

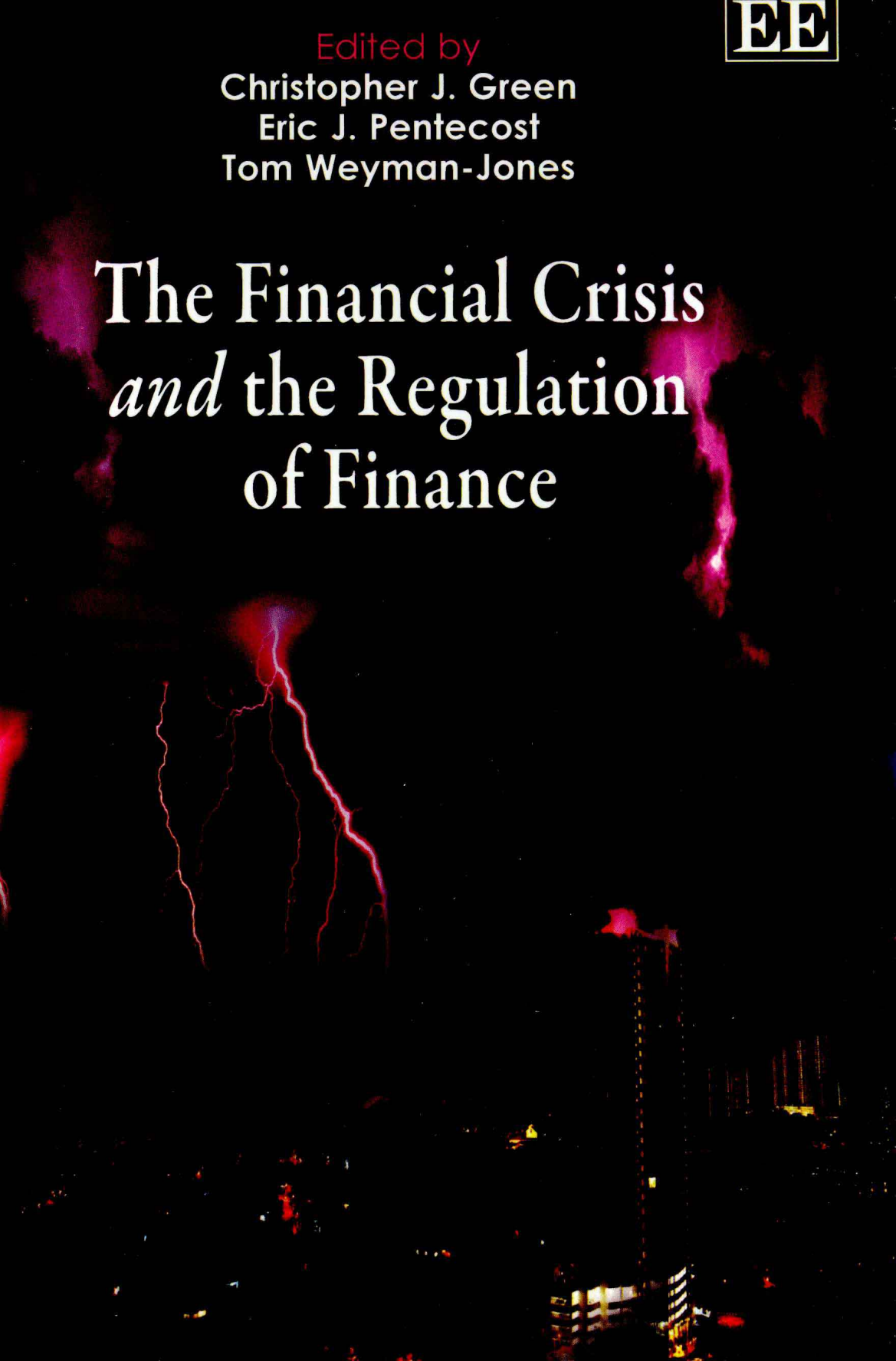
Edited by

Christopher J. Green

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Tom Weyman-Jones

The Financial Crisis *and* the Regulation of Finance

The background of the cover is a dramatic night photograph of a city skyline. A massive, bright red lightning bolt strikes down from a dark, stormy sky, illuminating the scene. The city lights are visible in the lower portion of the image, with a prominent skyscraper on the right side.

The Financial Crisis and the Regulation of Finance

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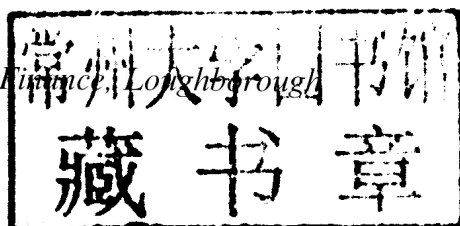
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The Financial Crisis *and* the Regulation of Finance

The 2007–08 financial crisis has posed substantial challenges for bankers, economists and regulators: was it preventable, and how can such crises be avoided in future? This book addresses these questions.

