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WHAT IS SYSTEMIC RISK AND WHAT CAN BE DONE ABOUT IT? A LEGAL PERSPECTIVE

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Abstract

The global financial crisis challenges scholars from across many different disciplines to think about causes, immediate consequences and long term responses from the perspective of their particular disciplinary standpoint. This paper focuses on one particular response to the landscape and architecture of financial regulation that results from the lessons about the need to better recognise and counter risk to the financial system as a whole as opposed to its constituent parts and participants. One important policy response to the challenges posed by systemic risk has been the construction of the emergent macroprudential regulatory agenda that is now beginning to take root in practical forms and institutional architecture within the global, European and national spaces within which norms, standards and laws operate. It is argued here that this emerging agenda will challenge lawyers and legal systems more than may be being currently imagined.

Keywords

Macroprudential Regulation: Systemic Risk: Legal Issues

Hitherto systems of financial regulation that have prevailed in Western financial economies have been organised as models of classic Weberian beauraucratic organisation, distilled down into rulebooks and bright line quantitative measures of risk (albeit immensely complex ones) with which lawyers and regulators feel reasonably certain in dealing. But as the need to adapt law and regulation to systemic stability first and foremost becomes imperative in the wake of the financial crisis then elements and characteristics of some of the suggested techniques and processes that look to flavour macroprudential financial regulation may appear to threaten this rational and certain legal and bureaucratic order. The shift in regulatory approach and attendant regulatory toolkit that will need to accompany placing systemic risk central stage as the overriding regulatory objective looks set to take those lawyers that advise financial institutions and whose task it is to constrain and account for the exercise of public power well outside of their comfort zone. However this paper argues that, despite the strong intellectual case being made for the paper concludes that, inherent, in the construction of the whole macroprudential regulatory agenda is a false premise that runs the risk of simply heightening further expectations of law and regulatory techniques' ability to forestall and prevent future crises and loss events. For macroprudential regulatory bodies and processes may result that employ a toolkit that results in a chilling effect on real economies, and may also set up perverse incentives for countries to game their macroprudential indicators. Most seriously of all is the existential risk that macroprudential regulation may hold out the promise of making systems that we still only barely understand safe and proof against all future losses and ultimately simply increase the public sense of anger and disappointment should they fail to prevent the consequences of cycles causing widespread public and economic loss and pain once again. Far better (yet far more difficult) instead is to concentrate efforts to engineer legal, economic and ultimately political and even psychological solutions that increase self reliance and resilience amongst individuals and communities in the face of financial losses.

What do we mean by Macroprudential Regulation?

The term 'macro-prudential' regulation is now in widespread use and its intellectual origins lie in macro-economics and central banking literature and in the context of the financial crisis has been put at the top of the reform agenda following the work done most notably by Goodhart[12] and others since the crisis began to try to show how existing financial regulatory standards and practice (focussed on specific institutions and firms) as well as the behaviour of individual firms and actors had a procyclical effect that was ultimately destabilising to the stability of the financial system as a whole. In many ways it is a new form of risk based regulation– but the risk it seeks to signal for and act as a buffer against (systemic risk or the risk of financial system instability) is a risk that cannot be diversified away or reduced by the actions of any single institution, sector or even country – for it is the risk that is endogenous to the whole game itself and thus requires a holistic and panoramic lens and a flexible and varied toolkit of practical action to counter. To those of us in disciplines outside of economics the term 'macroprudential' may seem to have come from nowhere in fact its use dates back to the late 1970s yet, as Clement has shown in his analysis of the origin of the term and evolution of the concept of 'macroprudential', [3] its use dates back to back to the late 1970s when, following the collapse of the Bretton Woods system the Basel Committee on Banking Supervision was formed to respond to some of the supervisory issues arising from the growth in banks without borders . Concerns were then emerging around the scale and pace of lending growth to developing countries and what this might mean to broader macroeconomic and financial stability. Maes has recently traced the immense

1 *Macroprudential Policy: An Organising Framework* IMF (March 2011)

2 The Fundamental Principles of Financial Regulation M. Brunnermeir, A. Crockett, C. Goodhart, A. Persaud & H. Shin(International Centre for Money and Banking Studies : Geneva Reports on the World Economy 11 : January 2009)

3 Piet Clement, "The term "macroprudential": origins and evolution" *BIS Quarterly Review March 2010,* See most recently *BIS Working Papers No 337* "Macroprudential policy – a literature review" by Gabriele Galati and Richhild Moessner (February 2011)

contribution made by Lamfalussy to early thinking on both the need for and the practical difficulties of operationalising a macroprudential approach to financial regulation.[4] While an Economic Adviser to the BIS Lamfalussy, in 1979, sounded a note of caution on the task facing regulators :

