Bank i Kredyt 44 (2), 2013, 119-158

BANK I KREDYT
BANK & CREDIT

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Regulation and self-regulation in banking: in search of optimum

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Submitted: 4 May 2012. Accepted: 8 February 2013.

Abstract

The paper explores the nature of regulation in the banking sector and considers the following regulatory *continuum*: from free banking through self-regulation to supervisory regulation. Because the state's responsibility for the functioning of the financial system requires the state to enact laws forming the system's legal framework, *laissez-faireism* in banking is not possible. Nevertheless, the modern regulatory dialectics – liberalisation and deregulation alternating with re-regulation – brings up the issue of possible advantages and disadvantages (benefits and costs) of the two approaches for the economy. Overregulation is costly, but lenient regulations may undermine economic stability. This means that a subtle balance between under-regulation and overregulation in the banking sector should be sought. There is a need for well-balanced proportions of legal standards and voluntary, negotiated rules. As perfect regulations do not exist, an effective and generally accepted legal framework must be created for the banking system, strengthened by the imperatives of ethics.

Keywords: banks, regulations, self-regulation, financial system safety

JEL: G28, G19, G21

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1. Introduction

The sector of financial institutions – including the banking sector – must comply with many regulations whose primary aim is to reduce the systemic risk (i.e. to make the system safe and credible) and to protect consumers, particularly depositors (Santos 2001; Matthews; Thompson 2007, p. 189).

Although central to market safety, banking laws are only one of its pillars. Institutional and legal solutions become more effective owing to self-regulation, financial awareness of customers and market discipline, which are termed private supervision (Iwanicz-Drozdowska 2008, pp. 31–33).

A financial system is as solid as the practices that govern it, the financial stability of its institutions and the efficiency of its market infrastructure. The responsibility for creating and implementing good governance practices is shared between market regulators and market players (Das, Quintyn 2002, p. 163). However, a single, effective solution that might shield a financial sector against corporate governance challenges does not exist. Both empirical studies and theoretical analyses agree that the banking sector needs more efficient regulatory supervision to strengthen its corporate governance, but private supervision improving transparency, market competitiveness and owners' commitment must also be supported (Litan, Pomerleano, Sundararajan 2002, p. 13).

It is frequently argued that the scope and costs of regulation in banking have already surpassed their rational level, that new regulations should be less frequent and that those in force need to be cut down and consolidated (Claessens 2006; Hartman-Wendels, Pfingsten, Weber 2007, pp. 369–371). At the other end, though, there is a large group of opinions calling for the tightening of the standards and restricting bank managers' decisional freedom. These opinions are based on arguments derived from studies pointing to a higher risk of banking crisis in countries with liberal financial systems (Demirgüç-Kunt, Detragiache 1998).

One of the most important goals guiding both regulation and self-regulation mechanisms in the banking sector is to safeguard the financial system. However, "the safety of financial services" is differently understood, so it is differently accounted for in the aims of particular groups of stakeholders (Table 1). The heterogeneity of approaches causes that various stakeholders have their unique expectations and ways of achieving their aims. Consequently, the necessary standards that banks should follow in their business are also looked at from different angles.

This article discusses the nature and the optimal scope of regulation and self-regulation, which calls for exploring the impacts of formal regulations as well as the efficiency of solutions negotiated by financial institutions. The ultimate aim of the article is to determine the optimal proportions of regulation and self-regulation.

The paper is structured as follows. Section 2 presents the issues of free banking; the critique of that system leads to conclusion, that some kinds of regulations are needed. Therefore section 3 explains why regulations are applied. Section 4 outlines the consequences of regulations and – based on that – presents which regulations are most desirable. Section 5 presents the issue of "regulatory dialectics" and the risks connected with dynamic approach to a legislative process: overregulation and under-regulation. Section 6 presents the issue of self-regulation (soft law), being a necessary element of a stable and sound financial systems and institutions. Sections 7 and 8 discuss the corporate governance and regulatory recommendations as a halfway between the regulations and self-regulation. Section 9 discusses the problem of seeking optimum between regulation and self-regulation and therefore section 10 describes the *continuum* of regulation and self-regulation in the banking sector. Section 11 points the key post-crisis challenges and formulated principles to guide the construction of regulations today. Last section draws conclusions and discusses the possible boundaries between regulations and self-regulations and stresses the importance of ethics as the fundamental building element of a stable and responsible financial system.

2. Free banking

"Free banking", sometimes called *laissez-faire banking*, describes a market-based, decentralised approach to money (White 1993; Dowd 1996).[1] In this concept, monetary authorities do not exist and private banks are free to issue bank notes and to take deposits. It is up to the banks what policies on liabilities (money and deposits) and asset portfolio construction they will implement, and the few laws that exist are intended to protect against frauds and the non-fulfilment of contracts. This system has neither entry barriers (regulatory or capital requirements) nor constraints that might exclude some types, purposes or structures of investment. The advocates of *laissez-faire banking* maintain that central banks, banking supervisors and regulations are the main source of problems impairing the functioning of banking systems. Accordingly, free banking in its pure (perfect) form has no regulations or restrictions, no central bank (particularly one acting as a lender of the last resort) and no deposit insurance (guarantee) system; the scope and types of business can be chosen at will, and price control is not imposed. This is a picture of a banking sector completely free from any regulations.

Free banking in its "pure" form is only a theoretical concept that has never been put into practice with the exception of certain historical experiments involving some variants of *laissez--faire banking*, such as Scottish banking in the 18–19th century or a 25-year period in the US history in the 19th century. As both these experiments somewhat differed from what one might call "full-fledged" free banking, its advocates defend it by stressing that they merely resembled true *laissez-faire banking*. This attitude allows them to keep developing the concept and to propose various models within its framework (Sechrest 2008; Rothbard 2007).

For those who oppose free banking, the key arguments are the following: money is a public good, so it cannot be produced at a profit in a free market; significant external effects may lead to suboptimal private money balances; money production is a natural monopoly; competition in money will lead to huge inflation; free banking is ineffective (as the available resources are wasted); privately produced moneys suffer from serious counterfeiting problems; the lender of the last resort (a central bank) must be in place to prevent crises or make their impacts less painful (Sechrest 2008). But the ultimate argument they reach for is that a free market is unable to prevent financial crises from happening and to make banks stay away from risky operations, thus failing to safeguard the financial system. In the opinion of the opponents of *laissez-faire banking* all these circumstances explain why regulations and supervision must exist.

[1] The creators and representatives of the school of free-banking there are, among others, Hayek, White, Selgin, Dowd; one of its other strand is represented by Glasner, Greenfield, Yeager, Woosley, von Mises.

The market-based alternatives to formal regulations issued by the state (such as the involvement of the private sector institutions, e.g. rating agencies) are faced with a different set of problems, mainly the possibility of the conflicts of interests (Tomasic 2011, p. 52).

There are concerns that deregulation and liberalisation that we have witnessed in the last decades may revive the era of free banking. Hypothetically, the worldwide competition of regulatory authorities striving to encourage businesses (also financial) to relocate to other countries may result in regulatory arbitrage called "regulatory dumping" (Sachdeva 2010). In the extreme cases, the awareness that less stringent legal requirements are more attractive for businesses may ultimately lead to their total abolishment.

Goodhart, Hartmann and Llewellyn (1997) argue, however, that a "no-regulation" risk does not exist today, because the competition among regulatory regimes is not likely to cause the complete atrophy of legal standards. Countries with weaker (less stringent) legal requirements will be at a disadvantage for as long as customers need financial services, because stricter rules will be in demand to strengthen customers' confidence in financial organizations. With regulatory arbitrage being blamed as one of the causes of global financial crises, including the most recent one (Davis, Karim 2010; Boorman 2009) and considering their costs, it becomes desirable not only to make regulations tighter, but also to harmonize and converge them, and even to introduce the global supervisory and regulatory architecture (Moshirian 2011).[2]

3. Why banking regulations are applied

The advocates of imposing legal restrictions on banks (as well as financial institutions) mostly point to the state's responsibility for determining the foundations of the financial system representing a vital component of the national economy, which, quite naturally, involves the enactment of laws governing banking business. The state regulates the banking sector to stabilize the financial system and to ensure monetary control, money supply and stability of prices, equal competition opportunities and pro-consumer competition in the market for financial services (Szpringer 2001).

