Insights on Financial Services Regulation

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INVESTOR IN PEOPLE

To Rose, Ivan and Helga

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Lord, please always help me to handle my neighbours'
monies like sacred vessels.
(from The Catholic Bank Official's Creed, Malta Catholic Action).

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Table of Contents

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List of Figures

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List of Abbreviations

ABS	Asset backed securities
ADR	Alternative dispute resolution
AIG	American International Group
ALM	Asset/Liability Management
AMF	Autorité des marches financiers (France)
APRA	Australian Prudential Regulation Authority
ASF	Portuguese insurance regulator
ASIC	Australian Securities and Investments Commission
ATM	Automated teller machine
BAFIN	Federal Financial Supervisory Authority
BBA	British Bankers' Association
BCBS	Basel Committee on Banking Supervision
BCFP	Bureau of Consumer Financial Protection
BFM	Bank financial management
BIS	Bank for International Settlements
BOE	Bank of England
BOP	Balance of payments
CAA	Commissariat Aux Assurances (Luxembourg)
CBR	Central Bank of Russia
CBRC	China Banking Regulating Commission
CEBS	Committee of European Banking Supervisors
CEECs	Central and Eastern European Countries
CESR	Centre for Economic and Social Research
CFPB	Consumers Financial Protection Bureau
CFTC	Commodity Futures Trading Commission

CGAP	Corporate Governance Action Plan
CIRC	China Insurance Regulatory Commission
CISF	Commission de surveillance du secteur financier (Luxembourg)
CMVM	Securities Market Commission (Portugal)
CONSOB	Commissione Nazionale per le Societa e le Borse (CONSOB)
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulations
CSR	Corporate social responsibility
CSRC	China Securities Regulatyory Commission
DD	Due diligence
DG	Directorate Generale' (EU)
DGS	Direction General de Seguros (DGS)
DLT	Distributed Ledger Technology
EBA	European Banking Authority
EBU	European Banking Union
EC	European Commission
ECB	European Central Bank
ECTS	European Credits Transfer System
ECU	European Currency Unit
EIOPA	European Insurance and Occupational Pensions Authority
EJS	European Justice Scoreboards
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
FCA	Financial Conduct Authority
FDIC	Federal Deposits Insurance Corporation
Fed	Federal Reserve System
FEMA	Faculty of Economics, Management & Accountancy (UoM)
FFEC	Federal Financial Examination Council
FFM	Five-factor model

Finansinspektionem	Financial supervisory authority (Sweden)
Finanstitsynet	Financial supervisory authority (Norway)
Finanstitsynet	Financial supervisory authority (Denmark)
FINCEN	Financial Crimes Enforcement Network
FINMA	Swiss Financial Market Supervisory Authority
FINRA	Financial Industry Regulatory Authority
FINTECH	Financial technology
FIRM	Financial institutions risk management
FMA	Financial Markets Authority (New Zealand)
FMC	Forward Markets Commission (India)
FNFC	First National Financial Corporation
FRS	Federal Reserve System
FRTB	Fundamental Review of the Trading Book
FS	Financial Services
FSA	Financial Services Agency (Japan)
FSB	Financial Stability Board
FSF	Financial Stability Forum
FSLIC	Federal Savings and Loan Insurance Corporation
FSMA	Financial Services and Markets Act (2000, UK)
FSMA	Financial Services and Markets Authority (Belgium)
FSOC	Financial Stability Oversight Council
FTC	Federal Trade Commission
GAO	General Accountant's Office
GARP	Global Association of Risk Professionals
GDP	Gross domestic product
GDPR	General Data Protection Regulation
G20	Group of Twenty (nations)
HMSO	Her Majesty's Stationery Office
IA	Impact Assessment
IAASs	International Accounting/Auditing Standards

