

The Essential Guide

Global Financial Regulation

The essential guide

Howard Davies and
David Green

polity

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Lastly, as is customary, but also necessary, we need to note that the views expressed here are entirely our own and not those of any of the organizations with which we have been associated.

Abbreviations

ACAM	Autorité de Contrôle des Assurances et des Mutuelles (France)
AMF	Autorité des Marchés Financiers (France)
APRA	Australian Prudential Regulatory Authority
ASIC	Australian Securities and Investments Commission
AuRC	Audit Regulatory Committee (EU)
BAC	Banking Advisory Committee (EU)
BAKred	Bundesaufsichtsamt für das Kreditwesen (Germany)
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)
BAV	Bundesaufsichtsamt für Versicherungswesen (Germany)
BAWe	Bundesaufsichtsamt für den Wertpapierhandel (Germany)
BCCI	Bank of Credit and Commerce International

Abbreviations

BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BOBS	Board of Banking Supervision (UK)
BOJ	Bank of Japan
BSC	Banking Supervision Committee (ECB)
BSC	Building Societies Commission (UK)
Buba	Deutsche Bundesbank
CBRC	China Banking Regulatory Commission
CCA	Commission de Contrôle des Assurances (France)
CDIC	Canada Deposit Insurance Corporation
CDO	Collateralized Debt Obligation
CEBS	Committee of European Banking Supervisors
CECEI	Comité des Établissements de Crédit et des Enterprises d'Investissement (France)
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CFTC	Commodity Futures Trading Commission (US)
CIRC	China Insurance Regulatory Commission
CMF	Conseil des Marchés Financiers (France)
COB	Commission des Opérations de Bourse (France)
CONSOB	Commissione per le Società e la Borsa (Italy)
CPSS	Committee on Payment and Settlement Systems
CRD	Capital Requirements Directive

Abbreviations

CSE	Consolidated Supervised Entity (US)
CSRC	China Securities Regulatory Commission
DBERR	Department of Business, Enterprise and Regulatory Reform
DICJ	Deposit Insurance Corporation of Japan
DTI	Department of Trade and Industry (UK)
EBC	European Banking Committee
ECB	European Central Bank
EFC	Economic and Financial Committee (EU)
EFR	European Financial Services Round Table
EFRAG	European Financial Reporting Advisory Group
EGAOB	European Group of Audit Oversight Bodies
EIOPC	European Insurance and Occupational Pensions Committee
ESC	European Securities Committee
EP	European Parliament
FASB	Financial Accounting Standards Board
FATF	Financial Action Task Force
FDIC	Federal Deposit Insurance Corporation (US)
FESCO	Forum of European Securities Commissions
FGD	Financial Groups Directive
FIBV	Fédération Internationale des Bourses de Valeurs
FRC	Financial Reporting Council (UK)
FSA	Financial Services Authority (UK)
FSA	Financial Services Agency (Japan – also JFSA)

Abbreviations

FSAP	Financial Services Action Plan (EU)
FSAP	Financial Sector Assessment Programme (IMF)
FSC	Financial Services Committee (EU)
FSCS	Financial Services Compensation Scheme (UK)
FSF	Financial Stability Forum
FTA	Free Trade Agreement
GAAP	Generally Accepted Accounting Principles
GAO	Government Accountability Office (US)
GATS	General Agreement on Trade in Services
IAA	International Actuarial Association
IAASB	International Auditing and Assurance Standards Board
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IFI	International Financial Institution
IFIAR	International Forum of Independent Audit Regulators
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IIF	Institute of International Finance
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee

Abbreviations

IMRO	Investment Management Regulatory Organization (UK)
IORP	Institutions for Occupational Retirement Provision (EU)
IOSCO	International Organization of Securities Commissions
IOPS	International Organization of Pension Supervisors
IPO	Initial Public Offering
ISAs	International Standards on Auditing
ISP	Insurance Supervisory Principles
ISVAP	Istituto per la Vigilanza sulle Assicurazioni Private e di Interesse Collettivo (Italy)
JFSA	Japan Financial Services Agency
LZB	Landeszentralbanken (Germany)
LIFFE	London International Financial Futures Exchange
MiFID	Markets in Financial Instruments Directive
NAIC	National Association of Insurance Commissioners (US)
NASD	National Association of Securities Dealers (US)
NGO	Non-Governmental Organization
NRSRO	Nationally Recognized Statistical Rating Organization (US)
OCC	Office of the Comptroller of the Currency (US)
OECD	Organization for Economic Co-operation and Development
OFC	Offshore Financial Centre

