Contributing to Financial Crisis Prevention Through Banking and Financial Services Regulation

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Introduction

Anabtawi and Schwarcz (2013) remind us that financial firms and financial markets operate in the context of various regulatory bodies that, generally speaking, “govern the provision, allocation, and deployment of financial capital.” At the same time, relevant legislation provides for penalties to (a) prevent breaches of the regulatory framework, (b) mitigate the adverse consequences of breaches of the regulatory framework, and (c) reduce the likelihood of further losses. Markets, of course, exist in order to exchange assets and the formulations of explicit rules that govern or control this process are vitally important for efficiently pricing traded assets.

Government financial regulations in the United States can be traced to the 1933 Banking Act, which was introduced to address problems that had contributed to the Great Depression and were designed to ensure the stability and safety of depository financial institutions and protect consumers. Inter alia, that act created the Federal Deposit Insurance Corporation (FDIC) to insure deposits in banks, compelled national banks to comply with federal regulations, and imposed restrictions on how much commercial banks could lend. In the same year legislation was introduced to regulate other depository institutions, namely, the 1933 Securities Act (for the securities markets), the Federal Home Loan Bank Board in 1933 (for the savings and loans associations), and, a year later, in 1934 the Bureau of Federal Credit Unions (for credit unions) was established. However, for several reasons that include computer technology, high interest rates, entrepreneurial innovations, political ideologies, and power, the regulatory system introduced in the wake of the Great Depression was not reformed until the 1970s.

More specifically, usury laws were changed in 1978, interest rate ceilings were removed in 1980, banks were allowed to offer adjustable-rate mortgage loans in 1982, and the Financial Modernization Act of 1999 repealed restrictions provided in the Glass-Steagall Act of 1933, including the vital separation between commercial and investment banks. The abolition of the separation of banks made it possible for financial institutions to become mega banks by combining banking, securities, and insurance operations.

In the United States the regulatory legislation and institutions developed since the Great Depression and the deregulation policies since the late 1970s have created a “fragmented and complex regulatory system.” Furthermore, the regulatory system was characterized by a risk-averse attitude, moral hazard, conflicting goals, unregulated entities, and political incentives.

The international experience tells us that in the wake of market crashes and the ensuing financial crises, legislators rush through ineffective legislation in an effort to ensure that such disasters do not recur; however, such legislation may well cause harm. Chelikani and D’Souza (2014) maintain that mechanisms for testing recently implemented regulations are essential and should be developed. The fact remains, of course, that a government’s response to a financial crisis inevitably entails both challenges and concerns that are not easy to address in a democratic country and market system because there exist different political philosophies, economic theories, and interest groups.

In order for regulation to be put into effect, political will and political influence are needed. Lobbying has become the means by which the stakeholders, often without transparent methods, encourage legislation to be enacted or not because it is in their interest to take excessive risks, oppose regulatory efforts, and externalize significant costs, stakeholders underestimate the
potentiality of catastrophic risks because of what Dallas (2012) termed “disaster myopia.” Thus, during financial stability or when the markets are calm, people are not worried about a financial crisis and, consequently, public policy is dominated by the special interests of the financial services industry. Let us next consider the concept of and the need for regulation.

**Regulation: The Concept and Need**

Generally speaking, regulation is “designed to facilitate the development of competitive markets and achieve social and public goals.” Meier (1985) proposed that the term regulation be used to mean “any attempt by the government to control the behavior of citizens, corporations or sub-government.”

Regarding the need for regulation, it should be remembered that not everybody agrees with regulating the financial sector. Bhattacharya argued that “banking is the most regulated among all industrial sectors of the economy” and capital regulation has increased the risk for the banking industry, rather than reduced it. Similarly, with regard to regulating financial institutions in order to aid economic recovery in Europe, in its 2014 “New Commission, New Parliament: An Agenda for Financial Services in the European Union,” KPMG’s financial services experts argued that the new European Parliament and Council have an opportunity and should reevaluate the reformatory measures introduced post crisis by their predecessors because those reforms are excessive, and in some countries, the costs of regulation exceed the benefits; instead, the emphasis now should be on regulatory reforms that shift the focus onto the contribution the private sector can make to the European Union’s growth and reform agenda. This means revisiting and rebalancing the reform agenda to deliver jobs and growth, underpinned by competition and innovation.

