"Reforms of the banking sector in response to the financial crisis within the EU: comparative analysis of the UK and Cyprus"

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REFORMS OF THE BANKING SECTOR IN RESPONSE TO THE FINANCIAL CRISIS WITHIN THE EU: COMPARATIVE ANALYSIS OF THE UK AND OF CYPRUS

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Abstract

The focus of this paper is on the role of banks in the financial crisis of 2007 particularly in the UK and in Cyprus. Economists, lawyers, politicians and the media worldwide, all consider as determinant the contribution of banks to the global financial crash which arose in 2007. Based on the assumption that governments will never let them fail, due to their importance for the economy of every country, banks' management tended to encourage enormous risks to be taken by promising huge bonuses, especially in the absence of strict supervision from the State. The UK faced the crisis by introducing reform measures on the field of banks supervision initially. Cyprus fell into financial disruption some years later, in 2011 and the first signs of recovery are expected now. The fact that the banking sector of the country was initially founded on the UK model, because of the colonialism of Cyprus by the British Empire, and it has then been influenced by Cyprus' accession to the EMU, leads to the discussion whether Cyprus could effectively follow the reforms of the UK in order to rescue its banks and its economy in general.

Therefore this paper begins with an analysis of the general role of banks in the development of financial crashes and an examination of three main theories of the way that banks can contribute to a crisis, and how these theories applied in the case of the UK crisis of 2007-2008 and in the euro area crisis. These three theories are the 'Too-Big-to-Fail' theory, the deficient corporate governance of banks and the ineffective supervision of them. Afterwards, the measures imposed by the UK government to its banking sector are discussed, followed by the corresponding EU financial measures. The EU approach leads to a brief presentation of the timeline of the crisis in Cyprus and an evaluation of the causes of this crisis in the island. It is remarkable that the reforms already introduced in the island, were all enforced by the 'Troika' in the form of a Memorandum of Understanding and were presented to Cypriots as their last lifebelt before the entire collapse of their country. Finally, it is discussed whether Cyprus could apply the reform adopted in the UK in order to improve its financial industry and to avoid a future crisis, in order to reach the conclusion that Cyprus can follow the example of

the UK and focus its efforts on the banks' supervision first, so as to deal effectively and terminally with the financial crisis.

The main point of this paper is to underline that a future financial crisis can only be avoided by improving risk management, enhancing corporate governance of banks, implementing effective resolution and support facilities and establishing macro-prudential oversight systems.

Table of Contents

1. Introduction

Financial crises, and especially bank crises, are not a novel phenomenon. They have been around for some time. The vulnerability of the banking system is seen worldwide, irrespective of the type of financial system.[1] This vulnerability stems from the very foundation of the banking activity, namely the granting of loans on the basis of attracted deposits. A bank operates by keeping in liquidity or in investments, some of the attracted deposits, so as to accommodate the withdrawals by depositors. Assuming that the majority of deponents decide to withdraw their savings, then the bank would face the threat of failure. The collapse of a bank works like the unbalancing of a domino piece which ends up in the collapse of the whole system. Moreover, if we consider that in recent years, the financial environment has assumed a global character, a financial crisis is more likely to be forwarded from one State to another with unpredictable consequences. Therefore, since the contribution of banks in the incidence and transmission of financial crises is decisive, the resolution of a financial crisis requires the initial prevention or settlement of the bank crisis.[2]

A financial crisis includes essential alterations in credit volume and asset prices, supply of external financing and the necessity of extensive support by the government. Banking crisis constitutes one type of financial crisis.[3] The notion of economic crisis encompasses a significant decrease of the national GDP, a total exhaustion of liquidity and the consequences of the resultant inflations and deflations. Generally, an economic crisis results from a financial crisis.

The present paper intends to take a closer look at the role of banks in the most recent financial crisis, particularly in the cases of the UK and Cyprus, as a Member State of the EU. As a starting point, the theoretical base of this paper is composed of a general examination of the

[1] Either market-based or bank-based, *See* R. Levine, 'Bank-based or market-based financial systems: Which is better?' (2002) NBER Working Paper Series, Working paper 9138 http://www.nber.org/papers/w9138 (Accessed 4 September 2015)

[2] A. M. Andries, 'What Role Have Banks in Financial Crises?', (2009) *Review of Economic and Business Studies*, 150

[3] S. Claessens and M. Ayhan Kose, 'Financial Crises: Explanations, Types, and Implications' (2013) IMF Working Paper, WP/13/28

decisive role of banks in the development of financial crises and a throughout critical analysis of three of the most popular theories of how banks can initiate a financial crisis. The theories that will be analysed in the present paper are the following: the 'Too Big To Fail' theory, the corporate governance of banks and the supervision and regulation of them. The paper first deals with the theoretical framework introduced above, and continues into a more practical part where it evaluates the reform measures being recently enforced in the UK in order to deal with the crisis. This part of the paper considers whether such measures could be effectively adopted by the government of Cyprus to cope with the crisis on the island, in light of the membership of the country to the European Monetary Union.

The objective of this study is to assess whether the reform, which has taken place in the UK banks, could also apply and work in Cyprus in order to handle the current disastrous financial reality of the island. The choice to examine the country of Cyprus is based on the fact that the entire Cyprus legal system and banking industry of the country were developed under English foundations, during the era when Cyprus constituted a part of the British Empire.[4] As a result, the two countries share some pillars relating to the operation and legal regulation of banks and the financial system in general.[5] It emerges that if Cyprus shifts its focus on the supervision of banks, following the example of the UK government, in conjunction with some other recommended measures; the current situation of the island could improve. The conclusions drawn are intended to be worthwhile targeting certain proposals aiming towards the solution of the existing financial turbulences in Cyprus and the prevention of similar situations in the future.

Following the defined purposes above, this paper is organized as follows: The first chapter includes a general examination of the contribution of banks in financial crises. In the second chapter the three aforementioned theories are analysed and evaluated. These three main

[4] 1878-1960

[5] After the accession of Cyprus to the EU in 2004, the government undertook the obligation to accede to the EMU and to adopt the euro as its national currency. Cyprus joined the euro zone in 2008, thus, its banking system is also affected by the European Central Bank policy.

arguments are also examined as to whether they apply to the case of the UK 2007 financial crash and to the case of the euro area crisis. The reform measures adopted in the UK and in the EU respectively will be presented in the third chapter. The case of Cyprus follows in the fourth chapter. This chapter incorporates a timeline of the crisis which arose in 2011 and led to the unprecedented rescue package of the 25th of March 2013, and an examination of the causes of the crisis taking into account the role of banks. The goal of the analysis conducted in the current paper is to discover whether the measures enforced in the UK could also be implemented in Cyprus and how. Additionally, the paper aims to explore what other measures could be adopted to deal with the crisis.

2. The role of banks in a financial crisis

Banks can cause a financial crisis by operating as financial intermediaries, by intermediating flows of funds from the ample agents to the deficient agents. Hence, their activities can affect interest rates, the precariousness on the market and the price of assets. Furthermore, banking failures can have consequences in the economy of a country, since their effects on credit intermediation and the money supply can result in welfare losses on society.[6] A period can be designated as a bank crisis if its financial circumstances are so onerous that most or all of the capital in the banking system is destroyed.[7]

Allen and Gale support that the structure of the financial system of a State does not play any role in the occurrence of a financial crisis; however, the degree of development of the financial system can be relevant.[8] What has frequently caused bank crises is the immoderate exposure of banks on the stock and real estate market.[9] Moreover, the lack of effective supervision and regulations which constitute the reality of financial liberalization and deregulation,[10] as well as the deficient and eroded bank management,[11] also play a determinant role in the occurrence of a financial crisis.

Several studies, such as the study of Caprio and Klingebiel,[12] argue that the fundamental cause of a financial crisis lies in both macroeconomic and microeconomic factors. Macroeconomic factors refer to the downturn circumstances and microeconomic factors describe the inefficient regulation and supervision of banks in combination with inappropriate

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[6] J. D. Turner, *Banking in Crisis: The Rise and Fall of British Banking Stability, 1800 to the Present* (Cambridge University Press, 2014) 16

[7] F. Allen & D. Gale, *An Introduction to financial crises* (2007), 11 http://finance.wharton.upenn.edu/~allenf/download/Vita/readings%20on%20financial%20crises%20introduction.pdf (Accessed 7 July 2014)

[8] F. Allen & D. Gale, 'Financial Contagion'(2000) 108 *Journal of Political Economy*, 1

[9] G. Kaminsky & C. Reinhart, 'The Twin Crises: The Causes of Banking and Balance-of-Payments Problems', (1999) 89 *American Economic Review*, 473

[10] A. Demigróc-Kunt & E. Detragiache, 'Financial Liberalization and Financial Fragility' (1998), *IMF Working Paper* 1998/83, International Monetary Fund

[11] C. Dziobek & C. Pazarbasioglu, 'Lessons from Systematic Bank Restructuring: A survey of 24 country' (1997) *IMF Working Paper* 97/161, International Monetary Fund established that the flaws in management and control of banks have caused 24 studied systematic bank crises.

[12] D. Caprio & D. Klingebiel, 'Bank Insolvencies: Cross-country experience'(1996), *World Bank Policy and Research* WP 1574

bank management. Macroeconomic factors are liable for the financial instability of the banking system of a State, since constant macroeconomic conditions, such as the stability of prices, are essential in ensuring financial stability.

A bank crisis can also occur due to structural evolutions. In essence, the stability of the banking sector can be guaranteed with the establishment of a consistent legal framework and a vigorous structure for supervision authorities. Liberalizing the excellent conditions on the local banking markets results in making competition between banks more acute and the position of each bank in the entire market may then change. In addition, financial innovations could adversely affect the financial stability of a State, in case a new product or service is introduced to the banking market and becomes popular without being accompanied by rigorous knowledge of how to manage it.[13]

Throughout the years, numerous mechanisms have been used in an effort to deal with financial crisis that threatened to destroy the entire banking system. These mechanisms involved the establishment of the last instance creditor, the bank deposits insurance system, public interventions through capital infusions or the bank supervision rules.[14] All the aforementioned had the purpose of preventing a systemic crisis from occurring. Systemic crisis constitutes one of the most severe types of financial crisis, since the entire banking system fails, with the collapse of one bank resulting in the bankruptcy of the other banks of the system.[15]

The emergence of the financial crisis of 2007 had to be regarded as unavoidable and, partly, predictable. The outspread of loans, the growth of financial innovations and risky speculations, the relaxation of regulations and the ceaseless efforts of investors to gain the largest possible profits, constituted signals for the upcoming financial crisis.[16] Among the

[13] The case of derivative financial products.
[14] J. C. Rochet, *Why are There So Many Banking Crises?* (Princeton: Princeton University Press, 2008) 24
[15] A. M. Andries, (n 2) 154
[16] Ibid, 149

various theories that have been developed, three were analyzed and supported the most; the ‘too big to fail’ theory, the deficient corporate governance of banks and the lack of effective supervision of banks.

3. The main theories and their application in the case of the UK

3.1. Too Big To Fail

The importance of banks in the economic development of a country is great, since they provide functions that facilitate trade, channel financial resources between savers and borrowers and deal with risk and uncertainty.[17] In particular, they provide 'a repository for saving, and then transform them into illiquid assets',[18] namely loans. Moreover, banks offer services for payment and settlement which enable households and companies to deal with their everyday transactions. If the depositors withdraw their funds on the fear of the bank's insolvency, then the bank will sell off its assets in so low prices that its illiquidity problem will be changed into a solvency problem. Such a situation will result in the insolvency of other banks and therefore the whole payments system of a country will be destroyed.[19]

If a bank constitutes counterparty to other banks, then an unexpected failure could decrease the finances of the other banks and cause their failure too. When the bankruptcy of one causes the bankruptcy of another, this is known as the risk of contagion. In the EU level, the concept of the single market further strengthens the contagion of bank failures, since it provides for the abolition of internal borders within the Union for the liberalization of movement of goods and services.[20] Further, the EMU, which promotes the model of 'one market, one money',[21] rendered the eurozone countries interdependent, with the permanent risk of contagion of one

[17] A. Bollard, 'The role of banks in the economy-improving the performance of the New Zealand banking system after the global financial crisis', (2011) *BIS central bankers' speeches*, 2

[18] Ibid

[19] J. R. Barth *et al.*, 'Just how big is the too-big-to-fail problem?', (2012) 13 *Journal of Banking Regulation*, 266

[20] In the Commission White Paper, 'Completing the internal market', COM(85) 310 final, the internal market is defined as 'an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured'.

[21] Directorate-General for Economic and Financial Affairs, 'One market, one money. An evaluation of the potential benefits and costs of forming an economic and monetary union' (European Economy 44, October 1990)

country's problems to other states within the eurozone. The failure of a bank in a Member State can cause not only the failure of other banks within the same country, but also the failure of banks in other Member States. As Snell describes it, 'if there are question marks over the health of the banks of one country, markets quickly become worried about the financial institutions of other countries as well; if the ability of one Member State to stay within the euro is questions, the markets quickly start to worry about the other countries'.[22]

In case the risk of contagion is so high that government is ready to take any measures necessary to prevent such failure, then the bank is considered as 'too big to fail' (TBTF).[23] The designation of too big to fail depends on the policymakers by determining whether to bail out a failing bank. It is more possible to decide to intervene when the extent of the counterparty risk is unforeseeable or when the general market or economic conditions require it.[24]

The concept of TBTF appeared in 1984 in the USA when C.T. Conover, while talking about how to save Continental Illinois, declared that federal regulators would prevent the largest 'money center banks' to fail.[25] This simple statement created a new regulatory principle and according to Stewart McKinney 'We have a new kind of bank. It is called «too big to fail» and it is a wonderful bank'.[26] At the same period, federal regulators intervened to rescue numerous large banks that were regarded TBTF and protected their creditors as well as their uninsured depositors.[27] Their interventional measures were reasoned as essential, since large banks were pivotal for the markets and the economy and the failure of one of these large

[22] J. Snell, 'The Internal Market and the Philosophies of Market Integration' in C. Barnard and S. Peers (eds), *European Union Law* (OUP, 2014) 314

[23]Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States , 'The Financial Crisis Inquiry Report'(2011), *Official Government Edition*, 431

[24]Ibid

[25]G. G. Kaufman, G. G., 2002, 'Too big to fail in U.S. banking: Quo vadis?' (2004)*Quarterly Review of Economics and Finance*, 163

[26]Financial Crisis Inquiry Commission, *Preliminary Staff Report: Too-Big-to-Fail Financial Institutions*(2010), 6-9 http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0831-Governmental-Rescues.pdf (accessed 24 July 2014)

[27] 'The Financial Crisis Inquiry Report'(n 23), 57

banks would cause the panic of uninsured depositors that would result in the collapse of more banks.

Since the rescue of Continental Illinois, three decades ago, big banks have become bigger and the whole financial systems worldwide have been complicated even more. In spite of these evolutions, regulatory measures have never been enforced 'that would allow deeply troubled big banks to fail'.[28]

The contribution of the notion of TBTF to the financial crisis was inevitable. A bank being considered as TBTF could readily take risks which otherwise would have been avoided. The incentives to manage risk and to grow leverage are destroyed by the government being an implied pillar or guarantor to creditors of such bank.[29] In other words, a TBTF bank operates based on the fact that in case of a failure, the government would always stand behind it due to its significance to the remainder financial system. By this mean, implicitly, governments encourage banks to take risks that could lead to huge dividend and remuneration payouts in periods of success, and losses for taxpayers in periods of failures.[30] The incentive to take on higher risks is created, a situation known as 'moral hazard', with the consequence of the misallocation of resources and management of risk. Through the years, the concept of TBTF has become universal and created the largest moral hazard in history, thus 'the «too important to fail» problem is too important to ignore'.[31]

The TBTF is a complicated or compound idea which encompasses several distinct issues. In essence there are five elements. These include complex risk management and defective internal governance ('too big to manage'), market resolution ('too big to close or resolve'), market stability ('too big to insulate or separate'), market support ('too big to bail'), and

[28]J. R. Barth (n 19), 267
[29]Speech by Mervyn King, Governor of the Bank of England, to Scottish business organisations, Edinburgh, (20 October 2009), http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech406.pdf (accessed 24 July 2014)
[30]Ibid
[31]Ibid

market or macro-prudential oversight ('too big to see or fail').[32] Numerous reform measures could be enforced with regard to each of these aspects which significantly diminish if not eradicate the risks involved, and each of them is discussed below in brief.

