RSCAS seminar Series on PUBLIC AND PRIVATE REGULATION IN EUROPE in collaboration with the Florence School of Regulation

Concluding remarks

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I. The case for regulatory intervention in the financial sector

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:

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

The total 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'.

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(b) The second requirement is to *ensure the stability of capital markets*. 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, operation, prudential supervision and corporate governance (including internal audit mechanisms) of financial intermediaries providing (on an individual or collective basis) investment services in capital markets.

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(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, operation 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.

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(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.

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(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:

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- 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

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(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 “softening” of the asymmetry of information potentially existing between the contracting parties and of their negotiation capacity. 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 facilitation of a recourse either to justice on the part of consumers though collective actions or to out-of-court dispute settlement systems

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(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.

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(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)

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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,
- environmental law,
- data protection law,
- taxation law,
- labour and social law.

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Regulatory intervention at European level

Regulatory intervention at European level in the financial sector has two principal objectives:

- the first is to ensure the two basic community freedoms, i.e. the freedom for establishment and the freedom to provide services of credit institutions and other financial intermediaries, and
- the second is to ensure the abovementioned (under A1-4) requirements, i.e.:
    - the stability of the financial system,
    - the efficiency of capital markets,
    - consumer protection, and
    - the prevention of the use of the financial system for the commission of financial crimes

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Regulatory intervention at European level (cont.)

- In this respect, European financial law includes seven (7) distinct but closely related sectors:
  - the European banking law,
  - the European capital markets law,
  - the European insurance law,
  - the European financial conglomerates law,
  - the European law of consumer protection in the field of financial services, and
  - the European law on the prevention of the use of the financial system for the commission of financial crimes

II. Policy issues

(i) Private regulation instead of public regulation?

- Private regulation could not and should not in principle be considered as a substitute to public regulation. This is impossible due to their different roles, functions and features. More precisely: Private regulation does not have the power to adopt rules institutionally and its rules are not legally binding. They constitute soft law.

- **Pros of private regulation:** know-how of professionals, flexibility with respect to the process of the adoption of rules, speed, low cost

- **Cons of private regulation:** bias (the fear is that professionals will favour unduly the interests of their members at the expense of other interests), not legally binding rules which cannot be enforced and punished (legally) (however efficient internal enforcement mechanisms have been settled in several occasions, political and market pressure)

II. Policy issues

(i) Private regulation instead of public regulation?

- Private regulation is desirable with respect to standard-setting if legislative rules do not exist or are principle-based.
- Private regulation could function under framework rules adopted by public regulation (**statute-backed self-regulation**). In this way, public regulation includes the core principles which are concretisized by self-regulation

II. Policy issues

(ii) The impact of European intervention on the division of powers between public and private regulators

- The banking sector is heavily regulated at European level by public regulation.
- Only a limited number of Recommendations in the field of payment systems and consumer protection. Recommendations could be adopted by private rules.
- Recently, private regulation is encouraged especially in the fields of payments systems' integration and consumer protection (e.g. SEPA, switching on bank accounts, home loans). Its success depends heavily on the professionals and the quality of private regulation (see below, under IV). However, in the fields covered by detailed public regulation rules there are no incentives for private regulation rules

II. Policy issues

(iii) The impact of European intervention on the division of powers between public and private regulators

- Another aspect of division of powers between public and private regulation has been introduced by Directive 2005/29/EC on unfair commercial practices. According to this Directive, the following commercial practices are considered to be misleading, amongst others:
  - Claiming to be a signatory to a code of conduct when the trader is not.
  - Claiming that a code of conduct has an endorsement from a public or other body, which it does not exist.

  By this way, codes of conduct may be monitored by public regulators.

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

- 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 on substance rather than technicality

III. Financial intermediaries' view

- 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 private regulation** (self-regulation) (see below, under IV)

IV. Conditions for adequate private regulation (self-regulation)

- Appropriate representation of the sector
- Collaboration or consultation of third parties concerned (if the rules adopted by private regulation concern third parties, e.g. consumers). Even if it is not required, it ensures the adoption of more efficient and commonly accepted rules. However, it requires good faith and realistic approach from both parties
- Realistic and concrete approach: determination of the goals to be achieved, adoption of clear and precise rules, respect of the already existing legislation in the field, concretization of legislative rules, if necessary

IV. Conditions for adequate private regulation

- The professionals possess by definition the necessary know-how in order to adopt the most adequate rules in each case. The detailed approach is to be preferred in order to avoid vague rules and differentiated application in member states.

- Private regulation rules should not repeat existing legislative rules. They should function either proactively (in order to cover lack of legislative rules) or in parallel (in order to concretisize or interpret legislative rules and provide guidance for their effective implementation)

IV. Conditions for adequate private regulation

- Sound management and active promotion of private regulation:
  - adoption of enforcement rules which ensure the efficient and effective application of the rules adopted: even if private regulation rules are not legally binding, it is possible to ensure their enforcement either directly (by applying internal enforcement mechanisms) or indirectly (ratification by the competent supervisory authority)
  - constant adaptation of the rules to the constantly developing needs of the market,
  - promotion of the rules to all stakeholders

IV. Conditions for adequate private regulation

Competition law and private regulation

- Private regulation rules should respect competition law and not intervene in price-fixing
- Competition law could not be considered as an obstacle to the development of private regulation