Since the 1980s, a strong argument against regulation has been that it does not facilitate competition to benefit consumers. One plausible response to this point of view is that regulation is not an all or nothing proposition; rather, it is a matter of degree as well as effectiveness in achieving specific aims, one of which is to protect investors and the taxpayer as well as to avert financial catastrophes. A financial crisis, of course, underscores government regulation as a top public policy priority.

Concerning justifications that have been offered for government regulation of financial markets, the following have been put forward:

- Governments ought to protect citizens and business, manage the economy, distribute national income and social resources, promote growth and development, and also regulate.
- Regulation results in “transparency by ensuring that organizations fully disclose all information (whether favorable or not) concerning the participants.”
- Regulation is necessary because more people will behave dishonestly if there are no legal constraints on their behavior backed by a reasonable likelihood of being found out and punished severely enough.
- There is a need to reduce fraudulent or corrupt activity; and a legislative framework is called for.
- When government is perceived to be corrupt, people are concerned that it might fail and, therefore, it needs to be regulated.
- Regulation is necessary to protect the economy from preventing or minimize market failure, reducing poverty and improve income distribution, protect citizens and businesses, guard the rights of future generations, and promote growth and development (Stern 1991; Liou 1998);
- Legislation is necessary in preventing, detecting, and punishing the offender;
- Regulation reduces the benefits derived from the illegal activity (e.g., taxing the gains derived); and
- There is a need to protect the whistle-blower.

As a further illustration of the need for regulation, the subprime crisis in the United States in 2008 soon became a global crisis. In Europe, the whole economic system faced a real threat of collapse as the financial crisis adversely impacted the economies of EU Member States. The crisis subsequently became a wider sovereign debt crisis with serious consequences for the whole European economic system. For the European Union’s economy, the response to the crisis came with a huge financial cost: Between 2008 and 2012 a total of €1.5 trillion of state aid was used to prevent the collapse of the system. At the same time, the crisis triggered a deep recession and high unemployment in countries like Ireland, Greece, Portugal, Italy, and Spain, and citizens in these countries experienced significant decreases in their wealth, income, opportunities, and quality of life.
Not surprisingly, trust in the financial system was seriously affected. To deal with the crisis, the European Commission in November 2008 put in place a European Economic Recovery Plan to slow down the pace of the economic downturn, create conditions for an upturn, and restore trust in the financial system. In its attempt to overhaul the regulatory and supervisory framework of the financial sector, the Commission introduced the European System of Financial Supervision in its March 2009 communication “Driving European Recovery.” The European Council and Parliament adopted a number of measures in its June 2010 “Regulating Financial Services for Sustainable Growth” that were aimed at creating a safe and responsible financial sector to drive economic growth. These measures were characterized by effective supervision, enhanced transparency, greater stability and resilience, and strengthened investor and consumer protection. Interestingly, the regulatory reforms adopted by the European Union were coordinated globally at the level of the G20 and the Financial Stability Board. One basic aim of the reforms has been to ensure that future banking crises would not become sovereign crises. For example, the reforms created a Banking Union, and they require investors, rather than taxpayers, to pay the bill when a bank fails because they are the ones who benefit from risk-taking.

In the United States in the aftermath of the financial meltdown, to protect borrowers and investors who participate in financial markets and to mitigate the financial instability caused by the 2008 crisis, the most comprehensive reform of the country’s financial regulatory system since the Great Depression came with the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010. Key outcomes of the legislation include the following:

- It created the Consumer Financial Protection Bureau, a new independent watchdog agency.
- It established the Financial Stability Oversight Council to address systemic risk.
- It put an end to too-big-to-fail bailouts by introducing new safe ways to liquidate failed financial corporations.
- It made the derivatives market transparent and accountable.
- It enabled regulators to aggressively pursue “financial fraud, conflict of interest, and manipulation of the system that benefit special interests at the expense of American families and businesses.”

