

Optimal financial regulation in the European Union: a further investigation of Marianne Ojo's theory

Author: Sjoerd Wartena; *Programme:* BA H Business Management ; *Year of Study:* 3;

Mentored by: Dr. Wim Vandekerckhove

Abstract

In today's harmonised European society, the importance of successful financial risk taking abilities and their subsequent governance is a current topic of discussion. The purpose of this paper is to test existing regulatory theories, and provide a framework for future research. Using Marianne Ojo's theory (Ojo 2010, 2011), this research attempts to answer the following research question: To what extent should the EU intervene in financial risk taking abilities at financial institutions? Using a deductive, qualitative research, five semi-structured face-to-face interviews were conducted. All interviewees have experience working for a financial institution in the City of London. All interviewees were of Dutch, Dutch/American or British origin. The study has identified two main findings. First, the EU is (currently) not capable of regulating the European financial institutions as a whole. Second, optimal regulation is a mixture between self-regulation and government regulation, favouring the self-regulation side. This finding forms the basis of the model of optimal regulation that slightly differs from the theories as discussed by Ojo. The paper concludes with further research avenues stemming from the adjusted model. As the model is an approach to optimal regulation, it still needs to be tested to find the precise point of this form. It is recommended to adopt an economical scientific approach to conduct further research into the proposed model and subsequent theories.

Key words: Financial regulation, Self-regulation, Government regulation, Financial risk taking, European union, Marianne Ojo.

Introduction

In today's competitive global financial market, there has been a growing European, and even worldwide, consensus that there ought to be a fundamental shift in financial regulation with regards to risk taking (Begg 2009; Nguyen 2011). The global financial crisis of 2007 starting with the collapse of subprime mortgage funds and related products indicates that the current regulatory framework cannot effectively deal with the 'new' financial products (FSA 2009; Lang & Jagtiani 2010). Nevertheless, during the last two decades, not only has there been a rapid growth in the availability of new financial products, but the financial sector as a whole grew, i.e. more risks were taken, more and quicker transfers of financial goods occurred, and increasingly complex financial products were introduced (Dorn 2010; Pisani-Ferry & Sapir 2010). A prime example of 'new' financial product and its vast growth is the Credit Default Swaps (CDS's). Stulz (2010), using survey data from the Bank for International Settlements (BIS), predicts that the total notional amount of the credit default swap market was \$6 trillion in 2004 and this grew to \$57 trillion by June 2008. Therefore, the global economy benefited for many years as the economic growth, facilitated by the financial markets, was perceived to be infinite.

Post-crises discussions have drawn on the subject of financial risk taking abilities of financial institutions in the EU, seeking to implement a framework that aims to limit systematic risk (Begg 2009; Nguyen 2011). In this context, two questions seem fundamental to any policymaking regarding European financial markets. First, is it possible to have a European financial regulatory framework? And second, what form of involvement of different actors is desired in order to optimally regulate financial risk taking? This paper contributes to answering these questions. More precisely, it aims to find out how feasible current theories on market regulation are from the point of view of financial professionals. Marianne Ojo conducted two separate researches in 2010 and 2011, which will function as a basis to which this research seeks to contribute.

For the purpose of this research, financial risk taking is defined as the search for the highest financial return (gain) possible, and includes the possibility of losing invested capital (Freixas 2010; FSA 2009; Nguyen 2011). It can be argued that financial regulation should seek to minimise these posed risks (De Larosière 2009). Risk-taking abilities are defined as the means a financial institution possesses to take financial risks (Ferguson & Johnson 2009; Johnson 2011). Since the creation of the European Union, more market harmonisation has been desired (Buckley & Howarth 2010). The European internal financial market has been created, in order to stimulate economic traffic between member countries (Buckley &

Howarth 2010; Garcia & Nieto 2005). Nevertheless, each country individually formulates its financial regulation (De Larosière 2009; FSA 2009). Thus, it is important to define financial regulation. Financial regulation can be explained as being the framework that seeks to address indifferences in the financial markets (Dijkstra 2009; FSA 2009; Mayes 2009). Begg (2009) argues that financial regulation has a number of purposes, including legislation and supervision. According to Johnson (2011), financial regulation has the task to serve and protect the integrity of the economy and financial institutions.