Abbreviations

OPRA	Occupational Pensions Regulatory Authority (UK)
OSFI	Office of the Superintendent of Financial Institutions (Canada)
OTS	Office of Thrift Supervision (US)
PBOC	Peoples Bank of China
PCAOB	Public Company Accounting Oversight Board (US)
PIA	Personal Investment Authority (UK)
PIOB	Public Interest Oversight Board
PSD	Payment Services Directive
RFS	Registry of Friendly Societies (UK)
ROSC	Report on the Observance of Standards and Codes (IMF)
SEC	Securities and Exchange Commission (US)
SESC	Securities and Exchange Surveillance Commission (Japan)
SEPA	Single European Payments Area
SI	Systematic Internalizer
SIB	Securities and Investments Board (UK)
SRO	Self-Regulatory Organization
UCITS	Undertakings for Collective Investments in Transferable Securities (EU)
WFE	World Federation of Exchanges
WTO	World Trade Organization

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Introduction

This book describes the existing system of international financial regulation and proposes some needed improvements. It assumes in the reader a certain basic knowledge of finance but it does not delve into any one subject in great technical detail; it is therefore not a complete handbook for the trader, compliance officer or line supervisor. It does not say all that can be said about current issues in the main financial disciplines, banking, securities and insurance, nor about the numerous questions needing to be addressed in the structure of regulation in the EU (and indeed elsewhere); rather it offers a bird's eye view of the main issues at the time of writing (September 2007) and gives the authors' views as to the broad direction in which solutions are to be found.

We seek to expose the remarkable range of financial regulation topics being addressed across the globe and describe the complex bureaucratic organisms through which they are discussed and occasionally resolved. These organisms have displayed a tendency to spawn.

Introduction

During the half a dozen years in which the authors were actively engaged in this field at the FSA in the UK, the number of international committees of which the FSA was a member multiplied from 76 to over 150. It is beyond the scope of this book to describe the role and composition of every one of them, though it provides links to enable the assiduous reader to drill down further. In any case, these committees constantly divide, dissolve and re-form so that no account will remain wholly reliable for long.

In Chapter 1 we remind the reader of the underlying rationale for the different kinds of financial regulation and why there is an international dimension to such activity. The financial system is in a constant state of evolution so that there is an equally constant debate about what should be regulated and what should not.

We go on in Chapter 2 to set out the main institutional arrangements for international co-operation by discipline – banking, securities, insurance and financial reporting – including some history as to how the arrangements have evolved. Chapter 3 discusses the role of the International Financial Institutions: principally the IMF and the World Bank. We then describe the much more highly developed structures for cross-border financial regulation created within the EU in Chapter 4.

Chapter 5 looks at the very diverse arrangements for the organization of supervision in the G7 countries and describes the various different philosophies underlying those structures. There is a lively debate under way in many countries about how best to respond to changing financial markets. Chapter 6 offers a brief guide to that

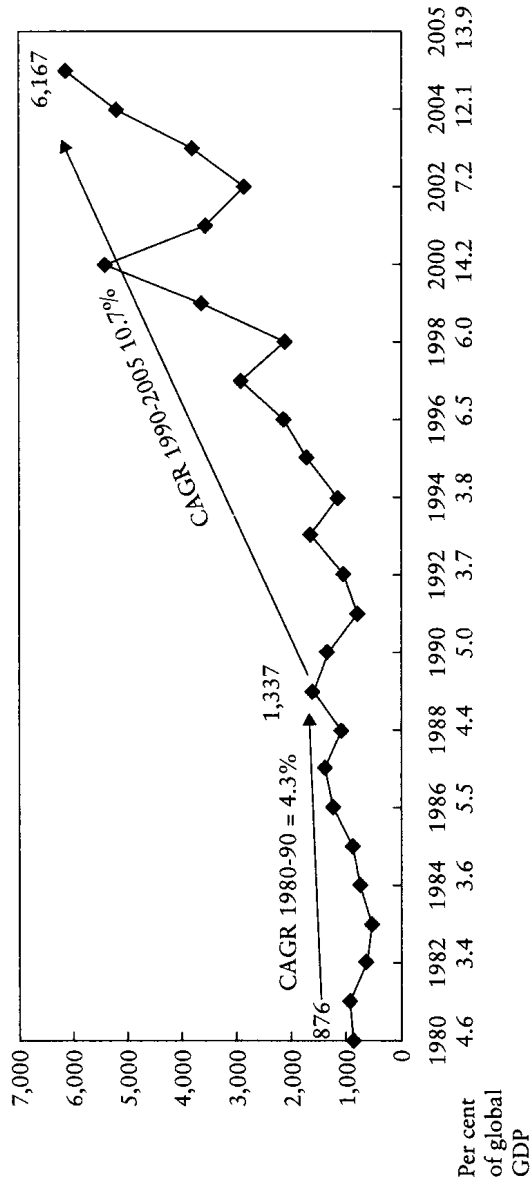
Introduction

debate. Finally, in Chapter 7, we look at the main current issues which pose a challenge to the existing arrangements and propose a number of important reforms.

