

BOOK REVIEW

Principles of Banking Regulation, by Kern Alexander, (Cambridge: Cambridge University Press, 2019), xxii + 473pp., hardback, ISBN: 978-1-108-42726-5.

Aims and objectives

Professor Dr Kern Alexander from the University of Zurich delivers a single-authored analysis of the main principles and rules of banking regulation, covering the most recent international, European and UK regulatory developments. Further, the author studies the impact of such regulation on banks' governance, compliance, risk management and strategy. Alexander's aims are to provide an analysis of the concepts and practices of banking regulation having emerged after the 2007–08 global financial crisis and to analyse critically the new regulatory terrain as of January 2018 and whether it is achieving its objectives.¹ In accomplishing his aims, the author takes multiple steps by explaining the rationale and economic and legal theories of banking regulation working with an inter-disciplinary perspective across law, economics, finance, management and policy studies. The book analyses all of the main post-crisis regulatory reforms including the 2017 amendments to Basel III, known as Basel IV, Brexit, regulatory initiatives concerning environmental sustainability and climate change, as well as regulatory reforms to govern bank mis-selling. In doing so, Alexander also considers macro-prudential regulation which has become an overarching theme for banking supervision developed by the global standard setters and applied, for example, in the EU concept of a banking union with the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF) as well as the Single Deposit Guarantee Scheme (SDGS).

Setting the stage

Preface

The author chooses a risk-based explanation for the need to regulate banks, pointing out that banking regulation is important to manage risks efficiently which benefits society economically but if mismanaged may result in economic costs for society. His book is about the regulatory principles, standards and legal frameworks that govern the banking business. Obviously, Alexander refers to the global financial crisis of 2007–08 as the trigger to transform banking regulation dramatically. Here, the author excels in identifying the most relevant aspects of international regulatory reforms capturing the reader's interest.² This task shall not be underestimated given the complexity of standard-setting as well as its implementation at global, supranational and national level covering general banking supervision, financial stability and specialist regimes like securities regulation or financial crime. Perhaps in Alexander's plea that banks must manage financial risks one could have also included non-financial risks (in particular compliance, information technology, cybersecurity) which have become significant in the management and supervision of banks. Based on the enormous losses some banks have recently experienced in the area of non-financial risks, banking supervisors expect banks to identify their potential non-financial risks in the context of an applicable taxonomy and to monitor them using the three lines of defence model for risk management. Since this is a very recent development, it may have been too late to be addressed by the author prior to completion of his book and could therefore be considered in its next edition.

Introduction

The author continues in an impressive manner to introduce to the subject matters of his book which analyses how the principles of banking regulation interact with the institutional structure of banking. Starting with the failure of most large banks and financial institutions to manage their risks with highly leveraged balance sheets during the global financial crisis, his analysis moves to the initially unfit crisis management of regulators and central banks at the beginning of the crisis. Here, Alexander already touches upon an evaluation of macro-prudential regulation as one of his main themes. While he rightly approves of the regulators' paradigm shift from micro-prudential to macro-prudential regulation, he points out that until today measures by policymakers and regulators are sometimes unsuccessful because macro-prudential regulation is viewed in an ad hoc manner, resulting in either overly specific regulatory proposals without realistic guidance as to their application or overly broad propositions that provide no regulatory guidance at all. The author argues that to develop a

¹ Kern Alexander, *Principles of Banking Regulation* (Cambridge: Cambridge University Press, 2019), Preface, p.xviii.

² Alexander, *Principles of Banking Regulation* (2019), Preface, p.xvii.

coherent and consistent approach to banking regulation, the regulators' objectives must be clear and guided by certain principles that aim to correct the fundamental types of market failures undermining banking sector stability and threatening legitimate interests of stakeholders depending on the banking sector.³ This is a brilliant observation clearly identifying the issue practitioners working as in-house lawyers, compliance professionals, risk managers or outside consultants are occasionally facing when working on behalf of banks with regulators and central banks: the failure by regulators and central banks to either set forth clear, transparent principles or the lack to apply such principles with consistent, fair and proportional treatment to all supervised institutions.

Content

Chapters

The book comprises of 15 chapters. In Ch.1: "The Business of Banking", the author describes the origins and evolution of modern financial markets, the differences between commercial banks and other deposit taking-institutions. Alexander outlines the primary economic function of banking, i.e. credit intermediation, and how regulatory changes resulted in bank disintermediation, i.e. alternative forms of credit outside the regulated banking sector. He explores how banks use low-margin lending to attract another high margin business, like underwriting or other forms of investment banking. Already at this stage, the author manages to build a bridge to highly up-to-date topics of banking like the use of technology. The chapter finishes, like any other chapter of the book, with a conclusion as summary, a set of questions and recommendations for further reading, which is a particularly helpful tool when teaching.

