis, between 1988 and 1990, characterised by the failures of several small banks, was resolved almost exclusively with private solutions, by merging the failed banks with larger, solvent institutions. The measures necessary to facilitate such solutions were financed by the Commercial Banks' and Saving Banks' Guarantee Fund funded and controlled by member banks. As Vale (2004) points out, these guarantee funds had a wider mandate than those existing in many other European countries. As well as compensating depositors in the event of a bank being wound up, they could also infuse capital into member banks and issue guarantees against portfolio losses of a member bank. These latter measures were used to convince the acquirer of a problem bank to agree to the takeover.

When the crisis hit the largest banks, and both guarantee funds were depleted, the government was authorised by a law, quickly passed by Parliament, to set up a Government Bank Insurance Fund (GBIF), which was granted a specific amount of capital and was allowed to grant interest-bearing loans to the two bank guarantee funds, to allow them to provide capital to distressed member banks. These support loans were, by law, subject to certain conditions: a write-down of the existing share capital according to bank's losses, restrictions on dividends, and a change of the board of directors and management. To avoid giving banks receiving capital from the GBIF a competitive advantage, restrictions were also put in place upon activities and plans for reducing operating costs and disposing of branch network. During the summer of 1991, the GBIF provided the first support loans to the commercial bank guarantee fund, for supplying capital to the second and the fourth largest banks, which had reported large losses and insufficient capital. Starting in 1988,

capital requirements were extended to savings banks: as BCBS (2004) outlines, Norway, in spite of the crisis, did not consider it a viable option to postpone full implementation of the Basel Accord, which was to be complied with by the end of 1992. Although this meant an increase and acceleration in recapitalisation actions required to banks, it greatly raised investor confidence.

By October 1991, when it became clear that in the largest commercial banks losses were much greater than had been forecast and that the support loans made by the GBIF to private guarantee funds had become unsustainable, the government strategy changed. The government decided to act as the “owner of last resort” (Vale, 2004, p. 14). The GBIF received further state financing and its powers of intervention were expanded, thus allowing it to buy shares, primary capital certificates (equity instruments of the savings banks), and other equity capital instruments in Norwegian banks directly, when they were unable to raise capital in other ways. The GBIF became consequently the real owner of banks which had lost their entire capital. At the same time the Government Bank Investment Fund (SBIF) was set up and financed, with the mandate to underwrite subordinate capital and participate together with private investors in the capitalisation of banks which were not in crisis, but which were unable to raise capital in the private market due to the general loss of confidence.

In order to avoid the state taking on all the risks which were supposed to be covered by shareholders, the Parliament soon passed a special amendment to the banking law, which entitled the government, by Royal Decree, to write down the share capital of a bank against losses recorded in the audited accounts, even if its shareholders decreed otherwise. By the end of 1991, the two largest commercial banks, Christiania Banks and Fokus Banks recorded losses greater than their share capital, and needed substantial capital support. In connection with the capital infusion from the GBIF, the existing shares had to be written down to cover losses. As the shareholders' meetings of the two banks failed to make such decisions, their share capital was written down to zero by Royal Decree, before the banks

were recapitalised by the GBIF, which thus became the sole owner.⁴⁵ Several months afterwards, the third biggest bank was nationalised too, and its shares were written down to zero.

The strict Norwegian approach to allocating losses to shareholders, however, did not stop the government having to pay off a large share of losses, given the size of subordinated debt included in regulatory capital, which could not be written down unless the bank was wound up. This meant that none of the owners of subordinated debt in the failing banks lost their capital. The government was probably forced to safeguard subordinated debtors during the crisis, largely because these were mainly foreign investors (Borio et al, 2010). However, after the crisis, in 1997 the law was changed and banks were no longer allowed to include subordinated debt in Tier II capital, unless it could be written down against the bank's losses, even if the bank was not closed (BCBS, 2004; Mayes, 2009).

