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**Challenges for Regulatory Reform in the Finance Sector: Learnings from the Last Decade**

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## Abstract

Over the last decade the finance sector has undergone significant scrutiny both globally and locally. Following the global financial crisis, the G-20 led a process of regulatory reform that had an impact internationally, yet the effectiveness of many of its reforms remains debatable. Scholarly experts have reviewed, assessed and critiqued the reform efforts yet this work is rarely used to inform new policy regimes. This article presents a systematic review of the academic literature on post-financial crisis regulatory reform with the aim of drawing out lessons for the future. The research finds that financial regulation faces challenges at three levels: (1) at a structural or architectural level in terms of who regulates what (2) at a processual level in terms of the style and mechanism of regulation; and (3) at the level of regulatory content – the details of the rules or standards. In addition, regulatory effectiveness can be facilitated or hindered by power and politics, blurred boundaries, and assumptions about behaviour. The article discusses these findings in the context of recent evidence of misbehavior in the Australian finance sector.

# Introduction

The global financial crisis (GFC) that began in 2008 has been analysed in depth by scholars of many disciplines. The causes of the crisis were extremely complex and over a decade later they continue to be debated.[[1]](#footnote-1) They involve intricacies of politics, economics, law, governance, finance and banking not to mention problems of culture and greed.[[2]](#footnote-2) Consequently the regulatory response to the GFC was also very complex, changes were made to the structure and mandate of supervisory organisations and reforms were put in place at multiple levels: international, regional, national and at the level of particular markets, industries or products.

Ten years on many of the same issues are being debated at a national level in Australia in the context of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission).[[3]](#footnote-3) Australia’s corporate and prudential regulators have come under scrutiny and the culture, governance and remuneration structures within the financial sector have been heavily criticised. As this article is written, regulatory reforms are being developed and implemented based on the recommendations of the Royal Commission’s final report, yet there is little reference to academic learnings. This paper asks whether there is anything we can learn from the academic literature on the post-GFC reform process that may assist in designing effective frameworks for the Australian financial sector going forward.

In order to do this the paper performs an analysis of the existing literature on post-GFC regulatory reform. These reforms have been very wide-ranging making it difficult to gain an overall picture of what has happened worldwide, let alone to judge the overall effectiveness of reform efforts.[[4]](#footnote-4) This article uses a method known as systematic review to navigate the huge literature on the GFC and to extract scholarly opinions on the effectiveness of regulatory reforms, the factors that may hinder their success, and any ideas for improvement. By collating work from different disciplines and geographies the paper draws out both theoretical and practical themes relevant to regulatory effectiveness in the finance sector. It identifies learnings that may be helpful in developing regulatory frameworks in the future, both in Australia and elsewhere. By bringing these ideas together in one place, this review paper aims to make it easier for academic research to influence policy debates in the area of financial regulation.

In terms of theoretical perspective, the research is driven by a desire to better understand the conditions necessary for modern styles of regulation to work effectively. The nomenclature surrounding contemporary regulation is unsettled however most non-traditional techniques would fall within the term “new governance”.[[5]](#footnote-5) Johnson describes new governance as an examination of “the contours of the theory of self-regulation”.[[6]](#footnote-6) Theorists are trying to explain the increasingly wide range of modern regulatory systems using labels such as process-based regulation[[7]](#footnote-7); meta-regulation,[[8]](#footnote-8) management-based regulation,[[9]](#footnote-9) as well as the widest term, new governance.[[10]](#footnote-10) New governance has been seen to have great potential in fast-moving areas such as financial markets.[[11]](#footnote-11) Yet at the same time it has been heavily criticised for failing to curb the behaviours that led to the financial crisis.[[12]](#footnote-12) This paper explores some of the challenges of these modern regulatory techniques and how they might be improved in the context of the finance sector.

The paper is structured as follows. Part 2 describes the methodology used to review and analyse the large body of literature on post-GFC regulatory reform. Part 3 discusses the research findings which reveal that financial regulation faces challenges at three levels: (1) at a structural or architectural level in terms of who regulates what (2) at a processual level in terms of the style and mechanism of regulation; and (3) at the level of regulatory content – the details of the rules or standards. Part 4 draws out higher level themes around the factors that facilitate or hinder effective financial regulation: power and politics; blurred boundaries and; and assumptions about human behaviour. Part 5 concludes by discussing these findings in light of the recent Royal Commission in Australia in order to extract any learnings that might inform future development of regulatory frameworks for the Australian financial sector.

# Methodology

The paper uses a methodology, common in the medical sciences and increasingly adapted to the social sciences, known as systematic review.[[13]](#footnote-13) This transparent process is well suited for cataloguing and analysing the vast and multi-disciplinary literature on regulatory reform post-GFC. It involves the use of clearly defined parameters to select and analyse a sample of literature in order to draw conclusions about what is known, and not known, about a certain topic.[[14]](#footnote-14) It is more than a literature review as its aims, “to go beyond mere description by recasting the information into a new or different arrangement and developing knowledge that is not apparent from reading the individual studies in isolation”.[[15]](#footnote-15)