Ojo

Marianne Ojo (2011) conducted research on meta-regulation, which is the ability of financial institutions to contribute to the regulatory framework, using their experience from internal regulation. Ojo (2011) argues that current legislative and enforcing frameworks are not yet prepared to successfully perform their tasks with regards to financial risk regulation. Ojo (2010) investigates the main theories involved with financial regulatory frameworks: self-regulation, government regulation, and mixed regulation. Self-regulation assumes that non-governmental actors possess the ability and willingness to regulate themselves (Ojo 2011). This implies that people are honest, that financials have an internal regulatory framework that can sanction according to the crime or foul committed, without the interference of the government (Ojo 2010; Short & Toffel 2010).

In theory self-regulation could work. However, in reality this only seems to work in times of economic growth. People and institutions have different social and economic motives; and in times of crises conflicts of interests occur (Short & Toffel 2010). Ojo (2010) argues that if people are working for the same company striving for financial gain, self-regulation will not happen adequately. Therefore, it can be argued that pure self-regulation currently does not enable successful financial risk taking, as it poses a risk to the European economy. Government regulation assumes that the more a government intervenes, the less malpractices there are (Garcia & Nieto 2005; Johnson 2011). Shleifer and Vishny (1998) state there are two forms of government regulation. There is the 'Helping hand' theory, which means that the government is adequately prepared to regulate and stimulate the financial sector (Shleifer & Vishny 1998). There is also the 'grabbing hand' theory, which implies that governments are inadequately prepared and slow. In addition, 'grabbing hand' argues that financial institutions can better regulate themselves as it is in their interest to stimulate economic growth (Shleifer & Vishny 1998).

Davis (1989) uses Adam Smith to argue that the more a government influences an economy, the less beneficial it is as it can result in protectionism. This implies that there should be as little government interference as possible. Geske & Roll (1983); and Atkaset *et al.* (2004), argue more or less the same using more economic, quantifiable research. Atkaset *et al.* (2004), have noted that most researches with regards to government interference and financial markets have concluded that regulatory activities can lead to limited or reduced competition. Additionally, more regulation can lead to less liquidity in financial markets, thus implying restrictions on available capital (Roll *et al.* 2007). However, leaving the financial sector unregulated has put the economy as a whole in jeopardy, as financials cannot cope with the great responsibilities (Lang & Jagtiani 2010; Nichols *et al.* 2011; Pisani-Ferry & Sapir 2010). Interestingly, others argue that regulation, notably the Basel II covenant, has allowed financial institutions to develop risky new financial products that aggravated the recent crises (Blundell-Wignall *et al.* 2008; Moosa 2010). Critical analysis shows that governments are too far removed from the market and are unable to adapt to new situations (Arlman 2003; Mayes 2009). Government regulation, the direct opposite to self-regulation, is not beneficial for the EU as it limits financial risk taking abilities (Ojo 2011). Hence, there should be a mean between overregulation and too much deregulation in order to stimulate the financial markets and the economy, yet maintaining their integrity.

Using the self-regulation and government regulation theories, some argue that optimal governance is the co-operative regulation framework, which is a mixture between the two (Johnson 2011). It can be stated that this framework is already being used. However, the communication between the different actors is confused, as they all pursue different goals (Begg 2009; Ojo 2010; Papaikonomou 2010). In order for this theory to work, those involved should align their goals and seek for a stable economy that continues to grow (Garcia *et al.* 2009; Garcia & Nieto 2005).

According to Ojo (2011), enforced self-regulation is a more individualistic approach to the co-operative framework, and to an extent builds on it. It differs from self-regulation as the government keeps an oversight (Ojo 2010). It differs from co-operative regulation, as the government does not intervene when not necessary (Ojo 2010). In other words, the Co-operative regulation and Enforced self-regulation are a middle or mixture between the two opposites. However, they do need clear communication, cooperation and monitoring in order for a successful enhancement of the European Union financial market's competitive edge.