The large public budget surplus of Norway, its positive external position, its rigid respect for capital requirements, and the transparency rules used in assessing non-performing loans and in determining loss loan provisions⁴⁶ were enough to maintain market confidence. The government was not therefore forced to issue any blanket guarantee for bank liabilities, even when the crisis reached its lowest point. The Norges Bank however publicly committed to give viable banks emergency liquidity support not pledged by any collateral.

Starting in 1995, the government progressively began selling nationalised bank shares by public issue. These were mostly acquired by foreign banks. In 2000 Christiania Bank became part of the pan-Nordic group Nordea, as a subsidiary of its parent bank in Finland. The government still decided to maintain a large minority share of capital in the banks,

⁴⁵ A detailed chronological reconstruction of the interventions of the GBIF and SBIF is presented by Wilse (2004), who illustrates how, as the result of the crisis, the government became the major or the sole owner of the three largest commercial and savings banks.

⁴⁶ As Steigum (2009 and 2010) outlines, unlike Sweden and Finland, Norway decided not to set up separate "bad banks" to handle problem loans in distressed bank. Several reasons may explain this difference: firstly, the "bad banks" would have ended up being completely financed by the state, thus requiring further taxpayers' money, in addition to that already infused as equity into the failing banks; secondly, it was felt that, with new directors appointed by the government, the banks would have within their staff the necessary skills to recover credits; finally, transferring bad loans from the banks to a "bad bank" would have required extra legal and accounting work.

mostly to keep the head offices of these banks in Norway. This choice has been widely criticised (Berg, 2009; Steigum, 2009), partly because it risks compromising the credibility of Norwegian regulatory policy, and partly because of the risk that the large presence of government in the banks' ownership may give them competitive advantages over private banks.

Thanks to the increase in the market value of bank shares which came about mainly in the late 1990s, net fiscal costs, i.e. total public outlay minus income for reprivatisation, were absent or even negative according to the assessment criteria used (Hoggarth et al., 2001; Vale, 2004).⁴⁷ Berg and Eitrheim (2009) and Mayes (2009) have analysed how the Norwegian banking crisis influenced bank regulation in the aftermath of the crisis. They find that, in the implementation of Basel I rules, the Norwegian supervisory authority chose to be more restrictive than most other European countries, especially as regards the admissibility of subordinated debts and hybrid capital in the regulatory capital. However, as Berg and Eitrheim (2009) outline, these stricter rules were eased some years later when memories of the banking crisis had become more distant.

The Swedish model of crisis management and resolution is different from the Norwegian one under several different aspects: leaving aside the actual measures implemented, the first differences can be seen in the fact that in Sweden bank nationalisation was only considered feasible as a last resort and for a short time (Ergungor, 2007; Ingves, 2009); secondly, because the measures implemented in Sweden caused a greater concentration of banks, which was already fairly high even before the crisis; and thirdly, because Sweden was much more dependent upon international credit, which conditioned the solutions implemented to handle the crisis.

The first blow struck the largest savings bank and the solution was the government providing subsidised loans to the savings bank foundation that owned the bank, and then facilitating the merger of the bank with several other ailing savings banks. When the crisis hit the state-owned Nordbanken, the government had to deal with the challenge of being at

⁴⁷ The measurement of fiscal costs refers solely to direct public expenditures for the resolution: as Hoggarth et al (2001) demonstrate, the resolution costs simply reflect the transfer of the income from taxpayers to bank stakeholders. In the case of Norway, this transfer benefited taxpayers to the detriment of the old shareholders.