The literature mentions two basic reasons underlying the introduction of banking regulations, namely (Santos 2001; Matthews, Thompson 2007, p. 189; Llewellyn 1999):

– the need to ensure that both particular financial institutions and the whole financial system are sound and safe; regulations are necessary to reduce the systemic risk – when a bank goes bankrupt the whole economy must pay many costs and in the extreme cases a crisis may hit the entire financial system, posing a threat to the stability of the economy (national or even global);

– the need to protect customers (mainly depositors); with limited strength in the market, low competencies and few opportunities to monitor financial institutions, consumers are vulnerable to monopolistic practices; therefore, there must be some special supervisory authority to monitor the market, and, additionally, laws must be made to narrow the range of risky options banks might wish to take.

[2] Bankers themselves admit that global harmonization of regulations is necessary to prevent some markets from reaping unfair benefits (79% of answers); only 14% of them are of the opinion that the current worldwide approach to regulation is sufficient to considerably reduce the probability of another global crisis (E&Y 2010). At the same time, most respondents in another E&Y survey (from 70% to 100% depending on the country) answering the question about whether international coordination of regulations had improved admitted that international dialogue became closer, but a coordinated programme was not established (Hart 2012).

Two types of banking regulations have developed over time (Llewellyn 1999):

– structural – protecting the banking market structure via licensing policies, control of market concentration, deposit guarantees, etc. – that lay out operational rules telling financial institutions how to deliver their services;

– prudential – intended to safeguard the banking business and to protect individual entities from going bankrupt (their range includes risk-restricting measures, capital as well as informational requirements, etc.).

The main issue within structural regulations is the provision of a so-called safety network to protect the banking system (or, generally speaking, the financial system) against crises or, should they materialize anyhow, to manage them and moderate their impacts, and to reduce systemic risk.

However, the introduction of banking regulations brings on at least two types of distortions (Freixas, Rochet 2007, p. 340):

– the availability of a safety system may encourage bank managers to get involved in riskier operations, so more rules will be necessary;

– if some types of banking business are not regulated, the government may decide to introduce banking regulations for reasons other than the safety and soundness of the sector, e.g. some form of direct taxes (for instance obligatory reserve) or an obligation that banks subsidy some of their products.

The key issue in seeking the optimal shape and scope of banking regulations is the trade-off between safety and efficiency, prevention of bankruptcies and promotion of competition, but also between the stability and profitability of the banking business, on the one hand, and the competitiveness of this sector and the national economy, on the other (Szpringer 2001, p. 34).

A well-regulated and supervised financial system plays a key public function: it has the power (authority) and if the leaders have the will to use it, this system may allocate savings and investments to economically productive activities and help prevent financial contagion (crises). As in the case of any other type of management involving complex risks, a "cristal ball" may not be a single source of financial regulations, but a variety of interrelated instruments for handling different risks is necessary (Moyer 2010).

4. The consequences of banking regulations

The economic perspective requires that regulation be judged not only on its fairness, but also with respect to its costs where the efficiency and benefits of regulation must be taken into account[3] (Marcinkowska 2010). Accordingly, stability, fairness and effectiveness of financial regulations are the key evaluation criteria of regulation (Long, Vittas 1991).

The process for assessing regulatory efficiency and payoffs is neither easy nor objective, because it will never be certain whether banks behave properly and responsibly only because of

[3] This field is covered by the economic analysis of law (more in Cooper, Ulen 2009; Golędzinowski 2009). Some economists tend to assess only the efficiency of regulation (in the sense that is maximizes wealth). However, treating economic efficiency as a sole criterion for assessing regulations ignores the fact that economy itself is involved in the social, cultural and ethical goals and values, and regulations should allow evaluation of economic behavior through the lens of these values (Baldwin, Cave, Lodge 2012, p. 25 and Szpringer 2009, p. 91).

the laws in force and whether the situation would be different otherwise.[4] Besides, the occurrence of some specific results of regulation depends on many factors, mainly on the degree of cohesion of the entire legal system and the efficiency of financial supervision, but also on the maturity of the economy and the development level of the financial system and its structure.

Research on the impact of regulation on the economy is conducted for many years, focusing mainly on regulatory costs, impact on productivity, growth and competitiveness. The conclusions are diverse – they indicate that the regulations may affect these factors either positively (e.g. supporting competitive markets and protecting intellectual property) or negatively (e.g. by diverting resources away from more productive uses, raising barriers to entry into industries and producing disincentives to investment and innovation) (BERR 2008). Regulations usually have negative impact on growth (Loayza, Oviedo, Serven 2005; Gorgens, Padam, Wurtz 2003; Nicoletti, Scarpetta 2003; Gelauff, Lejour 2006). It is pointed, that regulatory environment can contribute significantly to economic development and sustainable growth – it requires improving the openness of international markets and creating a less constricted business environment for innovation and entrepreneurship (LBRO 2012).

Most regulatory benefits are indirect and difficult to quantify (e.g. “safer consumers” or “lower probability that a bank will go bankrupt or that the financial system will implode”). As a way of dealing with the quantification problem, a comparative approach is proposed and a ranking of the benefits that might be reaped if different legal solutions were introduced (Alfon, Andrews 1999).

Despite the problems in determining the quality of regulation and supervision and the subjective nature of the process, one IMF study suggests that higher quality of banking regulations is correlated with better performance in the sector (Čihák, Tieman 2008).

Empirical studies support the thesis that some regulations (particularly deposit guarantees) make the bank-run risk and the threat of a systemic crisis less probable (Matthews, Thompson 2007, p. 192). At the same time, though, the presence of a deposit guarantee system may encourage banks and their customers to take moral hazards. These circumstances cause that researchers try to establish which regulations achieve their goals and positively stimulate banks and financial markets. According to the literature, the most desirable banking regulations are those that (Benson, Kauffman 1996; Wall 1989; Calomiris 1999; Tobin 1985):

– prohibit operations exposig banks to excessive risk,
– introduce mandatory monitoring and control of bank’s risky operations,
– require banks to have capital adequate for their risk exposure (to absorb possible losses),
– make the issuance of subordinated debt mandatory,
– restrict membership in the deposit guarantee system and the eligibility for the services of the lender of the last resort,
– impose transparency of information.

Regulations and protection of the financial system come with costs (Freixas, Rochet 2007; Matthews, Thompson 2007, p. 189; Szczepańska 2008, p. 45), These are:

– direct regulatory costs, i.e. costs necessary to create and enforce regulations and the costs of assistance when crisis comes,

[4] One of the examples available in the literature shows changes in bank capital ratios before any regulations were applied and after the introduction of successive requirements. See, for instance, Matthews, Thompson (2007, p. 207); Berger, Herring, Szegö (1995); Marcinkowska (2009b, p. 75).

– compliance costs (usually paid by the final users of financial services),

– bureaucracy (administration) costs of the system (mostly paid by public institutions),

– non-quantifiable costs of changes in the conduct of organizations – moral hazards and free riding,

– costs of lower efficiency of the overregulated system and sometimes of less dynamic business innovation,

– fixing costs (if regulations are found inefficient).

There are also the costs that the general public pays due to banking restrictions, such as higher prices of banking products or their availability constrained by regulatory requirements.

Too restrictive regulations may sometime render the delivery of financial services ineffective and the burden of additional costs and inefficiencies is usually transferred onto consumers. Overregulation may also make financial services less accessible.[5] According to OECD (2006) some regulations are hampering the development of financial systems, resulting in a weakening economic growth. The empirical analysis suggest that the financial system regulation matters for output growth both in a statistical and economic sense (de Serres at al. 2006).