Methodology

Research can be regarded as a systematic investigation to find answers to a phenomenon (Blaxter *et al.* 2006). In order to research the phenomenon of financial risk taking in the EU, this paper builds on existing theory, thus can be regarded as deductive. More precisely, Ojo's model of mixed regulation was used to inform discussions with financial professionals about potential and desired financial market regulation in Europe. Rather than attempting to quantify opinions through a survey, a qualitative approach was chosen. This would also allow contextualised ideas and regulatory alternatives to emerge through the research (Adler & Adler 1994 adapted from Denzin & Lincoln 1994). Qualitative observers are not bound by predetermined categories, which allows for a 'free' search (Blaxter *et al.* 2006; Saunders *et al.* 1997).

Due to the complexity of the subject, the research did not seek to include those without knowledge of financial risk taking and regulation. Therefore, five semi-structured interviews were conducted with financial industry experts. The researcher has tried to incorporate the views of politicians. However, due to their lack of willingness to participate, the research has focussed on industry specialists. This subsequently leads towards a bias view from within the industry. Regardless, the validity of this paper remains, as it tests an existing theory, using an industry perspective. The researcher acknowledges that the participants are personal contacts. The key informants work at a range of financial institutions: banks, investment firms and pension funds. Of the 5 interviewees, 3 were of Dutch, one of Dutch/American and one of British origin. All interviewees have worked or are currently working in the City of London. This allows a cross regional, cross sectional comparison, meaning that the participants operated in different areas of the financial market, but also have a different European national background. This latter is interesting as this research discusses the EU involvement. The participants work either at a senior or middle level.

When conducting a study, it is necessary to acknowledge that all research is to an extent contaminated by the values and beliefs of a researcher (Weber 1946 adapted from Gerth & Mills 1991). When critically looking at the research conducted, it is important to bear in mind that qualitative research is ideologically driven, and that there is no value-free or bias-free design (Denzin & Lincoln 1994). The researcher has experience working for a financial institution hence perhaps favouring the industry. Nevertheless, it can be argued that the 'free' search has allowed little biases. As the semi-structured interviews were conducted in both English and Dutch, it is also important to note that there are always translation issues, as

words get rephrased (Marschan-Piekkari & Reis 2004 adapted: Marschan-Piekkari & Welch 2004; Sinkovics & Penz 2011).

Findings and discussion

Even though it is desired by the European Union, our interviewees were of the opinion – in line with Ojo (2011) - that it is not possible at the moment to implement a European financial regulatory framework, which regulates, monitors and enforces successfully. Nevertheless, this research has indeed identified that it would be favourable to regulate financial risk taking on a European and perhaps even global level. The participants are of the opinion that you could set up some sort of framework or guidance. They all agree that it is currently not possible to successfully regulate financial risk in the EU, but that this will occur in the future. Participant 3 notably argued that the Euro was ‘not possible 20 years ago and look where we are now’.

It has proven to be extremely difficult to implement successful financial regulation and maintain a sufficient level of oversight in the EU (FSA 2009; OECD 2003). This has been confirmed by the findings of this research. As Dijkstra (2009) states, every country needs a different form of regulation as member countries have different needs. These needs will lead to a slower adaptation of new regulation and issues monitoring the financial market (De Larosière 2009; OECD 2003; Ojo 2011). Ojo (2011) argues that the law enforcers are not adequately equipped to deal with the pace of financial instruments developments. All participants fully agree with these two statements. However, our interviewees also believe that it is possible to create a successful framework, which governments can use as guidance yet at the same time amend it to the particular needs of the country. This is also desired, but not implemented by the EU as such. Hence our interview data seem to contradict Dijkstra (2009), De Larosière (2009), OECD (2003), and Ojo (2011) who have less positive expectations.