The Financial Crisis and the Regulation of Finance includes a comprehensive overview of the crisis and reviews the theory and practise of regulation in the UK and worldwide. The contributors – all international experts on financial markets and regulation – provide perspectives and analysis on macroprudential regulation, the regulation of financial firms, and the role of shareholders and disclosure.

This rigorous book will be of great interest to all those with an interest in banking and finance including academics, professionals, bankers, regulators, advisors and civil servants. Students on banking and finance courses will also find this clear and compact resource invaluable.

Christopher J. Green is Professor of Economics and Finance,
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Shelagh Heffernan was determined to take part in this venture to celebrate David Llewellyn's work: she prepared her paper for this volume and delivered it at the June 2009 conference even though she was already very unwell. Sadly, she died on 14 December 2010 before publication. The many tributes that have followed her passing constitute an eloquent testament to her own contribution to banking and finance.

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Abbreviations

AC World	MSCI All-Country World Index
ARROW	Advanced Risk Responsive Operating Framework
B&B	Bradford and Bingley
BIS	Bank for International Settlements
BoA	Bank of America
BoE	Bank of England
bp	basis points
BPRI	bank performance related information
CAR	capital adequacy requirement
CDO	collateralized debt obligation
CDS	credit default swap
CEBS	Committee of European Banking Supervisors
CEO	chief executive officer
CMO	collateralized mortgage obligation
CRD	Capital Requirement Directive
DBFOM	design-build-finance-operate-maintain
DBOM	design build operate and maintain
DIDMCA	Depository Institutions Deregulation and Monetary Control Act
ECB	European Central Bank
EEA	European Economic Area
EIB	European Investment Bank
EMEA	Europe, Middle East and Africa
EU	European Union
Fannie Mae	Federal National Mortgage Association
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
Fed	US Federal Reserve
FISM	financial institutions, systems and markets
FRC	Financial Reporting Council
Freddie Mac	Federal Home Loan Mortgage Corporation
FSA	Financial Services Authority
FSB	Financial Stability Board
FSMA	Financial Services and Markets Act

GDP	gross domestic product
GEM	global emerging market
HF	hedge fund
HMT	HM Treasury
IMF	International Monetary Fund
IndyMac	Independent National Mortgage Corporation
IPO	Initial Public Offering
IRS	Internal Revenue Service
LBO	leveraged buyout
LIBOR	London Inter-Bank Offer Rate
LoLR	lender of last resort
LSE	London School of Economics and Political Science
MBS	Mortgage-backed security
MoU	Memorandum of Understanding
OECD	Organisation for Economic Co-operation and Development
OIS	Overnight Indexed Swap Rate
P&G	Proctor and Gamble
PCA	prompt corrective action
PEF	private equity fund
PPP	Public Private Partnership
RBNZ	Reserve Bank of New Zealand
RBS	Royal Bank of Scotland
RIA	Regulatory Impact Assessment
RMBS	residential mortgage-backed securities
ROE	return on equity
RTO	risk to our objectives
SEC	Securities and Exchange Commission
SEIR	Structured Early Intervention and Resolution
SME	small and medium-sized enterprises
SPV	special purpose vehicle
SRR	special Resolution Regime
SUERF	European Money and Finance Forum
SWF	sovereign wealth fund
UBS	Union Bank of Switzerland
VAT	value added tax

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PART ONE

The financial crisis

1. Introduction

**Christopher J. Green, Eric J. Pentecost and
Tom Weyman-Jones¹**

DAVID LLEWELLYN

All of the chapters in this book are the product of a one-day conference entitled 'Financial Institutions, Systems and Markets: Structure, Performance and Regulation' held at Loughborough University on 16 June 2009 to celebrate the career of David Llewellyn and his contribution to the Department of Economics at Loughborough University.²

David was appointed as Professor of Money and Banking in the new Department of Economics at Loughborough University in 1976 at just 33 years of age, a post he has held for over 30 years. After graduating from the London School of Economics (LSE) in the mid-1960s David moved to Rotterdam to take up the post of economist at Unilever. He moved back to the UK one year later to work for HM Treasury where he advised on both domestic and external financial matters, before leaving to join the staff of Nottingham University in 1967. In 1974 David joined the Treasurer's Department of the International Monetary Fund (IMF) in Washington DC where he was responsible for the analysis of banking and capital markets and advising on the reform of the international monetary system.