Regulatory costs are as difficult to quantify as regulatory benefits. The marginal regulatory costs (which would not be paid if not for the forced compliance with certain regulations) are sometimes determined from questionnaire surveys.[6] This approach does not make their verification and confirmation much easier, because they reflect then subjective judgments of the regulated organizations that are usually interested in exaggerating their burdens.

The main issue in the economic analysis of regulations is to ensure that the private (and public) costs and the public (and private) benefits are appropriately balanced. One of most important goals in regulating financial institutions is to make them safe and to avert financial crises that invariably involve high costs (sometimes called the deadweight loss). The costs of economic incentives being distorted by regulations and administrative costs are also raised (Klapper, Zaidi 2005).

It has been generally observed that when the market entry is costly regulations tend to improve the well-being of consumers (although the overall effect of regulation is not unambiguous), but when barriers do not exist the costs of regulations exceed their benefits (Johnson 2009).

Interestingly, stricter restrictions do not always discourage banks from taking on excessive risk. As found, in countries with many regulations the risk of crisis may be greater (Barth, Caprio, Levine 1999). Wider research has confirmed that the probability of crisis is smaller in countries that have more concentrated banking systems, less restrictive banking and competition rules, and institutions that foster competition (Beck, Demirgüç-Kunt, Levine 2003).

The analysis of banks' performance between 2007 and 2009, i.e. in the period of the global financial crisis, has not clearly explained which legal systems made the crisis less painful. As reported, high levels of government and fiscal freedoms resulted in higher banking index returns, while high levels of financial freedom from regulation offered smaller returns (marginally significant). This proves that a mere tightening of financial regulations neither lessens the risk of crisis, nor reduces the scale of its impacts (Johnson 2011).

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[5] The authors stress, however, that standards should not be judged on a stand-alone basis, as they reflect a broader issue of the country's view on private ownership and competition (Demirgüç-Kunt, Leaven, Levine 2003; Claessens 2006).

[6] For instance, Deloitte (2006); Allen at al. (2008); Grant at al. (2011).

According to a World Bank study on bank capital regulations (Barth, Caprio, Levine 2008), their restrictiveness is of little effect on the growth, productivity and stability of banks, and on their management.[7] The data on most countries examined in the study have shown that the tightening of institutional banking supervision in line with the guidelines of the second pillar of the Basel II (New Basel Capital Accord) is frequently counterproductive. The study has confirmed, however, that market discipline (the third pillar of the Basel II) is effective, thereby pointing to higher efficiency of formal supervision combined with private monitoring.

The supervisors carry the responsibility for finding efficacious legislative solutions which would motivate banks to stay within the prescribed safety limits (but without restricting their competitiveness too much and without driving the costs up), as well as creating environment conducive to private monitoring and corporate governance.

5. Regulatory dialectics

In the history of economy periods of strict regulations alternate with periods when they were liberalised. This mechanism is explained by Kane's "struggle model" presenting the concept of "regulatory dialectics" based on Hegelian dialectics (Kane 1987, p. 114). According to Hegel, change consists of three stages that he calls thesis, antithesis and synthesis. Thesis and antithesis battle with each other leading to synthesis that becomes a new thesis giving rise to antithesis and the process of change (struggle) starts over again. The relations between regulators and banks can be described in a similar manner: the two parties are in a permanent conflict with each other. When regulators strive to impose new restrictions on the financial system (e.g. control of interest rates, products, lines of business), the regulated organizations pursuing their own goals (such as shareholder value maximisation or maximisation of profits) try to dodge them. Being more agile than the bureaucratic institutions, they usually manage to find loopholes in the laws that restrict them, so regulators make new attempts to close them. The good side of regulatory dialectics is that it drives innovation and the development of financial institutions (Sinkey 2002, p. 571). However, it also generates some costs that could be otherwise avoided, thus deteriorating the overall performance of banks.

Goodhart (1981) has formulated a similar concept, where all central bank's attempts to place restrictions on banks encourage them to venture into the unregulated areas.[8]

The political and public thinking about the introduction of legal standards is strongly determined by economic circumstances – when the economy is rising, the laws tend to be more relaxed, while an economic downturn makes it more probable that they will be tightened up. Particularly in the periods of crisis the tightening of regulations ("re-regulation") is rapid and thorough.[9]

[7] It is worth noting here that particular countries operate different banking regulations because they have their specific visions of the state's role in the economy.

[8] Goodhart's law (originally published in 1975) actually deals with central bank's activities within monetary policy (he noticed that when regulatory policy focuses – for control purposes – on certain indicator that has a relationship with another variable, the so far observed statistical regularity will tend to collapse), but after generalisation it allows drawing similar conclusions on all banking regulations.

[9] Many studies have documented a boom-bubble-bust-regulate cycle in financial markets (see Braithwaite 2008, p. 33 for further discussion). Imposing new regulations within this cycle is associated with the risk of short-termism, (especially after the recent global financial crisis there were many votes that the regulations were tailored to solve short-term problems without considering long-term effects and that in fact instead stabilizing financial system, they can generate higher risks (see Kasiewicz, Kurkliński 2012, p. 13–14).

A dynamic approach to a legislative process reveals its cycles with phases of regulation (when standards are made stricter) and deregulation (liberalization). This oscillation involves two risks, one being the possibility that an excessively regulated system will be established ("overregulation") and the other that the legal standards will turn out insufficient ("under-regulation") see Figure 1.[10] This swinging between the two extreme points may pose a threat to the economy, because both shortage and excess of legal standards generate costs.

Another issue is that the quality of the statute law is sometimes low, so it not only fails to perform as expected, but even produces adverse consequences. Sinkey (2002, p. 571) has compiled a list of banking laws in the USA which were introduced after 1863, finding that many of them were enacted to moderate the unexpectedly negative impacts of their predecessors that were introduced in good faith.

The consequences of financial system deregulation and liberalization are viewed differently. Generally, the processes help banks become more efficient and drive the development of financial markets, but they also produce negative effects and bring on disadvantages, e.g. higher interest rate, but mainly greater risk exposure of banks (Matysek-Jędrych 2008). This excessive freedom granted to banks is blamed for financial crises. It is worth noting however, that some argue that the recent crisis has its causes not in deregulation itself, but rather in the inability of regulators to keep up with financial innovation (Beck 2010).

6. The self-regulatory capacity of the banking sector

Self-regulation is based on negotiated and voluntarily adopted codes of good practice or other informal rules, so it is frequently termed "soft law".

"Soft law" is a capacious term applying to self-regulation, voluntary regulation, co-regulation, quasi-regulation, and private governance. It can be defined (Mokrzysz-Olszyńska 2007):

– broadly – than it stands for all rules of conduct other than formal laws, administrative regulations and agreements, or

– narrowly – when it is understood as a set of instruments developed by professionals on their own initiative, in cooperation with consumers and/or the state, or following an authorization granted by the state, and then implemented based on an agreement.

For self-regulation (defined as voluntary rules of conduct) to be effective it must be supported by self-control understood as a system ensuring compliance with the adopted rules. Both these elements together create self-discipline (Rutkowska-Tomaszewska 2010).

There are opinions that self-regulation is one of the pillars holding up western philosophy of regulation. The wave of deregulation that we have witnessed in the recent years by no means substantiates the view that the banking system has been deregulated and that the future of banking depends lies in self-regulation.

The opinions on self-regulation are sometimes extremely diverse (Davies, Greek 2010, pp. 251–252). Its advocates stress that its instruments are more flexible (faster developed, implemented

[10] Although the graph generally points to the expansion of regulation, the changes in both phases do not have to be alike, in fact, deregulation may be deeper than during the previous phase of prosperity, and the following re-regulation may not always aim to impose stricter legal standards than those established during the previous downturn.

and corrected) and better adapted to the needs and circumstances of particular entities and markets. They also indicate that voluntarily developed and adopted rules are more likely to be honestly implemented.[11] Those who disapprove of self-regulation argue that the full-scale implementation of the negotiated standards and their effective enforcement is difficult (if at all possible). Neither should it be forgotten that particular entities participating in these systems have their specific visions and objectives that translate into unique strategies of competition and different willingness to cooperate with other organizations. The efficiency of self-regulation depends on the players' will to work together to make their sector reputable and stable.