It becomes evident that although the arguments in favor of regulation outweigh those against it, not everybody has faith in the effectiveness of legislation to regulate activities.

Ways and Means of Regulation

In order to resolve the various problems caused by the 2008 financial crisis and to reduce the negative effects of past government-controlled regulation as much as possible, policy makers in the United States have invested in strengthening the financial industry regulatory framework by means of policy, structural, and operational changes. Anabtawi and Schwarz (2013) summarized the following three types of regulation:

1. Market-integrity regulation promotes fairness in the interactions among financial market participants.
2. Competition regulation addresses the structure of financial markets and ensures that financial markets behave competitively by overseeing both their conduct and conditions.
3. Prudential regulation ensures that financial firms are able to meet their obligations to their counterparts.

Whatever type of regulation is utilized, the challenge is to ensure its effective implementation by having an integrated regulatory system that is characterized by accountability and transparency and the ability to pay its own financial cost.

Writing on corporate harmony and confidence-building spheres on the financial market, Grabowski maintained that both legal regulation and self-regulation are needed. More specifically, his “rules and regulations square source” model consists of four quadrants but with an epicenter and inner and outer sectors. The outer sector consists of (a) hard law in the form of legal regulation (financial markets law and Company Law) and (b) soft law in the form of codes of best practices, self-regulation, and corporate governance principles. When all categories of regulation operate adequately, the synergy of (a) and (b) results in harmony, a state of affairs represented in Grabowski’s model by the “integration sphere” in the epicenter of the circle. Let us next focus on regulation by means of legislation.

Legislative Regulation

The ability of authorities and professional bodies to regulate the behavior of individuals and corporations
and their members, respectively, rests on there being laws, regulations, and rules that prescribe desirable behavior and prohibit undesirable practices as well as there being mechanisms and procedures to deal with violators and punish those convicted by the courts.

Financial regulation operates in the context of a complex interdependent system; interdependencies between firms, markets, and legal rules have implications for the financial regulatory policy one advances, especially with reference to \textit{ex ante} and \textit{ex post} regulation.\footnote{38} \textit{Ex ante} regulation aims to prevent financial failure, while \textit{ex post} regulation aims to respond to a financial failure or crisis. Anabtawi and Schwarcz showed that both can be effective at reducing systemic risk, but neither is sufficient as a lone strategy to protect a country’s financial system because each type of regulation has limits. The limits of \textit{ex ante} regulation are that it is incomplete, it has to cope with industry resistance, it discourages risk taking, and it encourages regulatory arbitrage. For these reasons, \textit{ex ante} regulation remains at best a partial solution for addressing systemic risk and preventing financial failure.\footnote{39}

Anabtawi and Schwarcz\footnote{2013} regard \textit{ex post} regulation as essential because it complements \textit{ex ante} regulation. It can respond to the failures of \textit{ex ante} regulation, address risk taking, and reduce the likelihood that policy makers will overregulate the financial markets in an attempt to avoid another financial crisis.\footnote{40}

Serious limits of \textit{ex post} regulation discussed by Anabtawi and Schwarcz\footnote{2013} highlight the danger of false positives or false alarms prompting attempts to safeguard the financial system, leading to a significant financial cost due to the unnecessary rescues of firms.\footnote{31} They also point out that \textit{ex post} regulation leads to “financial safety nets”\footnote{42} that are intended to mitigate the systemic consequences of financial failures but are conducive for moral hazard\footnote{43} and inefficiencies.\footnote{44} The safety nets also disrupt transmission chains (i.e., the mechanisms by which systemic risk travels).

Legitimate criticisms of \textit{ex post} financial regulation notwithstanding, Anabtawi and Schwarcz\footnote{2013} indicated that the potential benefits of \textit{ex post} regulation out-weight its potential costs, and more importantly, such costs can be managed. Because neither \textit{ex ante} nor \textit{ex post} regulation is by itself effective in reducing systemic risk and thus averting a financial crisis, governments need to balance the two approaches to financial regulation in their endeavors to achieve both economic efficiency and financial stability. To do so, of course, presupposes that the governments are aware of the relevant factors in selecting the best combination of \textit{ex ante} and \textit{ex post}.