The increase of the size of some banks lead to intricate management problems, particularly with regards to risk management, and creates the 'Too-Big-to-Manage or Govern' issue. Programmes such as the novel 'Risk Management Programmes' and 'Risk Enhancement Programmes' could constitute the response to risk management problems, since they provide for all risks to be acknowledged, insulated and quantified so as to be prevented in advance.

Large and complex banks face more difficulties in being reconstructed or closed in case of a financial crash. Thus, the 'Resolution and Recovery' plans proposed in many countries, including the UK, could be a solution to the 'Too-Big-to-Resolve or Close' problem. As of 1 January 2015 all EU Member States have to apply the provisions of the Bank Recovery and Resolution Directive — BRRD, which aims at the harmonisation of rules for the management of bank crises within the Union.[33] Such schemes could enable rapid reconstruction or even resolution of banks, if required. This would be achieved by establishing a series of pre-crisis and post-crisis restructuring options on the basis of disposal and winding-up.

The fact that some banks are 'Too-Big-to Separate' constitutes a problem as long as they are associated in various distinct markets and therefore the collapse of one of those markets subsequently destroys the stability of other markets. Consequently, it is essential to assure that each market functions independently and is isolated enough from other markets so as to preserve their existence in case of a crisis.

Large banks are particularly 'Too-Big-to-Bail'; in other words, their size makes their support more difficult. Thus, special market support mechanisms have to be ready to be implemented from the dawn of a financial crisis. Such mechanisms could involve specific vigorous rules of

[32] G. A. Walker, 'The Law of Financial Conglomerates-The Next Generation'(1996), 30 *The International Lawyer*, 57

[33] Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ 2 173/190

qualification, containing pricing and security conditions, since the existence of explicit, specific facilities for each market would be more effective. As examples could be used the two European emergency mechanisms, namely the European Financial Stability Mechanism and the European Financial Stability Fund, which were intergovernmental, thus outside the EU legal framework, and they financially supported euro area economies in need.[34] These temporary mechanisms were replaced by the European Stability Mechanism in 2012.[35]

The final element is the 'Too-Big-to-See or Fail' and refers to the ability of supervisory authorities to supervise all the markets and the entire financial system in order to impede systemic threats, through macro-prudential oversight. In an attempt to achieve the supervision of the entire EU financial system, the European Banking Authority has been established. The EBA regulates and supervises the banking industry across the Union, for the purpose of protecting 'the integrity, efficiency and orderly functioning of the banking sector',[36] without intervening in the task of the national supervisory authorities to supervise individual banks.

The financial crash beginning 2007 led governments to take phenomenal measures to avoid the collapse of TBTF banks. Such approach was adopted by plenty of countries which made efforts to 'protect both insured and uninsured depositors, guarantee bank debt, insure risky assets, provide liquidity for exceptionally long periods and inject public capital to the benefit of shareholders of banks that would otherwise have failed'.[37] In the meantime, numerous smaller banks were left unsupported to go bankrupt, since their importance for the economy was regarded as negligible.

In the USA this approach was considered in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which demonstrated that the bigger and smaller banks would not be regulated equally. This law has formalized that regulatory authorities are entitled to support a large bank that experiences insolvency while dictating losses on its

[34] *See* http://www.efsf.europa.eu/about/index.htm(accessed 7 September 2015)
[35] Treaty Establishing the European Stability Mechanism (ESM) [2012] D/12/3
[36]http://www.eba.europa.eu/about-us(accessed 7 September 2015)
[37]J. R. Barth (n 19), 266

creditors and shareholders. The purpose of this rule is to let big banks fail without resulting in harsh negative overflows among other banks.

The case of UK further reflects this vertical scale of support to the banking industry. Notably, one thousand billion pounds have been spent as loans and equity investment, an amount equal to the two-thirds of the annual output of the whole economy.[38] Since the TBTF problem continues to exist, the magnitude of this banking system will stay too large for the UK taxpayer credibly to maintain in future. London is considered a natural home for a banking system, being profited by an unsustainable reliance on the UK taxpayers, who are finally bearing the costs of the financial turbulence, if the TBTF problem will not be solved soon.[39] A vigorous solution could consist of 'a combination of limits on the leverage of individual financial institutions, a resolution framework for allowing individual institutions to fail',[40] irrespective of their size, and a general restructure of the banking sector.

According to Mervyn King, there are two alternative solutions to the TBTF problem; either to admit that some banks are TBTF and diminish the threat of their failure, or to refuse to establish that a bank is so important that the entire society would bear the costs of its failure.[41]

In essence, the first proposal centers on the decrease of the possibility of collapse of a TBTF bank. For this purpose to be achieved, regulators should enforce capital requirements to banks with regards to their risk-taking policies. This approach is adopted by the Basel III which requires banks to create a buffer against adverse consequences.[42] In more details, the Basel III provides for capital conservation buffer, that comprises common equity of 2.5% of risk-weighted assets, and countercyclical buffer, in case the credit grown is considered to lead to an unacceptable build up of systemic risk.

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[38]Speech by Mervyn King, (n 29)
[39]Speech by Mervyn King, Governor of the Bank of England, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, (15 June 2011) http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech504.pdf (accessed 24 July 2014)
[40]Ibid
[41]Speech by Mervyn King, (n 29)
[42]The Basel Accord III 2011 implemented counter-cyclical capital buffers and systemic group buffers

Such buffers 'would offer banks a greater ability to survive the strains of a crisis'[43] and they would provide more protection for taxpayers before the bank's failure triggers the necessity of a government intervention. In other words, these increased capital and liquidity regulations demonstrate the view that a stricter banking system is more vulnerable to crises.[44] However, this regime has some deficiencies, since the capital requirements provided for do lessen the necessity for taxpayer support but do not abolish it, and the amount of capital and liquidity might change from day to day due to the variation of market expectations. In fact, it is supposed that a fixed capital ratio can ensure stability of the banking sector, but this view constitutes 'the Achilles heel of the Basel regime',[45] as during the financial crisis banks were in need of a larger capital buffer to convince investors to sponsor them. Therefore, 'contingent capital' might be necessary as a form of insurance which can be automatically transformed into common equity 'upon the trigger of a threshold that kicks in before a bank becomes insolvent',[46] in order to reduce the costs burdening the rest of society in case of failure. There is a conflict of opinions on this issue: Admati argues that there is some adverse impact of higher capital requirements,[47] while Kashyap claims that there is a consequential impact on bank funding costs throughout the transition by raising additional equity capital, and then an adequate continuing impact.[48] Generally, the first proposal, although being attractive enough, does not actually eliminate the incentive of banks to take huge risks. Even if contingent capital diminished the contribution of taxpayers when a TBTF bank is threatened by bankruptcy, the government would still provide some insurance to impede destruction. Furthermore, it remains difficult to calculate risks of high-impact events, thus it is hazardous to let so risky activities to harm the fundamental services provided by the banking sector to economy.

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[43]J. R. Barth (n 19), 280

[44]M. Yan, M. J. B. Hall, P. Turner, 'A cost-benefit analysis of Basel III: Some evidence from the UK' (2012) *International Review of Financial Analysis*, 74

[45]Speech by Mervyn King, (n 29)

[46]Ibid

[47]A. R. Admati, *et al.* 'Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Expensive' (2010), *Stanford GSB Research Paper no. 2063*.

[48]A. K. Kashyap, *et al.* 'An Analysis of the Impact of 'Substantially Heightened' Capital Requirements on Large Financial Institutions' (2010) *Harvard University*

The second proposal shifts the focus on the reason of regulating banks, based on the fact that they engage in distinct activities. There are two basic categories of services that banks provide to the society, specifically the payment for goods and services by households and companies and the intermediate of flows of savings to fund investment. These activities are essential for the economy of a country, therefore their maintenance constitutes a public interest. In contrast, there are some activities, for example proprietary trading, which entail much more risk. What is fundamentally proposed is the separation of banking activities. On the one hand, the provision of payments services could be separated from the creation of risky assets, as was supported by John Kay, in order to protect deposits.[49] On the other hand, proprietary trading could be separated from retail banking, in accordance with the Paul Volcker's view.[50] Both opinions attempt to limit government guarantees to utility banking. Following the same rationale, the EU Commission proposed a banking structural reform which would prevent the biggest banks from engaging in proprietary trading in order to eliminate the risk of failure.[51] These big banks would have to separate their risky trading activities from their deposit-taking business, for the protection of the depositors and the preservation of financial stability. Although that Banking Structural Reform would further support the depositors' protection, it would have adverse effect on the Capital Markets Union, which aims to achieve the free flow of capital across the Union and the increase of investment choices for businesses.[52] A potential separation of trading activities out of the big banks would hinder the access to finance for investors.

However, separation of activities leaves some problems unsolved since incentives of banks are not totally destroyed. Indeed, the government will still stand behind financial institutions which do not operate in the utility banking sector, when their activities include a high degree

[49] J. Kay, *Too big to fail is too dumb an idea to keep*, Financial Times, 28 October 2009http://www.johnkay.com/2009/10/28/too-big-to-fail-is-too-dumb-an-idea-to-keep (accessed 24 July 2014)

[50] G30 report, former Chairman of the Federal Reserve

[51] European Commission, Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions, COM/2014/043 final - 2014/0020 (COD)

[52] European Commission, 'Building a Capital Markets Union' (Green Paper) COM/2015/063 final

of maturity transformation, due to the harmful consequences for the entire economy in case they fail.[53] Even if maturity transformation decreases the cost of finance to numerous activities which involve risk, that does not completely extinguish the government subsidy since the cost of maturity disparity does not burden those who enjoy the benefits. Separation of activities could contribute to the eradication of this government support, because it reduces the reliance of enormous numbers of households and companies on so few banks.

Irrespective of which of the two proposals would be adopted, Mervyn King highlights that TBTF banks 'should be made to plan for their own orderly wind down – to write their own will'.[54] And if banks do not separate their activities, then many of them would eventually be resolved.

Notably, the Banking Reform Act 2013[55] adopted the recommendations of the Independent Commission on Banking (ICB)[56] by requiring the Prudential Regulation Authority (PRA) 'to hold banks to account for the way they separate their retail and investment activities',[57] and entitling it to impose the absolute separation of banks.

[53]Speech by Mervyn King, (n 29)
[54]Ibid
[55]Financial Services (Banking Reform) Act 2013
[56]Independent Commission on Banking, *Nineteenth Report of Session 2010-12*, (2011) http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1069/1069.pdf (accessed 24 July 2014)
[57]HM Treasury, The Rt Hon George Osborne MP and Department for Business, Innovation and Skills, *Creating stronger and safer banks* (2014)https://www.gov.uk/government/policies/creating-stronger-and-safer-banks (accessed 17 June 2014)

3.2. Corporate Governance

The plenty of ink shed to discover the causes of the financial crisis has never referred to the corporate governance of banks, with the exception of the issue of remuneration.[58] The OECD Steering Group on Corporate Governance constitutes the turning point of that ignorance, by authorizing a study on some of the key areas of corporate governance of the banking industry which reached the conclusion that a more effectual application of the OECD Principles was imperative.[59] The significance of the banks' corporate governance was also conceded by the G20 in 2009.[60] The De Larosière Report also recognized corporate governance failures as one of the causes of the financial crisis.[61] Importantly, the UK government mandated Sir David Walker to independently evaluate that field in the UK banking sector.[62] Further, the most recent report examining that area has been issued by the Parliamentary Commission on Banking Standards, which underlined that the responsibility of ensuring high standards in banks must be primarily assumed by their boards and examined the role of shareholders and the internal control frameworks.[63] Although, at first, the FSA did not acknowledge any causal association between the deficient corporate governance of banks and the evolution of the financial crisis, that position was thereafter modified.[64] As far as the economics and functions of banks differentiate from those of other companies, inevitably the corporate governance practices of the banking industry indicate these discrepancies.[65]

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[58]P. O. Mülbert, 'Corporate Governance of Banks', (2009) 10, *European Business Organization Law Review*, 417

[59]OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*(2009), 7, http://www.oecd.org/corporate/ca/corporategovernanceprinciples/43056196.pdf (accessed 24 July 2014)

[60] G20 Working Group , *Enhancing Sound Regulation and Strengthening Transparency*, (2009) http://www.g20.org/366.aspx (accessed 24 July 2014)

[61]The Report of the High-Level Group on Financial Supervision in the EU published on 25 February 2009. The Group was chaired by Mr Jacques de Larosière. ('The de Larosière Report')

[62]Sir D. Walker, 'A review of Corporate Governance in UK Banks and Other Financial Industry Entities, (2009) *HM Treasury* (The Walker Review)

[63] Parliamentary Commission on Banking Standards, *Changing banking for good*, First Report of Session 2013-14, 324, http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/27ii.pdf (accessed 24 July 2014)

[64]Financial Services Authority Consultation Paper 10/3, 'Effective corporate governance (Significant Influence Controlled Functions and the Walker Review)', (2010) para.3

[65]P. O. Mülbert, (n 58), 412

The concept of 'good corporate governance of banks'[66] is equivocal enough, therefore while banking supervisors interpret this notion so as to represent their particular supervisory considerations, other proposals are more bank-central. Arguably, specific issues, such as risk management and remuneration policies, are generally acknowledged as inherent elements of the corporate governance of banks.[67] Accordingly, the Basel Committee has defined the banks' corporate governance so as to include 'the manner in which the business and affairs of banks are governed by the board of directors and senior management'.[68] This aspect of governance encompasses the way the board decides corporate aims, the daily operation of the business, the adjustment of the corporate activities with the expectation that the bank will function in compliance with the appropriate laws and regulations, the consideration and conservation of the interests of the stakeholders and the depositors and the duty of accountability to the shareholders.

Notwithstanding the fact that the OECD approach,[69] the Walker Review and numerous other studies of earlier financial crashes,[70] all argue that the weak corporate governance of banks has played a decisive role in the emergence of the financial crisis, other commentators contest this thesis. Notably, Adams has claimed that since there is no clear evidence supporting the view that boards of financial institutions perform differently from boards in other corporations, and the excessive remuneration is proportionate to the firm size, then there is no definite causal link between governance failure and the financial crisis.[71] Moreover, Moody, after studying the corporate governance of large banks, concluded that the existence of independent and experienced directors on the board does not relate to the operation of banks

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[66]P. O. Mülbert, (n 58), 412

[67]Ibid, 413

[68]Basel Committee on Banking Supervision, *Enhancing corporate governance for banking organizations* (Basel, BIS 2006) 4

[69]OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages*(2009) stated: 'The financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements' and noting weaknesses in corporate governance procedure that resulted in information about risk exposures failing to reach the Board and risk management being activity rather than enterprise-based'.

