

Franz R. Hahn

## Financial Market Regulation

**In modern economies the financial sector is the most strongly regulated field of economic activity. However, the regulation intensity varies substantially: It is very high at the core and very low at the periphery.**

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Banks, insurance companies, investment funds and pension funds are the basis of a modern financial sector. In their business and investment activities they are subjected to, in part, very tight supervisory legislation and permanent surveillance by supervisory authorities. Hedge funds (investment funds aiming at above-average yields via speculative investment strategies) and private equity funds (providing temporary off-exchange equity to companies), however, are among those financial institutions, which are subject to only very little or no supervisory limitations and controls.

In the financial sector, investor and consumer protection are the conventional criterion for the differentiation between a core with high regulation density and barely regulated peripheries. The financial sector is characterised by a very high information asymmetry at the cost of investors and savers. Overcoming this systematic information deficit does not only rely on market participants' above-average familiarity with the functioning of modern financial institutions (markets and financial intermediaries), but also requires the ability to obtain and process information efficiently.

Usually these preconditions are only met by professional or very wealthy private investors. The clientele of hedge funds and private equity funds consists almost exclusively of these customer groups.

Small investors and savers usually lack both specific financial know-how and the financial means to offset their structural information deficit. They form the main clientele of the core financial institutions (banks, insurance companies, investment funds and pension funds). To avoid market imperfections due to insufficient information, the government, in the form of the financial market regulator or the financial market supervisory authority, exerts its representative's authority and passes rules for conduct and investment in the financial sector to protect the interests of structurally disadvantaged market participants.

The dominating motive of the current regulatory paradigm in the financial sector thus is the prevention of market failure due to systematic, information-related disadvantages of market participants (e.g., small investors and savers). The high regulatory requirements, which all developed economies set for the reliability, integrity and solidity of banks, insurance companies, investment funds and pension funds (or their management), are closely linked to this objective. These regulatory themes are reflected most clearly in the legislation on deposit insurance for savings accounts and in the rules for capital adequacy of banks. If a bank is threatened with insolvency, they guarantee savings and current accounts of natural persons (up to a defined ceiling).

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**Central objective of regulation: investor protection**

Besides individual protection both measures also contain a systemic precautionary element. Deposit insurance is to reduce the systemic risk of a bank run by savers and small investors. By contrast, regulatory capital adequacy requirements are to limit risk-prone behaviour which harms the macro-economy.

During the current financial crisis both essential precautionary systems of the financial sector have proved successful only in part. In almost all countries public and private deposit insurance, supported by extensive government guarantees, significantly contributed to the prevention of systemically dangerous bank runs by panicking savers. In contrast, regulatory capital adequacy requirements for banks have hardly strengthened the banking system. Before and during the financial crisis they even had a destabilising effect on the financial system.

The undifferentiated and sketchy recording of credit risks and the rapid development of financial innovations undermined the effectiveness of the capital adequacy requirements (Basel I), which were in force until 2008, and made them completely meaningless. The stability of the international banking system was strengthened only insufficiently by the simple Basel capital requirements, as the financial crises in the second half of the 1990s had already shown.

The severity of the current financial crisis is often explained by the Basel capital requirements. Due to the crude differentiation of risks banks were able to increase their profits in many business areas without having to raise equity (equity arbitrage). This freedom left by supervisory legislation was used over-proportionately especially in the field of mortgage loans to private households (subprime mortgages).

The Basel capital requirement was seriously undermined by the strong increase of bank transactions involving risks which are not regulated in the existing capital requirements of supervisory legislation. By securitising loans banks could lower the capital required by supervisory legislation. This procedure led to a deterioration of the quality of the banks' portfolios, which ultimately triggered the current financial and economic crisis.

The new capital requirements (Basel II) were to overcome this and other shortcomings of the previous capital requirements and, above all, apply modern and improved methods of risk assessment to reduce the discrepancy between the capital required by supervision and the capital required from a banking perspective. The combination of a more effective supervisory surveillance process and increased market discipline is to ensure the stability of the financial system and reduce the danger of systemic risks.

However, the current crisis has shown that the new capital requirements are not sufficient to ensure the stability of the financial system. Central components of Basel II even had a destabilising effect on the system as a whole: The capital requirements under Basel II have a strongly pro-cyclical impact on banks' lending and make it easier for banks to obscure credit risks. Many banks, which proved severely undercapitalised in the current crisis, had a sufficient capital base according to the criteria of Basel II.

