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The Search for a New Regulatory Paradigm

by Michael Taylor

The regulation of financial services in developed economies has not kept pace with the enormous changes that the industry has experienced over the last two decades. Despite the rapid integration of financial services across a number of different boundaries—geographical, functional, and sectoral—regulation remains rooted in a set of assumptions dating back to the 1930s. I term these assumptions and their associated institutional and legislative embodiment a "regulatory paradigm." In this Article, I argue that the traditional regulatory paradigm has become outmoded as the result of recent industrial developments and that this necessitates the creation of a new regulatory paradigm. This would include, as a minimum, new public policy objectives for regulation, a reassessment of the scope of regulation, new techniques of regulation, and new institutional and legislative structures of regulation. Although the precise form of this new paradigm is still to emerge, there are already a number of indicators of its likely shape, and these predominantly involve reliance on the market rather than public agencies as a key regulatory device.

In this Article, I begin by considering the traditional regulatory paradigm and the way in which it has been superseded by market developments. Second, I consider some of the possible alternative regulatory approaches currently being mooted. I also reflect on how the organizational structure of regulation needs to be modernized to reflect the changed environment of financial services. My intention is to try to connect these various points to the outline of the new regulatory paradigm. Nonetheless, the focus of this Article is deliberately narrow: I consider these issues only as they apply to banks and only to the extent that they concern prudential regulation. Many of the points I

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make apply equally to the securities houses and even some insurance companies, and there is also another equally as long article to be written about regulation of the sale of retail investments.

I. THE CONCEPT OF A REGULATORY PARADIGM

The regulation of financial services depends on a set of shared models, practices, rules, and standards that might collectively be termed a paradigm.\(^1\) This paradigm includes both the techniques of regulation and the environment in which they are embodied, including the institutional arrangements and certain basic assumptions about the objectives of regulation and about the nature of the industry being regulated. In the sense in which I wish to use the term, a "regulatory paradigm" can therefore be thought of as involving a combination of three major elements:

* The first element comprises the public policy objectives set for the regulatory system, including certain basic assumptions about the trade-off between efficiency and stability and the extent to which government could or should seek to indemnify consumers against risk. These objectives are also informed by a number of theories concerning the nature of the regulated industry and the consequences of an unregulated environment.

* The second element concerns the institutional arrangements that are established for administering the set of regulatory requirements flowing from the public policy objectives. These include, for example, the manner in which regulation is organized, the basis on which agencies are structured, and the type and nature of the powers that are conferred on them.

* The third element includes the specific techniques and methods used by regulators for discharging the regulatory task. This third element comprises a wide range of issues, including the type and nature of the information that regulators gather from regulated firms, the standards they apply and the methods they use to ensure compliance with those standards, and matters like the kinds of knowledge and expertise regulatory personnel must possess.\(^2\)

The traditional regulatory paradigm can be outlined by considering each of these elements.

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2. This aspect of a regulatory paradigm has much in common with the concept of a "regulatory strategy" as developed by Helen Garten. See HELEN GARTEN, WHY BANK REGULATION FAILED (1991).
First, with regard to the public policy objectives, the traditional paradigm (at least as it concerned banking) emphasized stability rather than competition. In the United States, for example, the traditional paradigm of banking regulation had its roots in the New Deal legislation of the 1930s, which in turn reflected a policy consensus that "competition as practiced had failed, and that government needed to assume greater responsibility for economic performance." Thus, the New Deal legislation was "designed to correct the perceived failings of competition, gave unprecedented authority to the federal government, and tried to solve problems for which existing economic theory had no effective answers, at least before Keynes."

