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# A socioeconomic review on why bank capital regulation model is not fit for its purpose — Part I. Background and changing landscape of the banking and financial sector of the past decade

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ANALYSIS

# A socioeconomic review on why bank capital regulation model is not fit for its purpose — Part I. Background and changing landscape of the banking and financial sector of the past decade

**Professor Dr Koen Byttebier***

**Konstantinos Adamos****

Banking supervision; Capital adequacy; Economic conditions

## Scope and background of this article

### *General scope*

In this article, we examine a variety of theories on financial regulation and how these may apply within the context of prudential regulation in general and bank capital regulation more specifically.

The subject matter of our analysis will not be limited to technical standards (although these may form part of the wider picture); instead, this article will be characterised by a high-level degree of personal observation and analysis.

Building a good understanding of the theoretical framework in dealing with prudential regulation will help inform the debate on specific regulatory approaches and identify areas for improvement. We consider this preferable to a narrow technical review of the rules and regulation governing bank capital regulation.

The importance of this approach also lies with the fact that the regulation of bank capital standards is a relatively recent phenomenon which, given today's financial interconnectedness and diversification of banks, warrants a more substantial degree of societal control than has occurred in the past.

The further scope of this article is to identify, examine and analyse the theories surrounding financial regulation and in particular bank capital regulation. This part of our investigation will not be confined to an economic analysis only but will employ broader terms of reference and will, therefore, also examine social and political parameters to offer a more comprehensive understanding of the theoretical framework regarding capital adequacy regulation.

We shall mostly refrain from a technical analysis of specific rules as such, although it is possible that some superficial commentary may be offered wherever appropriate.

On the contrary, our objective is to link theory with regulatory practice and explain how and why the theories surrounding capital adequacy regulation have developed over time, under different socioeconomic conditions.

Ultimately, we aim to demonstrate how these theories have attributed in shaping the regulatory regime[1] dealing with the adequacy of capital standards. We shall of course identify the main pieces of legislation currently driving this area of regulation—Basel III, CRD IV etc.—and explore the normative objectives of said capital adequacy standards.

In the first part of our contribution, we shall examine the background to these questions and also provide an overview of the changing landscape of the banking and financial sector over the past decades. In the second part of our contribution, we shall examine the regulatory impact and also indicate the (policy-related and other) conclusions of our research.

### *Departing premises*

In our analysis, we shall depart from the hypothesis that the mere existence of a behaviour that in the view of the legislator warrants control, supervision, or correction, justifies the implementation of regulation.

There are, of course, several different ways in which a state may try to implement regulatory control which depend on a variety of factors. As an example, the "implementation method" may focus on social matters, or economic matters, or both.

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[1] EU: Capital Requirements Directive CRD IV—Directive 2013/36 and Capital Requirements Regulations CRR—Regulation No.575/2013 along with the Implementing Technical Standards and the Regulatory Technical Standards.

From this, it follows that there are at least two distinct, albeit connected elements a regulator may have to keep in mind; the first element being the reasoning or justification for the implementation of a system of regulatory control, and the second element being the reasoning behind the chosen method of implementation. This is a complex and interesting subject that we shall try to explore in our research.

Our literature review, moreover, supports the position that, on the matter of the prevailing financial regulation, there seems to be a single dominant view.[2] That view—determined by the dominating ideology to which societies on a global scale have become submitted during the past decades, namely "economic neoliberalism", which is based on an axiom of the supremacy of the economy above all other (societal) values—unduly posits that regulatory policy making should be based on a mere economic analysis of the regulation itself, attributing to a very narrow vision of regulatory activity.

(Neoliberal) economists have in this regard developed a tendency to completely ignore the social—and societal—dimension of regulation, besides, by extension, a variety of other dimensions, such as the protection of the environment, consequently ignoring a wide variety of (other than economic) problems arising from other forms of market failure.[3]

As a result, regulatory policy making of the past decades almost exclusively got based on the, to our opinion, erroneous assumption that where there is a competitive and free market, all is purportedly going well, besides on the idea that the state's sole role is to ensure that the market is made as free as possible.

It may indeed be clear that this assumption does not seem to be well grounded in evidence. Said assumption is, at the very least, an oversimplification and, most probably, even plainly wrong.

Lived experience and evidence on the contrary seems to suggest that regulation also exists to control markets in respect of which there is inadequate competition, or to help avoiding that societal imbalance could pose a threat to the safety of society or to the wellbeing of people in general. Reference can, for example, be made to competition between banks and non-bank financial institutions or that between the traditional financial system and cryptocurrencies (including what is known as "stablecoins" and "digital currencies"). Another example concerns the interest societies has in avoiding that voluntary association would lead to social exploitation or other contractual malpractices.

