WHY DOES REGULATION NOT PREVENT FINANCIAL CRISES?

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ABSTRACT

The subprime crisis that started in the United States spread its effects all over the world. The credit derivatives, a recent financial innovation, took part in the crisis. Governments – as the last resort – had to bail out its financial systems. Otherwise the crisis could have turned into a total chaos. Only many years later the rates of unemployment are comparable to the levels in the pre-crisis. The public opinion blames the bankers and speculators. The establishment of a new regulatory system is being questioned in the light of the current crisis. The principled-based regulation could be an answer as new approaches are being evaluated.

TABLE OF CONTENTS

1. INTRODUCTION

The recent global crisis that emerged as a consequence of the subprime crisis in the US has had a huge effect in the discussion regarding the role of financial institutions, banking regulation and even the bonuses paid to executives.

In the decade that preceded the subprime crisis the Federal Reserve watched financial crises in Asia, Russia and Mexico. As a result, it wanted to stimulate private sector borrowing to nurture the economy. Monetary policy decisions made the Federal Reserve drop the interest rates from 6 to 1.5%[1]. The very low interest rates and a huge inflow of investments subsidized very good credit conditions.

The plenty of liquidity rocketed the housing bubble. The interest rate was very low and as a result the housing prices were rising. The public had an all time debt load.

The banks offering the mortgages would securitise its receivables in order to capitalize and offer even more credit. The housing prices kept growing and the public would refinance its own houses to consume more.

At some point the housing prices stopped to grow, the debtors would not pay the mortgages and the system was clogged.

The first signs of the Subprime meltdown in the United States appeared in 2007 when a Bear Sterns Hedge fund flopped[2]. The prices of the houses started to fall and the mortgage default rocketed, despite of the very good credit ratings attributed to these loans. It first affected the lenders and the credit default swap sellers. As per the systemic risk, its effects polluted the financial system, illiquidity soared and volatility exposed Wall Street banks to near-bankruptcy.

As a result of the illiquidity, many European Sovereign States watched its bonds turning into toxic assets. Exporter developing countries were affected on their revenues. This turmoil grew to become the biggest economic crisis since the Great Depression that shocked the United States in 1929. Governments and Central Banks all around the world rushed to dump the financial system with greats amount of money besides nationalizing private companies.

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[1] < http: //www.federalreserve.gov/ board docs /press/ monetary/2004/ 20040504/ > Accessed on 29th September 2013.

[2] RYBACK, W. (2007): 'Case Study on Bear Stearns' – Toronto Center Leadership in Financial Supervision

The United States watched a reshuffling of its investment and high street banks and the federal take over of Freddie Mac and Fannie Mae. The levels of unemployment are unbearable in Portugal and Spain while Greece struggles to reorganize their finances. The global crisis will be always remembered as a negative hallmark for millions of people who became unemployed or governments with unbearable debts that will bypass their people's social needs.

The public response to the crisis was to immediately blame "greedy" financiers, politicians and, to some extent, the regulators. The instantaneous consideration was that somehow insatiable bankers were allowed to disorder the global economy. Imaginably the legislators were as guilty because of not passing stricter laws to avoid it.

However the role performed by banks must be duly observed. The financial system is constructed around this pillar. The criticism in the aftermath of a crisis may hide the results allowed by the banks in the modern society.

The recent crisis encouraged the discussions concerning government, moral, capitalism and the role of regulation.

The dualism between conservative and liberal gains momentum, whilst the discussion whether the regulation should be able to prevent or at least soften the consequences of a financial turmoil.

In this sense the words of Ayn Rand, an Objectivist philosopher, should be highlighted. To her point of view the regulation must be minimised to the level where it only serves to protect the individual against the force. In this hypothetical environment the State admits that regulation is not able to prevent crises[3]:

> "Capitalism. If it perishes, it will perish by default, undiscovered and unidentified: no other subject has ever been hidden by so many distortions, misconceptions and misrepresentations. Today, few people know what capitalism is, how it works and what was its actual history. When I say "capitalism," I mean a full, pure, uncontrolled, unregulated laissez-faire capitalism - with a separation of state and economics, in the same way and for the same reasons as the separation of State and Church. A pure system of capitalism has never yet existed, not even in America; various degrees of government control had been undercutting and distorting it from the start. Capitalism is not the system of the past; it is the system of the future - if mankind is to have a future."

