Regulation and Deregulation

From Legal Theory to the Practical Case of the Financial Sector Nowadays

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The two great challenges for any authority are to what extent and how to intervene in the functioning of the society. These challenges originate both in the world of ideologies, defining the type of state or authority based on its propensity for regulation, and in the technical expertise of technocratic management that can identify the "good practice" and "good governance" features.

Both policy sources are necessary and legitimate. The ideological sources help support a representative mandate obtained by an elected power, being validated by citizens' vote, while the technical ones contribute to optimising the efficiency of the public option by managing it in an appropriate manner. To set a simple example, if the ideological option is in favour of maintaining a company under state ownership, then the technical option may be to ensure a competency-based management controlled solely according to performance criteria. If the ideological option promotes the privatisation of a state-owned company, then the technical option may seek to ensure a privatisation procedure that should maximise the public benefit (through price, other contractual terms, enhanced market competition, clauses or measures to protect consumers, etc.)

Before starting a discussion on the topic, it is important first to define the terminology. It shall not be easy. There is no generally accepted definition of the term "regulation" in legal and economic literature. For the benefit of this presentation, we will attempt to identify one from an ideologically neutral perspective, as the employment of public coercion instruments, whereby prescribed behaviour is rendered mandatory under penalty of sanctions, with a view to implementing social and economic policy objectives. (den Hertog, 2010)

Based on the envisaged mechanism, there are two types of regulation, namely structural regulation and conduct regulation. Regulation may concern the market structure and its parameters: restrictions on market entry or exit, rules mandating firms not to supply professional services in the absence of a recognised qualification, mutual support systems for market players or ensuring a level playing field in terms of non-competitive services applicable to all market players. Regulation may equally aim at market participants' behaviour: price controls, the requirement to provide equal treatment for all, obligations related to consumer protection, cartel banning.

The legitimacy of regulation as an act of authority is *per se* a controversial issue. However, overlooking it implies a major discretionary behaviour risk, the risk of regulation going beyond the necessary limits and beyond public interest. The analysis of the legitimacy of regulation requires an approach based on the values that may be subject to protection – the axiological approach, as well as an approach based on the efficiency of regulation, on the relation between the pursued goals and the employed means – the economic approach[2].

In terms of values, a question arises as to how far regulation should go in controlling human behaviour? In other words, where should we trace the Hayek's boundary between Law and

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[2] See the distinction, as presented by (Dragomir Jora & Butiseaca, 2010)

legislation? The present crisis has raised a whole series of ethical accusations against the financial community and urged the authorities to regulate what had been previously deemed as a fundamental value of capitalism, but seemed to have been lost. The matter deserves a more in-depth analysis and I will do that in what follows.

From the regulation efficiency point of view, the costs related to the initiation and administration of regulation, as well as the systemic coherence of regulation should be considered.

As regards coherence, it must be noticed that, more often than not and definitely in the financial field, regulations must be assumed within a system that should ensure generality and universality. If the social player may circumvent the regulations governing different institutions or choose the most suitable one – i.e. domestic regulatory arbitrage – then the regulatory process fails to meet its goal, proving itself inefficient. Hence, the probability that the decision to regulate a certain field – such as credit institutions – may trigger the need to ensure, at a national level, contiguous regulations in fields such as financial markets, capital markets, consumer protection, etc.

Nevertheless, this is not enough, once the second challenge becomes apparent, namely ensuring that the regulation of the envisaged field covers the entire relevant market. To set an example, limitations on the volume of foreign-currency loans in Romania are not efficient if the bank may grant the same volume of loans via a structure based in another country where this regulation is not applied. We can see here a second type of regulatory arbitrage, at international level, by choosing the preferred law from among similar laws in place in different countries. In this case, the classical legal principle of the territoriality of the law is challenged by the economic reality of globalisation, via market integration and openness, which push the limits of the universality concept from national territoriality towards an open market territoriality (which, in rare cases, can be national, being extended to the European Union level for agricultural products, or quasi-global for financial products).

At present, regulators comprehend the need for regulatory coherence quite well, which is not the case with deregulation coherence. Indeed, for identical reasons, the deregulation process is at risk of causing the same two imbalances – in terms of harmonisation[3] and territorial coverage[4]. Furthermore, given the usual duration of a regulation – deregulation cycle, the know-how, the institutional memory of the previous process fades away unless it disappears completely.

