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2. The financial institutions of the Holy See are APSA and IOR, the first historically considered as the “institutional investor” (*iure imperii*), the latter more involved in financial activity on behalf of private third parties (*iure privatorum* or *iure gestionis*). Before looking into the activity and characteristics of these institutions, it is worth noticing that they are both canonical entities directly subject to the authority of the Holy See and neither of them have a banking license. They contribute, in different ways, to the financial support of the mission of the Holy See, that being the reason why they exist and they have their seat in the Vatican City State. While in the run-up to the Vatican financial reform their activity would almost – at some extent – overlap, today the recent regulations have contributed to better define their respective powers, both in the internal Vatican juridical framework and with respect to the European regulations and international policy makers. As already mentioned, the main difference between IOR and APSA is (today) the type of clients that they can accept and the kind of financial activity that they conduct.

2.1. The Administration of the Patrimony of the Holy See (APSA), created by Pope Paul VI on August 15, 1967, is governed by articles 172-175 of the Apostolic Constitution *Pastor bonus* of June 28, 1988, originally issued by John Paul II and recently modified by the *motu proprio* “Confirming a centuries-old tradition” of Ju-



















supervision.<sup>34</sup> AIF Statute was revised on November 15, 2013, through the Apostolic letter issued *motu proprio* by Pope Francis “By means”, which empowered the role of the Board of Directors and enriched the scope of supervision to: prudential supervision and regulation of the entities that carry out professionally a financial activity; supervision and regulation for the prevention and countering of money laundering and financing of terrorism; financial intelligence.<sup>35</sup>

Law n. XVIII set out the general principles of Vatican prudential regulation, while delegating to AIF the issuing of the specific regulation (as per article 54-63). In compliance with those provisions, AIF has issued Regulation no. 1/2015<sup>36</sup> over the prudential supervision of the entities carrying out financial activities on a professional basis, whose only addressee is – for the time being – the Institute for Works of Religion.

4. One of the objectives of the European prudential regulation is creating a level playing field between financial institutions in order to ensure a well-functioning internal market and foster stability. This implies the enhancement of the harmonization of supervisory practices and technical rules, in order to prevent

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<sup>34</sup>See the Apostolic Letter issued *motu proprio* of the Pontiff Francis for the prevention and countering of money laundering, the financing of terrorism and the proliferation of weapons of mass destruction, of August 8th 2013, available at [vatican.va](http://vatican.va), where it is stated that “The promotion of integral human development at the material and moral level requires a profound reflection on the vocation of the economic and financial sectors, as well as on how they correspond with its ultimate aim of achieving the common good. For this reason in conformity with its nature and mission the Holy See is participating in the efforts of the international community that aim to protect and promote the integrity, permanence and transparency of the economic and financial sectors and to prevent and to counter illegal activities. Pursuant to the steps already taken by my Predecessor Benedict XVI in this area with the *motu proprio* of 30 December 2010 for preventing and countering illegal activities in the area of monetary and financial dealings, I wish to renew the Holy See’s commitment to adopting the principles and juridical instruments developed by the international community, bringing further into line with them institutional structures for the prevention and countering of money laundering, the financing of terrorism and the proliferation of weapons of mass destruction”. Moreover, art. 2 of the *motu proprio* establishes that “The Financial Information Authority exercises the prudential role of the supervision and regulation of entities that are professionally engaged in a financial activity”.

<sup>35</sup>See the Statute of the Financial Information Authority available at [afi.va](http://afi.va) and the Apostolic letter issued *motu proprio* of the Pontiff Francis approving the new Statutes of the Financial Intelligence Authority, November 15th 2015, available at [vatican.va](http://vatican.va).

<sup>36</sup>The Regulation defines, *inter alia*, the criteria and procedures for granting the authorization to carry out financial activities on a professional basis and for managing risks (including liquidity risk), also establishing corporate governance measures and capital requirements regulation.

regulatory arbitrages between the national financial systems.

The cost of regulatory compliance – for banks and financial institutions – is high and it ordinarily implies a reinforcement of the control functions, especially risk management and compliance. Those costs are usually counterbalanced by the benefits coming from the membership to the European internal market, hence the freedom of establishment and provision of services in the member States.

Despite the regulatory harmonization towards the European financial discipline, the so called third countries, not being part of the European Union, are not likely to take advantage of the benefits, which are normally associated to the introduction of such laws. This situation concerns not only the Vatican, but also all third-countries as they respect the same rules of the European banks and financial institutions without being part of the Single Market. They do take the responsibilities connected to the membership to the single currency, but they do not benefit from the possibilities connected to the regulatory harmonization. Therefore, the Republic of San Marino, Andorra and the Principality of Monaco are trying to overcome this issue through a possible revision of their juridical status towards Europe that represents “a limitation to their development”, with the objective to reach a “better integration in the single market”.<sup>37</sup>

This situation is particularly critical for the Vatican City State since the institutions of the Holy See are not banking entities, and they have to limit their services to a range of clients determined *ex ante*. Therefore, not only does the Vatican financial system suffer from the competition asymmetry coming from its extra-EU status (like all the other third-States). It encounters all the difficulties connected to the lack of a banking system and the restrictions over the admissible client range.

In this context there is an important boundary to the possibility for the Vatican financial institutions to reach their potential target clients around the world and it lurks in the lack of a banking license, posing constraints to their financial ac-

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<sup>37</sup>See BANCA CENTRALE DI SAN MARINO, *Percorso di San Marino verso una maggiore integrazione con l'Europa*, bcsm.sm.



beyond the traditional paradigms that characterize modern positivism.<sup>41</sup> The extra-EU status of the Vatican City State – in which the EU directives and regulations are *per se* not legally binding – does not stop the enforcement of those standards. This endorses the rationale that leads to the creation of a level playing field among market participants, whereby all financial institutions should respect the same rules in order not to incur in the “market” sanction. Eventually the reiterate non-compliance to those principles could bring to the isolation of the intermediary. Compliant rules prevent banks from operating with a financial institution that does not respect, under an equivalent regime, market standards (and, *in primis*, the AML/CTF framework).

Theoretically the Vatican City State – not being a Member of the EU – would have not been subject to the respect of the European financial legislation; nevertheless, its application was deemed necessary in order to continue to operate with the European based institutions. As explained in the previous paragraphs the Monetary Agreement between the Vatican and the EU provided for the mandatory implementation of the AML/CTF framework, but it is very possible that this would have been necessary regardless of the adoption of the Euro. If the Vatican had created its own currency, it would have been still obliged to respect equivalent rules – at least as far as the AML/CTF regime – of the EU financial institutions in order to continue to operate.

This phenomenon is highlighted by the explicative document issued by the Bank of Italy in 2013 regarding the block of the use of debit and credit cards in the Vatican, as the Holy See was seen lacking anti-money laundering controls and oversight. Those payments were managed by Deutsche Bank Italy whose request of authorization was denied by the Italian central bank. The Bank of Italy highlighted that a EU bank can operate in an extra-EU country only under an equivalent regime in terms of financial regulation, vigilance and exchange of information, pointing out that in the Vatican City State a banking regulation was not in force,

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<sup>41</sup>See CAPRIGLIONE, *Fonti normative*, in AA. VV., in *Manuale di diritto bancario e finanziario*, F. Capriglione, Padova 2015, pp. 33 and 35.

















of factors which have generated real changes in the competitive context:

1. a macroeconomic environment of weak real growth combined with historically low interest rate levels. Both these factors have reduced the prospects for profits in banking operations in the traditional core business based on the savings/lending circuit;

2. regulation and supervision which are influencing and affecting banks' growth and diversification strategies. In order to ensure stability, regulators have set out to reinforce banks' capitalisation and liquidity levels, by introducing tight constraints on their operations. In fact, within the Basel 3 Accord, one part of the Supervisory Review and Evaluation Process (SREP), to be discussed below, envisages the evaluation of the feasibility and sustainability of banks' BMs, with the aim of identifying any vulnerabilities which could adversely affect their ability to generate capital organically in both the short and the medium-long term. Structural financial profitability thus becomes a factor for prudential assessment;

3. a competitive context undergoing radical changes due to the effects of technological innovation and the transformations which the digital economy is generating in the payments system and in the delivery of banking services. Technological innovation is an extremely important competitive driver, on the one hand enabling new players to enter the market, to occupy spaces and segments in the banking industry where traditional banks are penalised by the inadequacy and high costs of their supply systems. On the other hand, it is having dramatic effects on the service model of traditional banks themselves, enabling them to increase their efficiency and offer innovative digital services. The use of technology enables banks to cut their costs and improve their quality of services, but there is a downside in terms of squeezed profit margins, since technology removes the traditional barriers on entry to the credit and financial service markets. The overall effect on profitability is therefore not easy to predict.

In response to the changes in their operating context, banks have launched a sometimes radical review and transformation of their business models (Committee on the Global Financial System, 2018; Farnè and Vouldis, 2017; Ferretti et al.,

2017; Cosma et al., 2016 and 2017; Brighi and Venturelli, 2014 and 2016). As they redefine their strategies, banks are increasingly finding that their prospects for profitability are dependent on their development of functional diversification, partly linked to a drive to expand in size, and their ability to reorganise the services offered in terms of quality and efficiency. Within the review of business models, earnings from non-traditional services and especially from asset management activities (Landi and Venturelli, 2017), are apparently regaining strategic importance. This derives both from the direction of prudential regulation, which encourages banks to develop a leaner business model, and from structural changes due to the recent transformations in the demand for financial products, with a strong focus on pension and insurance products, both of which seem to indicate that additional, lasting expansion in the asset management sector is on the cards (Walter, 2016).

2. Business model analysis (BMA) has become the conceptual framework used by regulators, analysts and investors in the attempt to identify the bank's main strategic behaviours and their implications in terms of competitiveness and possible future performance and stability.

From the point of view of banking supervision this use is reflected by the strong focus on BMA embedded in the Supervisory Review and Evaluation Process (SREP) and the central role it has been assigned in the yearly Thematic Review since 2015 by the Single Supervisory Mechanism (SSM). For financial analysts and investors the business model is an important element in the evaluation of banks' ability to create value.

Since the business model has become a tool for assessing a bank's performance, identifying its idiosyncratic and systemic risk profiles and assessing its sustainability over time, it is important to arrive at a clear definition of exactly what a business model is.

In recent decades, business strategy has been a major area of research in strategic management studies (Grant, 1999), in particular, but the topic has re-



of areas of business, and decisions regarding "how to compete", meaning strategic choices made within the different business areas in order to achieve sustainable competitive advantage over competitors (Grant, 1999).

The consequences of decisions on these two strategic levels can be identified by analysing key financial statement aggregates, used as symptomatic measurements of the various levels of the strategy adopted (Cosma et al., 2016). Specifically, corporate level strategies are reflected in the bank's scale of business, its degree of internationalisation and the composition of its business mix, and thus in a specific asset, liability and cash flow composition. Business level strategies, on the other hand, affect earnings management, financial and operating efficiency profiles, and capital allocation decisions within each strategic area of business.

Naturally, from the empirical point of view, there are a large number of indicators which can be used as proxies for two levels of strategic planning, and there are also many potential techniques for identifying homogeneous clusters of banks. A survey of the empirical literature on banking BMs, the primary aim of which is to assess the effects of strategic decisions on performance, reflects this large number of alternatives (Cosma et al., 2017). The key differentiating factors in empirical studies lie in the choice of the proxy variables for strategic decisions and the grouping techniques used (parametric, hierarchical, etc.), and this range of methodologies complicates the identification of the different business model archetypes currently in use in Europe. In other words, these studies' findings are not conclusive in terms either of the type and number of the business model archetypes identified or with regard to the assessment of the economic and financial sustainability of the different strategies.

3. From the point of view of banking supervision, the main regulatory reference for the analysis and assessment of banks' BMs by the supervisory authorities is provided by the framework of prudential regulation, mainly based on the Basel Accord on Capital Adequacy (Basel 3), with specific reference to Pillar II. Pillar II is based on the Supervisory Review and Evaluation Process, SREP, the aim of which is



to strengthen the nexus/link between an intermediary's risk profile, its internal governance and risk management (identification, management, mitigation and control of the risks undertaken), and capital planning.

The current regulatory approach is defined as risk-based and organisation-based, since it is grounded on verification of capital adequacy and organisational functions (risk management and internal governance in particular) in relation to the risks banks undertake.

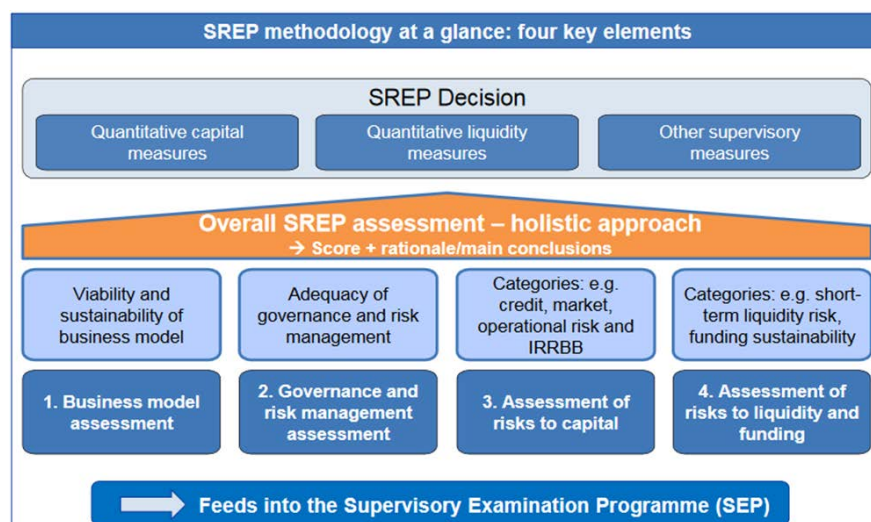
This approach, first introduced by Basel 1, was continually developed and improved through to the launch, in 2010, of Basel 3 (to be completely implemented by 1 January 2019), in response to the financial crisis of 2007-09. Basel 3 aims to reinforce microprudential measures (first of all by increasing the quality and level of capital and introducing global liquidity standards), and therefore requires assessment of the risk profile of the individual bank (idiosyncratic risk), while expanding the area of focus and intervention to systemic risk, by adding a macroprudential overlay that includes capital buffers in a macroprudential perspective (BCBS, 2010).

The SREP, which forms part of microprudential regulation, refers to individual banks' idiosyncratic risk profile, considering in particular the complexity of each bank's business operations and its interconnection with the banking system, and thus also its systemic importance.

The regulatory approach of which the SREP forms part can be defined as "one size fits all", since its provisions are addressed to banks in general: the aim of Basel 3 is that of strengthening the global capital framework in the international regulatory framework (BCBS, 2010), covering all jurisdictions and types of banks. To allow this, when defining the Core Principles for effective banking supervision BCBS (2012) states that: *"16) The first Core Principle sets out the promotion of safety and soundness of banks and the banking system as the primary objective for banking supervision...17) To fulfil their purpose, the Core Principles must be capable of application to a wide range of jurisdictions whose banking sectors will inevitably include a broad spectrum of banks (from large internationally active banks to*



Table 1 The House of SREP



Source: ECB, 2016, SREP Methodology Booklet

In the second phase of the SREP, supervisory authorities are tasked with reviewing and assessing the bank's internal assessment process in two of the four areas (ICAAP and ILAAP), using information provided by regular reporting flows (FINREP and COREP) and with regard to the Business Model and Governance. The assessment concerns: viability (one year) and sustainability (three years) of the business model; adequacy of governance and risk management; capital adequacy covering the entire spectrum of risks to which the bank/banking group is exposed; liquidity and funding risk and related measures.

Initially, with Basel 2 (which dates from 2004), two areas were considered: governance and risk management, and ICAAP. ILAAP and Business Model analysis were subsequently introduced by the Basel 3 Accord, in order to remedy the weaknesses and gaps in the regulatory and control system revealed by the financial crisis; this Accord therefore also extended the area covered by the supervisory review process.

Basel 3 was implemented within the European Union by the Capital Requirement Directive (CRD IV) - Directive 2013/36/EU) and the Capital Requirement Regulation (CRR) – Regulation (EU) No 575/2013. In its 2014 Guidelines, the EBA issued the necessary secondary regulation in the form of technical standards: reg-





of proportionality, since banks' business models have widely different degrees of complexity, which must be carefully considered for the supervisory evaluation and the SREP decision. The BM guides application of the proportionality principle, also with regard to the other components of the house of SREP, and highlights the interconnections between them, which are essential for a holistic evaluation of the bank's complexities intended to assess its risk profile, resilience and viability.

In the EU, the principle of proportionality is included in the key measures for the implementation of Basel 3, the CRD IV and the CRR, and in the secondary regulations introduced by the EBA.