Just five years after his arrival in Loughborough, David became head of the Department of Economics (1981–91) and from 1985–2004 was chairman of the Loughborough University Banking Centre, which with the aid of sponsorship from leading UK banks (especially the former Midland Bank, National Westminster Bank and the Halifax Building Society) made Loughborough a centre for the study of the financial system. David was one of the principal drivers behind this very first public-private initiative, and the banking centre was subsequently responsible for a number of important developments. In particular it was one of the main pioneers of the empirical study in the UK of bank and building society efficiency and competition. By the early 1990s sponsorship had been reduced nationally, and the banking centre staff merged with the Economics Department

and the Business School at Loughborough. However, David had put Loughborough on the academic map as a centre for excellence in the area of the economics of banking and financial markets and this reputation continues to this day.

Reputations are not built on sponsorship alone and David was very active in research. His book, *International Financial Integration: The Limits of Sovereignty* (1981), was the first in economics which tackled the implications of financial integration long before the topic was fashionable. This was soon followed by an edited volume on *The Framework of United Kingdom Monetary Policy* (1983) and the Gilbert lectures on the *Evolution of the British Financial System* (1985). In this pre-research exercise era academics focused less on academic journal papers and more on books, but as the demands changed so did the direction of David's output. David has contributed, *inter alia*, to the *Journal of Financial Regulation and Compliance*, *Journal of International Banking and Financial Law*, *Economic Notes*, *Open Economies Review*, *European Journal of Finance*, *International Journal of Financial Regulation and Compliance*, *Journal of International Financial Markets, Institutions and Money*, *Journal of Development Studies* and *Journal of International Financial Markets*. In addition, David has served on the editorial boards of *International Journal of Regulation and Compliance*, *International Journal of Bank Regulation*, and *Banking and Information Technology* and, of course, there are numerous chapters in books and reports on various aspects of the banking and financial sectors all around the world.

Throughout his career David has been extremely active in consultancy work for both private and public sector organisations. This reflected his belief that economics should be of practical use, as well as his wide interests in real-world problems, and these activities contributed greatly to his reputation. Between 1994 and 2002 he was a Public Interest Director of the Personal Investment Authority (the UK regulator of retail financial services until it was superseded by the Financial Services Authority (FSA)). In 2004 he was appointed by the South African Minister of Finance to be a member of the task group to investigate competition in the South African banking industry. He has been a consultant to the World Bank and the IMF and is currently a member of an IMF international advisory committee on governance in supervisory agencies. David was also a member of the advisory board of the European Banking Report at the Italian Bankers Association. In 2004 he was a consultant to HM Treasury on governance in life mutuals (the Myners report) and was a member of the PricewaterhouseCoopers team investigating the macroeconomic impacts of the Basel II Accord for the European Commission. In 2005–6 he was a member of the Council of Management of the European Money

and Finance Forum (SUERF), a network association of bankers, central bankers, financial practitioners and academics, and was president between 2000 and 2006. This was one of David's ideal roles: bringing together academics and practising bankers and getting both groups to learn from each other, for their mutual benefit and the benefit of the organisations that they served.

As remarked elsewhere in this volume, one of David's most influential papers was his overview of 'The Economic Rationale for Financial Regulation' (Llewellyn, 1999). Economically rigorous, but also addressed to a wider audience, especially those sceptical of state intervention in financial markets, this paper set benchmarks by which regulators could work and be judged in practice, and it has had a major impact on the thinking and work of the FSA, much of which has inspired regulators worldwide.

As if this activity was not enough, David has always undertaken a full teaching load – even into retirement! In this way David has been an outstanding colleague. Although for many years David taught first year macroeconomic principles, he is best known for his course on financial institutions, systems and markets (timetabled as FISMs) – the only course of its kind in the country. In this course David combined his natural talent as a presenter and lecturer with his intimate knowledge of the financial sector and how it operates in a way that was (and is) accessible to all students with only a basic understanding of economics. His lecturing style was very much of the old school: first and foremost a performance – a very entertaining performance as the nitty-gritty material was interspersed with anecdotes and short stories of his latest visits to foreign parts. This made the dry subject of banking regulation and financial markets fascinating, and many generations of Loughborough students are grateful for David's treatment of the subject. When we developed a suite of master's degree programmes in banking, economics and finance in the 1990s, needless to say David devised a postgraduate version of the long-standing FISMs course which became one of the core modules on this very successful programme.

With David's retirement, economics at Loughborough in many ways has lost, if not its founder (who was Denis Swann), its most well-known and influential figure. Given that the subject matter of much of academic economics has moved in the direction of ever increasing abstraction from the real world, it is likely that we will never again see David's like in a Department of Economics. To those of us who have directly witnessed the extraordinary impact of his teaching and thinking on generations of students at Loughborough, this is a sad reflection of the current position and possible future direction of academic economics, and one which may well reduce the popularity of the subject for study, and the viability of the discipline in times