Furthermore, Basel II suffers from the fundamental structural shortcoming that it regulates only risky investments and neglects those, which are (supposedly) risk-free but of systemic relevance. Almost all spectacular collapses of banks since 2008 have been triggered exclusively by a high and supposedly risk-free "exposure" to systemically relevant investments. According to regulatory criteria these banks had (almost without exception) backed their risks with sufficient capital.

After the bankruptcies of the investment banks Bear Stearns and Lehman Brothers in the USA, which were caused by a high systemic risk in their core assets and liabilities, the global financial system almost collapsed in 2008 (Morris – Shin, 2008). The current crisis thus made clear that the stability of modern and complex financial systems is threatened much more by the sudden occurrence of systemic external effects and spillovers than by market failure due to asymmetric information or imperfect competition.

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### **Essential precautionary systems: deposit insurance and capital adequacy requirements**

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### **Micro-prudential financial market regulation endangers system stability**

Thus, in the future financial market regulation must be oriented towards the objective of systemic safeguarding of the financial sector to a much greater extent than before. This requires a comprehensive reorientation of financial market supervision, especially in advanced economies.

The dominating guiding principle of financial market regulation is micro-prudential and relies on the basic assumption that the financial system is stable and efficient according to conventional measures, if every single financial institution acts prudently and with integrity. However, the current crisis has shown that this principle can entail disastrous consequences for the system as a whole, if (scarcely regulated) parts of the financial system have already been lastingly shaken by external shocks. The regulatory coercion to fulfil the capital requirements even in a crisis further exacerbated the banking crisis and entailed lasting disturbances of the system, which eventually paralysed the whole monetary sector.

The guiding principle of financial market regulation should therefore be oriented much more towards the macro-economy. The borderline between regulated and unregulated financial institutions (markets and agents) should exclusively follow the principle of systemic relevance (e.g., not only large systemically relevant hedge funds should be regulated, but also small ones, if they can produce macro-economically undesired systemic effects via uniform investment strategies).

Thus, the systemic relevance of financial institutions should be at the heart of the new financial market supervision. Scope and depth of the regulatory measures should be geared to the potential systemic effects of the respective financial institutions. Financial agents or financial institutions, whose activities and expenditures entail substantial systemic risks, should be induced, by appropriate supervisory measures, either to permanently reduce or completely internalise the negative systemic effects (e.g., via a very high capital requirement or tight limits for borrowing).

## Macro-prudential reorientation of financial market regulation necessary

Table 1: Assessment of the proposals for a reform of financial market regulation

	Larosière Report	Turner Review (UK)	G-20 proposals for financial system reform	US regulatory reform proposals
Macro-orientation	•••	••	•••	••
Micro-orientation	•••	•••	••	•••
Regulation density	••	•	•••	••
Cross-border cooperation	•••	•••	•••	•
Incentive systems	•	•	••	•

Source: G 20 finance ministers' and central bank governors' communiqué (2009), Larosière Report (2009), The Turner Review (2009), US Department of the Treasury (2009). ••• very important, •• important, • less important.

The potential systemic failure due to external effects and spillovers should be counteracted in a "forward-looking" manner by primarily macro-oriented financial market supervision and financial market interventions. This requires a close co-operation and co-ordination of financial market supervision and monetary policy both at the national and at the international level.

The most recent proposals for a reform of financial market supervision and financial market monitoring presented by the EU (Larosière Report), the British financial market supervision FSA (Turner Review), the G-20 (G-20 Report) and the US administration (US regulatory reform proposals) take the necessity of a stronger macro-orientation into account, but differ in their assessments of its relevance (Table 1).

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### *Financial Market Regulation – Summary*

The international financial crisis has shaken the confidence in the competence of financial supervisory authorities. In the light of massive system failures, the principles of financial supervision should be fundamentally revised. The experience of the current crisis has led to the consensus that the existing regulatory framework needs to be reinforced by more efficient macro-prudential control and steering elements. From a supervisory perspective, the systemic risk originating from internationally active banks or globally active hedge funds could be effectively controlled by raising minimum capital requirement relative to that of financial institutions operating only in the domestic market. The higher regulatory capital requirements ensure that the major banks bear at least part of the systemic risks that they create. A significant role in the re-orientation of banking supervision will also be played by the financial stability policy. A stronger integration of a forward-looking strategic banking supervision and banking surveillance policy into the stabilisation strategies of monetary policy would significantly increase the effectiveness of central banks and banking supervision.