> "Prudential measures are primarily concerned with sound banking practice and the protection of depositors at the level of the individual bank. Much work has been done in this area – which could be described as the 'micro-prudential' aspect of banking supervision. […] However, this micro-prudential aspect may need to be matched by prudential considerations with a wider perspective. This 'macro-prudential' approach considers problems that bear upon the market as a whole as distinct from an individual bank, and which may not be obvious at the micro-prudential level."[5]

Mr Andrew Crockett, General Manager of the Bank for International Settlements and then Chairman of the Financial Stability Forum, made the case in 2000 that a macro-prudential conception of economic processes is essential to understand the nature of financial instability, and hence to monitor and address it.[6] He spelled out the economic reasoning behind this in particular the collective distress that can result from individual rationality, herding instincts towards excessive risk-taking, the limitations on measuring and assessing aggregate absolute risk over time and the reliance of VaR models on time invariant and historic data. [7]

It is becoming clear then that macroprudential regulation is a cousin to "Systemic Risk" and "Financial Stability" and it is therefore worth examining the legal meanings of these more closely for they have taken centre stage in Court proceedings and judicial narratives in the UK signalling the challenges that macroprudential regulation will pose for judges and lawyers once it becomes operationalized through law.

Lastra, perhaps the leading voice among legal commentators when it comes to issues surrounding financial stability and how these become manifest in a legal system points out that systemic or contagion risk is not unique to financial systems. Systemic risk too features in analyses of disease epidemics and is used in the climate change discourse. In the context of finance it can be defined "as the risk that financial difficulties at one or more banks spill over to a large number of other banks or the financial system as a whole".[8] As we now know systemic risk became manifest from 2007 onwards and played out differently around the globe but with an underlying seam of interconnectivity as contagion spread through financial networks and market psychology.[9] For the UK the run on Northern Rock was the first tremor of systemic shock felt in the UK as interbank liquidity problems emerged and doubts over bank solvency and liquidity spread and took root most visibly after collapse of Lehmans. Financial Stability is therefore what is missing when systemic risk manifests itself and results in financial instability. So easy to see once it happens but so very ephemeral and elusive to construct ex ante preventive measures to guard against.

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4 Ivo Maes 'Alexandre Lamfalussy and the origins of the BIS macro-prudential approach to financial stability' *PSL Quarterly Review*, vol 63 n.254 (2010), 265-292

5 "The use of prudential measures in the international banking markets", 24 October 1979, pp 1–2, *in BISA 7.18(15) – Papers Lamfalussy*, LAM25/F67 quoted and cited by Clement, *supra* n. 3

6 Crockett speech in 2000 "Marrying the Macro and Micro Prudential Dimensions of Financial Stability" before the Eleventh International Conference of Banking Supervisors, held in Basel, 20-21 September 2000.

Borio, C E V (2003): "Towards a macroprudential framework for financial supervision and regulation?",

BIS Working Papers, no 128, Basel; Borio, C E V and W R White (2004): "Whither monetary and financial stability? The implications of evolving policy regimes", *BIS Working Papers, no 147*

7 "Value at Risk: A Critical Overview" R. Sollis *J.F.R. & C.* 2009, 17(4), 398-414

8 Rosa Lastra *Legal Foundations of International Monetary Stability* (OUP : 2006) at p138

9 I. Goldin and T. Vogel 'Global Governance and Systemic Risk in the 21st Century: Lessons from the Financial Crisis' *Global Policy* Volume 1 (1). January 2010

The Unstoppable Momentum for Macroprudential Financial Regulation

The fact that there was a failure at every level at which financial regulation operates, international/supranational (through the IMF and Basel Committee), regional (through the European Union's Lamfalussy architecture for financial regulation) and nationally (although the UK legislative and regulatory apparatus is used as an example here the same failures to spot the system pressures characterised most developed financial economies) has meant that the momentum towards constructing macroprudential regulation has taken root at all of these levels.

The Declarations of the G20 in Washington in November 2008, London 2 April and the September 2009 have led to action to promote financial regulatory reform – including the establishment and formal empowerment of the Financial Stability Board as responsible for global macro-prudential mapping and co-ordination. In Europe the High Level Group on Financial Supervision in the EU ('De La Rosiere Report')[10] and the European Commission Communication: on European Financial Supervision[11] have resulted in the establishment of a new European Systemic Risk Board (ESRB) charged with European Community-wide macro prudential oversight of the financial system.[12]