We shall in this regard attempt to break new ground, adding to the existing literature by arguing how there can be a synergy between social, economic, and financial reasons for banking regulation, but also for regulation of the entire financial services sector in a new way—one that accepts the interconnectedness between banks and other financial institutions, the shadow banking industry and the diversification of banking activities.

## *Position of this research in view of existing literature*

### Research contribution—a social perspective

We obviously recognise that there is already, a plethora of literature in relation to financial regulation.

However, the contribution this article hopes to make is to cover an aspect of financial regulation that until now has largely remained unexplored. Indeed, most research remains limited to presenting a mere economic analysis and to investigating the financial impact of regulation only. We posit that such an approach fails to recognise that economic regulation stems from social needs, and not the reverse. When we refer to social needs, we cast a very wide net as social needs may even manifest in consumer behaviour.

For example, the aggressive stimulus policies pursued by Central Banks globally and the historically low interest rates (especially in the aftermath of the financial crisis of 2008) have led return on investment seeking consumers to invest in alternative products such as cryptocurrencies. New platforms that make trading in the stock market or commodities trading accessible to non-experienced investors have democratised this activity.

Historically, someone with only limited financial means would not be able to have access to a shares' portfolio. They would probably keep their funds in a bank account (possibly interest bearing). Due to the foregoing factors, there has, however, occurred a fundamental shift of consumers away from banks and into alternative providers of financial services or into dubious (semi-)financial products which are to a far lesser extent subject to (financial) regulation. This illustrates how a high degree of regulation of a given market activity may drive away market players to segments of the market which are less regulated.[4] As a result, such a degree of high regulation may in the end turn out to have the opposite effect of the one intended (e.g. leading to less consumer protection instead of more, or to less financial stability instead of more).

Whilst the financial impact of regulation is undeniably a primary concern, it can be argued that, at the very least during the past decades, the social and political aspects of banking regulation have not been sufficiently considered in the development and implementation of financial regulation. In that sense, this article hopes to make a novel contribution to the existing literature on this topic.

[2] A. Ogus, *Regulation: Legal Form and Economic Theory* (London: Bloomsbury, 2004).
[3] K. Byttebier, "The tools of law that shape capitalism (and how altering their use could give form to a more just society)" in K. Byttebier and K. van der Borght (eds), *Economic and Financial Law & Policy—Shifting Insights & Values*, Volume III (Cham: Springer International Publishing, 2019), pp.237–239.
[4] M. Bernier and M. Plouffe, *Financial Innovation, economic growth and the consequences of macroprudential policies, Research in Economics*, Vol.73 (Amsterdam: Elsevier, 2019), pp.162–173.

## Post financial crisis regulation—the need for change

Needless to say that, during the past centuries, capitalism has evolved into the prevailing economic system on Earth. It is moreover, from a mere economic perspective to a large extent accepted to be an efficient one, inter alia one that produces value and profits (parts of) society.

However, in recent times both economists and other scholars have casted serious doubt over the social benefits derived by capitalism.[5] Indeed, the aftermath of the 2007–2008 economic crisis left most[6] politicians and academics alike with an important realisation, namely that financial institutions in general and banks more particularly forming the core of the financial services industry are closely interconnected and operate in ways (business and risk models) that demonstrate little to no diversity.

This realisation, coupled with the moral hazard problem that arose after the crisis of 2007–2008, whereby it became recognised that institutional players had to be bailed out by states (begging the expression of the capitalist "privatization of gains and socialization of losses"[7]-principle), created a renewed interest in financial regulation. Amongst others, this awareness in particular casted doubt on the hypothesis of free market efficiency, as in times of trouble, market mechanism clearly failed to provide both economically and socially acceptable solutions and, on the contrary, a general recourse to non-market conform solutions became mandatory to preserve a huge part of institutionalised market players.

It has even been argued that the frequency of financial crises during the last 20 to 30 years may be attributed to a lack of a comprehensive theory of financial regulation to guide policy makers, to the extent that existing theories fail to define the range of regulatory models, the causes of regulatory failure, and how to measure and prevent the latter.[8]

It can thus be observed that the faulty design of regulatory models, next to the lack of ongoing performance monitoring incorporating early warning systems, demonstrates a disrupting economic and social development.