This is why the deregulation approach must focus not only on identifying the impact of the norm to be abrogated, but also, simultaneously, on pinpointing the consequence of other relevant norms being kept in place. As a matter of fact, this gives rise to the main pros and cons concerning regulation when it comes to its economic approach. Let us look at the financial market for instance. Examining statistical data on numerous business cycles worldwide over the last centuries, gathered by K. Rogoff and C. Reinhart, deregulation is found to trigger growth, overheating, followed by crises. Promoters of tight regulation argue that responsibility falls to deregulation itself. On the other hand, promoters of minimal regulation blame the insufficient deregulation. I shall not come with an ideological option, that would rest with the polity. An ideologically neutral vision might point particularly to the non-systemic and imbalanced approaches to deregulation. In other words, if one regulation that was part of a stable system (or seemingly stable, according to libertarians) is eliminated, this will render the

[3] Referring to the previously mentioned general law enforcement, seen as the application of the same rule to all legal subjects performing the same operation or, as the case may be, to all the operations carried out by the same legal subject, regardless of their formal identification and the varied pieces of legislation regulating them.

[4] Referring to the previously mentioned universal law enforcement, seen as the application of the same rule to all legal subjects and to all the operations carried out by them, as long as they operate on the same (national, regional or global) market regardless of the origin country of the legal entity or the state where the operation is performed.

system unstable; yet, the blame does not lie with deregulation, but with its lack of correlation to the system of regulations and its effects.

In terms of the costs of regulation, the generally acknowledged principle is that there must be a difference between the financial and, by and large, social benefit of applying regulation and its attached cost, a "profit", large enough to warrant the implementation of the regulation. The estimates on the benefit and cost related to enforcing regulation take into account the financial dimension, but also aspects related to timing, social harmony among citizens, as well as between citizens and the authority or the functioning of the political representation – the fulfilment of electoral commitments.

The regulation costs and benefits may be deemed as absolute costs when they are related to a unique intervention formula or when they come with non-intervention respectively. Where there are several intervention solutions, they are assessed by reference to the alternative solution. Thus, in the economic field, including the banking system, the regulation costs must be assessed either by reference to the costs related to the regulation in force, or by reference to those attached to private mechanisms such as self-regulation, the enforcement of private contracts and commercial practices, the use of arbitrage as an alternative to public justice.

So much for regulation as the instrument of the legislator. When talking about the manner to use it, namely about the **process**, we will refer to the increase in the number or tightness of constraints on how citizens and credit institutions conclude financial agreements or manage their financial portfolios as the financial and banking **regulation process**.

In turn, the **deregulation process** in the banking and financial field would envisage the decrease in the number and tightness of the said constraints. As shown by the classical literature written before the Great Deregulation that took place after the 1980s, deregulation aimed at ensuring that:

- banks may charge for their services as they decide to and provide any conditions to take deposits;
- banks may hold and trade any category of financial assets and resort to any financing source, except to issuing currency.

Thus, deregulation was not theoretically perceived to contain prudential regulations, but we will come back to this issue in the course of the analysis. Furthermore, during the "classical period", deregulation would not go as far as to suppress the minimum required reserve system, the capital adequacy rules, the deposit insurance or the rules governing the access to the Lombard credit.

In the financial and banking world, the regulation issue was brought up for discussion many times and it is of utmost interest at present, with its two dimensions, namely to what extent one should intervene in the market and how – according to rules or in a discretionary manner.

The first dimension of the dilemma implies a series of options. Depending on the regulation degree at the moment of the decision, there may be regulation or deregulation. Looking at historical records, there is reregulation or overregulation.

The second dimension, i.e. the degree of discretion of public action implies a well-thought-out choice, weighing predictability, transparency, efficiency, adaptability to circumstances and last but not least accountability. An equivalent with the exact meaning of "accountability" is missing in Romanian and the reason for this word's absence is the historical lack of the institution. Mention should be made that, in the financial and banking field, the discretionary room for manoeuvre of the public authority in charge of monetary policy, supervision or macro-stability is markedly larger than in most public policy areas, for reasons developed by economists rather than by politologists or constitutionalists.