In the banking field, the emphasis of the New Deal legislation was on stability at the expense of competition. Taken collectively, legislation like the Federal Home Loan Bank Act of 1932, the Banking Acts of 1933 and 1935, the Securities Act of 1933, the Securities Exchange Act of 1934, the Federal Credit Union Act of 1934, the Maloney Act of 1938, and the Investment Company Act of 1940 "restructured the financial system, established a maze of new operating standards, segmented asset and liability markets by type and territory, fixed prices, and guaranteed risk. Stability was the overriding legislative objective; noncompetitive and inefficient markets were the result." The emphasis on eliminating risk and ensuring banking stability was discharged to a very high degree in the succeeding decades. Between 1934 and 1978, fewer banks failed in the United States than during any one year of the 1920s. This produced an amazing degree of industry stability over a forty-year period with the result that a time traveller arriving in the late 1970s from 1935 would have easily recognized the different types of financial institutions, most of their products, and their principal activities. This degree of stability was not only a product of the traditional regulatory paradigm but permitted its leading regulatory techniques to be practiced with a significant degree of success.

The institutional arrangements that flowed from these over-arching public policy objectives were also founded on clear segmentation of markets and products between debt, equity, and insurance contracts. Regulation of the financial services industry was conducted on largely sectoral lines with different agencies being charged with regulating each sector (and sometimes, as in the United States, with more than one regulator regulating each sector). Traditionally, banking regulation was

4. Id.
5. Id. at 247.
the preserve of the central bank or of a banking commission with particularly close links to the central bank. Securities and insurance regulation also had their own dedicated agency or agencies. Moreover, these different sectoral regulators had correspondingly different philosophies of supervision. For instance, banking regulators were traditionally loath to see their institutions fail, whereas securities regulators traditionally regarded the failure of a regulated firm with greater insouciance, aiming primarily to achieve only an orderly wind-down of the company. Finally, an especially important point is that the regulation of financial services was almost entirely a domestic matter. One consequence of the restrictive regime imposed on banks in the period between 1930 and 1980 was that comparatively little business was cross-border. This meant that the degree to which nationally-based regulators needed to communicate and cooperate was comparatively limited. Indeed, only towards the end of the 1970s did various fora for international regulatory cooperation such as the Basle Committee on Banking Supervision begin to emerge.

Finally, as far as the specific techniques of supervision are concerned, the assessment of banks' capital adequacy is central to the traditional regulatory paradigm. The standard international assessment framework is the risk-assets ratio approach that was enshrined in the 1988 Basle Accord and that represented an international agreement between all the major bank regulators. Key to the risk-assets ratio is an attempt to monitor the prudential soundness of banks by using a standardized risk measurement framework that is applied to all institutions and that employs data based on a snap-shot of their balance sheets on certain specified reporting dates. The purpose is primarily to ensure that the bank maintains a sufficient capital cushion to absorb the losses that occur in the normal course of its business.

The first assumption underlying this approach is that there are features specific to banks that justify the need to regulate banking. These are usually explained as a combination of banks' unique position as the providers of the means of payment, the contagion risks inherent in interbank exposures, and the contagious effects of a loss of depositor confidence. Second, it is assumed that the risk profile of a bank, unlike that of a securities firm, remains relatively stable for a long period of time. This makes it possible to monitor the risks relatively infrequently—usually once each quarter. Moreover, it is also assumed that credit risk, the risk of borrower default, is the main type of risk arising from banking activity and that problem loans can usually be detected some

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time in advance of default. If a loan goes bad, provisions can be made and possibly a workout organized. It is not necessary to monitor these risks on a real-time basis; the skills called for in monitoring them are those of credit analysis and audit. Have the credit risks been correctly appraised? Have the appropriate sanctions for granting the credit been sought? Has adequate provision been made for nonperforming loans, and have they been correctly recorded in the institution’s books? These represent the skills and assumptions that go to make up the paradigm of banking regulation in its traditional form.

II. CHANGE IN REGULATORY PARADIGMS

Paradigms, as Thomas Kuhn famously pointed out in the history of science, can become outmoded and are then supplanted by new paradigms. He described this process as one of scientific revolution, and I contend that in the regulatory field, we are currently dealing with a revolution of a similar magnitude. Only if we recognize that we are in the middle of a regulatory paradigm change can we begin to deal with what appears to be the crisis of regulation in the developed economies. This means being prepared to think radical thoughts about the aims, scope, and techniques of regulation.