It becomes clear that the business model is crucial both for calibrating the regulatory requirements to be applied and in their actual application. The CRR specifies that its provisions comply with the proportionality principle, which must also be adopted in their implementation by the member states, in view of the differences between banks in terms of both size and range of business areas covered, and thus the risks associated to the different business models: “CRR - *Whereas (46): “The provisions of this Regulation respect the principle of proportionality, having regard in particular to the diversity in size and scale of operations and to the range of activities of institutions. ... Member States should ensure that the requirements laid down in this Regulation apply in a manner proportionate to the nature, scale and complexity of the risks associated with an institution's business model and activities”.*

Turning to the secondary regulations, in its SREP Guidelines (2014) the EBA implements the principle of proportionality in two ways, with the aim of ensuring that supervision is proportionate to the complexity and systemic importance of the bank's business. Firstly, institutions are classified in four distinct categories, according to their systemic importance and the extent of any cross-border activities. Secondly, it requires the building of a minimum supervisory engagement model, where the frequency, depth and intensity of the assessments vary depending on the category of the institution and supervisory expectations of the standards the institution should meet (EBA, 2014, 2.4 *Proportionality and supervisory*

*engagement*).

CRD IV also refers to the business model in relation to internal governance. As the EBA also makes clear, in this area the principle of proportionality must be considered from two points of view: on the one hand, that of banks, called upon to implement a complex internal governance framework in line with regulatory requirements and best practices; and on the other, that of the supervisory authorities, tasked with verifying this framework and assessing its suitability for the bank's risk profile and business model, and taking the necessary measures, as part of a risk-based and organisational-based approach. On the subject of internal governance, CRD IV Article 74(2) requires banks to establish robust arrangements, processes and mechanisms, which: *"...shall be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the business model and the institution's activities" ...* so that the objectives of the regulatory requirements are effectively achieved" (EBA 2017, a, 4. Guidelines, Title 1, Proportionality).

The proportionality principle makes reference to the business model for the purposes of the standards imposed on banks by supervisors with regard to risk management, since supervisory expectations should be proportionate to banks' risk profile (type and degree) and their systemic importance, determined by means of factors including size, interconnectedness, substitutability, global or cross-jurisdictional activity (if any), and complexity (BCBS 2012, Principle 15 and executive summary point 17 page 5).

6. Following EBA Guidelines (2014) on the SREP, the SSM has implemented a methodological framework for Business Model Analysis. In the Single Supervisory Mechanism (SSM), for Significant Institutions the analysis is performed by the ECB itself, through the Joint Supervisory Teams (JST), while for Less Significant Banks it is performed by the National Supervisory Authorities (NSAs).

The SSM does not specify a preferable BM model, but rather requires that the present BM should be viable and sustainable, in a forward-looking perspective. In fact, supervision is placing more and more attention on the need for "for-

ward-looking" actions, based not only on the bank's current risk profile but also on its potential one, on the one hand estimated in relation to possible evolutions of the macroeconomic scenario and competitive context, and assessable by means of stress tests, and on the other considering potential changes to the BM, leading to variations in the risks undertaken (type and size).

Under EBA Guidelines and ECB SREP Methodology (EBA, 2014; ECB, 2016), the elements of business model analysis adopted by the SSM are: identification of banks' main activities; assessment of the business environment; analysis of the forward-looking strategy and financial plans; assessment of the business model's viability (within one year), sustainability (within three years) and sustainability over the cycle (more than three years); and assessment of key vulnerabilities (Lautenschläger, 2016; ECB, 2016). The SSM approach is based on both quantitative and qualitative analysis and incorporates a forward-looking perspective, linked to financial planning, business plan analysis and macroeconomic and market trends. The scheme of analysis identified by the EBA is quite exhaustive and different aspects are considered when focusing on the business model adopted by each bank, with the aim of revealing its key vulnerabilities due to risk assumptions. The specific levels of granularity of information on different aspects, product/business lines, breakdown of income and cost streams, impairment provisions and key ratios required by the SSM are not disclosed.

One of the main methodological innovations in the Business Model Analysis conducted by the SSM is the use of relative assessment, based on peer group analysis. Choice of the relevant peer group is of key importance, since the bank's performance, in relation to specific qualitative and quantitative indicators, is assessed not in absolute terms but with reference to the performance of the peer group selected.

The key indicators for the selection of peer groups, along with the banks included, are not officially disclosed. However, 2017 SREP Methodology Booklet (ECB, 2017) exemplifies the following business models archetypes:

- Custodian





framework used by regulators, analysts and investors in the attempt to identify a bank's main strategic behaviours and their implications in terms of competitiveness and possible future performance and stability. This interest follows the radical review and transformation of banks' strategies due to major changes to the competitive scenario in the financial industry, which affected their competitive positions and influenced their subsequent restructuring and strategic repositioning choices.

From the point of view of banking supervision, the main regulatory reference for the analysis and assessment of banks' Business Models by the supervisory authorities is provided by the prudential regulation framework, with specific reference to Pillar II of Basel 3, which is based on the Supervisory Review and Evaluation Process, SREP. The SREP rests on a building block approach, in line with EBA Guidelines, the aim of which is to strengthen the nexus/link between an intermediary's risk profile, its internal governance and risk management (identification, management, mitigation and control of the risks undertaken), and its capital planning. One of the four areas which define the so-called "House of SREP" is dedicated to Business Model Analysis (BMA).

The BMA embedded in the SREP is intended to reveal a bank's key vulnerabilities in the short-run and the viability and sustainability of its strategic plans in the short and medium term. The aim of BMA is not only to assess each bank's risks and therefore its vulnerability, meaning its idiosyncratic risk in a microprudential perspective, but also its contribution to systemic risk, in a macroprudential perspective. The SSM does not specify a preferable BM model, but rather requires that the present BM should be viable and sustainable, in a forward looking perspective, and verifies this with the aid of stress tests. In other words, the supervisory authority's aim is not to assign a rating to the different business models, the definition and implementation of which is left to the complete discretion of the bank's governing body/top management, but rather to pinpoint the main vulnerabilities to which the business macro-models identified may be subject.

The scheme of analysis identified by the EBA, and followed by the SSM

methodology, is quite exhaustive and different aspects are considered when focusing on the business model adopted by each bank. The approach is based on both quantitative and qualitative analysis and incorporates a forward-looking perspective, linked to financial planning, business plan analysis and macroeconomic and market trends. The analysis is developed on granular information on different aspects, such as product/business lines, breakdown of income and cost streams, impairment provisions and key ratios, mainly based on data by regular reporting flows (FINREP and COREP).

Within the SSM, since 2015 supervisory authority BMA has gradually evolved from basic to more sophisticated analysis, with an increasingly holistic assessment of institutions' viability, taking their specificity into account. In this case, the subject of proportionality becomes a relevant issue, since banks' business models have widely different degrees of complexity, which must be carefully considered for the supervisory evaluation and SREP decision. In this sense, the business model is crucial both for calibrating the regulatory requirements to be applied and in their actual application.

The task now awaiting the ECB with the NCAs for LSIs is to extend the application of the SREP to small and less complex banks, in accordance with the proportionality principle and the flexibility criterion.

In spite of the proportionality principle, it is clear that the regulatory costs and the large investments required by technological innovation are driving banks to seek economies of scale for both SIs and LSIs. This will probably open up a new era of consolidation among European banks, with a challenging scenario also for the SSM, given the dangers of systemic instability that might arise from any such consolidation within the banking sector.









be identified, directly or indirectly, in particular by reference to an identifier such as a name, an identification number, location data, an online identifier or to one or more factors specific to the physical, physiological, genetic, mental, economic, cultural or social identity of that natural person"<sup>3</sup>.

Therefore, for some organizations, the explicit inclusion of location data, online identifiers and genetic data within the definition of "personal data" may result in additional compliance obligations (e.g., for online advertising businesses, many types of cookies become personal data under the GDPR, because those cookies constitute "online identifiers").

### *Controllers and Processors*

The GDPR separates responsibilities and duties of data controllers and processors, obligating controllers to engage only those processors that provide "sufficient guarantees to implement appropriate technical and organizational measures"<sup>4</sup> to meet the GDPR's requirements and protect data subjects' rights. Processors must also take all measures required by Article 32, which delineates the GDPR's "security of processing" standards. Under the same Article 32, controllers and processors are required to "implement appropriate technical and organizational measures" taking into account "the state of the art and the costs of implementation" and "the nature, scope, context, and purposes of the processing as well as the risk of varying likelihood and severity for the rights and freedoms of individuals."<sup>5</sup>

The article 32 of GDPR states the security of personal data processing providing specific suggestions for what kinds of security actions might be considered "appropriate to the risk," including:

- the "pseudonymization" and encryption of personal data;
- the ability to ensure the ongoing confidentiality, integrity, availability and

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<sup>3</sup>See Art. 4, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

<sup>4</sup>See Art. 28, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

<sup>5</sup>See Art. 32, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)



resilience of systems and services processing personal data;

- the ability to restore the availability and access to data in a timely manner in the event of a physical or technical incident;
- a process for regularly testing, assessing and evaluating the effectiveness of technical and organisational measures for ensuring the security of the processing"<sup>6</sup>.

Controllers and processors are required to demonstrate compliance. Adherence to a code of conduct or to a certification system has an evidential value to demonstrate the compliance. Relations with data controllers must be better documented and managed with contracts that contain confidentiality clauses; ultimately, the controllers must guarantee the privacy capabilities of the processors.

#### *Fines and Enforcement*

There will be a substantial increase in fines for organizations that do not comply with the new regulation. Regulators will now have authority to issue penalties equal to the greater of "€10 million or 2% of the entity's global gross revenue for violations of record-keeping, security, breach notification, and privacy impact assessment obligations. However, violations of obligations related to legal justification for processing, (including consent...), data subject rights, and cross-border data transfers may result in penalties of the greater of €20 million or 4% of the entity's global gross revenue".<sup>7</sup>

The effectiveness of the sanctions will, however, depend on the collection mechanism that has not yet been defined. The current framework will probably have to change because the funding mechanisms will be different.

2. The GDPR establishes a new framework for the privacy protection, introducing new obligations and new protections. Impact assessment, treatment register, data breach notification procedures, appointment of the Data Protection Of-

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<sup>6</sup>See Art. 32, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

<sup>7</sup>See Art. 84, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

ficer: these are just some forms with which the GDPR is responsible for the data controllers that, now more than ever, must make data security a central element to their business strategy.

### *Data Protection Officers (DPO)*

Data Protection Officers must be appointed for all public authorities, and where their “core activities consist of regular and systematic monitoring of data subjects on a large scale”<sup>8</sup> or of processing sensitive personal data on a large scale<sup>9</sup> (including processing information about criminal offences) or where the entity conducts large-scale processing of “special categories of personal data” (such as that revealing racial or ethnic origin, political opinions, religious or philosophical beliefs, and the like). This is likely to apply to some of the larger scale Marketing Service Providers and Research Organizations – but needs further clarification. Although an early draft of the GDPR limited mandatory data protection officer appointment to organizations with more than 250 employees, the final version has no such restriction.

The regulation (article 37) requires that they have “expert knowledge of data protection law and practices and the ability to fulfill the tasks”. The level of which “should be determined in particular according to the data processing operations carried out and the protection required for the personal data processed by the controller or the processor.”

What is a Data Protection Officer (DPO) and why are they important for complying with the GDPR? The responsibility of data protection is not new to organizations. Since very large, public data breaches started occurring with alarming frequency in the early 2000s, and regulations such as HIPAA and PCI-DSS were created, oversight of data and its protection has been a C-suite, and now Board-level, concern. Some organizations have Chief Privacy Officers or Chief Information Technology Officers who have data protection under their purview.

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<sup>8</sup>See Art. 37, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

<sup>9</sup>See Art. 37, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

But according to GDPR article 37, one of the mandatory compliance requirements is that companies who manage and/or process large amounts of person data on EU citizens must have a dedicated DPO on staff. The role's responsibilities will include (according to article 39):

- "informing and advising the controller or processor and its employees of their obligations to comply with the GDPR and other data protection laws;
- monitoring compliance including managing internal data protection activities, training data processing staff, and conducting internal audits;
- advising with regard to data protection impact assessments when required under article 33;
- working and cooperating with the controller's or processor's designated supervisory authority and serving as the contact point for the supervisory authority on issues relating to the processing of personal data;
- being available for inquiries from data subjects on issues relating to data protection practices, withdrawal of consent, the right to be forgotten, and related rights"<sup>10</sup>.

Data Protection Officers may insist upon company resources to fulfil their job functions and for their own ongoing training. They must have access to the company's data processing personnel and operations, significant independence in the performance of their roles, and a direct reporting line "to the highest management level"<sup>11</sup> of the company. Data Protection Officers are expressly granted significant independence in conducting their job functions and may perform other tasks and duties provided they do not create conflicts of interest.

The regulation expressly prevents dismissal or penalty of the data protection officer for performance of his/her tasks and places no limitation on the length of this tenure. A company with multiple subsidiaries (a "group of undertakings") may appoint a single data protection officer so long as they are "easily accessible

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<sup>10</sup>See Art. 39, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

<sup>11</sup>See Art. 37, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

from each establishment.” The GDPR also allows the data protection officer functions to be performed by an employee of the controller or processor or by a third-party service provider.

### *Privacy Management*

Organisations will have to think harder about privacy. The regulation mandates a “Risk Based Approach:” where appropriate organization’s controls must be developed according to the degree of risk associated with the processing activities. Where appropriate, privacy impact assessments must be made – with the focus on protecting data subject rights. Data protection safeguards must be designed into products and services from the earliest stage of development – Privacy by Design. Privacy-friendly techniques such as pseudonymisation will be encouraged to reap the benefits of big data innovation while protecting privacy. There is an increased emphasis on record keeping for controllers – all are designed to help demonstrate and meet compliance with the regulation and improve the capabilities of organisations to manage privacy and data effectively. There is an exclusion for small businesses (less than 250 staff) where data processing is not a significant risk.

### *Consent*

Consent is a basis for legal processing (along with legitimate interests, necessary execution of a contract and others). According to the Regulation consent means “any freely given, specific, informed and unambiguous indication of his or her wishes by which the data subject, either by a statement or by a clear affirmative action, signifies agreement to personal data relating to them being processed”<sup>12</sup>. The purposes for which the consent is gained does need to be “collected for specified, explicit and legitimate purposes and not further processed in a way incompatible with those purposes”<sup>13</sup>, This means that consent should be demonstrable – in other words organizations need to be able to show clearly how

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<sup>12</sup>See Art. 4, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

<sup>13</sup>See Art. 5, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

consent was gained and when.

Consent must also be freely given – a Data Controller can't insist on data that's not required for the performance of a contract as a pre-requisite for that contract. And withdrawing consent should always be possible – and should be as easy as giving it.

#### *Information Provided at Data Collection*

The article 13 of GDPR discuss the topic of "the information that must be made available to a Data Subject" when data is collected has been strongly defined and includes:

- "the identity and the contact details of the controller and DPO;
- the purposes of the processing for which the personal data are intended;
- the legal basis of the processing;
- where applicable the legitimate interests pursued by the controller or by a third party;
- where applicable, the recipients or categories of recipients of the personal data;
- where applicable, that the controller intends to transfer personal data internationally;
- the period for which the personal data will be stored, or if this is not possible, the criteria used to determine this period;
- the existence of the right to access, rectify or erase the personal data;
- the right to data portability;
- the right to withdraw consent at any time;
- and the right to lodge a complaint to a supervisory authority".<sup>14</sup>

Importantly where the data has not been obtained directly from the data subject – perhaps using a 3rd party<sup>15</sup> list – the list varies and includes:

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<sup>14</sup>See Art. 13, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

<sup>15</sup>See CASALINO, CAVALLARI, DE MARCO, GATTI, TARANTO, Defining a model for effective e-government services and an inter-organizational cooperation in public sector, ICEIS

- from which source the personal data originate;
- the existence of any profiling and meaningful information about the logic involved, as well as the significance and the envisaged consequences of such processing for the data subject.

There are some exceptions – notably where the effort would be disproportionate (although this is unlikely be a good justification in day to day circumstances) and, importantly, where the information has already been provided to the data subject. This is likely to cause many headaches to marketers using multiple sources of third party data and to those building such data products.

### *Profiling*

The regulation respect to profiling theme is very clear. GDPR defines profiling as "any automated processing of personal data to determine certain criteria about a person"<sup>16</sup>. In particular "to analyse or predict aspects concerning that natural person' s performance at work, economic situation, health, personal preferences, interests, reliability, behaviour, location or movements".<sup>17</sup>

The normative definition of profiling is worrying to marketing companies because the boundary between selection and profiling is not clearly defined. For example, some marketing techniques like personalization and others are based on a selection process built on profiles of behaviour or purchase. In this case consent have to be required.

Therefore, it's enshrined the right of individuals to not be subject to the results of automated decision making, including profiling, which produces legal effects on him/her.

So, to be legal automated decision making must have explicit consent, or if profiling is necessary under a contract between an organization and an individual, or if profiling is authorized by EU or Member State Law.

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2014 - Proceedings of the 16th International Conference on Enterprise Information Systems. 2. 400-408

<sup>16</sup>See Art. 4, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

<sup>17</sup>See Art. 4, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

### *Legitimate Interests & Direct Marketing*

In relation to “direct marketing purposes”, GDPR establishes that the processing of can be considered as a legitimate interest. Legitimate interest and consent are the grounds that an organization can use in order to process data and satisfy the principle that data has been fairly and lawfully processed. GDPR says that processing is lawful if “processing is necessary for the purposes of the legitimate interests pursued by the controller or by a third party, except where such interests are overridden by the interests or fundamental rights and freedoms of the data subject which require protection of personal data, in particular where the data subject is a child.”<sup>18</sup> It is interesting to underline that the regulation does not define precisely what should be considered Direct Marketing, this could lead to interpretative doubts with respect to the use of consent, for example in advertising campaigns.

