THE CASE FOR REGULATORY INTERVENTION IN THE FINANCIAL SECTOR

Prof. Christos Vl. Gortsos
Secretary General,
Hellenic Bank Association

May 5, 2006

I. National level

A. The financial sector is heavily regulated. Sector specific regulatory intervention in the financial system serves several aims:

(1) The basic reason of regulatory intervention in the financial system is the **safeguarding of its stability**, which can be threatened by the occurrence of so-called 'systemic crises'. Within this framework, five individual –but closely interconnected- policy requirements develop:

I. National level (2)

(a) The first requirement is the *safeguarding of the stability of the banking system* from the possibility of the occurrence of chain bankruptcies of banks. In order to satisfy this demand, national regulators introduce rules concerning:

- The licensing and prudential supervision of banks,
- the winding-up and liquidation of insolvent banks, and
- explicit deposit guarantee.

The sum of the measures and mechanisms which are established for the satisfaction of the requirement in question make up the so-called 'safety-net of the banking system'.

I. National level (3)

(b) The second requirement is to *ensure the stability of capital markets*, which may be disrupted either by a sudden and major fluctuation of the prices of financial instruments traded on them, or because of the bankruptcy of a financial intermediary providing investment services in them. The satisfaction of this requirement is sought by the adoption of rules concerning:

- the proper operation of the infrastructures for trading in financial instruments;
- the licensing, prudential supervision and corporate governance (including internal audit mechanisms) of financial intermediaries providing (on an individual or collective basis) investment services in capital markets.

I. National level (4)

(c) The third requirement is the *safeguarding of the stability of the market for the provision of private insurance* from the possibility of the bankruptcy of undertakings which provide insurance and re-insurance services. The satisfaction of this requirement is sought by the establishment of rules concerning the licensing and prudential supervision of insurance undertakings.

(d) A fourth requirement (much highlighted recently) is the *safeguarding of the stability of the financial system (as a whole)* from the possibility of the occurrence of generalised financial crises in the economy which are due to the undertaking of excessive risks by the so-called "financial conglomerates" composed of banks, insurance undertakings and investment firms. The satisfaction of this requirement is sought through the adoption of rules concerning the supplementary prudential supervision of these groups.

I. National level (5)

(e) The fifth requirement consists in *ensuring the smooth operation of payment and settlement systems*. The danger to the systems in question consists in the transmission of liquidity and/or solvency problems from one member of the system to other members, with all the systemic effects that this can entail. Control of exposure to this risk and the taking of measures to reduce it are carried out in the framework of the oversight of the payment and settlement systems.

I. National level (6)

(2) The second reason of regulatory intervention in the financial system is to **ensure the efficiency of capital markets**, that is the optimal allocation of own and borrowed funds drawn upon on them, as well as the protection of investors in financial instruments. This requirement is satisfied by the introduction of rules in connection with:

I. National level (7)

- The obligations imposed on undertakings wishing to attract (own and/or borrowed) funds from capital markets (eg., terms and transparency in the listing of financial instruments on capital markets, periodical provision of information to investors)
- Transparency of the transactions carried out during the trading of financial instruments in capital markets
- The avoidance of practices leading to distortions on the terms of operation of capital markets (such as market manipulation and insider trading)
- Protection of the rights and interests of investors in listed companies in view of takeover bids
- Uniform presentation of financial statements for listed companies

I. National level (8)

(3) The third reason of regulatory intervention in the financial system consists in **ensuring the protection of consumers** transacting with financial intermediaries. The policy requirements in this case concern the elimination of the asymmetry of information potentially existing between the contracting parties and in dealing with the potential reduced negotiation capacity of the consumer. For this reason rules are adopted by which the following are sought:

- The provision of adequate information to consumers in connection with the content of the contracts they conclude (both prior to the contract and during its term)
- The elimination of abusive terms
- The prevention of unfair commercial practices
- The possibility of a recourse either to justice on the part of consumers though collective actions or to out-of-court dispute settlement systems

I. National level (9)

(4) The fourth reason consists in the **prevention of the use of the financial system for the commission of financial crimes**, such as, mainly, money laundering. Within this framework rules are established on the control of transactions carried out (with a view to locating 'suspicious transactions') and the forwarding of information to the competent authorities.

I. National level (10)

(5) Lastly, regulatory intervention in the financial system (particularly in the banking system) may be due to **reasons of economic and social policy**, a practice which is common in economically developing and less developed states. Indicative examples of this form of regulatory intervention are:

- The imposition on banks of restrictions in connection with the provision of non-banking services (eg., prohibition of the provision of investment or insurance services), and/or in connection with the geographical range of their activities
- The introduction of upper limits on the interest rates on loans and lower limits on the interest rates on banks' deposits
- The imposition on banks of the obligation to invest a percentage of their deposits in specific sectors of the economy (usually on privileged terms and with subsidisation of the interest rate) and/or in bonds issued by the state (in order to ensure the funding of public expenditure)

I. National level (11)

B. Financial intermediaries are also subject to regulatory intervention for *reasons applying also to other groups of service providers*, as reflected in the provisions of (indicatively) the following areas of law:

- company law,
- competition law,
- data protection law,
- taxation law,
- labour and social law.

II. International level

Financial regulation has been heavily internationalised during the last three decades. The requirement of recourse to international financial cooperation is justified on the following reasons:

(1) To begin with, recourse to international cooperation is necessary for the establishment of rules for the determination of the authorities to be responsible for the supervision of financial intermediaries which are active with a commercial presence in more than one state, with two alternative possibilities:

- either the establishment of a supra-national authority with the relevant powers or
- the division of competences between the competent national supervisory authorities.

II. International level (2)

(2) Recourse to international collaboration is also called for the establishment by states of harmonised rules (on the basis of the principles of maximum or minimum harmonisation as to the level and partial or full harmonisation as to the scope) in fields to which regulatory intervention is justified at a national level in order to deal with the following three issues:

- In an internationalised environment, unilateral recourse to the adoption of measures to shield the domestic financial system may lead to a distortion of the terms of competition of domestic financial intermediaries against their competitors who have their registered offices in states applying laxer rules. For this reason, some states may have reduced incentives for the unilateral adoption of the appropriate measures at a national level.

II. International level (3)

- The existence in two or more states of a different framework of operation of the financial system is a strong incentive for intermediary financial agencies to establish themselves in states in which a looser regulatory framework is in force (a practice known as 'regulatory arbitrage')

- Lastly, aware of the above argument, certain states may even choose the relaxation of existing rules in order to attract foreign financial intermediaries to establish a commercial presence on their territory or to engage in activity in it even without establishment (a practice known as 'competitive deregulation')

III. Financial intermediaries' view

- Resort to adequate regulatory pre-action rather than unwarranted re-action
- Proportionality of targeted regulatory intervention
- Intervention should be based on cost-benefit analysis potential implications (achievement of regulatory goals vs. business competitiveness and innovation - adequate balancing of conflicting goals)

III. Financial intermediaries' view (2)

- Preservation of competitive equality (nationally – internationally)
- Efficient design of the regulatory and supervisory framework in order to ensure: minimisation of excessive operating cost – adequacy of supervisory intervention – avoidance of regulatory duplication
- Focus should be based substance rather than technicality

III. Financial intermediaries' view (3)

- Establishment and preservation of adequate consultation processes with regulators and supervisors
- Adequate use by supervisory authorities of discretions granted to them by the regulatory framework
- Regulatory recognition of financial intermediaries' internal mechanisms for risk mitigation
- Respect to adequate self-regulation