**Crisis, Risk and Regulation**

**Synopsis**

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1. A brief look at some of the literature on risk points in two directions. One is at the need to take risks to progress; the other, that risk-taking has adverse consequences should be controlled or managed. Regulation has to balance this.
2. Early trade saw the separation or physical and financial risk-taking and the development of insurance as a means of managing the risks and uncertainties of sea trade. Insurance (and reinsurance) was a means of spreading risk.
3. More recently we have seen that more complex arrangements for spreading risk became opaque. Thus the risk-takers, here reinsurers in the London market in the 1980s, found that certain instruments had the effect of concentrating rather than dispersing risk. This was the "LMX spiral" which resulted in an unexpected aggregation of losses and consequent collapses of some reinsurers. Perhaps an early lesson in the consequences of a lack of transparency in financial instruments. Note that the intermediaries arranging these transactions did not run the transaction risk but benefitted from the commission.
4. At the turn of the millennium, there were moves to build an integrated financial market in the European Union. The European Commission's Financial Services Action Plan sought to ensure a Single Market for wholesale financial services, open and secure retail markets and state-of-the-art prudential rules and supervision. The Report by the Committee of Wise Men, chaired by Alexandre Lamfalussy laid out a series of proposals including regulatory reform.
5. There are 31 references to risk in Lamfalussy: they are mainly about risk warnings for customers and risk capital for SMEs. There are no references to risk management.
6. Lamfalussy led to the creation of the "Level 3 Committees". CESR CEBS and CEIOPS.
7. In 2008 came the financial crisis. Some commentators drew parallels with the LMX spiral crisis at Lloyd’s of London in the 1990s. In both instances the opacity of the relevant financial instruments (reinsurance policies; mortgage securitisations) played a part.
8. What are the risks that we need to regulate? And how do you classify them? Not to digress too much, lawyers and economists perhaps classify them differently.
9. The crisis led to the de Larosière report in 2009: Towards a new regulatory agenda: to reduce risk and improve risk management; towards stronger coordinated prudential supervision; towards effective crisis management procedures; to build confidence among supervisors. The report considered the crisis and made a number of recommendations.
10. De Larosière makes 131 references to risk: risk assessment; risk factors; risk exposure, risk-taking and risk concentration; risk monitoring; risk management and risk control; credit risk; liquidity risk; systemic risk. There are 25 references to risk management.
11. The de Larosière report led to the Commission's proposal in May 2009 for a European System of Financial Supervisors (ESFS) which included the transformation of the existing level three Lamfalussy Committees into new European Supervisory Authorities. ESMA is the authority for securities and markets.
12. The creation of ESMA and the powers provided to it are thus in a sense a regulatory response to the need to manage risk. Risk management through regulation.
13. ESMA's founding regulation refers to the need, in order to safeguard financial stability, to identify early, potential risks and vulnerabilities: micro-prudential, across borders and across sectors, and to monitor and assess this in the area of its competence. Systemic risk and cross-border risk are specifically identified, and ESMA has to have specific regard to systemic risks in carrying out its tasks.
14. ESMA and the other ESAs have a range of powers within the framework of the European institutions and relevant European sectoral legislation, to draft technical standards; to issue guidelines and recommendations, and opinions, and  other tools to promote convergence between national regulators. It can also take direct action in certain circumstances.
15. Unlike the other ESAs ESMA also has direct supervisory responsibility over credit rating agencies and trade repositories in Europe.
16. ESMA's intervention powers in respect of short selling include the power to prohibit entry into short-selling transactions. The lawfulness of certain of these provisions were upheld in the recent judgment of the Court of Justice in *UK* *v. Parliament and* *Council,* case c-270/12 (2014) in the context of the *Meroni* doctrine.
17. At a more specific level, EMIR is concerned with counterparty credit and operational risk in CCPs and requires a CCP to have a sound risk-management framework to manage specified risks. Thus specific technical standards lay down risk-mitigation requirements for OTC derivatives not cleared by a CCP.
18. To sum up: ESMA may be seen as one outcome of plans to manage through regulation the risks which were considered to underlie the 2008 financial crisis.

**Some useful references are given below.**

What is risk? (Stern business school): <http://people.stern.nyu.edu/adamodar/pdfiles/valrisk/ch1.pdf> \*

Risk Taking: A corporate Governance Perspective: IFC, 2012 <http://www.ifc.org/wps/wcm/connect/9ff11a804c40464698dddaf12db12449/RiskGovJuly2012.pdf?MOD=AJPERES>

The Report of the Committee of Wise Men (Lamfalussy) <http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf>

               4. THE NECESSARY EUROPEAN RULES ARE MISSING \*

               6. THE MAJOR PROBLEM: THE CURRENT REGULATORY SYSTEM IS NOT WORKING \*

Lloyd's of London's collapse has lessons for today's crisis: <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/insurance/4613377/Lloyds-of-Londons-collapse-has-lessons-for-todays-crisis.html> \*

The game of ‘Pass the Risk’: Then and now by Joy A. Schwartzman: <https://www.soa.org/library/essays/rm-essay-2008-schwartzman.pdf> \*

The de Larosiere Report <http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf>

Paragraphs 6-37 The Causes of the Financial Crisis; \*

Paragraphs 62-82: Regulatory repair \*

Legal Risk in the Financial Markets, Roger McCormick, Oxford, 2nd ed, 2010

The ESMA Regulation:

<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32010R1095&from=EN>

Recitals 1 to 3, Articles 1, 60, 61\*

The Credit Rating Agencies Regulation (consolidated):

<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02009R1060-20130620&rid=1>

Recitals 1, 2, 9, 10; Article 23e \*

Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (The European Market Infrastructure Regulation - EMIR)

<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN>

Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012. . .  with regard to regulatory technical standards on indirect clearing arrangements . . . and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:EN:PDF>