
Can regulation stop financial crises? An evaluation of banking laws in the USA, the UK and Australia after the financial crisis 2007/2008 in the light of what lesson can be learned and how such a crisis can be prevented in the future – part two

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Abstract: This two-part article deals with the broad field of financial regulation after the global financial crisis of 2007/2008. The legislative responses and regulation systems of the USA, the UK and Australia are evaluated and compared to each other. Concerning the USA the Dodd-Frank Act 2010 is evaluated. Regarding the UK the different reports on probable regulative responses are analysed as well as the legislation so far and the future legislation, especially the Financial Services Bill 2012. Consecutively, the system of financial regulation in Australia is analysed. The author concludes that there are visible first steps into the right direction in the USA and the UK in terms of financial regulation but that they do not reach far enough in order to prevent future crises. Concerning Australia the author concludes that despite a solid regulatory system competition issues may be imminent to the system and thus arise in the future.

Keywords: Dodd-Frank act 2010; financial regulation; Financial Services Bill 2012; global financial crisis; Vickers Report; too-big-to-fail; twin peaks regulation; Volcker rule.

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1 Introduction¹

This is the second part of a two-part paper dealing with the legislative responses of the USA, the UK and Australia in the aftermath of the global financial crisis of 2007/2008.

This second part firstly contains the description and evaluation of the legislative responses to the global financial crisis of the UK. Secondly, the effects of the global financial crisis to the Australian economy are being analysed followed by a description and an evaluation of the Australian legislative system.

Finally this part contains a comparison of the legislative approaches of each country followed by an overall conclusion.

2 Legislative responses

The first part of the paper (Section 2.1) contained the overall introduction and the description and evaluation of the legislative responses to the global financial crisis of the USA.

In this part of the paper the legislative reactions of the UK and Australia shall be evaluated especially in the light of the question whether regulation can ever stop financial crises.

2.1 UK

2.1.1 Impact of the global financial crisis

The UK did not have to request assistance from the European Union as other members countries had to do.² However, the combined effect of the global financial crisis is likely to amount up to 1.5 trillion pounds to the public sector net debt, consequently the UK taxpayers.³ The financial interventions were estimated to add 4.7 billion pounds to the general government net borrowing in 2008. The impact of the net liability position in the government financial balance sheet was estimated to be 5.2 billion pounds at the end of 2008.⁴ The global financial crisis brought a recession to the UK economy. The impact of the global financial crisis on the UK economy continues as the governor of the Bank of England stated that activity would return to its pre-recession peak in 2008 not before 2014.⁵

2.1.2 Immediate governmental reactions

One of the first governmental reactions was the nationalisation of the Northern Rock PLC, the UK's fifth-largest mortgage lender, in February 2008.⁶ This was preceded by the so called 'run on the rock', the wish of a significant numbers of customers to withdraw their deposits within a short period of time.

Further governmental interventions comprised inter alia recapitalisations of banks, government guarantees of some banks' medium-term funding and a significant extension of central bank liquidity support. Additionally the banking system was strengthened by the clear understanding that no major systemically important bank would be allowed to fail and that retail deposits would be protected.⁷

2.1.3 Independent reviews and reports

The UK government issued in particular three independent reports and reviews, the Turner Review, Walker Review and the Vickers Report, aiming to have a broad analytical foundation for further steps of reform legislation on the financial sector. These

reviews and reports are going to be analysed upfront before analysing the post crisis reform legislation.

2.1.3.1 Turner Review

The Turner Review was published on 18th March 2009 and it was created in order to review the causes of the global financial crisis and to make recommendations to the changes in regulation and supervisory approach needed to create a more robust banking system for the future.⁸ It contained 28 recommendations and four discussion points.

The Turner Review focuses on the long-term rather than the short-term macroeconomic challenges which the UK policymakers are facing.⁹

Some of the most important recommendations deal with capital adequacy, accounting and liquidity which are derived from the deficiencies in the Basel I and II processes revealed during the financial crisis. Summing up, the report demands in this respect an increase of quality and quantity of overall capital in the global banking system and thus an increase in minimum regulatory requirements, furthermore a significant increase in capital requirement against trading book activities and the reduction of unnecessary pro-cyclicality under Basel II regime, as well as the introduction of a counter-cyclical capital adequacy regime. Finally, the introduction of a backstop maximum gross leverage ratio is demanded in order to prevent excessive growth in absolute balance sheet size.¹⁰

The Turner Review animates according to recommendation eight to emphasise the economic substance of an institution when it comes to regulatory and supervisory coverage instead of its legal form.¹¹