In the UK (the jurisdiction used as a site in which to illustrate the emergence of what macroprudential regulation will look like at the interface of supervisor/market/firm) Lord Turner (Chairman of the FSA- until 2012 the financial regulator) drew from his analysis of the financial crisis, the same conclusions drawn in other jurisdictions and at supranational level, namely that a 'lack of [a system-wide macro-prudential] perspective, and the failure to specify and to use macro-prudential levers to offset system risks, were of far more importance to the origins of the crisis than any specific failure in supervisory process relating to individual firms'.[13] Lord Turner's conclusions were largely endorsed by both the UK Parliamentary Treasury Select Committee and the previous UK Government which drew on them to chart its vision of a new future for UK financial regulation. Even without the sweeping changes to the architecture and allocation of responsibilities for financial regulation now underway as part of the legislative programme of the current UK Government it was becoming increasingly clear before the election that the 'made in the UK' 'light-touch' and risk based financial regulation was effectively dead.[14] The run on Northern Rock marked the start of a progressive abandonment by FSA of an approach to its legislative responsibilities enjoyed under the Financial Services and Markets Act 2000 that respected the autonomy of regulated firms in working out how best to minimise risk to regulatory objectives through their interpretation and application of general phrased regulatory principles. An early example of this change of approach was the FSA's supervisory enhancement programme it put in place after its inquiry into its supervision of Northern Rock and the more intrusive and challenging approach taken to FSA's operation of its Approved Persons regime under Part V of the Financial Services and Markets Act 2000 in relation to its pre-approval of individuals to fill the key governance and senior management roles of systemically important financial institutions in particular.

The implementation of the outgoing Government's post crisis vision began with the Banking Act 2009 and was due to continue with the Financial Services Act 2010 but the intervening election and change of Government in the UK in May 2010 has meant that the blueprint of the last Government for financial regulatory reform was not taken any further. Instead a pared down Financial Services Act

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[10] ('De La Rosiere Report') Brussels: 2009

[11] (May 2009) COM(2009) 252

[12] For a useful critique of the ESRB see E. Ferran and K. Alexander ` Can soft law bodies be effective? The special case of the European Systemic Risk Board' *European Law Review (*2010) p. 751

[13] Turner Review – *a Regulatory Response to the Global Banking Crisis* (FSA March 2009)

[14] For a more detailed explanation of this de-centred and risk related regulatory approach employed by FSA see J. Black 'The Emergence of Risk Based Regulation and the New Public Management in the UK' [2005] *Public Law* 512-549; J Gray and J Hamilton *Implementing Financial Regulation* (Wiley Finance : 2006)

2010 was agreed and passed under the pre-election “wash up” procedure. That Act conferred a new financial stability objective on the FSA and extended its powers in support of that objective and in relation to its role under the Banking Act 2009. However the new legislation discussed above will be short lived for four years on from the run on Northern Rock it is now clear that fundamental institutional reform in financial regulation is well underway. The pre-legislative consultations[15], with their emphasis on supervisory judgment and discretion over rules and their promotion of stability as the central purpose of financial regulation clearly signal that changes now being taken forward into legislative form are not just at the formal and institutional level of financial regulation, but at every layer and process of regulation, in the inner meanings and psychology of regulation and regulatory actors, as well as in their external form. These changes require the repeal of the whole Financial Services and Markets Act 2000 experiment with unitary financial regulation. They will create new regulatory agencies and bodies’ with different responsibilities, duties and powers and cultures. A new subsidiary of the Bank of England, the Prudential Regulatory Authority, is set to assume formal operational responsibility for the prudential regulation of deposit-takers, insurers and investment banks – whose prudential health can impact most seriously on systemic stability – and a new Conduct focused regulator, the Financial Conduct Authority, will assume the conduct of business regulation responsibilities of the FSA along with responsibility for market infrastructure – with a primary remit to promote confidence in financial services and markets, through enhancement of both consumer protection and market integrity and efficiency. These proposals have been and continue to be the subject of intense scrutiny, consultation and debate but for the purposes of this discussion the most significant element of this reform is how macroprudential regulation looks set to be implemented in the UK. This is where, whether the central bankers like it or not, lawyers and legal technique will inevitably be engaged – for no matter how ephemeral and elusive the policy objective is if it is to be pursued in practice it must find expression through practical action and intervention in the affairs of businesses and individuals, and in societies where the rule of law has any meaning at all that has to be take place through law and within the limits of legal powers and authority.

What do we know about what it may look like in Practice: The UK as a Case Study

The UK added the financial stability objective to the FSA’s remit in the Financial Services Act 2010 it took the opportunity to refine the meaning of financial stability having already added it to the Bank of England’s statutory objectives and directed the Bank of England to use it as a ground for action in taking bank rescue and stabilisation measures) . There are currently three aspects to the FSA’s financial stability remit which require it to consider fiscal and economic consequences, effects on growth and the impact of events outside UK on financial stability. The task now preoccupying those engaged in fleshing out the detailed apparatus within which macroprudential regulation will work in the UK is considering the practical processes and interventions for what will become the key body charged with responsibility for macoprudential regulation – a new body, the Financial Policy Committee, to be set up as a committee of the Bank of England but with an external membership. This Committee (the FPC) is has already been set up in interim form within the Bank of England with primary responsibility for protecting financial stability and in June 2011 has produced its first report in which it scans the horizon for sources and signals of risk to the UK financial system. It replaces the discredited Tripartite arrangement established in 1997 whereby the Bank of England, HM Treasury and FSA exercised shared oversight and responsibility for financial stability under a non-statutory MoU. The FPC will towards the end of 2012 assume formal legal responsibility for analysing and responding to macro-prudential and system wide risk. Consultation has addressed the issue of to the