Four models of self-regulation have been distinguished (Davies, Greek 2010, p. 253):

– "pure" self-regulation – the players develop their rules themselves and obey them voluntarily (independent of formal regulations or laws, and without the involvement of public administration);

– self-regulatory organizations – these entities are responsible for the functioning of the adopted regime, but a regulatory mechanism for recognising principles (as sector-wide standards and codes of good conduct) also exists, and thereby supervisory support for the enforcement of law;

– self-regulation positioned at the top of the regulatory regime – ethical conduct and customer relations standards are added to the formal regime for the purpose of meeting legal requirements;

– market players contribute to the development of the statutory regime by participating in consultations or by having a formal role in the process.

The above list shows that self-regulation does not necessarily mean complete deregulation and *laissez-faireism*. Rather than that there exists some regulatory-deregulatory *continuum* made of appropriate proportions of laws, soft law (recommendations) and negotiated codes and standards.

Self-regulation – either existing alone or being partially incorporated into governmental regulation – rests on considerations of expertise (self-regulatory bodies usually posess higher levels of knowledge end expertise than regulators) and efficiency (the potential of self-reguation to produce controls efficiently, due to low costs of acquiring information and lower costs of monitoring and enforcement). On the other hand, worries about self-regulation concern: mandates, accountability and the fairness of procedures (Baldwin, Cave, Lodge 2012, p. 139).

The support for deregulation and self-regulation comes from the concept of market as the most effective and rational mechanism for allocating resources, monitoring corporations and disciplining them if they underperform or show inappropriate conduct. The neoclassical economists believe that the pressures from the corporate control market, capital market and the managerial labour market are the most powerful force balancing the interests of managers and owners. Market governance is perceived as the best choice, because of institutional imperfections and the shortcomings of hierarchical governance. It must be noted, however, that the key assumption about market being effective and rational has attracted criticism as simplified and empirically ungrounded. The efficient market hypothesis depends on an even flow of information through the market, so transparency is a necessity (Sun, Stewart, Pollard 2011, p. 10).

It is worth noting at this point that market competition has made rating agencies – treated so far as impartial institutions fostering market transparency, safety and efficiency – more vulnerable to pressures from their clients, which in many cases has led to frauds or breach of standards at best (as the ratings given to some financial instruments inadequately represented their risk,

[11] One reason is that an entity breaking "the club rules" tends to be more stigmatized than one breaching formal laws (whose rationality is sometimes questioned).

investors were exposed to losses). These circumstances has led to a conclusion that not only can competition and self-regulation not be treated as substitutes for regulation, but the mounting market competition makes it even more urgent to tighten prudential standards and institutional supervision of financial organizations (Coffee 2009).

The efficiency of self-regulation depends on the degree of responsibility among the financial market players and on the level of development of financial markets. The weaker the ethics and the greater economic expectations of the players, the less efficient self-regulation is. But the more developed financial markets, the more intricate new financial instruments and the less conservative financial institutions, the higher the risk that self-regulation will fall short of expectations.[12]

The examples of good practice codes include branch standards developed by industry-based organizations, self-governed associations, or associations bringing together professionals in particular occupations or economic sectors. These negotiated and voluntarily adopted initiatives addressed to institutions and/or their personnel are typical instances of self-regulation. They may apply to:

– an industry (e.g. advertising business),

– entities operating in some sector or of a given type (financial businesses, listed companies, financial markets, etc.),

– employees in some sectors or occupations (e.g. accountants, business consultants).

The first category of principles can be illustrated with the Kodeks etyki reklamy (Code of ethics in advertising) that the Rada Reklamy (Advertising Council) and Komisja Etyki Reklamy (Advertising Standards Board) have developed to draw a line between the acceptable and the unethical in advertising and to regulate all aspects of communication in this industry, while respecting the special character of different media (Rada Reklamy 2008).

An example of principles addressed to the financial sector is Kanon dobrych praktyk rynku finansowego (The Canon of good practices of the financial market) promoting professionalism and ethical values that should guide entities offering financial products or services.[13] The Canon is a negotiated initiative[14] that the KNF (Polish Financial Supervision Authority) has recommended for adoption by all financial businesses (uchwała 99/2008) as well as many institutions and organizations in the industry.[15]

Another, somewhat broader example is Kodeks postępowania i praktyki rynków finansowych (The model code. The international code of conduct and practice for the financial markets) which covers a wide range of matters within the inter-bank market (i.e. all unregulated markets) as well

[12] Cukierman (2011) uses the example of Canada and USA. He suggests that self-regulation may be more successful in Canada where banks are less innovative and have more conservative credit policies, and still Canada is doing much better than the USA despite a very large volume of subprime loans.

[13] The Canon provides principles on integrity, care and competence, dignity and trust, resources and procedures, internal relations, prevention of conflicts of interests, information from customers, security of customer information, information for customers, division of services, honest advertising, customers' complaints, mutual relations and fair competition, settlement of disputes, actions for market development and on the implementation of the Canon.

[14] The Canon of good practices of the financial market has been developed as a cooperative effort of thirty organizations associating entities offering financial products and services, organizations and institutions representing customers, and other market institutions, with the support from academic experts; http://www.knf.gov.pl/dla_rynku/kanon_praktyk/index.html.

[15] Including Polish Bank Association, Polish Institute of Directors, Financial Advisory Firms' Association, Polish Association of Brokers and Investment Advisors, Association of Individual Investors, Conference of Financial Companies in Poland etc.; http://www.knf.gov.pl/dla_rynku/kanon_praktyk/deklaracje_stosowania_KDPRF.html.

as instruments operated by bank treasury departments (currency transactions, money market transactions, options, futures, swaps, etc.).[16]

From the banking business perspective, Zasady dobrej praktyki bankowej (Principles of good banking practice) adopted by Związek Banków Polskich (the Polish Bank Association, PBA) are important (ZBP 2011). This document sets out good conduct guidelines for banks and their personnel (as well as other persons acting on behalf of banks) to follow. The matters covered by the guidelines include banks' conduct in contacts with their customers, personal data processing, the handling of customers' grievances and complaints, advertising, inter-bank relations and the rules of conduct for bank staff. The PBA's Banking Ethics Commission is responsible for judging if banks comply with the guidelines.

It is indicated that companies' codes of ethics may be an effective instrument of governance. The codes seem to be particularly important when other instruments (the market itself, government interventions, public attitude to ethics, etc.) fail to produce socially optimal effects (Thomson 2011). Regulations are not always effective and in some cases they do not help companies increase their value. It is frequently found that managers' ethics, ethical education or social norms offer better results than strict laws (He, Ho 2011). But codes of ethics alone, although designed to influence human behaviour and attitudes, shall not replace morals, culture and character (Razaee 2007, p. 440).

7. Codes of good corporate governance practices – between regulation and self-regulation

The importance of corporate governance as a determinant of responsible conduct of banks has been given much attention in recent years. It is stressed that effective corporate governance practices are central to winning and retaining public confidence (in individual banks and in the banking system as a whole), which is necessary for the financial system and the economy to function (BCBS 2010a; 2010b).

According to the OECD's fundamental document on corporate governance (OECD 2004), "[t]he corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities".

A single corporate governance model that could be used by all banks does not exist, though (Gup 2007, p. 18; De Young 2007, p. 62; Gischer, Reichling, Stele 2007, p. 249). Private, cooperative and state-owned banks, domestic and global banks, universal and investment banks, etc., pursue their own aims and so they operate dissimilar supervision systems. But the priorities are always the same (Marcinkowska 2012).