Our research agrees with Ojo’s framework that a form of mixed regulation is needed. It is noteworthy that all respondents believe that government regulation will not work when regulating the financial market. However, when asked whether financial institutions can regulate themselves, three out of five participants responded initially with yes. Nevertheless, they all acknowledge that it has proven to be unsuccessful. Still, in every interview it was mentioned that the current regulators are always playing ‘catch up’ with the market. Our interviewees seemed to agree with Shleifer and Vishny’s (1998) ‘grabbing hand’ theory where the government is too slow and inadequately prepared. Ojo (2011) describes this as

regulators and enforcers not possessing the right tools and means. All respondents have stated this, and believe that the regulators are slow and are always one step behind the market.

Whereas all participants agreed that things had to be changed, and that structural changes would be favourable, they were all sceptical about falling back into old habits. When asked, the interviewees all stated that a mix of regulation would be the best, when government work together with financial institutions in order to keep a successful oversight. All participants were of the opinion that the government should hold the enforcement role, but that the institutions should be left free in order to generate growth in the financial market. The respondents all agreed that even though a mix is favourable, it should be more towards the self-regulation side. Hence, our findings suggest that the successful regulation in order to stimulate financial risk taking without endangering the system can be found on the self-regulation side, but that government involvement is necessary. Short & Toffel (2010) and Ojo (2010) have argued that self-regulation in the pure sense of the theory does not work, as people have different social and economic motives, and therefore are not truly honest. Our interview data shows similar responses, although their stance is not as harsh as that of Short & Toffel (2010), as some respondents argue that self-regulation is possible, if necessary changes would be made. Ojo (2010) identified a mixed form of regulation between government regulation and self-regulation. Johnson (2011) regards this as the optimal form of regulation. All of our interviewees agreed that optimal regulation is cooperation between financial institutions and the government.

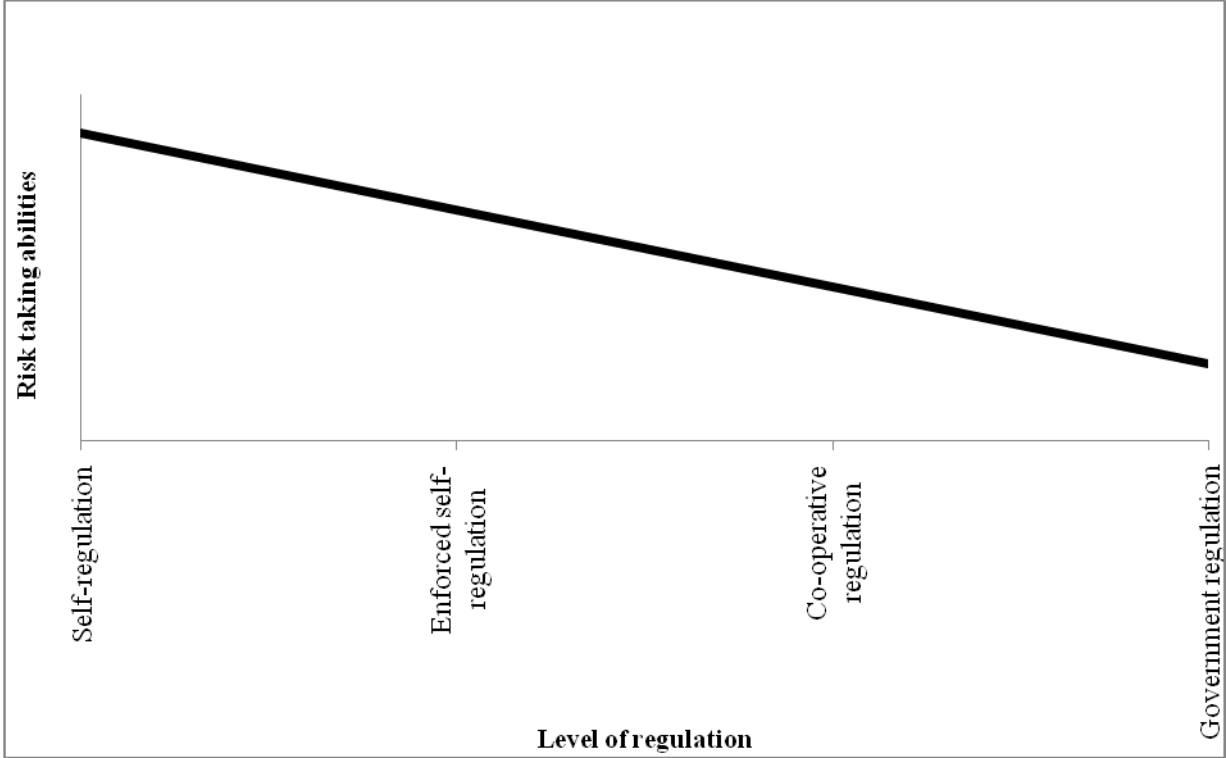
Ojo (2010, 2011) identified 'Enforced self-regulation' as self-regulation where the government keeps an oversight. Our interviewees leaned towards this form. However there were important elements in the interview data that did not fit Ojo's Enforced self-regulation. These elements suggest a further distinct form of regulation.