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[15] *A new approach to financial regulation; Judgment, focus and stability* (July 2010) HM Treasury Consultation Document, Cm 7824; *A new approach to financial regulation:building a stronger system* (February 2011) HM Treasury Consultation Document, Cm 8012; *A new approach to financial regulation: the blueprint for reform* (June 2011) HM Treasury Consultation Document, Cm 8083

ambit of the FPC's macro prudential financial stability role and whether 'financial stability' should be expressed as a pure and unconstrained norm or whether its interpretation should be made subject to consideration of the type of secondary factors which reflect the broader economic and political contexts of financial policy making. It is now clear that the latter approach is to be preferred thus recognising the essentially political and contestable nature of "financial stability".[16] The macro prudential task for the FPC which distinguishes the new approach to financial regulation is to be expressed in legislative form in the following terms :

> The Financial Policy Committee is to exercise its functions with a view to contributing to the achievement by the Bank of the Financial Stability Objective…. The responsibility of the Committee in relation to the achievement of that objective relates primarily to the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system. .. Those systemic risks include, in particular— systemic risks attributable to structural features of financial markets or to the distribution of risk within the financial sector, and unsustainable levels of leverage, debt or credit growth. [17]

Some of the techniques and levers through which macroprudential regulation will operate may appear at first sight of little concern to lawyers being couched in obscure language that appears to demand the need for technical economic expertise only, such as counter cyclical capital requirements, loan to value ratios for lending, use by systemically important financial institutions of contingent capital instruments (debt that converts to equity), forward looking dynamic provisioning etc. Paul Tucker, Deputy Governor with responsibility for Financial Stability at the Bank of England has driven forward much of the thinking about what macroprudential regulation will look like in practice and early on in the evolution of this policy he signalled how much more nuanced, calibrated, dynamic and judgment oriented as opposed to rules oriented it must be in order to be effective:

> "It seems unlikely that macroprudential instruments could be set wholly according to fixed rules. Judgement may be needed to make robust policy choices. That would call for assessments of the resilience of the system, credit conditions, sectoral indebtedness and systemic spillovers — all of which vary over time and according to circumstances…"[18]

William White of the Bank for International Settlements made much the same point in 2004 when he began the process of thinking about operationalizing macroprudential regulation and said :

> "There are particular impediments to prudential authorities behaving as suggested above. First, and perhaps most important, they do not have a macroprudential culture. It is a big leap for supervisors, in large part lawyers and accountants by training, and used to evaluating the health of single institutions, to think systemically. Shocking systems of simultaneous equations to see the effects on market clearing conditions is not their natural pastime. Moreover, it is an even bigger leap for prudential authorities to be convinced that action is needed when the financial system seems healthy, and only the corporate and household sectors seem overextended. Surely, they would argue, this is someone else's responsibility. A second very practical concern is that, in most jurisdictions, the prudential authorities do not have the power to use prudential instruments in the way recommended. Acquiring such rights would probably involve a long and difficult political process…"[19]

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[16] Para 1.26 and Chapter 2 *A new approach to financial regulation: the blueprint for reform* (June 2011) HM Treasury Consultation Document, Cm 8083

[17] Clause 3 Draft Financial Services Bill published as part of June 2011 HM Treasury Consultation *supra*

[18] "The role of macroprudential policy" *Bank of England Discussion Paper*, November 2009; Barclays Annual Lecture by Paul Tucker "The Debate on Financial System resilience: Macroprudential Insruments" October 2009

[19] Speech by William R White, Economic Adviser of the BIS at a Financial Stability Symposium organised by the Netherlands Bank, Amsterdam, 25-26 October 2004.