The systematic review process is detailed in **Figure 1**. It provides a pragmatic and objective method for selecting a relevant sample from a vast literature. The first step was to conduct a broad search for literature on the topic of post-GFC regulatory reform. The net was cast wide initially in order to catch all disciplines interested in the topic. For this reason searches were conducted in Google Scholar as a first step and then in discipline-specific databases (EBSCO, Lexis Nexis) as a second step to catch anything not indexed by Google Scholar. The final sample included journals covering law (58%); political science (13%); economics (11%), finance (11%); and business (7%). As the initial searches for variations on “financial crisis” combined with “regulation” found a huge number of documents it was decided to narrow this to only quality journal articles with the text “regulat” in the title. Quality was measured on the basis of whether the journal was included in the Scimago Journal rankings. By insisting that each article contained a stem of the word regulation in the title it was possible to reduce the sample size significantly. This undoubtedly resulted in some relevant articles being excluded, yet it was justified by the ability to objectively reduce the sample to a manageable size with an increased focus on regulation. The last step of the process was to review each of the remaining articles to ensure suitability in terms of focus. The test was whether the article was directed at a discussion of regulatory effectiveness. Any papers that were focused primarily on a financial (rather than regulatory) issue were rejected, for example, detailed examination of the nature of derivatives or measures of liquidity. Also rejected were articles that were highly descriptive with no analysis or commentary on regulatory effectiveness, for example, a timeline of national reforms.

**Insert Figure 1: Systematic review process**

At the analysis stage papers were categorised according to both the regulatory topic and the theories or arguments used to explain regulatory effectiveness or ineffectiveness. Coding decisions were discussed between the author and experienced research assistant until agreement was reached. **Table 1** shows the spread of papers across topics. Of course some articles dealt with more than one topic so were counted in multiple categories. Hence the total number of papers was less than the sum of all topic references. Many papers did not explicitly state their theoretical stance, rather they identified conditions affecting regulatory effectiveness. Thus themes arose from the data in an inductive manner and were merged and consolidated into structural levels (presented in Part 3) and higher level themes (presented in Part 4).

**Insert Table 1: Regulatory reform topics**

# Regulatory effectiveness: structural levels

The literature reveals three structural levels seen by scholars to influence regulatory effectiveness, with many papers focusing their analysis at only one level: (1) the architectural level in terms of who regulates what; (2) the processual level in terms of the style of mechanism of regulation; and (3) the level of regulatory content – the details of the rules or standards.[[16]](#footnote-16) Each of these three interrelated areas is discussed below.

## Regulatory architecture

Regulatory architecture refers to the structure of a regulatory regime in terms of its institutional and organisational design. This can be at an international, regional or national level. At an international level financial markets have been regulated by a system of codes and standards set up over the last 30-40 years as a response to the globalisation of finance.[[17]](#footnote-17) Organisations involved in this policy network include the International Monetary Fund (IMF); the Bank of International Settlements (BIS), the Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO) and the International Accounting Standards Board (IASB).[[18]](#footnote-18)

Post-GFC, the G20 initiated renewed efforts to improve these systems beginning with its declaration on “Strengthening the Financial System” of 2 April 2009. Of course, the switch from the G7 to the G20 as the basis for financial oversight was itself an architectural response to the crisis based on wide recognition that membership should be broader.[[19]](#footnote-19) At the core of the G20 plan sits the Financial Stability Board (FSB), successor to the Financial Stability Forum (FSF), with a strengthened mandate to monitor national implementation of the agreed reforms.[[20]](#footnote-20) The initial reform agenda set out a plan to: increase collaboration between the FSB and IMF in order to better identify macroeconomic risk; extend regulation to all systemically important financial institutions, instruments and markets; endorse the FSF’s principles on pay and compensation; improve capital adequacy in the banking system; take action against tax havens; improve accounting standards; and regulate credit rating agencies.

Thus the reforms at an international level were focused on coordination and collaboration rather than a major architectural shake up. Changes to international standards focused on macro-prudential regulation including how to tackle systemic risk and shadow banking.[[21]](#footnote-21) The IMF, BCBS and FSB are now monitoring financial stability through an international financial regulatory framework.[[22]](#footnote-22) However, the institutional structure of the financial system is still seen as in need of significant further reform.[[23]](#footnote-23) Bavoso concludes that a drastic redefinition of the relationship between regulators, market players and society is needed in order to shape culture and behavior in financial institutions. Christophers makes the point that international efforts at reforming regulation will struggle unless they actually penetrate behavior on Wall Street and in the City of London where the real power of global finance lies. Although the G20 reforms are excellent in theory, their effectiveness will depend on national implementation.[[24]](#footnote-24)

Post-crisis nearly all affected countries, as well as regions such as the European Union, have considered whether they ought to reshape their supervisory regime.[[25]](#footnote-25) Five common financial regulatory structures have been identified whereby the appropriate regulator for any firm is either determined by the firm’s (1) industry sector, (2) institutional structure, or (3) function; alternatively, (4) there is just one unitary regulator for all firms, or (5) a twin peaks structure as we have in Australia, splitting prudential regulation and conduct regulation.[[26]](#footnote-26)

In Australia, the Financial System Inquiry determined that the Australian framework was generally effective.[[27]](#footnote-27) The Australian Securities and Investments Commission (ASIC) regulates corporations, markets and financial services with the Australian Prudential Regulation Authority (APRA) ensuring the safety of banks, insurance and pension funds. Indeed, because the Australian economy emerged from the crisis comparatively unscathed, this twin-peaks structure has been lauded as a successful model. In the United Kingdom, the pre-crisis tripartite structure of supervision was replaced by a twin-peaks system with the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) each taking a more specialist regulatory role than the previous Financial Services Authority (FSA).[[28]](#footnote-28) Baber criticizes this replacement of the FSA as introducing more complexity and thereby eroding the “light touch” regulation for which the United Kingdom was known.[[29]](#footnote-29) In the United States the pre-crisis regulatory architecture was consistently described as fragmented and ad hoc: a patchwork of regulators, some at federal and some at state level.[[30]](#footnote-30) Fragmentation has some advantages: it permits a “palette of options” and “a close fit between regulatory expertise and the targeted firms”.[[31]](#footnote-31) However it is poorly suited to regulating systemic risk.[[32]](#footnote-32) Thus one of the major reforms in the US was to set up the Financial Stability Oversight Council (FSOC) with a mandate to identify and respond to emerging threats to overall financial stability.