[3] RAND, A. (1961): 'The Objectivist Ethics' - The Virtue of Selfishness (University of Wisconsin Symposium on "Ethics in Our Time" in Madison, Wisconsin)

2. BANKING

Banks perform a pivotal role in modern societies. Nowadays it is not conceivable that one would live the modern life in major cities independently of the banking system. The development flows accompanied by *bankarisation*. Keeping the deposits safe and being part of the payment system entitles to contemporary life.

Recent technologies like mobile banking are extending the reach of banks in places as unbanked as Latin America and Africa. The World Bank is among the organisms constantly monitoring and stimulating the financial inclusion. Access to loans per number of inhabitants and number of branches are major concerns for the institution[4]. The basic set of financial inclusion indicators also lists the percentage of “enterprises with outstanding loan or line of credit by regulated institutions”. It is understood that when a community gets more exposed to loans and savings it will flourish and allows the next generations to achieve better conditions.

Financial institutions – that might be private or state owned entities - are responsible for the recycling of the money. Banks gather short-term deposits from the public and become their owners. Afterwards they issue mid to long-term loans at their own name and risk. In addition banks also organise payments and set a complex payment system among them.

A very important concern to banks – and also a target for financial regulation – is the so-called “disintermediation”. The liquidity provided by banks is not the only source to fund businesses, governments and banks themselves. Having a better credit allows a company to access and be funded directly by the capital markets through the issue of bonds or shares and that is significantly lower when compared to the cost bank borrowing. At the same time that the disintermediation takes these low-risk borrowers away from banks it allows them to take part in other lines of business that are also profitable: advising, underwriting, brokerage, custody and market making to name a few.

As a consequence of managing deposits and loans banks are constantly challenged to keep the balance between short-term credits and long-term loans i.e. managing the liquidity risk. Keeping this delicate balance is the natural essence of banking. And it is worth mentioning that its risk is comparable to its profitability.

Only the long-term loans allow most of the companies to make investments as building new plants and infrastructure works – such as airports, roads or harbors – to be

[4] < http ://web.worldbank.org/WBSITE/EXTERNAL/TOP ICS /EXTFINANCIA LSECTOR /0 ,,contentMDK:232 24793 ~menu PK:8716800~ pageP K:210058~piPK:210062~theSitePK:282885,00.html > Accessed on 18th July 2015.

completed. Likewise, only long-term loans allow people to buy houses and cars. Thus banks are essential, to individuals, private and State owned companies. Therefore, the interruption of capital flows due to a financial crisis directly affects all sections of the economy and subsequently the welfare.

In order to manage risks and refine the system, banks altogether form a web bounding the “systemic risk“ as Professor J. Dalhuisen precisely defined:

> “(…) they are all closely connected in the interbank credit or whole sale markets and through payment system. They may be connected in many others ways, for example in the repo and swap markets or by having guaranteed each other’s risk in the credit derivatives markets. This raises the issue of *systemic risk* or *financial stability*.” [5]

When a bank shows signs of illiquidity it boosts the systemic risk as it is immediately spread: the domino effect. Additionally banking contracts generally include resolving clauses that are triggered by default; bankruptcy; change of control; or the degradation of risk rating. Thus the collapse of a centennial high street bank may take as long as a few days.

Furthermore, when banks are affected the public will also suffer. Accordingly, the State will be the most concerned party on the stability of the financial system and will enact laws and rules through its regulation bodies. These rules are created in order to combat the market failures and assure the proper performance of the system.

3. ILLIQUIDITY RISK

As per their nature banks constantly face the mismatch between deposits and loans, or assets and liabilities. While depositors may request their deposits at any given moment the loans will be paid in a different timetable, respecting the maturity forecast in the contracts.

