Chapter 1
Theories of Financial Regulation

ABSTRACT
There has been a long-standing debate about the pros and cons of two modes of financial regulation: command and control and self-regulation. These two regulatory modes have been favored by policy-makers and the dominant regulatory theories for decades in developed economies such as US, UK, and Australia. The design of financial regulations, consequently, has oscillated between these two modes during the pre-deregulation and financial deregulation periods in those developed economies. However, a third regulatory approach aimed at maintaining financial stability, which is the vital issue during post-GFC period, is introduced to policy-makers and a broad swath of other constituencies in this chapter.

INTRODUCTION
Attempts to conceptualize and incorporate the notions of risk and uncertainty within theoretical economics have spawned divergent schools of thought and policy prescriptions. This can be seen by examining the impact of the various schools of thought on the practical issue of the appropriate policy stance for regulation of the financial sector. Depending on which school of thought was in the ascendancy, the dominant regulatory theory oscillated between command-and-control and self-regulation as the proper means to guide the design of financial regulation aimed at financial stability. To show this, the first section of this chapter offers an outline of the commonly debated pros and cons of both modes of regulation. Based on the

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Keynesian edict that market failures associated with uncertainty and instability were unavoidable, Keynesian policy-makers normally embrace top-down forms of “command-and-control”. However, this stringent and direct regulatory approach has been criticized for weaknesses identified by legal authors and economists from the neoclassical and Austrian schools. These authorities tend to advocate the notion of self-regulation as the best guide to policy-making in financial systems.

The chapter then traces the influence of these two modes of regulatory theory in the historic records of the U.S., UK and Australia from Post World War II through the financial deregulation of the 1980s. A most important consequence of the historical tendency to advocate self-regulation has been the transit of banks’ behaviour from acting as financial intermediaries to taking the role as brokers in the structured finance market. The combined effects of financial deregulation, rapid technological change, the evolution of the banking function, and the increasing complexity and diversity of finance activities has left regulatory bodies grappling with the problem of designing appropriate prudential standards.

Next, the chapter moves to an exploration of the evolution of capital regulation from the days of pre-Basel regulation, based on the U.S, UK and Australian experience; to the 1988 Basel Accord (Basel I); the 1996 Basel I amendment; Basel II; and finally to new Basel III Accord that the G-10 countries and other developed economies, such as Australia, is are going to implement in 2013. Recall that the major thrust of this chapter is to discern the most appropriate and effective regulatory regime for the purposes of achieving financial stability of the system. Accordingly, the occurrence of the 2007-2008 Global Financial Crisis offers a preliminary appraisal of the effectiveness of Basel II and Basel III.

The chapter ends with the insight that effective prudential controls are essential in the current economic climate, but that neither command-and-control nor self-regulation holds all the answers. In highly complex and competitive financial markets, a new approach to regulation, which melds elements of earlier approaches, needs to be developed – the subject matter of the next chapter.

Oscillation between Two Modes of Regulation

Regulating the financial institutions, particularly the banking system, which has always played a key role in achieving financial stability, is a challenging task for policy-makers. For long periods, the design of regulatory strategies has been characterized by an oscillation between two approaches. On the one hand, direct and comprehensive forms of government intervention based on Keynesian theories. On the other hand, rooted in the conservative side of political economy, and influenced mainly by neoclassical and Austrian economic theories, the idea of a self-regulating financial market.
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