ABSTRACT

This paper traces the developments that have contributed to the importance of risk in regulation. Not only does it consider theories associated with risk, it also discusses explanations as to why risk has become so important within regulatory and governmental circles. Two forms of risk regulation, namely risk based regulation and meta regulation are considered. As well as considering the application of both in jurisdictions such as the UK, the paper places greater focus in discussing the importance of meta regulation in jurisdictions such as Germany, Italy and the US. The preference for meta regulation is based on the premises, not only of the advantages considered in this paper but also on the application of Basel 11 in several jurisdictions. Whilst meta regulation also has its disadvantages, the impact of risk based regulation on the use of external auditors plays a part in the preference for meta regulation.

THE GROWING IMPORTANCE OF RISK IN FINANCIAL REGULATION

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In his book, *Risk Society: Towards a New Modernity*, Beck (1992) illustrates the fact that "societies have become more reflexive about risk."[2] In many countries, even though there has been growing formalisation in that the regulatory and supervisory process is more statute and rules-based, emphasis has shifted not only from rules to risks, but also to management responsibilities. Regulation is often perceived as consisting of command and control strategies whereby the regulator imposes detailed rules with which the regulator monitors compliance.[3] However, meta regulation is a type of regulatory strategy which draws firms into regulatory processes and attempts to both influence and make use of firms internal risk management and control strategies[4] As a result, supervision is not so much about the simple monitoring of firms' compliance with regulatory rules but more about evaluating and monitoring firms' awareness of the risks created by their business and of their internal controls.[5]

In most countries however, different rules are applied to different types of financial businesses and these indicate the sectoral differences which exist in central business activities and risk exposures of these businesses.[6] As an illustration, credit risk is the dominating risk for banking institutions since loans constitute the major share of assets which are typically known to exist within a bank.[7] Even though balance sheets of individual bank institutions reveal differences, lending activities constitutes the core of the commercial banking business.[8] Other classes of risk which are connected to the general business of commercial banking include liquidity and other market risks.

Meta regulation can be described as the regulation of self-regulation.[9] Meta risk regulation concerns the management of internal risk and being able to use the firms' own internal risk management systems to achieve regulatory objectives.[10] The Basel II Capital Accord provides an example of the operation of meta regulation in that bank capitalisation is not to be imposed externally by regulators but will be determined by a bank's own internal risk management models provided these models are considered by regulators to be adequate.[11] One major advantage of meta-risk regulation is that it should enable the regulator exploit the expertise of the industry in an age when the complexity and volatility of modern risk calls into question

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[2] U Beck *Risk Society: Towards a New Modernity* 1992 Beverly Hills Sage

[3] J Gray and J Hamilton, *Implementing Financial Regulation : Theory and Practice* (2006) 36

[4] ibid

[5] ibid

[6] See 'Supervision of Financial Services in the OECD Area' pg 4 < http://www.oecd.org/dataoecd/29/27/1939320.pdf>

[7] ibid

[8] ibid

[9] The last but one chapter of Christine Parker's book, *The Open Corporation: Self Regulation and Corporate Citizenship*, provides this title. The theme of meta regulation was developed by Peter Grabosky, where he refers to "meta-monitoring" as government monitoring of self-monitoring. See J Braithwaite, 'Meta Risk Management and Responsive Governance' Paper to Risk Regulation, Accountability and Development Conference, University of Manchester, 26-27 June 2003

[10] J Gray and J Hamilton, *Implementing Financial Regulation : Theory and Practice* (2006) 37

[11] ibid

the ability of financial regulators to stay one step ahead.[12] Another advantage of meta regulation is that it not only provides greater means of overcoming challenges associated with regulation, but also those problems of rigidity resulting from too many prescriptive rules.[13]

"Two well-known theoretical perspectives addressing the different explanations for why risk has become central, are termed "risk society" theory and "governmentality" theory.[14] The "risk society" approach is one that identifies broad socio-economic and political changes which occurred in late modern societies. Along with these changes, loss of faith in institutions and authorities and a greater awareness of the limits and uncertainties linked to science and technology are identified.[15] The term "governmentality" refers to specific types of government that have arisen in modern societies in line with liberalist and neo-liberalist approaches.[16] It focuses on the exploration of how the identification of risks associated with certain behaviour or activities provide a way of exercising control over populations, groups or individuals in neo-liberal societies – in other words, identifying how risk is used as a "tool of governance" to shape behaviours".[17]

Liberalisation and Conglomeration

In the liberalisation process of the 60s, 70s and early 80s, the most substantive reforms in financial services involved *inter alia,* the removal of controls on interest rates. A number of factors played their part in the early period of liberalisation namely: the blurring of the financial pillars – institutions carrying out banking activities pursuing activities which depended on investment dealers; financial innovation ; technological developments; macro-economic developments which facilitated a more flexible financial system and a need for a more competitive environment.[18]

Ultimate liberalisation occurred since countries and their financial institutions realised that they were at a competitive disadvantage – as globalisation gained momentum. Regulators were not able to maximise their potential to regulate during the emergence of globalisation because they did not have the facility to adequately challenge the anti-competitive behaviour of the financial services industry. This was partly due to the asymmetric distribution of information between the industry being regulated and the primary regulator. This was notable in North America, the UK and Japan. In Germany and France where the financial sector was dominated by state ownership, the issue of asymmetry was not as important since banks were the dominant institutions in these countries – due to their universal bank structure.[19]

The decline of traditional banking, which has led many banks to venture into more profitable activities and the undermining of the role of banks, which resulted from commercial and industrial companies raising funds directly from markets, has also contributed to the blurring

[12] ibid

[13] F Haines,'Regulatory Failures and Regulatory Solutions: A Characteristic Analysis of the Aftermath of Disaster', *Law and Social Inquiry* (2009) 39 (forthcoming)

[14] See Gray and Hamilton at page 6

[15] ibid

[16] ibid at page 9

[17] ibid

[18] For more on this, see The OECD Report on Regulatory Reform 1997 Volume 1: Sectoral Studies 72 - 76

[19] See The OECD Report on Regulatory Reform 1997 Volume 1: Sectoral Studies 73-74

distinction between financial intermediaries.[20] In Germany, the desire to provide a wide range of products corresponding with the concept of *All finanz*[21] led to large banks adopting various strategies to enter the insurance sector.[22] The Deutsche Bank, for instance, established its own life subsidiary, Dresdner Bank and embarked on establishing alliance with insurance companies such as Allianz.[23] Commerzbank has also taken up a joint venture strategy.[24] In the UK, building societies provided life insurance-based endowment mortgage, a key product in the sector.[25] The mid 80s also saw the commencement of active sale of life insurance products produced by subsidiaries or allied companies of large clearing banks through their vast networks.[26] In the 1990s, financial conglomerates already controlled a large market share and currently have 28% of bank deposits and 46% of the total insurance income in Britain.[27]