The underlying argument we advance is that the international regulatory system has developed in a piecemeal fashion. It has been reasonably successful in maintaining financial stability in a fast changing world. But it is now seriously out of date and may not be adequate to address the challenges such change will bring. The global committees, whose structure is rooted in an old-fashioned breakdown of financial activity into the three 'sectors' of banking, insurance and securities, need radical reform if they are to keep pace with the rapid evolution of financial markets. The market turmoil of the summer of 2007, originating in the US sub-prime mortgage market, demonstrated vividly that the technology of credit transfer had developed to the point where it is often hard to determine where risks now lie – and it is quite impossible for the regulator of a single sector to do so.

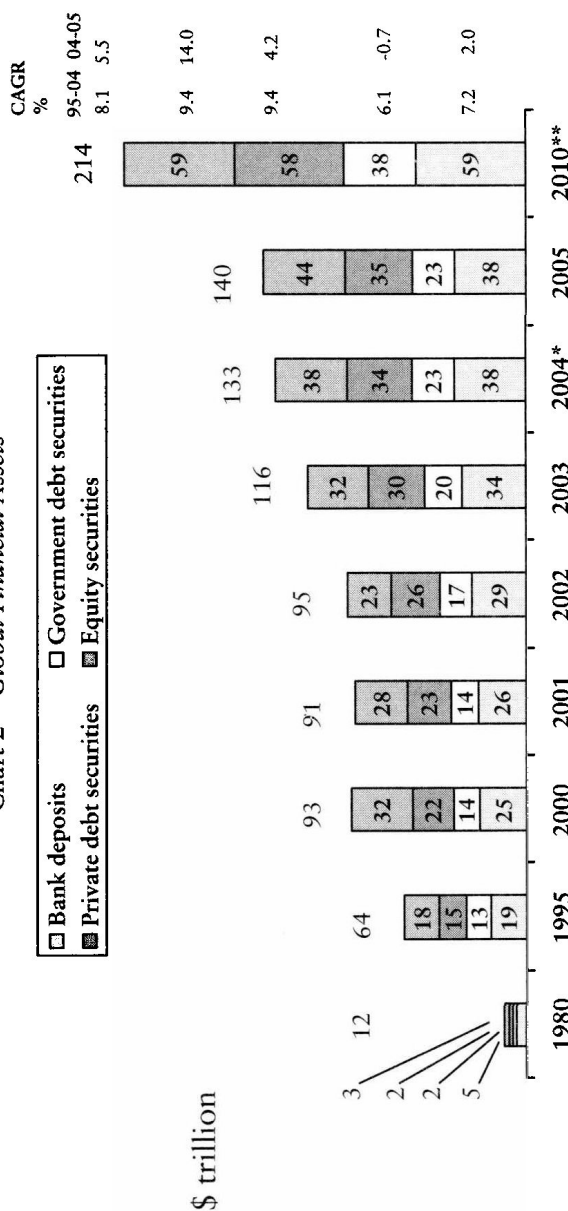
The scale of financial market activities has escalated dramatically in recent years. McKinsey and Company estimate that global financial assets have more than doubled in the last ten years, and are set to increase by a further 50 per cent by the end of this decade (Chart 1). It is therefore not surprising that a regulatory system designed some time ago is beginning to creak. Furthermore, the growth of cross-border financial activity is even more rapid: international capital flows have been expanding at over 10 per cent a year over the last fifteen years (Chart 2). So the international

Chart 1 Total Cross-Border Capital Flows
\$ billion, 2005 constant \$ and constant foreign exchange



Source: McKinsey Global Institute Capital Flows Database

Chart 2 Global Financial Assets



Nominal GDP	10.1	29.4	31.7	31.6	32.8	36.9	41.4	44.5	63.3	4.2	7.5
\$ trillion											
Depth (FS/GDP), %	109	218	292	289	290	315	322	316	338		

* 2004 figure dropped from \$136 trillion to \$133 trillion due to restatement of data by individual countries
 ** Extrapolation off 2005 base, with components grown at 2000-5 CAGRs
 Source: McKinsey Global Institute Global Financial Stock Database