What Challenges might this different Approach to Regulating Financial Markets pose for a Legal System

The long and difficult process to which White refers is now underway not just in the UK but at every jurisdictional level and much of it is informed by the supranational blueprint for the direction of reform set by the Financial Stability Board. Even when macroprudential tools are acquired, when used they will inevitably invoke appeals and legal challenges. Tucker has foreseen this and made a plea for a greater tolerance on the part of those hearing such challenges for the position of a supervisor faced with the need to make a forward looking judgment rather than a rules based decision:

> "..[Marcoprudential regulation] involves supervisors making judgments; and, no doubt, occasionally judgments that individual banks find unwelcome. They need to cover competence. But also the adequacy of liquidity portfolios and the reasonableness of asset valuations; over the decades too many banks around the world have failed after reporting apparently healthy ratios. Not a new lesson. But a vital issue is whether we are ready, today, collectively to back an approach based on judgments rather than on enforcing a book of detailed rules? If we are to tolerate supervisors where necessary substituting their judgment for that of managers and boards, then commentators, appeal tribunals and even parliamentarians will need to give supervisors the benefit of the doubt occasionally. Of course, such judgments need to be grounded and reasoned."[20]

But the grounding and reasoning to which he refers may be couched in terms of methodologies unfamiliar to lawyers and invoke values more familiar to systems theorists and economists. And it will be interesting to see how Courts will cope with hearing arguments about the materiality of various sets of time series data or about the predictive power of macroeconomic indicators.

For, if individual financial institutions, their owners and depositors are to find that their rights and interests are just one element to a multi-faceted equation to be considered by regulatory actors in an intervention that affects them they may well seek to invoke the more traditional values inherent in a legal system such as certainty, fairness, due process, equal treatment and challenge some of the underlying macroeconomic assumptions being used by macroprudential regulators on the grounds that they do not fully or properly incorporate values. Like it or not lawyers and Courts will invariably become involved in such challenges.

Indeed the UK has recently seen a sharper legal toolkit already introduced for the FSA and is further proposed for the PRA and FCA its successor regulators to enable actions and interventions to be taken in order to mitigate systemic risk. Examples of these include the strengthening of the regulator's ability to take enforcement action against key individuals working in the financial sector who require specific regulatory approval before they can undertake their functions under what is known as "the Approved Persons regime", as well as the introduction of a systemic risk mitigation basis to use of certain of the regulator's intervention powers over firms AND individuals so such powers will be able to be exercised in furtherance of what is an explicit financial stability objective. How will challenges to its use sit within a legal process where appeal tribunals and lawyers are used to looking at and basing argument on factors and evidence specific to the individual subject of law and not on evidence about the operation of the system in which those subjects operate? Practical application of these new powers will inevitably result in challenge imagine the situation of a firm closed down or with a restricted line of business 'in the interests of mitigating systemic risks…' yet to date that same firm may well have had no complaints received, no losses to firm's book or to its customers, no shareholder concerns have been voiced, and indeed be a veritable consumer champion and the all-round darling of the marketplace and the political classes etc. The firm will be emboldened to challenge a regulator's actions and reasoning and will request a judicial review of, for example, a variation of its regulatory permission or some other intervention by its regulator. Like it or not the Courts will be confronted with the issues pertaining to the exact meaning of systemic risk and financial stability and indeed as the penultimate section of this paper shows, in the context of the

[20] P. Tucker, *Barclays Annual Lecture*, 22 October 2009 (Bank of England website)

exercise of the UK Government's emergency powers taken in the Banking (Special Provisions) Act 2008 the Courts have already been confronted with them.

Intelligence Base

As well as affecting values such as certainty, ability to know *ex ante* when one may be subject to official action or intervention, substantive and procedural fairness it is clear that in order to be effective macroprudential regulation requires a vast intelligence base or mapping exercise which is an ongoing and real time process. For how else can macroprudential regulators make judgments about the sources of systemic risk and its extent? For this reason the Financial Services Act 2010 added to the FSA's intelligence gathering armoury a statutory information gathering power that can be used as regards specific institutions in order to assist the regulator in making operational its financial stability objective and the recently published draft legislation setting up and empowering the FCA and PRA goes even further in developing these tools. It has to be questioned whether even these powers will go far enough since tor the data mapping/information gathering exercise required to acquire the kind of intelligence systemic regulators need is awesome. Systemic oversight, in order to be meaningful, will require intrusive levels of micro due diligence into specific firms, sectors, products and practices for data in order to be meaningful must be mined from the markets on a bottom up basis and this must be done on a continuing basis. The subjects of such data requests may find them so costly and intrusive that they seek recourse to law to test their validity. Arguably too in order to be useful such powers should be used not so much against specific institutions but rather against those attendant professionals and intermediaries who advise, engineer and transact the deals and risk shifts that in aggregate lead to systemic pressures. For if the macroprudential regulator's ultimate goal is to dampen cycles and put a brake on potentially destabilising herding momentum the best placed group of people to keep them informed of where risk is being originated, created and sold on to are those who transact the often highly bespoke and confidential deals that constitute the financial markets namely lawyers. Acting as they do for a whole spectrum of clients across the financial services industry a few key law firms are uniquely well placed to provide the closest of any perspective on the pattern that is building up in risk creation and shifting. If banks are lending with abandon in what one leading UK private equity protagonist termed prior to 2007 a "covenant- lite" fashion, or if counterparties are acquiring risks that perhaps they do not fully understand and may not in turn be able to hedge, or if connectedness and exposures are building between large financial institutions to a level that seems dangerous then it is the lawyers advising on all this activity who will detect these trends first. Is there any scope for their being harnessed by the macroprudential regulators to act as gatekeepers or systemic stability? The difficulties encountered in imposing anti money laundering reporting requirements on lawyers as a profession shows the level of resistance there is within the profession to such a policing role, professional privilege and client confidentiality are values held dear by the legal profession and imposing duties which require its being set aside for economic data gathering purposes is exactly the kind of extreme political difficulty to which William White was referred in 2004.