### *Breach & Notification*

According to the regulation there is a coincidence between “personal data breach” and “a breach of security leading to the accidental or unlawful destruction, loss, alteration, unauthorized disclosure of, or access to, personal data transmitted, stored or otherwise processed”.<sup>19</sup> It’s important to underline that the deliberate destruction or alteration of data is as much a breach as theft.

In these cases, controllers must notify the appropriate supervisory authority “without undue delay and, where feasible, not later than 72 hours after having become aware of it.”<sup>20</sup> If notification is not made within 72 hours, the controller must provide a “reasoned justification” for the delay. However, notice is not required if “the personal data breach is unlikely to result in a risk for the rights and freedoms of individuals,”.

The GDPR provides exceptions to this additional requirement to notify data sub-

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<sup>18</sup>See Art. 6, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

<sup>19</sup>See Art. 4, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

<sup>20</sup>See Art. 33, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

jects in the following circumstances:

- the controller has “implemented appropriate technical and organizational protection measures” that “render the data unintelligible to any person who is not authorized to access it, such as encryption”<sup>21</sup>;
- the controller takes actions subsequent to the personal data breach to “ensure that the high risk for the rights and freedoms of data subjects” is unlikely to materialize;
- when notification to each data subject would “involve disproportionate effort,” in which case alternative communication measures may be used.

#### *The Right to Data Portability*

This part of the regulation seeks to drive automated transfers of data to help competition between service providers between services which primarily process customers automatically.

#### *Retention & The Right to be Forgotten*

The right to be forgotten refers to the obligation for controllers to inform subjects of the period of time (or reasons why) data will be retained on collection. Data subjects can subsequently decide to have their data removed and the data must be erased if it’s no longer required for the reasons for which it was collected. Adapting to such a complex regulatory system is a process of change for organizations that certainly has a technological dimension. The real challenge, on the other hand, is the ability of the organization to develop a new awareness of the value of privacy and an organizational culture capable of overseeing complex compliance processes.

3. In the previous paragraph the complex regulatory structure of the GDPR was analyzed. The Regulation appears as an “unusual hybrid of old and new.”<sup>22</sup> It includes, for example, new rules such as the right to data portability, the “right to

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<sup>21</sup>See Art. 34, Regulation (EU) 2016/679 of the European Parliament, Official Journal of the European Union L119/59 (May 2016)

<sup>22</sup>See MAYER-SCHÖNBERGER, PADOVA, (2016) Regime change? Enabling big data through Europe’s new data protection regulation. Columbia Sci Technol Law Rev 17:315–335



be forgotten”, and mandatory data breach notifications, and it puts a strong emphasis on privacy by design. But it also reaffirms older principles, such as the requirement of a legal ground to allow processing of personal data, although these also sometimes appear in a new guise.

In this way EU underlines that privacy is a central aspect for citizens and it is strongly safeguarded in most countries all over the world. In this sense, all organizations that operate with personal data of EU citizens must be compliant with the GDPR, otherwise, they may occur into legal punishments and monetary penalties.

From the organizational point of view, such organizations are systems made up of people and information systems that interact and share personal data to achieve their objectives. Given the complexity of such systems, privacy must be considered from the organizational planning stage, in fact the GDPR also encourages the principle of privacy by design, and the analysis of privacy should include not only technical aspects, but also social aspects, that are interactions and interdependencies between people and information systems. This socio-technical dimension is recognizable both in the distinction between privacy and data protection, as in that between privacy by design and privacy by default.

The concept of general privacy has been developed by philosophy, psychology, sociology, and in almost all spheres of the social sciences. And yet, it is widely recognized that, as a concept, privacy “is in disarray [and n]obody can articulate what it means”<sup>23</sup>. These different research trajectories that have characterized the contributions of the social sciences to the definition of the concept of general privacy, have encouraged researchers to identify a unique concept of privacy that considers the different research perspectives.

The defining areas can be based either on value or on personal data. The value-based definition considers general privacy as a human right that is part of the system of moral values of society. From an historical point of view, this repre-

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<sup>23</sup>See SOLOVE, 2006. “A Taxonomy of Privacy,” *University of Pennsylvania Law Review* (154:3), pp. 477-560.

sents the first attempt to define general privacy<sup>24</sup>. The debate focuses mainly on the status of general privacy as a human right: in fact, as Smith observed, if there is such a right it is necessary to understand its philosophical origins<sup>25</sup> and, above all, to identify who has the responsibility to protect it<sup>26</sup>.

This vision of general privacy is fundamentally normative<sup>27</sup>, it is not an absolute concept as it may conflict with the legal and social structures of various cultures. The US experience teaches that the right to general privacy was recognized only at the beginning of the twentieth century, in a sense limited to "the right to be left alone"<sup>28</sup>.

In this context, if privacy is considered a human right, its protection must be guaranteed by the state. Two important fields of scholars discuss the role of the state in protecting individual general privacy and then argue for or against the need to regulate general privacy<sup>29</sup>. From this comparison emerges a shared principle or the role of the state as the guarantor of individual general privacy. Paradoxically, the same principles of liberalism that underlie this topic represent the liberal theoretical basis that is contrary to the protection of privacy.

Finally, the economic perspective based on the privacy market. According to this view, privacy is "inherently an economic asset and should be treated as such"<sup>30</sup>. Subsequent works have defined the boundaries between public and private. The evolution of IT has complicated the debate on the boundaries between individual and general privacy. In fact, according to some scholars, "technological

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<sup>24</sup>See SMITH, DINEV, XU, Information Privacy Research: An Interdisciplinary Review, MIS Quarterly, Dec2011, Vol. 35 Issue 4, p 980-A27.

<sup>25</sup>See SCHOEMAN, (1984). Privacy: Philosophical Dimensions. American Philosophical Quarterly, 21(3), 199-213. Retrieved from <http://www.jstor.org/stable/20014049>

<sup>26</sup>See MILBERG, SMITH, and BURKE (2000), "Information Privacy: Corporate Management and National Regulation," Organization Science, 11 (January-February), pp. 35-57.

<sup>27</sup>See POSNER, 1984. "An Economic Theory of Privacy," in Philosophical Dimensions of Privacy: An Anthology, F. Schoeman (ed.), Cambridge, UK: Cambridge University Press, pp. 333-345.

<sup>28</sup>See WARREN, and BRANDEIS, 1890. "The Right to Privacy," Harvard Law Review (4:5), pp. 193-220.

<sup>29</sup>See ROSEN, 2000. The Unwanted Gaze: The Destruction of Privacy in America, New York: Random House.

<sup>30</sup>See BENNETT, P.D. (1995). Dictionary of Marketing Terms. Chicago: American Marketing Association.

innovation has accelerated the dissolution of the border itself"<sup>31</sup>.

Moreover, when the concept of the right to privacy was associated with consumer behaviour, a paradox was noted: despite complaints of continuous violations of privacy, they continue to communicate their personal data very lightly without making an individual and social costs-benefits assessment.

The cognitive dimension of the concept of privacy is extremely interesting. Westin<sup>32</sup> introduced the notion of "state" in the general concept of privacy: "voluntary and temporary withdrawal of a person from the general society". This point of view emphasizes a notion of general privacy concerning the mind, perceptions and cognition of the individual rather than an absolute moral value or norm. Because the withdrawal status is located within the physical or informative space, the concept of privacy concerns the control of physical space and information.

The concept of data protection is also multidimensional. It has a broad meaning and emphasizes a change of perspective: the underlying problem is not simply to be in possession of sensitive data, but to be able to manage them in the right way. It therefore places the emphasis on a process dimension rather than a content. The GDPR has six general data protection principles (fairness and lawfulness; purpose limitation; data minimization; accuracy; storage limitation; and integrity and confidentiality) but data protection by design and default is at the core of the GDPR.

These data protection principles are revised but are broadly like the principles set out in Directive 95/46/EC (the "Data Protection Directive"). It has stated a new accountability principle makes controllers responsible for demonstrating compliance with the data protection principles. These principles are identified in the article 5 of the GDPR that says:

- *Lawfulness, fairness and transparency*: Personal data must be processed lawfully, fairly, and in a transparent manner in relation to the data subject.

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<sup>31</sup>See ROSEN, 2000. *The Unwanted Gaze: The Destruction of Privacy in America*, New York: Random House

<sup>32</sup>See WESTIN, 1967. *Privacy and Freedom*, New York: Atheneum, pag.7

- *Purpose limitation*: Personal data must be collected for specified, explicit and legitimate purposes.
- *Data minimization*: Personal data must be adequate, relevant and limited to those which are necessary in relation to the purposes for which they are processed.
- *Accuracy*: Personal data must be accurate and, where necessary, kept up to date; every reasonable step must be taken to ensure that personal data that are inaccurate, having regard to the purposes for which they are processed, are erased or rectified without delay.
- *Storage limitation*: Personal data must be kept in a form which permits identification of data subjects for no longer than is necessary for the purposes for which the personal data are processed<sup>33</sup>.
- *Integrity and confidentiality*: Personal data must be processed in a manner that ensures appropriate security of the personal data, including protection against unauthorized or unlawful processing and against accidental loss, destruction or damage, using appropriate technical or organizational measures.
- *Accountability*: The controller shall be responsible for and be able to demonstrate compliance with these principles.

The process of compliance is based on two notions: transparency and accountability. Adapting to these principles involves proactive design and privacy conceptualization as a default setting for any data collection exercise. Besides, it must be incorporated into both the design systems of any IT architecture and the general business practices of the organization. Accountability requires organizations to set up appropriate technical and organizational actions, and to be able to demonstrate what they did and its effectiveness. This may also include the use of privacy impact assessments.

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<sup>33</sup>Personal data may be stored for longer periods insofar as the data will be processed solely for archiving purposes in the public interest, or scientific and historical research purposes or statistical purposes in accordance with Article 89(1) and subject to implementation of appropriate technical and organizational measures.

Privacy Impact Assessments and Privacy by Design represent some of the main innovations of privacy policy. A Privacy Impact Assessment is a “systematic process of evaluating the consequences regarding privacy of a specific system or technology”<sup>34</sup>. They are gradually making their way into the public address of privacy protection in Europe. Concepts of Privacy Impact Assessments have already been introduced by data protection and privacy officers in Canada, and in some other countries as well, and some scholars argue that PIAs should become mandatory<sup>35</sup>. Privacy by Design is a more complete procedure than Privacy Impact Assessments. Privacy by Design is described by one of its major promoters, Ann Cavoukian as a process of “building fair information practice principles (FIPs2) into information technology, business practices, and physical design and infrastructures.”<sup>36</sup>, Privacy Enhancing Technologies (PETs) are also related to Privacy by Design. There are several definitions of PETs and the EC communication on PETs<sup>3</sup> use the definition from the PISA project “PET stands for a coherent system of ICT measures that protects privacy by eliminating or reducing personal data or by preventing unnecessary and/or undesired processing of personal data, all without losing the functionality of the information system”.<sup>37</sup>

Regarding the complementary aspect of privacy by default, this principle establishes that, by default, organizations have to process only necessary personal data for the intended purposes and for the period strictly necessary for such purposes. The organizational consequences of implementing the two principles mentioned above is that organizations will need to design a privacy impact assessment model when a project is started, or a system is implemented.

GDPR can be extremely pervasive, so much to provide for the revision of the

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<sup>34</sup>See CLARK, Privacy Impact Assessment: Its Origins and Development, in *Computer Law & Security Review* 25, 2 (April 2009) pp. 123-135.

<sup>35</sup>See WRIGHT, “Should Privacy Impact Assessment Be Mandatory”, *Communication of the ACM*, Vol. 54, No. 8, 2011. pp. 121-131.

<sup>36</sup>See CAVOUKIAN, TAYLOR and ABRAMS, “Privacy by Design: Essential for Organizational Accountability and Strong Business Practices,” *Identity in the Information Society*, Vol. 3, No. 2, 2010, pp. 405-413.

<sup>37</sup>See TANCOCK, PEARSON and CHARLESWORTH, “The Emergence of Privacy Impact Assessments,” *Technical Reports*, Hewlett-Packard Laboratories, 2010.

standard contracts as well as the consequent distribution of the risk / responsibility between the parties. Finally, the data collection process must be rethought, ensuring that the collected data are not excessive. Lastly, the processes of deleting data must be automated.

One major barrier to privacy accountability and privacy branding practices among organizations is the “absence of incentives”<sup>38</sup>. From the branding point of view, stakeholders believe that there is no positive relationship between investments that are costly relative and the expected benefits, which seem low or even non-existent.

In a recent analysis of Privacy by Design and PETs in privacy regulation efforts in the US and the EU<sup>39</sup>, the author suggests instruments by which privacy regulators may develop appropriate incentives for organizations to adopt such schemes. There are several reasons why Privacy by Design and PETs have had a limited success so far. The author essentially observes an information asymmetry among consumers, of which few understand the risks of privacy, while the companies are not convinced of the real advantages of implementing privacy by default as privacy breaches are not publicized due to lack of transparency and regulatory enforcement, and therefore do not present real risks to reputation. Finally, the author suggests co-regulation, self-regulation and government regulation, which will incentivise self-regulation.

In this sense, GDPR follows the direction traced by Rubinstein, but defines negative incentives (penalties) rather than positive ones. While, on the one hand, organizations may not have immediate reputational benefits from the implementation of the GDPR, on the other hand the intensity of the sanctions is such as to encourage adaptation-oriented reforesting behaviour.

#### 4. A first consideration that emerges from the analysis of the problems re-

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<sup>38</sup>See RABAN, "Privacy Accountability Model and Policy for Security Organizations," *iBusiness*, Vol. 4 No. 2, 2012, pp. 168-172. doi: 10.4236/ib.2012.42020.

<sup>39</sup>See RUBINSTEIN, "Regulating Privacy by Design," *Berkeley Technology Law Journal*, Vol. 26, 2012, pp. 1409.

lated to the implementation of the GDPR in organizations is that the organizational culture becomes essential to coordinate the compliance process.

Even if the concept of compliance culture is not new, in the last decades we have seen an increased focus from the regulators on ensuring that companies adopt an effective compliance program as fundamental tool in reinforcing organizational culture.

However, by considering various local and global best practices we can identify some principles that can stimulate an adequate culture of compliance:

- *Compliance systems*: The Compliance system integrates the internal control system and is responsible for assessing, according to a risk-based approach, the adequacy of procedures, processes, policies of organization in order to prevent the risk of non-compliance. This is the risk of incurring legal or administrative sanctions, major financial losses or damage to reputation because of violations of mandatory regulations and self-regulation. Organizations also need clear procedures and protocols in place to ensure that these policies are followed and enforced. The culture of compliance requires a formalization effort, that manifests itself in development and distribution of written standards of conduct, as well as written policies and procedures, that reflect the institution's commitment to compliance.
- *Uniqueness*: there are no organizational solutions that work for everyone. Organizations operate differently and have different cultures. Companies are best placed to understand their own risks and put them into place. Companies must decide how to position themselves in relation to the GDPR theme. An 'off the shelf' is unlikely to work. Culture surveys and risk assessments can be a good start.
- *Leadership*: Sponsorship from the top. Culture is the outcome of a negotiation process at the level of top management that have the responsibility for developing and maintaining a culture of compliance. The responsibility to set the tone and act according to the organization's values is on the board,

chief executives and senior management.

- *Transparency*: transparency means information symmetry. It is important to promote a culture of communication in both directions where employees are encouraged to challenge recognized practices and raise issues when behaviours that expose companies to risks are assumed. The board should also have direct access to all levels of the organization so that it can perform a concomitant control action.
- *Updating*: “It's important to develop a regular, risk-based training plan. Enforcement trends, government priorities and laws change quickly, and it is imperative to stay up-to-date with these changes”<sup>40</sup>. It is fundamental to continuously update the compliance system using various information from risk assessment, analysis of current legislation or specific research. In this way the static compliance process becomes dynamic.
- *Risks and rewards*: Risk assessment is the most important instrument for knowing and understanding the nature of an organization's risks. The purpose of risk assessment is to evaluate the main areas of business risk in order to define policies and protocols able to minimize those risks.
- *Enforcement*: When all the appropriate compliance systems are in place, it is critical to check that employee behaviors are compliant. Disciplinary policies should also be established that clearly state the penalties that must be imposed when staff is involved in misconduct. In the companies where this is tolerated it's more difficult to develop a compliance culture. The definition of a fair and effective disciplinary system is a fundamental element to guarantee effectiveness of the compliance system. Failure to provide sanctions is one of the main causes of socialization and rationalization of misconduct. The culture of conformity is an absolute value for organizations that can minimize general risk on the one hand, and on the other they can defend themselves in the face of the judicial authority in the event of mis-

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<sup>40</sup>See SORRENTINO, DE MARCO and DEPAOLI, “ICT policies, the Mediterranean tradition and the Italian diet of discontinuity”. *Telematics and Informatics*, 34(5): p. 707-716, 2017.



conduct.