Over the last two decades, the financial services industry has been through what is best described as an industrial revolution, in which the nature of the industry has been rapidly and radically transformed. The scale of this transformation should be expected to have implications for the practice of regulation. In his Pulitzer prize winning history of business regulation in the United States, Prophets of Regulation, Thomas McCraw wrote:

[Every industry, whether regulated or not, does possess a certain underlying economic structure: characteristics that make it different from other industries and that help to shape the internal conditions for regulatory opportunities and constraints. More than any other single factor, this underlying structure of the particular industry being regulated has defined the context in which regulatory agencies have operated.]

7. KUHN, supra note 1.
8. See Tommaso Padoa-Schioppa (Chairman, CONSOB, Italy), Remarks on Regulatory Responses to the Integration of Financial Services delivered during a panel session of the XXII Annual Conference of the International Organization of Securities Commissions, Taipei, Nov. 5, 1997, for a good statement of these recent changes and their implications for regulation.
It follows from McCraw's observation that if the underlying structure of the industry changes, so do the "regulatory opportunities and constraints" and the context within which regulatory agencies must operate. My contention is that the financial services industry is currently experiencing exactly this type of change in underlying structure and that regulation will need to adapt if it is to be able to respond to the challenges and opportunities thus created.

There are a number of specific features of this industry change. In particular, the increased emphasis by banks on trading activities, the globalization of their activities, and their incorporation into diversified conglomerate group structures conducting a range of banking, securities, and insurance business, as well as the blurring of distinctions between debt, equity, and insurance contracts, all necessitate a rethinking of the traditional regulatory paradigm.

A. The End of Geography

The process of the internationalization of banking and financial systems has reached a very high level with cross-border operations experiencing exponential growth. This has resulted in what one observer has described as the end of geography. Market intermediaries and investors operate without geographical barriers, and markets also operate around the clock. The same products are now traded in a way that when markets close in Europe, contracts may continue to be negotiated on the U.S. markets. An example is the linkage in May last year between the London International Financial Futures Exchange and the Chicago Board of Trade.

B. Functional Despecialization

Different financial institutions are increasingly carrying out the same functions or types of operations. Technological innovation has also created products that cannot be easily accommodated within the traditional contractual forms such as debt, equity, and insurance; an example is the recent emergence of credit derivatives. On the one hand, financial innovation has hugely increased the marketability and standardization of financial products while, on the other, it has allowed the creation of more complex products and the unbundling of certain types of risk into separate components.

At the same time, contract standardization and the unbundling of risks has permitted different financial institutions to take on exposure

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The recent growth of securitization is one manifestation of this trend. As a result, securities houses will increasingly be exposed to the type of risk that is typical of traditional banking business as their assets include, for example, mortgage-backed securities or securitized bank loans. Similarly, bank balance sheets—previously characterized by their stability—are now subject to much greater volatility because assets can be securitized and sold and trading activities account for a much larger share of profitability.

C. Conglomerate Group Structures

Financial institutions are becoming increasingly global and increasingly diversified by sector. Group structures are becoming more complex and are tending to resemble conglomerate forms, involving a diversity of institutions operating in a range of different sectors and geographical locations and subject to different supervisory regimes. Institutional and geographical integration are, in fact, two sides of the same coin. Banks with strong international aptitude will be increasingly involved in asset management and broker-dealing activities while securities houses will increasingly take on bank-type financial risks.

D. Market Integration

Different financial markets are also growing more integrated. Investors can now diversify their risks by operating in several different markets at once, often on a cross-border basis, while intermediaries can choose the regulatory environment most convenient to them. However, markets are supervised by different authorities, and when intermediaries operate in more than one market at once, this may increase the potential for systemic risk through undetected large position taking as well as increase the scope for market manipulation or insider trading.