Contemporary economic theory, hence, illustrates the necessity for a more staged approach to issues such as market regulation and liberalisation, which assesses the capacity to conduct effective prudential supervision whilst applying the least protective measures.[9] This is, purportedly, one of the main objectives of the EU common market.

The latter approach may appear to be optimal to the extent that it minimises the risk presented by financial innovation and new products that will aim to circumvent risk exposure restrictions to recoup lost streams of income. In an era of extreme competition between banks and non-bank financial institutions, the risk of new, complicated financial products or non-bank financial service providers being developed to escape regulatory remit and accommodate financial innovation has proven to be extremely high.

## Impact of the changing landscape of the banking and financial sector of the last decade on financial regulation

### *Classic economic theories no longer fit for purpose*

Considering the foregoing, it is not surprising that the failure of classic, economic theories to deliver traditional goals of economic and social development, which in the extreme contribute to financial crises, has resulted in strategies of rethinking the role of governments in regulating the financial system to better promote such goals and prevent such crises, both in advanced and emerging nations, and in economies which range from command to free market.[10]

For instance, Caprio and Klingebiel, have defined a financial crisis as the exhaustion of bank capital. On the basis of this definition, they have identified no less than 117 systemic banking crises, occurring in 93 countries, since the late 1970s. These authors moreover reached the conclusion that these financial crises have become more frequent in the last 20 years.[11]

Lindgren et al. arrive at a similar conclusion[12], although using a broader definition than the one of Caprio and Klingebiel of zero or negative net worth of the entire banking system. Lindgrent, et al., thus identified that 75% of IMF countries had significant bank sector problems in the period between 1980–1995, with 87 countries experiencing a currency crisis between 1975 and 1995.

Other studies have identified that bank capital ratios, as well as several other traditional financial indicators, do not serve as effectively for evaluating bank behaviour

[5] Cf. K. Byttebier, "Towards a New International Monetary Order" in K. Byttebier and K. Van der Borght (eds), *Economic and Financial Law & Policy—Shifting Insights & Values*, Vol.I (Cham: Springer International Publishing, 2017); K. Byttebier, "The Unfree Market and the Law. On the immorality of making capitalism unbridled again" in K. Byttebier and K. Van der Borght (eds), *Economic and Financial Law & Policy—Shifting Insights & Values*, Vol.II (Cham: Springer International Publishing, 2018); K. Byttebier, "The tools of law that shape capitalism (and how altering their use could give form to a more just society)" in Byttebier K. and van der Borght K. (eds), *Economic and Financial Law & Policy—Shifting Insights & Values*, Vol.III (2019).

[6] It should however be remarked that there have been authors who beforehand had warned of some of the detrimental effects of unbridled capitalism, a notorious example being Nobel Memorial Prize in Economic Sciences (2001) laureate Joseph Stiglitz. (Cf. e.g., J. Stiglitz, *The Roaring Nineties* (New York and London: W.W. Norton & Company, 2003); J. Stiglitz, *Making Globalization Work* (London: Penguin Books, 2006).

[7] This phrase is attributed to Nassim Nicholas Taleb (but it is possible that it pre-existed), a professor at NYU and writer who used it in an article in the Financial Times in 2009 where he argued that the policy of bailing out private banks using funds from the public purse has managed to combine the worst of socialism and capitalism.

[8] See J.K. Galbraith, *A Short History of Financial Euphoria* (New York: Whittle Books in association with Penguin Books, 1990). Also J.K. Galbraith, *Money. Whence It Came, Where It Went* (Boston: Houghton Mifflin Company, 1975).

[9] E. Perotti and J. Suarez, "A Pigovian Approach to Liquidity Regulation", 12th Jacques Polak Annual Research Conference (November 2011).

[10] N. Crafts and P. Fearon, "Lessons from the 1930s Great Depression" (2010) 26(3) *Oxford Review of Economic Policy* 285.

[11] G. Caprio and D. Klingebiel, *Bank Insolvency: Bad Luck, Bad Policy, or Bad Banking?* (1997).

[12] Lindgren et al., *Three Pitfalls in Managing Closures of Financial Institutions* (Cambridge: Cambridge University Press, 2005).

in emerging market economies (as opposed to strong and established economies). In this context, for instance *Rojas-Suarez* (2002) has pointed out that the capital-to-asset ratio has under-performed as an indicator of banking crisis both in the Latin America and the Asia banking crisis. A probable explanation attributes this to the lack of liquid markets for bank shares and debt, as well as to the deficiencies in the regulatory framework in these jurisdictions.[13]

Hence, as regards said economies, the lack of a liquid market may render the regulation of bank capital standards through the existence of a robust regulatory framework into an even more pressing requirement.

