Central bank's role and involvement in bank regulation: Lender of last resort arrangements and the Special Resolution Regime (SRR)

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ABSTRACT

This paper considers developments which have necessitated greater involvement and a greater role for the central bank in financial regulation and supervision. The aftermath of the 2007/08 financial crisis has witnessed the enactment of legislation such as the Banking Act of 2009 which has not only introduced greater statutory powers for the central bank, but also the Special Resolution Regime. As well as a consideration of arguments which are in favour of the central bank's role as supervisor and lender of last resort, the importance of central bank independence and safeguards which exist to ensure that sufficient accountability is fostered, will be considered. Safeguards and accountability mechanisms which are adequate, such that, whilst ensuring that the regulator is not susceptible to regulatory capture, do not impede the ability of such a regulator to obtain vital and necessary information from systemically important individual financial institutions. In its support of the view that central banks should assume a greater role in supervision, this paper not only seeks to justify why such a degree of involvement is vital to ensuring and maintaining stability in the financial system, but also those factors which are considered to be necessary if such a role is to be effective.

Central Bank's Role and Involvement in Bank Regulation: Lender of Last Resort Arrangements and the Special Resolution Regime (SRR)

Introduction

In considering the importance of the central bank's independence in prudential supervision and whether such importance necessitates the adoption of legal provisions which would ensure such independence, this paper will commence with a brief overview of developments which have highlighted the growing importance of liquidity. It will then consider existing central bank arrangements in selected jurisdictions and the central bank's role in maintaining stability within the financial system. The next section will focus on developments will have lead to the introduction of the Special Resolution Regime in some jurisdictions whilst other jurisdictions are still deliberating on the matter. Central bank independence, with particular focus on central bank financial and operational independence, will then be elaborated on. This section will also consider arguments in favour of and against central bank independence. The concluding sections comprise of discussions on measures which have been introduced in the aftermath of the recent Financial Crises and why such measures will serve as suitable and necessary complements to previous and present measures aimed at safeguarding central bank independence. In concluding this paper, one of its aims is to highlight the conflicts which exist between the central bank's independence and the goal of maintaining and achieving stability within the financial system– particularly where adequate safeguards are not in place.

Ever increasing importance of liquidity and the role of the central bank as lender of last resort

From the events witnessed during the 2007/2008 Financial Crisis, the increased importance of liquidity, maturity mismatches, and the degree of interconnection between banks, make the central bank's role as a lender of last resort even more important. The ease with which an asset could be traded was also a prominent feature of the Crisis.[1] Even though it has been argued that investment banks are not systemically important[2], any bank which has a high degree of "interconnection" with other banks should be considered systemically important. As the fifth largest investment bank in the US, Bear Stearns played a significant role in the credit default swaps market, acted as prime broker to many hedge funds and was not only a primary dealer in the bond market, but also a counter party to many prominent Wall Street firms.[3] In the words of one Fed official, " Bear Stearns was too interconnected to be allowed to fail at a time when financial markets are extremely fragile".[4]

Central banks' roles as lenders of last resort arrangements and their oversight of systemically vital financial institutions is becoming increasingly acknowledged as a reason for an extension of their involvement in regulation and supervision of the financial system. Some reasons attributed to the central bank's ability to play such a vital role in supervision relate to:[5] Its ability to provide liquidity

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[1] See C Reinhart and A Felton, 'The First Global Financial Crisis of the 21st Century: Part II, June – December 2008 < http://mpra.ub.uni-muenchen.de/13604> at page 5. For further information on how a problem in sub prime mortgages, estimated to be less than 1% of the world's debt stock triggered a series of failures throughout the financial system, see ibid

[2] "In the sense that no investment bank performs tasks that cannot be performed readily and with comparable effectiveness by other institutions" see W Buiter, Central Banks and Financial Crises at page 99.

[3] See K Guha , Fed Moves To Minimise Systemic Risk' *The Financial Times* March 14 2008

[4] ibid

[5] See W Buiter, Central Banks and Financial Crises (Paper presented at the Federal Reserve Bank of Kansas

privately – by virtue of the vast amounts of liquid assets in its reserves; its ability to maintain sufficient liquidity - such that it can manage its business when markets operate at normal levels of liquidity. It also has access to sufficient liquidity through credit lines and swaps, for example.