## Regulatory process

Regulatory process or style is defined by MacNeil as “a function of the discretion given to the regulator in structuring and operating the substantive rules”.[[33]](#footnote-33) Thus regulatory style is found not only in the structure and form of a regulatory system but in the way in which it is practiced.[[34]](#footnote-34) Terms such as “principles-based” regulation, “light-touch” regulation and “risk-based” regulation can refer to the style of implementation and enforcement as well as the way rules are drafted. Almost all styles that fall outside the traditional “command and control” strategy of “detailed legal rules backed by criminal sanctions overseen by a government agency” can be classed as “new governance”.[[35]](#footnote-35)

This paper finds three overlapping debates are ongoing in the literature relating to policy decisions around style and process: (1) drafting style (rules v principles); (2) implementation style (outsourcing v supervision); and (3) enforcement style (public v private). Drafting style tells the target of regulation what they should do; implementation style tells them how to do it; and enforcement style checks that it has been done.

### Drafting style: rules v principles

The theoretical stance taken by many of the papers discussing regulatory style is to explain regulation in the context of the well-known debate between rules and principles; between hard legal prescriptions and softly-worded guidelines.[[36]](#footnote-36) Principles-based regulation is seen as a “new governance” strategy while strictly defined rules are seen as a more traditional regulatory approach.[[37]](#footnote-37) Important in choosing between these styles is the nature of the regulatory target, in this case complex financial markets. An increasingly popular theory prior to the crisis was that principles are better than rules at regulating fast-moving, complex targets especially those involving high economic stakes.[[38]](#footnote-38) The GFC gave this theory a beating but did not entirely knock it down. Braithwaite calls it a theory of legal certainty – “as the regulated phenomena become more complex, principles deliver more consistency than rules”.[[39]](#footnote-39) Some of the reasons behind the theory include: (1) the flexibility of principles; (2) their ability to cover the field; and (3) the way they make use of industry knowledge.

**Flexibility**: In areas where technology and other innovation is fast-moving, rules can quickly become out of date whereas broad principles can be redefined and adapted to a changing environment thereby maintaining consistency of approach.[[40]](#footnote-40) They are flexible, fast to create and cost-effective.[[41]](#footnote-41) As we cannot turn the clocks back and prevent the spread of financial innovation, we must deal with it as best we can. Ford rightly argues that “[d]etailed rules would be out of date almost as soon as drafted”.[[42]](#footnote-42) Awrey suggests that the nature and pace of change within modern financial markets demonstrates the “desirability of regulation designed and built with the objective of ensuring sufficient flexibility, responsiveness and durability”.[[43]](#footnote-43)

**Coverage:**When economic stakes are high, there is both incentive and resources for legal game-playing aimed at expanding the grey areas around rules, or determining them in a player’s favour.[[44]](#footnote-44) This behaviour, known as creative compliance, engenders a level of unfairness as it provides advantages for those who can afford to employ lawyers and accountants to help them weave a path through loopholes. Similarly, regulatory arbitrage is a practice whereby firms capitalise on loopholes or geographical variations in order to circumvent unfavorable regulation. It can create a never-ending spiral of rule-making and rule-evading.[[45]](#footnote-45) Principles, on the other hand, provide broad concepts regarding acceptable behavior that are much harder to evade. Their vagueness works as an advantage in a catching behavior that fails to comply with the spirit of the regulation.

**Information:** Principles also have the ability to trigger “regulatory conversations” amongst knowledgeable actors that help to interpret and clarify regulatory expectations.[[46]](#footnote-46) Financial market participants are seen to be in a better position than government when it comes to understanding complex market developments and potential problems.[[47]](#footnote-47) There are huge challenges for regulators in managing risk when financial markets are so dense and dynamic: “opacity and the pace of innovation also render it more difficult for regulators to effectively police financial markets and—in conjunction with interconnectedness and fragmentation—to locate and monitor potential risks”.[[48]](#footnote-48) Here we see the advantages of enrolling industry in the regulatory process as an information gathering exercise.

Ford explains that regulation can be comparably more or less principles-based but nearly all workable systems will comprise a mix of both rules and principles.[[49]](#footnote-49) Awrey believes that the “rules versus principles” debate has become stale – modern principles-based regulation is not just about the way standards are worded but about the nature of the relationship between the regulator and the regulated actor which includes processes of implementation.[[50]](#footnote-50)

### Implementation style: outsourcing v supervision

Another theme in the literature relates to implementation style. Firms can be given a level of choice over how to achieve desired regulatory outcomes or they can be closely supervised. New governance strategies, particularly the concept of management-based regulation have introduced more outsourcing or delegation into regulatory systems.[[51]](#footnote-51)