This revolution in financial services was in part the consequence of a series of specific policy choices. It has been facilitated by the deregulatory initiatives of the early 1980s in which policy-makers and legislators chose to abandon the old emphasis on ensuring stability by restricting competition. In its place they intended to enhance competition and to remove the market segmentation that the New Deal legislation had
created.11 Although the United States was in the lead in these deregu-
latory initiatives, just as it was in the lead in establishing the tradition-
al regulatory paradigm, they have since been widely copied elsewhere in
the developed world although it took the major initiative of the creation
of the European Union's Internal Market to force a number of continen-
tal European countries to follow suit.

When combined with rapid technological innovation based on the
personal computer and new intellectual techniques for managing risks,
like the Black–Scholes options pricing model, the removal of old market
segmentation by institution and product has radically transformed the
nature of the financial services industry. It has correspondingly
transformed the nature of the problems with which regulators now have
to deal.

III. THE NEED FOR A NEW REGULATORY PARADIGM

The traditional regulatory paradigm has been undermined by
developments in the financial markets that have eroded the basis upon
which it rested. The irony is that although these developments have
been facilitated by a policy choice to deregulate financial services, the
implications of this policy choice for the objectives, techniques, and scope
of regulation has not been adequately explored. The old regulatory
paradigm has given way, but politicians and the public who elect them
(and perhaps even the majority of regulatory professionals) continue to
act and behave as if it still remains valid and relevant. Certainly, the
experience of the United Kingdom is that the failure of a financial
institution like Barings is still predominately seen as a consequence of
regulatory failure rather than—as it might also plausibly be argued—as
part of a natural process in a competitive environment. Deregulation
has happened with politicians continuing to behave as if the stability
that the old regulatory paradigm existed to deliver can somehow still be
guaranteed.

The new regulatory paradigm, when it emerges, will have to accept the
volatility of financial markets and the failure of financial institutions as
a fact of life. It will also have to accept the blurring of the boundaries
between products and markets and to recognize that a sectorally-based
approach to regulation is no longer viable in an environment in which
it is increasingly difficult to tell a bank from a securities firm and vice
versa. This will require a radical rethinking of regulation and of the
institutional framework within which regulation takes place.

11. VIETOR, supra note 3.
There are some signs that the rethinking is beginning to happen. The United Kingdom has recently embarked on a bold experiment that involves the merger of nine of the existing financial regulators into a single agency, the Financial Services Authority ("FSA"). Unique among the leading industrialized countries, the United Kingdom proposes to regulate all banking, securities, and insurance business under one roof. The reasons for this reorganization are complex, and I do not have the space to discuss them here. However, part of the rationale given by Britain's Labour government (although not, I suspect, the primary reason) is that the reorganization is a response to the revolution in financial services that I have discussed in this Article. Introducing the changes, the Chancellor of the Exchequer (finance minister) said, "[I]t is clear that the distinctions between different types of financial institution—banks, securities firms, and insurance companies—are becoming increasingly blurred. Many of today's financial institutions are regulated by a plethora of different supervisors. This increases the cost and reduces the effectiveness of supervision."\(^{12}\)

In other words, the Financial Services Authority is a response to the integration of financial services I have discussed earlier in this Article. To this extent it represents a radical break from the old regulatory paradigm that assumed it was possible to make a fairly clear distinction between banking, securities, and insurance business and that structured the whole regulatory framework around this assumption. Because regulation can no longer be structured around institutions or products, we must instead seek a new basis on which to organize the conduct of regulation. The FSA is one possible answer to this problem in that it assumes that distinctions based on product or institutional boundaries are no longer relevant to the practice of regulation and that it is possible to apply uniform standards across all products and markets.

While in one respect I endorse the analysis on which the Financial Services Authority rests, there must still be considerable doubt about how successful this reorganization will be, given the very broad range of markets it will be responsible for regulating.\(^{13}\) The new system will not even have provision for the delegation of some of the new regulator's powers to self-regulating organizations as is the practice in the United States. Its creation seems to have proceeded in ignorance of the immense complexity of the regulatory task, particularly in a financial center of the magnitude of the City of London. Other countries that

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13. See TAYLOR, supra note 12, for more discussion of the author's criticisms of the FSA.
have proceeded down the route of regulatory consolidation—Australia being a leading example—have stopped short of creating a single super-regulator for the financial services sector.\(^1\)

Another disappointing aspect of the reorganization in the United Kingdom is that it apparently does not involve a radical rethinking of the aims and purposes of regulation or of the scope of regulation. It treats the problems of regulation as purely organizational, whereas, as I have argued, institutional structure is merely one component of a regulatory paradigm. It is unfortunate that having embarked on a radical organizational change, Britain’s Labour government did not also take the opportunity for a radical rethinking of regulation as well.