IBCFP	Independent Bureau of Consumer Financial Protection
ICOs	Initial coin offerings
ICSID	International Centre for the Settlement of Investment Disputes
ICTs	Information and communication technologies
IFAS	International financial auditing standards
IFRS	International financial reporting standards
IFSMs	Institutional financial services markets
IIAs	International investment agreements
IIN	Interbank Information Network
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
IRDA	Insurance Regulatory and Development Authority of India
ISVAP	Institute for the Supervision of Insurance (Italy)
LEI	Legal entity identifier
LIBOR	London interbank offered rate.
MARs	Market Abuse Regulations
MCAST	Malta College of Arts, Science and Technology
MIFID	Markets in Financial Instruments Directives
MISTs	Market integrity sensitivity tests
NBB	National Bank of Belgium (NBB)
NCUA	National Credit Union Administration
NIFA	New International Financial Architecture
NYSDFS	New York State Department of Financial Services
OCC	Office of the Controller of the Currency
OCRA	Office of Credit Rating Agencies
OECD	Organisation for Economic Cooperation and Development
OFR	Office of Financial Research

ONI	Office of National Insurance
OTC	Over-the-counter
OTS	Office of Thrift Supervision
PFRDA	Pension Fund Regulatory and Development Authority (India)
PRA	Prudential Regulation Authority
RBI	Reserve Bank of India
RegTech	Regulation of technology
S & L	Savings and Loans
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission
SFSC	Senate (House) Financial Services Commission
SIMEX	Singapore monetary exchange
SMA	Standard Measurement Approach
SRM	Single resolution mechanism
SWIFT	Secure Worldwide International Fund Transfers
TFMRD	Transatlantic Financial Markets Regulatory Dialogue
UCITS	Undertakings for Collective Investments in Transferable Securities
UoM	University of Malta
US	United States (of America)
WHO	World Health Organization
WTO	World Trade Organization

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Chapter 1

Introduction

"Regulation"…a simple term, but one which so quickly posits itself – often with a certain tinge of imposed immediacy – into some format of a conflictual mode. Possibly, some of the more beneficially inclined amongst us do not perceive it in such manner. But the nub is that many look upon regulation as an "interference" of some sort in the activity being regulated. The whole of the activity being regulated, and often also the total environment around it, has to be governed, ruled, altered, controlled, guided, in some way impacted upon, i.e. indeed, regulated.

The reference to immediacy needs to be contemplated. This regulator vis-à-vis, or indeed versus, the regulated (or regulate) scenario, implied in a conflict mode paradigm, has evolved in our times with a methodology which, even if, potentially and beneficially, one might see as moving away from conflict, and into a paradigm of ongoing processor relationship, it is in fact regulation occurring over, or at different, points in time. Hence, rather than just saying "regulation", we should perhaps be more concerned with the *means, or methods*, of regulation and over what period. In such a context the means of regulation do not need to be rules, laws, directives, regulations, or even indeed soft law. Regulation can conceptually also be studied in a pure context of incentives, as opposed to sanctions which so often go with most of the conventional rule-like regulation.

So we are here clearly and immediately positing criticism of the definitional attempt which views regulation as a process, or structure, imposing rules, directives, or laws, by means of authoritative direction. Where situations are normal, the two sides involved in any regulation process (the regulators and the regulated), plus even others in the market or environment, or certain related stakeholders, all easily come over as accepting the regulatory process, in the fulfilling of which is laid down a pattern that is, at the minimum, claimed to be correct, ordinary, usual, formal and stable.

So perhaps it is never quite just "regulation", but "a regulatory context", or environment, that warrants being discussed. To which the sceptic might reply: if it is such we speak of, then why have it at all? Here of course the answer may easily come over as simple. Total absence of regulation…or of a regulatory environment or context…is perhaps the hallmark of the uncivilized society. Total non-regulation, or total absence of the regulatory context, is as close to operational anarchy as one can get. All civilized societies have regulation, or are regulated in this or that function.

Not to do so, within any modern societal context, is to border on what some describe, as said, to anarchy. In its simplest definitions, anarchy is absence (indeed

Insights on Financial Services Regulation, 1–13

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a cruel one!) of governance (or its "owner", government), or, in milder terms, simply disorder and confusion. The counter-position to this is to see regulation as in fact, in its manifold forms, the central process of contemporary *governance* (central as opposed to corporate governance) as it seeks to blend the dynamism of market economies with responsiveness to political and normative demands for fairer financial services, more equitable and just health, safety, environmental protection and fairness generally.[1] In positing this approach, Kagan and Bardach (1982) had to, inevitably and with much reason and validity, submit that understanding regulation's varieties, vulnerabilities, virtues and processes has become a significant focus of academic research and theory.