Gerding criticizes the regulatory outsourcing set up by Basel II where regulators placed heavy reliance on internal risk-modelling by financial firms.[[52]](#footnote-52) He points out that great faith was placed in the new technology of these risk models which failed to anticipate the wave of mortgage defaults that ultimately spiraled into a global crisis. His detailed unpacking of the flaws of these risk models clearly demonstrates some of the weaknesses of outsourcing. The theory behind this kind of regulation is that through delegating process-design to regulated actors it makes efficient use of industry knowledge. However, inherent in this theory is the huge assumption that industry knowledge is superior to that of the regulator. Gerding shows that it is possible for huge sections of industry to get it wrong, sometimes by mistake but sometimes in order to game the system.[[53]](#footnote-53) His conclusion is that regulators cannot outsource oversight to risk models or other internal processes without thoroughly and continuously auditing those processes.[[54]](#footnote-54)

Credit rating agencies (CRAs) provide another example of the failure of outsourcing. In the US, ratings have been incorporated into hundreds of rules and regulations giving CRAs a quasi-regulatory status.[[55]](#footnote-55) The crisis revealed that they had provided overly high ratings to complex structured products, particularly securities backed by subprime mortgages, which otherwise would not have been so marketable.[[56]](#footnote-56) It also highlighted the conflicts of interest inherent in providing ratings when it is the issuer, not the investor, who pays for the rating[[57]](#footnote-57). Regulators must be acutely aware of the incentive structures at play within a system because bad incentives can very quickly make a good system worthless[[58]](#footnote-58).

Okamoto comes up with an innovative solution to excessive risk-taking by asset managers suggesting they should be required to put their own money at risk and “use ‘best practices’ in managing risk or be subject to legal liability”.[[59]](#footnote-59) This still permits outsourcing whilst supporting it through monitoring that can result in both economic and legal sanctions. Maintaining a strong monitoring presence whilst permitting market actors to identify and control risk is also discussed by Listokin-Smith in the context of OTC derivatives.[[60]](#footnote-60) This kind of hybrid regulation has been termed meta-regulation and is often described as layered regulation where one set of rules regulates another.[[61]](#footnote-61) It can be explained using Braithwaite’s theory of responsive regulation whereby enforcement options are escalated to the extent necessary to achieve the desired outcome - if light-touch persuasive techniques fail, stronger sanctions can be instigated[[62]](#footnote-62).

### Enforcement style: public v private

A third, closely related but distinct issue surrounding regulatory style is how the rules or principles are enforced and by whom. Traditional regulation would leave this to a government-led supervisor however new governance strategies, particularly the idea of smart regulation, have enrolled other actors into the process.[[63]](#footnote-63) A common technique is for the regulator to require disclosure of information and then let the market determine the consequences. For example, the “comply-or-explain” mechanism used by corporate governance regulation encourages the adoption of good governance but leaves it to the investment market to enforce this through its valuation of shares.[[64]](#footnote-64)

There is a clear debate in the literature around whether supervision of financial regulation should be public (directed by government); private (industry self-regulation often based on contractual agreement); or something in-between.[[65]](#footnote-65) The crisis has been seen as a turning point in shifting authority back towards public regulatory agencies.[[66]](#footnote-66) Canova laments the demise of the Keynesian command and control regime of the 1930s and 40s and criticises the movement towards industry self-regulation that began in the 1970s. Although he focuses on the situation in the United States his message is universal: that without a strict command-and-control system, regulatory capture occurs rendering regulation ineffective and uncoordinated.[[67]](#footnote-67) Cukierman concludes boldly that, “in a world with serious asymmetries of information, vigorous financial innovations and incomplete regulatory frameworks, self-regulation does not work”.[[68]](#footnote-68)

Of course this is directly related to the level of enforcement deemed necessary. Strict legal sanctions may only be available in the case of public, government-led policy, yet this is not always the case. Biggins and Scott tackle this issue in the context of OTC derivatives which, pre-crisis, were regulated primarily by a private, transnational regulatory regime overseen by the powerful International Swaps and Derivatives Association (ISDA). They explore how this private body has interacted with national governments to give the regime a stronger public dimension through standardised contracts.[[69]](#footnote-69)

Amtenbrink and De Haan discuss European regulation of credit rating agencies. This is an interesting example of a legislature (the European Commission) going against the recommendations of industry bodies and implementing a much stricter binding regime instead of a voluntary system. The Commission’s rationale for this seemed to revolve around a desire for a more robust and stringent regime, involving enforcement options. This was deemed necessary due to the severe nature of the problems identified and a need to restore confidence in the market and protect investors.[[70]](#footnote-70) Some say that arguments for private, self-regulation were dismissed rather quickly and the potential disadvantages of a legislative approach not fully considered. These include the fact that a comprehensive regulatory regime can encourage excessive reliance on ratings by giving a false impression of a seal of approval.[[71]](#footnote-71) The main difference between the former regime and the new EU Regulation is its enforceability which enables a CRA to effectively be banned from operating in the EU through removal of their registration.[[72]](#footnote-72)

Both public and private enforcement rely on somehow extracting information about whether a firm is complying with the rules or principles of the regulatory regime. Avgouleas and Awrey consider the rise of the disclosure paradigm as the cornerstone of financial regulation.[[73]](#footnote-73) Awrey notes that although timely and comprehensive access to information is undoubtedly a necessary condition for both optimal private contracting and effective public oversight, it is by no means sufficient.[[74]](#footnote-74) Indeed the dense “information thicket” faced by regulators suggests that the provision of more information is possibly the last thing they need.[[75]](#footnote-75) Awrey posits two potential answers: we could better fund the regulators to help them supervise complex markets; or we use hard law to try to reduce complexity, perhaps by prohibiting certain transactions.[[76]](#footnote-76) Darcy explores enforcement of credit rating quality through performance-based sanctions.[[77]](#footnote-77) If ratings were found to be of poor quality CRAs would be suspended from issuing ratings or forced to disgorge profits gained from such ratings. These proposals involve command-and-control rules with a quasi, strict liability element– a genuine legal threat. This was a common theme in the literature: that effective regulation should combine both rules and principles; disclosure and monitoring; state and corporate power.[[78]](#footnote-78)