[70]For example the analysis of the early 1990s Nordic banking crisis in D. G. Mayes, *et al. Improving Banking Supervision* (Houndmills, Palgrave 2001), 91

[71]R. B. Adams, 'Governance and the Financial Crisis', (2009) *Finance Working Paper No.248/2009*, 15

while in crisis.[72] However, these studies could not weaken the contribution of governance in a financial crisis, due to the fact that the outright deflection of performance between the 'bailout group' banks and the 'stand-alone group' banks does confirm the relationship of banks' corporate governance with the financial crash.[73] According to the Walker Review 'the fact that different banks operating in the same geography, in the same financial and market environment and under the same regulatory arrangements generated such massively different outcomes can only be fully explained in terms of differences in the way they were run'.[74]

The collapse or near collapse of some large financial institutions worldwide has underlined defects in the edifice of corporate governance of the last decades.[75] These defects concern the bank boards which could not manage risk properly, shareholders, stakeholders who have kept a passive position while their boards decided to massively expand, and a corporate culture which highly remunerated short-term profits. Consequently, responsibility for the recent financial crisis does not lie merely in the faults of bank boards, but it is the entire system of banking corporate governance that has been disputed. These deficiencies were also identified by the EU Commission and the De Larosière Report. In their wording 'boards and senior management of financial firms failed to understand the characteristics of the new, highly complex financial products they were dealing with… The "herd instinct" prevailed too often driving many firms into a race to inflate profit without paying proper attention to risk. In many cases, board oversight or control of management was insufficient and non-executive directors "absent" or unable to challenge executive directors... Inadequate remuneration structures for both directors and traders led to excessive risk-taking and short-termism.'[76]

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[72] I. M. Neil, 'The trajectory of regulatory reform in the UK in the wake of the financial crisis', (2010) *European Business Organization Law Review*, 17
[73] Ibid
[74] The Walker Review (n62)
[75] R. Tomasic & F. Akinbami, 'Towards a new corporate governance after the global financial crisis', (2011) *International Company and Commercial Law Review*, 1
[76] European Commission, 'Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices' SEC(2010) 669, 3

In the context of the UK banking sector, Northern Rock Bank, HBOS and the Royal Bank of Scotland had relied upon growth models under which short-term funding could be easily refinanced when debts became lapsed.[77] Such practices conceal high risks, even if they seem to be valid in the short run. Other financial institutions had followed the 'originate to distribute' model under which mortgage loans were repackaged or securitised and then sold on to capital market investors.[78] The operation of both models indicates the failure of bank boards to evaluate the nature and extent of risks that were taken, 'over-reliance on wholesale funding and over-extensive use of leverage'.[79] In other words, the defecting internal regulation of banks has played a primary role in their collapse or near collapse. For example, the board of Northern Rock failed to react immediately to the risks occurred and to secure the liquidity and solvency of the bank.[80] Similarly, the board of RBS unanimously agreed to the acquisition of ABN Amro, in conjunction with the overwhelming support of the shareholders, a transaction that cost to RBS a £24.1 billion loss in 2008. Both the executive directors and the shareholders were liable for staying either apathetic or futile in preventing the efforts of the CEO, Sir Goodwin to rapidly expand the bank, who was also remunerated abundantly by the boards, irrespective of the colossal losses suffered by RBS.[81]

The Walker Review focused its criticism on the areas of the massive taboo-remuneration schemes, the risk management, the fitness of the Combined Code on Corporate Governance, the composition and conduct of banks boards and the relationship with shareholders.

By way of exception, banks' remuneration policies had been identified as an area of concern even prior to the financial turbulence as they encouraged bankers to take enormous risks.[82]

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[77]N. N. Taleb, *The Black Swan: The Impact of the Highly Improbable* (London: Penguin Books, 2007)
[78]R. Tomasic & F. Akinbami, (n 75), 3
[79]Treasury Committee, House of Commons, 'Banking Crisis: Dealing with the failure of the UK banks'(2009) *London: The Stationery Office, HC 416*, 11
[80]Treasury Committee, *The Run on the Rock,* (2008), 19, http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf (accessed 24 July 2014)
[81] BBC, *Row over Sir Fred pension advance* (2009), http://news.bbc.co.uk/1/hi/business/7947844.stm(accessed 24 July 2014)
[82]P. O. Mülbert, (n 58),419

The issue of the immoderate and disproportionate remuneration has been addressed on numerous occasions, during the last two decades, both at the international level[83] and at the UK.[84] Notably, the Companies Act 2006 asks for an annual directors' remuneration report from quoted companies[85] on which shareholders have an advisory vote;[86] the Companies Act 2013 set out a maximum amount to be paid as managerial remuneration, based on the annual profits of the company;[87] and the Combined Code requires the existence of a remuneration committee including non-executive directors to decide the remuneration for the executive directors of listed companies; and the ABI guidelines introduce guidelines on the level and composition of remuneration.[88] However, all these interventions have not prevented these 'unsafe remuneration policies, which led to this calamitous state'.[89] At the EU level, the European Commission underlined that remuneration policies was not applied in practice, since boards did not preserve the consistency of the remuneration with effective risk management.[90]

On the authority of the FSA, the practices of excessive remuneration have been a 'contributory factor rather than a dominant factor behind the financial crisis',[91] though the regulation of remuneration was claimed to be necessary so as to achieve effectual risk management and expedite effective governance by shareholders. Accordingly, the Remuneration Code contained in the Senior Management Arrangements, Systems and

[83] Financial Stability Forum, FSF Principles for Sound Compensation Practices (2009) http://www.financialstabilityboard.org/publications/r_0904b.pdf (accessed 24 July 2014)
[84] I. M. Neil, 'The trajectory of regulatory reform in the UK in the wake of the financial crisis', (2010), 18
[85] Companies Act 2006, ss. 420-422
[86] Ibid, s.439
[87] Companies Act 2013, s.197
[88] Association of British Insurers
[89] The Walker Review, para. 7.1
[90] European Commission, 'Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices' SEC(2010) 669, 9
[91] I. M. Neil, (n 72), 18

Controls (SYSC) requires financial institutions to 'establish, implement and maintain remuneration policies, procedures and practices' which advance efficient risk management.[92]

Instead of recommending any cap on remuneration, the Walker Review focused on strengthening the role of the remuneration committee to be extended to all aspects of remuneration policy 'with particular emphasis on the risk dimension'.[93] Moreover, it has been proposed that 'at least half of the value of variable remuneration awards should be under a long-term incentive plan, which means that half of the shares subject to an award would be after 3 years'[94] and the balance after 5 years. With regards to short-term bonus payments, these would be carried out gradually over a 3-year period, with only a third to be paid the first year. A further suggestion has been some 'skin in the game' for executive board members and 'high end' executive as a shareholding or by retention of vested awards 'in an amount at least equal to their total compensation'.[95] Such recommendations could ensure a continuous steadiness of the banking sector.

The European Commission focused its proposal on the role of the boards of the banks. In particular it proposed the shift of responsibility of designing and implementing the bank remuneration policy towards boards. It also proposed that remuneration committees should consist of experts on the field which would be 'capable of forming an independent judgement on the suitability of the remuneration policy, including the implications for risk management'.[96]

Apart from remuneration, the most discussed aspect of banks corporate governance has been their unsuccessful risk management. In particular, acknowledged failures were the focus of risk management only in terms of measuring and not identifying risks and the use of past

[92]FSA Handbook of Rules and Guidance, *Senior Management Arrangements, Systems and Controls* (2014), 19, http://media.fshandbook.info/content/full/SYSC.pdf (accessed 24 July 2014)
[93] The Walker Review, (n 62) Recommendation 29
[94] Ibid, Recommendation 33
[95]Ibid, Recommendation34
[96]European Commission, 'Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices' SEC(2010) 669, 17

events in risk stress tests instead of looking at possible new schemes.[97] The Walker Review makes a distinction that was not addressed prior to the financial crisis: 'monitoring and management of risk in a BOFI is not only a set of controls aimed at the mitigation of financial risk but related to the core strategic objectives of the institution'.[98] Consequently, risk management primarily depends on a higher degree of focus at board level. In an attempt to analyse the risk management of banks, the De Larosière Report explained that the unsuccessful risk management was the result of misconception of the relationship between credit and liquidity, deficiencies in model based risk assessments and the weak governance of risk management of each bank.[99]

Therefore, in the UK, the constitution of a stand-alone risk committee was proposed by the Walker Review in order to counsel the board 'on risk appetite and tolerance for future strategy'.[100] In other words, that committee should focus its advice on the current risk exposures of the entity and future risk strategy, and on the maintenance through the entity of a supporting culture in relation to the management of risk alongside established prescriptive rules and procedures. Moreover, a Chief Risk Officer (CRO) could be authorized to impress the importance of sound risk management practices throughout its organisation, from the highest level and in total independence from individual business units.

According to the European Commission's proposal, the CRO should be placed at the level of executive director, so as to be independent from the instructions of the CFO. The placement of the CRO to such a high level aims at ensuring that his/her considerations will be taken into account in management decisions. The CRO would be expected to monitor and make suggestions on matters that might have any effect on individual and global risk exposures.[101]

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[97] P. O. Mülbert, (n 58), 433
[98] The Walker Review, (n 62) para.6.3
[99] The de Larosière Report, 8
[100] The Walker Review, (n 62) para.6.3
[101] European Commission, 'Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices' SEC(2010) 669, 21

The impression given by the Walker Review is that risk can be accurately quantified and managed, though in practice it is in the nature of business to take substantial risks without a predictable outcome in the expectation that those risks will be rewarded.[102] Guessing 'what was on the other side of the hill'[103] is hard to comprehend and it is unlikely that it will be amenable to the task of a risk committee.

It is worthy to mention that the operation of banks in the UK could not assure the success of risk committees. For example, Northern Rock did have a risk committee operating at the time of its breakdown in 2007, but which failed to save the bank. Lloyds Banking Group plc also had a risk committee, but it did not avoid the financial assistance by the government in the threat of collapse.[104]

Furthermore, the banks' boards themselves have operated deficiently, by over-relying on improper business models, adopting inadequately scrupulous management and control processes and exercising insufficient diligence on acquisitions throughout the crisis. The solution to these problems, in the Walker's view, primarily lies in the non-executive directors and the chairman in the boardrooms.[105]

According to the Walker, Review an appropriate balance should be achieved between the executive and non-executive directors 'to ensure that the latter are neither excessively acquiescent nor excessively intrusive'.[106] Higgs strongly supported the existence of a powerful group of non-executive directors,[107] with half of the board and the chairman also being NEDs, as these can provide a higher degree of 'dispassionate objectivity' than the executive directors, due to their independence.[108] The significance of independence was also

[102]C. A. Li & R. T. Wearing, 'Risk management and non-executive directors in UK quoted banks and other financial institutions', (2012) *International Journal of Disclosure and Governance*, 233
[103]C. Hibbert, *Wellington: A Personal History* (London: Harper Collins, 1998) 395
[104]C. A. Li & R. T. Wearing, (n 102), 234
[105]The Walker Review, (n 62) para.4.9
[106] Ibid
[107]Hereinafter NEDs
[108] D. Higgs, 'Review of the Role and Effectiveness of Non-Executive Directors', (2003) , 35

underlined in the 2014 UK Code of Corporate Governance.[109] What was further highlighted is the necessity for NEDs to spend more time on their role, with a minimum of 30-36 days per year being recommended. Even the Treasury Committee of the House of Commons observed that the financial turbulence unveiled 'serious flaws and shortcomings in the system of non-executive oversight of bank executives and senior management'.[110]

As the European Commission noticed, the majority of NEDs were not specialized on financial issues and they lacked the necessary skills to effectively perform their duties. That lack of expertise could have adverse impact on the corporate governance of banks. 'The presence of a sufficient number of experienced and informed non-executives encourages challenge as opposed to boards whose members do not question management decisions because the subject is too technical for them.'[111]

The fact that some NEDs are not experienced in banking issues led the Commons Treasury Committee to wonder whether being qualified in banking or other related fields should be required for them.[112] The European Commission also proposed that policies should be adopted in order to appoint NEDs with sufficient financial expertise, without limiting the independence and objectivity of the boards. However, the search for expertise should not prejudice the independence and objectivity of the boards.[113] However, if this applies to NEDs, it should equally apply to the executive directors and the chairmen. 'If banks are too big to fail, then the composition of boards should be seen as being too important to be left to

[109] UK Corporate Governance Code, para. B.1

[110] Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the City, (*2009), 10-11, http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf (accessed 24 July 2014)

[111] European Commission, 'Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices' SEC(2010) 669, 7

[112] Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the City, (*2009) http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf para.153

[113] European Commission, 'Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices' SEC(2010) 669, 10

chance'.[114] The validity of this argument can be supported by the fact that the chairmen of the three most-damaged banks in the UK lacked any banking experience.[115]

The role of a CEO is also of particular importance, since directors are unlikely to censure and refuse a high risk policy advanced by their CEOs. In cases where the chairman and the CEO had aligned roles, that had aggregated this excessive board support for the CEO.[116] Therefore, the Walker Report recommended that chairmen should have the duty to maintain an open debate and challenge within the executive team and the entire board, in order to ensure that the board would not be governed by one single person.[117] The European Commission further suggested that a CEO should not become chairman immediately after getting retired, in order to reinforce the independence of the board from management.[118]

Generally, the Walker Review constitutes a consistent and comprehensive evaluation of the failures regarding the banks' boards and reinforced the necessity for powerful and efficacious corporate governance, which exceeds remuneration and regards the duties and performance of boards on banks. However, the Review did not thoroughly examine how remuneration packages directly resulted in higher risk-taking and subsequent loss. It only stayed on the assumption that since some banks operated better than others then some failures in their governance occurred. Thus, the Review must be used carefully so as to avoid simply blaming individual managers for the collapsing status of some banks, without specific evidence of their faults.

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[114]R. Tomasic & F. Akinbami, (n 75), 7

[115]The chairman of Northern Rock Bank was a zoologist, the chairman of RBS was a mathematician and scientist and the chairman of HBOS was an 'entrepreneurial businessman'. Treasury Committee, *Banking Crisis,* (2009), para.143

[116]A. Kakabadse & N. Kakabadse, 'The Return of the Chairman'(2007) *Business Review Strategy* 60

[117]The Walker Review, 42

[118] European Commission, 'Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices' SEC(2010) 669, 11

3.3. Regulation - Supervision

Throughout the years, various financial crises have been attributed to deregulation and financial innovations,[119] with property bubbles being another significant cause of crises as well. Arguably, regulatory and supervisory agencies around the world have not managed 'to keep abreast of the rapidly evolving development of the financial industry and its myriad products and practices'.[120] Slack regulations on the banking industry have significantly contributed to the development of lending and investment practices of high risk, practices which have led to the outburst of financial turbulences. The opinions of commentators vary on this issue. On the one hand, there is the argument that rigorous regulations and precise institutional frameworks improve the stabilization of financial markets since they reduce the moral hazard problems arising from asymmetrical information.[121] On the other hand, it is claimed that as long as banks cannot expand to other financial activities due to restrictions imposed by strict regulations, then they cannot reduce their risks and financial crises are caused.[122]

Generally, banks and the whole financial sector provide financial stability by expediting payments, providing liquidity, merging savings and risk sharing and mediating credit between savers and investors. Financial stability is essential for the economic welfare of a State, as far as its default imposes substantial costs, and the maintenance of it depends on prudential financial regulation.[123]

The International Monetary Fund explains financial stability as the ability of a financial system to restrict, restrain and immediately react to imbalances that may appear before they

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[119] S. Morris &H. S. Shin, 'Unique equilibrium in a model of self-fulfilling currency attacks'(1998) *American Economic Review* 88 (3), 587–597

[120] K. Teakdong et al., 'Role of financial regulation and innovation in the financial crisis', (2013) *Journal of Financial Stability*, 662

[121] B. Eichengreen & R. Portes, *The anatomy of financial crises*. Portes, R. Swoboda, A.K. (Eds.), Threats to International Financial Stability. (Cambridge University Press, 1987)10–58

[122] J.R. Barth et al., 'Bank regulation and supervision: what works best?' (2004) *Journal of Financial Intermediation* 13(2), 205–248

[123] W. R. White, 'The Prudential Regulation of Financial Institutions: Why Regulatory Responses to the Crisis Might Not Prove Sufficient', (2014) *OECD Economics Department Working Papers, No.1108*, 6

become a danger for the whole financial system and the economy of a country, and underlines that the protection of financial stability requires both preventive and remedial actions. 'In a well-functioning and stable financial system, this occurs in part through self-corrective, market-disciplining mechanisms that create resilience and prevent problems from festering and growing into system-wide risks.'[124] The FSA identified four dimensions of financial stability: '(a) monetary stability; (b) employment levels close to the economy's natural rate; (c) confidence in the operation of the generality of key financial institutions and markets in the economy; and (d) where there are no relative price movements of either real or financial assets within the economy that will undermine (a) or (b)'.[125] The ECB describes financial stability as the feature of the financial system to resist on shocks and maintain the financial intermediation as less disrupted as possible. It further explains that financial stability implies a system which effectively transfer sources from savers to investors, is well managed and can comfortably absorb financial and real economic shocks.[126]

The role of prudential regulation is debatable. Regulation is considered necessary for the counterbalance of many market failures, such as the failure to estimate the side effects and consequences of their behaviour, the disregard of risks and the influence of moral hazard, which failures, if not regulated, would create financial instability and relating output losses.[127] However, regulations are regarded deficient for several reasons, the most important being two. Firstly, the lower static and dynamic efficiency of the financial system enforced by regulations should be less costly than the consequences of financial instability. Moreover, regulations could sometimes cause distortions and more market failures which would need more and more regulation to be managed.[128]