Regulation – and nowadays what is so much its very close concomitant, "risk" – is clearly present in a process of constant reconceptualization. Braithwaite holds that a main cause of this process, and restructuring, stems from the roles of institutional and national economic crises. He is part of a class of analysts that sees regulatory policy as complex and paradoxical, in ways that require us – as academics, students, practitioners, or even mere market participants – to attend to the substance and the politics of *specific* regulatory regimes (Braithwaite, 2002). I will be returning to the big issue of the paradox of regulation, and what it can, and what it cannot, do, later.

Regulation is on the rise across the world as the state continues to step back from public ownership of economic activities. Indeed the process of privatization may be described as having run out of its own subject matters: what, and where, is left to privatize? When the Central and Eastern European Countries (CEECs) were going through their variegated processes of privatizing – inter alia their financial services sectors – they did indeed offer to the detached, but simultaneously keen, analyst a plethora of examples of how regulatory vacua, as former Communist regimes went to ground, would hamper progress into the much desired but clearly unknown new worlds of reasoned new formal regulatory structures (*vide* e.g. Consiglio, 2006). But the way, and the style adopted, for political delegation to be passed on to regulatory authorities did not follow a uniform pattern. Administrative traditions, different attributes of institutional endowment, market structures and business cultures, legal and soft-law structures, these and other factors, all influenced the creation of regulatory authorities and implementation styles.[2]

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[1]In *The Better Regulation/Governance Nexus: A Discussion* – (Consiglio, J. A. (2018, August). *Finance readings for diplomats*. MEDAC, The University of Malta) – the linkages between the concepts of better regulation and organizational governance are discussed in more depth.

[2]Defined as a concept or structure of rule-based relationships (evolving over time, or through practice, or even as a result of specific agreements) whereunder the non-following of agreed rules, and/or practices and/or agreements of the structure or system, would entail the offending organization or individual being subjected to certain agreed sanctions. Sometimes such sanctions are structured in a manner that benefits the other complying member institutions or individuals in the system – e.g. fines, not being retained as member or subscriber to the system (which often has dire economic consequences), etc. Soft law very often becomes the basis of subsequently drafted laws that give a formal law character to the agreed practices or conventions.

In a different approach, Michael Moran's seminal 1986 study also concerned itself with the big issue of discretion. It is worrying that since Moran wrote we still have the situation where the rules governing the behavior of both regulators and regulated vary greatly across world markets in scope and detail, and consequently the extents to which discretion is confined do also vary considerably. By, hypothetically speaking, detaching regulation from the exercise of state power, it also constantly creates new complex problems. Common sense distinctions between private regulation (or self-regulation, as it is commonly described) and public (state) regulation are immensely difficult to maintain. Much *state* regulation depends for its effectiveness on private cooperation; much *self*-regulation is effective only because it is underwritten by state power; and, yes, unusual hybrids of public and private regulations are constantly evolving. Indeed Moran rises above this important issue of discretion by positing all regulation theory into four clearly distinct groups: a teleological (or public interest) theories grouping, an instrumental theories grouping, culture theories and administrative theories groups (Moran, 1986).

With all of the above as a general background, it therefore comes as no surprise that the discipline of regulation is indeed complex. Over time the attentive student of regulation would inevitably have noted the plethora of attributes or adjectives that have become almost inseparable from the topic: inefficient regulation, innovative regulation, under-regulation, over-regulation, better regulation, deregulation, re-regulation, "smart" regulation, "proportionate" regulation, prudential regulation, business conduct regulation, transparent regulation, knee-jerk or ad hoc regulation, the list is indeed endless. Similarly the tools and methodologies of the discipline.

In such a context, it comes as no surprise that many see too much ad hocism revolving around specific regulatory situations. This, considering the inseparability (within precisely the above-mentioned "anarchy" context) of regulation from the daily, monthly, constant grind of life and events, makes any attempt at writing "a history of regulation" as, if not impossible, certainly a herculean task. The sociologist may hold that regulation has always been here in some format or other with mankind. At the other end, the contemporary historian might, with some justification, differently hold that we even only first started to utter the word in the post-Lehman crisis world of September 2008 (Fig. 1.1).