The United States historically provided one or more regulators for each category of financial regulation, rather than one regulator for all activities, institutions, and markets.\footnote{46} However, as already mentioned, the US government’s response following the 2008 financial crisis was to establish a single command to coordinate various regulatory entities. In the United States, the government agency that acts as the ultimate regulator of the securities industry (including the Financial Industry Regulatory Authority, Inc. [FINRA]) is the Securities and Exchange Commission (SEC).\footnote{47} FINRA is a private corporation that acts as a self-regulatory organization.\footnote{48}

\textit{Ex post} regulatory strategies ought to prevent a financial crisis from recurring in the first place, by creating a “safety net” by which the government allocates the losses of an illiquid or insolvent firm to itself to stabilize imbalances and encourages prudent action in place of reckless behavior or risk-taking by the stakeholders.\footnote{49} Financial safety nets provide participants with protection against the risk that their counterparts will default or markets will collapse (e.g., European depositors are guaranteed that should the bank that holds their deposits fail, they are guaranteed €100,000 by the government through the Deposit Guarantee Scheme\footnote{50}). Furthermore, when the firm is “too big to fail” (TBTF) the government may choose to absorb the losses of the firm to prevent the firm from going under (e.g., the Italian government in 2009 approved an emergency decree to bail out the country’s eighth largest industrial group after the company faced a collapse of US$14 billion\footnote{51}) and prevent a ripple effect. Failure to do so, as the TBTF firm goes into bankruptcy, it will default on its obligations, be forced to sell its assets, and thus create a downward pressure on the prices of those assets and create a domino effect collapse. Many share the concern that governments need to be very careful with safety nets to prevent domino effect collapses because, while a government may be absorbing the losses of a financial firm in the hope of preventing a total collapse.
of the banking sector, the losses may be so large that the sustainability of the entire national financial system is at risk or the bail-out may be too late to minimize the systemic effects.\(^5\)

According to Anabtawi and Schwarz, the United States currently has no formal safety net mechanism for rescuing TBTF firms.\(^53\) The Department of the Treasury needs congressional approval to conduct bail-outs under the Dodd–Frank Act, while the FDIC has the authority to resolve a failing financial firm but only through liquidation. The Federal Reserve Bank is also limited in its capacity to address systemic risk. The fact, however, that “large firms have grown in dollar terms since the enactment of the Dodd-Frank Act has led some critics to question whether the TBTF problem has been solved.”\(^54\) Member states in the European Union appear reluctant to provide safety nets for smaller nations, and this was evident in 2013 when Cyprus, a member of the Eurozone, was refused a bail-out unless it firstly applied “bail-in.” As Lewis (2013) explained, a bail-in strategy was first tested in Cyprus in March 2013 when equity investors and most-junior creditors lost deposits in banks of over €100,000; less-junior creditors received a debt/equity conversion; and senior creditors got 100 percent.\(^55\)

A balance of \textit{ex ante} and \textit{ex poste} regulation ought to be enforced as long as the legislators consider the repercussions for the public and not only for the financial firms. The legislators therefore have a key role to play in enforcing regulation that is fair, protects the investors, and is beneficial for the economy.

**Regulating Financial Services and Banks**

In the European Union, uniform regulation across Europe applies for Central Securities Depositories (CSDs).\(^56\) Article 26 of Regulation 909/2014 expects CSDs to implement effective policies and procedures to ensure compliance with the said regulation, to maintain and operate effective written organizational and administrative arrangements to identify and manage any potential conflict of interest, and be subject to independent audits. The regulation expects a great degree of transparency, and the CSDs’ internal governance and conduct of business rules will be reviewed. If there are no independent directors on the board, CSDs will be expected to appoint at least two and will need to ensure that measures are in place against conflicts of interest. These are just a few of the regulatory measures outlined by Belghazi (2013).\(^57\) Furthermore, Article 27 of the regulation expects the remuneration of the board of CSDs to not be linked to the business performance of the entity.