The review recognises the important role that liquidity tensions played in the generation and transmission of financial turmoil during the crisis and the failure of regulators and institutions to contain liquidity risks. It is therefore recommended to equalise the importance of the supervision of bank liquidity to capital regulation.¹² A further important recommendation aims at the area of remuneration stating that incentives which have led to risk-taking behaviour that contributed to the financial crisis should be reduced. Apart from that, the Financial Services Authority (FSA)'s supervisory approach was addressed by the Turner Review. It is recommended to complete the 'supervisory enhancement programme' (SEP) which was put in place in the aftermath of the rescue of the Northern Rock PLC, in recognition of shortcomings in the past and the need to shift the primary focus from micro-prudential regulation, meaning the regulation of individual institutions, to a combination with macro-prudential regulation in terms of a strong focus on the overall system and on the management of systemic risks across the economy.¹³ This would take inter alia an increase in resources devoted to high-impact firms, in particular large banks; increased analysis of sectors and comparative analysis of firm performance and the introduction of more intensive information requirements on key risks, e.g., liquidity.¹⁴

A further recommendation aims at the increase of standards of risk management and governance in financial institutions since the global financial crisis clearly demonstrated that the internal risk management was too often ineffective and boards routinely failed to adequately identify and constrain too excessive risk taking.¹⁵

Apart from that the Turner Review recommends to introduce a clearing and central counterparty system for standardised CDS contracts since such standardised contracts would account for the majority of CDS trading.¹⁶

Moreover, it recommended that new capital and liquidity requirements should be designed to constrain commercial bank's engagement in proprietary trading, yet a legal distinction of banks engaging in such trading and 'narrow banks' is stated as not be feasible.

2.1.3.2 Walker Review

The Walker Review was published on November 26th 2009.¹⁷ Sir David Walker had been asked by the Prime Minister in February 2009 to review corporate governance in the UK banking industry in the light of the global financial crisis, which was later extended to the whole financial industry.¹⁸ The Walker Review contained 39 recommendations with the objective to enhance corporate governance in this way that the likelihood of a repeat of the global financial crisis is at least reduced. Five key themes can be identified within the Review: at first the Combined Code of the Financial Reporting Council (FRC) is deemed to remain fit for purpose, however, there needed to be tougher capital and regulatory stance on the part of the FSA.¹⁹ Secondly, it is stated that the main deficiencies of boards of banks or other financial institutions (BOFIs) related much more to patterns of behaviour than to organisation. Thus, there should be created an environment in which the executives can be challenged. This would require changes to the board compositions and a remarkably increased time commitment, at least 30–36 days, from non-executive directors (NEDs), who would also need more experience, training and support, as well as from the chairperson of the board.²⁰ Thirdly, the engagement of the board level in the high-level risk process should be remarkably enhanced, especially in terms of monitoring of risk. Furthermore board-level risk committees should be established separated from audit committees to ensure that executives do not take unreasonable risk.²¹ Fourthly, major shareholders should be encouraged to engage more productively with their investor companies with the aim of supporting longer-term improvement of the performance of the BOFIs.²² Finally, it is recommended that substantial enhancement is needed in board-level oversight if remuneration policies, in particular respective variable payments and associated disclosure. Apart from that the tasks and responsibilities of the board remuneration committees should be extended beyond board members to cover the remuneration framework for those whose remuneration exceeds that of the average board-level. Finally, not less than half of the expected variable part of remuneration should be on a long-term incentive basis of at least five years, subject to the performance condition.²³ This is considered to be necessary because of the clear evidence that defective control on the one hand and serious excess on the other hand concerning remuneration before and during the global financial crisis were causal factors for its breakout.²⁴

2.1.3.3 Vickers Report

In order to analyse and report what kind of reforms have to be undertaken in order to improve the stability and competition in UK financial system the Coalition Government set up the Independent Banking Commission (ICB) headed by Sir John Vickers. The final report, the so called Vickers Report, was published on September 12th 2011. The aims of the Vickers Report were determined as reducing the probability and impact of systemic financial crises in the future, avoiding future credit crunches and thus to maintain efficient flow of credit to the real economy and households and finally preserving the

functioning of the payment system and guaranteed capital certainty and liquidity for small savers including small and medium-sized enterprises (SMEs).²⁵ The recommendation would achieve these aims by curbing incentives for excessive risk-taking, by reducing the costs of systemic financial crises through increased resilience of institutions and the financial system as whole and by promoting effective competition in the provisions of banking services in the UK.²⁶ The recommendations of the Vickers Report can be divided into three categories. Firstly, there are proposals aiming at insulating the provision of banking services within the European Economic Area (EEA) to individuals and SMEs from the fluctuations of the global economic and financial cycle ('retail ring-fence').²⁷ This concept of retail ring-fencing describes the separation of bank services like deposit acceptance, payment services and loans to individuals and SMEs from other more sophisticated banking activities.²⁸ In particular investment banking should stay outside the ring-fence.²⁹ The ring fenced subsidiary of a financial group should be dealing with other parts of the group at arm's length.³⁰