In the US, separation between banking and securities business as established by the Glass Steagall Act, has not only been gradually relaxed by allowing interpretations of the Act by the Federal Reserve Board, and other banking regulators through the 1980s, but has also been superseded by the Gramm Leach Bliley Act.[28] The Gramm Leach Bliley Act removed the distinction between commercial banks and securities business. The early development of financial conglomerates which was restricted due to the functional separation of commercial banks and securities business resulted not only from the 1933 Glass Steagall Act but also from the National Bank Act of 1984, restrictions on branch banking imposed under the McFadden Act of 1927.[29] Separation of banking from other commercial activities hindered the competitiveness of US banks on the international market scene and made it difficult for some non US financial groups to gain access to the US market.[30] If such a group consisted of both bank and insurance companies, it could participate either in the banking or the insurance business.[31]

The need for a single regulator which regulates not just the banking sector, but also the insurance and securities sectors, has arisen principally because of the rise of conglomerate firms. Single regulators are able to manage more effectively cross sector services' risks. The

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[20] T Filipova *Concept of Integrated Financial Supervision and Regulation of Financial Conglomerates : The Case of Germany and the UK* (Nomos 2007) 39

[21] For more on the All-Finance concept, see E Boehmer 'Who Controls Germany? An Explanatory Analysis' Institut fuer Handels und Wirtschaeftsrecht, Universitaet Osnabrueck, Arbeitspaper Nr 71 (1998); Deutsche Bundesbank, Die Aufsicht ueber Finanzkonglomerate in Deutschland, Monatsbericht, (April 2005) 43-48

[22] K Koguchi, 'Financial Conglomeration', Financial Conglomerates (1993) OECD 11

[23] ibid

[24] ibid

[25] ibid

[26] The creation of the EC single financial market has accelerated the process of conglomeration of financial institutions in Europe. The implementation of the Second Banking Directive and the Investment Services Directive allows institutions holding licences from any EC member state to engage in banking or investment services and to offer them throughout the Community; ibid

[27] T Filipova 2007 p 48; Examples of collaborative forces between banks and insurance companies are those between Lloyds TBS/Scottish Widows, Prudential Insurance Company/M6G/EGG, AXA/Woolwich, AXA/Bank of Scotland, Zurich/Bank of Scotland, CGNU/Royal Bank of Scotland, Legal and General/Alliance and Leicester, Legal and General/ Barclays.

[28] In 1990, the Federal Reserve Board authorised, subject to certain conditions, four US banks to underwrite corporate equities ; ibid pp 12 and 13; also see RM Lastra *Legal Foundations of International Financial Stability* 2006 Oxford University Press See forward by Charles Goodhart on page vii

[29] T Filipova 2007 p 49

[30] ibid

[31] M Gruson 'Foreign Banks and the Regulation of Financial Holding Companies' p 4

adoption of the principle of consolidated supervision has enabled supervisors to assess more adequately the overall strength of a banking organisation and to monitor its susceptibility to risks based on the totality of its business, wherever conducted.[32] Moreover, bank collapses such as BCCI revealed that consolidation into a single entity was important for purposes of regulating a bank. Correspondingly, the functional overlaps between banking, insurance and securities business and their universal scope make it more difficult for a regulator to observe and comprehend such businesses.[33] The difficulty of measuring and assessing risk within such institutions along with the speed with which assets can be adjusted in derivatives markets has led to more emphasis being placed on internal managerial control. [34] Consideration is also being given to the structures that can be put in place to re inforce the incentives of all parties involved – not just to management but all parties including auditors and regulators.[35]

Following the "Big Bang" in 1986, most of the leading stock exchange member firms were bought by UK merchant or clearing banks, overseas commercial or investment banks. This started the trend developing to the growth of financial conglomerates.[36]

Another contributory factor to conglomeration arises from the change in demographic structure and increased income in the OECD countries as public pension systems face pressure as a result of aging population.[37] As a result, individuals with higher income have resorted to investing in additional pension schemes and other investment means to ensure security of their living standards after retirement.[38] Insurance companies have responded to these changes in the environment by placing more emphasis on those products with savings or investment character and less emphasis on those products of an "income protection" character such as annuities and pensions.[39]

Factors such as the growth of financial conglomerates and the derivatives markets fuelled by the impact of information technology and increased competition have triggered a change in the way supervision is carried out around the globe. In addition, bank collapses have also contributed to a re-think in the structure of financial regulation, that is, the way in which financial regulation is carried out. Developments in the 1980s considerably blurred earlier distinctions between product and institutional structures and various financial services have become closer substitutes for each other.[40] As traditional lines of demarcation between product and institutional structures became increasingly blurred, financial institutions also became exposed to new forms of competition.[41] As a result of this resulting scope for competition, there was an awareness by financial intermediaries of the need to re-assess their overall business strategies in order to cope with changing demands of their clients, as well as seeking new profitable ventures.[42] These events contributed to the growth of financial

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32 Organisation for Economic Co-operation and Development, 'Trends in Banking Structure and Regulation in OECD Countries' 1987 at p 14

33 CAE Goodhart, (ed) *'The Emerging Framework of Financial Regulation* (Central Banking Publications Ltd London 1998) 95-96

34 ibid

35 ibid

36 See DH Scott ' The Regulation and Supervision of Domestic Financial Conglomerates' August 1994 The World Bank Financial Sector Development Department Policy Research Working Paper No 1329

37 T Filipova *Concept of Integrated Financial Supervision and Regulation of Financial Conglomerates : The Case of Germany and the UK* (Nomos 2007) 38

38 ibid

39 ibid

40 K Koguchi, 'Financial Conglomeration', Financial Conglomerates [1993] OECD 7

41 ibid

42 ibid

conglomerates.