Amending Ojo's model

All interviewees saw regulation as directly interfering with financial risk taking abilities. Participant 5 also identified that with or without severe regulation and legislation, financial risk taking would occur to certain extent. Bearing this in mind, and the previous identified points, it can be argued that too much regulation will allow less risk taking abilities than self-regulation. Ojo's research into the concepts of mixed regulation can be regarded as a good framework to which this research would like to add a fifth category, one that more accurately describes the current views of financial professionals. Figure 1 presents Ojo's (2010) model. Figure 2 shows the amended model. In both models (figures 1 and 2), self-

regulation and government regulation are regarded in the pure sense of the theory. With regards to risk taking abilities, which is presented by the line in the models, self-regulation is the most favourable to risk taking. Under strict government regulation, financial risk taking will still occur, but at a minimum level.

Figure1: Ojo’s model (2010)



Our research confirms Ojo (2010) suggesting that optimal regulation is a mixed regulation method. But that is where similarities end. Enforced self-regulation is a form of mixed regulation (Ojo 2010). This research does acknowledge the significance of this theory, however, it is highly hypothetical. It does not specify the level of interference. Hence, a class was added. In the proposed model (figure 2), there are five classes of financial regulation. To illustrate the point, more self-regulation and more government regulation are explained in table 1.

Table 1: Proposed classes of financial regulation

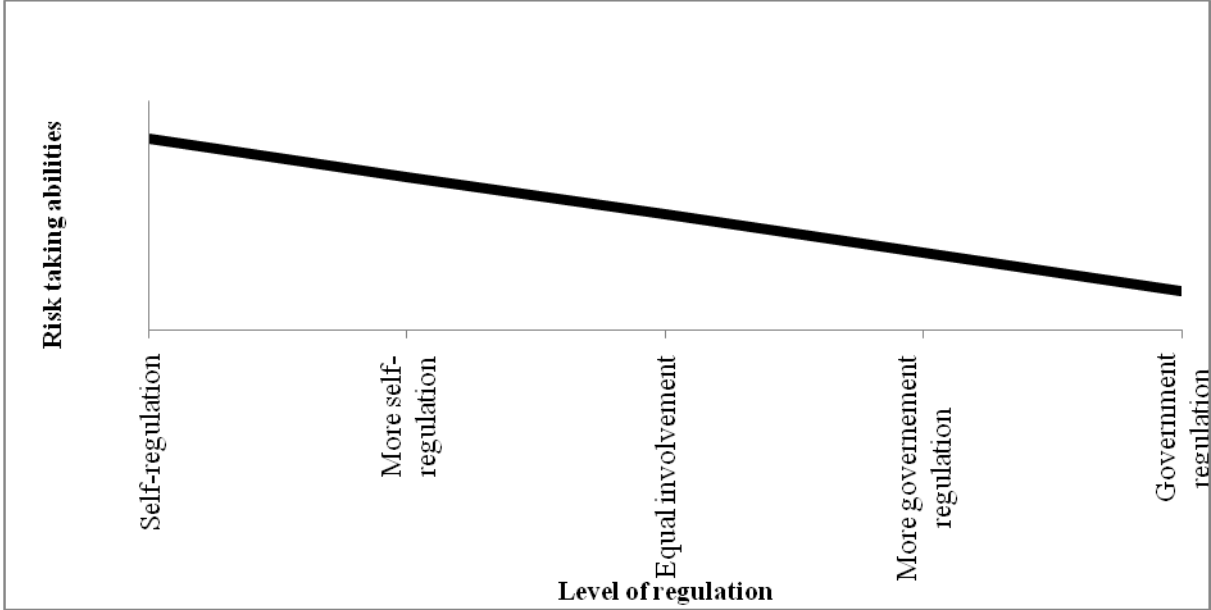
Model value	Regulation (% self-gov)	Risk taking abilities
Only Self-regulation	Only self-regulation (100%-0%)	High
More self-regulation	Mixed regulation, focussed on self-regulation (75%-25%)	Relatively high
Equal involvement	Mixed regulation, same contribution (50%-50%)	Average
More government regulation	Mixed regulation, focussed on government regulation (25%-75%)	Relatively low
Only Government regulation	Only government regulation (0%-100%)	Low