The Bank for International Settlements (BIS) defines liquidity[6] as:

> “Liquidity is the ability of a bank to fund increases in assets and meet

[5] DALHUISEN, J. (2010) **‘Transnational Comparative, Commercial, Financial and Trade Law – Volume 3’ 4 ed.** (United Kingdom: Hart Publishing). Page 442.
[6] Basel Committee on Banking Supervision (2008) **’Principles for Sound Liquidity Risk Management and Supervision** ‘(Basel: Bank for International Settlements Press & Communications)

obligations as they come due, without incurring unacceptable losses. The fundamental role of banks in the maturity transformation of short-term deposits into long-term loans makes banks inherently vulnerable to liquidity risk, both of an institution-specific nature and that which affects markets as a whole.

It brings the need to properly manage this cash flow insolvency risk. Financial models are used and the macroeconomic environment must be constantly evaluated. Whenever the public understands that a high street bank may be at risk a bank run will come to existence. As a consequence, liquidity becomes the most important regulatory concern and banks will be required to maintain a capital adequacy.

4. REGULATION

Regulation and law are distinct concepts applied by the State. While the latter protects the individual i.e. consumer or worker by punishing the initiator of force, regulation is the force itself that joysticks voluntary acts of market participants. An example of market participant disturbed by regulation is the entrepreneur. Even though his main objective is to create value the regulation imposed most of the times will challenge the new venture and avoid it coming to existence by creating additional burden.

The United States alone has a cost of about USD 1.75 trillion a year[7] to fund all agencies that regulate its economic affairs, among them: Bureau of Economic Analysis, Bureau of Public Debt and the prevailing Securities and Exchange Commission. This amount does not include the potential benefit that would be brought by innovations that did not come to existence due to obstructive parameters.

Professor Dalhuisen criticizes the existing financial regulation as it aims to reach the stability and the last crisis proved a wrong approach:

> "The true end-objective of financial regulation may well have become the promotion of financial stability, unlikely to be achieved, however, through financial regulation of the present type, to which regular financial crises testify." [8]

The financial system is subject to a regulation that forces financial institutions to accomplish minimum requirements and respect restrictions, aiming to maintain the

[7] BROOK, Y and WATKINS, D. (2012) **'Free Market Revolution'**(USA: Palgrave Macmillan). Page 29.
[8] DALHUISEN, J. (2010) **'Transnational Comparative, Commercial, Financial and Trade Law – Volume 3' 4 ed.** (United Kingdom: Hart Publishing). Page 486.

reliability of the financial system. The most basic concern of regulation is to limit the impact of an externality at the lowest cost to all stakeholders. Thus, regulators will be concerned with the insolvency risk, which is intrinsic to banks.

A regulatory framework which banks must comply with is provided. In addition to that the activity is constantly supervised. Thus the regulation focuses basically on authorisation and supervision. It is clear that in general there is not a daily involvement nor discretionary interventions but well-defined boundaries to work within.

Besides national regulators as the Prudential Regulation Authority and the Financial Conduct Authority in the UK, the Securities Exchange Commission in the United States or the *Comissão de Valores Mobiliários* in Brazil, there are regional regulators as the European Central Bank and global regulators such as the Bank for International Settlements and the Financial Stability Board (established by the G20). All of these entities had an active role managing the outcomes of the recent global crisis.

Although defining the exact way the system should work, none of the regulators were able to anticipate the global turmoil and prevent its happening. Now it seems to be a perfect time to analyze the historical development and discuss how could the most regulated system have entered into such a chaotic situation.

The last crisis almost ruined the economy and this suggests that the current regulation framework and all of its stakeholders were not able to shield the system against it. As per the cyclical nature of crises, it will never be anticipated due to financial innovation. If it is not possible to anticipate a crisis what would be the best way to protect the system?

In general, the main characteristic of regulation is to fight the market failures. A market failure is defined by John O. Ledyard in the Palgrave Dictionary of Economics[9] as occurring when there are too few markets, non-competitive behaviour, or non-existence, leading to inefficient allocations. The market failures are not exclusive of financial markets.

Financial regulation recognizes the market failures and is expected to soften its consequences. According to Goodhart [10], unfolding the main purposes currently pursued by financial regulators will list: (i) to avoid distortions caused by monopoly or oligopoly; (ii) to avoid the systemic risk; and (iii) to protect the customers considering the asymmetry of information available.

[9] DURLAUF, S and BLUME, L (2008) **'New Palgrave Dictionary of Economics** (USA: Palgrave Macmillan).