Even if the macro-prudential regulators are able to acquire such data, considerable skill and prescience is required of them as to its use in terms of the need to aggregate all the disparate and apparently unconnected bits of financial stability data and the need to see its significance in terms of the linkage that may lurk within it and foretell the hidden seams of systemic pressure . This whole exercise needs to be a dynamic , inter-temporal one with the capability of operating across vast networks and national borders.

Even viewed purely in the context of the task facing a national macroprudential regulator one cannot underestimate the difficulties in practically mapping cycles and bubbles in order to give the regulators the evidence base and authority to intervene or regulate in the interests of financial stability. Add to that the difficulties of conducting such mapping across jurisdictions and the geopolitical sensitivities of co-ordinating national, regional and global macroprudential mapping efforts and regulatory action and the task ahead looks ever more daunting.

How far will the Macroprudential Regulator's Powers extend?

Another obvious question will be just how intrusive will the FPC's reach into the microprudential law rule book will be? A less obvious but equally pertinent question which may arise if we seek to make macroprudential regulation really effective as a concept is how far will the macro-prudential regulators be able to go in re-writing and shaping the wider legal landscape? This point is one of joined up policy making in the wider legislative field too and could engage lawyers and those involved in legal policy beyond the financial sphere too. It is well known by now that laws can have unintended consequences and set up perverse incentive. It has been suggested by some that the drivers of macro-prudential/systemic problems lay not just within the incentives operating within the financial system (the ultimate guarantees offered by Fannie Mae and Freddie Mac) and that system's attendant legal framework (such as the Community Reinvestment legislation in the US) or US bankruptcy laws which prevent lenders pursuing those who surrender possession for the balance of any debts owing (otherwise known as " jingle mail") they also may lie in other parts of the statute book and in laws whose framers never considered or could not have foreseen any knock on effects to wider financial stability.[21] Examples range right across the legal system from tax laws which allow interest deductions on corporate debt hence skewing balance sheets away from equity capital through to ostensibly investor protective portfolio holding rules which can be found in the constitutive legal bases for many collective funds and trusts. [22]

Is there perhaps an argument for a body such as the FPC having a veto over existing and planned legislation in social and economic arenas that lie outside the financial system should they be likely to have macro prudential systemic effects such as general welfare laws and bankruptcy laws in order to encourage individual and household prudence for example?

In corporate law reform debates surrounding the proper scope of company directors duties why not include "systemic effects" in the list of stakeholder interests that UK company law requires directors to have regard to when making decisions about the company's business.[23] For is the overall health and stability of the financial system not equally important than the environment/ suppliers/ or community at large, all interests they must take into account currently?

Just as a macroprudential regulator needs to be able to see "how the complex inter-linkages across financial markets, and financial institutions' tendency to respond in common ways, can threaten stability"[24] then so too why should it not also look elsewhere in the legal and institutional landscape for threats to stability in laws affecting financial and social structures, individual, household and corporate behaviour? For those causes are more deeply rooted and embedded and tackling them may well be well beyond the scope of law reform alone.

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21 P Booth (ed)*Verdict on the Crash : Causes and Policy Implications* (IEA Publications 2009)

22 It can be argued that such ostensibly protective requirements can also be said to impede the goal of more active shareholder monitoring and militate against good corporate governance and a shorter governance chain R. Nolan, "Indirect Investors: A Greater Say in the Company?" *Journal of Corporate Legal Studies* 200[6]? [check cite] G. P. Stapledon, *Institutional Investors and Corporate Governance"* (Oxford, Clarendon Press: 1996) and J Gray "Personal Finance And Corporate Governance : The Missing Link : Product Regulation And Policy Conflicts" *Journal of Corporate Legal Studies* 2005

23 Schedule 2 Companies Act 2006

24 UK Government White Paper July 2009 on Reforming Financial Regulation

How have the Courts dealt so far with Individual Instances of Challenge to use of Legal Powers expressed to be in the Interests of Systems as Actors rather than of Individual Legal Actors?

How will Courts balance the macro and the micro if called upon to do so? Does a macro driven law trump a micro driven one – how much due process will Courts apply to such commission and positive interference in interests of systemic stability by regulators rather than failures to act/forbearance in interests of systemic health and stability?