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[124]G. J. Schinasi, 'Defining Financial Stability' (2004) IMF Working Paper WP/04/187http://core.ac.uk/download/pdf/7187004.pdf (accessed 9 September 2015) 7
[125]Ibid, 14
[126]See https://www.ecb.europa.eu/pub/fsr/html/index.en.html (accessed 10 September 2015)
[127]W. R. White, (n 123), 6
[128]Ibid

In general terms, regulatory measures can be distinguished into seven major categories, including capital regulation on the minimum required amount, the scope of a government's supervisory power, private-sector monitoring of banks,[129] constraints on bank activities, restrictions on entry into the banking sector, guidelines on the variety of assets and liabilities, and government ownership of banks.[130]

Before the 1930's banks were slightly regulated. Financial regulation became tighter during that decade, since the Great Depression was partly caused by banking extremities, particularly in the US. Notably, the tightening of regulation appreciably decreased the bank collapses and the financial crises in the 1950's, 1960's and 1970's, even at the expense of some static inadequacy and a decline in financial innovation.[131] As soon as the economic costs of regulations were assessed to be increasing, a more deregulated financial framework was established. The trend towards financial liberalization was further supported by the belief that self-interest and market discipline could suffice to restrain bank failures and financial crises. The 'Bing Bang' legislation of 1986 reflected that position in the UK.[132]

In the EU, the financial liberalization was achieved through the establishment of the free movement of capital.[133] At first, Member States were required to abolish some of their restrictions only for the operation of the Single Market. Later, the creation of the EMU required the complete freedom for capital transaction. Article 63TFEU provides the prohibition of any restrictions on the movement of capital between Member States and on payments between Member States and third countries.[134] In particular, banks enjoy the freedom of establishment and provision of services and their operation is regulated by a single

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[129] Basel II Accord, 2004
[130] J.R. Barth (n 122)
[131] W. R. White, (n 123), 8
[132] London's 'Big Bang' of 1986, see M. Whitehouse, *'Big Bang' Pioneers Rethink Banking Overhaul*, (2009) The Wall Street Journal, http://online.wsj.com/news/articles/SB123844838879571027?mg=reno64-wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB123844838879571027.html (accessed 2 July 2014)
[133] See http://ec.europa.eu/finance/capital/index_en.htm (accessed 10 September 2015)
[134] Consolidated version of the Treaty on the Functioning of the European Union, Art.63 [2012] OJ C326/01

regulatory framework according to Directive 2006/48.[135] Banks can access the market of any Member State, due to the mutual recognition of supervision systems, expressed through the 'single bank licence', which is valid throughout the EU.[136]

However, deregulation could play a central role in the creation of financial crises due to the failure of regulators to monitor the high leverage or identify its risks. As such, deregulation led to the creation of the shadow banking system, the globalization of the financial system and the consolidation of large banks.[137] In particular, shadow banking activities could turn out to be especially dangerous as long as they are not subject to the same tough regulations as depository banks. These developments, even if initially considered as improvements, gradually became serious threats to the stability of the financial system. Therefore, central banks and supervisory authorities published Financial Stability Reports, in an effort to maintain the regular operation of the financial sector.[138]

The breakdown of the Bretton Woods system of managed exchange rates and the subsequent major losses of numerous banks in the 1970s,[139] led to the establishment of the Basel Committee on Banking Supervision. The role of this Committee is to operate as a forum for systematic cooperation between the States that are members, on issues of banking supervision, in order to heighten financial stability. Subsequently, the two Basel Accords were declared.

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[135]Directive relating to the taking up and pursuit of the business of credit institutions (recast) [2006] OJ 2 177/1

[136]The single licence gives authorisation to a bank of a Member State to open branches without any other formalities or to propose its services in any other Member State.

[137]W. R. White, (n 123), 8

[138]Ibid

[139]On 26 June 1974, Bankhaus Herstatt's banking licence was withdrawn because the bank's foreign exchange exposures amounted to three times its capital. Banks outside Germany took heavy losses on their unsettled trades with Herstatt, adding an international dimension to the turmoil. In October the same year, the Franklin National Bank of New York also closed its doors after incurring large foreign exchange losses.

Basel I imposed risk-weighted capital requirements and assets of banks were allotted into groups according to the riskiness associated with them.[140] The continuing rise of financial crashes led to the promulgation of Basel II, which had the purpose of limiting regulatory arbitrage.[141] That could be achieved by reinforcing discipline in three dimensions; Risk taking could be self-disciplined, supervisory authorities could exercise control, and discipline by market could be obtained through transparency and reporting.

Definitely, the stability of the financial sector is contingent on prudential regulations, which are distinguished into micro-prudential and macro-prudential regulations. The former type is based on the assumption that 'if each institution is healthy, the system will be healthy',[142] therefore it focuses on the correct operation of each individual institution and it is a rather static approach. As long as failures could occur at any time, the regulatory focus should be on limiting the possibility of this happening. On the contrary, the latter type shifts the focus on the stability of the entire financial system, and it is both static and dynamic at the same time. While it tries to reduce the extent of economic costs resulting from a crisis, as the actions of an individual institution can affect the health of others, it also assumes that expected losses are not fixed but change over time.[143]

The financial crisis of 2007, being characterized as the most calamitous in recent years, belongs to 'a series of boom-bust-regulate-deregulate-boom-bust' cycles.[144] The desire of lenders and borrowers to assume risks is grown with the manifest force of the circular upturn, constituting the 'boom' process which is 'driven by leverage, speculation and rapid credit growth', and which often climaxes in an expensive 'bust'.[145]

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[140]The Basel Capital Accord 1988
[141]Basel II Accord 1999
[142]W. R. White, (n 123), 12
[143] Ibid, 13
[144]J. O'Brien, 'The Future of Financial Regulation: Enhancing Integrity through Design', (2010)*Sydney Law Review*, 63
[145]W. R. White,(n 123), 13

Apart from the catalytic role of strict and more specific regulation, the latest financial crash has also been attributed to the deficient implementation of the regulations by the supervisory authorities. Particularly, in the UK the Financial Services Authority[146] has been heavily criticised for its famous risk-based approach to regulation, as it has been humiliated to the same extent as the failed, now nationalised UK banks.[147] The same disrepute of the supervisory authorities is faced in countries such as Iceland and Ireland, which also had their banking sector dismantled.[148] For example, in Ireland, thousands of people have protested against the public sector which spent cuts and the costs of bailing out the banking industry, particularly the saving of Anglo Irish Bank, a bank which collapsed due to its deficient corporate governance.[149]

The leading position of the UK in the international financial industry made the country exceptionally vulnerable to the dissemination of the global financial crisis.[150] Nevertheless, it would be wrong to regard the recent crisis solely as the outcome of worldwide financial events, since inadequate financial regulation has also played a role of equal, or even greater, importance. Specifically, the light-touch approach to supervision adopted by the Financial Services Authority before the dawn of the financial crisis let the risks taken by banks accumulate in an uncontrolled manner.[151]

The FSA was established in 1997 and, in June 1998, became the supervisory body for the banks. The regulatory structure of the UK was tripartite, consisting of the Financial Services Authority which was the foundation of this system, the HM Treasury and the Central Bank. The Financial Services Authority had responsibilities over authorisation, conduct regulation

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[146]Hereinafter FSA
[147]J. O'Brien, (n 144), 67
[148]International Monetary Fund, *Crisis Creates Testing Times for Europe's Policymakers*, (2009) IMF Survey Magazine, http://www.imf.org/external/pubs/ft/survey/so/2009/CAR061009A.htm(accessed 2 July 2014)
[149]M. Wall & S. Collins, 'Change to Cuts Strategy Ruled Out as Protests Seek "Fairer" Way', (2009) *Irish Times* (Dublin), 1
[150]L. Cox *et al.,* 'United Kingdom regulatory reform: emergence of the twin peaks', (2012) *Compliance Officer Bulletin*, 4
[151] Ibid

and the prudential supervision of financial institutions. The HM Treasury was mandated with overseeing the whole regulatory structure and authorising any support operation in case of financial crisis. Finally, the Central Bank was authorised to preserve the steadiness of the monetary and the financial systems.

The first years of the newborn tripartite system were characterized by financial stability. However, the collapse of Northern Rock Bank in the September of 2007 indicated the weak supervision by the FSA. More importantly, the tripartite system turned out to be deficient, since it was unclear which regulatory body had the priority in taking immediate action to handle the crisis.[152] The subsequent bankruptcies of RBS and Lloyds banks confirmed the shortcomings of the UK regulatory system.

Among the various reviews which have analysed the causes of these financial turbulences, the Turner Review is considered to be the most all-inclusive one, classifying plenty of factors which contributed to the crisis.[153] The primary causes being indicated were macro-economic imbalances, financial innovation without social worth and serious flaws in decisive bank capital and liquidity regulations. Specifically, the focus of that Review was shifted towards the expeditious development of securitisation, which was regarded as a 'win-win' concept by reconstituting interest-paying loans into dividend-paying securities and releasing the bank's capital to let it engage in more lending activities.[154] Securisitisation began to work against banks and the whole financial system when the sub-prime mortgage market started to totter. Notwithstanding the disastrous consequences of that process on the financial system of the UK, securitization could not be considered as the sole cause of the financial crisis. The Turner Review acknowledged additional factors which also conduced to the crisis. Those factors included the expansive involvement of commercial banks in trading activities, an action which unsettled confidence in the heart of the banking system; the heightened use of leverage in different forms, which reinforced the upswing and downswing of market conditions; the

[152] L. Cox, (n 150), 3
[153] FSA, 'The Turner Review, a regulatory response to the global banking crisis', (2009)
[154] L. Cox, (n 150), 4

development of shadow banking; and the insufficient capital buffers, which did not allow banks to continue their lending activities since downturn.[155]

That criticism compelled regulators to admit that the UK regulatory system was based on some erroneous ideas, such as that more liquid markets were sometimes worse, and that securisitisation created distinct risks but regulation could ensure the safety of its operation.[156] Unfortunately, the entire tripartite system turned out to be completely unprepared to face the financial crisis which was coming and the consecutive failures of banks.

Following the identification of the causes of the crisis of 2007, the Turner Review made numerous recommendations for the improvement of the regulatory system and the prevention of future crises, after underlying the necessity of constructing a regulatory and supervisory system based on a system-wide 'macro-prudential' approach.

The recommendations involved changes to capital and liquidity regulations, in order to ensure bank capital of higher quality and counter-cyclical capital buffers to be used as safety in periods of downturns. Moreover, liquidity was proposed to be much tighter, and the regulation of shadow banking was suggested to be structured based on its economic substance and not its legal form. Finally, the Review strongly recommended the reconstruction of the FSA so as to primarily supervise the business strategies and the system wide risks of banks, and then their internal processes and structures. According to Lord Turner: 'the approach has to build on a system-wide perspective: failure to look at the big picture was far more important to the origins of the crisis than any specific failures in supervising individual firms.'[157]

Both government and regulatory authorities reacted immediately to the Review by implementing two post-crisis reform laws for the purpose of reinstating the trust of public and managing the resolution of failing banks, namely the Banking Act 2009 and the Financial

[155] FSA, (n 153)
[156] L. Cox, (n 150), 4-5
[157] FSA, (n 153)

Services Act 2010. The former made an effort to enhance the depositors' protection in order to ensure financial stability, while the latter entitled the Financial Services Authority to safeguard financial stability and broadened its powers.[158]

In 2009, the Conservative Party published a report which heavily criticised the tripartite system for its flawed operation that led to one of the most severe financial crises in the UK. The weaknesses of the regulatory system were divided into four categories. Firstly, the structure of the tripartite system had failed to delegate the responsibility of supervising the entire system to a single authority, thus even if each authority had recognised some threats to the financial stability of the State none of them had acted properly in order to restore balance. That lacuna became known as the 'underlap' according to Lord Turner and Paul Tucker.[159] Secondly, the tripartite system has never provided an appropriate resolution regime for failing banks. In other words, regulators lacked the necessary instruments to hamper the unsustainable increase of credit and leverage prior to the crisis, or instruments to preserve the ability of banks to remain undamaged by the losses ensuing from deleveraging when the crisis began. Thirdly, the FSA concentrated only on supervising the conduct of business regulation; hence it did not properly pursue its responsibility to exercise prudential regulation. In essence, 'financial supervision relied too much on «tick-box» compliance with rules at the expense of proper in-depth and strategic risk analysis'.[160] Finally, the tripartite system lacked expertise and was not adequately prepared to manage the crisis and to resolve the failure of banks that followed. That latter weakness became evident when Northern Rock Bank collapsed, since the inadequate handling by the supervisory authorities resulted in a threat to financial stability.

In general, the task of the FSA was argued to be too challenging, 'simply too broad to be effective'.[161] Assuming responsibility for the whole financial regulation of a State meant that

[158] L. Cox, (n 150), 5
[159] Ibid
[160] Ibid
[161] Ibid

a single supervisory authority was expected to deal with an enormous range of issues, from the safety and integrity of the largest global investment banks to the everyday matters of customer practices of the smallest high street financial adviser. Since this monolithic financial regulator had become unable to handle such a variety of issues, the regulatory framework was proposed to be reconstructed and replaced by a 'twin peaks' structure, distinguishing prudential and conduct regulation. What has been clear is that the financial crisis of 2007 has operated catalytically for implementing tighter regulation in the UK.[162]

[162]W. R. White, (n 123) 7

4. The UK reform measures

All the aforementioned theories have obliged the UK government to acknowledge the urgency to reform the existing banking industry regime and decide how to handle all these arguments.

The government focused its efforts on ensuring financial stability, which has always been one of its dominant purposes, and recognized that the applicable regulatory system was characterized by essential shortcomings and its radical reform was indispensable. While the old regulatory framework divided the responsibility of maintaining financial stability between the Bank of England, the HM Treasury and the Financial Services Authority, the UK government took into consideration the Turner Review and decided the abolishment of the Financial Services Authority.[163] Chancellor George Osborne, in his 2011 Mansion House speech, declared that the original Tripartite System belonged to the past.[164] Three years later, on the 1st of April 2013, the Financial Services Authority was replaced by the Financial Conduct Authority and the Prudential Regulation Authority which assumed the responsibilities of observing the health of banks and supervising the conduct of financial institutions. Moreover, the government set up the Financial Policy Committee within the Bank of England, in order to diagnose and deal with financial risks to the stability of the system.