The original purpose of corporate governance was to protect investors (against inefficiencies, non-compliance, fraudulent financial reporting), but today its broader aim is stressed – making

[16] The model code regulates issues such as office hours and time zone issues, personal conduct issues, operations of back office, payments and confirmations, disputes, differences, mediation and compliance, authorizations, documentation and telephone taping, brokers and brokerage, dealing practice, general risk management principles, as well as providing guidelines on dealing with corporate/commercial clients.

sure that the justified expectations of all key stakeholders of the entity are met.[17] Corporate governance regulations are part of the company law, security trading law, listing standards of securities on stock exchanges, and codes of good practice (Razaee 2007, p. 23).

The code of good practice is positioned between regulation and self-regulation. Although its source is an official market supervision authority, its adoption is voluntary. The supervisory authority only provides a set of principles which are recommended practices rather than enforceable law.

The Polish legislation defines a code of good practice in the following way: "a code of conduct – shall be understood as a set of rules of conduct, in particular ethical and professional standards, of traders who undertook to be bound by them in relation to one or more commercial practices" (ustawa 23.08.2007). The codes of good practice are practically intended to assist not only entrepreneurs (institutions), but also specialists in different fields. Their definition is very wide and includes also codes of corporate governance.

A corporate governance code provides principles, standards or good practices applicable to different aspects of corporate governance. Not being a formal law, the code is not a binding document (Weil, Gotschal & Manges 2002). It can be very briefly characterised as a system of principles for managing and controlling companies, one part of which is standards for different entities that either prescribe (or ban) certain practices and the other part is criteria for entities to evaluate their organizational documents with respect to corporate governance practices. The guiding theme is the accountability of companies' management bodies (Marcinkowska 2004, p. 15).

Corporate governance codes usually provide principles on (Marcinkowska 2004, p. 17):

– the main formulas that a company and its interest groups may use to reach consensus,

– owners' rights and responsibilities, including the protection of minority owners' interests,

– the management and supervisory structures and procedures, as well as on the role of the management board and the supervisory council,

– the remuneration schemes for the board members, including stock and stock-option remuneration,

– the disclosure of information on company's dealings and performance,

– the auditor selection procedure and the way to ensure its independence,

– the effective control of the company and its bodies,

– acquisitions and capital mergers, i.e. on the ways to protect (or not) the company against a takeover.

As a source of "soft law", corporate governance codes may perform a variety of functions (Oplustil 2010, pp. 77–78):

– provide investors with better protection in the capital market, because they impose higher standards than the company law does,

– the "soft" codes may be used by capital markets as a means of international competition in order to attract issuers and investors through the promotion of good practices,

– codes of good practice give foreign investors information about the country's company law and the prevalent corporate standards,

[17] Jeżak (2005, p. 49) stresses that "the importance of good corporate supervision extends far beyond the interests of company shareholders and has effect on the economy as a whole. It is so, because the quality of corporate supervision has a direct bearing on the economy's ability to mobilize capital, as well as on rational allocation of the capital and effective monitoring of its use".

– the codes can be used as a benchmark in making on-going and periodical assessments of the company's compliance with the principles of corporate governance (leading to ratings and rankings),

– "soft" regulations can be a sort of "a testing ground" where the real-life implications of new regulations are put to a test before they become mandatory.

Codes of good practice may be developed by supervisory authorities (on the initiative of the government or the Stock Exchange), by the representatives of some interest group, e.g. managers, or by some category of investors, such as institutional investors, pension funds, etc. (Oplustil 2010, p. 84).

In practice, the requirement to notify about the implementation of good practices and the monitoring activity of the supervisory authority receive different supervisory treatment (see Figure 2). The European Commission indicates that the "comply or explain" principle typically used in codes of good practice would be much more effective if some monitoring authorities (such as securities regulators, the Stock Exchange and other bodies) had the right to verify whether the published reports (particularly explanations) are as informative and comprehensive as they should be. However, their authorization should not allow the bodies to interfere in the contents of the disclosed information or to assess companies' solutions, as these rights should belong to the market. The monitoring authorities could publish the results of their activities to promote best practices and to encourage companies to be fully transparent. There should also exist an option of imposing regulatory sanctions on entities in serious instances of non-compliance (European Commission 2011).

As shown by the analysis of companies' corporate governance compliance reports, the definite majority of companies do not explain why they have failed to adhere to certain principles, or the informative quality of their explanations is low, which accentuates the call that regulators take action to strengthen "the comply or explain" mechanisms, to monitor companies' reports, and to react when explanations are either unavailable or insufficient (Seidl, Sanderson, Roberts 2012). The problem is specific mostly to companies controlled by one or several large shareholders; in these organizations in particular the independent members of their supervisory councils should have a special role in approving corporate governance reports and should take care that sufficiently comprehensive explanations of why some principles were disobeyed be provided (ECGF 2006).

The studies on mature economies show that organizations with sound corporate governance practices are successful independent of what their regulatory environment might be (Bruno, Claessens 2010). This suggests that most significant are the inner motivators for good corporate governance – ethics and morality. A model of self-regulation must be, however, supported by both external and internal supervision, so that compliance with the corporate governance rules can be ensured (Weismann 2009).

It seems, therefore, that the optimal solution is one combining a corporate governance system with the organization's ethical culture. Ethics has been rarely viewed as the underpinning of corporate governance to date (Sullivan 2009, p. 3), but the interaction between the two areas fosters the erection of a framework appropriate for the functioning of each entity. The entity's principles and code of ethics strengthen its attitudes of responsibility to the stakeholders, which constitutes the essence of corporate governance. On the other hand, an efficient system of corporate governance helps the entity adhere to its code of ethics.

Bhimani (2008) argues that corporate governance codes promote certain principles, ethical values and moral dimensions of proper conduct among people and organizations. Drawing on neoclassical economic concepts, the codes naturally incorporate moral values and ethical ideas into their economic, rationalistic underpinning.

The ethical choices made within corporate governance particularly concern the manner and scope of application, as well as the addressees, of the basic corporate governance "virtues", i.e. responsibility, accountability, integrity and transparency. The character of moral choices (judgements) made in this area explains why particular models of corporate governance are different, for instance regarding the groups of stakeholders and their expectations that the bank will respect, as well as their share in its goals. Moral judgments are also built into the performance evaluation criteria, such as economic and operational efficiency of the entity, stakeholders' involvement and the creation of "corporate citizenship", or narrowing the gaps between particular groups of stakeholders (West 2009).

8. Supervisory recommendations – halfway between regulation and self--regulation

A discussion of the shape and scope of regulation and self-regulation may not omit the issue of supervisory recommendations. Being outside the statute law they are not formally binding, but the deficiencies of formal regulations (limited adaptability, frequently time-consuming legislative processes and obligatory consultations before new laws are enacted) frequently cause that regulators use them as an intermediate solution.

In discussing regulation and self-regulation the nature of supervisory recommendations must be established. They are not part of the body of law, so compliance with them is not mandatory. Despite that, supervisory authorities' recommendations are mostly respected, which can be explained by the fluid line between the "hard" and "soft" banking laws. The supervisory authorities have instruments they can use to exert pressure on particular institutions, such as the introduction of additional capital requirements[18] or obliging a bank to increase its equity capital. Within its supervisory capacity the KNF may advise a bank to take measures necessary for the bank to meet and follow prudential standards[19] (ustawa 29.08.1997, art. 138, item 3).

When a bank fails to follow KNF's recommendations or orders, when its actions are in breach of its charter or the law in force, or pose a threat to the interests of its clients (account holders) or of traders in financial instruments, then the KFN may impose sanctions on it.[20] The sanctions

[18] Particularly when the supervisory authority finds a bank to be in breach of regulations (irregularities impairing the efficiency of the bank's risk management system and internal control system, or irregularities making the identification, monitoring and controlling of the concentration of commitments, including high-value commitments, less effective), and when the internal capital does not match the bank's risk exposure and risk management shows major flaws.

[19] It concerns liquidity standards and other acceptable risk standards in banking, as well as to the recommendations on good practices for prudential and stable bank management.