## Regulatory Content

Regulatory content refers to the details of the rules or principles set out in law or as a code, standard or other format. These will be highly topic-specific and it is out of the scope of this article to go into detail regarding all areas of post- crisis regulatory reform discussed in the literature. The key topics discussed have been summarised in **Table 1**. In general, regulatory content was seen to be lacking in that it did not cover all risky transactions, particularly in the area of derivatives-trading;[[79]](#footnote-79) or did not adequately assess the extent of relevant risks, for example, Basel’s capital adequacy rules.[[80]](#footnote-80)

# Higher level themes

Part 3 has set forth the ways in which regulatory architecture, process and content can influence the effectiveness of financial regulation. However, the paper also reveals a higher level of factors that go towards determining the architecture, process and content of any regulatory regime and either facilitate or hinder its effectiveness. These higher level factors can be grouped into three categories: (1) power and politics; (2) blurred boundaries; and (3) assumptions about behaviour. **Figure 2** demonstrates how these factors impact on the overall effectiveness of a regulatory regime, providing an integrative framework for assessing regulatory design. Each of these three factors is discussed in more detail below.

**Insert Figure 2: Integrative framework**

## Power and politics

There is a consensus amongst scholars that regulatory reform has been gradual rather than radical; incremental rather than transformative.[[81]](#footnote-81) Most reforms have involved tweaking the existing regime rather than scrapping it entirely. This can be seen as a consequence of power and politics - some of the more aggressive approaches were curbed by active opposition and timid alternatives.[[82]](#footnote-82) Davies explains that four years after the crisis, “grander ideas have disappeared from the agenda and the art of the possible has again become the key skill for reformers”.[[83]](#footnote-83)

Helleiner and Pagliari discuss the political dynamics associated with global economic policy-making.[[84]](#footnote-84) They point out that the broadening of the group of nations involved in standard-setting may make it more difficult to make decisions despite the fact that the FSB has a more robust structure than its predecessor.[[85]](#footnote-85) Karmel comments that often, due to differences of opinion, “politics stand in the way of a genuine reform”.[[86]](#footnote-86) Certainly political factors are just as important as economic factors in shaping the framework for financial regulation.[[87]](#footnote-87) Indeed, commentators have noted the tendency for politicians to focus on the effectiveness of the structure of the regulatory system, at the architectural level, rather than the effectiveness of the regulatory instruments themselves.[[88]](#footnote-88)

Concerns over international “regulatory arbitrage” are often raised particularly in EU policy-making.[[89]](#footnote-89) This refers to the competition between major financial centers and concerns that unnecessary regulation could reduce the attractiveness of a particular location as compared to its competitors. Rixon explains how jurisdictional competition for financial activity can be a serious obstacle to regulatory reform.[[90]](#footnote-90) International standards and harmonisation are seen as the solution to regulatory arbitrage by creating a more equal playing field. Yet too much consolidation can create systemic risks by reducing diversity: if every financial institution works in the same way there is the potential for them all to collapse in the same way.[[91]](#footnote-91) Although there are strong arguments for international coordination of standards through organizations such as Basel, the FSB and the OECD,[[92]](#footnote-92) there is also a need for regulation that permits local innovation and experimentation at corporate level.[[93]](#footnote-93)

Power and politics can also affect the implementation of regulation. Baker examines the phenomenon of regulatory capture. He defines this as follows:

Regulatory capture occurs when bureaucrats, regulators and politicians cease to serve some notion of a wider collective public interest and begin to systematically favour specific vested interests, usually the very interests they were supposed to regulate and restrain for the wider public interest.[[94]](#footnote-94)

This can occur via different mechanisms including: (1) lobbying by the finance industry due to its immense power; (2) political salience and/or (lack of) interest in financial regulation; (3) colonisation of regulatory agencies by industry (due to “revolving doors”); and (4) intellectual capture – in this case by efficient market theory.[[95]](#footnote-95) Canova also highlights the problem of regulatory capture giving several examples of the “revolving door” – the movement of key personnel back and forth between regulators and the regulated.[[96]](#footnote-96) Although seen as a problem by some, this practice can have advantages in terms of much needed information exchange. Indeed, it is advocated by Edgar as a solution to the problem of regulators only looking in the “rear vision mirror”.[[97]](#footnote-97) He suggests that immersion of regulators in industry might help them to become more forward-looking such that they are better equipped to predict future problems before they occur.[[98]](#footnote-98)

## Blurred boundaries

The process of dividing the regulatory literature into topics revealed a high level of overlap: discussion of hedge fund regulation refered to broader market risks and discussion of shadow banking led to credit derivatives and investment schemes. This reflects the network of interconnections revealed by the GFC and the lack of attention to what has since been termed systemic risk. The IMF explains how systemic risks led to: “large losses to other financial institutions induced by the failure of a particular institution due to its interconnectedness” (IMF 2010, p2). In other words, although individual market participants made risk-avoiding decisions in relation to their own interests they did not consider or take action to reduce unstable situations at the systemic level.[[99]](#footnote-99) Boundaries were imagined to be in place but in reality did not exist.