Chapters 2: "Economic Theories and Institutional Design", 3: "International Banking Regulation", 4: "Capital Adequacy and Risk Management" and 5: "Bank Corporate Governance: Law and Regulation" complete the first section. The next section includes Chs 6–10. Chapter 6: "Deposit Insurance and Bank Resolution" considers the importance of depositor protection regulation with a particular focus on UK and EU regulations and a comparison with the US. Chapter 7: "Bank Organisation and Structural Regulation" discusses the conceptual basis of structural regulation and compares the main regulatory approaches—the UK, France, Germany and the US—and how they are designed to meet regulatory objectives and their impact on bank governance. The author puts an emphasis on the UK's so-called ring-fenced banking regime which applies to

UK-incorporated banking groups but not to non-UK banking groups operating retail branches in the UK. Chapter 8: "Liability for Bank Mis-Selling" focuses on the sale of risky financial products to non-professional customers and how previously the EU, UK and US legal frameworks have been called into question. The EU's reaction in 2014 thereto with MiFID II⁴ and MiFIR⁵ receives significant attention reflecting the practical relevance of the topic in the banking market since becoming effective.⁶ These rules essentially require banks to create organisational structures to review the development of financial products and to ensure that products and sale processes are suitable for bank customers. Chapters 9: "Misconduct and Administrative Sanctions" and 10: "Shadow Banking" conclude this section.

The final section covers Chs 11–15 and is arguably the highlight of the book. Here, the author captures all current and prospective regulatory issues as well as trends occupying banks' senior management. If a bank's board of directors invited all of the heads of departments central to its internal control system to come up with a list of topics they are presently working on, it would look very similar to the table of contents of this section: Chs 11: "Regulating Risk Culture", 12: "Financial Technology, Digital Currencies, and Regulation", 13: "Environmental and Social Sustainability Challenges", 14: "Administrative Sanctions and Regulatory Enforcement" and 15: "Future Challenges for Banking Regulation". In this section, Alexander addresses such highly relevant subjects like regulatory initiatives for risk culture examining the UK's Senior Managers and Certification Regime (SM&CR), the concept of self-regulation, financial technology, digital currencies, regulation technology, environmental sustainability risks and administrative sanctions for regulatory breaches. The final chapter is devoted to future challenges and in his proposition for the development of a coherent macro-prudential–micro-prudential framework, the author comes back to one of his main themes. He advocates a more holistic approach for macro-prudential regulation and banking supervision linking micro-prudential supervision of individual banks with broader oversight of the financial system and macro-economic policy.⁷ In his analysis of the regulatory and policy issues raised by Brexit, Alexander discusses how third-country jurisdictions outside the EU will regulate their financial sectors to obtain access to EU financial markets. Moreover, the extent to which Brexit may restrict the access of UK banks to the European Single Market is of vital concern.⁸ In the "Epilogue: Trust and Banking Regulation", the author observes that the failures in bank corporate governance, risk management and compliance

³ Alexander, *Principles of Banking Regulation* (2019), Introduction, p.3.

⁴ Markets in Financial Instruments (MiFID II)—Directive 2014/65 on markets in financial instruments and amending Directive 2002/92 and Directive 2011/61 [2014] OJ L173/349.

⁵ Markets in Financial Instruments (MiFIR)—Regulation 600/2014 on markets in financial instruments and amending Regulation 648/2012 [2014] OJ L173/84.

⁶ MiFID II as an EU directive had to be implemented in the Member States by 3 January 2018, MiFIR as an EU regulation has immediate effect as of that date.

⁷ Alexander, *Principles of Banking Regulation* (2019), Future Challenges for Banking Regulation p.407.

⁸ Alexander, *Principles of Banking Regulation* (2019), Future Challenges for Banking Regulation p.408.

culture have resulted in a loss of trust by the regulatory community and the creation of an adversarial relationship between regulators and banks. Only the reintroduction of trust into the operational framework of bank managers and regulators can enhance performance of banking and protect society from the risky business of banking.⁹

Figures, tables and cases

The author supports his analysis with meaningful figures, for example comparing regulatory capital between Basel II and Basel III or a stylised model of bail-in. Comprehensible tables complete the parts on capital adequacy and risk management. The cases were selected from an impressive array of jurisdictions and courts, in particular the UK, US, EU and various national jurisdictions.

Conclusion

Alexander's *Principles of Banking Regulation* will undoubtedly become one of the pre-eminent books in the field, if not its champion. The book is conceivably superior to the competition for two reasons. First, by one author covering the entire subject it is profoundly concise. After setting the stage with his main themes, especially the proposition for a coherent macro-prudential–micro-prudential framework, he follows through with his analysis in outstanding consistency. Such clarity is sometimes missing in the financial regulation books that are team efforts by multiple authors. Secondly, Alexander's book combines academic rigour with an astonishing immediacy to the practice of banking regulation making it a mandatory reading for banking and finance law students as well as for practitioners.

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⁹ Alexander, *Principles of Banking Regulation* (2019), Future Challenges for Banking Regulation pp.414, 415.

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