[20] KNF may (the act of 29 Aug. 1997, art. 138, item 3):
- apply to the appropriate directing body of the bank for the recall of the president, vice-president or another member of the management board directly responsible for the regularities noted;
- suspend from office the members of the management board pending the adoption of a resolution on their recall (suspension from office shall involve such persons being excluded from participation in decisions of the bank in respect of its financial rights and obligations);
- restrict the scope of the bank's activity or of its organizational units (this decision may specify conditions and dates);
- levy a financial fine on the bank (to 1 million zlotys) and/or on the members of its management board (up to three months' gross salary);
- revoke the authorisation to establish the bank and order the bank's liquidation.

also have a preventive function, as they aim to ensure that bank managers will run business in a manner adequately protecting their clients' interests and the accumulated funds (which is an important aspect in bank managers' evaluation).

The above laws that have been enacted in to increase the efficiency of institutional supervision in fact blur the line between regulations and supervisory recommendations, so the adoption of recommendations becomes a forced decision (unrelated to self-regulation).

9. Seeking optimum between regulation and self-regulation

In addition to the great number of cases when regulations were found inefficient or ineffective, there are also proofs to the existence of defective deregulation and self-regulation mechanisms (Tomasic 2011, p. 68).[21] This situation makes it necessary to seek "the golden mean" – an optimal combination of regulation and self-regulation.

Considering the state's responsibility for the stability of the financial system, the financial regulators must prevent a situation where self-regulation is the only instrument constraining banks' activities, and where prudence and good practices are their only signposts. Because of that, banks are covered by strict regimes that primarily aim to protect clients' deposits, provide market players with equal competition opportunities and ensure stability of the financial system.

Market regulators themselves stress that self-regulation is important and call for extending the range of governance policies to non-legislative solutions, because, as they indicate, legislation is frequently only part of a comprehensive solution that should be made of formal rules and voluntarily adopted measures (recommendations, guidelines, self-regulation, etc.) (European Commission 2001). This means that self-regulation should not be developed independent of the laws in force – rules negotiated "in the shadow of the law" must meet specific legislative standards. Self-regulation may sometimes precede the creation of legal standards, in which case negotiated initiatives serve as the underpinning of the statute law and a sort of co-regulation, a joint legislative effort, takes place (Senden 2005).

In seeking to determine the optimal amounts of regulation and self-regulation the costs and problems that may arise from the two approaches must be considered (Lazzarini, de Mello 2001).

The weaknesses of regulation are the following:

– bureaucratic costs – funds consumed by the regulatory and supervisory apparatus (spent on offices, seeking information and monitoring the market),

– credibility of the proposed mechanisms,

– rent seeking – changes in the attitudes of the directly regulated organizations, which will try to seek profits or minimise losses,

– constraints on financial innovations.

The weaknesses of self-regulation include:

– limited market competition,

– agency problems,

– nonsocially optimal provision of goods and services.

[21] The author indicates that the deregulatory activity of the UK government which was intended to strengthen corporate supervision in banks in fact made self-regulation in this sector less effective. To illustrate this case Tomasic analyses the example of Northern Rock, pointing to the failure of corporate governance mechanisms and its contribution to the bank's bankruptcy.

It is indicated that the analysis of the costs of introducing, operating and enforcing regulations leads to a conclusion that they are not economically justified and that the available private systemic solutions – based on self-regulation – might serve the same purpose (Wallison 2005–2006).

Another noteworthy fact is that public pressure on legislators makes them introduce regulations even though they are known to be costly and imperfect. Consumers obviously expect regulations, because (Llewellyn 1999):

– their transaction costs are lower in the regulated environment (compared with those they would have to pay if they monitored and evaluated financial institutions themselves),

– information is not available (or difficult to find) and/or consumers have no skills they would need to use it (analyse),

– there must be some reasonable degree of certainty in transactions made with financial institutions (some trust as to their feasibility),

– there were previous cases of financial institutions' misconduct and it is believed that preventing wrong and risky attitudes is better than claiming damages after something wrong has happened.

In seeking "the golden mean" between overregulation and under-regulation in the financial sector, the dynamics of the sector's markets and institutions and the changing economic and political priorities must be taken into account. The statute law is a product of a compromise forged after diverse views, expectations and interests have been brought into a line. Unless consensus about the aims is reached, the standards for ensuring their achievement will not be established. A case in point is the process employed to develop the Basel III recommendations (BCBS 2011). Even with the global acceptance of tighter prudential standards in banking, the efforts to bring forward the implementation of more radical requirements proved unsuccessful and for a very ordinary reason – the analysis of the impacts of the new regulations revealed that they would considerably increase banks' demand for new capital. The costs of meeting it would be very high and the banks' capability to raise new funds in the market was very uncertain. The limited availability of funding would make banks abandon some of their activities, particularly lending, which would act as a brake on economic growth. The final recommendation was that radical changes should be avoided; more lenient proposals were put forward instead, the main change being a considerably delayed deadline for the introduction of the new regulations. This example shows that a legislative process must seek balance between its outcomes and the rationale behind the low. The final shape of a law embodies a compromise between the expectations of various stakeholders and the legislative circumstances surrounding its enactment.

History proves that perfect regulations do not exist and that it is unreasonable to expect that one day they will become possible. Rules prescribing some actions and banning others are created in response to certain circumstances. Rules refer to known facts, situations and entities. New circumstances, technological and economic progress, and the implementation of innovations make them outdated and expose their loopholes. It is technically impossible that regulations could address every detail of what may happen in the future. To cope with the problem the legislative process would have to provide only an outline of the regulatory framework – a set of templates – setting out general principles and rules. This is the point where the question about the nature of regulation needs to be asked: should the system be based on principles or rules (Marcinkowska 2009a)?

The underpinning of the first approach is standards outlining general principles of conduct within the regulated area. The advantage of the system is that it offers universal solutions applying to all circumstances, so they do not have to be adjusted to handle innovations. The downside is that the solutions may be interpreted too broadly and that standard rules for dealing with some situations are not available.

The second system is also built on general standards, but in this case their set is supported by regulations addressing specific issues and providing guidelines on concrete events, situations, instruments, transactions, legal constructs, etc. As a result, the system contains many detailed and increasingly intricate laws. Arbitrary interpretations of regulations are not possible – the rules prescribed by the standards must be obeyed. The weak point of the system is that some situations are not regulated, so certain events and transactions may be interpreted freely (there are even suggestions that the system encourages structuring transactions in a manner allowing the rules and intentions of the standards to be evaded).

Choosing which of the two systems is better is not possible, as there are arguments in support of both them. The rules-based approach to solving ethical dilemma is more frequent in bureaucratic societies, while the principles-based system characterises societies where public control is strong and efficient (Sama, Shoah 2005). However, with the blurring differences between and within nations and societies, it is becoming less obvious when rules and when principles are more appropriate to establish good governance. Globalisation calling for the reconciliation of global principles with domestic rules makes this choice even more difficult.

One example of general guidelines (corporate rules of conduct) is the FSA standards (Table 2) that all regulated entities are required to adopt.

In establishing the optimum proportions of regulation and self-regulation there may appear the choice between protectionism (economic nationalism) and liberalism, and between the trust in the market's ability to discipline entities (in the "invisible hand of the market") and a total lack thereof; the latter attitude ultimately leading to a system fully controlled by regulators and institutional supervision. Consequently, the degree to which supervision should be individualized or integrated must be additionally considered. The EU's legislative context calls for considering the degree of harmonization between regulation and supervision, including the choice between exclusively national supervision and single pan-European supervision (Flejterski 2011). Altogether, finding the aforementioned optimum is not an easy task, but with the additional requirements being taken into account it becomes possible to lay foundations for EU's regulatory order (see Figure 3).

The examination of the four analytical schemas leads to recommendations that can be summarised as follows (Flejterski 2011):

– as much freedom as possible, and as much (skilfully applied) protectionism and interventions as really necessary;

– generally, deregulation of the banking/financial sector should be sought in both medium and long term, but it does not seem likely (now and in the foreseeable future) that a high – and sometimes even rising – level of regulation and supervision can be completely given up;

– individualized (specialised) supervision should be gradually replaced by integrated and consolidated supervision of the whole banking/financial market;

– because of the requirements of globalization and the progressing integration of the European Union, regulation and supervision should be "Europized" (a single European system should be established), but without prejudice to the national interests of particularly the host countries (and in the global context the regulation and supervision could be internationalized/globalized).