[10] GOODHART, C., HARTMANN, P., LLEWELLYN, D. (1989) **'Financial Regulation: Why, How and Where Now?'** (London: Routledge).

The abovementioned monopoly is closer to reality in the post-crisis scenario as financial institutions merged in order to survive as the example of Bank of America Merrill Lynch while Leman Brothers sign is no longer in Wall Street. Very few market participants offer some products and lines of businesses, as it is necessary to attain a considerable volume in order to become profitable.

The systemic risk is not easily managed. Banks are constantly getting more and more connected through derivatives contracts. To conclude on the struggle of regulators, the asymmetry of information is even higher regarding new products, the “financial innovations”. While financial institutions are able to apply financial models and predict the results before launching them, the regulator is totally blind to its impact.

The regulation is static, despite its role of guaranteeing the balance and avoiding the systemic risk both in the bonanza and during the crisis. The authorisation for banks to operate and the supervision is motionless. It is not possible then that the same rules will apply in a period of global economic growth and in times when there is absolutely no hope.

5. FINANCIAL INNOVATION

Financial innovation is the conception of instruments or strategies that may create solutions and generate original results. In relation to the traditional contracts and its structures, it may also be described as “unbundling and repackaging these characteristics to create new instruments” [11].

These financial products and structures are developed aiming at first – and obviously – to allow financial institutions to achieve better results and profitability but also at fulfilling the ever greater and more complex needs of the corporations in regards to credit and risk managing. Professor Dalhuisen links financial innovation to regulation:

> “It follows that regulation is always behind or may be ill-focused because it tries to control newer realities which are not fully clear or transparent, whilst aggressive experimentation and innovation are necessary to meet the ever greater demand for credit and financial products of all kind, involving the activation of ever larger pools

[11] GASTINEAU and KRITZMAN (2000) **‘Dicionário de Administração de Risco Financeiro’** (São Paulo: Bolsa de Mercadoria & Futuros). Page 131.

> of liquidity, now especially also at the international level on a mondial scale. The modern idea of and desire for growth would appear to depend on it."[12]

The policy and regulation are directly impacted by financial innovations. At the same time that the regulation is not able to predict the consequences of a new financial instrument prior to its introduction, it might prevent useful innovations in finance. In the words of Michael Haliassos:

> "The recent crisis provides some telling examples. (…) the securitization of mortgages, even of subprime mortgages, and their breakdown into different risk classes that could be disseminated to portfolios around the world was an *a priori* positive development. It was subsequent bad use, lack of transparency, and the failure of rating agencies to assess the risk of securitized products that contributed to the ensuing crisis.[13]

5.1 Securitisation

The securitisations are an example of financial innovation that became massive on financial markets in the last 30 years. Securitising loans is a technique that allows a corporation or a financial institution to leverage its balance sheet using a mechanism that is similar from a secured loan but less transparent. Through this method a company with receivables – such as a bank, telecom or credit card company – known as the originator is allowed to pack these receivables and offer it to the market as a collateralised debt obligation (CDO). The receivables are isolated from the originator not to consolidate into the parent company's balance sheet and become part of a special purpose vehicle company (SPV). These assets are serviced by the payment of the loans by the debtors. The investor of the CDO accepts the counterparty risk that is transferred from the originator.

The first securitisation involving auto loans was established on 1985 by the Certificate for Automobile Receivers Trust and accounted for 60 million US dollars[14]. According to the Bank for International Settlements, by the end of June 2009 there was an estimated of US$ 4.5 trillion worth of securitised assets in the world, while circa 85% were related to

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[12] DALHUISEN, J. (2010) **'Transnational Comparative, Commercial, Financial and Trade Law – Volume 3' 4 ed.** (United Kingdom: Hart Publishing). Page 451.
[13] HALIASSOS, M. (2013) **'Financial Innovation – Too Much or Too Little?** (USA: MIT Press). Introduction, Page ix.
[14] Hearing before the U.S. House subcommittee on Policy Research and Insurance **(1991) 'Asset Securitization and Secondary Markets'** (1991), page 13.

retail finance from the United States [15].