More self-regulation can be regarded as enforced self-regulation. Nevertheless, the involvement level is specified more accurately. It can be argued that the pre-crisis regulation was indeed more self-regulation as financial institutions were left relatively free, and thus regulated themselves, and the government would only interfere when needed. This is an example of post-Thatcherism, harmonised union ideal, and enabled great innovation and economic prosperity.

More government regulation can be explained as a theory where the government controls and where the financial institutions have little input. Again risk taking will occur, but at a relatively low level. This is what is proposed for standardised financial products, where the government allows risk taking, on the basis of sufficient capital, understanding of risk, etc. and it will actively supervise and control in this market. Whether this works to avoid a new crisis is highly questionable.

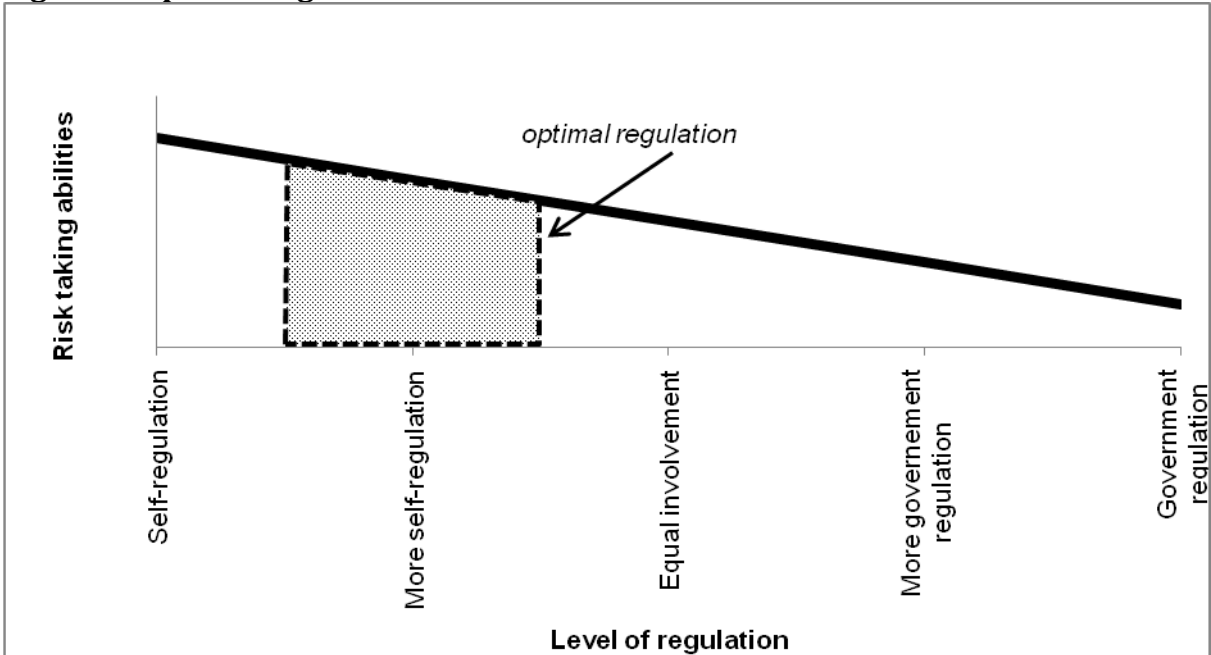
The second column in table 1 explains the form of regulation, and the approached % of self-regulation in comparison to government regulation. For instance, 75%-25% means 75% self-regulation and 25% government regulation, and 0%-100% means no self-regulation and a 100% government regulation. It can be assumed that Ojo’s Co-operative regulation is between equal involvement and government regulation, but this could mean that this form of regulation is actually equal involvement (table 1). Additionally, this works for Ojo’s Enforced self-regulation, as this again could include equal involvement (table 1). Figure 2 visualises our model as set forth in table 1.