A wave of conservatism is going through the financial system today – standards are being tightened up and countries put more energy in their interventions. The discussions conducted in the aftermath of the crisis are dominated by suggestions that economic and regulatory policy should be fundamentally redefined (mainly its component on financial markets and institutions) and that financial control should be stronger (Szambelańczyk 2011).

The global financial crisis has triggered re-regulation, a natural reaction from the supervisors. In all such circumstances prudential standards are introduced under public pressure and regulators' rigorous opinions are fanned by the feelings and emotions of the public – new rules are adopted in a punitive climate. Their obvious purpose is to close the system loopholes, to prevent a new crisis, and to stabilize the financial system. They are accompanied by opinions that those responsible for the crisis should be punished.[22] This retaliatory aspect of the new regulations makes them more like a manifestation of the weakness of the state. It is hard to avoid the impression that this "act of revenge" on the part of the regulators is actually staged to divert public attention from their previous inefficiency and the failure of the regulatory and supervision system. The opinion that the crisis would not have happened if the new regulations had been in place is ungrounded. Overly restrictive actions on the part of the state having also goals other than providing the financial system with an optimal legal framework carry an inherent risk of overregulation. As already mentioned, alternating phases of regulation and deregulation are an immanent feature of the financial system – overregulation is usually replaced by the gradual relaxation of the standards. But regulatory optimum is never reached, because the rising phase of a business cycle brings excessive deregulation.

As shown, too much regulation hurts. The arguments for making prudential standards less restrictive are the following (IMF 2009):

– market discipline and self-regulation may effectively discourage the weakly regulated and non-regulated institutions from taking on too much risk,

– systemic risk is specific to some types of institutions only; banks in particular should be viewed as the backbone of the financial system, due to their function of deposit-taking and their role in payment systems,

– banking regulations should be sufficient to ensure that banks' lending to some entities will not compromise systemic stability,

– trying to regulate a larger group of non-banking institutions (and new financial instruments) may be too costly, suppress innovation and, potentially, increase systemic risks by reducing markets' ability to transfer risk.

On the other hand, though, there are also solid pieces of evidence pointing to the inefficiency of regulations, institutional supervision and market discipline, as well as to the inability to assess and moderate systemic risks (originating not only in banks, but also in the shadow-banking entities).

[22] For instance, it is openly stated that one of the goals in levying additional taxes and charges on banks is to punish the financial sector for triggering the global crisis. Because the blame for sparking off and spreading the crisis is put on the financial institutions' failure to comply with basic safety rules, it is suggested that banks should pay the costs of governments' interventions. For many people financial sector' responsibility for the crisis is an unchallengeable argument for making it pay the fiscal costs of the crisis. More in: IMF Staff (2010); European Commission (2010c); Marcinkowska (2011).

It is therefore suggested that new legal solutions and principles of supervision be introduced, because all financial activities susceptible to systemic risk should be monitored and the systemic institutions should be covered by tighter standards.[23] At the same time, the new supervisory instruments should enable individualized approaches and flexible responses to market changes and the actions taken by banks.

10. The *continuum* of regulation and self-regulation in the banking sector

Because the character of supervisory recommendations is not clear and the states want banks to comply with the pertinent requirements, some good practices (e.g. business practices, customer relations practices, risk management rules, remuneration rules for bank managers) have been made mandatory laws under the recent wave of re-regulation.

The regulatory *continuum* can be illustrated with internal governance[24] and a more recent case of remuneration for bank managers.

The key internal governance rules have been defined within the second pillar of the New Basel Capital Accord (BCBS 2006b) and in the guidelines on improved corporate governance in banking institutions (BCBS 2010b). The Basel Committee on Banking Supervision is not a supervisory authority, so its guidelines are not formal laws. The Committee develops supervisory standards, guidelines and best practice recommendations in the expectation that the authorities in particular countries will implement them as national laws in a manner best suited to their systems. The Committee thereby promotes convergence towards a homogenous approach and uniform standards, but without trying to make the member states harmonize every detail of their supervisory techniques (Marcinkowska 2009b, p. 85).

The supervisory review rules formulated under the second pillar of the Basel II have been implemented into Community legislation via the Directive 2006/48/EC. The European Banking Authority has used both the documents to prepare its guidelines on corporate management and an internal control system (EBA 2011). The EBA guidelines provide rules on the structure and organization of companies, the management board and the supervisory council, risk management, internal control, information systems and business continuity, as well as transparency.[25] The document has become a basis for KNF's resolution providing detailed rules on the functioning of a risk management and internal control system (uchwała 258/2011 KNF). The resolution has been followed by recommendations on internal control systems in banking institutions (KNF 2011).

[23] The following classification of financial institutions is proposed: (1) individually systemic (very big organizations strongly tied to other institutions), (2) systemic as part of a herd (these may be small institutions, but acting together with other similar entities they may affect the system – a case in point is high-leverage hedge funds), (3) non-systemic large and not highly leveraged (e.g. insurance companies and pension funds), (4) tinies (especially if low leveraged). The macro-prudential regulations should apply to organizations in the first two groups. The systemic-risk fees could be contributed under capital requirements, a Pigovian tax (a special charge levied on financial institutions), a private system of deposit insurance/guarantees or a private-public system (Brunnermeier at al. 2009).

[24] Internal governance (i.e. corporate management and an internal control system) is a narrowly defined but vital element of corporate governance focused on the internal structure and the organization of an institution (EBA 2011).

[25] The document revokes the earlier CBES (EBA predecessor) guidelines on risk management (CEBS 2010) and management remuneration policies (CEBS 2009), as well as Section 2.1 of the guidelines on the supervisory review implementation provided under the second pillar of the Basel II (CEBS 2006).

The issues have been also addressed by the corporate governance principles (e.g. Dobre praktyki spółek notowanych na GPW – Best practice for WSE listed companies), 2011). For instance, the Polish code of corporate governance requires in its part on internal governance that supervisory councils make annual reviews of the internal control systems and the vital risk management systems (and to present their findings to the ordinary general meeting together with a concise evaluation of the company (principle III.1); the code also recommends displaying the evaluation and the supervisory council activity report on the company's website (principle II.1.6).

The final link in this chain of standards, principles and guidelines is principles that banks adopt voluntarily or develop on their own initiative under their corporate (and internal) governance models.

The second example concerns remuneration for senior bank managers. This issue was long treated as the exclusive domain of the banks and the pertinent rules were established by their supervisory councils or owners. Its importance and the irregularities observed in this area have caused, though, that it has been covered by the Basel guidelines on enhancing corporate governance for banking (BCBS 2010b). Remuneration principles and standards assessment methodology have been covered by a separate document (BCBS 2010a).

The remuneration issue has also been addressed in the EU green paper on corporate governance in financial institutions (European Commission 2010a; 2010b). Earlier on the EC had published its recommendations on remuneration policy in the financial service sector (2009/384/EC).[26] At the Community level the issue was also raised by the European Banking Authority that made it part of its guidelines on corporate management and an internal control system (EBA 2011).

In Poland, the EBA guidelines have been reflected in good practices developed for listed companies. The KNF presented formal requirements on bank management remuneration in its resolution (uchwała 258/2011 KNF) and additionally published its interpretations (UKNF 2011a; 2011b).

The above examples show that there is some supervisory-regulatory *continuum* at the supranational level – an international body issues negotiated guidelines that become a basis for Community laws and supervisory guidelines which are subsequently implemented into the Polish legal framework via a resolution made by the national supervisory authority. A regulatory-recommendatory *continuum* also exists – in both EU's and Polish financial systems formal regulations (binding laws) are supported by supervisory recommendations (negotiated guidelines).[27]

11. The new shape of banking regulations – the post-crisis challenges

The financial crisis of 2007–2009 is recognised as a systemic failure of financial regulations.[28] There is a widespread opinion that they were ineffective, because they did not prevent the crisis.