In the United Kingdom the regulatory framework for financial services, which had developed over the course of the 20th century, has been described as “complex and fragmented.”\(^58\) There were multiple regulators; the governing legislation and regulatory requirements were embodied in various legislations, codes, and regulations; and overall the consumers and practitioners were confused. In an effort to improve prudential and supervisory arrangements, a Prudential Regulatory Authority (PRA) and a Consumer Protection and Markets Authority (CPMA) were established by the Financial Services Act in 2012\(^59\) in place of the FSA. The PRA is part of the Bank of England with the aim to oversee macro-prudential policy, while the CPMA is responsible for “conduct of business regulation for both retail and wholesale firms.”\(^60\)

As previously mentioned, and drawing on Gambacorta and van Rixtel (2013), structural measures were introduced in several countries to separate “commercial” and “investment” banks in the wake of the financial crisis.\(^61\) These measures were intended to minimize the contagion effect from risky activities and decisions within and between banking institutions and also to protect certain categories of financial activities considered vital for the national economy or significant in terms of consumer or depositor protection from riskier but less significant activities. In the United States, the Volcker Rule since 2012 allows market-making activities on behalf of customers but has done away with proprietary trading, while having several exemptions for transactions for such instruments as US Treasury and agency securities. It does, however, restrict such trading and banking activities in different subsidiaries within the same group (p. 2). The Volcker Rule also prevents banks from investing in and sponsoring entities trading in hedge funds and private equity funding because it would expose them to the same risk as those entities.

The 2011 Vickers Commission in the United Kingdom concluded there were difficulties in applying Volcker’s distinction between proprietary trading
and hedging activities, and it proposed a narrow definition of activities that would be permitted within a ring-fence but with a recommended higher level of capital (in the main domestic deposit-taking and lending to households and SMEs). Consequently, the Commission proposed ring-fencing the country’s banks without completely separating commercial from investment banks. Ring-fencing was introduced by the Financial Services (Banking Reform) Act that received Royal assent in December 2013 and separated core banking services from risk laden activities.

In response to the global financial crisis in continental Europe, in December 2010 two EU Regulations establishing the European Systemic Risk Board (ESRB) entered into force as part of the European System of Financial Supervision (ESFS) and with the purpose of ensuring macro-prudential supervision of the EU’s financial system. In addition to the ESRB, the ESFS consists of the European Banking Authority; the European Insurance and Occupational Pensions Authority; the European Securities and Markets Authority; the Joint Committee of the European Supervisory Authorities (ESAs); and, finally, the competent or supervisory authorities in the member states as specified in the legislation establishing the three ESAs.

In addition, the European System of Financial Supervisors (ESFS), which is the framework of financial supervision in the EU, has existed since 2011. It was first proposed by the European Commission in 2009, in response to the 2008 financial crisis, and it replaced the Committees of Supervisors with ESAs. The ESFS has the task of supervising individual financial institutions, that is, so-called “micro-prudential supervision.”

In February 2012, the European Commission established a High-Level Expert Group to examine the structure of the European Union’s banking sector. Modeled after the United Kingdom’s Independent Commission on Banking, the group produced a report in October 2012 (the Liikanen Report) that separated “proprietary trading and all assets, liabilities and derivatives positions incurred from other banking activities.” It was proposed that, with certain exemptions, the former activities should operate on a stand-alone basis and be assigned to a separate entity, which would not be allowed to fund itself with deposits or provide retail financial services. One restriction recommended in the Liikanen Report was an upper limit of 15 to 20 percent of a bank’s total trading assets; otherwise, a second stage of examinations would be imposed on the bank.

As one might expect, the idea of a single European Banking Supervisor attracted some opposition on the grounds that (a) such an entity would create political problems because it would be in a position to overrule national regulators, (b) taxpayers would fear that the deposit insurance fund could be used to transfer funds from countries with adequate banking systems to those with deficient banking systems, and (c) it would require a system of burden sharing. After five years in operation, the challenge for researchers is to evaluate the performance of the European Banking Authority.