Secondly, there are proposals aiming at the holding of regulatory capital against risk-weighted assets (loss-absorbency). The Report recommends an equity capital rate for large UK retail banks of at least 10%, which exceeds the Basel III recommendations.³¹ Thirdly, there are recommendations aiming at the improvement of competition, such as the assistance of new market participants and the improvement of transparency.³² The Report reaches the conclusion that there are long-standing competition issues in UK retail banking, especially bearing in mind that the largest four banks amount to 77% of individual accounts and 85 % of the SMEs' accounts. This is furthered by difficulties concerning switching the provider for customers and a lack of transparency.³³ Finally, the crisis has impaired competition since already large merged, i.e., HBOS and Lloyds which was not brought before the Competition Commission.³⁴

2.1.4 Legislation

After the first impact of the global financial crisis the UK legislator has already reacted with the enactment of banking reform legislation, in particular the Banking Act 2009 and the Financial Services Act 2010. Currently waiting for the committee stage within the House of Lords is the Financial Services Bill 2012.³⁵ These acts as well as the Financial Services Bill shall be analysed in the next part followed by an evaluation of the generally speaking legislative responses of the UK to the above mentioned causes for the global financial crisis.

2.1.4.1 Banking Act 2009

The government acted quickly to encounter some of the identified weaknesses by way of legislative response. The Banking Act 2009 received Royal Assent in February 2009 and was created to improve the resilience of the UK financial system and to support the financial stability by strengthening depositor protection and providing mechanisms for dealing with banks in financial distress.³⁶ In turn, one of the overarching objectives of this Act was to try no longer to prevent banks from failing but to allow them to fail in an organised way which will not lead to knock-on effects as in the global financial crisis.³⁷ The Banking Act 2009 contained some major reform approaches. The Act comprised the special resolution regime (SRR), the bank administration procedure, a new bank insolvency procedure, the inter-bank payments system, the financial services

compensation scheme and the strengthening of the Bank of England.³⁸ The introduction of the SRR was particularly remarkable because it abandoned the existing insolvency regime in case of banks in distress. This happened on the one hand because of the moratorium of depositors' rights to access their funds for a certain period of time and the coherent negative effect on markets resulting from the delay in receiving compensations. On the other hand the SRR was brought forward because of the implications of a fire-sale of bank assets.³⁹

2.1.4.2 Financial Services Act 2010

A second legislative response was the Financial Services Act 2010 which received Royal Assent in April 2010. This act featured the improvement of corporate governance and remuneration practices and upgraded consumers' rights and information. Apart from that the Financial Services Act 2010 equipped the FSA with the new objective to maintain financial stability and to observe consumer education and the issue of remuneration and thus extended its powers.⁴⁰ This act was not meant as a new systematic approach but as an amendment of existing legislation and regulation.

2.1.4.3 Financial Services and Markets Bill 2012

The Financial Services Bill 2012 was published by the government on 27th January 2012. With this Bill the legislator is up to respond to the shortcomings of the single regulator system during the global financial crisis by way of introducing a 'twin-peaks' regulatory structure.⁴¹

In order to understand the changes in the structure of financial regulation it is important to look at the hitherto existing regulatory structure. So far, the responsibility for maintaining macro- and micro-prudential oversight of the UK financial system falls within the competence of the UK Tripartite system, the Bank of England, the HM Treasury and the FSA.⁴² In 1997 the 'new labour' succeeded the Conservative Party in the general election and took office and introduced with the Financial Services and Market Act 2000, in accordance with the content of their manifesto to overhaul the financial services industry, the FSA as a single financial regulator.⁴³ The FSA had the overall regulatory responsibility for deposit-taking businesses, investment business and insurance businesses.⁴⁴ The FSA focused on the objectives deriving from the Financial Services and Market Act 2000 of market confidence, public awareness, the protection of consumers and the reduction of financial crime.