One possible consequence or result from this contemporary viewpoint of regulation is a realization of the truth that at the time of the mess of 2008–2010 (see box for front row seat of the industry's self-defence) the finance industry was more concerned with sorting itself out, than with following up what the realities of financial technology – fintech – could contribute to itself. Artificial intelligence, distributed ledger technology, robotic advisory and technology, and other fintech developments were still far away from the mindset that by a decade later was coming round to accepting that data are the facts of this twenty-first century: by which time, however, the ever more forward-thinking amongst us are most certainly already realizing that data and its technologies both have their own product

Fig. 1.1. What They Were Saying to Defend Themselves!
Source: Carfang (2018).

life cycle. The more realistic will hopefully look upon fintech (including what are so much some of its taken-for-granted ATMs, Internet banking, mobile banking, etc.) as an opportunity, not a challenge. Not for the first time in history, the finance industry practitioner too is called upon to be considerate of the truth that knowledge (true or false) and wisdom (right or wrong) are not always freely interchangeable.

So one could even argue, yes, that 2008–2010 was indeed the time when the world, or at least big parts of it, "discovered", or woke up to, regulation. The international post-September 2008 financial crisis was not an even one across the whole world. But the Western world economy was indeed badly hit, and financial communities and sectors in many countries found themselves in what may be described as battle modes, clamouring for sense, sensibility, calm, leadership, and generally a modicum of reassuring financial environments. Bankers in London were living particularly anxious times. When, with the crisis raging high, the European Union appointed a new financial sector chief at the end of 2009, Michel Barnier, a Frenchman, he quickly sought to reassure London's bankers that new regulation introduced in the wake of the crisis would be both "smart" and "proportionate".

In Britain, that appointment raised fears of greater regulation from Brussels. In March 2010, Barnier told the British Bankers' Association (BBA) that Britain's institutions would continue to play an important part in assuring continuance of their business. The bankers in London, at that time home to 80% of Europe's financial services funds, were arguing and insisting that proposed new EU-wide rules would make it more difficult to lend, which would slow economic recovery. When Barnier was seeking to reassure the City's bankers, he articulated his objectives in very ambitious terms: "An efficient and innovative financial sector will provide the engine to power our companies". "To restore confidence we need regulation. And much better supervision. But [also] smart, effective, and proportionate regulation…well supervised institutions, well capitalized institutions, and responsible institutions".

Barnier was also the EU's Commissioner for the internal market. Significantly, his views on the new regulatory structures being introduced were broad-based,

and internationalist almost to an extreme. His seeking to engage with vital players in Britain was impressive: the British Bankers' Association, the British Chancellor of the Exchequer, the finance spokesman of the British Conservative Party George Osborne, the Bank of England's governor Mervyn King, the Head of the Financial Services Authority (the nation's main FS regulator) Adair Turner. But not only: he urged "Our American friends and other global partners to work together to introduce a new financial rulebook".[3]

One could argue that what Barnier saw as his mission, for Britain and for other countries of the EU, was really tackling, in diagrammatic terms, the outer circle of the problem. But, arguably, the core of problems in the world financial crisis was centred in the United States. There the various government agencies regulating the finance industry (indeed some 20 bodies, all fiercely jealous of their patches, see box), with their varying missions, rules and standards, ironically led in fact to certain entities not being regulated at all, with others subject to less oversight than their peer financial firms organized under different charters.[4] The Dodd–Frank Act of 2010 aimed to, amongst other objectives, overhaul their existing agency oversight system.[5] Indeed, no less than five new agency creations came into the new picture in its wake (Fig. 1.2):

- Creation of a Financial Stability Oversight Council (FSOC);
- Creation of the Office of Financial Research (OFR) within the US Treasury to support the FSOC;
- Creation of an independent Bureau of Consumer Financial Protection (BCFP) within the national Federal Reserve Bank (the nation's central bank);
- Creation of the Office of National Insurance (ONI) within the Treasury;
- Creation of the Office of Credit Rating Agencies (OCRA) within the then already existing Securities and Exchange Commission (SEC).