The topic of moral hazard and excessive risk-taking appears both at the level of large organisations and individual managers.[[100]](#footnote-100) At the organisational level large banks became comfortable that they would be bailed out by government rather than left to collapse. Compounding this, at the individual level, managers became comfortable that their personal wealth would not be affected by losses to the firm. In this case, boundaries were put in place where they should not be, encouraging dangerous risk-taking behavior.

Boundaries were also poorly defined when it came to the content of regulation. A key problem hindering many reform efforts was, and still is, difficulty in labelling, categorising and defining the risky products, processes or organisations that need to be regulated. For example, do all hedge funds need to be regulated or only the large ones; should all derivatives be regulated or only certain types? Every regulatory scheme has its limits both in terms of who is regulated and what they can do.[[101]](#footnote-101) Where do we draw the lines around regulatory regimes and is this even possible? One aspect of this boundary problem is that defining a regulated sector can provide incentives for operators to move into the unregulated sector where they have more freedom.[[102]](#footnote-102) This is exactly how “shadow” financial markets arise.

Thus it is not just an issue of gaps and grey areas between regimes it is a problem of not knowing where to draw the lines. Ongoing innovation and change in financial products make it very difficult to define regulatory regimes and to ensure they cover the most risky products or organisations.[[103]](#footnote-103) This is why principles-based regulation still finds favor amongst both scholars and policy-makers. By using a broad brush approach and by measuring outcomes rather than inputs, principles have the flexibility to cast a wider net based on risk rather than structure. The idea of dividing activities by risk rather than function could revolutionize regulation, permitting stricter rules and self-insurance for high risk products and lighter treatment for standard banking.[[104]](#footnote-104)

## Behavioral assumptions

Policy-makers make assumptions about the way regulation will alter human behaviour. Behind all of the advantages and disadvantages of different regulatory styles are assumptions about the way market participants will respond. The literature reveals that these assumptions have been inaccurate at several levels. The incentives behind both individual and organisational behaviour have not been fully explored and yet understanding these motivations is vital for effective regulation.

### Regulator behavior

Ford argues that although principles-based regulation failed to prevent the financial crisis this was not a failure of the regulation itself but of its implementation. MacNeil also makes this point suggesting that an important distinction needs to be made “between formal grant of powers” to a regulator and “the capacity or willingness to use them”.[[105]](#footnote-105) If principles-based regulation is to be effective it requires considerable regulatory capacity and resources which were lacking in many jurisdictions pre-financial crisis.[[106]](#footnote-106) Awrey also raises this point noting that an obvious policy response to the complexity of financial regulation is to enhance the resources and expertise of the regulators, yet budgets continue to be squeezed rather than expanded.[[107]](#footnote-107) Kennedy’s paper discussing the new Consumer Financial Protection Bureau (CFPB) in the United States is one of the more positive stories. He describes how the CFPB has hired experts to study particular consumer financial markets and has increased opportunities for public input and transparency.[[108]](#footnote-108) Liou also comes up with some positive ideas, pointing out that new communication and information technologies can improve interaction between regulators and firms thereby enhancing transparency.[[109]](#footnote-109)

### Market behavior

A recurring theme in the literature has been the flaws in the assumptions surrounding market enforcement. These assumptions, particularly the rational market actor hypothesis, have had a profound influence on how we regulate financial markets and institutions.[[110]](#footnote-110) The financial crisis has shattered belief in this paradigm.[[111]](#footnote-111) Avgouleas discusses the “misguided reliance on the persuasive power of market discipline” focusing on the fact that market actors do not behave in accordance with rational choice theory.[[112]](#footnote-112) He draws on the work of behavioral finance scholars to argue that the biggest shortcoming of post-crisis reform is the ongoing lack of attention to non-rational behavior.[[113]](#footnote-113). He uses the GFC to draw out three reasons why investors do not always behave rationally: firstly they may fail to fully understand complex products; secondly, they react readily to other market actors’ behavior – herding rather than taking rational contrarian positions; and thirdly their behavior is influenced by market euphoria.[[114]](#footnote-114) Podolski also refers to managerial myopia (excessive focus on the short-term) and over-confidence.[[115]](#footnote-115)

### Individual behavior

The last theme centered on behavior is that of individual greed and irresponsible risk-taking.[[116]](#footnote-116) Many blame the investment bankers for selfishly boosting their bonuses at the expense of firm stability. However, home-owners in the United States have also been criticised for their greed and financial naivety in buying homes that they could not afford.[[117]](#footnote-117) Regulatory responses to these problems include corporate governance reforms as well as consumer protection regimes. However implementation of these measures can again be seen to be lacking. Executive remuneration levels remain excessive and reports of claw-back mechanisms actually being used are hard to find.[[118]](#footnote-118) Indeed, for the most part financial sector behavior across the globe appears largely unchanged.[[119]](#footnote-119) Nicholson et al provide a helpful explanation of the strong influence of social norms in the finance sector. These norms can no longer be ignored and must be studied in conjunction with regulatory reform if it is to be successful.[[120]](#footnote-120) The crisis revealed that the norm of excessive risk-taking had become a systemic problem with the balance of incentives providing a strong force for imprudent behavior.[[121]](#footnote-121) How to change the culture and norms of the financial sector has become an important and topical issue.[[122]](#footnote-122) For example, in the Netherlands, financial institutions have been required to permit their board meetings to be observed by experts in psychology, governance and change management.[[123]](#footnote-123) The Dutch government has also introduced a mandatory “banker’s oath” for all employees in the financial sector requiring them to sign a statement emphasising their responsibility to act with integrity and care.[[124]](#footnote-124)

