Critically evaluate whether the financial crisis of 2007-2009 has been a wasted o...

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Critically evaluate whether the financial crisis of 2007-2009 has been a wasted opportunity for regulatory and corporate governance reforms.

The Global Financial Crisis (GFC) of 2007-2009, rooted from the United States subprime mortgage market, is not the first time in the history of the financial system collapses; crisis like this undermine the public's confidence in the banking sector. In fact, the Bank of England went through a crisis in 1694, shortly after it was founded. A financial crisis is defined as unexpected and sharp drop in the value of the financial economy at a macro or micro level.[1]Banks play a central role in the financial system, and if they are not well regulated, crises may occur. Banking regulations are put in place to minimise risk and maintain economic stability. Phase one of the GFC began in 2007 with the seizure in the banking system. The Financial Services Authority (FSA), which regulates the financial services industry in the UK, published recommendations by its Chairman Lord Turner in order to create a more robust banking system and how banks should be regulated. The Turner Review suggested that it started with a localised credit concerns followed by the failure of two large hedge funds, in addition to, accumulation of losses and liquidity strains.[2]The system by which banks are directed and controlled is called corporate governance. The CFG brought into focus the unfettered greed and uncontrolled hazard, and it has been proved that poor CG was one of the major causes of the crisis. The Walker review made thirty nine recommendations in order to improve the weaknesses of corporate governance in banks.[3]

The GFC was unpredicted; led to a massive collapse in the economic growth and the investment sector in the whole world. Therefore, governments responded by introducing a new regulatory framework designed to prevent future crisis to occur.[4]In order to evaluate the effectiveness of the new regulatory architecture for the prevention of future crises in the banking sector, a critical analysis of the current regulatory system and Corporate Governance will be discussed.

Bank regulation is a form of government regulation which subjects banks to certain requirements, restrictions and guidelines.[5]The miscarriage of financial regulation and weak supervision were one of the main GFC causes. Yeoh suggested that the causes of the GFC were a ‘ combined result of adverse macro-economic conditions, bad corporate governance and loose regulatory oversight.’[6]Therefore, since the GFC, regulators have placed increased emphasis on prudential regulation; capital adequacy requirements are one of the central tools regulators use. The current method to capital adequacy is micro-prudential regulation, which involves the regulation of individual financial businesses.[7]Whereas, macro-prudential is essentially designed to regulate the financial system as a whole. Deregulation and lack of supervision were one of the causes that led to credit crises and accordingly many banks went into insolvency. The contribution of numerous financial and investment banks in the mortgage market is a case of the influence deregulation. Accordingly, interests rates started to fall; banks started to increase their leverage and it was evidenced that banks’ share price was increasing after the declaration of asset securitisation. Therefore, policy-makers concluded that investment banks have amplified the

systematic risk of the financial sector, in order to reduce their idiosyncratic risk.[8]

Shadow banking, which is a network of credit intermediation outside the regulated banking sector, was also triggering the crisis. Paul Krugman described the shadow baking as the core of what happened.[9]He pointed out the fact that shadow banking did actually surpass the traditional banking system, in its size besides importance, and criticised the fault of having let this sector deregulated.[10]Furthermore, the moral hazard is one of the most underrated problems of the economic system. Busato and Coletta speculated that the moral hazard problem entails the possibility that managers may deceive investors to peruse their own goals.[11]

The regulatory reforms that have been introduced post-crisis were mainly aiming to prevent future crises in the banking sector, however, as it was revealed, banking regulations that already existed were not effective to prevent the crisis, nor to protect the banking sector from a financial turmoil. The Basel Committee on Bank Supervision (BCBS), which was formed in the 1970s, operates at international level aiming to improve the quality and reinforce the stability of the international banking supervision.[12]The Basel Committee has released a framework for regulating capital surcharges for banks of global systemic importance, starting with Basel I in 1988, the first capital accord, followed by Basel II in 2004.[13]The new regulatory framework Basel III, was a response to the systemic risk, is a comprehensive set of reform measures developed to strengthen the regulation and risk

management of the banking sector. It also increased the standards of leverage, capital and liquidity.[14]

The main changes Basel III brought to banks were, raising the minimum capital requirements for banks, in addition to, buffer capital. It also enhanced the coverage of banks toward their exposure to credit risk. Vousinas pointed out that the new leverage and liquidity ratios proposed a non-risk-based measure to ensure that adequate funding is maintained during stress periods.[15]Moreover, Basel III adopted a more restricted measure with regard to the balance sheet, it insists on limiting the balance sheets and stimulates banks to take initiatives to reduce them. Song explained that the way to impose this is by putting a limit on the size of the activities a bank can develop compared to its own capital.[16]

Basel II distinguished three types of Tier capital, however, Basel III brings this down to two types of Tier capital. Crucially, under the Basel agreements after the crisis, all commercial banks in the UK must have sufficient Tier one capital. This is basically to assess the financial strength of the bank. [17]Another interesting concept is the Counter-Cyclical Capital Buffer (CCCB). The purpose of this rule is to correct the pro-cyclicality of Basel II particularly in periods of economic growth. Persaud argues that '[C]ounter-cyclicality needs to be at the heart of the new regulatory regime and not an optional extra and if it were, it would make no difference if we were to introduce these initiates in the depth of a crash or the peak of a boom.'[18]Howarth and Quaglia contended that the initial drafts of the Basel III agreement constituted a significant step change in regulatory values.