For the United States, the Dodd–Frank Wall Street Reform and Consumer Protection Act – better known as the Dodd–Frank Act – enacted the most comprehensive financial regulation reform measure taken after the great Depression of the 1930s. It is too generic to simply state that it had its roots in the fact that a nationally calamitous financial crisis had occurred. The real rationale of the crisis's roots was deeper. Despite, on the mere face of things,

[3] *Malta Today*, 3 March 2010.

[4] Is there hypothetical analogy to be made with the way the criminal perpetrators of the 1990s Bank of Commerce and Credit International (BCCI) crisis managed to drive coach and horses through big gaps in the contacts and relations between the regulatory authorities and central banks of various countries? (*vide* e.g. The World's Sleaziest Bank, *Time International*, 1991, June 29, No. 30).

[5] Formally the *Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L.111-203 HR 4173)*, signed into US federal law by President Barack Obama on 21 July 2010, after having been introduced in the House of Representatives in July 2009, i.e. significantly within less than the first year after the Lehman crisis.

- Board of Governors of the Federal Reserve System (FRS)
- Bureau of Consumer Financial Protection (BCFP)
- Commodity Futures Trading Commission (CFTC)
- Consumers Financial Protection Bureau (CFPB)
- Federal Deposit Insurance Corporation (FDIC)
- Federal Financial Examinations Council (FFEC)
- Federal Reserve System (the Fed)
- Federal Trade Commission (FTC)
- Financial Crimes Enforcement Network (FINCEN)
- Financial Industry Regulatory Authority (FINRA)
- Financial Stability Oversight Council (FSOC – post Dodd-Frank Act)
- General Accountant's Office (GAO)
- House (Senate) Financial Services Committee (SFSC)
- Independent Bureau of Consumer Financial Protection (IBCFP) within FRB, post Dodd-Frank Act
- National Credit Union Administration (NCUA)
- New York State Department of Financial Services (NYSDFS)
- Office of Credit Rating Agencies (OCRA), (post Dodd-Frank Act)
- Office of the Controller of the Currency (OCC)
- Office of Financial Research (OFR) within the Treasury, (post Dodd-Frank Act)
- Office of National Insurance (within the Treasury, post Dodd-Frank Act)
- Office of Thrift Supervision (OTS)
- Securities and Exchange Commission (SEC)

Fig. 1.2. Financial Regulatory Authorities and Supervisory Agencies in the United States.

having all the right processes in place, in the United States it became clear as the crisis unfolded that consumer protection regulators had not been delving deep enough into the substance of service providers' abuse against consumers. The regulators came over as functioning and operating as seemingly more concentrated on legal niceties which the market simply allowed them to exploit to the hilt in their own favour. One example was significant mis-selling, especially of products which were at the core of rampant securitization processes. When the poor retail public awoke, it was far too late. It had received a really bad deal from investment services providers (including some highly reputable names), and when the regulatory agencies reacted to the disaster it was evident to the unbiased observer that they had been caught doing too little, too late, only after public pressure, and next to nothing was ever resulting in terms of effective compensation being made to victims. Delays in appropriate regulatory action being taken resulted in millions of life savings of the retail public going up in smithereens.

The security markets were not the only arena disastrously tainted by the demise of Lehman Brothers and, later, the near-default of AIG and Bear Stearns. In 2011, a commission of international regulators recommended that all trade in over-the-counter (OTC) derivatives be made more transparent to

curb financial market instability. Whilst, at the popular or populistic levels, in the formerly mentioned part of the big market arena, transactions were mainly of a nature concerning selling to small (or possibly even not so small) investors who were in the full eye of the maelstrom, at the conceivably higher business levels where use was habitually made of these OTC instruments, the reality was one where a big lack of adequate information on the exposures involved in such tools was in fact exacerbating a big number of corporate distress situations in the crisis.