Relevant issues remain open. The current data protection framework, implemented through an EU Directive, has led to divergent interpretations in the Member States. One of the major changes with the new framework is that, as a Regulation, it is directly applicable, with limited scope for Member States to impose their own rules.

It will be established the European Data Protection Board to aid the Member State to adopt consistent rules. It will consist of the supervisory authorities from all the Member States that will issue guidance, work towards uniformity of enforcement proceedings and determine disputes involving processing in more than one Member State. Uncertainties remain, however, in relation to national legislative derogations (flexibilities) to create different rules in a range of areas such as the age that children can consent to online information services, the acceptable legal grounds for processing sensitive personal data and the requirements for mandatory appointment of a data protection officer. One unifying thread is that pseudonymization must become the default for all research projects, and clear ethical and organizational measures put in place. However, the EU data protection program is not yet complete. The final content of the ePrivacy regulation will impact on the online environment.

GDPR gives more power and "dignity" to people in the processing of sensitive data as it establishes higher standards for organizational processing data that are philosophically in line with best practices and ethical approaches practiced by research practitioners. GDPR builds on transparency and trust in national and international codes and on best practices that put the interests of the user rightfully at the center.

# THE BANKER'S DUTIES IN THE UK AND EU REGULATORY FRAMEWORK: AN ANALYSIS OF THE ACCOUNTABILITY REGIME

Martin Berkeley\*

**ABSTRACT:** *This paper examines the utility and effectiveness of enforcing banker's duties. In the aftermath of the Global Financial Crisis there has been increased desire by both the public and regulators to make bankers more accountable for their actions. New legislation and regulations have been introduced to address what is essentially an old problem – making bankers responsible for their alleged misdemeanours. Despite the reassurances of regulators and legislators, this paper argues that the effectiveness of sanctions is doubtful and the claims that 'this time it is different and 'something will change' are unlikely to be correct.*

**SUMMARY:** 1. Introduction. – 2. The problem of bankers. – 3. Duties of bankers – 4. The MiFID regime. – 5. The UK Senior Managers Regime. – 6. Fraud, Crime and Dishonesty. – 7. Jailing bankers. – 8. Senior banker accountability. – 9. The court of public opinion. – 10. Conclusions.

1. While hanging bankers may seem a little harsh, the possibility of jailing them for criminal transgressions appears very popular. Moneylenders have never enjoyed a good reputation; historic religious texts warn of the risks of usury,<sup>1</sup> and the fallout of the Global Financial Crisis (GFC) has more recently reinforced the view of bankers as embodying the worst excesses of the capitalist system. Politicians and the media have been quick to tap into public sentiment with even

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<sup>1</sup>For example Exodus 22:25, 'If thou lend money to my people poor by thee, thou shalt not be to him as an usurer' or The Qur'an 3:130 'Devour not usury, doubling and quadrupling'.

the former Mayor of London Ken Livingstone stating: ‘hang a banker a week until the others improve’.<sup>2</sup>

This article discusses how this sentiment has manifested itself in legal and policy terms and what duties bankers owe, how they are judged, punished and the potential consequences and effectiveness. This article primarily focuses on the UK perspective but with reference to wider jurisdictions to illustrate key points. Themes including the unpopularity of banks as institutions and bankers as individuals are considered as well as the effects of formal and informal sanctions.

2. The desire for banker accountability is understandable not only for members of society who have either been harmed or outraged by apparent banking excesses, but also regulators, politicians and members of the banking profession who appreciate the necessity of a stable and orderly financial system.<sup>3</sup> Banks can be lightning rods for socioeconomic frustrations; the impact of a catastrophic financial crisis can have a profound impact on the global economy as well as individuals. The ostensible willingness of governments to intervene in order to regain financial stability with substantial liquidity injections when funds are seemingly unavailable for more popular causes such as education or healthcare fuels the politics of envy, as does the inequality of pay and perceived special treatment of banks as being ‘too big to fail’.<sup>4</sup> The apparent absence of accountability of bank bosses and lack of senior management ‘paying the price’ or even taking responsibility or apologising for failures further fuels the dislike and distrust of both banks and bankers.

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<sup>2</sup>See MULHOLLAND, *Ken Livingstone sparks anger with ‘hang bankers’ speech*, The Guardian 17 February 2012, <https://www.theguardian.com/politics/2012/feb/17/ken-livingstone-hang-bankers-speech>.

<sup>3</sup>For a comprehensive review and analysis of the state of the banking industry and how it is perceived by different sections of the industry see Joris Luyendijk, *Swimming with Sharks: My Journey into the World of the Bankers*, Faber 2016.

<sup>4</sup> Andrew Ross Sorkin provides a detailed account of this concept in his book *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System—and Themselves*, Viking 2009

The necessity of a healthy, efficient and fully functioning financial system is often lost in the criticism of bailouts; without an operative banking system commerce would effectively stop, payments would not take place and trade would be reduced to little more barter.<sup>5</sup> It would seem the vital nature of the financial system, where it is effectively an indispensable utility, leads to the requirement to impose on those responsible for its efficient and stable organisation and functioning obligations and duties of care. Some of these have now found their way into regulation and law.<sup>6</sup>

3. With possibly the exception of central banks and state owned banks, most banks are private or joint stock companies. The directors have duties to comply with the requirements of directors under The Companies Act 2006 in the UK or similar laws.<sup>7</sup> The principle duties for directors are to operate within the law, ensure success of the company, be competent and avoid conflicts of interest.<sup>8</sup> As commercial organisations they are usually ultimately responsible to their shareholders or owners, and without returning a profit, the tenure of a bank's Chief Executive Officer is unlikely to be long. Due to inherent risks in financial systems additional regulations are imposed to ensure financial stability, efficient market functioning, assist in reducing financial crime, enhance competition and additionally to ensure consumer protection.<sup>9</sup> To this end detailed

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<sup>5</sup>See BOAIT, *What would the world look like if the banks crashed tomorrow?* The Independent, 7 February 2016, <http://www.independent.co.uk/voices/what-would-the-world-look-like-if-the-banks-crashed-tomorrow-a6859221.html>.

<sup>6</sup>For example The Financial Services Act 2012, led to the formation in the UK of the Prudential Regulation Authority whose main focus is the stability of the financial system and the Financial Conduct Authority, whose role encompasses appropriate market conduct and consumer protection. See also footnote 10 for full list of the FCA's statutory objectives.

<sup>7</sup>See The Companies Act 2006 <http://www.legislation.gov.uk/ukpga/2006/46/contents>.

<sup>8</sup>See The Companies Act 2006, sections 171 – 177.

<sup>9</sup>In the UK the statutory objectives of FCA predecessor the FSA are described in the Financial Services and Markets Act 2000 (FSMA 2000) part 1. The objective to promote competition was added in 2013 to the newly formed FCA's objectives.

and obligatory conduct of business regulations have developed in addition to high-level financial principles and more detailed conduct rules.<sup>10</sup>

What are bank's duties and where do these come from? These duties may be self-imposed through internal codes or moral standards that pervade an organisation, or they may be externally imposed through laws and regulations. Examples of these external duties would be the duty to investigate such as the Know Your Customer (KYC) rules, duties to disclose all relevant information and warn of unsuitable investments (unless a client knows the risks). There are also duties to act in good faith and in some situations fiduciary duties may arise. How these duties are implemented depends on the circumstances of each client and the duty towards commercial clients is less than those towards inexperienced private client.<sup>11</sup>

There are more restricted rights of action for companies to pursue legal redress than individuals in the UK.<sup>12</sup> Individuals are better protected by the UK financial regulations, as companies cannot sue for breach of statutory duty under the FCA's COBS rules. The Financial Services and Markets Act 2000 (FSMA) describes those that have rights of action as principally being 'private persons',<sup>13</sup> and the case of *CGL v RBS* [2017] confirms that UK courts will not allow small companies to hold banks to the same standards that the regulator requires of them for individuals.<sup>14</sup> Does this also mean that the duties owed by bank directors to companies are less than individuals, and what does this mean for shareholders and investors? The situation is not uniform across Europe, for example the Dutch Supreme Court; the *Hoge Raad*, has ruled that banks have a special duty of care

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<sup>10</sup>For example the FCA's COBS, Conduct of Business Rules and PRIN, Principles of Regulation in the UK.

<sup>11</sup>See BUSCH and VAN DAM (eds), *A Bank's Duty of Care*, Hart (2017) Ch 12.

<sup>12</sup>However MiFID 2 is narrowing this discrepancy. How this will develop practically is yet to be seen.

<sup>13</sup>FSMA 2000 Section 138D and FSMA 2000 (Rights of Action) Regulations, 3(1)(a). Lloyd Maynard notes it would be straightforward for HM Treasury to redefine the meaning of 'private person' within FSMA 2000 Rights of Actions regulations. See Lloyd Maynard '*Holmcroft Properties: will a contractual phoenix rise from its ashes?*' *JIBFL* Vol. 31 No. 6 (June 2016) 358.

<sup>14</sup>*CGL v RBS* [2017] EWCA Civ 1073.

for investors and certain third parties due to the special roll banks play in society.<sup>15</sup>

4. The Markets in Financial Instruments Directive (MiFID)<sup>16</sup> imposes threshold conditions for national regulators to implement not only the detailed rules but also the high level principles required under the so-called 'Lamfalussy' process of Principle-Based Regulation.<sup>17</sup> This process in essence establishes the high-level regulatory objectives with detailed rules being written at a supranational level (such as MiFID) and national regulators implementing these requirements through national business conduct rules, such as the Conduct of Business Rules (COBS) in the UK.

An example of a duty imposed by MiFID is the requirement for banks to classify customers and treat them appropriately according to their circumstances. In essence, more sophisticated and wealthy customers will have less statutory protection because they are deemed to have sufficient knowledge, understanding and experience to enter into a financial contract. This is principally true of individuals, but the same principle applies to commercial customers, who may be deemed to be professional clients or market counterparties. The duty to classify clients and treat appropriately is aimed to addressing the information asymmetries between contracting parties. This classification assists in deducing what level of information is appropriate to be supplied to a customer before entering into financial contract, specifically an investment. MiFID also requires investment firms to act honestly fairly and professionally and in accordance with the best interests of the clients, this is sometimes known as a general duty of

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<sup>15</sup>The Netherlands Hoge Raad, NJ/1999/285, *Mees Pierson/ Ten Bos*, 9 January 1998, Cited in Busch & van Dam (2017).

<sup>16</sup>MiFID, [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/investment-services-and-regulated-markets-markets-financial-instruments-directive-mifid\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/investment-services-and-regulated-markets-markets-financial-instruments-directive-mifid_en)

<sup>17</sup>The Lamfalussy architecture of regulation: <https://ec.europa.eu/info/node/11713/>.

loyalty.<sup>18</sup> However, this duty to act in the best interests does not preclude making a profit. The concept of best interests, while worthy does seem hard to quantify and agree on. Bank directors have what seem to have conflicting duties – the duty to maximise profits for their company and to act in their customer’s best interests.

MiFID has now been superseded by MiFID II (and also the Markets in Financial Instrument Regulation - MiFIR).<sup>19</sup> Notably, MiFID II has expanded and clarified duties of banks and consequently directors, for example widening the scope of what are classified as investments from conventional products such as securities to new asset classes such as structured deposits, insurance based investments and emissions trading.<sup>20</sup> The consequence of the requirements of classification; KYC and suitability will be extended to these assets and resultantly consumers should have greater protection.

In respect of client classification, MiFID II also increases significantly the number of customer types that will be now deemed to be retail customers. For example effectively all customers will be treated as retail clients unless they meet the requirements for professional or counterparty status. In practice this means that even local authorities and municipalities will be treated as retail clients.<sup>21</sup> The thresholds for a business to be defined as a professional client are contained in COBS 3.5 in the UK. It is unclear as yet how the rights of UK companies will balance the new classification realignments against their current limited rights of action. There is divergence in the implementation of the regulations, for example EU Member states are being permitted to apply their own opt up criteria from retail to professional classification.<sup>22</sup> This could potentially lead to regulatory arbitrage between jurisdictions by financial institutions.

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<sup>18</sup>MiFID, Art 19(1) and MiFID II, Art 24(1) Notably, the general duty of loyalty has been extended to eligible counterparties under MiFID II.

<sup>19</sup>MiFID II, [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L\\_.2014.173.01.0349.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L_.2014.173.01.0349.01.ENG) and MiFIR: [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_2014.173.01.0084.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_2014.173.01.0084.01.ENG).

<sup>20</sup>Busch van Dam (2017) Ch 2, 14.

<sup>21</sup>Ibid, 19.

<sup>22</sup>See COLLINS, DOLAN and BROWN, *MiFID II - client classification, agreements, reporting to clients and telephone taping*, Lexology 10 November 2016, <https://www.lexology.com/library/>

MiFID II introduces many other new provisions the consequences of which will take sometimes to manifest their effectiveness. Inducement regulations are expanded and clarified in order to reduce conflicts of interest between a bank and its clients. This could be seen as part of the general duty of loyalty and if a bank allowed its interests to be unduly influenced by external parties, it may be judged to have failed to act in an honest, fair and professional manner.<sup>23</sup> The subject of inducements is potentially problematic for bank directors: banks are rewarded for their business not only in financial terms, but also by provision of research, favourable terms or at a personal level through corporate entertainment. At what point does corporate hospitality cross the boundary to become bribery that may fall foul of anti-bribery laws? In the UK the Bribery Act 2010 introduced stringent requirements for companies to prevent bribery and penalties of up to ten years custody, director disqualification and seizure of assets where guilt is established.<sup>24</sup> The FCA has warned of its concerns in the finance sector, and the law extends to acts of bribery outside the UK.<sup>25</sup> The first prosecution of a bank under the Act took place in 2015 and this will be of concern to bank directors as they may be held liable for the failure to prevent bribery within their organisation, even where the act itself took place abroad.<sup>26</sup>

5. The regulatory burden for bank directors and senior managers have further been augmented in the UK through the introduction in 2017 of the Senior Managers and Certification Regime (SM&CR), which aims to increase personal responsibility of bankers and is being further extended to smaller firms and

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<sup>23</sup>See Busch van Dam (2017) Ch 2, 53.

<sup>24</sup>See Bribery Act 2010, <https://www.legislation.gov.uk/ukpga/2010/23/contents>.

<sup>25</sup>See PICKWORTH, *Beware the Regulator cracking down on Corporate Hospitality*, The Financial Times, 22 May 2016, <https://www.ft.com/content/e37a1632-1da9-11e6-b286-cddde55ca122>.

<sup>26</sup>See *Serious Fraud Office v Standard Bank Plc* (Now Known As ICBC Standard Bank Plc) [2016], The Bank was prosecuted under section 7 of the 2010 Bribery Act, however, this was also a Deferred Prosecution Agreement was entered into, potentially limiting the immediate punishment of bank directors. See <https://www.sfo.gov.uk/2015/11/30/sfo-agrees-first-uk-dpa-with-standard-bank/>.



insurance companies in 2018.<sup>27</sup> This framework has its genesis in the UK Parliamentary Commission on Banking Standards (PCBS),<sup>28</sup> which considered the professional standards and culture in the UK banking sector with the aim of improving standards in banking and restoring public trust in the industry.

The PCBS recommended ‘making individual responsibility in banking a reality, especially at the most senior levels,’<sup>29</sup> as it believed that senior bankers had operated without culpability and with little real chance of being penalised or sanctioned. The PCBS also was of the view that senior bankers would hide behind collective decision-making or claim ignorance of events that happened on their watch. The new approach also made recommendations as to changes to incentives and remuneration structures. The PCBS felt that the existing Approved Persons Regime (APR),<sup>30</sup> benefits were largely illusory and responsibilities were not meaningfully assigned with little risk of enforcement. The UK SM&CR is also an example of where a jurisdiction imposes regulatory requirements above the standard required by MiFID.<sup>31</sup>

Regimes such as the SM&CR bring with it administrative overhead in terms of establishment by the regulator and on-going monitoring, as well as the firms own implementation of the scheme.<sup>32</sup> Mapping exercises of staff reporting lines, as well as scoping and definition of director’s responsibilities have to be undertaken to establish clearly who is responsible for each business area or function. Accountability realignment or organisational reorganisation may be required to ensure that there is no replication or omission of responsibilities. There is also the requirement by the regulator to approve the individuals in the

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<sup>27</sup>See Senior Managers and Certification Regime <https://www.fca.org.uk/firms/senior-managers-certification-regime>.

<sup>28</sup>See Report of the Parliamentary Commission on Banking Standards, *Changing Banking for Good*, June 2013, <http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/>.

<sup>29</sup>Ibid, 8.

<sup>30</sup>See <https://www.fca.org.uk/firms/approved-persons>.

<sup>31</sup>See *Senior management accountability: diverging paths across Europe*, King & Wood Mallesons, 2 December 2016.