the same time the majority owner and responsible for ensuring the stability of the banking system (Sandal, 2004). The government chose to guarantee an equity issuance, in which it bought a share. In early 1992, the Nordbanken's crisis worsened and Parliament allowed substantial funds to be used (which Sandal, 2004, p. 90, estimates at 1.3% of GDP in 1992) to restructure the bank and to buy out the private shareholders, who were not written down. This was probably because the government, as the major shareholder, felt responsible for the banking problems and feared a lawsuit from private shareholders for having underestimated the problems of the bank at the time of the equity issue in 1991. As part of the restructuring programme, most non-performing loans were transferred to a separate "bad bank," an asset management company (Securum) capitalised by the state. Since then the use of asset management companies has been one of the main characteristics of the Swedish model for solving banking crises. In April 1992 Sweden's fourth largest commercial bank, Gota Bank, recorded huge losses and the owners said they could not provide any additional capital. Gota Bank went into bankruptcy. The government provided capital support and sold the bank off via public auction. To facilitate the sale, the non-performing loans were transferred to an asset management company (Retriva) funded by the state. At the end, the state-owned Nordbanken took over Gota Bank when it won the auction arranged by the government, even though there were several other bids at a similar level (Ingves et al., 2009)⁴⁸. Private shares in this case were written down to zero (Calomiris et al, 2004; Sandal, 2004; Englund and Vihriälä , 2009).

The Gota Bank crisis, however, seriously undermined confidence in the Swedish banking system, both in Sweden and especially abroad. This affected the banks' cost of funding and generated a substantial net outflow of foreign exchange. In December 1992 Parliament issued an unlimited blanket guarantee in which it undertook to guarantee that banks would meet their obligations in a timely manner (Ingves and Lind, 1996)⁴⁹. At the same time, Parliament decided to set up under the Finance Minister a special crisis resolution agency, the Bank Support Authority (BSA), with the task of implementing public capital support to

⁴⁸ Ingves et al (2009, p. 14) outline that the government decided to award the Gota Bank to Nordbanken, mainly due the fact that the branch network of the two banks complemented one another.

⁴⁹ The state guarantee of banks' liabilities was maintained until July 1996 when it was replaced by a deposit guarantee entirely financed by the banks.

distressed banks.⁵⁰ Given that, unlike Norway, Sweden had no legal framework for the resolution of banks, it immediately became necessary to set up the rules covering the treatment of existing shareholders of banks needing capital support from the state. A law (the Bank Support Act) was passed to enable the state to take over a bank and undertake the compulsory redemption of shares, according to a price calculated by an impartial body, if its Basel capital ratio fell below 2%. As Ingves and Lind (1996) explain, the purpose of this law was to ensure that public capital support could not be delayed or obstructed by negotiations with existing shareholders, trying to set higher prices than the market ones for their shares; at the same time, the law allowed for government intervention before a bank's capital was depleted⁵¹. Tightened accounting rules applied by the BSA in assessing the net worth of banks applying for public support helped, in some cases, to stimulate private solutions, when old shareholders realised that public recapitalisation would give the government a significant share of equity and voting rights (Ingves et al, 2009).

A broad political consensus for the measure adopted was promoted by the government, which announced it was ready to share detailed information about all the interventions adopted to support the banks; the political opposition was also represented in the board of the BSA. As Ingves and Lind (1996, p. 7) stress, “[i]f the political parties had disagreed about the support measures, not only would the latter have been delayed but the disagreement would also have attracted attention abroad, with serious consequences for the efforts to restore confidence in Sweden's financial system”. The BSA began operating in early 1993. The guiding principle was to make use of objective, transparent criteria for the treatment of banks applying for support. All bank applicants for government support had to submit to a severe due-diligence process, performed by BSA with the aid of independent

⁵⁰ In their widely appreciated reconstruction of the measures implemented to solve the Swedish crisis, Ingves and Lind (1996) relate that the Bank Support Authority benefited not only from the abilities of the Riksbank and the Bank Supervisory Authority, but also from Swedish and foreign consultants, most of whom already had experience in banking crises in other countries, such as the US and Norway. The costs of these consultant services were paid for by banks when applying for support.