The Memorandum of Understanding (MoU) which was first published in 1997 and revised in 2006 set forth the primary responsibilities of the three authorities in order to support the coordination of their respective work and to assure the discrete responsibilities and the respective jurisdiction.⁴⁵ The overall objective was to maintain financial stability. The Treasury had the overall responsibility for the structure of legislation and regulation which oversees the financial system.⁴⁶ The Bank of England and the FSA had to deal with the operational business. The Bank of England was responsible for contributing to financial stability by executing monetary policy functions and monitoring the infrastructure of the payment system. The Bank of England also provided 'emergency liquidity support' to banks in order to avoid the risk of contagion, in other words the Bank of England acted as the Lender of Last Resort (LOLR).⁴⁷ The

FSA as the single financial regulator was required to monitor the financial institutions it regulates and supervises such as banks.⁴⁸

The Financial Services Bill 2012 amends the Bank of England Act 1998, the Financial Services and Market Act 2000 and the Banking Act 2009. It remarkably enhances the authority of the Bank of England by transferring the responsibility for protecting and enhancing financial stability, bringing together macro and micro prudential regulation.⁴⁹ It abolishes the FSA and creates a regulatory architecture which consists instead of the new established Financial Policy Committee (FPC), the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).⁵⁰ The FPC will be housed within the Bank of England and will be equipped with primary statutory responsibility for maintaining financial stability across the financial system by using macro-prudential tools to make sure to reliably detect systemic risks to the financial stability of the UK.⁵¹ The provision of these specific macro-prudential tools increases the current power of the Bank of England insofar as currently it does not have any such tools to achieve the above mentioned objective.⁵² The PRA will be responsible for the prudential regulation of all deposit-taking institutions, insurance companies and investment banks.⁵³ It will be formed as a new legal entity being a subsidiary of the Bank of England and thus expanding its field of responsibility and powers.⁵⁴ The FCA's primary statutory responsibility will be to promote confidence in the financial services and markets.⁵⁵ It will oversee the conduct of business of all regulated entities and will focus on the issue of consumer protection in bank related businesses.⁵⁶ Apart from that the FCA will be the prudential regulator for all firms other than deposit takers, insurance companies and systemically important investment banks.⁵⁷ Furthermore the FCA will be the UK listing authority and the regulator for a large number of consumer credits.⁵⁸ Whereas the FPC will conduct macro-prudential regulation, the micro-prudential regulation will be split between the PRA and the FCA.

2.1.5 Evaluation

The new provisions of the Banking Act 2009, the Financial Services Act 2010 and the yet to come provisions of the Financial Services Bill 2012 on the one hand and some of the important recommendations of the independent reviews and reports on the other hand need to be analysed in the light of the overall research question of the dissertation whether regulation can stop financial crises. This has to be done by way of critically comparing the causes of the crisis, as far as applicable to the UK, to the responses which the UK legislator and the reporters and reviewers have given so far. The recommendations of the reviews and reports are analysed in a more abstract way because obviously not all of the recommendations have found their way into a piece of legislation yet.

The Turner Review made important points in order to encounter causes of the global financial crisis however falls short at other points as well. The capital adequacy requirement would address the problem of high debt-to-equity ratios and thus the issue of a high level of corporate leverage. The liquidity supervision for banks however aims rather at the indication than at the cause, which would be a possible credit crunch. The combination of micro- and macro-prudential supervision seems to be a good approach in closing lacks of regulation. This will be discussed further down because as the only main recommendation this has already found its way to the Financial Services Bill 2012. A central clearing for CDSs would be useful to control the acting of highly sophisticated

market participants of the financial markets. Likewise, the recommendation relating the constraint for commercial banks to perform proprietary trading would tackle the too-big-to-fail issue and the problem of interconnectedness of financial institutions.

The Walker Review's recommendations on remuneration have already found their ways in parts to practice through the Project Merlin, however, not in legislative form. The Walker Review compensates in this regard the shortcomings of the Turner Review. The identification of adverse incentives as a reason for the global financial crisis seems to be addressable through these recommendations; however, it is questionable whether these recommendations will find their way into a legislative product in their whole complexity. The recommendations on the improvement of corporate governance have been in parts addressed in the Financial Services Act 2010. The complete transfer into legislative form seems to be as questionable as concerning the recommendations on remuneration.

The Vickers Report recommended to ring-fence the retail parts of huge banks in order to insulate them from external shocks caused, e.g., by misled security trading. The ring-fenced part of a financial group would need to be a separate legal entity dealing with the other group members at arm's length. The creation of a separate legal entity could be achieved either by transferring the business into a subsidiary that would not suffer from the insolvency of the whole group or by transferring the ownership to a ring-fenced bank. It was stated that these structural reforms are problematical.⁵⁹ The special subsidiary solution would involve turning a cost centre into a profit centre which poses problems as to the source of the income of the subsidiary.⁶⁰ The transfer of ownership solution would leave difficulties regarding the efficient split of group services that are relevant to the ring-fenced bank from the remainder of these services.⁶¹ Furthermore it is stated that the requirement of dealing at arm's length to the rest of the group is likely to reduce synergies between the formerly affiliated companies. The loss-absorbency recommendations of the Vickers Report correspond to the capital adequacy recommendations of the Turner Review and have not found their ways to legislation yet. However, they are likely to reduce the risk of excessive corporate leverage and therefore are adequately addressing a driving factor which led to the global financial crisis. The recommendations concerning the improvement of competition within the financial sector are appropriate to tackle a lack of consumer protection on the one hand but, much more important, to encounter the too-big-to-fail problem since this is inherent of a lack of competition. Thus, these recommendations, which have not found their ways to legislation yet, are adequate as a beginning to tackle the too-big-to-fail issue.