4.1. Financial Conduct Authority[165]

Initially established as the 'Consumer Protection and Markets Authority', the FCA operated as an independent business regulator, responsible for monitoring the conduct of all firms in relation to retail customers, the wholesale financial markets and their comprehensive market conduct.[166] In essence, the FCA has inherited most of the Financial Services Authority's

[163] FSA, (n 153)
[164] Chancellor of the Exchequer George Osborne, speech on 15 June 2011, <https://www.gov.uk/government/speeches/speech-by-the-chancellor-of-the-exchequer-rt-hon-george-osborne-mp-at-the-lord-mayors-dinner-for-bankers-and-merchants-of-the-city-of-london-mansi (accessed 14 July 2014)
[165] Hereafter FCA
[166] J. Perry *et al.,* 'The new UK regulatory landscape' (2011) *Compliance Officer Bulletin*, 3

market conduct regulatory tasks. All the functions of the FCA have as an objective to strengthen 'confidence in the UK financial system by facilitating efficiency and choice in services, securing an appropriate degree of consumer protection, and protecting and enhancing the integrity of the UK financial system'.[167] The importance shifted on the conduct of firms aims to enhance the protection of retail customers and to demonstrate that the FCA is 'an integrated conduct of business regulator of the financial services sector'.[168] In order to guarantee the protection of retail customers, the FCA is also responsible for regulating 'those wholesale activities which flow through to retail financial services'.[169]

Furthermore, the FCA operates in such a way as to promote competition, a function that was not inherited from the Financial Services Authority.[170] Another novelty is the means by which products are regulated in the UK. The basic activities of the FCA involve the prudential regulation of all firms except deposit takers, insurers and systemically important investment firms, the operation as the UK Listing Authority and the regulation of consumer credit firms which were not regulated by the Financial Services Authority before.[171] All these activities reflect the intention of the FCA to constitute a more dynamic and interventionist authority than the Financial Services Authority in order to maintain the enforcement policy of 'credible deterrence' and eliminate the risk of loss to consumers.[172]

The entire idea behind the FCA is summarized in the words of Lord Turner, according to whom 'it is fundamental to shaping the regulatory philosophy of the new organization. Our analysis has led us to the conclusion that a significant shift in approach is required'.[173]

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[167] HM Treasury, *A new approach to financial regulation: building a stronger system*, (2011), 5, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81411/consult_newfinancial_regulation170211.pdf (accessed 14 July 2014)
[168] Ibid, 11
[169] Ibid
[170] Ibid, 61
[171] L. Cox, (n 150), 17
[172] Ibid
[173] FSA Discussion Paper 11/1 (January 2011): Product Regulation, 3 http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf (accessed 14 July 2014)

4.2. Prudential Regulation Authority

The PRA constitutes a separate legal entity, subsidiary of the Bank of England, responsible for the micro-prudential regulation and daily supervision of those financial institutions that are subject to significant prudential regulation, namely banks, insurers and major investment firms.[174]

The government acknowledged that financial supervision in the country as was applied prior to the financial crisis, operated on the basis of 'tick-box' compliance with rules and directives instead of focusing on an appropriate and thorough risk analysis.[175] In essence, the supervisory authorities, and especially the FSA, did not keep an eye on the build-up of systemic risks in individual institutions and in the entire system. Thus, the creation of the PRA was decided with the mandate to scrutinize and manage risks and vulnerabilities within individual firms and disregard their sales strategies. The fundamental objective of the establishment of this authority was to preserve the security and soundness of both regulated firms and the financial system.[176] In other words, the PRA has the purpose of promoting 'the stable and prudent operation of the financial system through the effective regulation of financial firms, in a way that minimizes the disruption caused by any firms that do fail'.[177]

Specifically, the firms that belong to the sphere of the PRA's regulation comprise banks, credit unions, insurers, building societies and investment banks. Banks have been included in the scope of PRA's regulation, since they constitute a pillar of the financial system by facilitating maturity transformation. The functions of the PRA consistin the assessment of the safety and soundness of the regulated firms, rule-making with regards to prudential regulation, the authorization of firms and the supervision in order to ensure that they comply with its rules.[178] The PRA only gives approval to firms which can undeniably be prudently

[174] J. Perry, (n 166), 3
[175] Ibid, 9
[176] L. Cox, (n 150), 14
[177] J. Perry, (n 166), 9
[178] Ibid, 10

managed. The responsibility of making prudential rules covers issues which affect the safety and soundness of firms, such as remuneration.

4.3. Financial Policy Committee

The FPC operates within the Bank of England and exercises macro-prudential regulation, in order to ensure financial stability. Its primary obligation is to recognize the macro-issues which threaten the stability of the financial system and to direct either the PRA or the FCS to take appropriate action to deal with such issues.

The commentators of the financial crisis of 2007 studied the contribution of central banks to the financial regulation of a State.[179] It is argued that the great variety of tasks being assumed by a central bank, including macro-prudential and micro-prudential regulation, supervision and the provision of liquidity insurance to banks, entails both advantages and synergies. Central banks can reasonably bear the responsibility of supervising the financial institutions due to their 'competitive edge thanks to their first-hand exposure to markets and the consequential depth of their staff's experience'.[180] Furthermore, the Financial Services Authority was acknowledged to have shifted all of its focus on conduct supervisionand thus there was not supervisory authority responsible for macro-prudential issues. That was the rationale behind the establishment of the FPC, which has clarified that area.

The FPC exercises its functions with the purpose of striking a balance between financial stability and sustainable economic development.[181]According to the objectives of the FPC, the improvement of financial stability could be achieved through the improvement of the flexibility of the financial system by classifying the vulnerabilities of the system and through the improvement of macro-economic stability.[182]

When referring to macro-prudential regulation, what is meant is the control of the financial system so as to eliminate risks to the financial stability of the State. This control of the financial system is achieved through the monitoring of financial stability, the recognition of arising risks and vulnerabilities and the evaluation of the operation of the FCA and the PRA.

[179]J. Perry, (n 166), 5
[180] Ibid
[181]Ibid, 6
[182]Ibid

The FPC deals with risks and vulnerabilities of the system in two ways; namely by recommendations and directions. Recommendations are made in order to 'be complied or explained' by the FCA and the PRA in relation to actions that must be imposed so as to ensure financial stability. Directions are made to demand the FCA and the PRA to put into action specific macro-prudential tools.

4.4. Ring-fencing

Regarding the structural aspect of the reform, the Commission considered the scenario of separating retail banking from wholesale and investment banking in the UK. This distinction could be achieved in numerous ways, according on 'how sharply the line is drawn'.[183] On the one hand, the government might choose to create two completely separate entities in which cross-ownership would be prohibited. On the other hand, it might be decided to simply separate the operation systems of retail and investment banking. Both options have their drawbacks; since the former prevents the customers from taking advantage of universal banking while the latter does not provide the sufficient degree of protection to retail banking.[184] Taking all these into account, the Commission is looking for the golden mean in order to segregate retail banking into a separate subsidiary which would belong to a wider group. Under such a scheme, universal banks would keep minimal capital ratios and loss-absorbing debt for the operation of their retail banking, thus banks could convey capital between their banking activities.[185]

The benefits of ring-fencing the UK retail activities of a bank are many. Firstly, the management of banks when in crisis would be much simpler and less expensive if each part of a bank is treated differently. In practice, the retail activities of the bank would still be exercised in an undisturbed manner even if the wholesale and investment activities would need restructuring. Secondly, the retail activities of UK banks would be protected from risks that banks or the entire financial system might face and taxpayers would also be protected from being revealed to those risks and 'sharpen commercial disciplines on risk taking'.[186] In case of any failure, the losses would burden only the investors and not the rest of the society. In the words of Robert Peston, ring-fencing guarantees that in case of a major crisis 'a retail

[183] Independent Commission on Banking, *Interim Report Executive Summary*(2011), 3, http://s3-eu-west-1.amazonaws.com/htcdn/ICB-Interim-Report-Executive-Summary.pdf (accessed 14 July 2014)
[184] Ibid, 4
[185] Ibid
[186] Ibid, 3

bank could be hived off and saved by the Bank of England at less cost to taxpayers, because the investment banking part of the same bank would be allowed to fail'.[187]

On the 14th of June 2011, Chancellor George Osborne declared his support to the suggestions of ring-fencing retail and investment banking and his plans about the future of Northern Rock Bank as well.[188] The failed bank was divided into a 'good bank' and a 'bad bank'. The good bank consists of the customer's deposits and was set to be sold. In contrast, the bad bank consists of the more toxic loans and continues to be under State control. Those plans led to the development of several arguments. It is doubtful whether ring-fencing could be the solution against a future financial crisis, since it offers banks the security that the State would stand by the retail sector and encourages them to take risks on that basis, therefore increasing the possibility of a bailout. Lord Lawson supported that 'with the pressures of the real world, the ring fence will not be completely...watertight',[189] while Stephen Hester argued that ring-fencing of retail banks might amplify riskiness and raise costs for banks and their customers.[190]

[187]R. Peston, *The dangers of a retail ring-fence*, (2011) http://www.bbc.co.uk/news/business-13775164 (accessed 14 July 2014)
[188]Chancellor of the Exchequer George Osborne, speech on 15 June 2011, <https://www.gov.uk/government/speeches/speech-by-the-chancellor-of-the-exchequer-rt-hon-george-osborne-mp-at-the-lord-mayors-dinner-for-bankers-and-merchants-of-the-city-of-london-mansi>(accessed 14 July 2014)
[189]M. Holehouse, *Lawson wary of bank ring-fencing, urges full separation*, (2011) http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8576679/Lawson-wary-of-bank-ring-fencing-urges-full-separation.html (accessed 14 July 2014)
[190]BBC NEWS Business, *Banks must ring-fence retail operations, Osborne to say*, (2011) http://www.bbc.co.uk/news/business-13770746 (accessed 14 July 2014)

4.5. Evaluation of the new structure

The new structure of the regulatory system has given rise to certain concerns, particularly with regards to the danger of creating regulatory 'underlap' and duplication.[191] Notably, Hector Saints expressed concern by stating that 'any structure which is anything other than a monolithic organisation, across the whole spectrum of regulation, is going to have fault lines. And where you have a fault line, you have a coordination risk'.[192]

In response to these arguments, the government clarified that coordination mechanisms would be established in order to maintain the effectiveness of the regulatory system.[193] As it was further elucidated, the FCA and the PRA enjoy the same status and flexibility to engage with each other.[194] However, it has been demonstrated that in case of disagreement between the two authorities regarding the course of action to be followed, the PRA would prevail and hinder the FCA from exercising a function if the risk of failure of a firm is high.

In addition, the operation of the FPC might also be rendered troublesome, in case some individual regulated firms would belong to the sphere of FPC's regulation. Thus the government plans to enact new legislation which will establish that any recommendations and directions made by the FPC to the FCA and PRA will not be addressed to a specific individual firm.[195]

It has been argued that the UK strongly influenced the EU on the financial regulation of the Union. As Sharon Bowles supported, the powerful knowledge and experience of the UK regulators was very useful.[196] The technical expertise and the contribution of the UK

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[191] J. Perry , (n 166), 22
[192] Thomson Reuters Newsmaker Event, December 2010 http://live.reuters.com/Event/TRNewsmaker?Page=0 (accessed 24 July 2014)
[193] HM Treasury, *A new approach to financial regulation: building a stronger system*, (2011), 11, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81411/consult_newfinancial_regulation170211.pdf (accessed 14 July 2014)
[194] Ibid
[195] J. Perry, (n 166), 24
[196] European Union Committee, *The post-crisis EU financial regulatory framework: do the pieces fit?*, 2 February 2015, HL 103 2014-15, 79

regulators were also acknowledged by the David Lawton.[197] On the other hand, the UK representatives' attitude on the negotiations did not remain without criticism and it was presented as 'regulatory selfishness'.[198]

[197]European Union Committee, *The post-crisis EU financial regulatory framework: do the pieces fit?*, 2 February 2015, HL 103 2014-15, 79
[198]Ibid, 80

5. The EU financial measures

As has been already analysed, the UK attributed the failure of the regulatory structure of its financial sector primarily to the inappropriate and insufficient supervision of banks and the market in its entirety. In response to the deficient banking supervision, the 'tripartite' system was abolished, two novel authorities were established and most banking supervision was restored to the Bank of England. Moreover, investment banking activities were 'ring-fenced' from retaining banking in order to enhance the protection of banks and the re-empowering of market forces.

The EU preferred a different avenue for dealing with the financial crisis. The priorities of the new EU regulation were 'the increased control of the market by extending the scope of regulation; curbing specific "undesirable" behaviours; protecting consumers and taxpayers; and enhancing Euro-zone solidarity'.[199] The EU organs focused primarily on the protection of consumers and taxpayers rather than the re-empowering of the market forces and they considered that the reinforcement of the regulatory system was more necessary than the review of supervision, at least initially. 'Across much of Continental Europe, the financial crisis is seen as having been the consequence of an "Anglo-Saxon" light touch, low supervision deregulatory approach to the financial services sector'.[200] The different philosophy adopted by the UK as opposed to the one adopted by EU is reflected even in the implementation of international regulatory changes, for example the Basel III rules.[201]

The multi-faceted Union's response to the crisis consisted of some instances of quick intervention in order to achieve stability in some euro countries that were heavily hit;[202]measures of budgetary surveillance and economic coordination;[203] and reforms aimed at

[199]'EU Financial Regulation: A report for Business for Britain', (2014) Europe Economics http://forbritain.org/EUFinancialReg.pdf (accessed 10 September 2015) 24
[200]Ibid
[201]Ibid
[202]Loan facilities were created such as the European Financial Stability Mechanism and the European Financial Stability Fund, in order to deal with the urgent sovereignty debt crises of Ireland and Greece in 2010.

the creation of more powerful and steadier financial framework, and a so-called 'European banking union'.[204] The paper will discuss only the third limb of the EU response.

The financial crisis revealed the necessity for financial stability and the mitigation of systemic risks at the EU level. The legal reforms that have taken place in response to the crisis have a 'pan-European' character and are intended to manage 'financial stability under the conditions of market integration' within the EMU.[205]

The idea of creating a European Banking Union was firstly introduced by the President of the EU Council on June 2012,[206] consisting of three pillars, namely a 'single supervisory mechanism', a harmonized recovery and resolution framework and a common deposit guarantee scheme for all the euro-zone States.

Substantive legal reforms as well as institutional reforms have been implemented in order to ensure that regulatory convergence is compatible with the requirements of financial stability. Furthermore, the establishment of a single supervisory mechanism, led by the ECB, for all the financial institutions of the Member States was decided, since 'the single market and the banking union are mutually reinforcing processes'.[207]

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[203] A package of measures adopted in November 2011, the so-called Six-Pack, for the improvement of the budgetary surveillance and economic policies. That surveillance was further strengthened in May 2013 by the Two-Pack. Moreover the Treaty on Stability, Coordination and Governance was entered into force on 1 January 2013 dealing with budgetary discipline, economic convergence and cooperation and the governance of the euro.

[204] See A. Hinarejos, 'Economic and Monetary Union' in C. Barnard and S. Peers (eds*), European Union Law* (OUP, 2014)

[205] M. Andenas and I. H-Y Chiu, 'Financial stability and legal integration in financial regulation' (2013) 38 *European Law Review* 337

[206]President of the European Council, 'Towards a Genuine Economic and Monetary Union' (26 June 2012), available at:http://ec.europa.eu/economy_finance/focuson/crisis/documents/131201_en.pdf (Accessed 10 October 2015)

[207]European Commission, Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union, COM (2012) 510 Final, (Sept. 2012)

5.1. Substantive legal reforms

Numerous Regulations and Directives have been enacted from 2007 and on, in order to enhance the regulation and supervision of banks of EU Member States. On November 2010 the Capital Requirements Directive was adopted, in order to improve the risk management and risk recognition of banks, to review the remuneration policies and to provide for further micro-prudential regulation.[208] The Directive provides for fully comprehensive disclosure of information on the banks' exposure to complex products, the careful examination of the risks associated with their trading books and the abolition of remuneration policies of the past that rewarded excessive risk-taking.

Moreover, the Capital Requirements Directive[209] and Regulation[210] IV have been enacted to implement the provisions of the Basel III Capital Accord. The package aims at strengthening the regulation of the banking sector, with the Directive governing the access to deposit-taking activities and the Regulation establishing the prudential requirements that banks must follow.

Further, the Directive on Alternative Investment Fund Managers 2011[211] provides for a regulatory and supervisory framework for the activities of Alternative Investment Fund Managers, with the purpose of reducing systemic risk and increasing the protection of investors within the Union.

[208] Directive 2010/76/EU amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies [2010] OJ 2 329/3

[209] Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ 2 176/338

[210] Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ 2 176/1

[211] Directive 2011/61 on Alternative Investment Fund Managers and amending Directives 2003/41 and 2009/65 and Regulations 1060/2009 and 1095/2010 [2011] OJ L174/1

The abovementioned substantive legal reforms indicate the increase of the regulatory sphere in the EU-wide financial sector, 'setting standards for the prudential aspects and conduct of business of hitherto unregulated entities such as hedge and private equity fund managers'.[212]

[212] M. Andenas, (n 205), 338

5.2. European System of Financial Supervision

The implementation of the substantive legal reforms would not have been achieved without some institutional reforms of the Union.

Among the proposals of the De Larosière Report was the establishment of a European System of Financial Supervision.[213] The ESFS was implemented in 2010 with the purpose of promoting legal integration in substantive legal reforms. This institutional architecture consists of three EU financial regulators, namely the European Banking Authority,[214] the European Securities and Markets Authority[215] and the European Insurance and Occupational Pensions Authority.[216] These three authorities in conjunction with national regulators have a Joint Committee and also the European Systemic Risk Board as well,[217] which operates as a macro-prudential supervisor at the EU level. The roles and powers of these authorities are not thoroughly provided for by the relevant Regulations.

The ultimate purpose of these authorities is to strengthen the stability and effectiveness of the EU financial system, by managing closer cooperation between national supervisors and expediting the adoption of solutions to cross-border problems at the Union level.