IV. THE MARKET AS A REGULATOR

A new regulatory paradigm will also need to involve a radical rethinking of the scope of regulation and of regulatory techniques. One superficially attractive option would be to use the market as the primary regulator, and in so far as public regulation would continue to exist, it would seek to work with market mechanisms as far as possible. On this view the supervisory function might be limited to monitoring compliance with a few simple principles (for example, relating to management competence and probity) leaving the more difficult issues to be assessed by the marketplace (for example, other financial intermediaries or credit rating agencies) on the basis of legislatively mandated full disclosure of a bank’s risk exposures. This proposal deals with the difficulty that the supervisory community generally lacks the human resources to be able to monitor the more sophisticated risk management systems, and the argument has been given added impetus by the example of New Zealand, where banking supervision has been drastically curtailed and a set of statutory disclosure requirements set up in its place.

Although the New Zealand experiment owes part of its motivation to the desire to reduce the taxpayer risk that arises from traditional banking supervision appearing to give a government guarantee to individual banks, it also arises out of a recognition that there are, in the words of Reserve Bank of New Zealand Governor Don Brash, “inherent limitations in the extent to which prudential regulation and supervision can minimise the incidence of bank distress and failure .... [W]e believed that market disciplines were being under-utilised as a means of promoting stability in the financial system.”\(^1\) Accordingly, the obligation to disclose is backed up by draconian penalties on directors to

ensure that they take full responsibility both for the activities of their institutions and for the information released into the public domain.

However, there are a number of problems with reliance on greater disclosure. Critics of the New Zealand model point out that most banks active in that country are subsidiaries of major international banks and are therefore subject to the consolidated supervision of their “home” country supervisors. Thus, the New Zealand experience does not necessarily demonstrate that it would be possible to rely exclusively on disclosure mechanisms for major international banks. In addition, the kind of problems discussed in this Article—in particular the problem of supervising institutions with active trading operations—do not arise in the New Zealand context, and there remain serious obstacles to the reliance on enhanced public disclosures as a way of dealing with these problems. In particular, the use of derivative instruments has added to the complexity and opacity of the risk profiles of financial firms in ways that conventional accounting techniques are not able to capture. The new financial instruments are “off-balance-sheet” in the sense that entering into a derivatives contract does not give rise to immediate cash flows to the extent of the contract’s face value (in this respect they differ from conventional loans). Instead, a derivatives contract concerns future rights and obligations, and there remains considerable debate within the accounting profession about how these are to be valued.

Although a purely disclosure-based regime might have its difficulties, it could be supplemented by enhanced reliance on the forces of self-regulation. It was a great irony that at the time the British government was declaring self-regulation to have been a failed experiment, a group of the international financial system’s Great and Good was proposing an extension of self-regulation at least as it applies to large internationally-active financial institutions. The Group of Thirty’s (“G30’s”) recent report, Global Institutions, National Supervision and Systemic Risk, proposed an international standing committee of the world’s leading financial institutions to agree on guidelines and principles for the

16. These issues were first examined by a working party of the Bank for International Settlements’ Euro-Currency Standing Committee of which the author was a member. See EURO-CURRENCY STANDING COMMITTEE, PUBLIC DISCLOSURE OF MARKET AND CREDIT RISKS BY FINANCIAL INTERMEDIARIES (1994). This report has formed the basis for much subsequent work, including the now annual survey of public disclosures by leading internationally-active financial institutions conducted jointly by the Basle Committee and by the Technical Committee of the International Organization of Securities Commissions (“IOSCO”).

management and control of risk in those institutions. The standing committee notion is in effect a proposal for the leading international financial institutions to adopt a system of self-regulation because, in the words of the G30 report, "the fundamental responsibility for ensuring the stability of financial institutions, and thereby limiting systemic risk, rests with the board and management of global institutions themselves." The G30's recommendation has been put forward as a possible solution to a further problem that flows from the various forms of integration that I discussed earlier: that whereas major financial institutions now operate on a global scale, regulation remains rooted in national jurisdictions.