The Banking Act 2009 introduced the SRR. This can be deemed as an adequate starting point to tackle the too-big-to-fail problem as well since SIFIs are not limited to the regular insolvency procedure but can be treated with a special focus on the reactions of the financial markets.

The changes that will be introduced after the Financial Services Bill 2012 was enacted are substantial and extensive for the UK financial sector.⁶²

It was stated that it is a shift in the approach of financial oversight that the Chancellor of the Exchequer, and thus politics, gains more influence towards the Bank of England in the case that a financial institution experiences distress which poses any risk of recourse to public funds. Thus, the independency of the central bank is more limited than before, in particular because of the enormous costs for bailouts during the global financial crisis.⁶³ Concerning the new established FPC it was stated that standards concerning macro-prudential regulation will have to be developed in first place.⁶⁴ Furthermore it was argued that it could be a concern that the PRA will have to regulate a much larger pool of

firms than probably anticipated. Concerning the FCA it was brought forward that this agency will have to transfer its focus from supervising individual firms to a thematic approach and it will need to establish expectations and limitations in the case of exercising its interventionist powers.⁶⁵ More broadly it was critically mentioned that the government decided to leave many details concerning the jurisdiction between the new agencies to MoUs and to interagency agreements which eventually may lead to ambiguities and thus regulatory weaknesses which were points of critique on the predecessor system.⁶⁶ The return of the Bank of England to a financial stability mandate parallel to its price stability mandate as such was generally speaking appreciated.⁶⁷ However, since the substantially expanded powers of the Bank of England regarding macro-prudential supervision through the FPC and micro-prudential supervision through the PRA there are serious concerns brought forward concerning the accountability of the strengthened Bank of England.⁶⁸

Summing up it has to be said that the future Financial Services Act 2012 will introduce major changes to the UK financial oversight system. There are clear tendencies to less independency of the Bank of England on the one hand and a much stronger position of the Bank through the new, partially incorporated agencies, on the other hand. However, the Bill falls short in terms of addressing a central clearing of high complex financial products and stricter equity capital rules for financial institutions. Furthermore the new construction of financial supervision embodies the potential risk of missing exchange of information or ambiguities relating to the jurisdiction.

2.2 *Australia*

2.2.1 *Impact of the global financial crisis*

The Impact of the global financial crisis to the Australian economy was relatively light. The economy has recorded clearly better growth than most other developed economies.⁶⁹ The financial system has been markedly more resilient.⁷⁰ Furthermore, Australian banks have continued to be profitable and have not required governmental capital injections.⁷¹ However, the Australian economy and financial markets were not immune. The financial industry of Australia was struck by the global financial crisis quite rapidly through equity market adjustments but the real economy was spared for some time since improved terms of trade associated with the resources boom driven by exports to China.⁷² Early effects on the financial industry were the collapse of the hedge funds Basis Capital and Absolute Capital in July 2007.⁷³ The downswing of the stock markets by 17% until the end of January 2008 led to the fall of share prices of non-bank listed investment companies with highly leveraged structures, e.g., Centro Property and Allco Finance Group, of between 70 and 90% from August 2007 to February 2009.⁷⁴ In a number of cases the speculations that margin calls on executives and directors would be triggered unleashed a wave of short selling which led in turn to companies being put into receivership which had highly leveraged, unsustainable business models, e.g., ABC Learning.⁷⁵ Australian banks, though, had only limited exposure to high-risk securities such as CDOs or CDSs.⁷⁶ The National Australia bank, one of the four major banks, reported an exposure to 1.2 billion US dollars of SIVs in July 2008, but with the general economic downturn the bank profitability declined.⁷⁷ The four major Australian banks have been able to raise additional equity capital during the global financial crisis and thus to perform relatively well despite intermediate stock price declines of 25 to 50%.⁷⁸ Other companies had to

undertake large equity capital raisings as well to be able to repay high debt levels, in particular the property and minerals sector.⁷⁹ The economic growth slowed to half a percent and the unemployment rate rose by almost two percentage points by November 2009.⁸⁰ The most noticeable impact of the global financial crisis on most Australian households was the large decline in equity prices, which reduced the wealth of Australian households by almost 10% by March 2009.⁸¹ Though, the Australian equity market recovered half of its decline by the end of November 2009. The credit and money markets in Australia have also proven to be more resilient than in many other countries, which made considerably less intervention by the Reserve Bank of Australia (RBA) necessary than in other countries.