Figure2: Proposed model



Furthermore, the findings have indicated the ideal mixture between self-regulation and government regulation is the optimal mixture, as it will stimulate financial risk taking without creating a systematic financial market risk. Figure 3 highlights the area in our proposed model where, according to our interview findings, optimal regulation occurs.

Figure 3: Optimal regulation model



Notwithstanding, although the participants have identified the area as shown in figure 3, more in-depth study should be conducted to identify the ‘perfect’ mixture, seeking for the exact point of involvement.

Conclusion

In summary this research agrees with Ojo (2011), that the EU is (currently) not able to implement a successful single financial regulatory framework. Our findings are also in line with Ojo (2010), namely that optimal European financial regulation is understood to be a mixed regulatory framework, leaning towards the self-regulation side. However, our interview findings suggest that the Ojo (2010)4-type model does not accurately describe the needs of the EU and financial institutions. Therefore, this research has proposed to add a fifth type, renaming existing theories to accommodate this type. As figure 3 shows, optimal regulation can be found in the more self-regulation class. It is important to note that the proposed optimal regulation model (figure 3) is merely a framework, and does not stipulate a concrete optimal regulation initiative or policy. Further research aimed at identifying such initiatives might find our framework helpful. Further research could also test the proposed model with governmental policy makers, as with constituents in other financial centres around the world. Notwithstanding, it can be assumed that optimal financial regulation can be found in more self-regulation, in order to maximise financial risk taking without creating structural economic risk.

References

- Arlman, P. (2003). All in the name of competition: European securities exchanges. *Journal of Financial Regulation and Compliance* 11 (3): 236-240.
- Atkas, N., De Bodt, E. & Roll, R.(2004). Market Response to European Regulation of Business Combinations. *Journal of Financial and Quantitative Analysis* 39 (4): 731-757.
- Begg, I. (2009). Regulation and Supervision of Financial Intermediaries in the EU: The Aftermath of the Financial Crisis*. *Journal of Common Market Studies* 47 (5): 1107-1128.
- Blaxter, L., Hughes, C. & Tight, M.(2006). *How to research*. Maidenhead: Open University Press.

- Blundell-Wignall, A., Atkinson, P. & Lee, S.H.(2008). The Current Financial Crisis: Causes and Policy Issues. *OECD Journal: Financial Market Trends* 2008 (2): 11-31.
- Buckley, J., & Howarth, D. (2010). Internal Market: Gesture Politics? Explaining the EU's Response to the Financial Crisis. *Journal of Common Market Studies* 48: 119-141.
- Davis, J. (1989). Smith's Invisible Hand and Hegel's Cunning of Reason. *International Journal of Social Economics* 16 (6): 50-66.
- De Larosière, J. (2009). The high level group on financial supervision in the EU. http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf
- Denzin, N., & Lincoln, Y. (1994). *Handbook of Qualitative Research*. Thousand Oaks: SAGE Publications.
- Dijkstra, R. (2009). Liability of financial regulators: Defensive conduct or careful supervision? *Journal of Banking Regulation* 10 (4): 269-284.
- Dorn, N. (2010). Regulatory conceptions of unacceptable market practices under three policy scenarios. *Journal of Banking Regulation* 12 (1): 48-68.
- Ferguson, T., & Johnson, R. (2009). Too Big to Bail: The “Paulson Put,” Presidential Politics, and the Global Financial Meltdown: Part II: Fatal Reversal—Single Payer and Back. *International Journal of Political Economy* 38 (2): 5-45.
- Freixas, A. (2010). Post-crisis challenges to bank regulation. *Economic Policy* 25 (62): 375-399.
- FSA. (2009). The Turner review. http://www.fsa.gov.uk/pubs/other/turner_review.pdf
- Garcia, G., Lastra, R. & Nieto, M.(2009). Bankruptcy and reorganization procedures for cross-border banks in the EU. *Journal of Financial Regulation and Compliance* 17 (3): 240-276.
- Garcia, G., & Nieto, M. (2005). Banking crisis management in the European Union: Multiple regulators and resolution authorities. *Journal of Banking Regulation* 6 (3): 206–226.
- Gerth, H.H. & Mills, C.H.(1991). *From Max Weber: Essays in Sociology*. Abingdon: Routledge.