Importance of Risk

“Different explanations have been given as to why risk has become central across regulatory and governmental circles and these explanations are partly influenced by different approaches as to what risk is.[43] One view in attempting to account for risk as a strategic organising principle in the public sector, attributes the specific needs of government.[44] Political scientists, however suggest that the adoption of the language and practices of risk reflects a deeper, more complex process, one of “political isomorphism”.[45] According to this view, risk becomes accepted and embedded in one organisation or institution such that it acquires recognition within other organisations and institutions.[46] Other explanations, mainly from socio-cultural disciplines suggests that the importance of risk derives from issues related to control, accountability, responsibility and blame in late modern society.”[47]

Historically, systemic risk was considered to be more relevant for banks generally, and for large banks particularly than for non-bank financial institutions.[48] The Basle Committee’s Core Principles[49] states that the primary task of bank supervision is “ to ensure that banks operate in a safe and sound manner and that they hold capital reserves sufficient to support risks that arise in their business”. According to the drafters of the Basel Core Principles, “Banking, by its nature, entails a wide array of risks. Banking supervisors need to understand these risks and be satisfied that banks are adequately measuring and managing them.”[50] The Core Principles attempt to address the main risks encountered by banks in Principle Six which states that banking supervisors should set prudent and appropriate minimum capital adequacy requirements for all banks.[51]

The focus on risks by the Basel Core Principles is illustrated by the number of principles dedicated to risk related issues.

Principle 12 – Country and transfer risks: Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.
Principle 13 – Market risks: Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

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43 J Gray and J Hamilton *Implementing Financial Regulation* (2006) at page 5
44 ibid
45 ibid
46 ibid
47 ibid
48 See 'Supervision of Financial Services in the OECD Area' page 5 <http://www.oecd.org/dataoecd/29/27/1939320.pdf>
49 'Core Principles For Effective Banking Supervision' October 2006; See <http://www.bis.org/publ/bcbs129.pdf> (last visited 11th July 2008)
50 D Quiroz Rendon, ' The Formal Regulatory Approach to Banking Regulation' Badell & Grau Legal Consultants, see <http://www.badellgrau.com/legalbanking.html> (last visited 10 June 2008) pg 10 of 26
51 ibid pp 10,11

Principle 14 – Liquidity risk: Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

Principle 15 – Operational risk: Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

Principle 16 – Interest rate risk in the banking book: Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

As stated earlier, over the years, there has been a growing number of large, internationally active financial groups which operate in several financial sectors. Financial convergence has assumed a number of different forms. As well as cross sectoral investments and cross distribution, convergence is also taking place through cross sector risk transfers.[52] Commercial banks, along with their investment and securities branches, have become users of products such as credit derivatives and other hedging instruments which are used as means of off-loading specific credit risk exposures.[53] As revealed by data from the US Office of the Comptroller of the Currency, end-sellers of credit risk protection are usually large commercial banks, insurance companies, collateral managers of collateralized bond obligations, pension funds and mutual funds.[54] Whilst commercial banks, hedge funds and to lesser extent non-financial companies, appear to be end buyers, banks and securities firms function as intermediaries – it is not possible to distinguish banks' participation as intermediaries from their direct involvement as end-buyers or sellers.[55] However, according to the Bank of England's Financial Stability Review, is seems on average, that credit risk is being transferred from the banking sector to insurance companies and investment funds, mainly through portfolio transactions.[56]

As a result, new forms of risk have accompanied the changes in relation to financial structures, which have taken place over the years. Whilst individual entities could appear risky and the entire organization well-diversified or hedged, risks which did not appear at the level of individual entities could exist at the group level.[57] Risks identified with integrated financial services groups include lack of transparency owing to complex intra-group exposures, the risk of contagion as a result of non-existent or ineffective firewalls, multiple gearing risk, problems emanating from unregulated group members, the possibility of regulatory arbitrage occurring within financial services groups which involve more than one type of institution.[58]

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[52] See 'Supervision of Financial Services in the OECD Area' page 8 <http://www.oecd.org/dataoecd/29/27/1939320.pdf>

[53] ibid

[54] ibid

[55] ibid

[56] ibid

[57] ibid pg 6

[58] ibid at pg 9

The Impact of Risk-Based Regulation as a "tool of governance" on Behaviors of Regulators in the UK, Germany, Italy and the US.

The supervision and monitoring of management performance and ensuring accountability of management to shareholders and other stakeholders constitute the two key aspects of corporate governance.[59]

The UK

Whilst the contested nature of risk, the values attached to it, and the likelihood of different interpretative frameworks have raised questions about the ability of risk to carry the weight of expectations attached to its as a regulatory tool[60], relating risks to its objectives enables the FSA to establish a boundary around its regulatory role.[61]

Impact of Risk-Based Supervision

With the FSA under its risk-based approach dedicating more resources to the supervision of insurers, the extent of the involvement of external auditors in the supervision process is of considerable interest.[62]

Overall, the FSA's risk based approach has led to a reduced role for auditors in banking supervision.[63] Since the date of implementation of the FSMA known as N2,[64] there have been 84 skilled person reports of which the Enforcement Division has initiated only six.[65] From 1 April 2003 to 31 March 2004, the FSA exercised its power under section 166 of the Financial Services and Markets Act 2000 to require firms to produce a skilled person's report in 28 situations.[66] This figure dropped to 17 in 2005/06 and 18 in 2006/07.[67] This is a considerable reduction in investigations from the number of reporting accountants commissioned under section 39 Banking Act 1987 which frequently exceeded 600 reports annually.[68]

Impact of Meta Regulation

Legal and General Assurance Society v FSA highlighted how the more holistic focus which meta regulation has on systemic failures on the part of firms, rather than their specific acts or omissions, is starting to influence the ways of approaching issues of causation in the framework of regulatory responsibility.

In contrast to the FSA's use of holistic approaches, to fact finding to establish regulatory responsibility and the Tribunal's acknowledgement in *Legal and General Assurance Society v FSA*, of the need to do so, in *Lloyds TSB General Insurance Holdings Ltd and others v Lloyds*

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59 V Beattie, S Fearnley and R Brandt 'Behind Closed Doors: What Company Audit is Really About' (Institute of Chartered Accountants in England and Wales) 26

60 J Gray and J Hamilton, *Implementing Financial Regulation,* pg 20

61 ibid at page 30

62 P Dewing and P O Russell, *The Role of Auditors, Reporting Accountants and Skilled Persons in UK Financial Services Supervision* Institute of Chartered Accountants of Scotland (2005) 118

63 P Dewing and P O Russell at p 107

64 December 1 2001

65 See M Blair and G Walker, *Financial Services Law* (2006)136 and <http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf> pg 35

66 ibid

67 *FSA Annual Report 2006/07* at page 162

68 Blair and Walker, page 35

Bank Group Insurance Co Ltd, the House of Lords warned against the acceptability of using an overly holistic approach to establishing the "cause" of regulatory responsibility for the purposes of determining civil liability as between the insured and insurer under an insurance contract.