2.2.2 Immediate governmental reactions

The Australian federal government announced on 12th October 2008 that it would guarantee all deposits held by authorised deposit taking institutions regulated by the Australian Prudential Regulatory Authority (APRA) including Australian banks, building societies and Australian subsidiaries of foreign banks.⁸² More precisely, the government issued a 700 billion dollars package to last for three years and established a Building Australia Fund of 20 billion dollars to speed up infrastructure development, whereas the latter happened in association with the state and territory governments.⁸³ This fund was one of several new 'nation building funds' amounting to 42 billion dollars in total.⁸⁴ The 'economic stimulus plan' included several other grants, including the payment of a tax bonus to a large number of Australian taxpayers and a variety of rescue arrangements for distressed industries.⁸⁵ The Australian stimulus package had a huge scale because over the planning period from 2008 to 2010 it reached 2.6% of the Australian GDP which was double that of the highest spenders among the OECD countries.⁸⁶ The parliament authorised the stimulus package in major parts by the end of 2008 among others within the National-building Funds Act 2008.⁸⁷ Furthermore, the Australian Securities and Investment Commission (ASIC) temporarily banned covered short sales from the Australian Securities Exchange (ASX) and the APRA released a consultation paper on proposals for ensuring that executive remuneration practices in financial institutions were consistent with good risk management.⁸⁸

2.2.3 Structure of the Australian financial regulation system

Since the Australian financial industry proved to be rather resilient in the light of the global financial crisis, the structure and characteristics of the Australian financial system are analysed in this chapter followed by an evaluation in the light of the impact of the global financial crisis.

Firstly, in order to determine the resilience of the financial industry it is important to analyse the Australian banking system as such. It was described as being in a tradition with 'old-fashioned' British banking, meaning a tradition of a central approach of banks in contrast to an originally fragmented, small local banking approach of the USA.⁸⁹ Australian banks were well capitalised by private investors and continued to collect onshore and offshore capital.⁹⁰ Generally speaking, there is a small number of banks, especially the big four Australian banks (National Australia Bank, Commonwealth Bank, Westpac and Australia and New Zealand Banking Group) under one primary regulator, the APRA.⁹¹ The federal structure of the banks is communality to the US system;

however, the single regulator model is deduced from the British banking tradition which is dissolved through the placement of banking in the sphere of federal constitution competency.⁹²

Furthermore, the business model of Australian banks has to be mentioned because of its relatively strict lending practices and high interest rates. Subprime loans do not exist in the meaning of the term as described above, the nearest equivalent are non-conforming loans, which are provided to consumers who do not comply with the standard criteria for gaining a loan and which made up only 1% of the mortgage market in Australia.⁹³ Apart from that, these non-conforming loans are only available from specialist non-deposit taking lenders. Finally, non-conforming loans were often kept on-the-books of the issuing institution which eliminated moral hazard issues.⁹⁴ Furthermore, Australian courts may set aside mortgage agreements where the lender could have reasonably known that the borrower could not repay the loan without substantial hardship aside on the grounds of the Uniform Consumer Credit Code.⁹⁵

Finally, there is the so-called 'four pillars policy', in order to prevent the four largest banks from merging.⁹⁶ This policy is said to have reduced the pressure of corporate supremacy among the banks and thus the pressure to maximise short term earnings.⁹⁷

Secondly, the financial regulation structure has to be analysed. The structure of the financial regulation system was mainly introduced as a result of the so-called Wallis Report of 1997.⁹⁸ The Wallis Inquiry was charged in 1996 with developing recommendations on the nature of regulatory arrangements that would best ensure an efficient, responsive, competitive and flexible financial system in order to underpin stronger economic performance, consistent financial stability, prudence, integrity and fairness.⁹⁹ Remarkably, the reforms were introduced within a long period of continuous economic growth and increasing deregulation, especially in the light of the relatively resilience of the Australian economy to the Asian financial crisis in the beginning 1990s.¹⁰⁰

With the adoption and implementation of first recommendations in 1998 the Australian financial regulation moved from a system of institutional regulation to a system of twin peaks regulation, meaning a system of two financial regulators, together with the central bank, one responsible for prudential regulation and the other for the regulation of conduct as well as for the oversight of the compliance with disclosure duties.¹⁰¹