Maintaining the close involvement of national central banks in prudential supervision has been highlighted by the European Central Bank (ECB) as a vital pre requisite, not only in facilitating the Euro system's adequate contribution to monitoring risks to financial stability in the Euro zone, but also in ensuring smooth coordination between central bank functions which are carried out at supra national level and supervisory functions carried out at national level.[6] It has been observed that since the start of the Crisis, the ECB has complained of a lack of information on banks which have the potential to trigger systemic failures.[7] Further, the existence of legal impediments to the sharing of information between national regulators in the Euro zone and the ECB has been noted.[8] An approach whereby a European system of supervisory agencies consisting of national prudential agencies which would be aggregated within a single supervisory system with cross border structures – similar to the European System of Central Banks, has been proposed.[9] Further, a European prudential supervisory agency would not only be responsible for strategic supervisory decisions, but also the design of policies[10]. It would also assist in the resolution of disputes between home and country supervisors.[11]

The task of harmonisation in the area of bank regulation and supervision in the Euro zone however, appears to be a daunting one. Given the diverse structures of regulation across Euro member states, it is not so difficult to understand why the ECB has no formal supervisory role.[12]The recommendations of the Report of the High Level Group on Financial Supervision in the EU, which are aimed at re building the structure of financial regulation and supervision in the EU, consist of three new elements.[13]

Financial crises such as those of Northern Rock, IKB and Hypo Real Estates in Europe, have lead to a review of arrangements involving the central banks in the jurisdictions concerned. The occurrence of these crises also highlighted the need for a special resolution regime and a "bridge bank" whose aims are to address the needs of failing banks.

City's symposium on "Maintaining Stability in a Changing Financial System", at Jackson Hole, Wyoming, on August 21-23, 2008) at page 31

[6] LB Smaghi, 'Central Bank Independence in the EU: From Theory to Practice' European Law Journal, Vol. 14, No. 4, July 2008, p454

[7] W Buiter, Central Banks and Financial Crises (Paper presented at the Federal Reserve Bank of Kansas City's symposium on "Maintaining Stability in a Changing Financial System", at Jackson Hole, Wyoming, on August 21-23, 2008) at page 113

[8] ibid

[9] See J Lawson and S Barnes and Marte Sollie 'Financial Market Stability in the European Union: Enhancing Regulation and Supervision' Economics Department Working Paper No. 670 page 37 and also D Schoenmaker and S Oosterloo, "Financial Supervision in Europe: A Proposal for a New Architecture", in: L. Jonung, C. Walkner and M. Watson (eds), *Building the Financial Foundations of the Euro - Experiences and Challenges*, 2008 Routledge, London. <http://www.olis.oecd.org/olis/2009doc.nsf/LinkTo/NT00000C9A/$FILE/JT03259984.PDF> (last visited 11 June 2009)

[10] ibid

[11] ibid

[12] See W Buiter Central Banks and Financial Crises at page 113

[13] See W Nier, 'Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis' IMF Working Paper WP/09/70 April 2009 at pages 21 and 22; Also see De Larosière, 2009, "Report of the High-level Group on Financial Supervision in the EU," Brussels, Feb 25, 2009. These elements comprise of a macro prudential authority (ESRC), a micro prudential authority (ESFS) and a consolidation of sectoral committees such as those of the CEBS,CEIOPS and CESR which elevates their status to that of "authorities" which are conferred specific powers aimed at guaranteeing consistent supervision across the EU.