One of their functions is to make recommendations of technical standards for uniform implementation of EU Directives in relation to financial regulation, and also to give guidelines on supervisory practices and ensure the consistent supervision taken by the Member States. Moreover, they have the task of promoting a common supervisory culture and 'conducting peer reviews of national regulators for convergence in supervisory measures'.[218]

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[213]Hereinafter ESFS

[214]Regulation 1093/2010 establishing the European Banking Authority [2010] OJ L331/12, hereinafter EBA and EBA Regulation

[215]Regulation 1095/2010 establishing the European Securities and Markets Authority [2010] OJ L331/84, hereinafter ESMA and ESMA Regulation

[216]Regulation 1094/2010 establishing the European Insurance and Occupational Pensions Authority [2010] OJ L331/48,hereinafter EIOPA and EIOPA Regulation

[217]Regulation 1092/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board [2010] OJ L331/1 Hereinafter ESRB and ESRB Regulation

[218]EBA Regulation, ESMA Regulation and EIOPA Regulation, Article 30

A further function of these authorities is to take all the necessary measures for the financial protection of consumers and the consistent implementation of financial guarantee schemes.[219]

Their final role relates to crisis management and systemic risk. According to Article 18 of EBA Regulation, the three authorities must facilitate co-ordinated crisis management by national regulators. They also have the power to address decisions to national regulators and more importantly to financial institutions, in case the regulators do not comply with their decisions.[220]

The management of systemic risk should be based on quantitative and qualitative system risk indicators and on specific policies and governance created by the authorities, in coordination with national regulators. The EU Parliament, the Council, the Commission and the ESRB should be informed about potential risk exposures on an annual basis.

The ESRB aims at the macro-prudential regulation of EU financial markets, by identifying system risk signals and issuing the necessary recommendations regarding these risks. The chairman and vice-chairman of the ECB, governors of national central banks and the chairpersons of the three abovementioned authorities and a European Commission member compose the Board. After collecting and analyzing information from the three authorities and the national central banks, the ESRB can issue warning and make recommendations to the Union or to particular Member States.

The criticism that the ESRB received is that it does not constitute a centralised EU function and that it lacks the authority to issue corrective mechanisms, so it only gives measures of 'soft law'.[221] On the other hand, it is argued that the warnings issued cannot be ignored and

[219]EBA Regulation, ESMA Regulation and EIOPA Regulation, Article 26
[220]EBA Regulation, ESMA Regulation and EIOPA Regulation, Article 18
[221]E. Ferran and K. Alexander, 'Can soft law bodies be effective? The special case of the European Systemic Risk Board' (2013) 35 *European Law Review*, 751

that they 'facilitate a form of economic governance that could be adapted to suit both boom and crisis times'.[222]

The European Commission in its 2014 Report on the operation of the three EU Supervisory Authorities,[223] focuses its evaluation on three main aspects, these being their regulatory supervisory and monitoring and coordination roles.

It was acknowledged that regulatory harmonization and coherence in EU banking and financial sector have been remarkably improved and promoted, through the development of the single rulebook, which shortly supplied well-established rules to the Union. This regulatory harmonization became the priority for the supervisory authorities, leaving their supervisory role aside temporarily.

However, the authorities have already conducted some peer reviews, with the ultimate purpose of establishing a pan-European supervisory culture of the banks and other financial institutions as well as the financial practices of Member States. EBA and EIOPA participate in the supervisory activities; they provide guidance and oversee the supervisory agendas. The supervision of these authorities could be enhanced by strengthening their right of access to data from competent authorities and financial institutions.

The ESFS contributes to the monitor of the financial markets and it checks the ability of the EU financial system and the financial institutions to recover quickly from emergency situations. It has also implemented numerous measures in order to promote coordination and exchange of information between the various financial authorities in national and EU level.[224]

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[222] M. Andenas, (n 205), 342

[223] European Commission, Report on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS), COM (2014) 509 Final, (Sept. 2014)

[224] Most notable examples include the 2011/12 recapitalisation exercise as well as the Joint Committee report on cross-sectoral risks, the ESMA coordination of measures adopted by competent authorities on short selling, and the EIOPA opinion on the low interest rate environment.

The new supervisory architecture, with the ESAs and the ESRB at its centre, is a cornerstone of the comprehensive reforms that have been initiated by the Commission since the outbreak of the financial crisis.

By preparing uniform standards and ensuring supervisory convergence and coordination the ESAs should shape the further development of a single rule book applicable to all 28 EU Member States and thus contribute to the functioning of the Single Market.

5.3. Single Supervision Mechanism – European Central Bank

According to Article 127(1) TFEU, the primary objective of the European System of Central Banks is the maintenance of price stability. The ECB can achieve this objective by taking of measures that include the setting of interest rates and the supply of liquidity to the banking system.

In 2013, a Council Regulation conferred more tasks on the ECB regarding the prudential supervision of banks and other financial institutions.[225] This Regulation followed a political agreement for the creation of a European Banking Union and the establishment of the ECB as the supervisory authority for all the big euro-zone banks of each Member State.[226] Now, the ECB supervises approximately 150 euro-zone credit institutions, which are equivalent to 80% of the banking assets in the Euro area. The remaining banks, which are considered 'less significant', are still supervised by the respective national competent authorities.[227] The criteria for determining whether a bank is 'less significant' are its size, its relevance for the economy of the Member State or the Union as a whole, the volume of its cross-border activities (if any) and the ranking amongst the three most important banks in the relevant Member State.[228] The distinction between 'more significant' and 'less significant' banks based on these particular factors clearly reflects the application of the TBTF theory by the Union.

The Single Supervisory Mechanism,[229] in conjunction with the Single Resolution Mechanism,[230] serves as a 'crucial and significant first step' on the way to a comprehensive

[225]Regulation 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ 2 287/63, hereinafter SSM Regulation

[226] 'Eurozone Agrees Common Bank Supervisor', Financial Times, December 13, 2012http://www.ft.com/cms/s/0/2946cbfe-44d4-11e2-8fd7-00144feabdc0.html#axzz3q2GqemVh(accessed 25 October 2015)

[227]SSM Regulation, Article 6,hereinafter NCAs

[228]SSM Regulation, Article 6(4)

[229]Hereinafter SSM

[230] Hereinafter SRM

Banking Union.[231] Moreover, harmonized rules on deposit guarantee schemes for each Member State are prepared, on the basis of the Deposit Guarantee Directive.[232]

What the SSM provides for is the sharing of the prudential supervision of banks between the ECB and the NCAs. In some aspects of prudential supervision 'dual supervision' applies, while other aspects will remain exclusively in the competence of national supervisors. In particular, NCAs are still responsible for the supervision of bodies which are not covered by the EU law definition of credit institutions,[233] the supervision of payment services, the consumer protection and the protection against money laundering and terrorist financing. Furthermore, the 'low-level' aspects of prudential supervision will remain in the realm of the NCAs, namely dealing with matters of establishment and provision of services of credit institutions, supervising credit institutions from non-EU countries with branch or cross-borders services within the Union, and assisting the ECB on its supervisory role.

The tasks of the ECB are found in Article 4 of the SSM Regulation. Within its responsibilities, there are matters relating to authorizations to credit institutions, the compliance with rules on fund requirements, large exposure limits, compliance with EU governance requirements, such as risk management and remuneration policies, carrying out stress tests, early intervention and structure changes to avoid failure of some credit institutions in danger.

The authorization of the ECB as the main supervisory body of banks in the eurozone could be considered as a mean of either enhancing integration or weakening it, since a Banking Union introduces a differentiated tier of integration for the banking sector within the euro-zone.[234]

[231]European Commission, 'Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union', COM (2012) 510 Final, (Sept. 2012)
[232]Directive 2014/49/EU on deposit guarantee schemes [2014] OJ 2 173/149
[233] Though they might be supervised as credit institutions under national law
[234] M. Andenas, (n 205), 339

5.4. Single Resolution Mechanism

In 2013the European Commission proposed a draft Regulation providing for a uniform rules procedures for the resolution of banks within the eurozone.[235] The Commission's intention was to put those banks which are close to solvent into resolution 'with minimal costs to taxpayers and to the broader economy'.[236] By establishing the 'bail-in' method, the burden of covering the losses and resolving a bank in failure is shared between the shareholders, the creditors and the unsecured depositors, thus taxpayers are protected.

The SRM covers the same banks that are also covered by the SSM, thus the receive supervision and management by the same level of authorities. In particular, the resolution of these 'significant' banks is transferred from the national to the European level, therefore it is ensured that these banks are approached consistently and the integrity of the single market is strengthened. The 'less significant' credit institutions within the EU are still managed by the national resolution authorities.[237]

Being fully operational from 1 January 2016, the SRM provides for the creation of a Single Resolution Board,[238] with the purpose of ensuring 'a coherent and uniform approach' to bank resolution, and a Single Resolution Fund that will be funded by contributions from all the banks that are covered by the SRM.

According to the SRM, the procedure for a bank's resolution is as follows: Firstly, the ECB, as the supervisory authority entitled by the SSM, identifies a bank that should be resolved. Secondly, a SRB prepares a recommendation on resolution to the European Commission. In each case, the SRB will consist of representatives from the ECB, the European Commission and the NRAs of the Member States which are affected by the activities of the bank in

[235]European Commission, 'Proposal for a Regulation establishing uniform rules and uniform procedures for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation 1093/2010' COM(2013) 520

[236]K. Alexander, 'European Banking Union: a legal and institutional analysis of the Single Supervisory Mechanism and the Single Resolution Mechanism' (2015) 40 *European Law Review* 156

[237]Hereinafter NRAs

[238]Hereinafter SRB

question. Thirdly, the European Commission decides whether to approve the recommendation and refer its decision to the Council of the EU for final review. Finally, NRAs implement the approved resolution plan under the supervision of the SRB.

The role of the SRB is to prepare the bank resolution plans, contribute to the implementation of these plans, and recommend the resolution of a bank to the Commission and Council, by suggesting the appropriate resolution tool, including the bail-in option. In case the SRB identifies any serious obstacles to the implementation of the resolution plan, it can order the bank to make legal, operational or structural changes in order to remove the obstacles.[239] Furthermore, the SRB, in co-ordination with the NRAs, has the discretion to decide whether or not to resolve a failing bank, in case the resolution of the bank would cause important adverse consequences to the economy and the financial stability of a State.[240]

As the Bank Recovery and Resolution Directive[241] now allows for the use of early intervention resolution tools, the SRB will decide whether and when to use the bail-in tool. This function of the SRB serves the SRM's objective to provide the Union authorities with a methodical means to manage failures of banks, large banking groups and certain investment firms.

Concerning the third pillar of the EBU, i.e. the aspect of deposit insurance, the Deposit Guarantee Scheme Directive of 2014[242] provides for the protection of €100,000 of each retail depositor in the case of the resolution of the bank[243] with increased contributions from the banks to a deposit guarantee fund in each State.[244]

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[239]Regulation (EU) No 806/2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 [2014] OJ 2 225/1Article 10(11)(g)

[240]Ibid, Article 12(7)

[241]Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ 2 173/190

[242]Directive 2014/49/EU on deposit guarantee schemes [2014] OJ 2 173/149

[243]Ibid Article 6

[244]Ibid Article 10

Generally, the European Banking Union constitutes an unprecedented transmission of sovereignty from the national authorities of Member States to institutions of the Union in the sensitive area of banking supervision and resolution in cases of failing banks. The harmonization of banking rules and their common implementation by the SSM and SRM aims to ensure financial stability and complete the EMU. Moreover, the resolution of failing banks has the purpose of putting 'an end to the era of massive bailouts paid by taxpayers'[245] and thus it contributes to the restoration of confidence in the banking sector and to the recovery of the euro-zone economy.

[245]European Commission, 'Banking Union: Restoring financial stability in the Eurozone', (2014 Commission BU Memo) 2

6. The case of Cyprus

Cyprus was declared an independent nation in 1960. The island has undergone a constant development for almost 56 years, emerging into an open and dynamic economy. In particular, the island's economic recovery and growth following the Turkish invasion in 1974 is truly impressive. The island's accession to the EU in 2004 and to the eurozone four years later brought several changes to the structure of various fields of its economy, including the areas of competition, the financial sector and the business environment.

Cyprus has some features, which render it as 'unique' for the EU.[246] Firstly, the geostrategic position of the island, as it is found between three continents, makes it popular not only in Europe but also in countries of Asia and Africa which have an interest in the area. Moreover, Cyprus has been a well-known 'tax haven' which attracted money from all over the world, particularly from Russia. Even after its accession to the EU in 2004, Cyprus remained lax in relation to international standards, as it kept the tax rate for foreign companies to only 10%.[247] It is of importance that Turkey illegally occupies the 1/3 of the island and British military forces and a UN peacekeeping force exist in the country. When Cyprus fell into a deep financial crisis in 2011, the approach of the EU following and the rescue package that was proposed and imposed by the eurozone in 2013 was also 'unique', as it was the first time that the bail-in tool was used in the EU. While the eastern Mediterranean was under the risk of being hit by the international crisis, accompanied by the 'shockwaves of a number of upheavals in the Middle East and in Europe',[248] the Cypriot government did not react promptly so as to avoid any external financial assistance.

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[246] I. M. Oehler-Sincai, 'Financial Contagion Reloaded: the case of Cyprus', (2013) *Global Economic Observer*, 66

[247] http://www.mof.gov.cy/mof/ird/ird.nsf/All/5C27792BB4607D71C22573A30024C374?OpenDocument (accessed 25 October 2015)

[248] M. Clarke, 'Cyprus: The Mouse That May Yet Roar', (2014) *Mediterranean Quarterly: Winter 2014*, 95

6.1. How did Cyprus reach this point

On the 16th of March 2013, Cyprus dominated the news worldwide, when the Eurogroup and the President of the Republic of Cyprus reached an agreement regarding the implementation of a rescue package, which would impose the bail-in of all insured and uninsured depositors in every bank of the island.[249] The Ministry of Finance of the island described that agreement as 'a one-off, extraordinary measure that will not be repeated under any circumstances. The levy will be imposed on the credit balance of deposits accounts.'[250] But the crisis did not come out of the blue.

The phenomenal financial crisis in Cyprus has been the result of numerous failures in several areas. Factors that have brought the country to this tragic situation include the national financial and prudential fiscal policy, the banking supervision and the internal governance of the banks and their practices. The fact that deficiencies on these levels occurred under an extraordinarily severe political environment, with the previous government of Demetris Christofias[251] refusing to accept that the crisis was forthcoming, resulted into an even more dramatic crisis.