<sup>32</sup>See *Senior Managers & Certification Regime (SM&CR): An Overview – Getting Ready for 2018*, Phasellus, undated, 1.

roles. The aim of ensuing personal responsibility, while worthy does open up the possibility of ‘gamesmanship’ by firms in terms of indistinct roles and lack of clarity.<sup>33</sup> Unsurprisingly, a bank is not going to ask for approval of an individual who is likely to be deemed inappropriate by the regulator. The acceptance of a key role also entails risk for the individuals involved. This may raise questions about the rights of the senior manager not only as company officers but also their wider employment rights.

The UK SM&CR regime is not without its weaknesses. There are plans to permit ‘grandfathering’ to allow already approved persons to be transferred without the need to complete any documentation, with the exception of non-executive chairman who will be required to submit documentation.<sup>34</sup> This will result in existing staff that may have committed historic, but yet undiscovered misdemeanours to have the mantle of respectability by being within the curtilage of the SM&CR without any apparent scrutiny as to their probity. Though, being inside the regime will mean that they are potentially now answerable for their historic actions. The use of a ‘grandfathering’ approach is often found in UK financial services and is seen as a pragmatic method of migrating large numbers of staff to new regimes. Whether this is the best method of ensuring better behaviour within banks and senior management accountability remains to be seen, but such an approach does little to increase public confidence in banks. There may be the perception that new regimes such as the SM&CR and little more than bureaucratic public relations exercise and little will actually change as a result.

6. Bank directors like any other actors have to comply with the law. Criminal acts can take place in the corporate environment as well as on an

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<sup>33</sup>See WILLIAMS-GRUT, *Britain's top banking watchdog says some banks are gaming new rules designed to punish execs*, Business Insider UK, 28 September 2016.

<sup>34</sup>See COLLINS, *Key Issues from the FCA Extending the SMCR Meeting 29th January 2018*, Eversheds Sutherlands Consulting, 12 February 2018, [https://www.eversheds-sutherland.com/global/en/what/articles/index.page?ArticleID=en/Financial\\_services/fca-extending-smcr-meeting-120218](https://www.eversheds-sutherland.com/global/en/what/articles/index.page?ArticleID=en/Financial_services/fca-extending-smcr-meeting-120218).

individual basis.<sup>35</sup> Fraud and dishonesty are criminal acts and standard test for criminal dishonesty in the UK is the so-called *Ghosh Test*.<sup>36</sup> This has two elements, the objective test – whether ordinary honest people would regard a behaviour as dishonest, and the subjective test, whether a defendant realised that ordinary honest people would regard a behaviour as dishonest. The media if it accurately reflects public opinion, suggests that many people may regard bankers as criminally dishonest due to the disenchantment with the banking sector in general,<sup>37</sup> thereby superficially satisfying the first test in their minds, but this may fail the second test, as the modus operandi of business operations for banks are no more than standard commercial practice. However the UK Supreme Court recently ruled that it was for a tribunal to judge whether a defendant was guilty of dishonesty in civil cases, which would be consistent with the jury system in criminal cases.<sup>38</sup>

The criminal law remains a method of bringing ‘white collar’ criminals to account and the test for a criminal offence, being higher than civil offence may cause difficulties in obtaining convictions. The difficulty of obtaining criminal convictions led to the creation of a new civil offence in the UK of Market Abuse as opposed to the criminal offence of Insider Trading. Insider trading is described in the *Criminal Justice Act 1993* (CJA),<sup>39</sup> and originally Market Abuse was a criminal offence under FSMA.<sup>40</sup> However, the difficulty in obtaining convictions and lack of effectiveness as a deterrent led to new civil offences being classified as Market Abuse; for example the provision of false or misleading impressions or distortion

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<sup>35</sup>For example both individuals and corporations can be responsible for an unlawful death. An individual causing an involuntary death may be found guilty of manslaughter and a company may cause accidental death for example through safety violations and may be found guilty of corporate manslaughter. See Corporate and Corporate Homicide Act 2007, <http://www.legislation.gov.uk/ukpga/2007/19/contents>.

<sup>36</sup>*R v Ghosh*, [1982] EWCA Crim 2, [1982] 3 WLR 110, [1982] QB 1053, [1982] 2 All ER 689.

<sup>37</sup>See HASTINGS, *Yes, the bankers who robbed us all are criminals. Now let's throw them in jail!* The Daily Mail 29 July 2014, <http://www.dailymail.co.uk/debate/article-2709066/MAX-HASTINGS-Yes-bankers-robbed-criminals-Now-let-s-throw-jail.html>.

<sup>38</sup>See *Ivey v Genting Casinos (UK) Ltd t/a Crockfords* [2017] UKSC 67.

<sup>39</sup>See CJA Section 52 states that an individual who has information as an insider is guilty of insider dealing if he/she deals in stocks or shares whose price will be affected by that information when it is publicly disclosed.

<sup>40</sup>See FSMA Section 397.

of the market. The test of dishonest intention is not required and negligent action or inaction is sufficient.<sup>41</sup> While this demonstrates proactive recognition of legislative failures, it also shows the lack of deterrent effectiveness of the criminal law in particular for white-collar crime. Where the rewards are high and the chances of detection are low, and the prospect of punishment seems remote, it is unsurprising that market abuse or insider trader is still commonplace.<sup>42</sup>

Would ordinary people consider the action of bankers during the GFC dishonest? Certainly the views expressed by the PCBS if representative, reflect the views of ordinary people. Additionally, there is the question whether it is the conduct of individual bankers or banks as institutions that are the dishonest parties or both. If it is individual bankers who are found guilty of a criminal act it is easy to see how the Ghosh test may apply. However, if a bank due to its organisation and lack of oversight is it the directors that are then responsible for these organisational failings. Will the directors of the bank be the ones that ultimately pay the price, or will a lower-level executive effectively become the scapegoat?<sup>43</sup> This raises the question of do senior bankers or directors really know what is going on in their organisations, or are they too big to manage?<sup>44</sup> If the banks are too big and too complex to manage, how can the directors of the bank be held responsible for what happened about local level, especially if they do not have direct control? The head of Global Compliance at HSBC, David Bagley, in

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<sup>41</sup>See BARNES, *Insider dealing and market abuse: The UK's record on enforcement*, undated, [http://www.paulbarnes.org.uk/images/Z\\_IMAGES/Ijlcj.pdf](http://www.paulbarnes.org.uk/images/Z_IMAGES/Ijlcj.pdf).

<sup>42</sup>Paul Barnes reports that research has shown 75% of a share's price rise may be attributable to insider knowledge 'leaking'. See BARNES, *The Regulation of Insider Dealing in the UK: Some Empirical Evidence concerning Share Prices, Merger Bids and Bidders' Advising Merchant Banks*, *Applied Financial Economics*, 6:383-391 (1996).

<sup>43</sup>Tom Hayes a former UBS banker was sentenced to 14 years for LIBOR manipulation in 2015. He maintained that a guide to rigging LIBOR was widely distributed among UBS employees as the practice was commonplace and that he was made a scapegoat. See Ian Fraser, *Libor scapegoat found guilty, sentenced to 14 years*, 3 August 2015, <https://www.ianfraser.org/libor-scapegoat-found-guilty-sentenced-to-14-years/>.

<sup>44</sup>See HEINEMAN JR, *Too Big to Manage, JP Morgan and the Mega Banks*, Harvard Business review, 3 October 2013, <https://hbr.org/2013/10/too-big-to-manage-jp-morgan-and-the-mega-banks>.

defence of his role in the HSBC Mexican Money Laundering Scandal,<sup>45</sup> stated he did not manage or control compliance departments at HSBC subsidiaries, despite his job title, but only set policy and escalated any issues that were reported to him.<sup>46</sup>

Additionally, if key information is being kept from the bank's directors should they be punished for not knowing it if it was effectively impossible to know due to the deceit? In large complex organisations with confused reporting lines it may be difficult to know exactly who was responsible for particular area. A senior manager working for the UK regulator, the FCA also has commented: 'the real threat is not a bank's management hiding things from us: it's the management not knowing themselves what the risks are, either because nobody realises it or because some people are keeping it from their bosses'.<sup>47</sup> In essence, the problem is deciding who is responsible and whether they should have known through their role, and what is an appropriate level or punishment to deter others from committing similar offences. The question at stake is: when criminal penalties are a real rather than a remote possibility, do they act as a deterrent?

7. The GFC reignited or perhaps reinvigorated the desire for bankers to be punished and the PCBS report paints a dire picture of the state of banking and the public's perception of it. Though it is UK in focus, many of the criticisms could be levelled at banks in different jurisdictions.<sup>48</sup>

The actual number of bankers punished is perhaps smaller than the public perception and desire following the GFC. In the UK the Serious Fraud Office (SFO)

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<sup>45</sup>In 2012 HSBC admitted laundering money for Mexican drug cartels and other criminal entities. The bank entered into a Deferred Prosecution Agreement with the US Department of Justice, giving undertakings to improve its internal controls.

<sup>46</sup>See NASIRIPOUR, *HSBC's Mexico nightmare on money laundering*, The Financial Times, 18 July 2012, <https://www.ft.com/content/832b582a-d0f2-11e1-8a3c-00144feabdc0>.

<sup>47</sup>See Joris Luyendijk Banking Blog: *Senior FSA regulator: Can you say no to four or five times your salary?* The Guardian, 25 June 2012.

<sup>48</sup>For further details see Report of the Parliamentary Commission on Banking Standards, *Changing Banking for Good*, June 2013, Chapters 1- 4.

charged 28 people with LIBOR and Euribor manipulation and fraud,<sup>49</sup> of which only 5 have been convicted to date.<sup>50</sup> In the USA the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) charged 402 individuals of whom 324 were convicted 222 were sentenced to prison, of this number 97 were bankers.<sup>51</sup> Possibly Iceland with a population of 330,000 was the country propositionally most damaged by the GFC.<sup>52</sup> In terms of jailing bankers, 26 senior Icelandic bankers have been convicted since 2010, with terms of up to over 5 years imprisonment for individuals such as the Chairman and Chief Executive Officer of Iceland's largest banks.<sup>53</sup> In juxtapose to Iceland, in the UK and USA charges and conviction of bankers have not been at the CEO or senior director level.

The reasons for the effectiveness of the Icelandic approach to director accountability and its higher incarceration rate of bankers may be complex, but one reason may be Icelandic judicial system is not jury based, instead using neutral experts who help judges understand the intricacies of the financial system.<sup>54</sup> The small population and well connected nature of Icelandic society would also make difficult to constitute a jury of individuals unknown to one another, either directly or indirectly, thereby potentially undermining the rule of law and independence of the judiciary. The contention that the shame of wrongdoing and public censure may have a punishing or deterrent effect, particularly in a small and closely knit society, while attractive does not seem valid as it appears that in Iceland that fears of 'crony capitalism' are on the rise again.<sup>55</sup>

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<sup>49</sup>London Interbank Offer Rate and European Interbank Offer Rate, bench mark interest rates.

<sup>50</sup>See LEE, *How many bankers were jailed for their part in the financial crisis?* Channel 4 Fact check, 20 November 2017.

<sup>51</sup>Ibid.

<sup>52</sup>By 2008 the Icelandic economy had become grossly distorted with bank balance sheets growing to 10 times Iceland's \$17.5 Billion economy. Bank defaults shortly after reduced Icelandic purchasing power by 20% and ultimately IMF intervention was required.

<sup>53</sup>See ROBINSON and VALDIMARSSON, *This is where bad bankers go to jail*, Bloomberg Markets, 31 March 2016.

<sup>54</sup>Ibid.

<sup>55</sup>Ibid, the so-called 'Borgun affair', where state assets are allegedly being sold to relatives of politicians via offshore entities without proper scrutiny or oversight, as well as the Icelandic Prime Minister, Sigmundur Davíð Gunnlaugsson, having to stand down following the disclosure of his offshore holdings in the so-called 'Panama Papers'. The continued lack of trust in the established Icelandic political and financial system is also reputed to be a factor in the growth of popularity in

Problems of investigations into bankers and banks are the effectiveness of investigation itself, the timescales and the costs. As already observed, only a handful of senior bankers have faced formal sanction following the GFC. This problem still persists, for example after an investigation of over 10 years incurring enormous costs, the Central Bank of Ireland punished the former Chairman of Irish Nationwide Building Society with a €20,000 fine and a three year disqualification for breaches of the Irish Financial Services Law.<sup>56</sup>

The jailing of bankers may be popular, but understanding what are the duties of bankers and at what point does their breach constitute a criminal rather than a civil offence is more complex.

8. The objective of making senior directors responsible for misdemeanours in their bank can have unintended consequences. The case of JP Morgan Chase and the so-called 'London Whale' illustrates the risk that senior managers of banks, who are not at director level, now may run.<sup>57</sup> In 2013 the FCA concluded there were failings by the bank and fined the bank £137.6 million.<sup>58</sup> These failings were set out in a Decision Notice and Final Notice by the regulator. The FCA published only the latter of these, as it was its practice at the time. Though not named in the notices it was possible to identify Mr Macris by his job title as CIO of the bank's International Unit based London.<sup>59</sup> Mr Macris was not supplied with a

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the new left leaning Icelandic 'Pirate Party', who won 14.5% of the vote and 10 parliamentary seats in 2016 Icelandic election.

<sup>56</sup>See GLEESON, *Former Irish Nationwide chairman censured by Central Bank*, The Irish Times, 12 February 2018, <https://www.irishtimes.com/business/financial-services/former-irish-nationwide-chairman-censured-by-central-bank-1.3389383>.

<sup>57</sup>JP Morgan Chase suffered losses of over US\$6 billion on a synthetic credit portfolio in 2012. The trader responsible for the loss Bruno Iksil and no senior managers faced initially any criminal charges because of the loss, however Iksil's boss Javier Martin-Artajo and junior trader were subsequently charged for hiding the true extent of the losses and there was widespread criticism of the bank's senior management and regulator due to oversight failures. <https://www.hsgacsenate.gov/subcommittees/investigations/hearings/chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses>.

<sup>58</sup>See FCA, *JPMorgan Chase Bank N.A. fined £137,610,000 for serious failings relating to its Chief Investment Office's "London Whale" trades*, 19 September 2013, <https://www.fca.org.uk/news/press-releases/jpmorgan-chase-bank-na-fined-%C2%A3137610000-serious-failings-relating-to-its-chief>.

<sup>59</sup>CIO – Chief Investment Officer.

copy of the notices and was thus unable to make representations to the Regulator before the information appeared in the public domain. Subsequently, Mr Macris took his case to the UK Court's Upper Tribunal who ruled in his favour, agreeing that notices had prejudiced him, as Mr Macris was identifiable from the content of the notices.<sup>60</sup> The FCA appealed to the Court of Appeal who upheld the Upper Tribunal's decision. The FCA made a further appeal to The Supreme Court who upheld the FCA's contention that they had not breached Mr Macris rights as members of the public could not identify him easily.

The Supreme Court was not unanimous in this view and did recognise that the ruling had implications for individuals who may have their reputation or career harmed by public notices.<sup>61</sup> The effect of *FCA v Macris* is that even senior managers who are not bank directors and are not named in a formal notice, but may be identifiable through circumstantial material and hence may find their names appearing in the public domain. This may have the effect of making managers more reluctant to take on roles carrying this type of risk, and raises the issue as to individuals who are not censured by the FCA, may still suffer detriment in the court of public opinion by association.

9. The fear of having one's reputation tarnished by public scrutiny is very real, even when a banker maintains they have done nothing wrong. The appearance of four senior bankers from the failed banks RBS and HBOS before the Treasury Select Committee in 2009,<sup>62</sup> elicited only 'lame partial and insincere' apologies, which angered politicians and increased public fury at both bankers and bank post the GFC.<sup>63</sup> The bankers appeared not to take responsibility for their

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<sup>60</sup>The Upper Tribunal is an administrative tribunal of record in the UK, broadly similar to a High Court, can set and enforce precedents and has the power of Judicial Review, <https://www.gov.uk/government/organisations/hm-courts-and-tribunals-service/about>.

<sup>61</sup>See *FCA v Macris* [2017] UKSC 19.

<sup>62</sup>HM Treasury Committee, *Banking Crisis – Examination of Witnesses (Questions 1880-1899)*, 10 February 2009, <https://publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/09021014.htm>.

<sup>63</sup>See FRASER, *Shredded: Inside RBS: The Bank that broke Britain*, Location 7402, Birlinn 5 Jun. 2014.



actions, maintaining they had done nothing wrong and only expressing regret at the distress the collapse of their banks had caused.

The trepidation of appearing before a Parliamentary Committee or other public body that can hold banker's to account may also have a deterrent effect or alternately give a banker a chance to give their explanation of events. Appearances before Parliamentary Committee's may as noted do little to enhance the reputation of a bank or an individual banker. An example of this is the exchange of the former Barclays Bank Chief Executive Bob Diamond who appeared before the HM Treasury Select Committee and was asked by John Mann MP if he: 'could remind me of the three founding principles of the Quakers who set up Barclays?'<sup>64</sup> Mr Diamond was unable to assist Mr Mann who reminded the former Barclays CEO the founders of Barclays' values could be summarised, with some irony as 'honesty, integrity and plain dealing'.<sup>65</sup> The inference that was drawn was that even the CEO of a major bank did not know the most fundamental principles of his own bank. As judged in the court of public opinion, this did little to rebuild trust in banks or bankers.