As a matter of fact, if we go beyond the boundaries of today's debates, we shall find an alternation between regulation and deregulation, between many and few laws, as well as a relatively continuous increase in the acceptance of discretionary action. Browsing the literature, we learn that, until the Great Depression, regulations were extremely few, and the state's discretionary behaviour was virtually inexistent based on the epoch's golden rules on the inviolability of private property and the state's non-involvement in the economy. In reality, even at that time these rules had their limitations, if we look at the arms industry or the navigation companies, but interesting enough, not in the financial field, where even issuing institutions were generally private institutions.

Starting with the New Deal, there followed a period of strict regulation of the financial sector: the segregation of investment banking from retail activities, interest rate control, capital flow controls, a time of great stability. As for the authorities' action, this was limited to enforcing legal provisions (i.e. to set the overnight rate), since the very solid stability of the system at that time never posed any challenges calling for intervention.

The 1970s ushered in the period of the Great Deregulation. This time, the very concept of deregulation as defined above – namely the liberalisation of fees, lending and deposit rates, asset holdings and the use of financing sources, currency issuance excepted, of financial transactions and the capital account – was taken one step further. Prudential requirements in terms of both bank capitalisation and customer eligibility for loans were cut down in the United States and elsewhere. On the other hand, the discretion of administrative action rose moderately, particularly via more frequent active monetary policy measures, particularly geared towards loosening the screw.

The tide turned yet again with the advent of the Great Recession. Regulation was back on the agenda and a return to the levels seen after the Great Depression cannot be ruled out. Discretion skyrocketed, including via resorting to ad-hoc monetary policy instruments, administrative interventions in the management of credit institutions, nationalisations and other types of administrative changes in ownership with a view to safeguarding macro-stability.

Anecdotal evidence points to similar century-old instances in the history of the Romanians. Thus, what we would now scholarly refer to as rule-based administrative action might trace its roots back to the hearth tax levied by the ruler squeezed by creditors. Conversely, the propensity for discretion reminds us of the Wallachian ruler Mihai Viteazul (Michael "the Brave") locking up his creditors and setting the dungeon on fire.

Nowadays it is clearly interventionism that prevails. It suffices to look at the G8 and the G20 discussion fora of the major economies, including the Financial Stability Board charged with implementing their decisions, the Basel Committee on Banking Supervision – the melting pot of the future standard for global prudential regulation, the Dodd-Franck Act and the proposal to implement the Volcker rule in the United States, the legislative package the British Cabinet is currently working on, as well as the avalanche of EU directives, to which a flood of EU regulations will probably add soon. Tighter regulations and keener discretion are visible at all levels throughout the world.

As far as regulation is concerned, several lines of action can be identified, all of which are subject to controversy. The rationale behind the heated debates and the identity of the debate participants are actually quite interesting when it comes to assessing the importance of the proposed changes.

1. Capital Requirements

A first line of action is a prudential one, which focuses on higher bank capital and liquidity requirements. The goal is to enhance bank resilience and mitigate the risk of credit institutions defaulting on their obligations, case in which either they become insolvent or, due to the large volume of externalities generated, they force governments into costly bailouts hurting the public budget.

Several criteria, some of them minimal, have been set for assessing capital adequacy, complemented by a capital conservation buffer – i.e. additional equity for systemically-important banks – and a time-varying, countercyclical capital buffer, which is to be accumulated in times of growth and be used during an economic downturn.

Banks in Romania are in a comfortable position in this respect. Capital requirements in Romania have long been markedly higher than elsewhere. In the likely event that Basel III comes up with an increase in the Tier 1 capital ratio to 7 percent from 4 percent previously, along with a capital conservation buffer of 2.5 percent for systemically-important banks and a countercyclical buffer of 2.5 percent, credit institutions in Romania already boast a capital adequacy ratio in excess of 10 percent.

Criticism to Basel III proposals came from two directions. On the one hand, independent analysts and authors of studies published by highly-regarded central banks, such as the Bank of England, suggest that the capital adequacy ratio should actually be raised to around 20 percent of risk-weighted assets, at least for large credit institutions. Such a marked reduction in risk would obviously imply a drastic cut in the volume of financial intermediation. Given both the current and the foreseeable levels of banking industry profitability, shareholders are expected to go for deleveraging rather than for such a capital increase. On the other hand, the prominent figures in the banking industry are not enthralled with the idea; the shareholders and bondholders of US and large European banks alike look upon recapitalisation as an unwarranted cost in terms of return.