The foundation causing the financial crash has been the ignorance, either voluntary or involuntary, of the extremely vulnerable status of the Cyprus economy accruing from the high-risk business activities of banks. 'The combination of loose fiscal policies, ineffective supervision and the lack of formal arrangements to deal with a crisis opened the way to

[249] Eurogroup Statement on Cyprus, 16 March 2013 https://www.google.com.cy/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&uact=8&ved=0CB4QFjABahUKEwi0h_3H8_jIAhVGuhQKHeHOAO4&url=http%3A%2F%2Fwww.consilium.europa.eu%2Fpress%2Fpress-releases%2F2013%2F03%2Fpdf%2FEurogroup-Statement-on-Cyprus(1)%2F&usg=AFQjCNEJfftVqLs60VMQ9GND-mHVX_4D8Q (accessed 25 October 2015)

[250] Ministry of Finance, Agreement for a Financial Assistance to the Republic of Cyprus, 18 March 2013 http://www.mof.gov.cy/mof/mof.nsf/All/BB670607715A44D6C2257B3200368FE9/$file/agreementfinancialassistance.pdf (accessed 25 October 2015)

[251] 2008-2013

catastrophe'.[252] The classification of Cyprus as 'one of the worst cases of self-inflicted damage in the EU' is more than well-documented.[253]

Starting with the national policy level, it has been acknowledged that the risk involved in operating a large banking industry had not been properly estimated. In essence, society was erroneous in believing that banks were contributing to the economic development and wealth of the country by focusing on their international business. Unfortunately banks were not well run, and in fact their operations were unwise and lacked prudence. Moreover, their expansion to international markets caused dangerous imbalances in the domestic market. In spite of improper attitude, there was no interest towards the establishment of mechanisms to deal with the event of a financial crisis. It has been claimed that the ignorance of these risks may be attributed to the political purpose of avoiding 'spoiling the party'.[254] The ignorance of risks was proven with the exposure of Cypriot banks to Greek debt. Specifically, two of the country's biggest banks, the Bank of Cyprus and the Cyprus Popular Bank,[255] held significant proportions of Greek bonds in Europe and operated several bank branches and subsidiaries in Greece. The amount of Greek bonds held by these two Cyprus banks[256] was disproportionate for the size of the country's economy. Comparing them to Germany and France, for example, which have a tenfold sovereign budget, they owned Greek government bonds of €22 billion and €15 billion respectively. It has been argued that the excessive exposure to Greek bonds could be partly attributed to the ECB, which allowed commercial banks of the euro-zone States to hold precarious government bonds to such an extent.[257] The excellent evaluation of Greece by international rating agencies until September 2009 encouraged banks within eurozone to buy Greek government bonds. Moreover, further encouragement occurred due to

[252]Independent Commission on the Future of the Cyprus Banking Sector, Final Report and Recommendations (October 2013), 31
[253]Ibid
[254]Ibid, 25
[255]Hereinafter Laiki Bank
[256] Namely Greek government bonds worth around €6 billion
[257]Ch. Ioannou and A. Emilianides, 'Πώς και γιατί η Κύπρος βυθίστηκε στην κρίση Ταπραγματικάαίτιακαιοιευθύνες' (2013) *Foreign Affairs, The Hellenic Edition*, http://www.foreignaffairs.gr/articles/69205/xristina-ioannoy-kai-axilleas-aimilianidis/pos-kai-giati-i-kypros-bythistike-stin-krisi?page=show (accessed 25 October 2015)

the transposition of the Basel II[258] into EU legislation, since they provide covered bonds.[259] Covered bonds 'encompass debt securities issued by EU banks that are subject to particular collateral arrangements under public regulation and supervision'[260] and are treated 'as exposures to banks' which are secured.[261] As a result of the improper attitude of the national banking industry, banks in Cyprus decided to expand to Greece during 2009-2010, when the deep recession of Greece was more than visible and the enforcement of a Memorandum of Understanding was unavoidable. Consequently, by the end of 2010 the exposure of the two Cyprus banks to Greek bonds and Greek companies exceeded 2.5 times the GDP of the country.[262]

Responsibility for the supervision of banks lies with the Central Bank of Cyprus,[263] whose mandate is to maintain financial stability 'through the conduct of micro-prudential supervision of banks, macro-prudential supervision, payment, clearing and settlement systems oversight and by acting as lender of last resort or through the resolution of distressed banks'.[264] In spite of these powers of the CBC, there is evidence that banks were not prevented from adopting an expanding policy and from taking on risky activities by an appropriate regulatory mechanism.[265] In particular, the custodian of the island's financial stability proved unable to monitor banking risks, notwithstanding the engagement of the two systemic banks in such perilous operations. However, it is argued that the responsibility must be shared between the CBC and the relevant EU authorities, since the EBA undertook the annual stress test in 2011 and it determined that Cypriot banks had sufficient capital to

[258]Basel II 2004
[259]Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions [2006] OJ 2 177/1 and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions [2006] OJ 2 177/201
[260]F. Dierick *et al*, 'The new Basel capital framework and its implementation in the European Union' (2005) European Central Bank Occasional Paper Series, Paper No. 42, 28
[261]Ibid, 42
[262]Ch. Ioannou (n 257)
[263]Hereafter CBC
[264]Central Bank of Cyprus, http://www.centralbank.gov.cy/nqcontent.cfm?a_id=8130 (accessed 24 July 2014)
[265]Independent Commission (n 252), 26

withstand a financial crisis,[266]when they were all aware of the excessive holdings in Greek bonds while the Greek economy was near total collapse. It is noteworthy that international agencies in their reports described the financial supervision in Cyprus as not rigorous enough.[267] In addition, the deficient governance of the CBC, due to the absence of firm leadership, challenged the independent nature of the supervision and demonstrated that the CBC was not explicitly accountable to the government for its supervisory functions. The CBC's independence is protected by the TFEU[268] and the Protocol on the Statute of the European System of Central Banks and of the European Central Bank.[269] Though EU law provides for the independence of national central banks only regarding monetary policy, the national legislation protects the supervisory role of the CBC as well.[270] After the accession of the country to the EMU, the CBC's duty of establishing and implementing the monetary policy was delegated to the ECB. The Governor of the CBC participates in the General Council and the Governing Council of the ECB as a permanent and ex officio member with the governors of all the other EU national central banks.[271]

The defective corporate governance of banks was another cause of the financial crisis in Cyprus. It is argued that the boards of the big banks of the country failed to put in place suitable mechanisms and procedures for monitoring risk and controlling executive directors. 'A culture of deference rather than challenge prevailed in the face of domineering chief executives who increasingly ignored their boards and bypassed what controls did exist'.[272] Such a culture was more manifest in Laiki Bank and the Bank of Cyprus, which led their operations with the mere objective of increasing income so as to fund their expansive

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[266] See http://www.eba.europa.eu/risk-analysis-and-data/eu-wide-stress-testing/2011/results and http://www.centralbank.gov.cy/nqcontent.cfm?a_id=11847&lang=en (accessed 25 October 2015)
[267]Independent Commission (n 252), 26
[268]Consolidated version of the Treaty on the Functioning of the European Union, Art.130 [2012] OJ C326/01
[269]Protocol (No 4) on the Statute of the European System of Central Banks and the European Central Bank as annexed to the consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union [2010] OJ 83/01, Chapter 3, Art.7
[270]Central Bank of Cyprus Laws of 2002-2007, part 2 section 7
[271] Core principles for Effective Banking Supervision, *Basel Committee on Banking Supervision*, September 1997
[272]Independent Commission (n 252), 25

activities and 'meet their bonus targets'.[273]Apart from ensuring their bonus, directors had conflicting opinions and interests, a fact that undermined the integrity and impartiality of the boards.

The case of cooperatives is remarkable. The detrimental concurrence of wills and interests between the boards, the management and the customers, resulted in loan favouritism with the failures not being recognised. The position of cooperatives with regards to their harmonization with the EU law requirements remained unclear for many years. Initially, cooperatives did not constitute credit institutions and thus, they were not bound by the relevant Banking Directive,[274] which the banks in Cyprus had to implement after the accession of the country to the EU in 2004. After long negotiations, it was finally decided that cooperatives should fully comply with EU law. Therefore, the Cooperative Societies Law, which regulates the establishment and operation of cooperative banks, was appropriately amended to implement the *acquis communautaire* in relation to credit institutions.[275]

Furthermore, the flaws of corporate governance have been recognised in the lending activities of banks. Specifically, loans were frequently granted without any prior proper assessment of the ability of the borrowers to repay them, based on property or personal guarantees only. Nothing seemed wrong until the property bubble burst in the country, and the guarantees that were given turned out to be useless. Faced with that situation, the banks preferred to extend the repayment terms of such loans and continue to treat them as good, instead of acknowledging that those loans became bad. Such practice reflects the insufficient management of the banks and the lack of strict rules and internal controls, from which huge

[273]Independent Commission (n 252), 25

[274]Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions [2000] OJ 2 126/1

[275]Cooperative Societies Law (No. 22 of 1985 and 68 of 1987 as amended)http://www.cssda.gov.cy/cssda/cssda02.nsf/All/6E3792FAA204B18EC2257C0500336F10/$file/%CE%9F%CE%B9%20%CF%80%CE%B5%CF%81%CE%AF%20%CE%A3%CF%85%CE%BD%CE%B5%CF%81%CE%B3%CE%B1%CF%84%CE%B9%CE%BA%CF%8E%CE%BD%20%CE%95%CF%84%CE%B1%CE%B9%CF%81%CE%B5%CE%B9%CF%8E%CE%BD%20%CE%98%CE%B5%CF%83%CE%BC%CE%BF%CE%AF%20%CF%84%CE%BF%CF%85%201987%20%CE%AD%CF%89%CF%82%202012.pdf (accessed 10 November 2015)

losses resulted. Notably, in 2012, the private sector debt in Cyprus was the highest in the entire EU, most of this being guaranteed against property that was diminishing in value.[276] A final example of the weak governance of banks was the irresponsible outspread in Greece, a country in deep crisis. This was the final blow for Cypriot banks and it demonstrates the weakness of their risk management systems. While the first signals of the financial crisis appeared in the country, the EU was still reforming its legislation regarding the corporate governance and the supervision of banks. Remarkably, the SSM and the SRM were established in 2013 and 2015 respectively, while the ESFS and the other institutional authorities were established in 2010 and they could not have effective results within a time period of one to two years of operation. Thus, it could not be argued that Cyprus made tragic omissions, but rather that the EU framework was not comprehensive at that time.

[276]Independent Commission (n 252), 22

6.2. Timeline of the crisis

In 2009, the effects of the global financial crisis created the first marks upon Cyprus, and the island's economy experienced its first recession in 35 years.[277] After three years of limited growth, the economy slipped into a double-dip recession in 2012.[278] Specifically, the general government balance became negative, public debt was rapidly growing; and private sector debt was the third highest in the EU.[279]

It was evident, even from the beginning of 2009, that the economic recession led to a decrease in deposits, which resulted into a reduced supply of loans, since banks faced a consequential lack of adequate liquidity. The decrease in loan supply limited the expenditure in the real economy, since most of the businesses could not operate and grow as usual. Despite these signals, the government's initial response to the warnings concerning the country's economy was rather defensive. The government supported that the global crisis could not affect Cyprus, because its economy was based on solid foundations.[280] The President of the country announced a liquidity injection of €1.4 billion to commercial banks and cooperatives in the form of government securities, in order to strengthen the banking sector and lessen the lending rates.[281] It is apparent that the reaction of the government was based on temporary and occasional measures, and did not aim at long-term reinforcement and restructuring of the banking industry of the country. The official statement of the then Minister of Finance, Charilaos Stavraki, that the role of the Ministry of Finance is to promote optimism among businesses and taxpayers 'no matter whether predictions become true',[282] illustrates the policy adopted by the government at that time. In the same line, Demetris Christofias accused the

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[277] I. M. Oehler-Sincai, (n 246), 67
[278] Ibid
[279] Eurostat, *Indicators of the Macroeconomic Imbalance Procedure* (2012a), (MIP) Scoreboard, data base http://epp.eurostat.ec.europa.eu/portal/page/portal/macroeconomic_imbalance_procedure/indicators (accessed 24 July 2014)
[280] Ministry of Finance, Annual Report 2009, http://www.mof.gov.cy/mof/mof.nsf/All/7DFDC796E60E2986C2257765003D4269/$file/Annual%20Report%202009%20[low].pdf?OpenElement (accessed 1 November 2015)
[281] Ch. Ioannou (n 257)
[282] Ibid

international rating agencies of being partial when evaluating the economy of Cyprus, and underestimated the importance and accuracy of their ratings.[283]

As a result of the sovereign debt crisis in Greece, the rating agencies of Fitch, Moody's and Standard & Poor's downgraded government bond ratings and bank credit ratings.[284] Notably, the country faced its block from the international bond market in September 2011.[285] Among the attempts made by Cyprus to deal with this crisis, was a loan of 2.5 billion Euros from the Russian Federation in December 2011; an expression of Russia's support to Cyprus, which operated as an offshore centre for the Russian 'big business', the so-called 'Cyp-Rus' relationship.[286]

In December 2011, the Financial Crisis Management Law came into force,[287] in order to enable the Council of Ministers and the CBC to take necessary measures to deal with liquidity problems, the solvency of the financial system, and the strengthening of the balance sheets of financial institutions in the country; assuming that this is the required support and considering that without it the financial system would be seriously disrupted. In particular, the Council of Ministers and the CBC became entitled to grant government loans to banks, to provide government guarantees for loans to be raised by banks, and to provide capital against the obtainment of equity participation in the ownership structure of banks.[288] Moreover, they could make a grant to the Deposit Protection Fund, to cover any compensation of depositors, which the latter may be entitled to in case a bank failed, according to what EU law provided

[283]S. Clerides, 'The Collapse of the Cypriot Banking System: A Bird's Eye view' (2014) 8 *Cyprus Economic Policy Review* 31
[284]I. M. Oehler-Sincai, (n 246), 69
[285]A. Hadjipapas & K. Hope, *Cyprus nears €2.5bn Russian loan deal*, (2011) Financial Times http://www.ft.com/intl/cms/s/0/655a3fd2-de31-11e0-9fb7-00144feabdc0.html#axzz392NlzAkX (Accessed 24 July 2014)
[286]E. Pelto *et al.,* 'Cyp - Rus investment flows to central and Eastern Europe−Russia's direct and indirect investments via Cyprus to CEE', (2004), *Journal of Business Economics and Management*, Volume 5, Issue 1, 3-13
[287]The Management of Financial Crises Law of 2011 (200(I) of 2011) http://www.centralbank.gov.cy/media/pdf_gr/GR_nomos_diaxirisis_kriseon_200_2011.pdf(accessed 10 November 2015)
[288]Ibid, Article 4(1)

for.[289] All those measures could only be taken on the recommendation of the CBC and/ or after consultation with the competent supervisory authority.[290]

In June 2012, the real danger of collapse of the Laiki Bank, with catastrophic consequences for the rest of the country's banking industry looming in the horizon, led the government to request assistance from the Troika, a tripartite body consisting of the International Monetary Fund, the European Commission and the European Central Bank. However, the negotiations over the final rescue package proved fruitless until March 2013, since not only economic but also political considerations came into play.[291] The international bailout was more than essential for the island, as the banking sector was about to collapse. Since the bank assets were almost seven to eight times the size of the entire economy,[292] the collapse of the banking sector, due to the failure of one or two of the major banks, would unavoidably cause the bankruptcy of the whole country.

Some members of the eurozone were reluctant to offer Cyprus any support,[293] with German officials wondering whether it would be avoidable to bail out such a small island economy, which only represents only0.2 percent of the euro-zone output. It was considered that the island's collapse was virtually impossible to cause a systemic risk to the euro-zone, unless default proved to be contagious across the Euro region.[294] On the other hand, the European Central Bank held the opinion that the funds required for the Cyprus were not of significant value and that they would lessen eurozone's headaches, as Ireland, Greece, Portugal and Spain were still failing.[295]

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[289]The Management of Financial Crises Law of 2011 (200(I) of 2011), Article 4(1)
[290]Ibid, Article 4(2)
[291]G. C. Georgiou, 'Cyprus's Financial Crisis and the Threat to the Euro', (2013*) Mediterranean Quarterly 24:3*, 60. Presidential elections took place on February 2013 with a strong battle between the communist and the conservative parts of the country, each of them representing different views on the rescue package of Troika.
[292]G. C. Georgiou, (n 291), 62
[293] Namely Germany, France, Austria, the Netherlands, and Finland
[294]V. Pop, *German Musings: Is Cyprus Too Small for a Bailout?* (2013),EU Observer, http://euobserver.com/economic/118893 (accessed 24 July 2014)
[295]G. C. Georgiou, (n 291), 59

The initial proposal of the Troika required 'all bank deposits to bear the brunt of the haircut'.[296] Never before in the history of modern banking had such a measure been imposed. Depositors in Cyprus were to be forced to save their economy by giving their own assets. In other words, while other countries were given a debt haircut, Cyprus was surprisingly given a deposit haircut. Such an unprecedented proposal was presented as being necessary because of the small number of bondholders in Cypriot banks, who were unable to assume all the losses on their own.[297] As the President of Eurogroup commented 'Cyprus is a specific case with exceptional challenges'.[298] According to the relevant Eurogoup statement, the measures proposed included 'the introduction of an upfront one-off stability levy applicable to resident and non-resident depositors... the increase of the withholding tax on capital income, a restructuring and recapitalisation of banks, an increase of the statutory corporate income tax rate and a bail-in of junior bondholders'.[299] Remarkably, it was about time for the nominal corporate tax rate to be increased, the lowest in the EU until then, in order to abolish the 'offshore' character of Cyprus.