Nonetheless, the implementation of Basel III was delayed until 2019 despite the intense awareness raised by the GFC and the gravity of the financial situation.[19]The ongoing debate, satisfied that Basel III has managed to address most of the problems occurred during the financial crisis, as well as, closed the gaps in Basel I and II, however, some issues remain unsolved.

In response to the crisis, the UK government enacted the Financial Services Act 2012 and brought a new approach towards banking regulation, moving away from the tripartite system (The Bank of England, FSA and HM Treasury) to the twin peaks (PRA and FCA) system of regulation.[20]It was criticised that the collapse of Northern Rock bank and HBOS were an actual example of the tripartite failure, moreover, the FSA failed in regulating and supervising banks despite the fact that they were aware of the deficiencies before the crisis happens.[21]There are arguments for adopting the twin peaks model of Australia, by supplanting the FSA with two bodies in charge of micro-prudential issues and conduct of business. The focus of micro-prudential of conduct of business regulator could be improved by expelling other policy responsibilities.[22]

The GFC elevated a critical argument about the omissions of financial regulation; whether or not it is sufficient to prevent future financial crises. It was made clear that the financial regulation needed a co-ordinated and harmonised macro-prudential approach, as well as, corporate governance in the banking system. Thus, the post-2000 market and macro-economic condition requested the most out of corporate governance courses of action, boards must be clear about the technique and hazard craving of the

organisation and to react in a convenient way, requiring productive reporting system.[23]The role of corporate governance is to protect and advance the interests of shareholders. The Financial Reporting Council (FRC), is the regulator for corporate governance in the UK. The UK Corporate Governance Code sets out the standards of good practice with regard to the board viability and the relation with shareholders. Merino et al. suggest that weakened public confidence in the corporate governance system brought to the top of the policy agenda the need to reconsider the existing corporate governance models to restore this confidence and to address problems associated with management and governance relations.[24]The finding suggests that corporate governance can play an important role in determining individual firms' behaviour, in particular, the incentives of insiders to expropriate minority shareholders during times of distress.[25]

Banks have a contagion risk; because they are very much inter-connected, if a bank fails in the UK it will not only have ramification in the UK but also a worldwide consequences. During the GFC most banks were negligent, incompetence and reckless, therefore, the LIBOR scandal started to approach. So, during the financial crises the banks were experiencing financial difficulties already and therefore there was not an incentive to keep the LIBOR rate down.[26]The Financial Conduct Authority (FCA), which replaced the FSA in 2013, and The Prudential Regulation Authority (PRA) started adopting a new policy called creditable deterrence, which means that a harsher methodology towards banks and a lot more proactive in enforcing penalties against wrongdoers.[27]Lui is in the view of, that the PRA and FCA have been a lot more forceful in enforcing sanctions post the crisis and this is

a good step towards more effective corporate governance.[28]Moreover, The FCA introduced the Senior Managers Regime (SMR), essentially, the approval process to become a director of a bank is now stricter than before the crisis.[29]In addition, The PRA in 2014 introduced a new accountability regime regarding the insurance sector, as required by the Banking Reform Act 2013. The PRA believes that there should be a regulatory framework, which reinforces similar standards of fitness and propriety, conduct, and accountability for individuals in positions of responsibility at both insurers and banks.[30]

The shareholder engagement is a basic philosophy in corporate governance, it revolves around the idea of the separation of ownership and control. In theory, this means that directors run the company for shareholders, therefore, there is an asymmetry of control and information. One of the most severe criticisms levelled against shareholders is by Lord Myners, he stated that hedge funds became ownerless corporations, essentially shareholders were not monitoring what the managers were doing, and that is why things went out of control.[31]Still, no one was monitoring what the directors were doing and therefore, the reckless behaviour lead to an extremely high leverage ratio.

One of the recommendations that were made by the Walker review was that institutional investors should be more active and engage with individual investments, as a result of that, a new controversial approach was introduced in 2010 to enhance the quality of shareholder engagement called the Stewardship Code, adopted by the FRC.[32]Although the code sets out a

best practice for investors that choose to engage with investee companies, the Institutional Shareholders Committee made clear that it does not constitute an obligation to micro-manage, or preclude a decision to sell a holding where this is considered the most effective response to concerns.[33]

Better corporate governance generally pays for firms, markets, and countries. The question then arises why firms, markets, and countries do not adjust and voluntarily adopt better corporate governance measures. The answer is that they do adjust to some extent, but these steps fail to provide the full impact, work only imperfectly, and involve considerable costs.[34]

Conclusion

To summarise, lack of supervision and regulations over the financial market, expansion of financial derivatives beyond acceptable norms, imbalance in the world trade, and greed of Wall Street has led to this exceptional global financial and economic crisis.

The regulatory response around the world was dramatic. Regulators moved from a light touch model, which assumed banks would regulate themselves, to a far more rigorous system of capital and liquidity requirements.

The financial system is dynamic and adaptive. So any financial regulatory regime will need to be flexible, if it is to contain risk within this system. Finally, reformers and policy-makers did not waste the opportunity of the GFC to create a new safer and more protective financial system, however, the prudential regulatory framework will need to be re-oriented to have a

system-wide focus and improvements still need to be made to avoid any potential financial fails. Overall, the scale of imbalances in the global economy is definitely less than ten years ago, however, the risk of the potential future crisis remains, and early preventive actions might still not stop it from occurring again.

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