⁵¹ According to Ingves and al (2009, p. 15), the law gave previous shareholders the right of legal appeal if they judged that the compensation offered by the BSA did not correspond to the value of the bank. “However the appeals process should only deal with compensation and should not delay the takeover by the government or delay any other measures to deal with the situation of the banks.” Interesting to note, the recent EU Recovery and Resolution Directive includes this same clause.

specialists. For the assessment of the extent and forms of the support, the banks were assigned in three different categories, based on estimated losses and expected profits' actualisation. Support was given, always under strict conditions, in forms of equity capital, guarantees or loans if, according to these estimates, the bank was considered able to recover eventually as an independent entity. If capital losses were assessed as too large in relation to the present value of future profits, stricter measures were applied, including winding up or a take-over. In these cases, as happened for example with the Gota Bank, government money was used to recapitalise the good part of the bank to make it saleable and to provide capital to a "bad bank."

As we have already seen, the widespread recourse to asset management companies was one of the elements which, according to many authors, contributed most to the success of the Swedish model (Calomiris et al, 2004; Ingves and Lind, 2008; Jonung, 2009b Englund and Vihriälä, 2009).⁵² According to Borio et al. (2010), the purpose of the transfer of the troubled assets to the "bad bank" was mostly to enable management of the healthy parts of the bank to focusing primarily on restoring profitability, instead of having to worry also to manage and recover non performing loans. The main task of the asset management companies was to maximize the remaining economic value of the loan transferred, preventing fire-sales and their negative effects on the collateral's market prices (mainly property). In most cases, the asset management company tried to force debtors into bankruptcy, so they could take over the collateral, which was then sold through public offering or private sale. In other cases, the bad bank, which was not subject to the activity restrictions that applied to banks, injected capital into troubled borrowers, becoming responsible for running defaulting companies until liquidation (Ergungor, 2007; Bergström et al, 2003).

Securum, the "bad bank" of the state-owned Nordbanken, which was dissolved at the end of 1997 when it finished its operations, was very successful in selling off its assets, recovering from it significant funds. As Calomiris et al. (2004) explain, several factors contributed to their success: a strong and efficient judicial system, which allowed it to force

⁵² "Bad banks" were also established by banks which did not use public support (Ingves and Lind, 1996).

debtors who were no longer viable into bankruptcy; a strong governance mechanism and a skilled management team; the provision of adequate funding by the state; the fact that most of the assets transferred had property as the underlying value, which is relatively easy to value.

As several authors (Berg, 1998; Ergungor, 2007) outline, the main contrast between the strategy of the Norwegian government and those of the Swedish government was that the Swedish model allowed some undercapitalised bank to continue operations, backed by the blanket guarantee of their liabilities, which would be an incentive to risk-taking and reduced market discipline. The problems of moral hazards were in some ways expanded by the large-scale concentration processes promoted during the crisis. According to the IMF (2002, p. 26) "Sweden... is facing a too-big-to-fail problem with regard to each of its FMFGs [four major financial groups]... A perception of an implicit guarantee that the government would not allow any of the FMFGs to cease payments at short notice can be traced back to the authorities' response to the 1992 systemic banking crisis where a blanket guarantee was extended to all Swedish banks' debt holders, even as the authorities sought to reduce moral hazard by **not** bailing out banks' shareholders and by replacing bank management in most cases. The consequence of moral hazard is that risk premium on banks' funding costs may be too low and weaker market discipline."

However, learning from the crisis, Sweden became one of the first countries to introduce in 2008 a specific framework for official financial support to systemically important financial institutions (SIFIs) which, as the IMF (2011) outlines, is a pragmatic response to the oligopolistic structure of the banking sector.⁵³

The Finnish model of crisis management and resolution was very similar to the one in Sweden, with slightly different characteristics, especially as regards the instruments used by the government to recapitalise failing banks (Nyberg and Vihriälä, 2003; Honkapoja, 2009; Englund and Vihriälä, 2009). The first intervention to deal with a failing bank was quite atypically accomplished by the Bank of Finland which, in September 1991, took