The institutional regulation system of Australia before the reforms consisted of the Reserve Bank as the prudential regulator for banks, the Insurance and Superannuation Commission as oversight authority and prudential regulator for insurance companies and pension funds and finally of the Australian Securities Commission, which oversaw the disclosure obligations of companies and managed funds.¹⁰² With the reforms according to the Wallis Report this system was replaced. The Reserve Bank of Australia (RBA) persisted with the competency to formulate monetary policy, to ensure systemic stability of the financial system and to regulate the payment system. The APRA was established as one of the regulators which main function is the prudential regulation of deposit-taking institutions, life and general insurances and superannuation. Finally, as the third institution, the ASIC was established with the main duties to administer and enforce the national corporation's legislation, to ensure market integrity and to protect consumers of financial products.¹⁰³

With the Financial Services Reform Act 2001 the financial products and services, the markets on which they are traded as well as the industry participants were to be regulated

exclusively by the Corporations Act 2001. Derivatives for example are classified as financial products according to Chapter 7 of the Corporations Act.¹⁰⁴

Among others, the APRA introduced in 2004 in the light of the inherent danger which lies also in non-conforming loans significantly higher capital charges for such loans which is related to a conservative approach on capital adequacy taken by APRA.¹⁰⁵

2.2.4 Evaluation

Firstly, the immediate governmental reactions, especially the stimulus package, were described as being one of the best-designed of all developed countries.¹⁰⁶

Apart from that, obviously the Australian financial system was well organised with the twin peaks regulatory approach and prepared in the light of the relatively less impact of the global financial crisis on this country. This is probably the major reason why a discussion is going on about what, if at all, should be reformed within the Australian financial regulation system.¹⁰⁷ However, even the Australian financial regulation system did not prevent the marketing of high-risk high complex financial products to retail and other 'unsophisticated' wholesale investors who were not deeply familiar with the counterparty risks of such transactions.¹⁰⁸ Furthermore competition within the financial sector, especially within the banking sector, has said to be significantly affected by the global financial crisis. Competition was constrained by industry consolidation and second-tier providers facing additional funding costs.¹⁰⁹ Thus, Australia has one of the most highly concentrated banking sectors in the developed world.¹¹⁰ The lack of competition embodies two threats: a disadvantage for consumers on the one hand and the likelihood of the development of too-big-to-fail institutions on the other hand. In order to limit these effects the Competition and Consumer Act 2010 came into force at 1st January 2011, which was subject of parliamentary discussion not only because of the global financial crisis so that this Act is not a direct response to this crisis.¹¹¹ If the thereby introduced single Consumer Law as well as the Competition amendments will curb the described effects remains to be seen.

Finally, it has to be mentioned critically that it was observed that it was not only good management and sound regulation which led to the relatively resilience of the Australian economy but also the specific trading relations of the real economy.¹¹² The Australian economy has strong trade relationships with rapidly growing Asian nations, especially China. While the Australian exports to the European Union and the USA fell in 2009, the exports to China showed a strong growth of 23.3%. This, in turn, led to Australia's second biggest trade surplus, adding 2.2% to the GDP growth and keeping the economy from sharing the fate of recession as many other developed countries.¹¹³

3 Comparison

In this chapter the different approaches to financial regulation and to the reform of financial regulation of the USA, the UK and Australia, which have been explained and analysed above, are being compared in order to figure out parallels and differences and finally to ascertain whether and what can be done to reliably avoid or at least contain financial crises in the future.

Concerning the immediate governmental responses it can be stated that the difference between Australia on the one hand and the USA and the UK on the other hand was that in

Australia there was no need for neither governmental provisions of debt or equity funding to distressed banks or even their nationalisation nor of forced mergers or bail-outs. This is in contrast to above mentioned famous examples of AIG in the USA or Northern Rock PLC in the UK. The losses of non-prudentially regulated companies with highly leveraged business models were largely born by the stakeholders.¹¹⁴

Turning towards the above analysed causes for the global financial crisis, in the following the responses of the countries, if applicable, are compared to each other and analysed for their efficiency.

The first identified cause for the global financial crisis was the lax monetary policy. Since this is within the discretion of the central banks, neither of the countries directly addressed this issue in their reform approach or in their current regulation system.

The second identified cause for the global financial crisis was the first 'housing bubble' related reason, the lack of consumer protection.