The Financial Services Authority operates on a risk-based approach whereby it differentiates between regulated institutions and allocates resources to areas of greater perceived risk.[69] It identifies three sources of risk namely:[70] The external environment ; consumer and industry-wide risks and the regulated institutions themselves. The risk-based approach operates on two levels: at an organisation level, and at the firm level which is articulated in the 'firm risk assessment framework'[71] Referred to as the ARROW framework (Advanced Risk-Responsive Operating Framework) by the FSA and its staff, the approach is not focused on compliance with the prudential requirements that exist within the Interim Prudential Source Book or the Handbook Guidelines, but encapsulates risks that exist externally and internally in the financial services industry.[72] It takes into specific consideration the interests of wider stakeholders such depositors, investors and other financial intermediaries, as well as its own interests and compliance with its statutory objectives and principles.[73]

The FSA, being a risk-based regulator, has to make difficult choices about how it deploys its enforcement resources, as with its other resources.[74] A consequence of its risk-based approach is that more of its supervisory resources will be devoted to its supervision priorities and, within this framework, to the larger financial firms and groups.[75]

When firms are contacted by the FSA, they automatically assume that, because they have been selected, it means that the FSA has already decided that there is a problem in that firm - which is not the case.[76] The decision to select a firm takes into account a number of factors such as the number and type of firms which are active in the market or product that the FSA is interested in; the desire to find a sample of firms that is representative of the various different sizes or structures in the market the FSA is considering; the desire to create a representative sample which includes some firms which the FSA considers are likely to set the highest standards in terms of systems and controls and practices in that area.[77] The sample may also include some firms about whose practices the FSA has concerns and how the FSA can most efficiently use its resources to obtain sufficiently information for its needs.[78]

The combination of more resources being committed to priority areas and the application of the FSA's risk-based approach to enforcement may give rise to an external perception of unfairness or 'rough justice'.[79] Any firm which believes its standards to have been no different to those of its peers may be aggrieved if enforcement actions are imposed on it while

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69 See J Hitchins M Hogg and D Mallett, *Banking : A Regulatory Accounting and Auditing Guide* (Institute of Chartered Accountants 2001)120,121. In January 2000, the FSA announced its adoption of risk as a driver for its "business", see J Gray and J Hamilton 'Implementing Financial Regulation' 2006 p 25. There are however questions surrounding the suitability of risk as a capable regulatory tool due to its contested nature.

70 Ibid p 121

71 FSA (2000) *A New Regulator for the New Millennium*, January; FSA (2000) *Building the New Regulator*: *Progress Report 1*, December; FSA (2002) *Building the New Regulator*: *Progress Report 2*, February; FSA (2003) *The Firm Risk Assessment Framework*, February.

72 FSA *Progress Report 1*, ibid., at p. 8.

73 FSA *Progress Report 1*, ibid., at p. 8

74 <http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf> at page 18

75 ibid

76 ibid p 19

77 ibid

78 ibid

79 ibid p 20

its peers are not sanctioned.[80]

The approach taken by the risk supervisory process to flesh out decisions and show how they are arrived at as regards resource allocation between different sectors of the financial services industry improves transparency and thereby provides a form of accountability mechanism as government can gauge how efficiently the FSA is utilising its resources to achieve its objectives.[81]

It is important to distinguish between risk and uncertainty.[82] "Risk is traditionally associated with probability calculation and this suggests that an event can be predicted and controlled.[83] Uncertainty however is not capable of measurement and deals with possibilities incapable of calculation which are based on guesswork and judgment".[84]

There are four elements to the FSA's response to risk namely :[85] (i) **Diagnostic** : To identify, assess and measure risks ; (ii) **Monitoring** : To track the development of identified risks; (iii) **Preventativ**e : To limit or reduce identified risks and prevent them from crystallising or increasing and (iv) **Remedial :** To respond to risks when they have crystallized. Six principal regulatory tools in this response are as follows :[86] **An authorisation process** – led by the Threshold Conditions for authorisation; **The approval of individuals** – applying fit and proper person criteria; **Supervision -**where the regulators monitor authorised business; **Enforcement** – of the regulatory rules and penalising transgressors; **Publicity** – highlighting areas of concern to the industry and consumers and **Education** – Forewarning or forearming investors.

The FSA states in its risk assessment framework that it functions to measure firm risks differently to the way firms normally manage risk.[87] The FSA's operating framework has also been designed to link its statutory objectives with its regulatory activities.[88] Risk, in particular risk to its four statutory objectives, is now used as the determinant for all regulatory activity, including overall strategy and development.[89] It has the following stages :[90]

- Identifying the risks to the statutory objectives
- Assessing and then prioritising the risks : The FSA will first assess the effect of the collapse or lapse of conduct of a firm on the industry as a whole, on public perception and market confidence and on retail consumers, considering the availability of compensation or redress for them.
- It will then consider the probability of a problem occurring by considering factors such as business risk, external context and the firm's business strategy and decisions.

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80 ibid
81 D Singh, 'Bank Regulation of UK and US Financial Markets: Legal Aspects of Prudential Supervision' 2007 at p 90
82 J Gray and J Hamilton, *Implementing Financial Regulation: Theory and Practice* (2006) 20
83 ibid
84 ibid
85 J Hitchins M Hogg and D Mallett p 121
86 See J Hitchins M Hogg and D Mallett, *Banking : A Regulatory Accounting and Auditing Guide* (Institute of Chartered Accountants 2001) 121
87 FSA (2003) at p 12.
88 See J Hitchins M Hogg and D Mallett, *Banking : A Regulatory Accounting and Auditing Guide* (Institute of Chartered Accountants 2001)123; The FSA refers to the risk-based approach as a 'bridge linking the statutory objectives and our regulatory activities' see FSA *A New Regulator* at p 14.
89 J Gray and J Hamilton, *Implementing Financial Regulation* (2006) 25
90 J Hitchins M Hogg and D Mallett pp 123-124

- The FSA then prioritises its regulatory position by "multiplying" the impact of the problem (if it occurs) by the probability of the problem occurring.[91]
- Having completed these assessments, the FSA, taking into account the resources at its disposal, will decide on its regulatory response.