Existing arrangements in Germany and the UK

In contrast to the UK where the Bank of England is not really involved in the supervision of financial institutions, the German Central Bank, the Deutsche Bundesbank, not only assists BaFin in exercising supervision over credit and financial institutions, but is also in charge of ongoing monitoring of credit institutions. Parliament had good reasons for involving the Bundesbank through section 7 of the Banking Act in the banking supervision process.[14]The Bundesbank is involved in basically all aspects of banking supervision and these include:[15]The issuing of general rules such as principles and regulations; undertaking regular surveillance which excludes sovereign and isolated measures directed at institutions – as these are reserved for the Federal Financial Supervisory Authority; banking supervisory audits; ongoing monitoring of institutions[16]; international cooperation in coordination of prudential matters and crisis management roles. Regulators with combined regulatory and supervisory roles such as the Federal Reserve, or supervisory systems where the central bank and regulator are closely involved in supervision, such as that which exists in Germany, are advantageous in that such regulators possess more accurate, complete and timely information about systemically important institutions than those jurisdictions where the central bank has less involvement in regulation.

The Central Bank's Role in Maintaining Stability.

Central bank independence has been the preferred means to facilitating monetary stability since the end of the 1980s and the beginning of the 1990s and factors contributing to this include: Fact that in the EU, the Maastricht Treaty on European Union made legal central bank independence a *conditio sine qua non* to participating in European Monetary Union. This is in addition to the other four criteria of economic convergence and the additional requirements regarding fiscal responsibility. The second factor emanates from the skills, expertise and superior qualifications of central bankers when compared to those of politicians.[17] The separation or combination of the roles of the central bank as lender of last resort and supervisor constitutes a controversial topic. It is argued that whilst a supervisory authority like the Fed Reserve has greater likelihood to possess "institution specific information" which is vital for performing the LLR role effectively, it is also susceptible to regulatory capture.[18] Furthermore, supervisory authorities such as the Bank of England and the European Central Bank are considered to be less vulnerable to the possibility of being captured, but not so well informed about impending liquidity or solvency problems in systemically prone and important financial institutions.[19]

In addition to its monetary policy setting functions, there are many reasons in favour of the central bank also acting as supervisor[20] and these are as follows: That the central bank must have concern for the efficient working of the payments system and that as a result, it should also supervise and regulate at least the main money-market commercial banks at the heart of the system; that any rescue or liquidity crises will usually require quick injection of cash-which can only be done by the central bank. For this reason, it is argued that the central bank and supervisory body work closely together and

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[14] Deutsche Bundesbank, 'Deutsche Bundesbank's Involvement in Banking Supervision' Monthly Report (September 2000) p 34

[15] ibid

[16] This involves the evaluation of documents submitted by institutions; auditors' reports pursuant to section 26 KWG, annual financial statements, as well as performing and evaluating audits of banking operations in order to assess the adequacy of institutions' capital and risk management procedures and the appraisal of audit findings (Division 2 , Section 7 of KWG). Ongoing monitoring of institutions are to be performed by the Bundesbank's regional offices; For more on this, see The Deutsche Bundesbank's Involvement in Banking Supervision Monthly Report September 2000 p 34

[17] See RM Lastra, Legal Foundations of International Financial Stability 2006 45-46

[18] See for example Buiter 'Central Banks and Financial Crises' at page 120

[19] ibid

[20] C Goodhart and D Schoenmaker ' Institutional Separation Between Supervisory and Monetary Agencies ' (Financial Markets Group Special Papers 1992)140-141; CAE Goodhart *The Emerging Framework of Financial Regulation* (1998) 249

that this can best be achieved through internalising the supervisory body within the central bank; and that separation would involve wasteful duplication as there is bound to be a lot of overlap between areas of interest of and information required by and accessible to both the supervisor and the central bank.

Arguments for separation include: Where government financing is required for any large rescue, politicians and the Ministry of Finance are likely to be involved. For this reason, it is important for the central bank to become more independent in the conduct of monetary policy and less politically involved in its supervisory role; that bank failures affect credibility and the central bank requires credibility in conducting its monetary policies; and where concerns for the micro-level health and stability of parts of the banking system might affect the aim of the central bank's conduct of monetary macro-policy – that is, where there is conflict of interest between the combination of monetary and regulatory function.