Finally, at the international level, an article in New Scientist revealed that 147 interconnected entities control the network of global capitalism. As a consequence, if one of those entities (not necessarily a large organization) had a problem, the rest of the interconnected entities could experience a significant adverse effect. Concern about the vulnerability of the interconnected entities to a ripple or domino effect led the Financial Stability Board to publish a list of 29 systemically important financial institutions (SIFIs). If SIFIs fail, the world’s economy would be jeopardized. To safeguard themselves against collapse, these organizations are required to hold a significant proportion of their capital as collateral, despite the effect on their profitability. An entity is designated as SIFI on the basis of three criteria: its size, interconnectedness, and complexity. However, a company’s SIFI designation can and has been legally challenged because there is no agreement on how the three defining criteria interact to define a company’s importance worldwide. As a result, the regulation of SIFIs will be gradually eroded. One may legitimately ask, however, how about banking regulation in developing countries?

According to Evrense (2009), “Developing countries have stricter banking regulations with respect to auditing requirements, various capital related ratios, reserves etc.,” but as in the case of developed countries, the greater strictness in banking regulations does not mean they underpin their applicability and effectiveness.
addition entry restrictions on foreign banks in developing countries reduce competition among banks and create greater safety nets for existing banks because relevant information is not made available to the public. External supervision of bank regulators is reduced because supervisory agencies seem to be directly accountable to the government and not a legislative body, and finally, supervisory agencies “seem to have power over courts and bank shareholders in the event of a liquidation or closure.” Interestingly, countries with fewer years of independence tend to have weaker executive constraints and more corruption, and bank regulations reflect the political systems of countries and not necessarily their ignorance of effective banking regulations.

Why then do some countries decide to implement certain bank regulations and not others? In some countries, special interest groups “politically organize themselves and extract rents from others by using the coercive power of the government.” Regulation, of course, does not necessarily guarantee stability. Barth, Caprio, and Levine (2006) argued that discovering best practices that would minimize a banking crisis would not necessarily convince policy makers to adopt them because it depends on the power and authority of the government.

In order to create a single market and facilitate competition in the European Union, banks chartered anywhere in the European Economic Area have a “single passport” entitling them to open a branch in any other member state subject to the same regulation as in the home country (chartering country authorities) and the branch will be supervised by the authorities in the home country, with a “mutual recognition” where overseas regulators trust the judgment of “local regulators.” The trust seems to have been erased following the 2008 financial crisis. Faced with “potentially catastrophic failure of a bank…many national supervisors felt that they had no choice but to intervene” by, for example, “restricting the scope of the banking sector by separating commercial banking from the so-called ‘casino banking’, as proposed in the Vickers Report in the UK.” Critics of the single-passport approach in banking contend that it “may have served to distort market signals and to undermine the free operation of banking markets in Europe.”

It takes a crisis to reform financial regulation simply because it is only during an economic downturn that the public discontent tends to encourage regulatory reform. Regulation, however, cannot exist without administration capacity for an effective regulatory system. Recipes for the future, as far as having a holistic reform on the regulatory system is concerned, will minimize the impact of the financial crisis through accountability on the part of the regulators (the lack of which led to the financial crisis) together with the administrative capacities and skills of the stakeholders promoting transparency at all levels from firm, market, government, and consumer; managing risk; promoting e-government; following transparent lobbying procedures (the lobbyist and lobbied); and holding elected and appointed officials accountable. Such reforms will change the view that “the banks own the political system.”

Discussion and Conclusions

Although not everybody agrees with regulating the financial sector, financial firms and financial markets currently operate in the context of various regulatory bodies and government financial regulation. As Grabowski (2013) emphasized, however, there is a need for (a) hard law in the form of legal regulation (financial markets law and Company Law) and (b) soft law in the form of codes of best practices, self-regulation, and corporate governance principles. Furthermore, when all categories of regulation operate adequately, the synergy of (a) and (b) results in harmony.

A number of justifications can be offered for regulation, including that it is designed to ensure the stability and safety of depository financial institutions and to protect consumers and, also, that it is essential to minimize the likelihood of a financial crisis and to facilitate the development of competitive markets and achieve social and public goals. If regulation is to be successful and prevent financial catastrophes, it ought to be inclusive of institutions. Such regulation is better designed and implemented in developed than in developing countries, but this has not spared them financial crises. There is no consensus on the causes of a financial crisis or how best to respond to one. During the period from 1933 to the late 1990s in the United States, the financial regulatory system introduced after the Great Depression was gradually deregulated because of computer technology, high interest rates, entrepreneurial innovations, and political ideologies and power. It was a time bomb waiting to explode. The 2008 crisis
showed that in the absence of a supporting infrastructure of governance, laws, and culture, markets cannot and will not function well.