Reasons for the FSA's risk based framework relate to uncertainty not only from the challenges of regulation but an increasingly complex and global financial environment, public expectation that the regulator would clean up the industry and by political demands for a safe but innovative and globally competitive industry.[92] It is quite implicit in any risk-based regime with limited resources that priority will be given to the greatest risks – hence not all risks will be addressed.[93] Relating risks to its objectives also enables the FSA to establish a boundary around its regulatory role.[94] This boundary allows it to justify the exclusion or limitation of other roles such as that of regulating for distributive goals.[95]

Firms remain the main focus of regulatory activity and as a result, immense attention is given to identifying the risks-to-objectives that they might pose.[96] This process involves an assessment of the impact that a firm's failure or lapse of perspective will have on the FSA's objectives.[97] The scoring process is mainly based on balance sheet information supplied by the firm and on this basis firms are scored into one of four categories: low, medium-low, medium-high, high.[98] Generally, low impact firms will not be subject to a full risk assessment and will receive less intensive monitoring.[99]

Just as risk is used as a technology of governance in relation to firms, it is also used in relation to consumers – in particular, to private citizen consumers of financial services.[100] At first instance, the specific statutory objective to achieve "an appropriate degree of protection for the consumer" suggests that the regulator should take a proactive, protectionist role – however, this statutory objective is governed by statutory principles which require the FSA to recognise the different types of risks involved in different transactions as well as the general principle that consumers should take responsibility for their own decisions ("caveat emptor").[101]

The FSA has identified four principal risks that consumers may face namely: prudential risk, bad faith risk; complexity/unsuitability risk and performance risk.[102] It has also made it clear that in pursuing a risk-to-objectives approach it will not guarantee a zero-failure regime.[103]

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[91] ibid; *Banking : A Regulatory Accounting and Auditing Guide* (Institute of Chartered Accountants 2001) 124; in doing this it takes into account (i) Its confidence in the information on which the risk assessment is based; (ii) The quality of home country supervision – for overseas banks in the UK and (iii) The anticipated direction of change in the impact and probability gradings.
[92] J Gray and J Hamilton, *Implementing Financial Regulation* (2006) 29
[93] Ibid p 30
[94] ibid
[95] ibid
[96] Ibid p 31
[97] ibid
[98] ibid
[99] ibid
[100] Ibid p 47 ; Through the implementation of "consumer protection" and "public awareness" objectives, the FSA attempts to portray citizens as proactive and risk-aware consumers who seek the opportunity to secure their financial future through participation in financial markets and who accept responsibility for the results of the choices they make.
[101] ibid
[102] Ibid p 48
[103] Ibid : Firms will be allowed to fail with resulting consumer loss.

Germany

Risk-Based Regulation and Supervision in Germany

The importance of risk-related information as a vital component of companies' annual reports when performing operating and financial reviews (OFRs) of listed companies was highlighted in a report aimed at inquiring into the arrangements for financial regulation of public limited companies in the UK.[104] This ensued from the realisation that traditional financial statements, no matter how well constructed, would not always provide sufficient information for analysts and investors.[105]

As part of the implementation of the Financial Conglomerates Directive, section 25 a (1) was amended in the last quarter of 2004.[106] The implementation of the European Financial Conglomerates Directive into German Law took effect on the 1st Jan 2005 and it requires clearly for a strategy whereby the institution's ability to manage risks as part of a proper business organisation is taken into account[107].

The adoption of a risk based approach to financial regulation and supervision in Germany has been prompted by the significance of financial conglomerates.[108] Financial conglomerates have significant influence on financial stability particularly when they have a notable level of market share in several financial sectors and gain increasing significance in the market as a result of their size.[109] The objectives of the Financial Conglomerates Directive *interalia* includes ensuring the sound supervision of additional risks associated with financial groups who are involved in cross-sector financial activities.[110] It also encourages member states to develop their standards for limits on risk concentrations or permit their national supervisors to do so until there is further coordination.[111]

The implementation of the EU Financial Conglomerates Directive in Germany considers the growing economic importance of financial conglomerates and for the first time, supervisors now have a weapon in overcoming risks to the financial system attributed to financial conglomerates.[112] The Bundesbank's significant involvement in financial conglomerates' reporting enhances its ability to assess risks to enterprises within a conglomerate and the risks to financial stability attributed to financial conglomerates.[113]

Despite the Bundesbank's involvement, supervisors are still challenged by the fact that sectoral supervisory requirements address the relevant risks differently and that there is still no integrated approach to cross-sector supervision of equivalent risks.[114] Supervisors are therefore still largely confining themselves to a form of monitoring that informs them about

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104 See House of Commons - Treasury – Minutes of Evidence , House of Commons Environmental Audit, Fourth Report 13 March 2007 Session 2006/2007 <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmenvaud/227/22702.htm> (last visited 22nd August 2007)

105 ibid

106 NO Angermueller, M Eichhorn and T Ramke, 'New Standards of Banking Supervision – A Look at the German Implementation Approach for the Second Pillar of Basel II' 2005 (2) Journal of International Banking Law and Regulation 52; Section 25 (a) deals with particular organisational duties of institutions

107 See also Deutsche Bundesbank, 'Supervision of Financial Conglomerates in Germany' Monthly Report (April 2005) 39

108 Ibid p 44

109 Ibid pp 45,46

110 Ibid p 48

111 Ibid p 51,52

112 Ibid p 55

113 Ibid ; also see Deutsche Bundesbank, 'The Deutsche Bundesbank's Involvement in Banking Supervision' Monthly Report (September 2000)

114 See Deutsche Bundesbank, 'Supervision of Financial Conglomerates in Germany' Monthly Report (April 2005) p 55

risk concentrations and intra-group transactions but does not yet set integrated supervisory upper limits across all sectors - which appears reasonable[115].

It is therefore important, prior to creating more extensive supervisory standards, to compile information and gather experience based on incoming reports. Arrangements to resolve or at least disclose conflicts of interest resulting from business activity in different financial sectors have also not been reached.[116] The focus of the supervision of companies belonging to a financial conglomerate remains on individual supervision that is supplemented, but not overrided, by rules governing group-wide supervision (solo-plus approach).[117]

Has the Approach to Risk-based Regulation influenced the Degree of involvement of External Auditors in Germany?

Bundesbank and German Financial Supervisory Authority (BaFin): Statistics ongoing banking supervision[118]

Ongoing banking supervision operations, Number of operations conducted

Item	2002	2003	2004
¹ Revised from the previous year. Source: Deutsche Bundesbank			
Individual reports pursuant to sections 13 to 14 of the Banking Act	206 971	153 035	186 754
Single borrowers included in the summary reports submitted pursuant to sections 13 to 14 of the Banking Act	2 314 292	1 832 038	2 126 336
Reports pursuant to sections 24 and 24a of the Banking Act	47 585	44 561	47 002
Monthly returns pursuant to section 25 and 25a of the Banking Act	42 992	40 918	38 558
Reports on the volume of foreign lending (country risk) pursuant to section 25 (3) of the Banking Act	270	370	912
Auditors' reports on annual accounts	3 378	3 263	3 253
Reports on the auditing of safe custody accounts	614	483	644
Routine, special and deposit guarantee fund auditors' reports	1 887	1 755	1 678

