Global Bank Regulation
Dedications:

For Pete, Steve, Thor and John (H.M.S.)

For J.B., as always (M.W.T.)

Acknowledgments:

We thank our editor at Elsevier J. Scott Bentley for his patience and encouragement from the very beginning to the much delayed end of this project. We are also grateful to Elsevier’s production team, including Melinda Rankin, for assistance in seeing this book through the press. We also thank various anonymous referees for their thoughtful input; David Llewellyn and Howell Jackson for their support; and Timothy Mueller for his excellent research assistance. Students in various classes that we have taught over the years have helped us to refine individual chapters and the concept of the book. To our families, we are grateful for their forbearance (which when not practiced by regulators is a virtue).
## Contents

*Introduction: The Global Financial System and the Problems of Regulation*  xi

1. **The Changing Nature of Banks**  1
   - Definitions  2
   - Money, Credit Creation, and Fractional Reserve Banking  3
   - Financial Innovation and the Changing Nature of Banks  7
   - Three Distinctive Features of Modern Banking  11
   - References  17
   - Further Reading  17

2. **Panics, Bank Runs, and Coordination Problems**  19
   - The Structure of Banks’ Balance Sheets  20
   - Coordination Problems and Bank Runs  24
   - Panic and Contagion in Modern Financial Systems  27
   - Free Riders and Regulation  32
   - References  34
   - Further Reading  34

3. **Collapsing Dominos and Asset Price Spirals**  35
   - Collapsing Dominos  36
   - Asset Price Spirals  42
   - The Global Financial Crisis of 2007–2009  45
   - References  49
   - Further Reading  49

4. **The Financial Safety Net and Moral Hazard**  51
   - The Financial Safety Net  53
   - Moral Hazard  60
   - Is There an Alternative?  67
   - References  70
   - Further Reading  72
### 5. Sources of Financial Regulation

- National Laws  74
- International Law  76
- References  87
- Further Reading  88

### 6. Bank Licensing and Corporate Governance

- The Purpose of Bank Licensing  92
- The Fundamentals of Bank Licensing  95
- Fitness and Propriety of Bank Management  97
- Significant Changes in Ownership  99
- Choice of Bank Charter  100
- Cross-Border Issues  103
- Principles of Sound Corporate Governance  105
- Sarbanes-Oxley Act of 2002  107
- References  109
- Further Reading  110

### 7. Bank in Corporate Groups: Ownership and Affiliation

- Bank-Commerce Linkages  112
- The Separation of Banking and Finance  121
- Changes to Structural Regulation of the Combination of Banking and Other Financial Services  124
- References  129
- Further Reading  130

### 8. The Rationale for Bank Capital Regulation

- Why Regulate Bank Capital?  132
- Leverage Ratios  135
- Risk-Weighted Capital  137
- Criticisms of the Basel Capital Accord  141
- References  144


- The Standardized Approach  149
- The Internal Ratings-Based (IRB) Approaches  152
- Dealing with Financial Innovation  159
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>References</td>
<td>164</td>
</tr>
<tr>
<td>Further Reading</td>
<td>164</td>
</tr>
<tr>
<td><strong>10. The New Capital Adequacy Framework: Basel II and Other Risks</strong></td>
<td>165</td>
</tr>
<tr>
<td>Market Risk</td>
<td>166</td>
</tr>
<tr>
<td>Operational Risks</td>
<td>174</td>
</tr>
<tr>
<td>Pillar 2 Risks</td>
<td>177</td>
</tr>
<tr>
<td>References</td>
<td>182</td>
</tr>
<tr>
<td>Further Reading</td>
<td>182</td>
</tr>
<tr>
<td><strong>11. Direct Limits on Banks’ Risk Taking</strong></td>
<td>183</td>
</tr>
<tr>
<td>Credit Concentration Risk</td>
<td>184</td>
</tr>
<tr>
<td>Liquidity Risk</td>
<td>193</td>
</tr>
<tr>
<td>References</td>
<td>202</td>
</tr>
<tr>
<td><strong>12. Consolidated Supervision and Financial Conglomerates</strong></td>
<td>205</td>
</tr>
<tr>
<td>What Is Consolidated Supervision?</td>
<td>208</td>
</tr>
<tr>
<td>The Need for Consolidated Supervision</td>
<td>211</td>
</tr>
<tr>
<td>Consolidated Supervision of Cross-Border Banks</td>
<td>215</td>
</tr>
<tr>
<td>Financial Conglomerates</td>
<td>216</td>
</tr>
<tr>
<td>References</td>
<td>222</td>
</tr>
<tr>
<td><strong>13. Anti-Money Laundering</strong></td>
<td>223</td>
</tr>
<tr>
<td>What Is Money Laundering?</td>
<td>224</td>
</tr>
<tr>
<td>The Impact on Banks</td>
<td>225</td>
</tr>
<tr>
<td>International Response</td>
<td>226</td>
</tr>
<tr>
<td>Banco Delta Asia Case Study</td>
<td>235</td>
</tr>
<tr>
<td>References</td>
<td>238</td>
</tr>
<tr>
<td>Further Reading</td>
<td>239</td>
</tr>
<tr>
<td><strong>14. Bank Insolvency</strong></td>
<td>241</td>
</tr>
<tr>
<td>The Goals and Types of Bank Insolvency Regimes</td>
<td>243</td>
</tr>
<tr>
<td>Legal Framework for Bank Insolvency</td>
<td>245</td>
</tr>
<tr>
<td>Determination of Insolvency</td>
<td>245</td>
</tr>
<tr>
<td>Administration Orders and Conservatorships</td>
<td>246</td>
</tr>
<tr>
<td>Receivership</td>
<td>247</td>
</tr>
<tr>
<td>References</td>
<td>258</td>
</tr>
<tr>
<td>Further Reading</td>
<td>258</td>
</tr>
</tbody>
</table>
15. **Institutional Structures of Regulation** 259
   - Institutional and Functional Regulation 260
   - Rise of the Integrated Regulator 265
   - Twin Peaks (Objectives) Approach 267
   - Role of the Central Bank in Bank Supervision 269
   - Evaluation of Structural Reforms 273
   - References 276
   - Further Reading 277

16. **Regulation After the Global Financial Crisis** 279
   - The Causes of the Crisis 280
   - Rethinking the Assumptions of Regulation 284
   - New Directions in Capital Adequacy 286
   - More Radical Options 289
   - The International Dimension 292
   - References 294

*Appendix: Introduction to Regulation and Market Failure* 297
*Index* 307
We've decided to write off 47 billion dollars in bad loans.

You might think this is my fault. But in actuality it is all caused by poor regulatory oversight.

Who is in favor of those guys taking a big pay cut? Anyone?