The credit worthiness of these asset-backed securities is evaluated by credit risk agencies and a credit rating is attributed, in general endorsing the acquisition by investors. Besides being qualified as triple-AAA, it is sometimes over collateralised i.e. the package of receivables includes more receivables than its face value. The joint use of these features enhances the quality of the asset-backed security and allows the originators to easily sell it to the market.

As the receivables are excluded from the balance sheet the companies are entitled to improve its credit rating, liquidity and – especially in the case of the banks – be in line with regulatory premises. Nevertheless being legally conceived the development of the securitisations structure was guided by the regulatory deadlocks. In order to keep the capital adequacy required the securitisation was a solution found.

5.2 Credit Derivatives

One of the most important innovations brought by bankers from Wall Street are the credit derivatives. Prior to the 90's there was not a market established. In 1992 JP Morgan pioneered it[16] what later became a USD 62 trillion market in the pre-crisis[17].

Paradoxically the Leman Brothers Guide to Exotic Credit Derivatives[18] clarifies the benefits of using credit derivatives:

> "This growth in the credit derivatives market has been driven by an increasing realisation of the advantages credit derivatives possess over the cash alternative, plus the many new possibilities they present to both credit investors and hedgers. The primary purpose of credit derivatives is to enable the efficient transfer and repackaging of credit risk. In their simplest form, credit derivatives provide a more efficient way to replicate in a derivative format the credit risks that would otherwise exist in a standard cash instrument."

Thus credit derivatives are an alternative to avoid the counterparty risk. The most common credit derivative is the credit default swap (CDS). The owner of an asset that pays interest

[15] The Joint Forum: Basel Committee on Banking Supervision (2011) **'Report on asset securitisation incentives'** (Basel: Bank for International Settlements publications) 2001, page 1.
[16] < http :// www.economist.com/news/ finance-and-economics/ 21571139-insurer-has-done-good-job-rehabilitating-itself-can-it-stand-its-own > AIG: America's Improved Giant. Acces on September 31st 2013.
17 HOSKING, P., COSTELO, M., LEROUX, M. (2008). **'Dow dives as Federal Reserve lines up 75bn emergency loan for AIG'** (London: The Times).
[18] LEMAN BROTHERS (2003) **'Guide to Exotic Credit Derivatives'** (New York: Leman Brothers)

i.e. a British Petroleum 10-year bond purchases credit protection from another entity. This credit protection allows the bondholder to receive its face value back if a “credit event” occurs. A credit event is previously defined and in general includes a failure to pay, bankruptcy, restructuring, change of the currency or moratoria.

The buyer of the CDS shorts the credit risk while the seller goes long in the credit risk. This contract will have a maturity date that can be the redeeming of the bond.

Ironically, the credit derivatives are self-regulated by a private entity. The International Swaps and Derivatives Association (ISDA) was established in 1.985 by the most active financial institutions in the world. The standard documentation regarding derivatives is ruled by ISDA and its main committee is responsible for resolving conflicts in the matter of derivatives. A noteworthy example of the authority of ISDA was the definition if the Greek bonds restructuring in 2013 should be treated as a credit event or not. If yes, bondholders that acquired CDS’s would receive its face value back and the financial institutions that sold the protection would have this bonds transferred to its balance sheets.

Although innovations may agitate the financial markets, the true reason for every crisis is not a new product but the hidden leverage. What the innovation brings either associated with a credit derivative or a securitisation is to make-up leveraged ratios. Leverage in this sense refers to the ratio of debt to equity. As higher the leverage the riskier a company will be. At the same time, leveraging the business will allow bigger profit.

6. FINANCIAL CRISES

Every financial crisis has a cost. The fiscal cost is easily measured, as it is equal to the amount underpaid in taxes. With regards to unemployment and inflation, politicians are there to be blamed.