The USA approached this issue with the establishment of the CFPB and the reforms on the mortgages market. The CFPB as a central agency will be able to work relatively independent and thus probably be able to improve consumer protection. The reform of mortgages securities almost definitely ensures that a new bubble in the consumer mortgages securitisation market will not develop. The UK addressed the consumer protection issue as well by establishing a new agency, the FCA. Its primary responsibility will be to promote confidence in the financial services and markets but it will also focus on the issue of consumer protection in bank-related business. In Australia the ASIC is responsible for the protection of consumers whereas the issue of consumer protection was reformed by the Competition and Consumer Act 2010 in order to gain more consumer protection to one single consumer protection legal body. All the approaches have in common that one agency is in charge for the broad field of consumer protection. However, the improvement of financial literacy among consumer falls short in all of the described approaches. Hence, it will be probable that the agencies will be able to improve the supply part of consumer related financial products but in terms of self-protection against too sophisticated financial products the financial literacy should arrive at the focus of the agencies and the legislators for a sufficient protection for future losses and crises in this field.

The third identified reason for the global financial crisis was the continuous increase of complexity of financial products issued by financial institutions and their OTC trading, also off the balance sheet through SIVs. The USA approached this issue with the requirement that at least the standardised products need to be cleared and exchange traded. However, the OTC trading system and, even more important, the shadow banking system of off-balance-sheet structured activities remains unregulated. In the UK, the Turner Review recommended to install a similar clearing requirement for at least standardised high complex financial products. However, this recommendation has not found its way to legislation so far. In Australia, the market for securities exchange is broadly deregulated; however, the exposure to foreign high complex securities of the Australian Banks was relatively limited. Neither of these countries tackles the issue of shadow banking. At least in the US only standardised derivatives need to be cleared and exchange traded. This is considerably questionable since the off-balance sheet activities are not subject to regulation and impaired the situation during the global financial crisis if such activities failed. Thus, in order to strengthen financial systems, these issues should be approached more rigid by the compared countries.

As a fourth reason for the global financial crisis the lack of regulation was determined. The USA encountered this issue by trying to streamline the existing regulators; however, this did not go too far as bottom line more agencies exist than before the Dodd-Frank Act. The establishment of the FSOC and the OFR might be a step into the right direction, but there are the above mentioned concerns about the structure and the exchange of information. The UK made a big step in abandoning the single regulator approach towards a twin peak regulator approach with the establishment of the FPC and the PRA, which divide macro- and micro-prudential regulation. However, it has to be mentioned that the UK emphasised the role of the central bank which lost some of its independency to the HM Treasury, comparable to the FSOC and the OFR housed within the US Treasury, so that overall there will probably be more political influence on financial regulation. Furthermore, missing clear jurisdiction rules may lead to ambiguities. Australia took the twin peak approach already in the early 2000s and was described as being well-regulated during the global financial crisis. Thus, it can be concluded that the twin peak approach turned out to be successful in preventing or at least mitigating crises so that the UK is potentially on a good way. Yet it seems doubtful regarding the US structure that there will be an improvement of macro- and micro-prudential regulation.

As the last major reason for the global financial crisis the too-big-to-fail issue was identified. The USA tackled this issue by a number of reforms, especially the establishment of the OLA, the introduction of the Volcker Rule and the Lincoln Amendment to limit the interconnectedness of institutions as well as the Collins Amendment to improve the capital ratio of SIFIs and the Kanjorski Amendment to limit high risk operation branches. The UK approached this issue as well with the creation of a special insolvency scheme, the SRR, and the Vickers Report recommended among others the introduction of ring-fencing and the improvement of capital adequacy. In Australia there did not fail a major bank or systemically important institution. The introduction of the special insolvency schemes seems to be capable of at least minimising panic market reactions and knock-on effects in the event of failing of a SIFI which was a major issue during the global financial crisis. Especially the rules of capital adequacy and proprietary trading have the potential, if conducted strictly, to prevent future systemic crisis resulting in the failure of a SIFI.

4 Conclusions

After all it can be concluded that there are some approaches in the reference countries which do have the potential to improve issues which led to the global financial crisis. However, they needed to approach these issues more consequently which is of course hard to realise in the light of the major interests within the financial sector to keep the business running. Only the negotiations of the Dodd-Frank Act were accompanied by more than 3.000 lobbyists. As well the City of London does have huge influence as being one of the major economic assets in the UK. Australia will certainly have to improve its competition law but so do the USA and the UK because in the aftermath of the global financial crisis there are even larger financial institutions on the market with even more debt. Summing up it can be stated that preventing future crises will not be possible because of the characteristic of the market to move in amplitudes. However, the analysed

legislation has in parts the potential to at least curb the amplitudes which would mean less harm to the real economies and less excesses within the financial industry.

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