As a result of its business relationships with credit institutions, its local presence and its general proximity to the market, the Bundesbank has deep insights into the financial sector and possesses knowledgeable, qualified staff who deal with issues relating to the financial market and its stability.[21] It is therefore not surprising that the German Parliament approved the Bundesbank's involvement in banking supervision in section 7 of the Banking Act.[22] As well as being involved in the supervisory process, the Bundesbank is also involved in matters relating to supervisory policy-making. As a member of the Financial Markets Regulatory Forum, it is acknowledged as an authority that together with BaFin is responsible for the stability of the financial system.[23]

As a result of the Bank of England Act 1998[24], the Bank of England has a limited role in the regulation and supervision of banks. A review of the extent of the Bank of England's role in bank regulation has achieved partial realisation with the introduction of the 2009 Banking Act.

The Need for a Special Resolution Regime

The Northern Rock crisis highlighted problems which were inherent in the tripartite arrangement between the Treasury, the Financial Services Authority and the Bank of England for dealing with financial stability which includes amongst others, the inability of the Bank to act as lender of last resort for a limited time without such a role being made public. The consultation paper issued in July 2008,[25] as a response by the authorities to the Northern Rock Crisis and to strengthen the U.K. framework for financial stability, envisaged a leading role for the Bank of England in the implementation of a special resolution regime for banks.[26]

The establishment of a "special resolution regime" which should enable the seizure of a failing bank and facilitate all or part of its business to be transferred to a "bridge bank" which would manage services for customers, is also a consequence of the Northern Rock crisis.

The Banking Act 2009 received Royal Assent on the 12 February 2009 – legislation having been introduced into Parliament on the 7 October 2008.[27] As well as formalising the role of the Bank of

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[21] http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_bafin.en.php (last visited 11 July 2007)
[22] ibid
[23] ibid
[24] Whereby powers related to the supervision and regulation of banks were transferred to the Financial Services Authority
[25] HM Treasury, Bank of England and FSA, 2008, "Financial Stability and Depositor Protection: Further Consultation," July 2008.
[26] See W Nier, 'Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis' IMF Working Paper WP/09/70 April 2009 at page 21
[27] See <http://www.hm-treasury.gov.uk/fin_banking_act2009.htm> (last visited 7 June 2009)

England in its oversight of systemically vital payment systems, the Banking Act 2009 has also resulted in statutory powers being granted to the Bank of England, in respect of its responsibility for financial stability.[28] The Act is divided into eight sections which deal with the special resolution regime, bank insolvency, bank administration procedures, inter bank payment systems and the Financial Compensation Scheme.

The special resolution regime, which constitutes the focal point, in respect of measures aimed at dealing with failing banks, is the new statutory and permanent regime which consolidates temporary measures introduced by the Banking (Special Provisions) Act 2008 (BSPA) which was implemented as a means of exercising control and bringing Northern Rock into temporary public ownership in February 2008. According to Part 1, section 1 (1) of the Act, the purpose of the special resolution regime for banks is to address the situation where all or part of the business of a bank has encountered, or is likely to encounter financial difficulties. The special resolution regime consists of [29] three stabilisation options,[30] the bank insolvency procedures[31] and the bank administration procedures.[32]

The Act not only consolidates the tripartite arrangement as established under the 2006 Memorandum of Understanding, but is also evidential of the extension of the Bank of England's role in the supervisory process .[33] This is reflected in sections such as those of 7 and 8 of the Act, which clarify responsibilities in relation to the exercise of powers. In respect of bank insolvency procedures, an insolvency order may be made only on the application of the FSA with the consent of the Bank of England, or on the application of the Bank of England.[34] Further, before exercising insolvency powers in respect of a residual bank, the FSA is required to give notice to the Bank of England.[35]

Central Bank Independence

Central bank independence is considered as a means of achieving the goal of price stability.[36] It is also interesting to note that Lastra recommends the inclusion of regulatory powers in any law which truly safeguards independence.[37] This would infer that central bank independence would be ensured if the central bank was responsible for both monetary policy setting and regulatory functions – hence price stability would be better facilitated through a central bank whose powers not only consisted of monetary policy setting functions, but also of regulatory and supervisory functions. The strong record held by the *Deutsche Bundesbank* and in particular, the pre-1999 *Bundesbank* in maintaining price stability is reiterated.[38] However, the difficulty in finding a central bank whose independence is absolute is also noted.[39] In as much as certain events and developments make it difficult to ensure that