The balance in between regulating and privileging the free market may anticipate or postpone a crisis. Therefore, the market needs to re-balance itself from time to time allowing the appropriate amalgamations or split-ups to happen. According to the major investor and philanthropist George Soros, both regulation and free market hide imperfections:

> “History has shown that financial markets do break down, causing economic

> depression and social unrest. The breakdowns have led to the evolution of central banking and other forms of regulation. Laissez-faire ideologues like to argue that the breakdowns were caused by faulty regulations, not by unstable markets. There is some validity in their argument, because if our understanding is inherently imperfect, regulations are bound to be defective. But their argument rings hollow, because it fails to explain why the regulations were imposed in the first place. It sidesteps the issue by using a different argument, which goes like this: since regulations are faulty, unregulated markets are perfect. The argument rests on the assumption of perfect knowledge: if a solution is wrong, its opposite must be right. In the absence of perfect knowledge, however, both free markets and regulations are flawed. Stability can be preserved only if a deliberate effort is made to preserve it. Even then breakdowns will occur, because public policy is often faulty. If they are severe enough, breakdowns may give rise to totalitarian regimes."[19]

6.1 Inability to Prevent Crises

The cycle of economic crisis exposes how it is not expected that the Regulator will be able to avoid a new crunch. In the beginning of this century the dotcom bubble brought the chaos to the stock market and consequently to the financial environment. It was possible to learn with the episode and recharge the knowledge regarding a bubble. The economy was back on tracks on 2007 when the subprime originated another liquidity crisis.

Josef Ackerman, in a Deutsch Bank Conference synthetized the feeling that emerged right after the crisis:

> "Indeed, it is the natural instinct of human beings to ask after every catastrophe: What can we do to avoid a repetition of such an experience? The financial crisis is no exception to the rule. It has triggered a strong resolve on the part of market participants, authorities and rule-makers to prevent a recurrence of the events that brought our financial system, indeed our economies close to the point of collapse two years ago." [20]

What is seen after the subprime crisis is a moral discussion regarding the role of banks and should the State deal with these institutions. Following a political agenda the Regulation tends to be even stricter.

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[19] SOROS, G. (1997): **'The Capitalist Threat'** Atlantic Monthly*,* Volume 279, No. 2.
[20] ACKERMAN, J. (2010): **The new architecture of financial regulation: Will it prevent another crisis?**" FMG Deutsche Bank Conference London October 2010.

It is clear that a more extensive regulation is not able to avoid the crisis. Reducing regulation in its current formula may be the best option to keep the economic development on its pace, as the crisis may not be anticipated.

Additionally, Professor Dalhuisen presents the "principled-based regulation"[21]and explores the modern regulation mechanisms that may explain how the system evolved in the recent times. The principled-based regulation differs from the prescriptive rules in which banks are supposed to accomplish a list of requirements. Instead, eleven basic principles must be duly followed: integrity, due skill and care, adequate financial resources, proper market conduct, treating customers fairly, proper use of financial promotions, avoidance of conflicts, suitability of advice, protection of client assets, and active interacting with regulators.

Although it may not be easy to clearly define a breach of principle and punish financial institutions, the principled-based regulation styles a modern regulation and challenges the regulators.

6.2 International Safety Net

In the recent crises banks and corporations were not able to keep the liquidity of the system, even by moving the interest rates. There were too many troubled assets to be cherished. In response to the chaotic scenario of illiquidity all governments had to act and avoid a total disaster.

In the US, a proposal submitted to the House of Representatives in response to the subprime was voted and approved on October 2008. It was enacted into law by the President George W. Bush as the "Emergency Economic Stabilization Act of 2008". Critics would call it the "bailout act" and refer it exclusively to the irresponsive behaviour of bankers and speculators who hunted the profit above anything else.

The law[22] provided authority to the Federal Government to purchase and insure certain types of troubled assets aiming at providing stability and preventing a total disruption of

[21] DALHUISEN, J. (2010) **'Transnational Comparative, Commercial, Financial and Trade Law – Volume 3' 4 ed.** (United Kingdom: Hart Publishing). Page 493.

[22] **Emergency Economic Stabilization Act of 2008** (Public Law 110-343, 122 Stat. 3765, enacted October 3, 2008).

the economy. At the end its intention was to protect taxpayers, but spending up to 700 billion US dollars.

The funds were used mainly to buy distressed assets and supply money straight to the suffering banks and other financial institutions as the American International Group (AIG), an insurance company.

The Emergency Economic Stabilization Act entitled AIG to a credit facility[23] of up to USD 85 billion what allowed the government to take its control. AIG had sold credit derivatives (mainly CDS's) to insure nearly half a trillion US dollars worth of securities holding a triple-A rating. When the assets defaulted it had to pay the face value to investors who bought the CDS's and keep the toxic assets. Interestingly these credit derivatives were sold from AIG's London office.