On 24 August 2011, a commission made up of representatives of the Bank for International Settlements (BIS), the International Organization of Securities Commissions (IOSCO), and the European Commission (EC), following a request made by the Group of 20 (G20) international leaders who had met in Pittsburgh two years earlier in September 2009 – and thus only one year from the fatidical year of 2008 – presented their recommendations for OTC derivatives to be made more transparent to curb financial market instability. The G20 wanted transparency rules on these types of potentially very opaque transactions, often valued at thousands of billions of dollars. The recommendations dealt with various types of derivatives, including interest rate, equity, credit, foreign exchange and others. The recommendations also included that:

- OTC trades reported to trade repositories be harmonized and improved;
- At a minimum transaction level data should be reported to trade repositories;
- Information should be available to public authorities;
- A system should be developed to allow authorities to determine the authorship of all transactions through legal entity identifiers (LEIs). LEIs, it was argued by the G20 Group, would be able to contribute to fulfill systemic risk mitigation, transparency and market abuse goals. The G20 even described LEIs as potentially constituting a global public good.

In all of this a big element or issue posits itself. What is the essence of the nexus between financial regulation and disclosure? It has been argued that no modern system of financial regulation relies entirely, and solely, on disclosure (and its related devices). In modern times, authorization (or licensing) has become a standard technique. The objective is to create a perimeter from which unauthorized persons are excluded, and within which the regulator can exert control over authorized persons. The authority of the regulator, at its ultimate extreme, rests on his ability to punish non-compliance with exclusion from the regulated activity. The regulator is typically given a wide discretion to grant, or refuse, authorization. In the UK, and in other jurisdictions, this has taken the form of requiring the applicant to satisfy a "fit and proper" test as well as other specific requirements.[6]

[6]In principle, one may distinguish registration from certification and licensing, but it is to be noted that, historically, there has been a tendency to combine registration with licensing.

Much is made of the distinction between prudential and business conduct regulation. The former is generally that which focuses on controlling and dealing with financial soundness (solvency and liquidity) of regulated institutions and, through them, the financial markets (Blair et al., 2001). The overriding objective of such controls is to ensure that customers of financial institutions are not threatened by the risks to which financial institutions are exposed in the normal course of their business. In the case of banks, for example, the most obvious risk is credit risk, which is the risk that borrowers will default on loans to such an extent that the solvency of the bank is threatened – i.e. the risk of high numbers of non-performing loans.

In the case of securities firms (or even of banks involved in such types of business), the main risk is market risk, which is the risk that the value of the firm's holdings as quoted on open securities trading markets will fall to such an extent as to threaten the firm's, or the bank's, solvency. Regulators attempt to protect customers from these types of risks by requiring banks and security firms to have minimum levels of shareholders' capital (sometimes also referred to as "regulatory capital") and to hold a certain proportion of their assets in a liquid (readily realizable) form. This has the effect that if the firm were to face financial difficulties, losses would be borne by shareholders *before* customers become affected.[7] In this sense, prudential supervision uses regulatory capital to protect customers. Shareholders in financial institutions, on the other hand, receive no special protection from the system of prudential supervision. They are assumed to face the normal risks arising in any business, which includes insolvency.

The underlying thematic here is that of "constant capital adequacy", viz. the institutions always ideally being endowed with suitably thick cushions of readily available capital, to be able to cope and deal with problems as and when they arise, and from whatever source, including non-domestically sourced. Over long years, the Basel system of bank supervisors, in a chain of accords evolving from the first Basel Accord of 1988 up to Basel IV as proposed in 2016, has produced agreements, directives, regulations, reports and endless discussion with governments, regulators and lobbying groups that, however, in what may be criticized as very much an *a* posteriori view, still often strike observers as not having in fact always totally coped with events that led to the failures of either individual financial institutions or, for that

[7]At the higher than just mere local institutional level, i.e. at government or state levels, the later, analogous historical development was the EU's move towards centrally required "bail-ins", to be imposed on institutions, as opposed to the prior substantial "bail-outs" made (for example, to Greece) by various EU governments. The latter were mostly in the form of government-to-government loans, whilst bail-ins would require recovery and/or resolution processes of institutions to first make use of shareholder and bondholder funds to be used first to solve problems. (*Vide* Directive 2014/59 EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.)