115 ibid
116 ibid
117 ibid
118 Source : <http://www.bundesbank.de/bankenaufsicht/bankenaufsicht_bafin_fenster.en.php>

Item	2002	2003	2004
Audits pursuant to sections 44 and 44c of the Banking Act	69	79	155
Auditors' reports on the special funds of investment companies	1 431	1 309	1 459
Reports from investment companies on their activities	6 635	6 891	6 606
Reports under Principle I	32 846	29 923	28 907
Reports under Principle II	31 617	28 990	27 789
Audits of internal risk models	8	9	6
Reports under the Capital Accord of the Basel Committee on Banking Supervision	76	76	81

From the statistics on ongoing banking supervision, it can be seen that although auditors' reports on annual accounts, routine special and deposit guarantee fund auditors' reports have decreased, audits pursuant to sections 44 and 44c of the Banking Act, auditors' reports on the special funds of investment companies have increased. Particularly notable is the significant increase in sections 44 and 44c audits pursuant to the Banking Act. Between 2002 and 2004, these audits have more than doubled.

From this, it can be inferred that the adoption of risk based regulation in financial supervision in Germany has overall, not resulted to a reduction in its use of external auditors. The growing importance of risk-based regulation is also highlighted through risk-oriented reporting as it now represents a significant component of standard disclosure requirements and credit institutions must not only explain their assets and other elements but also outline their own risk situation and their ability to manage these risks.[119] The growing importance of using external auditors is also demonstrated through the Basel Committee's recommendations[120] and certain post Enron reforms.[121] It is therefore difficult to establish which is of greater importance – whether it is risk-based regulation or the use of external auditors.

The Impact of Basel II on German Banking Supervision

It was expected that the new Basel Capital Accord would result to a shift as on-site prudential audits assumed greater importance within the supervisory review process and came to supplement the evaluation of reports and returns from institutions.[122] This seems to be reflected in the above table of statistics on ongoing supervision. Basel II has three

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[119] See Deutsche Bundesbank, 'New Transparency Rules for Credit Institutions' Deutsche Bundesbank Monthly Report (October 2005) p 69

[120] Basel Committee's Core Principles for Effective Banking Supervision and the Relationship between Banking Supervisors and Banks' External Auditors , International Auditing Practices Committee

[121] See Deutsche Bundesbank, 'The Evolution of Accounting Standards for Credit Institutions, Deutsche Bundesbank Monthly Report (June 2002) p 39

[122] Deutsche Bundesbank, Deutsche Bundesbank's Involvement in Banking Supervision Monthly Report (September 2000) p 37

pillars namely : Minimum capital requirements, supervisory review process and market discipline. Even though the past years have concentrated on pillar 1, pillar 2 presents a great challenge for banks and supervisory agencies.[123] In October 1995, following the collapse of Barings Bank, which was attributed to inadequate control mechanisms, organisation and risk management, BaFin's predecessor, the Bundesaufsichtsamt fuer das Kreditwesen circulated the statement on "minimum requirements for the trading activities of credit institutions".[124] BaFin gave an official statement regarding the implementation of Pillar 2 on the 15th April 2004.[125] The foundation for this is a new circular called MaRisk (minimum requirements for risk management).[126]

Pillars 1 and 3 are to be covered by the new solvency directive *Solvenzverordnung.* Section 10 (1b) of the German Banking Act will be amended with regards to pillar 2.[127] Pillar 2 not only seeks to ensure that banks have adequate capital to support all the risks related to their activities, but also encourages banks to develop and implement better risk management techniques in monitoring and managing their risks.[128]

Basel II goes beyond the current German bank regulations – as a result there are not only inconsistencies, but also gaps between the regulations.[129] When comparing the minimum requirements for the credit business of credit institutions (MaK) with Basel II Internal Risk Based approaches, in detail, it is evident that requirements for IRB approaches are beyond those of the MaK.[130] As a result of its higher sophistication, those ratings which fulfil IRB requirements will also fulfill MaK requirements but the reverse is not the same.[131]

The minimum requirements for risk management (MaRisk) combines the minimum requirements for the credit business of credit institutions (MaK), MaH and MaIR.[132] As well as paving way for more holistic regulation, this merger should prevent further risk classes specified in the New Basel Capital Accord.[133]

Italy

Risk Based Approach to Bank Supervision in Italy

Supervisory activities aimed at increasing the capitalisation of banks – particularly major ones and to manage their risks of large exposures became more of a regular practice in 2001.[134] Methods for certifying banks' internal models for market risk calculation and related capital charges were also established.[135]

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[123] NO Angermueller, M Eichhorn and T Ramke, 'New Standards of Banking Supervision – A Look at the German Implementation Approach for the Second Pillar of Basel II' (2005) 2 Journal of International Banking Law and Regulation 45
[124] Ibid p 47
[125] ibid
[126] ibid
[127] Ibid p 52
[128] ibid p 55
[129] ibid
[130] ibid 52
[131] ibid pp 52,52
[132] ibid p 54
[133] ibid p 55
[134] See 'Supervision of Banks and Other Intermediaries: Banking Supervision", Bank of Italy at p 205 <http://www.bancaditalia.it/vigilanza_tutela/vig_ban/pubblicazioni/rela/2001/Supervision.pdf> last visited Jan 20 2007
[135] ibid

The Bank of Italy is taking measures to implement the new Basle Capital Accord.[136] In accordance with the EU's Capital Adequacy Directives 2006/48 and 2006/49 on the taking up and pursuit of the business of credit institutions and the capital adequacy of investment firms and credit institutions respectively, the so-called Basle II capital-adequacy principles will take effect as from January 1st 2007. The exception will be for financial institutions adopting more sophisticated methods of risk calculation, who will be allowed to adopt the principles on January 1st 2008. Although the EU will apply Basle rules to all banks and investment firms, and not just to those that are internationally active as required by the Basle Accord, a number of adjustments have been made to incorporate EU specifications and to make life easier for smaller firms. There are areas where national discretion may be exercised. There will be lower capital requirements in the EU rules for banks venture-capital business in order not to put excessive dampers on finance for start-ups, given that these are regarded as crucial for the future growth and competitiveness of the EU. This directive will introduce a common regulatory approach to securitisation across the EU for the first time. The Bank of Italy was still consulting with Italian financial institutions as of end-July 2006 on details relating to the Italian legislation for the purposes of transposing EU directives into national legislation.

In the area of **credit risk,** low- and medium-risk investment firms will be able to continue using the existing expenditure-based rules for credit risk, though they will have to divide their exposures into a larger number of classes. This will be known as the standardised approach. The more sophisticated approach for other financial institutions uses t**he internal ratings-based (IRB) method** based on the Basel agreement, but will comprise foundation and advanced approaches. Less complex institutions will be able to mix the less and more sophisticated methodologies.