The American government alone and consequently the American taxpayer disbursed the 700 billion US dollars salvation package.

At the same time the United Kingdom reacted to the crisis and also had a package directed to flood liquidity into UK banks. The government had already nationalised the Northern Rock, after a bank run and the public opinion was already panicked. The Chancellor of Exchequer addressed to the House of Commons on October 8th 2008[24]:

> "A healthy banking system is the cornerstone of the economy – strong banks underpin a strong economy. But many banks, all over the world, don't have sufficient capital. And banks need adequate capital so that they can keep on lending to people. This is why today the Government has established a Bank Recapitalisation Fund – to allow UK banks to increase their capital position. Failure to act would have meant far greater risks to the economy and to the public finances in future."

Correspondingly, governments of Belgium, Luxembourg, France, Germany and Brazil to name a few had their very own plans to support their financial systems. Besides bailing out with new money, stimulus packages were launched and regulatory requirements were reviewed.

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[23] ANDREWS, E., MERCED, M., WALSH, M. (Published on September 16th 2008) **'Fed's $85 Billion Loan Rescues Insurer'** (The New York Times).

[24] http:// web .archive.org /web/ 20081011062730/ http://www.hm-treasury.gov.uk/ statement _chx_081008.htm

Nowadays, subsequent to the extreme internationalisation of trade and complex funding needs of governments, corporations and consumers it is clear that the flows of capital are trans nationalised. The money will follow the trace of goods and services. Companies get funded from overseas, accessing credit facilities or issuing shares and bonds abroad.

Notwithstanding, the financial regulation is still a matter of each State. It will raise a concern on the risks of multiple regulations. Each Central Bank is prepared to act as a lender of last resort[25] when needed. And to date there is not an intergovernmental structure established to protect the global liquidity and react when needed.

An international safety net could align the opinions of each State and guarantee that a reaction to any sign of illiquidity would be faster and more agile. As the assets are spread around the world it does not make sense that only the place of incorporation of a bank would be responsible for it. If regulators from all over the world establish a common net, economy will be safer.

7. CONCLUSION

The banks perform a pivotal role in our society. It is clear that the State does not have the means to offer liquidity and comply with the needs of corporations and consumers. Even the public banks have proved not to be as efficient as the private entities.

Financial institutions have been crucial to the growing complexity of services and for international trade to achieve the magnitude it has today. Questioning the morality of bankers equals to not seeing the whole picture. Financial institutions are the device to feed all engines with liquidity. Without this reorganisation of credit the world as it is would not be feasible.

This is the moment to re-evaluate the consequences of a inflexible regulation. The world foresaw the economic hecatomb and the reasons why the financial system was exposed should serve as a lesson. There must be a balance between the laissez-faire supported by Ayn Rand and the extremely regulated system.

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[25] DALHUISEN, J. (2010) **'Transnational Comparative, Commercial, Financial and Trade Law – Volume 3' 4 ed.** (United Kingdom: Hart Publishing). Page 515.

Regulation has been concentrating its efforts on assuring that the capital adequacy of banks is enough to guarantee that no cash flow insolvency will materialize. Billion of US dollars are spent every year to keep the regulatory entities all over the world.

There are thousands of regulatory requirements that a company must comply with. But these are static. The regulator applies the same rules both in a liquid and in an illiquid financial environment, despite the dynamism of the economy and the fast-changing reality. The motionless rules are not wise enough to deal with financial innovations and highly demanding borrowers and lenders.

In 2015 some countries are still confronting the late consequences of the subprime crisis. Although the United States can now consider this chapter concluded, the recovery in Europe is mixing with the more recent facts in Greece. The lessons were not yet learned at this point and a new challenge is in front of the regulators.

After a crisis of gigantic proportions, the economy should be back in tracks as soon as possible and growing as much as possible in order to allow the faith in the markets to be re-established.

The regulation should be flexible enough to accept that the rules of capital adequacy could be stretched. If financial institutions had lower capital requirements at these times, the credit availability would be closer to the pre-crisis period and the economy would react faster. A principled-based regulation would be more suitable for the elaborate and ever intricate financial relations.

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