⁵³ Under the Government Support to Credit Institutions Act 2008, the government was given power to take over a trouble bank if there was a serious systemic risk and bank capital fell below 25% of the regulatory requirements. It was set up a stabilisation fund, funded with levies on banks according to their riskiness, aimed to finance government measures to support the financial system (IMF, 2011).

control of Skopbank, a commercial bank owned by the savings banks. During this phase, the existing shareholders were not written down. The bank's non-performing loans were transferred to two new established asset management companies, owned and capitalised by the central bank. The take-over of Skopbank by the central bank was due, as Sandal (2004) notes, to the lack of alternative authorities with the financial competences and resources to handle the situation at the time. However, starting in early 1992, the government addressed banking problems more systematically. Consistent funds were set aside in the state budget to increase the capitalisation of banks and avoid a credit crunch. The capital injections were made in the form of 50-year preferred floating-rate certificates, designed to be included in the Tier I capital, while avoiding direct government ownership. These instruments, according to Santomero and Hoffman (1998) and Englund and Vihriälä (2009) had the main target of encouraging banks to replace as soon as possible public capital support with equity. The certificates carried an interest linked to the short-term money market rate; interest payment was due at the end of the year, and during the first three years only one payment was required. After three years, if interest payments were not made, or if the bank capital ratio fell below minimum regulatory requirement under Basel I, the government had conversion rights of preferred certificates in common shares; after ten years, interest rates would be increased. Even if, as Sandal (2004) argues, capital support in this form could be considered a virtual subsidy to existing shareholders, this solution in reality was particularly onerous for banks, many of which, faced with this government option, chose to raise capital on their own.

A special independent body was established, the Government Guarantee Fund (GGF), financed from the state budget, to manage financial support for ailing banks, subject to strict conditions.⁵⁴ Any support programme for a bank should meet general guidelines defined by the government: support was to be transparent and public; the attractiveness and public funding of the programme was to be minimised; conditions in the support programme were supposed to promote efficiency in the banking system and bring about the necessary structural changes; the distorting effects of competition were to be

⁵⁴ More detailed information about the organization, the governance and the public accountability of the GGF is provided by Nyberg and Vihriälä (1993).

contained as far as possible; public monitoring of the activities of the bank receiving support was to be guaranteed; the remuneration of a bank's directors was to be within "reasonable" limits (Nyberg and Vihriälä, 1993, p. 30).

By the end of 1992, the crisis worsened; a medium-sized commercial bank (KOP, i.e. Kansallis-Osake-Pankki) experienced huge losses in trading and currency market speculation. All deposit insurance funds were exhausted⁵⁵ and overseas investor confidence was seriously compromised. The Finnish Parliament then issued a blanket guarantee, under which the state committed that, under all circumstances; the Finnish banks would be able to meet their obligations in time. Equity holders were not covered.

The GGF acquired Skopbank from the central bank in June 1992 for a nominal sum, and existing shareholders were written down to zero. At the same time, the GGF offered support to several savings banks where the largest problems were to be found. Savings banks were forced to merge into a joint-stock company, the Savings Bank of Finland: savings bank foundations, the owners of the merging savings banks, lost all their capital. GGF acquired the majority of the voting shares in the new bank, which was obliged to reduce the risks and size of its balance sheet, and cut costs by reducing staff and branches. In order to contain excess capacity in the banking sector, the bank was then split into four parts and sold to competitors. To facilitate the sale, the non-performing loans were transferred to an asset management company owned and capitalised by GGF and the state. As Englund and Vihriälä (2003 and 2009) show, one of the main effects of the restructuring processes implemented in Finland during the crisis was that most of the savings banks disappeared from the market and the excess capacity of the banking system was drastically reduced. During the 1990s the number of bank employees and branches fell by more than 50%, with large operational efficiency gains.