However, in light of the aforementioned accountability issue, what regulators need to point out is the dual effect of these regulations. Additional equity is tantamount to extra safety, but it also means lower return ratios and hence a potentially less appealing banking sector for investors. Further on, since financial intermediation is pivotal to market functioning, incentivising investors implies improving the margins, and thus enhancing profitability, which can only be achieved by matching the rise in revenues (via higher prices of banking services) with capital increases. More plainly said, if the society pursues extra safety of financial services, it needs to accommodate a higher cost for such services.

Similarly, setting higher liquidity thresholds entails a decline in the financial intermediation activity. In institutional terms, this means a narrowing of banks' social function, whereas in economic terms it is a cut in the financing of the real economy, implying slacker economic growth and a more strenuous exit from the recession. In other words, more liquid banks mean lower risks of non-redeeming deposits on demand, but this comes at the expense of muted economic growth.

2. Lending Regulations

Reregulation by reintroducing lending limits and conditions is yet another line of action currently pursued in the regulatory field. The purpose of such regulations is to ensure the public-interest finality of financial intermediation, namely the closing of a loan cycle (originate-service-repay). Any disruption in this cycle entails major private costs incurred by the borrower and lender alike, as well as public costs arising from inefficient resource allocation.

In this case, criteria are usually defined at a national level and may seek to contain an entity's overall indebtedness, to introduce tighter requirements on loan down-payments and length or to stress-test the debt servicing capacity depending on risk factors such as income, interest rates and, where appropriate, foreign exchange rate movements.

We saw the response to such a regulation only a few months ago in Romania. The main objection to the new NBR regulation on lending was that the introduction of stricter requirements would depress lending, already hurt by the recession. But here we are dealing with a confusion of terms, generated by the confusion of principles referred to earlier: the very process of lending means, or at least should mean, the complete cycle ending with full repayment. It is this particular type of lending that should not be deterred, because it contributes to economic revival. On the other hand, it is of public interest and to the benefit of each stakeholder not to foster unsustainable lending, which deepens the recession by wasting resources.

3. Regulations on Business Ethics and Remuneration Mechanisms

There is a century-old dispute as to the extent to which law can intervene in public and/or private ethics. The starting point now is a virtually complete lack of regulation. Back in 2007-2008 and for a long time beforehand, as early as the introduction of free market mechanisms, it was believed that business ethics related to economic agents' individual cultural dimension, be it religious or secular, and to market self-regulation – at the level of professional and industrial associations. As for remuneration mechanisms, the belief was that they were regulated exclusively by the market and by corporate governance controls, also an integral part of the market – the shareholders' control over the board of directors and the latter's control over executives.

In fact, it turned out that industry showed no concern whatsoever for ethical matters, which were not regulated, monitored or discussed within the trades of the financial world. In addition, the "classic" expectation according to which an economic agent's market activity is usually ethical for fear of market rejection was proven wrong for at least two reasons: one has to do with remuneration, which will be discussed in more detail hereunder, and the other relates to information asymmetry. The latter is a specific trait of the financial and banking areas, given the complex operations that are difficult to fathom by customers. The more complex these operations grew, the less intelligible they became even for bank managers in the run-up to the crisis. In turn, this led to serious conflicts of interests in dealing with these instruments. Providing buy recommendations to customers for derivatives while short-selling the underlying assets is a good example in this sense.

As far as remuneration is concerned, it is obvious that the mechanisms introduced by market players were wrong and that the corporate control tools did not work. This issue of shareholders losing the grip emerged not only in the banking industry, but became widely-spread among corporations. Since there is a deeply-entrenched rejection of the idea that the remuneration system might ever malfunction for a long time and across numerous companies in a free market context, let us look into how practice has not proven theory wrong, but rather has deprived it of its underlying premises. The short-circuit occurred as follows: the management and the shareholders are two different groups of stakeholders for most of the large corporations. The majority of the shares are, more often than not, held either by small investors or by portfolio investors, none of whom are essentially specialists in the company's line of business. This generates an obvious information asymmetry between such investors and the management. Besides, the management resorted to the wide-scale technique of linking the stipends of shareholders' representatives – members of the Boards of Directors or Supervisory Boards – to the remuneration of the executive management, which placed such representatives in a clear conflict of interests in relation to those they represented when it came to wage policy decisions.