The notion that the fear of publicity should act as a deterrent, while appealing is probably simplistic. Analysis of has shown that in the United States when large corporations are prosecuted individuals are often not charged. Nonetheless, Individuals must have committed the crimes within the organisations and the charge rate of individuals is reported to be 34%.<sup>66</sup> Where there have been prosecutions, the majority of these have been low-level employees. Though appearing before a Parliamentary Committee is not the same as being prosecuted, the possibility of having to publically account for the actions of your company may act as a deterrent. The adverse publicity may have long-term consequences; Fred Goodwin, the Ex-CEO of RBS, despite not being found guilty of any criminal

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<sup>64</sup>See <https://www.home.barclays/about-barclays/history/our-quaker-roots.html>.

<sup>65</sup>Evidence by Barclays Bank CEO Bob Diamond to HM Treasury Select Committee - 4 July 2012.

<sup>66</sup>See STEWART, *In Corporate Crimes, Individual Accountability is Illusive*, The New York Times, 19 February 2015, available at <https://www.nytimes.com/2015/02/20/business/in-corporate-crimes-individual-accountability-is-elusive.html>. See also GARRETT, *Too Big to Jail*, Harvard University Press, 2015.

offences was the focus of much public anger and suffered the public humiliation of being stripped of his knighthood.<sup>67</sup>

10. The quest for banker answerability is understandable given the long history of lack of senior accountability by bank directors. It is therefore unsurprising that legislation has been enacted by many countries to act as a deterrent or as a punitive method and potentially as a route to redress for banking system failures by bank directors. The effectiveness of this regulation is however questionable, not only because banks may 'game' systems, but also the use of judicial devices such as Deferred Prosecution Agreements (DPA) give the appearance of letting bankers 'get away' with a crime. The HSBC Mexican money-laundering affair is illustrative of this; the bank was with served with a 5-year DPA, and the bank deferred selected bonuses of some senior bank officials. The fine paid by the bank of \$1.9Bn, which was less than five weeks income for HSBC's US subsidiary. This was despite HSBC having been found to have had 'stunning failures of oversight' allowing drugs cartels and sanctioned countries to launder money with apparent impunity.<sup>68</sup> It does appear that in such cases bank bosses have paid very little in terms of a personal price for extraordinary levels of negligence, incompetence or criminality, the fines of course being paid ultimately by the shareholders, rather than the directors who had responsibility for the failures. Whether the UK's SM&CR regime will be effective in prevention of such cases is perhaps too early to tell, but the concerns of banks 'gaming' the system and the use of 'grandfathering' do not inspire confidence.

The phenomenon of badly behaved banks and bankers is not new, as is the wishing for responsibility to be taken where there is culpability. The lack of trust in bankers and the banking system is not helped by the apparent ease with which

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<sup>67</sup>See WINTOUR, *A Reputation Shredded: Sir Fred loses his Knighthood*, The Guardian, 31 January 2012, <https://www.theguardian.com/business/2012/jan/31/fred-goodwin-loses-knighthood>.

<sup>68</sup>See VULLIAMY, *HSBC has form: Remember Mexico and laundered drug Money*, The Guardian, 15 February 2015, <https://www.theguardian.com/commentisfree/2015/feb/15/hsbc-has-form-mexico-laundered-drug-money>.

effective sanctions can be avoided. The apparent low risk of detection of profitable, but unscrupulous behaviour, will still motivate some to commit misdemeanours and while the senior directors may be criticised a more junior employee may be the one who faces jail. As Walter Bagehot noted: 'a bank lives on credit. Till it is trusted it is nothing; and when it ceases to be trusted, it returns to nothing'.<sup>69</sup> Continuing and repeated financial scandals, lack of deterrence and effective punishment has rapidly emptied the banking industry's credit account in the court of public opinion.

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<sup>69</sup>Attributed to Walter Bagehot, the editor-in-chief of *The Economist* in the 1860s.

## REGULATION OF SHADOW BANKING SYSTEM IN CHINA. FOCUS ON ALLOCATION OF REGULATORY POWERS

WU Fengjun MIN Le\*

**ABSTRACT:** *The shadow banks, considering their peculiarities, shall be subject to strict supervision by the competent Authorities. In the supervision on such banks and on the shadow banking system in its whole, the balance between the need for supervision and the rights of the several subjects involved in the system represents the main issue. The supervision should be aimed at granting both the stable financial order and the rational allocation of regulatory powers, considering the interests of financial customers. In China, the regulation activity on the shadow banking system shall be carried out considering the relevant context, realizing the coupling of macro and micro prudential needs, granting the coordination between the activity of the “three associations” (see infra) and the local financial authorities and considering both the self-discipline of the system and other legal powers.*

**SUMMARY:** 1. Introduction. – 2. The need for regulation of the shadow banking system. – 3. The theoretical basis of regulatory power allocation for shadow banking system. – 4. The value orientation of regulating shadow banking system.

1. The shadow banking system in China has grown at full speed during the last years. Even if the development of the shadow banking system has been considered depending on the economic growth (Shen, 2013), empirical data and the experience of certain developed countries showed that the development of such system is preventable in China.

To proper enhance the regulation of the shadow banking system, the im-

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portance of such system shall be considered due to its influence on the banking system in its whole.

There is a strict connection between shadow and traditional banking activity. First, there are cross interests related to both systems; furthermore, shadow banks directly influence the traditional banking industry and, therefore, (indirectly) the development of the Chinese financial sector. More specifically, when traditional commercial banks do not meet the needs for finance of their clients, shadow banks can offer new financial products and instruments. Therefore, shadow banks can give credit due to their flexibility; on the other hand, the risk of losses in case of default of such banks is much higher than the same risk in case of default of traditional banks, being the capacity of the former to give credit strictly connected with their little or none regulation.

2. Since the 2008 Global Financial Crisis, several regulations on shadow banking system have been proposed in western countries, in order to reduce its endogenous vulnerability and maintain the stability of the international financial system. Hence, the shadow banking system became the focus of attention and has been treated as a dreadful monster. Mark Carney, chairman of FSB, considered that the greatest danger to the world economy are the shadow banks in emerging countries (Economist, 2014)<sup>1</sup>. Neither financial markets nor the shadow banking system in China are so developed and highly complicated. Which are the risks of shadow banking in China? Are these risks big enough to trigger regulation?

*Liquidity risk and credit risk aroused by maturity mismatch*

The shadow banking system has some specialties on terms of its operating structures of financial assets and liabilities; for example, the phenomenon of short-term borrowing with long-term lending is quite common. Take the bank's financial products as example: the biggest exposure that shadow banking is facing is the li-

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<sup>1</sup>The economist: the *lure of shadow banking*, May 10<sup>th</sup> 2014.

quidity risk caused by mismatch maturities, as the maturity of bank's financial products is mainly within six months which request highly liquid assets to back up, while the investment of bank's financial products is mainly composed of long or indefinite maturity asset such as bonds, asset back securities (ABS) and investment funds. The investment period of the assets does not match the maturity of the bank's financial products. Hence, the problem of mismatch. To solve it, commercial banks undertake the management mode of "fund pool-asset pool". The banks continuously renew the sales of financial products, so that they can make investment in long-term assets. However, the liquidity risk will occur once the fund chain breaks.

Credit risks and operations of shadow banking institutions go along with each other: the clients of shadow banking institutions are mainly enterprises with high credit risks and low credit ratings, among which SMEs. In the meantime, off-balance sheet activities of traditional banks are expanding, thus increasing the off-balance sheet credit risk. Take real estate as example: the collateral value decreases as its market value shrinks, so that the effectiveness of such collateral to hedge credit risks will be greatly reduced. When the market value is lower than its collateral value, credit risks occur, chain reactions make credit risks spread across the shadow banking system and, eventually, financial systemic risks erupt. This scenario is not just envisaged in the United States but can also take place in China, so it is worth to have a closer look at the phenomenon and take serious supervision measures.

### *Systemic financial risk*

The growth of the shadow banking system is an important element of the financial liberalization process in China and, therefore, such a phenomenon should be treated as a new and important element also for the existing commercial banking system. Such circumstance explains why the shadow banking system may give rise to a systemic financial risk; there are no tested supervisory and control systems for shadow banks nor sophisticated crisis management mechanisms. Should the crisis affect the shadow banking system, it can easily affect the traditional banking system and, subsequently, considering the current financial globalization, the financial crises

could soon evolve into systemic global financial ones.

It has to be pointed out that the systemic financial risk does not entirely derive from the shadow banking system and, therefore, the crises of the shadow banking system and the systemic financial crises do not always occur simultaneously. The major source of systemic financial risks are still traditional banks; however, the risks caused by traditional institutions are considered predictable and manageable and then are often neglected because of the presence of the competent Authorities and legislative restrictions. For example, during the Chinese stock market disaster of July 2015, without the attention of the Central Bank of China, the China Securities Regulatory Commission (CSRC) and other Authorities, a systemic financial crisis and even an economic bust, would have happened. Besides, the local Government's debt and the operational risk of the real economy are also the source of systemic financial risks, if current land finance mode of local Governments has crisis, then the systemic financial crisis may also occur.

Therefore, the shadow banking system represents only one of the elements potentially triggering systemic financial crises. Nevertheless, among these elements the shadow banking system is the less regulated. Thus, this seems to justify why it is the target of criticism. One of the arguments for regulation of the shadow banking system is just the fear of systemic financial risk arising from its inadequate regulation. *The shadow banking system which is outside the financial safety net has increased financial instability*

Shadow banking institutions, typically operating in the asset securitization and internet finance fields, have recently occupied the forefront of financial activity. Financial innovation is the driving force and the symbol of the shadow banking system. The unregulated shadow banking system escaped from the financial security network, increasing the instability of the whole financial system.

The core of the financial safety net is usually made up of three patterns of defense: (i) the risk-based capital requirements of micro-prudential supervision, represented by the Basel Accords; (ii) the central banks' role as "the bank of banks"; (iii)

the deposit insurance system, aimed at protecting the interests of depositors (Tang, 2012) <sup>2</sup>. However, the financial safety net based on the abovementioned three patterns does not work for the shadow banking system. In fact, the Basel Accords are not binding for non-traditional banking financial institutions, such as the shadow banks, and the Central Bank's role is to support traditional commercial banks but shadow banking institutions are unable to get such support; finally, the deposit insurance system, which is the last line of defense, is designed for "depositors" of the commercial banks and not for the "investors" of the shadow banking products.

Shadow banking institutions and businesses – such as non-bank payment institutions, asset securitization business, margin trading and securities lending – are out of regulation but not isolated from traditional commercial banks. They all provide for financial products based on their own financial platform and form a credit chain with commercial banks by means of securitization, loans, mortgages and other instruments aimed at attracting money into the shadow banking system. This makes non-bank payment institutions huge pools of capital, while financial companies become a place to put money other than banks. The reason why the shadow banking system is likely to aggregate, infect and spread financial risks is just because it escapes from the protection and regulation of traditional financial safety nets, which has exacerbated the fragility of the modern financial system.

3. The operativity of shadow banks mainly involves three types of relationships: *(i)* firstly, the relationship between the shadow banking institutions and the financial customers, deriving from investments, lending, transfer and other financial activities; *(ii)* secondly, the relationship between the Authorities and the shadow banking institutions governed by several rules deriving from mandatory requirements aimed at preventing systemic risks, *(iii)* finally, the relationship, which has a relevant impact on transactions, between shadow banking institutions and other in-

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<sup>2</sup>See TANG, The shadow banking system: function, vulnerability and regulatory reform [M]. Beijing: press of intellectual property rights, 2012:74.



stitutions involved in the financial system, such as rating agencies and guarantee institutions.

The main issue concerning the abovementioned relationships is the balance between the Authorities' needs for supervision and the rights of the other subjects involved as well as equilibrium between internal and external compliance.

### *(1) Interest balance theory*

#### *The meaning of the theory of interest balance*

What is the "interest"? From a legal standpoint, the so-called benefit refers to people's various objective requirements for certain objects, which are restricted by objective laws and are created to satisfy survival and development (Zhao,1999)<sup>3</sup> Interests are expressed through money, power, rights and status, and the pursuit of interests constitutes a rich and colorful lifestyle in society. However, pursuit of interests without control will lead to obsessive behaviors and social chaos, so that the interests of each individual will be difficult to achieve. Therefore, society should allocate interests. Pure self-discipline does not realize it properly. Therefore law is needed to adjust and control. Law becomes the yardstick for the adjustment and control of interests, and the law becomes the standard upon which interests are divided and distributed. Thus, the basic function of law to dispute settlement is realized.

According to Ezra Pound, the function of law lies in adjusting, reconciling and mediating various complicated and conflicting interests, so that most of the interests or the most important interests in our culture are satisfied, and other interests are at least sacrificed (Zhao, 1999) <sup>4</sup>. Human reasoning makes people realize that there is common interest in the private interests among people. The overall interest of society must be safeguarded when protecting individual interests. The realization of the former is a precondition for the realization of the latter. Should we only consider the individual ones, then the foundation of our overall interests would be lost. On the contrary, excessive emphasis on the overall interests may harm the individual ones.

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<sup>3</sup>See ZHAO and FU, Modern jurisprudence [M]. Beijing: Peking University press, 1999:85.

<sup>4</sup>See ZHAO and FU, Modern jurisprudence [M]. Beijing: Peking University press, 1999:89.

One main function of law is to compare the different interests of individuals and to find a balance between conflicting interests, which are, from a general standpoint, closely related to socio-economic relations. Philip Heck, a German jurist, states that law is a balance of interests (Zhao, 1999)<sup>5</sup>. Therefore, legal provisions can be regarded to as a generation of value judgment, *i.e.* “*the social groups in the side of the conflicting interest should take precedence over the interests of the other party, or the interests of both sides in the conflict should be subject to the third party interests or the interests of society as a whole*” (Bodenheimer, 1999)<sup>6</sup>.

The balance of interests helps to provide the legal standards and basis for the coordination of conflicts of interest after making judgments on the importance of various interests. From a general standpoint, law should represent several interests and coordinate and integrate personal, public and social interests. Social organizations, as social intermediaries, can coordinate the relationship between individual and national interests, as well as that existing between stakeholders and the market, becoming tools and buffer zones to realize the social, individual and the Government’s interests. Law acknowledges the existence of groups and individuals representing their own interests, and the corresponding work of the Government is to enable social organizations to have access to public order and individual interest to be expressed through institutional arrangements. There is no equilibrium in society itself. Law requires the Government to balance the conflicts of interests so that human society does not destroy itself in such a conflict. The law should balance private and public interests, short-term and long-term interests, material and spiritual interests, as well as overall and local interests. The balance is usually achieved through the allocation of powers and the design of the system. Specifically, the balance of interests in the shadow banking system is shown in the allocation of the supervision powers of regulators and the design of the supervision system.

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<sup>5</sup>See ZHAO and FU, *Modern jurisprudence* [M]. Beijing: Peking University press, 1999:88.

<sup>6</sup>See BODENHEIMER, Translated by DENG, *Legal philosophy of jurisprudence and legal method* [M]. Beijing: China university of political science and law press, 1999:144.

*Balance of interests when regulating shadow banking system.*

When we look at the regulation of the shadow banking system, there is a question that cannot be avoided: what is the goal to be achieved in regulating the shadow banking system? To be specific, is the goal of regulating the shadow banking system to prevent systemic financial risk or to protect the operating order of the shadow banking system? Is the goal to ensure national financial security and efficiency or to protect the interests of financial customers? Is the goal to maximize overall interest or to maximize individual rights? To answer these questions, we can't just make simple choice of either A or B.

Different legal relationships need different regulation principles, and the legal relationships in the operating of the shadow banking system should have both public and private law attributes. Therefore, the mechanism based on the balance of interests should be applied in the supervision of the shadow banking system. From an economic perspective of the law, which maintains the overall economic interests of society, the State is the representative of the overall interest of society, whereas the Government is its main contributor (Feng, 2004)<sup>7</sup>. The aim of regulation on the shadow banking system is to safeguard the interest of the whole society, while Commercial law's is to protect individuals' interests.

Except in some cases, individual and social interests converge but usually are not compatible (Zhao, 2002)<sup>8</sup>; therefore, the protection of the overall interest of society and the maintenance of individual interests should be both part of the modern rule of law. With the interaction of these two interests, the supervision of the shadow banking system is established through legislation and a realistic maintenance mechanism is established as well with the aim to achieve a balance of interests.

If financial markets are competitive enough and symmetry of information is

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<sup>7</sup>See FENG, WAN, Research on the representation and formation mechanism of the overall interests of the society -- on the position of state and Government in the view of economic law [J]. Contemporary law, 2004 (3): 89-97.

<sup>8</sup>See ZHAO, Basic problem of commercial law [M]. Beijing: law press, 2002:101.

granted, there is no need for any regulatory intervention<sup>9</sup>. However, the existing financial market is not the ideal market, which is filled with the chaotic phenomena such as information fraud and improper competition. Therefore the Governmental intervention in financial market is necessary. Highly-innovative financial instruments brought great benefits and at the same time huge damages to the financial system. The outbreak of financial crises, or the likelihood of outbreaks, has prompted regulators to step up in oversight of the shadow banking system in order to eliminate regulatory gaps. However, today's financial markets are much more complex than those of 50 or even 20 years ago, because globalization has made financial subjects, regulatory concepts, tools and measures much more complex. In order to focus on the interests of each financial subject in the financial markets and to coordinate their interests, different regulatory approaches shall be used.