A financial crisis provides motivation for reform and emphasizes government regulation as a top public policy priority. In an effort to protect borrowers and investors who participate in financial markets (and in order to mitigate the financial instability caused by the 2008 crisis), the most comprehensive reform of the United States’ financial regulatory system since the Great Depression came with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Dodd-Frank Act strengthened the financial industry regulatory framework by means of policy, structural, and operational changes. Furthermore, the US government’s response to the crisis was to establish a single command (SEC) to coordinate various regulatory entities. In 2013 the United Kingdom broke up its FSA, which had jurisdiction over securities, banking, derivatives, and insurance, and split it into the Prudential Regulation Authority and the Consumer Protection and Markets Authority.

To deal with the crisis, the European Commission put in place a European Economic Recovery Plan in the autumn of 2008 in an attempt to overhaul the regulatory and supervisory framework of the financial sector. The Commission introduced the European Systemic Risk Board (for macro-prudential supervision) in 2010 and the European System of Financial Supervision (for micro-prudential supervision) in 2011. In 2014 uniform regulation in the European Union was also applied to CSDs. This does not mean, of course, that there has been consensus when it comes to balancing sufficient safety and soundness in financial institutions to protect consumers and investors and avert financial crises on the one hand, and allowing dynamic and innovate capital markets in the European Union to flourish and drive jobs and growth on the other. It should also be noted in this context that in considering how different countries responded to the financial crisis, it is interesting to remember that research by Kinetic Partners (2014) indicated that in recent years global regulators have shown a more focused commitment to combat industry misconduct and to preempt abusive behavior.90

Financial regulation can be effected, first of all, through legislation. However, neither ex ante nor ex post regulation is effective in reducing systemic risk by itself. Consequently, to avert a financial crisis, governments need to balance the two approaches to financial regulation in trying to achieve both economic efficiency and financial stability. To do so presupposes that the governments are aware of the factors relevant to selecting the best combination of ex ante and ex post regulation. The absence, however, of corporate governance principles such as openness, honesty, transparency, trustworthiness, and accountability undermines the financial viability of companies and can lead to their eventual downfall, as revealed by numerous examples from the 2008 financial crisis. To illustrate, focusing on the case of the Republic of Cyprus, Arsalidou and Krambia-Kapardis (2015) have demonstrated that bad corporate governance in the banking sector complimented with strong political and business connections contributed to the country’s financial catastrophe.91

A deliberate balance of interests between different market sectors is essential for institutional stability and its absence “plants the seeds of institutional destruction.”92 The challenge here is that no one country has managed to regulate effectively enough to prevent financial crimes and financial catastrophes. If regulation is to be successful and prevent financial catastrophes, it ought to be inclusive of institutions. For example, it is catastrophic if politicians make laws to benefit a particular industry or group of individuals at the expense of others.

The science of averting a financial crisis has yet to be perfected and this, as shown by the preceding discussion, is unlikely to be achieved in the foreseeable future because “disaster myopia” may be reduced, but it will not be eliminated. It is easier, of course, to be wise in hindsight, and regulating unreasonably risky decisions and unethical or outright criminal behavior in the financial world remains a major challenge for governments, corporations, professions, and researchers alike.