There will be similar **flexibility in addressing operational risk**, consisting of **three levels: the basic indicator approach, the standardised approach, and the advanced measurement approach (AMA)**[137]. These levels reflect the increasing levels of risk sensitivity. The standard definition of operational risk as agreed to by the Risk Management Group of the Basel Committee and industry representatives is " the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events."[138] This definition includes legal risk and excludes strategic and reputational risk and depends on the classification of operational risks according to the underlying causes[139]. Other important operational risk issues currently encountered by banks include business-continuity planning, the role of internal and external audits, the outsourcing of business functions and electronic banking.[140] Since 2001, the Basel Committee's Risk Management Group has been carrying out surveys of banks' operational loss data with the aim of obtaining information on the sector's operational risk experience and also with a view to refining the capital framework.[141]

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[136] Ibid

[137] The basic approach is founded on a fixed percentage of gross income, the standardised approach extends the basic approach by breaking down banks' activities into components' and the advanced measurement approach is based on the adoption of banks' internal models. See M Moscadelli, 'The Modelling of Operational Risk: Experience with the Analysis of Data collected by the Basel Committee' (July 2004) *Banca D'Italia Temi di Discussione del Servizio Studi* Bank of Italy, Banking Supervision Department Number 517/2004

[138] ibid p 10

[139] ibid

[140] D Quiroz Rendon, 'The Formal Regulatory Approach to Banking Regulation' Badell and Grau Legal Consultants ; also see <http://www.badellgrau.com/legalbanking.html> (last visited 10 June 2007)

[141] See M Moscadelli, 'The Modelling of Operational Risk: Experience with the Analysis of Data collected by the Basel Committee' (July 2004) *Banca D'Italia Temi di Discussione del Servizio Studi* Bank of Italy, Banking Supervision Department Number 517/2004 p 10

The Bank of Italy checked the state of preparedness of Italy's eight largest banking groups in 2005 and concluded that management was well aware of the imminence of the changes and that statistical systems were adequate. However, it identified a need for improvements in the quality of data and in IT systems for modelling.

There will be a single consolidating supervisor through which cross border groups will channel applications to use the IRB and AMA methodologies. Decisions will be made within six months by the different supervisors acting together.

The US

Risk Based Supervision in the US

The Federal Reserve also operates according to a risk-focussed method of supervision which was adopted not only as a result of the ever growing size and complexity of banks, but also because of the continuity inherent in its nature – as opposed to a point-in-time examination.[142] The risk based approach was also introduced following the 'savings and loans' debacle of the late 1980s and 1990s.[143] The risk-based supervision process aims to ascertain the greatest risks to a banking organisation and evaluate the ability of the organisation's management to identify, measure, monitor and control those risks.[144] Businesses which have the potential to produce the greatest risks form the main focus of examination carried out by Federal Reserve examiners.[145] The risk management component consists of four sub components which indicate the effectiveness of the banking organisation's risk management and controls namely: Board and senior management oversight; Policies, procedures and limits; Risk monitoring management information systems and Internal controls.[146] According to Alan Greenspan, a combination of improved risk management and the utilisation of financial derivatives to manage the risk portfolio has enabled banks to calculate risks more efficiently in business, which in turn has resulted to a reduction of the burden of the banking system on its regulators.[147]

The move towards a risk-based approach is an attempt to realign bank regulation and supervision with the commercial realities faced by banks and this involved institutions managing their risks in a more efficient way to reflect the increase in modes of obtaining finance for business and also to hedge risks.[148] The risk based approach in the USA concentrates on both small 'community banks' and 'large banks' and the mode of supervision has developed in distinct ways as a result of the existence of more than one bank regulator at the federal level.[149]

The risk based approach consolidates on the extent to which a risk could adversely affect the safety and soundness of a bank.[150] Benefits of the OCC's risk based approach include:[151] Core

[142] *The Federal Reserve System Purposes and Functions* p 63
[143] D Singh 'Legal Aspects of Prudential Supervision' 2007 p 127
[144] *The Federal Reserve System Purposes and Functions* p 63
[145] ibid
[146] ibid
[147] A Greenspan, 'Banking', *Federal Reserve Bulletin*, 7 October (2002)
[148] D Singh, *Bank Regulation of UK and US Financial Markets:The Legal Aspects of Prudential Supervision* 2007 p 129
[149] ibid
[150] ibid p 130; The OCC sets out its policy on supervision of national banks in its Comptrollers Handbooks of 1996 and 2001. It emphasises that the supervisory process does not seek to restrict risk taking but that it expects banks to maintain such risk taking by having appropriate risk management processes available to capture those risks. Also see OCC *Large Bank Supervision, Comptrollers Handbook*, (2001) at p. 3
[151] D Singh, *Bank Regulation of UK and US Financial Markets:The Legal Aspects of Prudential Supervision*

assessment criteria which assist the OCC in its application of a common methodology to evaluate the risk profile of individual group entities to ensure that risks can be measured consistently and ; the forward looking and proactive nature of the OCC's approach which enables it to gauge how risks will change over the next 12 months.

Impact of Basel II on US Financial Regulation and Supervision

Basel II is important not only because it is a common standard for measuring capital adequacy but also because it is based on the risks of an institution's investments.[152] It therefore allows for greater facilitation of harmonisation and easier comparisons between different countries, particularly at a time when globalisation and the increase of multinational firms has made this necessary. The risk based capital standards not only mandate institutions that assume greater risk to have higher levels of capital but also take into consideration risks associated with operations that are not included on a bank's balance sheet, such as those risks resulting from obligations to make loans.[153] Basel II has been pursued by the Federal Reserve due to the increasing inadequacies of Basel I regulatory capital rules particularly in the context of the growing complexity of products and services provided by large internationally active banks.[154] A more risk-capital framework has been called for and it is believed that Basel II would provide such framework for such internationally active banks.[155] As banking involves the acceptance and management of risks, it is of great importance that bank supervisors ensure that an adequate level of capital is maintained to insulate itself against potential losses. Minimum regulatory capital requirements are vital to ensuring that such protection is facilitated.[156]

On the 25th of September, 2006, the Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and Office of Thrift Supervision, Treasury (OTS), which are collectively known as the Agencies, issued a notice of proposed rule making (NPR or proposed rule).[157] This notice welcomes comments on the New Advanced Capital Adequacy Framework that will replace the present general risk-based capital standards which have been applied to large, internationally active US banks.[158] The proposed framework would also implement the "International Convergence of Capital Measurement and Capital Standards : A Revised Framework," which was published in June 2004 by the Basel Committee on Banking Supervision (Basel II) in the US.[159] Basel II consists of three pillars namely: capital adequacy requirements, centralized supervision and market discipline.