There has always been a tendency to socialize the interests of financial institutions. A company must face different stakeholders and try to balance their interests, while shareholders of companies have been transformed from a single entity to multiple entities. One of the great lessons of the 2008 Global Financial Crisis is to establish a protection system for the financial consumer's rights<sup>10</sup>. For the first time, they have emerged as important stakeholders in the field of financial supervision. In a civilized society, the respect and protection of customers is the focus of legislation and law enforcement. Regulators cannot treat financial customers as a mature and per-

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<sup>9</sup>The total earnings of U.S. Banks in 2014 are about \$150 billion, and we expect an additional \$11 billion in profits over the next five years. These shadow Banks are likely to earn 7% of the bank's annual profits. See: shadow banking will eat \$11 billion a year in annual profits[EB/OL]. <http://bank.cf8.com.cn/news/20150308/51686.shtml>.

In June 2009, the Obama administration announced the reform named "*the new basis of financial regulatory reform: reconstruction of financial regulation*". More than a year later, after the debate in the house and senate of the United States, an agreement was finally reached. On July 21, 2010, the financial regulatory reform law signed by President Obama. At this point, one of the important financial consumers' rights and interest protection legislation came up, the *Dodd - Frank Wall Street reform and consumer protection Act*.

fect investor. Although consumption should be rational in theory<sup>11</sup>, in real terms financial customers are not completely rational. Many financial customers are affected by emotions when making investment decisions or accepting financial services, or engage in financial consumption with blind or herd mentality. In other words, the financial consumer's rationality is limited. Human behavior may be systematically biased, so collective irrational financial transactions are not uncommon. Financial transactions between financial customers and financial service providers are based on the so-called rational judgment of both parties. In other words, financial transaction prices are ultimately determined by rational market participants. In practice, however, the price formation of financial markets reflects only the events and possibilities that traders can foresee. Market prices do not reflect events beyond the cognitive abilities of those traders, while these unforeseen events have had a significant impact on financial prices. When the fat-tail event occurs, financial transaction prices will be significantly affected<sup>12</sup>. It is unfair for financial customers alone to bear the heavy losses caused by the financial crisis and let them face unstable financial markets and financial transactions themselves. Regulators have an obligation to legislate for financial customers and to protect financial customers through the exercise of regulatory authority. The balance between the power of supervision and the rights of customers should be sought to ensure the realization of the rights and interests of financial customers.

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<sup>11</sup>Rational consumption refers to the consumption by consumers in accordance with the principle of utility maximization. From a psychological point of view, rational consumption is the consumer make reasonable purchase decision according to their ability and judgment. When the material is not abundant rational, consumer psychological pursuit of goods is cheap and fine durability.

<sup>12</sup>Fat tail refers to an increase in the probability of extreme events, which may cause a major market shock due to unusual events. Tail Risk refers to the statistical two extreme value possible risks, according to the normal bell-shaped distribution, at the ends of the probability distribution is fairly low (Thin Tails). However, the distribution of the two extreme values may also show the risk of fat-tail, which is the probability of deviation from the mean increases. That is, the probability of being less likely to appear suddenly increases. Applied in financial markets, that is the extreme market appears more likely and frequent, which could lead to market swings, the reason may be unusual events appear in the market, these events are called "fat tail" events, such as the collapse of Lehman Brothers in 2008, such as southern Europe's sovereign debt crisis of 2010.

A good financial order is the result of the multi-party game and balance between the power of national financial supervision Authorities, the individual rights of financial customers and the rights of financial institutions. Government regulators should help financial customers reduce and control the trading risks, while financial institutions pursuing their own economic interests shall be under the control of the regulatory Authority and the realization of the financial consumer's rights. On the theoretical level, we can consider the obligation of financial institutions as their social responsibility. The lack of social responsibility of financial institutions is an important cause of financial crisis. At present, the primary obligation of financial institutions is to comprehensively guard against financial risks, maintain financial security and prevent the recurrence of financial crises (Gao, 2011)<sup>13</sup>. Therefore, the boundary of rights should be balanced between the macro financial order and micro rights protection.

#### *(II) Theory of Financial Constrains*

Hermann, Murdock and Stiglitz (1997) proposed the theory of financial constraints, after examining the issue of deregulation and strengthening of Governmental intervention in financial regulation. They argue that the experience of financial repression is dreadful for developing economies or economies in transition. The effect of financial liberalization is less decisive than expected, so there is a need for additional policy - financial constraints. The aim of "financial constraints" is to set up rents in the financial sector and the production sector, where rents are referred to the benefits more than the revenue generated by competitive markets. The essence of financial constraints is that the Government creates rent opportunities in the private sector through a series of financial policies, rather than directly subsidizing the private sector. Although the theory of financial constraints is reasonable, the execution may be poor or distorted due to a variety of reasons. The biggest danger is that

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<sup>13</sup>See GAO, WU, Legal research on corporate social responsibility under the perspective of globalization [M]. Beijing: law press, 2011:238-245.

financial constraints are turned into financial repression<sup>14</sup>. Financial constraints differ from the financial repression policy, although both theories recognize that the development of finance must have an open and liquid financial market. The financial repression theory holds that the problem should be solved through market mechanism and measures. The function of the Government is to build a fair competitive market environment rather than directly intervene in the development of financial market. The theory is based on a stable macro environment, low inflation rate and positive real interest rate, where the most important point is that the Government does not snatch rents from the financial sector.

The theory of financial constraint stresses out that market failure is very common, and market players cannot solve the market failure by themselves, where it is necessary for the Government to intervene in market activities to stabilize the financial order and promote financial development through institutional and policy arrangements. Financial constraints include lending rates, restrictions on market access, restrictions on banking competition, etc. There is a wide debate about whether there should be more Governmental intervention or more market regulation. Government intervention cannot replace the self-regulation of the market. Direct Governmental intervention on financial institutions can easily destroy the order of the financial market. The financial market has its own laws of development and the Government can neither replace nor ignore the market. The Government can guide non-Governmental organizations and financial market institutions to conduct self-discipline and external control through policies and institutional measures. The market's ability to solve market failure is huger than we think. The good game between Government and market can reduce or solve market failure. On the other hand, the financial constraints theory is embodied in the promotion of the Governmental power to market mechanism. So far the development of the shadow banking system is concerned, the Government can either provide for institutional arrangements for the

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<sup>14</sup>See HERMANN, MURDOCK, STIGLITZ, Financial constraints: a new analytical framework [J]. *Economic guide*. 1997 (5): 42-47.

development environment of the shadow banking system or harmonize the financial self-discipline of the market which is to attain the goal established by Governmental regulation.

In the financial sector and other industries there are self-regulatory organizations, most of which are in form of industrial associations. Although these organizations are self-disciplined, they are not subject to the rules applicable to private entities. Financial self-discipline combines business freedom with Governmental regulation, and it is also a good coordination and arrangement of commercial rights and Governmental power, as a mechanism for self-management and restraint within the industry. Financial self-discipline has the right of management within the industry, which comes from the assignment of the Government's regulatory Authority to industry organizations, it brings market power back to market and allows self-realization of the market subject.

When people consider the experiences and lessons from the financial crises, they focus more on the Government's financial regulation and less on self-discipline to solve the financial crises and the role of the financial risk prevention. Experience proves that Governments before crises do not effectively combine the direct enforcement of supervision right with the delegation of supervision authority. Now we need to take a close look at the value of self-discipline in the industry. From the perspective of the effectiveness of supervision, governmental regulation of individual financial institutions cannot effectively inhibit and detect systemic risks, for it should focus on the overall systemic risk and even more on the overall financial order. The risk investigation based on the industry self-discipline cannot fully discover the systemic risk of the financial system. Instead, it provides a way to overcome the failure of the market and the Government. As scholars have pointed out, in the modern economic system, the main body of society is based on the needs to make up for market failures and the Government's defects. Generally speaking, market failure can be offset by the Government and the Government's failure can be offset by the market. However there are still some failures that cannot be offset. In this case, the main



body of society can perform some functions which the Government has assumed. It can also replace some of the functions previously assumed by the Government, to a certain extent, to compensate the double failures (Wang,2002)<sup>15</sup>.

Although financial self-discipline has its advantages, Governmental regulation cannot be replaced. The subjects involved in the financial self-discipline entities support private interests and could neglect public interest. Financial supervision and financial institutions operating in self-discipline are strictly connected: the regulator is short of professional knowledge in financial industry, so financial institutions need to provide regulators with information. The self-discipline system of financial institutions is supposed to control financial institutions' speculation, improve the level of self-discipline, taking advantage of the financial self-discipline characteristics to serve financial regulation. The common goal of both sides is to guard against systemic risks, and financial self-discipline becomes an important supplementary form of financial regulation.

The continuous development of the shadow banking system has led the regulatory authority to be rearranged and distributed between the regulatory agencies and the industry associations' self-regulatory bodies. Financial self-discipline is shown as the regulatory Authorities entrust power and process of administrative supervision to industry associations, and associations have the right to self-management. In the case of the China Banking Association, which has the characteristics of autonomy, non-profit, membership, voluntariness and entity, there is no State power organ, despite having certain characteristics similar to that, and there is no market subject, despite being similar to the market subject (Xiong 2013)<sup>16</sup>. The value of industry associations is that it serves as a buffer and bridge between market failure and State intervention. This should be undertaken only if the market and industry associations cannot resolve it. The previous two-step model of "market failure

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<sup>15</sup>See WANG, Research on basic theory of economic law [M]. Beijing: China monitoring press, 2002:274.

<sup>16</sup>See XIONG, Research on the boundary of banking supervision rights [M]. Beijing: law press, 2013:190-194.

- State intervention” has evolved into a three-step model of “market failure - industrial autonomy - State intervention” (Lu, 2006)<sup>17</sup>. Shadow banking institutions have the potential to trigger financial systemic risk, but they also need financial regulators to give them greater financial autonomy, allowing them to control and manage themselves.

4. The development of the shadow banking system, as well as its constant innovation, has led financial regulators to face new challenges and obstacles. Before taking regulatory measures, complete shadow banking system supervision value concept is crucial, which points out the direction of development for regulatory actions and measures, and it is also the measuring stick on the basis of which behaviors and measurements are regulated. As an integral part of the national financial supervision, the value orientation of the shadow banking system and the value orientation of financial supervision have their points in common and differences. We think that the basic value of the regulating shadow banking system is embodied in a stable financial order, being its instrumental value characterized by a reasonable allocation of supervisory powers and its purposeful value represented by the comprehensive social interest centered on financial customers.

*(1) Basic value: stable financial order.*

Order is the basic value of law. As a social norm, one aim of law is to settle disputes to realize the orderliness of society. The realization of the order value of law is to adjust the social order effectively, to realize the order goal set by law, and to maintain, consolidate and develop the order established according to the law (Zhuo, 1997)<sup>18</sup>. The stable financial order is the most fundamental value of regulation for the shadow banking system. The referred stable financial order should be the order that takes financial security as core. In other words, the basic goal of the regulation

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<sup>17</sup>See LU, On the interaction between industry association autonomy and state intervention [J]. Journal of southwestern university of nationalities (humanities and social sciences), 2006 (9): 75-79.

<sup>18</sup>See ZHUO, The axiology of law [M]. Beijing: law press, 1997:190.

for the shadow banking system is to achieve a stable financial order.

Vulnerability, negative externality and information asymmetry of the shadow banking system are more serious than in traditional financial institutions. The allocation of financial market resources will result in inefficiency and moral hazard, which cannot be overcome by its own spontaneous adjustment. Financial market participants make decisions based on their own interests, which is an inevitable operational mode. Only Governmental regulation for public interest can overcome the disorder of the shadow banking system itself. To avoid systemic financial risks, the goal of the shadow banking system is to realize the ordering operation of the shadow banking system, so to determine stability in the overall financial order and even stability in the social order.

Not only does the regulation of the shadow banking system consider the local financial market order where shadow banking institutions and businesses operate, but it should also take much more into account the shadow banking's influence on the overall financial order, so as to avoid the pursuit of the interests and efficiency of the shadow banking business and ignore the whole financial order and interests. The stable financial order is the consequence of legal governance. In the process of its realization, the law should be at the supreme status, while other social norms should be based on the law.

*(II) Instrumental value: reasonable supervision power allocation.*

The regulation of the shadow banking system has an important impact on shadow banking institutions, as well as their participants and businesses. As mentioned earlier, the aim of regulation is financial stability. Nevertheless, the relationship between financial stability and efficiency is likely to prove negative. In fact, in the absence of supervision, within the shadow banking system new and innovative operations can be carried out with consequent increase in efficiency even if interests of customers may be harmed; on the other hand, excessive regulation inhibits innovation, potentially reducing financial efficiency. Financial efficiency, together with financial stability, can be reached and therefore the balance between deficiency and

excessiveness in regulation is crucial for the competent bodies and concerns the regulation of the whole shadow banking system. Such efficiency could be reached by a reasonable allocation of the supervisory powers.

When establishing the mechanism for the implementation of each value, such a mechanism should aim at realizing the determined value of its existence (Pan, 2009)<sup>19</sup>. When shadow banking institutions harm the interests of the customers, markets make “their choices” through the customers’ decisions. Anyhow, the choice of customers is often inconsistent with financial stability. Therefore, taking measurements on the allocation of regulatory powers of the shadow banking system, such as legislation recognizing the financial customers’ rights including information security rights and equal rights to cope with possible bad behaviors of shadow banking institutions, should be considered and customers should be provided with rights that constrain financial institutions through deposit insurance system and financial institution crisis disposal measures.

States must choose and compromise between financial efficiency and financial security, needing to find the right status between the public legal power of the regulatory agency and the private legal power of the industry association. Industry associations link financial customers with shadow banking institutions: on one hand, they are subject to the mandates and directives of the regulatory authority, thus administering the members of the associations and realizing the regulatory authorities’ pursuit of financial order; on the other hand, industry associations are facing the demand for protecting the rights of shadow banking institutions and even the legitimate rights and interests of financial customers until the realization of rights relief. The right of financial supervision only indirectly influences and directs the relationship between industry associations and customers. There should be no confrontation between regulators and institutional autonomy, but rather coordination and integra-

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<sup>19</sup>See PAN, The legal value and realization mechanism of financial supervision -- on the reform of financial supervision mechanism after financial crisis [J]. Journal of Dalian university, 2009 (5): 102-105.

tion.

In fact, the regulation of the shadow banking system performs differently according to different relationships between financial subjects. Table 1 below lists the basic content of the supervision right for different legal relationships when regulating the shadow banking system's operating. Financial regulation is subject to the financial operation situation, the reasonable configuration of financial supervision can ensure the proper financial operation. The realization of the basic value of supervision is also of great significance to the realization of financial efficiency.

Table 1: a short list of regulatory powers for the shadow banking system.

| Subject  | Regulatory powers (rights)   |
|--|--|
| Regulators and shadow banking institutions.          | Access to financial markets; regulation and Control of financial market behavior; discipline and punishment.     |
| Shadow banking institutions and financial customers. | Information disclosure (rights and obligations); deposit insurance protection; lender of last resort protection. |
| Financial consumer and industrial association.       | Financial self-discipline; judicial relief; private assistance.  |

*(III) Objective value: a comprehensive social interest centered on financial customers*

Financial customers of the shadow banking system are in a state of vulnerability and marginalization because of their dispersion and independence. Financial innovation is too complex for non-professional customers to understand, therefore, according to the special status of financial customers, the Government should provide for some institutionalized protections. Protecting financial customers in the operation of the shadow banking system is demonstrating the philosophy of providing relief to the weak. The shadow banking institution is the creator of the social and economic interests, but it is clearly unfair when it operates at the expenses of financial customers. The objective value of regulating shadow banking is the social comprehensive interest centered on financial customers, and its realization will reflect real financial equity.

The common characteristics between financial customers who consume financial commodities and customers in other industries lies in the fact that they all promote social production through consumption. Since financial customers are also investors in financial markets, that play an important role in economic growth, without the investment, lending and financing from financial customers, there will be no development of the financial sector, and there will be no social and economic prosperity either. The development of national economy is based on financial customers' confidence in finance, and the essence of protecting financial customers' rights is to give them confidence in national finance.

Financial commodities are different from ordinary commodities as they are professional and complex, and financial customers are different from ordinary customers, too. Ordinary customers are people who buy goods and receive services for the purpose of living, while financial customers are participants in financial activities that have legal relationship with financial institutions based on the use of financial credit in the finance field. In general, consumers belong to the disadvantaged group of society, not being able to stand alone against proprietors, especially the consumer of financial commodity who has even more unequal position with respect to the proprietor.