There are two fundamental problems with relying on greater public disclosure or on industry self-regulation as a substitute for supervision. The first is the residual contagion risk that can be caused by the failure of one bank, either through a loss of confidence in the sector as a whole or through banks' complex interaction in the payments system. The loss of confidence argument has probably been overstated in a modern economy: there is little evidence that the failure of one bank leads to a widespread systemic crisis as the result of panic withdrawals by depositors. Indeed, the evidence of recent bank crises like those of East Asia is that bank collapses are accompanied by a "flight to quality" in which depositors tend to move their funds to well-capitalized institutions authorized by jurisdictions with a high regulatory reputation. The payments systems aspects of contagion risk are also being reduced by improvements to the payment and settlements systems themselves. An example of this is the move to Real Time Gross Settlement ("RTGS") in a number of Group of Ten ("G10") countries; these settlements systems reduce the amount of "daylight" exposure between institutions in the banking system through a combination of fees on overdrafts, collateral requirements for institutions using the payments system, and caps on overdrafts within the system. Risks are not eliminated entirely, but their character changes. For example, risks within the payments systems become legal risks—the ability to take a charge over the collateral—rather than the credit risk of large intra-day exposures. Thus, it might be theoretically possible for a large bank to fail without being the cause of widespread disruption to the whole banking system, but there remain residual risks which it may be difficult to eliminate entirely.

The second reason that pure market-driven regulation may not be the answer is that it is politically unfeasible provided that the taxpayer continues to underwrite banks' deposit liabilities in the form of deposit

18. GROUP OF THIRTY, supra note 17, at 12.
protection schemes and access to lender of last resort facilities. New Zealand was able to embark on its experiment in part because it did not have any deposit insurance arrangements; in the United States and Europe, by contrast, there are extensive deposit guarantee schemes (and some continental European countries are only now putting these arrangements in place as a result of the Deposit Guarantee Directive). The movement towards relying on greater use of market forces and self-regulation can only be carried so far if there remains an explicit (or even implicit) taxpayer guarantee against the consequences of firm failure.

Thus, the continued existence of deposit guarantee arrangements are themselves a legacy of the old paradigm. As we have seen, the essence of the old paradigm was that it provided a publicly-funded indemnity to consumers against the risk of loss, and the potential risk to taxpayers was supposedly limited by a regulatory system that emphasized stability. Deposit insurance schemes could exist precisely because a plethora of regulations ensured that firm failures would be rare even though the price of this was steadily accumulating inefficiency in the financial system. Thus, a key component of the new regulatory paradigm must be to rethink the role of deposit insurance schemes now that their symbiotic relationship with restrictive regulation has vanished.

V. ARE THERE OTHER ALTERNATIVES?

The abolition of deposit guarantee arrangements is probably not practical politics on either side of the Atlantic. One possible solution might be to privatize them instead, converting them into mutual guarantee schemes that would be policed by agents (perhaps the rating agencies) appointed by the members of the scheme. A proposal has been put forward by Bert Ely, a banking consultant based in Washington D.C. An alternative approach is to redraw the boundaries of the deposit guarantee arrangements, restricting them to a narrow core of banks that accept limitations on the range of business they can conduct as the price of having taxpayer-insured deposits. The rest of the banking system would be permitted to operate without the benefit of either deposit guarantee arrangements or access to lender of last resort facilities but would have no restriction on the range of activities they could conduct. Although this “core banks” idea has a long pedigree, it has recently won support from a number of influential figures, most