Traditionally in the UK in any event Courts have been uncomfortable with engaging in substantive balancing of macroprudential and microprudential policy interests on the rare occasions in the past when a financial regulator's actions have been challenged by either financial institutions affected by those actions, or by other groups of stakeholders affected by regulatory action or inaction, and the Court has been confronted with arguments which potentially involve it in reviewing the regulator's judgments made about the level of systemic risk or the risk of financial instability that led to its action or forbearance from exercise of its regulatory powers.

Examples of such challenges before the UK Courts when they have been seised of liability questions relating to macro judgments made by banking regulators reveal the Courts have shown considerable sympathy with the difficult and multi-faceted nature of the task confronting a financial regulator. The Courts have talked in terms of the near impossibility of the task of balancing the concerns of a banking regulator properly has with systemic safety and resilience with its microprudential concerns of depositor protection with respect to depositors in an individual institutions for whose prudential soundness it also carries regulatory responsibility.[25] The UK's Privy Council (the final Court of Appeal for the UK's dependent territories including the offshore jurisdiction of the Isle of Man) was urged by representatives of the depositors in failed banking institutions in the Isle of Man to impose liability in damages for losses suffered by them. The depositors argued that the regulatory authorities owed a duty of care to the depositors to decide on the appropriate use of their regulatory powers and functions when faced with a failing or troubled financial institution in such a way as to prioritise the safety of the depositors funds rather than to take into account wider public interest factors that related to the effects of any action they took on the financial system as a whole. The Court disagreed and in refusing to impose such a duty showed itself to be sensitive to the delicacy of the task affecting a regulator responsible not just for microprudential regulation but also for aspects of what we know term macroprudential regulation, namely the wider public interest in the health of the financial system

> "In circumstances such as these, competing considerations have to be carefully weighed and balanced in the public interest, and, in some circumstances, as counsel for the respondents observed, it may for example be more in the public interest to attempt to nurse an ailing bank back to health than to hasten its collapse. The making of decisions such as these is a characteristic task of modern regulatory agencies and the very nature of the task, with its emphasis on the broader public interest, is one which militates strongly against the imposition of a duty of care being imposed on such an agency in favour of any particular section of the public."[26]

The use of the powers to take emergency action in the face of threats to financial stability in the UK conferred on the regulators by the Banking (Special Provisions) Act 2008 has, not surprisingly, given rise to litigation that has inevitably involved the Courts in consideration of the meaning of financial stability and the proper use of legal and discretionary powers conferred in order to enhance and sustain stability. This has happened in the context of the litigation brought by shareholders in the nationalised Northern Rock referred to in the first part of this paper and resulted in judicial consideration of the nature of one of the central banker's core defining tasks, that of acting as lender of last resort to banks

[25] *Davis v Radcliffe* (Privy Council) [1990] 2 All ER 536,

[26] *Ibid* per Lord Goff pp 6- 7

experiencing funding crises. The Judge at first instance described the need for a central bank to act as lender of last resort in a way that is unpredictable, selective and highly discretionary in order to minimise the obvious moral hazard risk that would otherwise arise. The lender of last resort function is seen by central bankers as a bulwark against systemic instability and If the Courts were, in the future, to adopt a similarly non-interventionist and hands off approach to the exercise of other new discretionary powers expressed to be in furtherance of macroprudential financial regulation in the interests of financial stability then this may go to allay some of the concerns expressed by Paul Tucker in his plea to appeal tribunals and others to respect the need for discretionary, finely tuned judgments to drive regulatory action in the macroprudential domain.

The Courts have been confronted recently too by challenge brought by the parent company of a failed Icelandic bank and backed by the Icelandic Government to the legality of the UK Governments action in relation to a UK subsidiary of the bank, Kaupthing Singer & Friedlander Ltd (KSF). On 8 October 2008 the UK Government exercised its powers under the Banking (Special Provisions) 2008 legislation and made an order which had the effect of transferring to a third party the liabilities of KSF to UK depositors[27]. The Financial Services Authority then placed KSF into administration. The Icelanders argued that the legislation empowered the Government to act only for reason related to threats to financial stability in the UK and in actual fact, they argued, the evidence revealed that the Government's action was motivated not by threats to financial stability but rather by its desire to protect and be seen to be taking urgent protective action in interests of UK depositors. For the Government justified its actions publicly in terms not of the need to ensure financial stability but rather to ensure consumer confidence in the banking system and to protect depositor funds. That, the claimants argued, was a microprudential concern and not one that bore on stability of the system as a whole. They also argued that the failing Icelandic banking sector which, although significant for Iceland, was a tiny fraction of the size of the UK banking sector as a whole and was dwarfed by the far larger UK banks (which themselves were teetering on the brink of their own liquidity crises in October 2008) could not possibly be said to imperil the UK financial system or have any material causative effect on its stability. The claimants argued that the authorities failed to consider the effects on UK financial stability if the transfer order were not made and instead simply took the decision not in the light of specific threats to UK financial stability but rather by treating the matter simply as an undifferentiated part of a wider global, or Icelandic, financial crisis. However the Court rejected that argument and ruled that the evidence showed the Treasury had indeed considered the consequences to the UK of not making the transfer order and had acted reasonably in taking the decision.