The most immediate victims of the 2008 Global Financial Crisis were financial customers. Neglecting protection for the financial customers' rights was one of the causes that triggered the financial crisis. As a result, the United States place the financial customers' rights and interest protection on a very important position of the financial regulatory reform, trying to prevent financial customers from being harmed by information fraud, insider trading and market manipulation, etc. Although some think that the losses resulted from consumer defaults threaten one or several important financial institutions, leading then to the emergence of systemic risk, actually the financial institutions, which undervalue the consumer default risk so that consumer default losses cannot be predicted and the risk cannot be promptly responded, is the root cause of systemic risk.

Financial consumer - centered allocation of regulatory powers is key in protecting customers' rights and interests, so to avoid systemic risk and realize comprehensive social benefits.

*(IV) Allocation of regulatory power for shadow banking system in China*

Although the shadow banking system is a relatively simple phenomenon in China, it still faces a complex credit system expansion. The creation and balance of powers are requested by the integration of commercial Bank business and non-commercial Banks business, and the innovation of traditional financial institutions and new Internet financial services. The more complete the laws and regulations of the shadow banking system are, the more positive the economic growth will be. Inappropriate supervision or its failure will hit the real economy hard. Jurists Grotius once said: "when things move to one direction, as they use to do, try hard to pull in the opposite direction. They will finally make it back to the middle position but, if you pull too hard in the opposite direction, it often causes a great deviation from the proper middle position, which can have harmful consequences". Therefore, we "must find an appropriate remedy between the two extremes. We can neither believe everything that is impermissible nor believe everything that is permissible"<sup>22</sup>. The Chinese stock market crash in July 2015, to some extent, is the result of the over-amplification of margin financing and the expansion of the shadow banking system in order to stimulate the stock market. We need to find the right balance between tight and loose to try to keep the shadow banking system on the right path. At the same time, we should consider the preventive function of the law, for justice is achieved through proper procedures rather than strict punishment.

- Financial regulation mode adjustment

The mode of financial regulation refers to the arrangement of financial regulators and financial regulation laws in a country. Depending on different regulatory objects, financial regulation can be divided into two modes: institution regulation and function supervision. Financial institution's regulation sets up different regulators according to different financial institutions, each regulator supervising different finan-

cial institutions. The powers of the regulators are separate, for example, banks, securities and insurance institutions are regulated by different regulatory agencies. However, there is no regulatory overlap between the regulators and strict independent supervision is implemented. Financial function regulation sets up different regulatory agencies according to the different behaviors of financial business. Each regulator regulate specific financial activities regardless of which financial institution is conducting the activity. Financial institution's regulation emphasizes separate regulation, whereas functional regulation emphasizes comprehensive supervision. Both types of regulation have advantages and disadvantages, and different regulatory modes can be adopted in different stages of financial development.

At present, China's shadow banking business is integrated in different financial institutions and industries. The cross-industry, cross-regional and cross-market shadow banking system has gradually increased, so the business boundaries between traditional banks and other financial institutions are blurring. Bank stockholders participate in insurance and securities, forming a large financial group. Objectively, mixed operations have been produced. At the same time, the ever-changing financial innovation and the addition of internet finance have led to the serious financial disintermediation, increasing the spreading of financial risks. The original institutional supervision mode cannot adapt to the special requirements of the shadow banking system regulation, thus the requirements of functional regulation are put forward.

Functional regulation can avoid conflicts and absence of the regulatory powers, improve the efficiency of supervision and reduce financial risks to the greatest extent. Current regulators have one single object, either banks or securities firms or insurance companies. Banks will do regulatory arbitrage through the shadow banking system, by using off-balance sheet business to escape from regulation. As mentioned above, the shadow banking business and traditional banking business both provide essentially indirect financing for the real economy, basically making profit with term conversion and credit conversion. When the separate supervision is strengthened, shadow banking institutions will evade regulation through other credit intermediar-



ies, and realize the business functions of traditional Banks. Only functional regulation can unify the supervision between traditional and shadow banking, as well as supervision among banking, securities and insurance. As shown in Table 2 below, under the two different regulatory modes, the Central Bank and “three associations” have different regulatory responsibilities from the aspects of current supervision. The administrative tendency of China’s financial supervision system is greater than the marketization. The point that we make is that we should focus on how to provide “better” regulation rather than a “stricter” one. For the target of regulatory power allocation, comprehensive functional supervision should be established. The Government should establish a functional supervision mode in addition to the institutional regulation, where the People’s Bank of China acts as the overall coordinating body. So far as legislation is concerned, the Central Bank and the “three associations” should be given more powers to make rules and regulations when amending the organization law of the Central Bank and the “three associations”, leaving the power room for functional supervision. Before the formal legislation, the implementation of functional comprehensive legislation will be promoted by the timely issuance of financial policies. In particular, the regulatory bodies of the shadow banking system should make the Central Bank and the CBRC principal, the insurance regulatory commission and the securities regulatory commission supplementary, and other relevant Governmental departments supportive.

Table 2: the content and the target of regulatory power allocation under the functional regulation mode and institutions regulation mode.

| Regulation mode         | Regulator                                    | Content of regulatory power   | Objectives the allocation of the regulatory power.  |
|-------------------------|--|---|---|
| Functional regulation   | People’s Bank of China                       | Financial market access, shadow banking transaction management; information filing and disclosure; financial self-regulation behavior management.   | Establish a financial stability board and a financial stability supervision center to match the relationship between virtual and real economy.  |
| institutions regulation | CBRC(China Banking Regulatory Commission)    | Bank financial products business examination and approval; financial product risk control requirements; comprehensive financial supervision such as financial management and credit management. | Under the framework of the financial stability board’s power configuration, protect the financial market with regulation of compliance and the protection of financial customers’ rights and interests. |
|                         | CSRC(China Securities Regulatory Commission) | Examination and approval of securities finance business; securities trading risk control requirements.  |   |
|                         | CIRC(China Insurance Regulatory Commission)  | Qualification, examination and approval of insurance finance business; request for risk prevention and control of insurance companies.  |   |

- The coupling of macro-prudential regulatory power and micro-prudential regulatory power

Coupling refers to the phenomenon that two (or more) systems or movements affect each other through various interactions<sup>20</sup>. Macro-control and micro-management are two indispensable systems for market economy running. Macro-control is based on the control of the market as a whole and only the legalized macro-control can be institutionalized. Therefore, macro-control mainly adopts the path of legal regulation (“macro-control power”). Germany, the United States and other countries promoted the “New Deal” under the impetus of the Keynesian intervention theory, strengthening State intervention, resulting then in a gradual emergence and, lastly, in the prevalence of macro-control (Qiu, 2007)<sup>24</sup>. The micro-market manage-

<sup>20</sup>“Cihai”, Shanghai dictionary press, 2010, page 2920.

ment cannot be neglected when macro-economy is operating normally. Market management law is the law of State administration and market intervention. It mainly acts on micro-operators and customers. Ensuring free and fair competition in the market is the main task of micro-management, whose specific form is micro-regulation power. Macro-economic regulation and control is one of the basic functions of financial law, by controlling monetary supply, regulating monetary flow, stable currency and curb inflation financial law reinforce financial supervision and realize the legal system of macro-control. Micro-cosmic management, instead, supplements, complements and coordinates with macro-control. This theory also applies to the legislation of the shadow banking system.

The macro-prudential relative to the micro-prudential, refers to the financial regulatory authorities implementing the various institutional arrangements from the perspective of financial market as a whole rather than a single organization to reduce the financial crisis or economic fluctuation of loss to the financial system (Yu, 2013)<sup>21</sup>. Britain's Financial Services Authority (FSA) in its crises response report points out that the financial crisis is at present on the basis of the micro-prudential level of financial regulation and supervision system of the fundamental challenges. A strong micro-prudential system is necessary but not enough to guarantee stability across the financial system, while macro-prudential is the target of systemic stability<sup>22</sup>. In the regulation of China's shadow banking system, macro-prudential regulation and micro-prudential regulation should be both considered and let them play a different role. Table 3 below lists the differences of macro-prudential and micro-prudential regulation of the Chinese shadow banking system from the perspectives of regulators, power targets, regulatory objects, regulatory content and regulatory approaches. In view of the current needs for shadow banking regulation, we suggest that Chi-

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<sup>21</sup>See YU and CHEN, From the micro to macro-prudential: the transformation and enlightenment of the international financial supervision and regulation in the post-crisis era [J], Southeast academic journal, issue 3, 2013, pp. 50~56.

<sup>22</sup>See FSA, *A Regulatory Response to the Global Banking Crisis*, available on <http://www.fsa.gov.uk/pubs/discussion/dp09~02.pdt>, March 2009.

na's macro-prudential and micro-prudential regulation are structured as follows:

a. Under macro-prudential regulation, the systemically important financial institutions should be subject to monitoring to guard against systemic financial risks. Because such institutions may have "too big to fail" features, macro-prudential regulation should be enforced so as to regulate its capital adequacy ratio, liquidity and internal governance, guard against potential financial risks, and even raise regulatory standards and higher the basic ones, such as risk capital requirements, leverage limits and liquidity requirements. It should also consider relevance between shadow and traditional banking, include the business relations between shadow banks in the scope of monitoring powers, giving integrated and combined regulation.

b. Legalize the coordination mechanism of the Central Bank and the "three associations". According to the authorization of the People's Bank of China to the State council<sup>23</sup>, the latter is responsible for coordinating such a mechanism with the Ministry of commerce, the Ministry of finance and other financial supervision businesses related to Ministries and commissions. It is as well responsible for formulating a cooperation memorandum between departments based on the financial regulation, and for jointly establishing the financial stability board by the departments. It shall establish a permanent institution to realize information sharing, policy coordination and decision-making reference between financial regulators and departments. The Committee should complete at least two tasks, namely establish the sharing mechanism of decision-making information among Ministries and Commissions in order to guarantee information security and build a risk assessment and prevention mechanism, including warning on the risks deriving from the shadow banking system.

c. Shadow banking institutions and businesses should be fully integrated into the scope of micro-regulation, which includes traditional banking financial services business, asset securitization, small loan companies and other financial institutions,

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<sup>23</sup>See Article 9 of the law of the people's bank of China: "*the state council shall establish a coordination mechanism for financial supervision and administration, and specific measures shall be formulated by the state council*".

the internet business, etc. Lack of supervision, power vacuum and absence of responsibility should be avoided.

d. Micro-prudential supervision should focus on and provide for a financial consumer protection law system, specifically including clear definitions of the concepts of “financial consumer”, “qualified investors”, “consumer financial protection agency and measures”, “financial system of dispute settlement”, etc.

Table 3: allocation of macro-prudential and micro-prudential supervisory power.

| Type of power | Macro-prudential supervisory power  | Micro-prudential supervisory power  |
|---------------|---|---|
| Regulators    | The State council; the people’s bank of China; the banking regulatory commission; the CSRC and the CIRC.  | CBRC; CSRC; CIRC; the Ministry of commerce; the local Government; etc.  |
| Objective     | Avoid systemic risks and their negative effects on the economy; maintain the stability of the financial system.   | Guard against the risk of individual subjects including shadow banking institutions; avoid bankruptcy; safeguard the rights and interests of financial customers.   |
| Target        | Systemic risk; systemically important financial institutions; common risks of financial institutions.   | Traditional bank’s personal finance services; asset securitization business, small loan companies and other quasi-financial institutions; internet financial institutions and businesses.                             |
| Content       | The influence of monetary policy on shadow banking; the comprehensive supervision of the “three associations” supervision power; the power framework of the future financial stability committee. | Supervision on the establishment of shadow banking institutions; supervision on access to financial markets; supervision on market financing behaviors; regulation of market rules; supervision of crisis management. |

- The coordination between the “three associations” and the local Financial Authorities

China’s “three associations” are a vertical system, and regulators are only re-

sponsible towards their higher authorities, not being bound to report to local Governments<sup>24</sup>. This criterion has ensured the independence of financial decision-making and reduced the interference of local Governments with regulators. In the current organization framework of “three associations”, local Financial Offices are needed to carry on the overall coordination for the branches of Central Bank and the “three associations” to make them synergetic in implementing financial management regulation<sup>25</sup>. In order to fulfil the purpose of establishing local financial offices to coordinate the relationship between the finance institutions and financial regulators, proper coordination should be ensured between the “three associations” supervision right and the of local financial supervision right.

With reference to the division of powers, the dispatched office of CBRC covers prefecture-level cities, the that of the CSRC covers provincial level, whereas CIRC is not set up in accordance to the administrative division. The “three Associations” adopt a divided regulation model, focusing on financial institutions. The local financial supervision departments, instead, adopt a mixed regulation model, focusing on local financial development. Due to the different goals, local financial offices should be centered on the regional financial services regulation and configure financial resources according to the market, without interfering with the “three Associations” and with the behavior of the business of financial institutions under their supervision. As to supervision, the objects of the local financial office is non-systemically important financial institutions, local, small and medium-sized legal entities financial institutions or non-financial institutions with financing and local financial transactions. For crossed and integrated financial businesses, the local Financial Office and the “three Association” branch Agencies should share information and coordinate super-

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<sup>24</sup>See Article 5 of the Banking Supervision and Administration Law states that “*the banking supervision and administration institutions and the personnel engaged in supervision and management shall perform their duties of supervision and administration according to law and shall be protected by law. Local Governments, Government departments at all levels, social organizations and individuals shall not interfere*”.

<sup>25</sup>See Yun R. *The exploration of the function of local Government finance under the new normal economy* [J], Wuhan Finance, no. 7, 2015, pp. 66-68.

vision to maintain local financial order.

At time being, the relationship between the “three Associations” regulatory authority and the local financial management system are not specified in legislation. The legal status and management system of local Financial Office need to be confirmed at national level or by local legislation. We propose to confirm the legal status of the local Finance Office through the administrative legislation of the State council and clarify its relationship with the “three associations” branch agency. The macro-financial management of the local Finance Offices should rely on local Governments and the Central Bank and the “three associations” system. On the other hand, the micro-financial supervision should comply with a regulatory framework concerning the supervision of small loan companies, pawnshops, finance guarantee institutions, imitate the pattern of self-regulatory industry association, such as the “three associations”, organize the small loan company association, pawn association and so on, so as to establish a financial self-discipline organization, and, lastly, realize the regulation model by resorting to the help of a third party.

- The boundary between financial self-discipline and external control in the shadow banking system

Financial associations in China are not independent, being subject to the supervision and intervention of the “three associations” and other regulatory agencies. Therefore the main issue of the financial is to choice whether to supervise or not and, in this latter case, to which extent. There is little doubt that regulators’ interference with industry associations should be limited, and that regulators should fully respect the autonomy of industry associations and leave room for them to exercise their powers. There comes the question of how to give consideration to such an autonomy and the rights of the regulators in the supervision of the shadow banking system and, specifically, how to leave the industry room for self-discipline, allowing the shadow banking system to exercise its own self-discipline.

First and foremost, there is a need for protection of the autonomy of the shadow banking institutions and their industry associations. The law guarantees the

financial liberalization of the shadow banking institutions and allows them to exercise autonomy of will, which allows commercial subjects to form private law rights and obligations of their own<sup>30</sup>. The shadow banks, as the main body of business, have the right of self-determination on the organizational body. The legal relationship formed by commercial organizations can be divided into two parts: external relations, formed through autonomy of will, such as contractual relationship, and internal relations.

Commercial organizations adopt the rule of autonomy (articles of association, partnership agreement, etc.) to establish the legal status of the organization. Internal rules should be respected by all members of the business, even if are not binding on external third parties. Hence, the trade associations which can deal with internal affairs independently, but need anyway a supervision. The industry associations of the shadow banking system are the autonomous organizations of all members, including the shadow banking institutions. The regulator shall respect the autonomy of the industry association, shall not regard the industry association as its subsidiary body and not arbitrarily interfere with the power of autonomy exercised by the industry and its members. If supervision is arbitrarily involved in the autonomy of the association, it will weaken such an autonomy and shake its legal basis.

Secondly, supervision on the shadow banks should be realized through the industry association, which could possibly fail in the management. This is the reason why the industry associations shall be regulated as well as the shadow institutions. If we are to consider the source of the powers recognized upon industry associations, autonomy is only the basis for such an existence. Regulators have delegated the Administrative Supervision Authority to the trade association in the interests of exercising powers and reducing the costs of supervision. The power of industry association increases, increases the character of public law and ensures the association's control and execution of its members. Therefore, the power of the associations increases, public law becomes more evident and the association's control, as well as the member's execution, is ensured.



With these powers being entrusted, regulators could infiltrate the regulatory powers of shadow banks into the power system of industry associations, implement regulation intention, through internal governance by industry association.

Third, the intervention of financial supervision power and the exercise of industry autonomy should both be limited. The entrance of financial regulators' power into industry association must adhere to the rational principle of finiteness, meaning that regulators should consider the industry association is as autonomous organizations exist rather than as a for-profit shadow banking institutions exist. Therefore, intervention of regulatory power should be limited. The method of legal supervision should be adopted as long as the autonomy of industry associations is ensured. As one of the behaviors of the legal supervision of the industry association, the exercise of the autonomy by the industry association must meet the relevant laws and regulations including the organization law of the industry association and the industry business regulations. The public interests or the legitimate rights and interests of financial customers shall not be infringed in the name of the association. In other words, the self-disciplined industry association also abide other laws from third parties.