Moreover, up until the late 20th century, there has been plenty of legal analysis regarding specific regulatory regimes but that has been largely confined to specific analysis of technical standards, with little or no room for high-level critique, let alone for socioeconomic analysis.

Anthony Ogus has in this regard made a very interesting observation which may help explain the lack of critical analysis of regulatory regimes in common law countries. His suggestion is that common law jurisdictions are characterised by deference in judicial determination of rules and by an aversion to state intervention.

As a result, common law scholars who were not exposed to non-common-law legal systems, may have less interest in conducting a critical legal analysis of state policy making, let alone one at a higher level.[14]

Nevertheless, some notable exceptions seem to stand back from the details and have been exploring regulatory objectives from a wider angle, as can be seen in the works of, for instance, Ernst Freund who has made some path-breaking, but now largely forgotten attempts to generalise critically investigate regulatory law in the United States.[15]

Going further back in history, one will however notice that a large group of scholars (including Jennings, Laski and Robson) of the London School of Economics commented on the matter as early as 1935.[16]

In the post-war period, one of the most striking contributions was probably Wolfgang Friedman's work entitled "Law in a Changing Society"[17] which registered the rapid growth of public law incursions on private law, including land-use planning on private property rights; state welfare provision on family law entitlements; social insurance on tort liability; and health and safety regulation and consumer protection on contract.

There, moreover, seems to be a common denominator between all the above-mentioned works, to the extent that they were all highly insightful and, in many ways, ahead of their time as far as the treatment of legal forms for interventionist measures is concerned.

The functions ascribed to the state pursuant to classical liberal and neoliberal theory are—more or less—confined to protecting citizens from violence, theft, fraud (i.e. criminal law) and to enforcing contractual obligations.[18]

During a brief period after World War II (until the late sixties, early seventies) there has in this regard even been a certain shift in attitude from the (classic-liberal) "night-watchman state" to the "Keynesian state" model, which probably only occurred because of the devastating effect of the second World War on the then global economy. A notorious example of this shift has obviously been the New Deal in the United States of America, which has been one of the key moments for this turn to Keynesian thinking.

As a side-effect of the Keynesian (or "welfare") state model, a great degree of control was granted to regulatory agencies and (economic and social) activity previously left unregulated, came thus under state control. The underlying reason hereof was that under Keynesian ideology, the appropriate response to any form of disorder is to increase state control.

## *Microeconomics and macroeconomics: acknowledging a symbiotic relationship*

The Keynesian revolution[19] in macroeconomics is not the only major development that shifted attitudes towards regulation. Economists also began to develop arguments about the microeconomic efficiency of the market economy as early as the 1930s with various theories emerging regarding imperfect competition.

Microeconomic theory[20] has, of course, lost much of its relevance over the years and the focus has now shifted once again on macro-economic analysis.

As said, in response to the last (huge) financial crisis of 2007–2008, governments around the world were called to save banks from collapsing. Private banks had to be re-capitalised with public funds to avoid a wider collapse of the economy with damaging effects. It is hereby widely accepted that the root cause of the 2008 crisis can be traced to the microeconomic complexity of derivative financial products.

However, it can be logically argued that the microeconomic inefficiency of such products was only allowed and generated because of macro-economic policies. It is also true that some of the banks that were

[13] L. Rojas-Suarez, "Rating banks in emerging markets: What credit rating agencies should learn from financial indicators" in R.M. Levich, G. Majnoni, C.M. Reinhart (eds) *Ratings, Rating Agencies and the Global Financial System, The New York University Salomon Center Series on Financial Markets and Institutions*, Vol.9 (Boston: Springer, 2002).
[14] A. Ogus, *Regulation: Legal Form and Economic Theory* (2004).
[15] E. Freund, *Standards of American Legislation, An Estimate of restrictive and Constructive Factors* (Chicago: University of Chicago Press, 1917).
[16] I. Jennings, H.J. Laski and W. Robson, *A Century of Municipal Progress, 1896–1935* (Crows Nest, NSW: George Allen & Unwin, 1935).
[17] W. Friedman, *Law in a Changing Society* (Berkeley: University of California Press, 1959).
[18] R. Nozick, *Anarchy, State and Utopia* (Oxford: Blackwell, 1974).
[19] M. Blaug, "The Keynesian Revolution" in John Maynard Keynes (ed) *Keynesian Studies* (London: Palgrave Macmillan, 1990).
[20] Y. Otani and M. El-Hodiri, *Microeconomic Theory* (Berlin: Springer, 1987).