This led to bank managers being remunerated based on their own appraisals, rather than the appraisal and the degree of satisfaction of the beneficiaries of their performance. Two consequences emerged related to the specifics of their term in office. Thus, the time-limited tenure resulted in linking managers' bonuses to their short-term and very short-term performance. The risk of terminating a manager's employment by shareholders' decision was countered by severance payments that were not linked to performance – the so-called "golden parachutes".

Further down the hierarchical ladder, managers set the stage for cashing in their own bonuses. In other words, they based their remuneration on the actual volume of loans granted, regardless of the default risk. The subprime mortgage crisis traces its roots back to this practice. Or, at least, this is the simple explanation. There are more intricate accounts as well, so it is up to the reader to choose the most plausible version.

The regulators' response to this market distortion targeted especially its effects, namely the way in which bankers' remuneration was determined. As for the underlying cause, i.e. the lack of shareholders' control over the management of large corporations, it is still to be tackled. Returning to the effects, regulations were introduced whereby bankers' incentives and bonuses were linked to the institution's long-term interests, depending on the bank's longer-term performance (around four years). In addition, it was decided that such benefits be provided mostly in other forms than in cash. Such regulations are already in place across the EU, via a directive of the European Parliament and of the Council, and they have also been transposed into national legislation. However, mention should be made that domestic bankers have pursued a reasonable wage policy.

4. Regulations on Macro-Stability

The very concept of macro-stability, or financial stability, still lacks a positive definition. Until then, we have to make do with an institutional definition: financial stability as the absence of financial instability.

Given the negative externalities peculiar to the banking system, financial instability is an extremely serious threat to private life and the functioning of the economy alike. Besides, a close scrutiny of banking crises across countries and across history yields the same statistical conclusion: among all types of economic crises, banking crises leave behind significant increases in public indebtedness.

For these two reasons, at the end of the day it becomes apparent that preventing the emergence of financial instability, costly though it is, proves less pricey over the medium term than leaving it up to market rules. This implies a wide array of early intervention tools in relation to banks that run the risk of facing an unsustainable position in case of making recourse to the usual means, such as funding of last resort, capitalisation, market takeover. We are referring to administrative tools, i.e. asset and/or liability transfer, bridge-banks, temporary nationalisation. All these involve key decisions on the financing source (shareholders and bondholders, the banking industry or the public budget) and enhanced corporate governance mechanisms. After all, the bailout is meant to give the business renewed impetus, not a push back into a state of default.

5. Conclusions

Public debate is admittedly tilted in favour of the strict regulation of the financial sector. A major moral objection raised as part of this argument refers to the blatant inconsistency between the social function and the individual motivation of financial intermediation. Thus, the social function means securing the funding of projects that bring added social value, one of the components of which is, undoubtedly, loan repayment. After all, the amounts earmarked for lending in the financial system do not usually come from a bank's shareholders, but rather from its depositors. Instead, both in the run-up to and in the aftermath of the crisis, it has been found that banker remuneration mechanisms have not targeted social finality; quite on the contrary, they fostered granting doubtful loans, treasury operations and trading in derivatives, all the way to manifest conflicts of interests, such as proprietary trading operations to the detriment of their own customers.

In my opinion, the system is now firmly on the path of strengthening regulation. But in order to lead to a successful outcome, this path needs to have the proper ethical and systemic foundation. Let me conclude by listing several examples of such principles:

- Ensuring a competitive environment: the overconcentration of the industry implies the risk of losing the benefits of competition and a wider share of "too big to fail" institutions;
- Bringing bankers' individual motivations in line with the industry's social function;
- Strengthening the industry's ethical basis by regulating conflicts of interests between the banker and the bank and between the bank and the customer;

Setting up buffer funds and mechanisms to ensure higher resilience of institutions and the system alike during times of crisis, enabling the system to regain balance via its own resources and thus precluding any further bailouts from public money.

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