[28] Regulatory and supervisory responsibilities had been formally passed to the Financial Services Authority (FSA) under the Bank of England Act 1998

[29] Section 2 of the Act

[30] See section 1 (3a-c) : These are a) transfer to a private sector purchaser b) transfer to a bridge bank, and c) transfer to temporary public ownership

[31] As stated under Part 2

[32] As provided under Part 3

[33] See < http://www.fsa.gov.uk/pubs/mou/fsa_hmt_boe.pdf>

[34] See section 117(2) of the Act

[35] See section 157 of the Act

[36] See RM Lastra, *Legal Foundations of International Financial Stability* 2006 45-46

[37] ibid at page 46

[38] ibid at pages 51-61

[39] The Bundesbank's scope for independence has been restricted as a result of two major developments namely: The German unification and the European Monetary Union. In the case of German unification, the issue concerned national identity, not price stability. The Exchange Rate Mechanism of the European Monetary System was sacrificed in order to achieve the greater national objective of unifying the German people. With regards to the European Monetary Union, supranational integration was held to be more important for the future of the German nation than the maintenance of an independent central bank. For further information on this, see ibid at 58-61. Lastra highlights the fact that the independence of the Bundesbank has seldom been sacrificed on the basis that the economy was suffering.

a central bank's independence is absolute, developments such as conglomeration and globalisation have warranted the need for the involvement of a single regulator. However, this is a function which if not absolutely carried out by the central bank, should still, to a great extent, involve the central bank.

There appears to be greater support for central bank independence when compared with independence granted to supervisory and regulatory agencies. Even though there is and there has been support for central bank independence – particularly with reference to independence from political interference, there is still some reluctance to grant independence to financial regulators and supervisors.[40] According to Hüpkes and others, it is more difficult for financial regulators to design accountability arrangements than it is for central banks.[41] In their opinion, the reluctance by policy makers to grant independence to supervisory and regulatory agencies is attributed to three factors.[42]

The significance of central bank financial independence as a component of overall independence has been emphasised by the European Union.[43] According to Buiter[44] two types of central bank independence exist, namely, target independence and operational independence. Four aspects of central bank independence are considered by Smaghi[45]namely, functional, institutional, personal and financial independence. For the purposes of the discussion in this paper, operational and financial independence will constitute the focus of discussion.

Central bank Financial Independence

Financial independence involves the independence of the central bank - when considered from the perspective of the funding of its activities and the exercise of its powers.[46] In Amtenbrink's view, the central bank's legal basis may facilitate a system whereby a government which has been elected democratically determines the boundaries within which the central bank should decide on an actual capital increase.[47] However, the success of such an arrangement would be dependent on the existence of a key factor, namely, the bank's independence from the government at the time when the actual need for re capitalisation occurs.[48] Furthermore, central bank financial independence would be safeguarded where the central bank is not dependent on the government's general budget but is able to address the needs of its financial operations through its own generated income.[49]

According to Smaghi,[50] legal provisions alone are generally not adequate to guarantee the appropriate level of central bank independence – the respect for independence and its boundaries, amongst parties

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[40] See EHGHüpkes, M Quintyn, M Taylor, 'The Accountability of Financial Sector Supervisors: Theory and Practice 2006 at page 1

[41] ibid, preface

[42] ibid at page 1; The three factors include: Firstly, the fact that independent regulatory and supervisory agencies could become another branch of government which is not subject to the same level of scrutiny as that which is prescribed to the executive, legislative and judicial branches. Secondly, without adequate regulatory oversight, regulators may favor industry interests over those of the public – hence facilitating the possibility of a "regulatory capture" occurring. Thirdly, self interest may contribute to policy makers' reluctance to giving up their oversight functions.