# Discussion and Conclusions

This paper presents a review of scholarly analysis of post-GFC regulatory reform and develops an integrative framework for assessing regulatory design (see **Figure 2**). It identifies three structural levels at which reforms are implemented as well as factors seen to hinder or facilitate the effectiveness of financial regulation. Many of these findings are pertinent to the situation in Australia following the Royal Commission into misconduct in the finance sector. Although the Commission was asked to investigate issues around consumer protection rather than broader macro-prudential reform, the resultant questions follow a similar pattern: should we alter the architecture, style or content of regulation? How can we mitigate any problems stemming from power and politics, regulatory boundaries and human behaviour? This Part 5 applies the integrative framework to the findings of the Royal Commission and considers how this might inform future regulatory reform in Australia.

In terms of the architecture of financial supervision in Australia, the Royal Commission reviewed the twin peaks model and recommended improved collaboration between ASIC and APRA including a duty to cooperate and mandatory information sharing.[[125]](#footnote-125) Here we see a new way of tackling the issue of blurred boundaries and fragmentation. Although each regulator will maintain its specialist focus the boundaries between them will be reduced rather than re-defined. The review of post-GFC literature would suggest this improved coordination may assist in reducing regulatory arbitrage.[[126]](#footnote-126) Commissioner Hayne also recommended that a new and permanent oversight body be established with a mandate to assess the effectiveness of ASIC and APRA in meeting their statutory objects.[[127]](#footnote-127) This again ought to help counter any boundary problems by providing overall oversight and a broader view of the regulatory playing field.[[128]](#footnote-128) Depending on its composition, the oversight body may also help to reduce the negative effects of power and politics.

Interestingly, Hayne considered altering the composition of the governing bodies of ASIC and APRA to include non-executive members. In light of his other recommendations this proposal was not put forward, yet the findings of this paper would suggest it is something that perhaps should be revisited as an additional mechanism to balance the effects of power and politics. Instead, Commissioner Hayne suggested that both ASIC and APRA should, in consultation with the oversight body, apply the tenets of the new Banking Executive Accountability Regime (the BEAR) to their own management structures to improve personal accountability.[[129]](#footnote-129) As will be discussed next, ASIC was heavily criticised during the Royal Commission hearings over its enforcement style. It became obvious that ASIC had, to some extent, been captured by the powerful ‘big end’ of town, failing to tackle the shortcomings of the major banks and focusing instead on small operators that were easier and cheaper to prosecute.[[130]](#footnote-130) Learnings from post-GFC literature would suggest that a new oversight body could have an important role in monitoring against ‘regulatory capture’ and ought to carefully consider the composition of ASIC and APRA’s governing bodies through the lens of power and politics.

Indeed, Commissioner Hayne expressly referred to theories concerning regulatory capture in discussing ASIC’s enforcement style.[[131]](#footnote-131) He questioned ASIC’s heavy reliance on negotiated compliance rather than public denunciation and punishment.[[132]](#footnote-132) As this paper has revealed, regulatory failures often result from the way discretion has been exercised within the existing regulatory system rather than the system itself. Although Hayne considered transferring ASIC’s civil penalty enforcement powers to an independent agency he decided against this on the basis of ASICs acknowledgement of a need for significant changes to its enforcement culture.[[133]](#footnote-133) It will be vital for any new oversight body to remain vigilant against regulatory capture and the effects of power and politics on enforcement strategy. The Royal Commission referred many times to Braithwaite’s pyramid of responsive regulation and there was consensus that although negotiated settlements have their uses, banks must feel threatened by court action if they are to take financial regulation seriously.[[134]](#footnote-134) If ASIC is to retain discretion over enforcement strategy its choices must be closely monitored.

Other changes to regulatory mechanisms can be seen in the Commission’s recommendations regarding industry codes. Hayne concluded that industry self-regulation in the form of codes, such as the Banking Code, should become enforceable. Academic theories of new governance, particularly the concept of meta-regulation, help to explain these practical developments. Financial regulation is becoming increasingly layered such that industry codes are approved and monitored by some sort of supervisory body and non-compliance can then result in sanctions, whether these be implemented through contracts or public law.[[135]](#footnote-135) Here we see a shift in the balance from private self-regulation to public enforcement yet in a responsive way, designed such that the stricter sanctions are used only when other options fail.[[136]](#footnote-136)

Problems around implementation of regulation were also revealed by the Royal Commission. Although post-GFC there was much activity internationally around improving culture and remuneration systems, these issues were still found to be at the core of misconduct in Australia. Commissioner Hayne observed that misconduct stemmed from at least four issues: firstly reward systems that incentivised pursuit of profit to the detriment of consumers, secondly, power imbalances due to information asymmetry between advisers and clients which were taken advantage of; thirdly conflicts of interest that were not managed; and lastly individuals and entities who were not held to account.[[137]](#footnote-137) We must first discuss the problems around reward systems because they have been raised so many times before.[[138]](#footnote-138) Why are incentive schemes still promoting bad behaviour despite significant international and national reform efforts?[[139]](#footnote-139) With hindsight it is thought that this was a problem of implementation: that the Australian finance sector interpreted the FSB principles on Sound Compensation Practices in a narrow way (looking primarily at financial rather than non-financial risks) and that this was permitted through a lack of adequate guidance from APRA.[[140]](#footnote-140) Here we see a strong disadvantage in the vagueness of principals and the level of discretion that they give to their targets. Learnings from post-GFC reforms help to classify this, not simply as a problem of drafting style but as a failure of outsourcing of implementation, including too much reliance on industry to interpret risk in its widest sense. Zalewska argues that due to the unique nature of the banking sector, remuneration systems in banks should not be treated in the same way as for other firms and require increased regulatory scrutiny.[[141]](#footnote-141) The literature therefore supports the Commission recommendations that call for improved supervision by APRA in this area. APRA has amended its Prudential Standard CPS 150 yet is still relying on self-evaluation and disclosure by regulated institutions.[[142]](#footnote-142) Improved monitoring efforts will be essential to support these changes and review their impact.