On the basis of the preceding argument, it becomes clear that reducing the risk of a financial crisis will not be achieved by regulation alone. As argued by Krambia-Kapardis (2016), what is called for is a holistic approach.93 Such an approach is encapsulated in the Corruption and Corporate Fraud Prevention (CCFP) model she proposes, which comprises three inter-dependent pillars, namely person, company and society. Needless to say that implementation of such a model requires political will.
Notes
3. Id. at 86.
4. Id. at 84.
6. Also known as the Glass-Steagall Act, 1933.
7. This has included a range of complex investment products that include derivative instruments such as credit default swaps and bond insurance as well as new types of mortgages before the financial crisis such as subprime. Liou, Kuotsai Tom. “The Financial Crisis and the Challenge of Government Regulation.” Public Performance & Management Review 69, no. 4 (2009): 265–364.
8. Id.
9. Known also as the Gramm-Leach-Bliley Act.
10. Liou 2013, supra n.7 at 211.
13. Liou 2013, supra n.7 at 219.
20. Akisk 2013 supra n.16 at 33.
21. Liou 2013, supra n.7 at 208.
28. Liou 2013, supra n.7 at 214.
29. Id.
31. Liou 2013, supra n.7 at 217.
32. Anabtawi and Schwarcz, 2013, supra n.2.
36. Liou 2013, supra n.7 218.
38. Anabtawi and Schwarcz, 2013, supra n.2.
39. Id. at 101–102.
40. Id. at 102.
41. Id. at 77, 126.
42. With this term Anabtawi and Schwarcz, 2013, mean “the authority of a government or other publicly governed body, in the case of financial firms, to allocate the losses of an illiquid
or insolvent firm to itself and, in the case of financial markets, to stabilize supply and demand imbalances." Id. at 103.

43. “Moral hazard occurs when a decision maker in incentivized to take risks beyond the level that he or she would have otherwise taken because some or all of the negative consequences of taking those risks are shifted to third parties.” (Anabtawi and Schwartz, 2013, supra n.2, at 122 citing Okamoto, Karl S. “After the Bailout: Regulating Systemic Moral Hazard.” UCLA Law Review 57, no. 18 (2009): 204–205, at 189).

44. Anabtawi and Schwartz, 2013, supra n.2 at 77.


47. It is a nongovernmental organization that regulates brokerage firms and exchange markets.

48. Anabtawi and Schwartz, 2013, supra n.2 at 103.


53. In fact “all insured deposits (individuals and legal entities) up to €100,000 have, as of 26 March 2013, been transferred from Marfin Laiki Bank to the Bank of Cyprus. In addition, the entire amount of deposits belonging to financial institutions, the government, municipalities, municipal councils and other public entities, insurance companies, charities, schools, educational institutions, and deposits belonging to JCC Payment Systems Ltd have been transferred to the Bank of Cyprus.” Lewis, Nathan. “The Cyprus Bank ‘Bail-In’ Is Another Crony Bankster Scam.” Forbes, March 2013. http://www.forbes.com/sites/nathanlewis/2013/05/03/the-cyprus-bank-bail-in-is-another-crony-bankster-scam/ (last accessed July 5, 2016).


55. “Moral hazard occurs when a decision maker is incentivized to take risks beyond the level that he or she would have otherwise taken because some or all of the negative consequences of taking those risks are shifted to third parties.” (Anabtawi and Schwartz, 2013, supra n.2, at 122 citing Okamoto, Karl S. “After the Bailout: Regulating Systemic Moral Hazard.” UCLA Law Review 57, no. 18 (2009): 204–205, at 189).


68. Gambacorta and Van Rixtel 2013, supra n.63.
69. Id. at 24.
73. It is an international body tasked with monitoring finance worldwide. http://www.financialstabilityboard.org/about/ (last accessed July 5, 2016).
74. Aron 2015, supra n.74 at 10.
76. Id. at 100.
77. Id. at 109.
80. Booth and Morrison 2012, supra n.73 at 25.
81. Id. at 25.
83. It also applies to insurance companies.
84. Booth and Morrison 2012, supra n.73 at 24.
85. Coffee 2012, supra n.15.
87. Liu 2013, supra n.8 at 219. “e-government includes publishing government information on the Internet to expand access, using two-way communication methods to enhance the interaction between government and citizens, and providing fully online services through the integrated Internet system. The techniques used in the publication, interaction, and transaction of public information will be valuable for both the regulatory agencies and the financial institutions in their efforts to enhance regulatory transparency and revitalize financial industries.”
89. Grabowski (2013), supra n.37.
90. Kinetic Partners (2014), supra n.50.