- Geske, R., & Roll, R. (1983). The Fiscal and Monetary Linkage between Stock Returns and Inflation. *The Journal of Finance* 28 (1): 1-33.
- Johnson, W. (2011). International economic freedoms, banks and the market crisis of 2007–2009. *Journal of Banking Regulation* 12 (3): 195-209.
- Lang, W., & Jagtiani, J. (2010). The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance. *Atlantic Economic Journal* 38 (3): 295-316.
- Marschan-Piekkari, R., & Welch, C. (2004). *Handbooks of Qualitative Research Methods for International Business*. Cheltenham: Edward Elgar Publishing Limited.
- Mayes, D. (2009). The Role of Central Banks in Financial Supervision and Regulation. *Economic Affairs* 29 (3): 40-46.
- Moosa, I. (2010). Basel II as a casualty of the global financial crisis. *Journal of Banking Regulation* 11 (2): 95-114.
- Nichols, M.W., Hendrickson, J.M. & Griffith, K. (2011). Was the financial crisis the result of ineffective policy and too much regulation? An empirical investigation. *Journal of Banking Regulation* 12 (3): 236-251.
- Nguyen, T. (2011). A macro-prudential perspective of financial regulation. *Journal of Financial Regulation and Compliance* 19 (3): 289-297.
- OECD (2003). Supervision of financial services in the OECD area. Available at: www.oecd.org/dataoecd/29/27/1939320.pdf
- Ojo, M. (2011). Co-operative and competitive enforced self-regulation. *Journal of Financial Regulation and Compliance* 19 (2): 139-155.
- Ojo, M. (2010). The growing importance of risk in financial regulation. *The Journal of Risk Finance* 11 (3): 249-267.
- Papaikonomou, V. (2010). Credit rating agencies and global financial crisis. *Studies in Economics and Finance* 27 (2): 161-174.
- Pisani-Ferry, J., & Sapir, A. (2010). Banking crisis management in the EU: an early assessment. *Economic Policy* 25 (62): 341-373.

- Roll, R., Schwartz, E. &Subrahmanyam, A. (2007). Liquidity and the Law of One Price: The Case of the Futures-Cash Basis. *The Journal of Finance* 62 (5): 2201-2234.
- Saunders, M., Lewis, P. &Thornhill, A.(1997). *Research methods for business students*. New Jersey: Prentice Hall.
- Shleifer, A., &Vishny, R. (1998). *The grabbing hand: government pathologies and their cures*. 2nd print. Cambridge, Massachusetts: Harvard University Press.
- Short, J., &Toffel, M. (2010). Making Self-Regulation More Than Merely Symbolic: The Critical Role of the Legal Environment. *Administrative Science Quarterly* 55 (3): 361-396.
- Sinkovics, R., &Penz, E. (2011). Multilingual elite-interviews and software-based analysis. *International Journal of Market Research* 53 (5): 705-724.
- Stulz, R. (2010). Credit Default Swaps and the Credit Crisis. *Journal of Economic Perspectives* 24 (1): 73–92.