The Royal Commission placed a strong focus on behavioural incentives and culture within the finance sector.[[143]](#footnote-143) It identified greed, for personal wealth and organisational profit, as one of the main drivers for misconduct in the banking sector.[[144]](#footnote-144) Incentives inherent in remuneration schemes and investment markets were much stronger than any fear of consequences for misbehaviour. Thus market incentives were at odds with regulatory objectives such as consumer protection. Safeguards such as risk management and corporate governance failed to identify or prevent misguided decision-making and conflicts of interest. Although laws were in place to provide remedies they were not enforced by the regulator and penalties were seen to be too small to act as a deterrent. Much of this is rightly explained by culture: individuals not only weighed up economic advantages but followed norms of behaviour entrenched over many years. Commissioner Hayne advocated going back to simple principles with ethics at their core: obey the law; do not mislead; be fair; provide services that are fit for purpose; deliver them with due care and skill; and when acting for another, act in their interests.[[145]](#footnote-145) He has recommended extending the scope of the BEAR to assist in bringing personal accountability back into the equation.[[146]](#footnote-146)

What is clear from this review is that although most regulation is created to serve the public interest, it is often private interests that influence the style and form of a regulatory system and ultimately its effectiveness. These can include the private interests of political parties, industry groups, trade unions, consumers or investor groups.[[147]](#footnote-147) Also the interests of the individuals working in the finance industry who may be searching for wealth, thrills or simply a sense of belonging. Governments must facilitate competitive economic growth whilst also protecting public welfare.[[148]](#footnote-148) The initial political reluctance to initiate a Royal Commission on this issue demonstrates the ongoing need for vigilance against the immense power of the finance sector. It was only when the banks requested an inquiry that the politicians agreed. Levine describes the lack of public input (or input from democratically elected representatives) into financial policy and regulation as a key problem in finding an appropriate balance.[[149]](#footnote-149) The public hearings of the Royal Commission and its use of individual case studies have helped to bring the views of civil society into the reform debate. The ultimate purpose of financial regulation is to strike the right balance between ensuring the safety and fairness of the financial system and encouraging development of financial markets.[[150]](#footnote-150)

History demonstrates that much financial regulation is “a well-meaning but hasty overreaction to an unfortunate episode”.[[151]](#footnote-151) The aim of this paper is to try to mitigate this kind of reaction by drawing out common factors impacting on regulatory effectiveness that may guide future policy-making. A regulatory regime must take into account the limits of existing architecture, the political situation, powerful actors and the incentives likely to drive behaviour. Regulation, whether hard or soft, needs to carefully alter incentives in order to align public and private objectives. If the finance industry fails to self-regulate in accordance with public policy goals it must expect interference in its freedoms.[[152]](#footnote-152) Thus a responsive system of escalating interference is likely the best solution to many of the regulatory dilemmas explored in this paper.[[153]](#footnote-153) Following the revelations of the Royal Commission, the Australian finance sector will find itself monitored much more heavily with increasing consequences for misbehaviour.

**Table 1: Regulatory reform topics**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Topic** | **References (total 178)** | **% of papers (total 122)** |
| 1 | Systemic risk and regulation of institutions deemed ‘too-big-to fail’ | 21 | 17 |
| 2 | Banking regulation - the Basel Committee and its Basel III regulatory framework | 14 | 11 |
| 3 | Shadow banking and hedge funds | 10 | 8 |
| 4 | Derivatives markets including OTC derivatives and credit derivatives | 24 | 20 |
| 5 | Credit rating agencies | 27 | 22 |
| 6 | Corporate governance and executive remuneration | 21 | 17 |
| 7 | Consumer protection and accounting standards | 11 | 9 |
| 8 | Financial regulation overall | 50 | 41 |

**Figure 1: An overview of the systematic review process**

**Establishing the research question**

What factors are thought to impact on the effectiveness of post-GFC reforms?

**Search: Initial inclusion criteria**

**Sources**

Google Scholar

EBSCO

Lexis Nexis

**Keywords and search strings**

‘global financial crisis’ AND regulat\*

‘financial crisis’ AND regulat\*

**Time period**

Jan 2008 to Dec 2016

**Total items sourced**

839 items

**Type and Title screening**

Journal articles only

Regulat\* in the title

**152 items**

**Quality and focus screening**Schimago journal ranking

Full-text analysis

**120 items**

**Data analysis**

Initial coding categories piloted by two individuals

Subsequent validation through cross-comparison and refining of categories

**Figure 2: An Integrative Framework for Assessing Regulatory Design**

Power and politics

Boundaries

Architecture

Process/Style

Drafting style
rules/principles

Implementation style
supervision/outsourcing

Enforcement style
sanctions/incentives

Content

Assumptions about behaviour

Budget

Lobbying

Mandate

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