[43] See P Stella and A Lönnberg, ‚Issues in Central Bank Finance and Independence' IMF Working Paper WP/08/37 and in particular, the European Monetary Institute's report EMI (1998) "Convergence report" at page 295

[44] See W Buiter, 'What's Left of Central Bank Independence?' < http://blogs.ft.com/maverecon/2009/05/whats-left-of-central-bank-independence/> (last visited 10 June 2009)

[45] See LB Smaghi, 'Central Bank Independence in the EU: From Theory to Practice' European Law Journal, Vol. 14, No. 4, July 2008

[46] See R Smits, 'European Central bank Institutional Aspects' 1997 Kluwer Law International at page 157

[47] F Amtenbrink, 'Securing Financial Independence in the Legal Basis of a Central Bank' at page 6

[48] ibid

[49] ibid

[50] See LB Smaghi, 'Central Bank Independence in the EU: From Theory to Practice' European Law Journal, Vol. 14, No. 4, July 2008, p. 446

involved, also being an important factor . He considers four elements of central bank independence, namely, functional, institutional, personal and financial independence.[51] Furthermore, he goes on to state that:

"The concept of financial independence should therefore be assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over the tasks of a central bank but also over its ability (understood both operationally, in terms of manpower, and financially, in terms of appropriate financial resources) to fulfil its mandate."[52]

Ensuring absolute independence with central bank financial independence also constitutes a difficult task. This is illustrated by the close links which exist between the central bank and the Treasury in many countries. Is it possible for a central bank to operate effectively - given the presence of absolute independence? The importance of close collaboration and exchange of information between the tripartite authorities in the UK (the FSA, the Treasury and the Bank of England) was highlighted by the Northern Rock Crisis. These, if effective as they should have been, could have helped, not only in identifying the problems which existed at Northern Rock[53], but to facilitate timely intervention which would have averted the scale of the crisis.

Operational independence

This is defined as "…the freedom or ability of a central bank to pursue its objectives (regardless of who sets them) as it sees fit, without interference or pressure from third parties."[54] In order for such independence to be effective, it is also argued that freedom from political influences is vital.[55] As is the case with financial independence, absolute independence is extremely rare given the fact that the central bank, in many jurisdictions, is connected in one way or the other to the State and the sovereign. Illustrating with the scenario which exists in the UK, the central bank is owned by the Treasury[56] and several checks, for example, the role of the Treasury in underwriting risk attending emergency lending, are vital to ensuring accountability in matters relating to the central bank's position.[57] Furthermore, regional and global developments are factors which may contribute to the status of independence attained by a central bank. For instance, the Bundesbank's scope for independence has been restricted as a result of two major developments namely: The German unification and the European Monetary Union.[58]

Arguments for and against central bank independence

Arguments in favour

1) Need to ensure that central bank can act freely in pursuit of its objectives without interference from political pressures or other third parties.

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[51] ibid

[52] ibid at 452

[53] It should be added that a lot of factors contributed to Northern Rock's collapse – amongst which are the inadequacies of the measurements under Basel 2 and issues related to liquidity.

[54] See W Buiter, 'What's Left of Central Bank Independence?' < http://blogs.ft.com/maverecon/2009/05/whats-left-of-central-bank-independence/> (last visited 10 June 2009)

[55] ibid

[56] W Buiter Central Banks and Financial Crises (Paper presented at the Federal Reserve Bank of Kansas City's symposium on "Maintaining Stability in a Changing Financial System" at page 40

[57] See P Stella and A Lönnberg, 'Issues in Central Bank Finance and Independence' IMF Working Paper WP/08/37

[58] See RM Lastra, *Legal Foundations of International Financial Stability* 2006 at page 58

Where operational independence exists, excessive interest rate cuts resulting from political pressures could be avoided.[59] However, excessive interest rates cuts may not be consequential of political pressures as they may arise through the application of the precautionary principle.

