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Financial regulation in the crisis regulation, market discipline, internal control: the big three in turmoil

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Abstract. The financial crisis has revealed the dysfunction of all banking and financial regulatory mechanisms. *Prudential regulation* failed to prevent the meltdown. *Market discipline* neglected to send any warning signals. *Internal control* was seriously undermined by doubtful dealings, in France as elsewhere. Does the crisis call the big three into question? No regulation mechanism is omniscient, whether it be state, market or self-regulation. As such, none of three can operate without the other two, with the corollary that they can only function together. It means that splitting up the big three can therefore not be the answer to the crisis. By contrast, since each one of them has shown its weaknesses, the only solution is to work on reinforcing each one. Unfortunately there is no guarantee that the reforms go far enough.

JEL Classification: G01; G18; G21; G38
Keywords: Prudential Supervision; Market Discipline; Internal Control; Financial Regulation.

Résumé. La crise a révélé les failles de l'ensemble des mécanismes régulateurs de la finance mondiale : la réglementation prudentielle a échoué dans sa mission de prévention, la discipline de marché n'a pas envoyé les signaux d'alerte qu'on pouvait en attendre et le contrôle interne a été sérieusement écorné par des affaires retentissantes en France comme ailleurs. La crise remet-elle en question ce triptyque et condamne-t-elle à faire entièrement reposer la régulation financière sur la seule action des pouvoirs publics ? Si l'on part du principe qu'aucun mode de régulation n'est omniscient, pas plus l'État que le marché ou l'auto-contrôle, alors aucun des trois ne peut fonctionner à l'exclusion des deux autres. Défaire ce triptyque ne peut donc pas constituer une réponse à la crise. Mais puisque chaque bras du triptyque a montré ses faiblesses, il convient de travailler au renforcement de chacun. À cet égard, il n'est toutefois pas garanti que les réformes aillent assez loin.

Classification *JEL* : G01 ; G18 ; G21 ; G38
Mots-clefs : Supervision prudentielle ; discipline de marché ; contrôle interne ; régulation financière.

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1. Introduction

The financial crisis, born in the summer of 2007 and still arguably alive in 2010, has revealed the dysfunction of all banking and financial regulatory mechanisms. Prudential regulation failed to prevent the meltdown. Market discipline neglected to send any warning signals – low risk premiums, high ratings. Internal control was seriously undermined in France by doubtful dealings such as the Société Générale, Caisse d'épargne and Madoff affairs on a larger scale. The big three are nevertheless the basis for today's financial regulation and this situation is the result of a slow process of evolution.

The reforms that gave rise to "financial safety nets" in the 1930s in the United States – *e.g.* the 1933 *Banking Act* – then in post-war Europe and in Japan were all initially inspired by the desire to replace dysfunctional market regulation. The resurgence of economic imbalances in the 1970s did, however, give financial operations a massive shot in the arm. Three factors brought about new financial needs and prompted the creation of new financial products and new markets: first, the petrodollars from the oil-price shocks, recycling surpluses from oil-producing countries; second, the unstable interest rates subsequent to post oil-price shock inflation and the monetary change in course in the United States in 1979 with Paul Volker's arrival as head of the Fed; and third, the fluctuating exchange rates related to the collapse of the *Bretton Woods* system in 1973. The boom in the capital market then automatically caused banking activity to evolve and the regulatory framework of the banking sector necessarily had to adapt accordingly. The new regulation, termed "prudential" (minimum capital requirement), set up from the end of the 1980s, no longer attempted to substitute for the market mechanisms, but rather to limit risk taking by banks. Market logic gradually found its place again in the banking sector, with the suppression of credit constraints, the liberalization of rates and the privatization of financial institutions among others, and held financial institutions to the relevant potential sanctions, such as investors' demand for profitability, threats of buyouts, and the variability of resource costs. Rising risks also made banks more sensitive to the need to manage risks and prompted bankers to adopt suitable evaluation and risk management tools. Along the way, internal control was developed to the extent that major international banks endeavoured to get international authorities to recognize the use of these tools. From the mid-1990s, the Basel Committee on Banking Supervision recommended authorizing banks to use their internal "value at risk" models to calculate their capital needs. As a result, the relationship between regulation, internal control and market discipline gradually grew stronger.

Does the crisis call the big three into question? Will it entail massive backtracking in regulation? In order to answer these questions, let us begin with a simple principle put forward by the 2009 Nobel economics Prize Oliver Williamson in analyzing governance modes. No regulation mechanism is omniscient, whether it be state, market or self-regulation. As such, none of three can operate without the other two, with the corollary that they can only function together. Splitting up the big three can therefore not be the answer to the crisis. By contrast, since each one of them has shown its weaknesses, the only solution is to work on reinforcing

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