2007 p 131

[152] *The Federal Reserve System, Purposes and Functions* p 73

[153] ibid

[154] See 'An Update on Basel II Implementation in the US', 'Reasons for Basel II', 'Remarks by Governor Susan Schmidt Bies at the Global Association of Risk Professionals Basel II Summit, New York, February 27 2007 <http://www.federalreserve.gov/boarddocs/speeches/2007/20070226/default.htm> last visited February 27 2007

[155] ibid

[156] ibid

[157] See 'Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation. <http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070215/attachment.pdf> last visited 20th February 2007

[158] ibid

[159] Ibid; Even though Basel II lists various possible approaches for calculating regulatory risk-based capital requirements under Pillar 1, the US has proposed only the advanced approaches for implementation.

In relation to Pillar 1, the proposed framework as described in the NPR, would require some qualifying banks and permit others to calculate their regulatory risk-based capital requirements using an internal ratings-based (IRB) approach for credit risk and the advanced measurement approaches (AMA) for operational risk.[160] As well as giving guidelines for the supervisory review process and requiring a process for the supervisory review of capital adequacy under Pillar 2, the NPR also highlights requirements for improved public disclosures under Pillar 3.[161]

Three documents lay out the proposed supervisory guidance for implementing proposed revisions to the risk-based capital standards in the US and this new capital framework would be compulsory for large internationally active US banking organisations and optional for other institutions.[162] Two of these documents relate to the Basel II advanced approaches for calculating risk-based capital requirements namely, the advanced internal ratings-based (IRB) approach for credit risk and the advanced measurement approaches (AMA) for operational risk.[163] Under the IRB framework, internal estimates of certain risk components would be used as key inputs by banks in determining their regulatory risk-based capital requirement for credit risk.[164] As well as updating and consolidating previously proposed supervisory guidance on corporate and retail exposures, the IRB Guidance also provides new guidance on systems which a bank may require in order to distinguish risks posed by other types of credit exposure.[165]

The second guidance document provides supervisory guidance on the AMA for operational risk and updates the proposed AMA Guidance published in 2003.[166] The third document, issued for the first time, sets out proposals for guidance on the Basel II supervisory review process for assessing capital adequacy.[167]

Conclusion
Meta Risk regulation: The Way Forward?

Compliance will always remain vital in determining the success of meta regulation. In order to ensure the least deviation between what is expected of a firm and its actual compliance with rules, the issue of monitoring will therefore, be crucial. Whilst enforced self regulation (a form of meta regulation), provides the benefits of flexibility derived from self regulation, it also attempts to avoid the weaknesses of its voluntary nature. In considering more ambiguous factors such as the external environment of the firm, the risk based approach to supervision

[160] Ibid; The internal ratings -based approach and advanced measurement approaches are both known as the advanced approaches.
[161] ibid
[162] See 'Agencies Seek Public Comment on Proposed Supervisory Guidance for Basel II' <http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070215/default.htm>
[163] ibid
[164] See 'Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation. <http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070215/attachment.pdf> last visited 20th February 2007
[165] ibid
[166] ibid
[167] See 'Agencies Seek Public Comment on Proposed Supervisory Guidance for Basel II' <http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070215/default.htm>

would appear to produce less accurate results than meta regulation. Furthermore its impact on the use of external auditors, as illustrated by the Financial Services Authority (FSA), contributes to its being a less favorable option than meta regulation.
According to Fiona Haynes[168], meta regulation "with its collaborative approach to rule generation", could controversially be considered to be the approach with greatest evolvement when considered in relation to other approaches such as co-regulation, enforced self regulation and process or management-based regulation. Meta regulation is a method which is capable of managing "self regulatory capacity" within those sites being regulated whilst exercising governmental discretion in stipulating the goals and levels of risk reduction to be achieved in regulation.[169]

Meta risk regulation is proposed as a means of quantifying and managing risks under the risk society theory – risks which I would like to refer to as institutional risks. Such a proposal would not only address, to an extent, the concerns of Beck (in relation to matters of accountability), but would also be a more appropriate means of controlling more complex risks which have resulted from developments of science and technology. Such risks can be contrasted with the more "traditional and novel societal risks". Enforced Self Regulation is proposed as a means of addressing such less complex and more traditional forms of risk – whilst providing some scope for the role of judicial governance and the involvement of courts. Courts are simply not adequately equipped to deal with the pace with which some financial instruments, such as derivatives, operate. Even though the Capital Requirements Directive had provided for increased pro cyclicality, it came into force after the 2007/08 Financial Crises had practically ended – thus making it impossible for it to have any impact on the Crisis. As a result, the role of courts and judicial governance in risk regulation should constitute a topic for purposes of future research. Furthermore, the theory of risk colonisation which involves the dynamic linkage between societal and institutional risks, as propounded by Rothstein et al, and within this context,[170] would constitute a fertile ground for research.

The ability of responsive regulation to address such a complex[171] factor as risk, its flexibility and responsiveness to regulatees and its environment, among other advantages, make it a more desirable regulatory tool than traditional regulation or risk based regulation. Whilst direct monitoring by the State would be required, the involvement of third parties such as non government organisations would also be crucial to ensuring that a situation, whereby the State could be captured, is avoided. Furthermore the possibilities available in achieving the right "regulatory mix" make it a promising regulatory tool. Even though the contested nature of risk contributes to the difficulty of relying on risk as a regulatory tool, its presence and ever growing significance cannot be ignored – hence the need for a form of regulation which is able to manage risk more effectively and which would best suit an evolving regulatory environment.

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[168] F Haines,'Regulatory Failures and Regulatory Solutions: A Characteristic Analysis of the Aftermath of Disaster', Law and Social Inquiry (2009) 39 (forthcoming) at page 3

[169] ibid at page 1

[170] See H Rothstein, M Huber and G Gaskell 'A Theory of Risk Colonization: The Spiralling Regulatory Logics of Societal and Institutional Risk at page 107

[171] According to Baldwin and Cave, risk regulators encounter problems with the search for legitimation as a result of differences between the lay and experts' perceptions of risk. For additional information on what could be done to improve the effect of legitimating arguments and solutions advanced to counter problems of risk regulation, see R Baldwin and M Cave, *Understanding Regulation: Theory, Strategy and Practice* (1999) Oxford University Press at pages 145 –149. For problems with defining and assessing risk, see page 138 ibid

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