Other factors which may contribute to excessive interest rate cuts include extreme sensitivity to matters relating to the financial sector (which indicate "cognitive regulatory capture") and failures by strategic members of the FOMC to comprehend adequately the way in which the interest rate mechanism should operate (hence an inappropriate application of the mechanism)[60]. At times of high uncertainty, appropriate application of the interest rate mechanism as a tool of monetary policy should be timely, decisive and flexible and should focus on the principal risk.[61]

Arguments against

1) This could lead to abuse of powers. The level of independence granted should correspondingly be justified by sufficient checks and balances.
2) Regulatory capture: Bank collapses such as BCCI and Barings raised concerns regarding the ability of the Bank of England , as supervisor to separate itself adequately from the culture of the banking industry in order to enable it function as a truly independent supervisor and regulator.[62] Due to lack of transparency, the kind of regime under which the Bank of England operated then, as regulator, a regime of informal and negotiated enforcement, was prone to two forms of abuse.[63] Firstly, it could degenerate into the capture of the regulatory system by the regulated, and secondly, it could conceal selective enforcement and possible harsh treatment of less significant regulatees.[64]
3) Close collaboration with other authorities may be vital to ensuring that complete, adequate and timely information relating to systemically relevant individual institutions is obtained.

Provided adequate balances and checks are in place to guard against any abuse that could result from a grant of independence, impediment to close collaboration between regulatory authorities should be overcome. Furthermore, adequate mechanisms of accountability should help to avoid a situation whereby regulatory capture could occur.

Having highlighted the fundamental role contributed by central banks to the regulatory and supervisory process and the importance of central bank independence, measures aimed at safeguarding an extension of such powers should be in place.

Measures adopted in the aftermath of the recent crises

Following the introduction of the 2009 Banking Act in the UK, the following measures which are aimed at ensuring greater independent accountability, have been adopted correspondingly with an extension of the Bank of England's powers in regulation:

1) A new Financial Stability Committee (FSC), which is a product of the Act and which is a sub committee of the Court of Directors.[65] It comprises of the Governor of the Bank, deputy

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[59] W Buiter, Central Banks and Financial Crises (Paper presented at the Federal Reserve Bank of Kansas City's symposium on "Maintaining Stability in a Changing Financial System" at page 113
[60] ibid at pages 113,114
[61] See ibid pages 53 and 54; For further information on optimal decision making under uncertainty and whether regulator's focus should be directed at extreme risks, also see ibid at page 54
[62] See Treasury and Civil Service Committee, Sixth Report: "The Regulation of Financial Services in the UK" House of Commons, (1994-1995) 332 para 108
[63] C Hadjiemanuil, *Banking Regulation and the Bank of England* 1995 Lloyds of London Press at page 182
[64] ibid
[65] see < http://www.bankofengland.co.uk/publications/news/2009/048.htm> (last visited 11 June 2009)

governors and four non executive directors appointed by the chair of the Court.[66] The functions of the Committee as stipulated in the Act are:[67] To make recommendations to the Court of Directors, which they shall consider, about the nature and implementation of the Bank's strategy in relation to the Financial Stability Objective; to give advice about whether and how the Bank should act in respect of an institution, where the issue appears to the Committee to be relevant to the Financial Stability Objective; in particular, to give advice about whether and how the Bank should use stabilisation powers under Part 1 of the Banking Act 2009 in particular cases; to monitor the Bank's use of the stabilisation powers; to monitor the Bank's exercise of its functions under Part 5 of the Banking Act 2009 (inter-bank payment systems), and any other functions delegated to the Committee by the Court of Directors for the purpose of pursuing the Financial Stability Objective.

2) Efforts are being undertaken to facilitate the Bank's access to supervisory information with the Treasury indicating that the Bank will be able to make recommendations to the FSA in respect of its framework for regulation and supervision.[68]

3) The Turner Review which not only elaborates on ways in which responsibilities of a macro prudential nature could be allocated between the Bank and the FSA, but also on how this could be implemented.[69]

In Germany, the perception that the allocation of responsibilities between the *Bundesbank* and BaFin had lacked clarity and transparency resulted in the issue of a new Memorandum of Understanding in February 2008.[70] This followed a series of government bailouts of state owned banks in 2008 – which in part, was attributed to the systemic importance assumed by such banks and the potential disastrous consequences which could occur if they had been allowed to fail.[71] Close links exist between member banks of the German Savings Banks Finance Group (Sparkassen-Finanzgruppe) and as long as they are in the position to do so, they are required to bail each other out. The problem which existed at the time resulted from the fact that many of these banks were facing financial difficulties – hence were not in the position to assist other member banks.[72]