In its rejection of the claimant's argument on the first issue the Court showed itself alive to the reasons why HM Treasury chose not to emphasise risk to systemic stability in its public justification for the Transfer Order and chose instead to couch in terms of consumer confidence and depositor protection. The Court pointed out the way in which financial contagion can take root and spread defies logic and reason and the rhetoric and language used by those in authority at times of crisis can either dampen the severity of the loss of confidence and trust and allay public fears or, if the wrong language is used and the true horrors of possible imaginable scenes of financial Armageddon are spelt out, then the language may have the opposite effect and fan the flames of panic so exacerbating the severity of the systemic crisis. However the Icelandic Government, which lent its full support to the claimant's challenge took the view that the UK Government's emergency actions with respect to Icelandic bank assets in the UK simply exported that systemic risk to the entire Icelandic banking sector and onwards into its economy. The geopolitical shifts and fault lines of the global financial system do not often surface so clearly in a UK Court of law and this case will certainly not be the last time that they do given that macroprudential regulation is bound to produce more claimants in the position of the Icelandic banks here who find themselves on the wrong end of an intervention or decision taken for reasons of systemic resilience.

[27] Kaupthing Singer & Friedlander Ltd (Transfer of Certain Rights and Liabilities) Order 2008 (SI 2008/2674),

Macroprudential Regulation: Can it deliver?

The construction of macroprudential regulatory apparatuses and toolkits worldwide shows that policy makers continue to adhere to a belief in our ability to foresee events and dangers on an 'ex ante' basis. In other words we continue to believe that the future can be expressed in terms of "risk", but this time it is risk to the entire system (and its sources) we are talking about, rather than institution or sector specific risks. This overlooks the stubbornly persistent reality of true Knightian uncertainty, that which is genuinely unknowable not yet merely unforeseen and the fundamental problem with the emergence and continuing refinement and remodelling of risk based financial regulation (which the reform proposals take to a new plane – systemic risk – to be foreseen from the lofty perspective of a new viewing platform – that of the macroprudential) is that it continues to occlude a vital distinction between uncertainty and risk. The danger in doing this and in not being honest about the limitations in our ability to "risk manage" every eventuality and turn of fate is that it may lead to unrealistic expectations of and signalling by financial regulators.

For better or worse, the development and use by a financial regulator of complex risk assessment and measurement models (such as the risk based model developed by the UK's FSA under the FSMA 2000 regime), invariably implies superior and clearer foresight on the part of that regulator. Whether it is fair or wise to have such expectations and belief in the powers of financial regulation is another question but this 'moral hazard' effect on public expectations of what can be achieved by regulation is well known.[28] As and when in years to come the new UK Financial Policy Committee, with its macroprudential toolkit designed to identify and counter future sources of danger to systemic stability and greater use of macroeconomic modelling,[29] fails in its task when it is foiled by some future unexpected and unforeseeable unravelling of markets our expectations of financial regulation will be all the more disappointed. Far better to now begin the task of constructing what Power has termed a new 'politics of uncertainty'[30] in households, firms and individuals which acknowledges that the future can unfold in a radically different manner from that which our models, systems and processes embedded in regulatory design would dictate. Those who are caught in the fall-out of such uncertainty will at least have been able to develop strategies for surviving it and coping with it. The problem with attempts now being made to be able to regulate on an even grander 'macro prudential' scale and to eliminate and dampen down future systemic problems is that, unless accompanied by a realism about the limits of all *ex ante* action and perspective on systems as complex and riddled with the unknown as financial markets, they risk being seen to continue and compound the same type of protective claims that the FSA's model of risk based regulation carried within it. This carries within it the seeds of the next round of disappointment and dismay when the financial system stumbles the next time under the watch of the various macro prudential regulatory authorities now being established.

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[28] Goodhart, C.; Hartmann, P.; Llewellyn, D.; Rojas-Suarez, L. and Weisbrod, S., (1998) *Financial Regulation; Why, how and where now?* Routledge, Ch 4.

[29] *Supra* note 42, Chapter 2 and *'The role of macroprudential policy'* Bank of England Discussion Paper (November 2009)

[30] Power, M. (2007), Organised Uncertainty: Designing a World of Risk Management, Oxford University Press, Chapter 7.

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