Banks in the country remained closed for a world record of a 12-day banking holiday, with bank runs not occurring after the reopening of the banks, since rigorous capital controls continued to be in force.[300] Two years later, in July 2015, Greek banks got a new world record

[296] G. C. Georgiou, (n 291), 63
[297] Ibid
[298] Statement by the Eurogroup President on Cyprus, 25 March 2013 http://www.consilium.europa.eu/press/press-releases/2013/03/pdf/Statement-by-the-Eurogroup-President-on-Cyprus/ (accessed 1 November 2015)
[299] Eurogroup Statement on Cyprus, 16 March 2013 https://www.google.com.cy/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&uact=8&ved=0CB4QFjABahUKEwi0h_3H8_jIAhVGuhQKHeHOAO4&url=http%3A%2F%2Fwww.consilium.europa.eu%2Fpress%2Fpress-releases%2F2013%2F03%2Fpdf%2FEurogroup-Statement-on-Cyprus(1)%2F&usg=AFQjCNEJfftVqLs60VMQ9GND-mHVX_4D8Q (accessed 25 October 2015)
[300] J. Treanor *et al., Cyprus banks reopen – but stock exchange will remain closed* (2013) The Guardian, http://www.theguardian.com/business/2013/mar/28/cyprus-reopen-banks-stock-market-closed (accessed 24 July 2014)

of a 3-week banking holiday and strict capital controls,[301] until Greece reached a new bailout deal with Troika.[302]

The Cypriot House of Representatives rejected the first proposal and 'the race was on to reach a solution to what was turning out to be a bigger problem that any of the negotiating parties had bargained for'.[303] The take-it-or-leave-it approach of the Eurogroup obliged the government to accept the terms of a revised bailout on the 25th of March 2013. The difference between the new and the prior proposal was the fact that in the new proposal only depositors of Laiki Bank and the Bank of Cyprus would be affected; and deposits of less than 100.000 Euros deposited would be guaranteed.[304] However, the Laiki Bank was forced to close, and a 'good bank' and a 'bad bank' were created instead. Similarly to the case of Northern Rock Bank, the bad bank would absorb all toxic assets, i.e. deposits of more than 100.000 Euros, and non-performing loans. The good bank consisted of all the guaranteed deposits and did in fact become a part of the Bank of Cyprus, which operated under restructuring and downsizing and also terminated the operation of all its branches in Greece. The consequences of these measures will be discussed below.

[301]EU Commission, Statement on behalf of the European Commission by Jonathan Hill on the capital controls imposed by the Greek authorities, 29 June 2015 http://europa.eu/rapid/press-release_STATEMENT-15-5271_en.htm (accessed 1 November 2015)
[302]Eurogroup Statement on the ESM programme for Greece, 12 July 2015 http://www.consilium.europa.eu/en/press/press-releases/2015/08/14-eurogroup-statement/ and Euro Summit Statement, 12 July 2015 http://www.consilium.europa.eu/en/press/press-releases/2015/07/12-euro-summit-statement-greece/ (accessed 1 November 2015)
[303]G. C. Georgiou, (n 291*)*, 63
[304]Eurogroup Statement on Cyprus, 25 March 2015 https://www.google.com.cy/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0CBoQFjAAahUKEwj3pY3yrP7IAhVJwHIKHZkjBbE&url=http%3A%2F%2Fec.europa.eu%2Fspain%2Fpdf%2Facuerdo-eurogrupo-chipre.pdf&usg=AFQjCNHo_ur28MGvNlUs9aUeaoWE777GSA (accessed 1 November 2015)

6.3. Measures imposed

Even though the rescue package which was put in place prevented the default of the entire country, it caused plenty of problems 'that go well beyond the shores of this small island nation'.[305]

The guarantee of bank deposits by the State was first introduced in 1929, when banks failed after the US stock market crash. An example of such a State-insurance mechanism is the Federal Deposit Insurance Corporation, which covers bank deposits completely in case of a bank collapse, irrespective of the magnitude of the deposit.[306] A similar mechanism applies in the EU.[307] Evidently, these mechanisms indicate that banking authorities worldwide regard banking confidence as very significant and take all the necessary measures to maintain it. This pillar of modern banking appears to have collapsed following the bailout agreement for Cyprus, since the savings of a considerable number of depositors were uninsured by the State and were consequently lost. Therefore, it is argued that asking the uninsured depositors to bear the losses has in fact generated a hazardous precedent for banking crises in the future.[308] According to Dijsselbloem, the Dutch finance minister, President of the Eurogroup, the philosophy of penalizing large depositors, adopted in the Cyprus agreement, could now constitute a model to be followed in the future when banks are in need for rescue.[309] However, following the outrage caused by his comments and the subsequent harm to the banking confidence of the EU, he withdrew his statements and explained that the case of Cyprus was distinct and could not serve as a formula to be implemented in other cases. He failed, however, to convince economists and lawyers. Though the bail-in has not been imposed on any other Member State yet, all the necessary steps for authorizing such a measure were taken. In fact, the bail-in tool used in Cyprus expedited the finalisation of the Deposit

[305] G. C. Georgiou, (n 291), 66
[306] http://www.fdic.gov/about/history/timeline/1920s.html (accessed 24 July 2014)
[307] In EU bank deposits are guaranteed up to 100.000 Euros per account
[308] G. C. Georgiou, (n 291), 66
[309] M. Birnbaum, 'Cyprus Bailout Deal Stokes Fears about Euro," (2013) *Washington Post*

Guarantee Scheme, with the relevant Directive being implemented one year later,[310] and, subsequently, the bail-in tool was introduced as a concept in EU legislation.[311] Without doubt, the case of Cyprus constitutes a precedent of capital controls within a common monetary area, such as the eurozone, which was followed two years later in Greece.[312]

Furthermore, the bailout agreement has in fact increased financial uncertainty. Instead of ensuring stability of the financial system, both for the country and for the entire EU, the risk of contagion still exists. A study of the bailout agreements implemented in Greece, Ireland and Portugal, reveals that the faults of banks were never rectified using depositors' money. Transferring the burden of rescuing a bank to the depositors leads to the question as to whether deposits have been changed from bank credits to taxpayers' money available in emergency conditions. In case the governments have the power to change the law in order to annul the guarantee of deposits, then 'nobody's money is safe from the tax collector'.[313] In other words the seizure of private property *ad lib* would be legally allowed. The uncertainty caused by such an agreement could easily spread to other countries, such as Italy or Spain, which are currently the most vulnerable in facing a banking crisis. If such a hard approach was followed in a banking system with only €68 billion in deposits; then an even tougher approach could be foreshadowed in case the Italian government were to ask for financial assistance, with its banking system having more than €500 billion in current accounts and €400 billion in other deposits.[314]

Financial observers in the US have been quite surprised and pleased with the bailout agreement for Cyprus; as for the first time in history 'someone has found the courage to

[310]Directive 2014/49/EU on deposit guarantee schemes [2014] OJ 2 173/149 was implemented on 16 April 2014.
[311]Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ 2 173/190 was implemented on 15 May 2014
[312]European Commission, Statement on behalf of the European Commission by Jonathan Hill on the capital controls imposed by the Greek authorities, Brussels, 29 June 2015 http://europa.eu/rapid/press-release_STATEMENT-15-5271_en.htm (accessed 30 October 2015)
[313]G. C. Georgiou, (n 291), 67
[314]D. Valiante, 'The Cypriot Precedent' (2013) 48 *Intereconomics* 134

execute a credible solution to large bank failure that is not backstopped by taxpayers'.[315] When the US was hit by the banking crisis of 2008-2009, many banks, which faced the fear of failure, were, in the end, rescued by the US government. Their rescue was considered necessary since they were seen as TBTF and their failure would have exposed the financial system and the entire economy of the US to great dangers. Nevertheless, the Eurogroup believed that the banking industry of Cyprus was 'oversized' or disproportionate to the size of the country's economy. Hence, it supported that the Main Street of Cyprus was not worth rescuing.[316] In essence, the Eurogroup did not consider that the banks of Cyprus fall under the TBTF category in the EU, even if the two banks running the greater risk of failure were the largest of the island. However, the fact that they were TBTF for the local economy but still forced to apply such measures, demonstrates that the TBTF principle can be overturned; and it is the first time this has actually happened. This can lead to the conclusion that, since a small and economically weak country has the courage to subject its two largest banks to such strong measures, the same process could be applied to any other large and economically well-developed country.

[315] L. Bennetts, *The Cyprus 'Bail-In' Exposes as 'To Big To Fail' As All Too Timid* (2013) http://www.forbes.com/sites/realspin/2013/04/18/the-cyprus-bail-in-exposes-too-big-to-fail-as-all-too-timid/ (accessed 24 July 2014)
[316] G. C. Georgiou, (n 291), 68

7. Recommendations for Cyprus

The need for reform of the banking sector in Cyprus has emerged, because the Memorandum of Understanding constitutes an interim rescue package for the purpose of preventing the whole collapse of the country. In any case it does not operate as a permanent reform proposal for the Cyprus' banking industry, therefore a complete reconsideration of the banking system within the EU context is more than urgent, so as to prevent similar crises in the future. Among others, the implementation of the EU recommendations regarding the corporate governance of banks as well as the effective cooperation between the national competent authorities with the EU authorities on the supervision of banks, within the framework of the European Banking Union, can strengthen the banking sector of the country so as to achieve financial stability and avoid a recurrence of the current financial crash.

As the UK commenced its reform with the restructure of the supervision of banks, Cyprus could also consider proposals for the improvement of its financial supervision structure. The Cyprus legislation authorizes the CBC as the competent authority for the supervision and licensing of banks,[317] in accordance with the guidelines issued by the EBA and the Directions and Regulations adopted by the EU. Until now, banks were supervised by the CBC;[318] cooperative credit institutions were supervised by the Cooperative Societies' Supervision and Development Authority;[319] insurance companies are under the responsibility of the Superintendent of Insurance;[320] investment firms are monitored by the Cyprus Securities and Exchange Commission;[321] and the firms which deal with pension funds fall below the supervision of the Registrar of Occupation Retirement Benefit Funds.[322] The implementation of the SSM Regulation introduced some changes on the existed system of supervision. Now,

[317] Central Bank of Cyprus Law 2002-2007, Banking Law 1997-2009
[318] http://www.centralbank.gov.cy/nqcontent.cfm?a_id=1&lang=en (accessed 24 July 2014)
[319] http://www.mcit.gov.cy/mcit/mcit.nsf/dmlinspection_en/dmlinspection_en?OpenDocument (accessed 20 October 2015)
[320] http://www.mof.gov.cy/mof/mof.nsf/page28_en/page28_en?OpenDocument&print (accessed 24 July 2014)
[321] http://www.cysec.gov.cy/default_en.aspx (accessed 24 July 2014)
[322] http://www.mlsi.gov.cy/mlsi/sid/sidv2.nsf/page43_en/page43_en?OpenDocument (Accessed 24 July 2014)

the Bank of Cyprus, the Cooperative Central Bank, the Hellenic Bank and the Russian Commercial Bank (RCB) have been transferred from the supervision of the CBC to the supervision of the ECB. According to the view of the IMF, the initial structure was fragmented and thus there could not be an effective and unified supervision of the financial institutions of the country.[323]

It is interesting to examine whether a 'Twin Peaks' model similar to that adopted in the UK would be successful. Similar to the UK reform, the banking regulation could be divided into two categories: monitor of the banks' conduct and prudential supervision. The former would deal with the relationship of banks with their retail customers and their general market conduct, like the FCA, and the latter would administer the soundness of the financial system, like PRA. Such a division of responsibilities ensures the healthy operation of the banking industry. Nevertheless, the establishment of two peaks of regulation 'would be excessive in a country of Cyprus' size and would also create an additional regulatory interface for the firms themselves'.[324] The 'size' of the country is considered in terms of its banking industry and its economy in general. Arguably, ensuring that the supervisory authorities of the country deal both with the conduct of banks and the micro-prudential regulation and daily supervision of them is necessary. However, the size of the Cyprus economy enables these two functions to be performed by the same authorities.

The approach used by the UK, which focused on the restructuring of its supervision mechanism, could constitute the best example for Cyprus to follow. Although various models are used worldwide, the most suitable and streamlined for our case is the integrated structure. Having the ECB, in coordination with the CBC, assuming the responsibilities of the four existing components of the supervision system, as the Single Supervisory Mechanism, would provide more efficient and strict supervision. Such an authority would enjoy the complete

[323]A. Orphanides & G. Syrichas, *The Cyprus Economy, historical review, prospects, challenges* (2012) Central Bank of Cyprus, 266 http://www.centralbank.gov.cy/media/pdf/CBC_book_EN.pdf (accessed 24 July 2014)
[324]Independent Commission (n 252), 70

legal and financial independence to perform its role, exercising prudential and conduct supervision, such as the FCA and the PRA do in the UK. The model of 'one-stop shop' regarding financial supervision is already supported by numerous countries,[325] since it avoids the overlap between the various authorities and provides the regulators a thorough view of the financial sector of the country. Moreover, there are supporters of the argument that countries like the US which keep their specialist supervisors lack efficiency and effectiveness. Furthermore, a sole supervisory authority will operate more independently, thus an integrated model has been characterized as providing 'a bulwark against political interference'.[326]

After improving the banks' supervision, Cyprus must also implement other recommendations as well. Most importantly, the country should review the national philosophy regarding the role of banks and financial services. The dependency of Cyprus on its banking system for financial services is extraordinarily high and therefore the government must enforce a financial services strategy in order to guarantee its constant growth. The aftermaths of this extremely high dependence on banks should be fully understood in order to manage their operation carefully. The independence of the banking system of the island should be quickly reinforced. 'Cultural change of this kind would transform the banking industry in all the necessary ways, by delivering better governance, sounder banks, and greater trust internationally'.[327]

The corporate governance of banks should also be improved in order to prevent boards from continuing to manage the banks improperly and insufficiently and to fight the policy of offering enormous bonuses to those who would take the highest risks. Ensuring the independence of the boards; selecting directors on the basis of merit; increasing the number of non-executive directors so as to poise the executive directors; and enforcing regular

[325] Independent Commission (n 252), 68
[326] Ibid, 70
[327] Ibid, 104

assessments of the performance of boards, are all measures that could raise the standards of banks' management.[328]

Finally, the Cypriot government could shift its focus on effectively adopting the principles established in the Basel III in order to reinforce the regulation and risk management of the banking industry. In that way it can achieve the enhancement of the banks' competence 'to absorb shocks arising from financial and economic stress whatever the source, improve risk management and governance and strengthen banks' transparency and disclosures'.[329] In practice, banks must increase their capital levels and decrease their debt levels, macro-prudential regulation must ensure that the banking sector can tolerate higher risks, and micro-prudential regulation must become more rigorous in times of stress.

[328]Independent Commission (n 252), 61-62
[329]G. A. Walker, 'Basel III Market and Regulatory Compromise'(2010) *JBR*, Editorial 1-5

8. Conclusions

The present paper aimed to determine whether the reforms applied in the UK regarding banks could also apply in Cyprus in order to overcome the tragic financial reality of the island, while being part of the EU. For this purpose, the paper investigated and evaluated the main theories of how banks can decisively contribute to the cause of a financial crisis and how these theories apply regarding the crisis of 2007-2008 in the UK, further examining the case of Cyprus.

It has been shown that the deficient corporate governance of banks and their lack of effective supervision do constitute major causes of the financial crisis. Moreover, the TBTF theory has also played a crucial role in the matter. The UK commenced reforms by restructuring and improving the supervision framework of banks, by abolishing the FSA and establishing the 'Twin Peaks' model of supervision. The purpose of these reforms was to improve the effectiveness of markets' operation and to ensure the financial stability of the country. In the case of Cyprus, an unprecedented measure was implemented requiring depositors to pay for the faults of banks, in an effort to prevent the entire collapse of the banking sector of the country. The exposure of Cypriot banks to Greek bonds, the significant deficiencies in the corporate governance of banks, and the inadequate supervision from the CBC brought the island to a tragic economic position.

Regarding the stance of the EU, the Cyprus case constituted a barometer of the willingness of the Member States to resolve failing banks and avoid bailouts which burden the taxpayers; and also expedited the creation and implementation of a comprehensive legal framework concerning the protection of depositors. All these changes at the EU level are necessary for the achievement of the EMU and the European Banking Union, since 'a banking union will not thrive on shaky foundations'.[330]

[330] D. Valiante,(n 314)

In conclusion, Cyprus could benefit from adopting the example of the UK and starts its reform from the supervision of banks. Like the UK, it should reinforce the implementation of measures to strengthen the supervision of banks' conduct and their prudential supervision. In the context of the EBU, this could be achieved without establishing a 'Twin Peaks' model, since the size of the Cyprus economy does not offer the space of two peaks.

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