19. The Ely proposals have been published in a variety of different fora. See, e.g., Bringing Market-Driven Regulation to European Banking (London, Centre for the Study of Financial Innovation, 1996).
Critics of the core banks proposal have traditionally argued that there is a danger of confusion in the public mind between the regulated and nonregulated (and therefore uninsured) sectors. In my view this argument has been overstated. The legal requirement for clearly displayed notices, such as those that currently are used in conjunction with FDIC insurance, would more than adequately deal with this problem. However, it is true that the success of these proposals depends on the ability of the general public to perceive a clear distinction between the supervised and unsupervised sectors so that the failure of a major institution in the unsupervised sector does not become the trigger for widespread public concern about the safety and soundness of the banking system. Another more substantive problem is that the distinction between the supervised and unsupervised sectors will be difficult to draw, particularly because even banks engaged in traditional lending and investment activities need access to the new financial markets in derivatives for hedging purposes. Finally, there must be some doubt about whether the core banks will be sufficiently profitable given the restricted range of activities in which they can engage. It is worth noting that the move out of traditional lending activities into the new financial markets is in part a product of the fact that banks have otherwise found it difficult to make an adequate return on capital.

The importance of the Hoenig proposals is that they represent a serious attempt to think through the implications for regulation of the shift in industry structure to which I earlier referred. It is no longer realistic to assume that the techniques or scope of regulation applied under the old paradigm can be transposed into the new environment of financial services. Market forces may not entirely replace the need for regulation, but the balance between competition and regulation has surely been shifted by recent developments. This has implications both for public safety nets and for devising mechanisms by which the threat to the rest of the financial system arising from the failure of a particular institution can be contained.

The changes also have important implications for the nature of regulation itself. As I have argued elsewhere, it is no longer feasible to design the structure of regulation around product or institutional

20. My summary of Mr. Hoenig's views is based on Rethinking Financial Regulation, FIN. REGULATOR, June 1996, which was itself based on a speech given at the World Economic Forum meeting at Davos, Feb. 2, 1996. The core banks proposal was advanced in ROBERT E. LITAN, WHAT SHOULD BANKS DO? (1987). It has also been powerfully restated as "collateralised banking." See FRANKLIN EDWARDS, THE NEW FINANCE (1996).
boundaries that are increasingly meaningless.\textsuperscript{21} This implies a need for an approach to regulation that is neither institutional nor functional in the accepted sense of the term—based on the distinction between different product categories. Instead, regulation should be structured around its objectives or the risks it seeks to reduce. Put another way, the future of financial regulation is in the regulation of processes: the process of the transfer of value (payments, settlements, and clearing systems), the process of price formation (ensuring financial markets are transparent and orderly), and the process of selling to the customer (conduct of business regulation for retail investors). The shift in focus from institutions and products to processes will surely be enhanced by future technological changes. In particular, the development of electronic money issued by a variety of nonfinancial institutions raises important payment systems issues that a purely institutional approach to regulation would be adapted to deal with.\textsuperscript{22}

VI. CONCLUSION: A NEW REGULATORY PARADIGM?

The essence of my argument is that we are currently in a state of transition. The old regulatory paradigm has broken down, but the new paradigm is yet to emerge. To a large extent, what we currently perceive as the problems of regulation are generated by a failure to recognize that we are still in a transition stage: We now wish to accept liberalized, and therefore volatile, financial markets in which banks can be brought down by the inadequately controlled activities of one rogue trader, but we still hanker after the stability and the guarantees against risk that were a feature of the old regulatory paradigm. These two aspirations are contradictory, and it is unlikely that they can be brought into anything like a satisfactory equilibrium. One or the other must be given up, and that means finding a new regulatory paradigm that will involve much less of a role for external, governmental regulation than was the case before. It is only by accepting that governments cannot guarantee to indemnify consumers and users of financial services against all risks that we will move to healthier balance of competition and regulation.


\textsuperscript{22} See Stacey L. Schreft, Looking Forward: The Role of Government in Regulating Electronic Cash, 82 THE FED. RESERVE BANK OF KANSAS CITY ECON. REV. 59-84 (1997) (containing a useful review of some of these issues).