"saved" and recapitalised with taxpayer money in 2008 were considered as "too big to fail"—or even, in the words of Chomsky, "too big to jail"[21] in the context of the wider economic interconnectedness.

As a result, it can be seen how microeconomic considerations dictated macroeconomic developments. We posit that the situation is completely different today and the focus has shifted in macroeconomics.

As a side topic of this analytical exercise, we shall also aim to demonstrate why, or rather how, a bank does not operate in the same way as any other business and therefore, demonstrate the importance of bank capital regulation and its great financial and social importance.

## *Some final developments adding to the financial regulation dilemma*

During the past 5 to 10 years, financial markets have been facing further turmoil to a large extent driven by technological innovation. One of the main concerns in this has been that, on a global scale, these technological evolutions have largely remained unaddressed by the financial regulatory systems.

A specific area of concern in this regard is that existing prudential measures tend to focus on banks by setting down very detailed rules in terms of capital requirements, while a majority of the recent developments can be attributed to other financial institutions, or even non-financial institutions, such as economic agents that have their historical and core business activities outside the field of finance, and to a large extent fall outside the scope of financial regulatory systems (e.g. providers of online social networks).

As an example, the size of the quasi-banking sector such as 'Electronic Money Institutions' has grown rapidly over the years even expanding to the provision of unregulated consumer credit in the form of Buy Now Pay Later BNPL consumer loans, causing concern to regulators. Arguably, imposing protective prudential measures on banks, whilst leaving non-bank financial institutions, and by extension non-financial economic agents, which perform largely similar market functions (at the very least from a consumer point of view), could distort competition leading to adverse societal effects.

When considering the example of "Credit Default Swaps", an instrument that was demonised in the aftermath of the last financial crisis of 2008, this becomes very clear.

Credit Default Swaps started as a secondary market for mortgages and were initially intended to remove risk and add value to markets and the society. However, a principle that is fundamentally accepted is that risk cannot be completely removed but only "pushed" further down the line.[22]

Credit Default Swaps originate from the mortgage/retail lending of high street banks. Mortgage lending is an activity very tightly regulated and restricted by rules regarding lending and affordability criteria. However, when bundled together and re-packaged as an entirely different product these mortgages escape the tight regulation afforded to retail bank clients.

We, therefore, posit that the answer is not in overly prescriptive regulatory measures but in liberal prudential measures, coupled with effective conduct supervision that could make a real impact in improving market monitoring, whilst maintaining the least amount of economic disruption.

It is also worth noting that existing economic theories of regulation fail to give a concrete definition as to what constitutes a financial crisis and what indicators may be deployed to measure such a crisis. This failure derives, amongst others, partially from the fact that bank stakeholders are not being properly defined and identified, and partially due to a narrowly defined theoretical framework with extremely narrow terms of reference. Such a faulted framework obviously fails to incorporate concepts of economic and social development and how this impacts societal wellbeing and the overall soundness of its economy (all too often merely defined in terms of economic growth).

One example that falls out of these narrowly defined terms of reference has been that of shadow banking. We use this term to refer to the ever-growing ecosystem of non-bank financial intermediaries providing services to consumers like traditional banks. Economic theories that fail to recognise this ecosystem which has been growing at exponential rate are outdated and they do not reflect the reality of the market.

Whilst the ecosystem of non-bank service financial providers has grown to become more regulated, its regulation is in no way as strict or detailed as that of banks, both in terms of conduct regulation and in terms of prudential requirements. However, these institutions essentially perform the same functions—at least from the consumer point of view—as banks, and their interactions with banks lies at the core of their existence. For example, a regulatory requirement for e-money institutions is that they must safeguard relevant funds with authorised credit institutions (i.e. banks).

[21] N. Chomsky, Requiem for the American Dream. The 10 Principles of Concentration of Wealth & Power (New York: Seven Stories Press, 2017), p.83.

[22] In its simplest form, a CDS, is an agreement between the seller of the CDS and the buyer, stipulating that in the event of a debt default, the seller insures the buyer against the risk of default of said debt in exchange for a series of payments. In this simple example one can easily identify the risk and follow it through the transaction lifecycle as it is transferred from the initial lender to the insurer (i.e. the issuer of the CDS). However, the market grew to become extremely complex, with derivative products such as synthetic CDSs being opaque and representing an unacceptably high risk. Therefore, the problem with Credit Default Swaps lies in their inherent complexity as well as the lack of adequate reporting and supervision of the transactions.