The crisis faced by IKB, Landesbanken and Hypo Real Estates not only revealed an absence of a special resolution regime for banks, but also raised the issue of optimal measures which could be implemented to control (in part) privately owned, but publicly-sponsored or (in part) publicly owned financial enterprises.[73]

Counter cyclical instruments

As well as a consideration of the Special Resolution Regime and central bank independence, the need to adopt counter cyclical instruments has been brought to the fore as a result of the flaws inherent in Basel 2. According to Goodhart[74], "Central banks cannot achieve price and financial stability with one

[66] ibid
[67] ibid
[68] See W Nier, 'Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis' IMF Working Paper WP/09/70 April 2009 page 21
[69] ibid
[70] See W Nier, 'Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis' IMF Working Paper WP/09/70 April 2009 at pages 21 and 22
[71] http://www.spiegel.de/international/business/0,1518,536635,00.html
[72] ibid
[73] W Nier, 'Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis' IMF Working Paper WP/09/70 April 2009 at page 22
[74] CAE Goodhart., "Central banks' function to maintain financial stability: An uncompleted task," VoxEU.org (June 24, 2008), http://www.voxeu.org/index.php?q=node/1263.

instrument (interest rates). A counter-cyclical regulatory system is needed to dampen asset booms and to smooth busting bubbles". Problems resulting from a reliance on the interest rate as an instrument of monetary policy were revealed through the failure of the ECB and the Bank of England to implement such an instrument to organise a "substantially globally coordinated interest rate cut in 2008.[75]

Counter cyclical instruments such as the Spanish pre-provisioning measures and the use of time varying loan to value (LTV) ratios have been identified as the only counter cyclical instruments which currently operate.[76] Goodhart highlights the fact that accounting standards such as those of the IFRS and the IASB have impeded the potential of the Spanish pre provisioning measures.[77] Furthermore, criticisms in introducing counter cyclical variations in LTVs or capital/liquidity requirements have also been highlighted.[78]

Conclusion

Given these considerations, it could be deduced that preventive measures such as those of interest rate facilities and counter cyclical measures should not be relied on, in their entirety. For legal provisions to function effectively, safeguards aimed at ensuring central bank independence are not only necessary, respect for such safeguards is required. As highlighted in the introduction, adequate balance will have to be struck by ensuring that accountability mechanisms, whilst not placing regulators in a position where they become prone to "capture", are also implemented and applied to facilitate the necessary level of information interchange between the regulator and regulated institutions. The need for remedial measures such as that of the special resolution regime become all the more important. Whilst it is evident that necessary action should be undertaken to prevent a scenario where remedial measures should be implemented, it is also necessary to have precautionary measures.

According to Paramo[79], a line should be drawn between both (what the central bank can and cannot do) "..in terms of the goals that specific measures are designed to achieve (which should be compatible with the mandate of the central bank) and in terms of the level of risk taken (which should be compatible with the ability of the central bank to absorb risk without jeopardising its financial independence)".

Central banks have vital roles to play in the maintenance of price stability, achieving and maintaning stability within the financial system, and the provision of liquidity. As well as the possibility of the central bank assuming roles as catalysts for private rescue measures, a coupling between extraordinary liquidity measures and non standard monetary policy measures has been recommended.[80]

[75] The 8 October 2008 cut was considered to be extremely inadequate, See J Muellbauer, 'The Folly of the Central Banks of Europe' October 2008 <http://www.voxeu.org/index.php?q=node/2488> (last visited 10 June 2009)

[76] See Goodhart, Charles A.E., "Central banks' function to maintain financial stability: An uncompleted task," VoxEU.org (June 24, 2008), http://www.voxeu.org/index.php?q=node/1263.

[77] ibid

[78] ibid

[79] J González-Páramo, 'Managing risk: The role of the central bank in a financial crisis' Speech given at Risk Europe 2009 Frankfurt am Main, 4 June 2009 <http://www.ecb.int/press/key/date/2009/html/sp090604.en.html>

[80] ibid