According to Drees and Pazarbaşıoğlu (1995), in Finland the amount of funds recovered by asset management companies was, in relative terms, much less than in Sweden, especially because in Finland the banking crisis was more serious and the recession longer and

⁵⁵ In Finland compulsory deposit insurance was introduced in 1969; there are also additional voluntary insurance funds of commercial, cooperative and savings banks. However, the funds accumulated were minimal (Nyberg and Vihriälä, 1993).

harder. For Finland, the net fiscal cost was estimated as 5.2% of GDP, as against the 1.9% in Sweden (see also Sandal, 2004).

Conclusions

Right from the start of the current financial turmoil, experience of the Nordic crises has attracted much interest from politicians willing to learn lessons about the causes of systemic banking crises, how to deal with them, and how to manage them successfully. The current global crisis has an international dimension, and has been made worse by the contamination between banks and financial markets; whereas the Nordic crises were “pure credit” crises and their effects were only felt in those countries. Despite this, the same ingredients can still be seen: bad bank practices, weak banking regulation and supervision, inadequate market discipline, serious external imbalances, and inadequate macroeconomic policies related to financial liberalisation.

Although the models of crisis management and solution were different in each of the three Nordic countries, the policies implemented “taught the world powerful lessons about the need for prominent state involvement in the resolution process” (Ingves and Lind, 2008, p. 21).

One must still wonder if experience of previous crises left such long-lasting lessons to the Nordic countries, leaving them better equipped at a political and regulatory level to deal with financial crises of a systemic dimension. The fact that the three Nordic countries were hit relatively lightly during the recent crisis⁵⁶ – especially Finland, which during the 1990s saw a crisis much worse than the Great Recession of the 1930s (Mayes, 2009b) – would appear to prove that the crises in these countries had a positive learning effect, giving the lie to theories about some collective removal of those painful lessons of the past. Actually, the answer to such a question is still more or less open.

Generally speaking, as a consequence of the crises of the early 1990s, banking systems in the Nordic countries gradually became more concentrated and integrated, making the

⁵⁶ As Mayes (2009) notes, the Nordic countries hit hardest by the recent crisis were Iceland, which avoided the Nordic crises, and Denmark, which experienced only a mild crisis in the early 1990s. The widespread exposure to the Baltic region impacted significantly on Swedish financial sectors in 2008-9, but it recovered reasonably soon (Ingves, 2010).

problem of dealing with cross-border banks' crisis the principal – and as yet unresolved – regulatory challenge for the Nordic countries.⁵⁷ A Memorandum of Understanding on financial stability, crisis management and crisis resolution has been signed by the ministries of finance, central banks, and financial supervisory authorities of the Nordic and Baltic countries in August 2010. This is undoubtedly a big step forward, but experience shows that such non-binding agreements have only limited effects when an actual crisis comes about (Nieperman and Schmidt-Eisenlohr, 2011). This is especially true when the political approaches for crisis resolution remain, as they were during the 1990s, so widely different between the three Nordic countries. As a recent analysis by the IMF confirms, “[t]he authorities [have] different views on the relative merits of bailing-in and recapitalising banks and when and how to use taxpayers’ funds. Some [stress] the flexibility associated with a bail-out approach, while others [point] to the importance of removing moral hazard through bail-ins.” (IMF, 2013, p. 20).

A European solution, as part of the Banking Union, may be an opportunity, although it will not be easy, given that Finland’s automatic membership of the Banking Union contrasts with Norway, which is precluded to join by its constitution, and Denmark and Sweden will probably remain outside it. New European financial regulation (the CRD/CRR and the Bank Recovery and Resolution Directive) and single banking supervision are destined to provide new and difficult challenges for Nordic regulatory coordination in financial crisis prevention and resolution.

⁵⁷ For example, the Nordea Banking Group, set up after the crisis, is headquartered in Sweden and had subsidiaries in Norway, Denmark, Sweden and Finland (the largest of the group), branches in other countries, including Estonia, Poland, Singapore and New York.

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