[26] This recommendation follows the Commission's recommendations 2004/913/EC and 2009/385/EC.

[27] The EBF (2010b) concludes that EC's involvement in the self-regulation process leads to "co-regulation" instead of a situation where the regulator endorses rules negotiated between the interested parties (the sector and the consumers), which blurs the boundaries of self-regulation.

[28] It is thought that the need for financial system to be regulated arises from the necessity to foster economic and social growth that benefits all entities in the country. A failure of regulations means that they have fallen short of their goals and that the regulatory costs outweigh benefits at both micro and macro level (Curie 2006).

It is frequently challenged by those who claim that the crisis was sparked off by (excessive) legal regulations and wrong political choices (Nichols, Hendrickson, Griffith 2011).

Levine (2010)[29] argues that the causes of the recent crisis should not be sought in the lack of regulatory powers, unclear regulatory policy, shortage of capital, or regulators having insufficient information. He tends to blame the political apparatus for its reluctance to respond to the dynamic and innovative financial system.

Goodhart (2009) speaks in a similar tone, stating that even though politicians may have missed the symptoms of the looming crisis, central banks were certainly aware of it. He explains their passiveness in terms of the unavailability of instruments that could defuse the negative phenomena (e.g. asset-price bubbles or overlending). Interestingly, Goodhart too points to the probable unwillingness of central banks and supervisory authorities to use instruments that were available.

The key regulatory challenges are defined in terms of the recent crisis (Dewatripoint, Rochet, Tirole 2010, pp. 8–9). The most important thing today is to avoid too strong, exaggerated reactions from the supervisory authorities; politicians should try to resist the temptation to treat banks harshly. They should view legal standards setting out banking rules and boundaries as a kind of corporate governance standards in the non-financial companies, rather than punishing banks just to show who is guilty of the crisis. Another challenge has to do with the threat to cross-border banking. Because of the problems with delimiting the areas of responsibility and accountability of national supervisory bodies and deposit guarantee systems, and due to the question of nationalization of some banks threatened by bankruptcy, governments may press banks and make them reduce their activities to local areas, which might put an end to the single market for banking services and have a negative effect on the growth and effectiveness of economies. The risk of regulatory arbitrage would also be higher then.

In analysing the roots of the recent crisis, Goodhart (2008) lists seven issues that need to be discussed and solved. These are:

- the scale and scope of deposit guarantees (insurance),
- bank insolvency regimes (prompt corrective action),
- central banks' money-market transactions,
- liquidity risk management in banks,
- procyclicality of capital adequacy requirements and lack of counter-cyclical instruments,
- boundaries of the banking business (and thus of regulation),
- crisis management (within countries and cross-border).

An essential issue would be to develop a regulatory strategy increasing the stability of functioning of banks. This calls for analysing the key areas where the present regulations

[29] He proposes establishing a new institution (the Sentinel), which would be responsible for collecting information necessary to assess the quality of financial regulations (including the corporate governance principles of a bank). The institution would use the information to prepare annual reports evaluating the current and long-term impacts of public financial regulations, supervisory practices and rules. It would not have any bearing on the monetary, supervisory or law-making authorities, though. The institution would be a politically non-partisan entity, independent of financial markets, with very competent and reputable staff. These requirements arise from the need to have an institution where the professional and personal ambitions of the participants are aligned with its mission to improve the match between financial regulations and public interest.

have failed.[30] The conclusions might be used for formulating the main principles to guide the construction of prudential regulations today (Acharya, Richardson 2009, p. 30):

– the internal governance system should be strengthened and compensation policies should be redefined to discourage excessive risk taking and reduce financial leverage ratios,

– government guarantees should be priced fairly and in some cases they should not be available at all,

– transparency should be improved to reduce the counterparty risk externality,

– prudential regulations for large and complex financial institutions should be based on their systemic risk contribution to the financial sector or the economy.

It is necessary to determine the scope and types of indispensable regulations and to establish the proportions of legal standards and self-regulation. Worth mentioning here is the study by Barth, Caprio and Levine (2004) who have proven that the best driver of banks' growth, good performance and stability is supervisory policy built on guidelines that:

– require the disclosure of certain types of information,

– strengthen corporate control exercised by the private sector,

– provide private agents with incentives to use corporate control.

These findings give a good starting point for the regulatory and supervisory authorities to define strategies improving bank governance. Because financial sectors are better developed and more stable in countries whose authorities support private monitoring of banks (the same has been confirmed by the above study), the first responsibility of the authorities should be to avoid actions that might be detrimental to private monitoring. The next step should be to improve the flow of information (this concerns accounting and auditing issues and presentation of information in a comprehensible manner) in order to make banks more transparent. Finally, to increase the quality of bank corporate governance, strong and clear incentives for their owners, creditors and supervisors must be introduced, encouraging them to monitor banks correctly and discipline them if they tend to take on too much risk (Caprio, Levine 2002).

Davies (the former FSA President) rightly observed that no corporate governance system will work well without committed shareholders. Regulators cannot replace interested and responsible owners, but they can support and assist them to some extent (Davies 2003).

There is, naturally, the problem of multidirectional and complex relations between the financial sector and public sector that may function as a regulator for financial businesses, sometimes an owner of financial institutions, a market player, a fiduciary agent, and in some instances as an agent directly interfering in market operations. Therefore, the key governance principle for the public sector to follow is to ensure that the regulators are independent, responsible and honest, and that the operational goals and processes are transparent (Carmichael 2002).

The above discussion raises a broader issue of the setup of bank supervision (more generally, of the financial market supervision), of the powers of particular bodies and of the coordination of actions taken by particular institutions making up the safety network.[31] However, the most important of all is the responsibility of those who develop and guard regulations (Page 2001; Goodhart 2001; Lastra, Shams 2001).

[30] It is particularly stressed that some regulations encourage banks to take on excessive risk and that poorly designed and inadequately priced regulatory guarantees give rise to the problem of institutions which are "too big to fall".

[31] This issue is beyond the scope of this article, but it is one of those that have fundamental importance today and need an optimal solution.

The establishment of banking regulations should also be viewed in terms of the principal--agent conflict. Economic theory explains the regulation of financial institutions in two ways (Marcinkowska 2009b). In the altruistic theories (public interest view) regulations are instruments that the state uses to make the society more honest and more productive, and its interventions follow from a failure of the market mechanisms.[32] This contrasts with the private interest theories (private interest view, self-interest view) where regulations may express the self-interests of politicians, government officials and the regulated sectors, pursuing better pay and other monetary benefits, power, reputation, etc. (Kane 1997; Peláez, Peláez 2009). It is stressed that preventing regulators from acting in their own interest may be difficult, even though their biased approach considerably distorts the regulatory policy.[33] In practice, regulators' attitudes are moulded by a compromise between their obligation to represent the public, on the one hand, and their desire to reap some private benefits, on the other (Dijkstra 2010). Barth, Caprio and Levine (2012, p. 203) argue that the 'Guardians of Finance' often do not work for public good because the public lacks the institutional mechanism to compel the regulators to do so.[34] The conflict between public expectations and the supervisors and officials' hidden agendas may render regulations and financial supervision ineffective. This entanglement of purposes could be solved by making supervisors personally responsible for their actions, which should boost their motivation for task fulfilment (Dijkstra 2009).

Finding new rules for the functioning of the banking sector is extremely difficult today. The pressure on making regulations tighter, on improving supervision or even on carrying out "retaliatory" actions against banks makes it difficult to determine the golden mean between the dangers of under-regulation and over-regulation. As the European Banking Federation put it "policy-makers will need to strike a delicate balance between their instinctive reaction in times of stress to regulate and control on the one hand; and on the other, the need to preserve the financial sector's ability to serve the economy and society" (EBF 2010a).

The financial sector over-regulation risk must be emphasised again. Despite the general consensus that stricter legal standards are needed to keep future risks at reasonable levels, it is indicated that the introduction of too many regulations or poorly constructed standards would be detrimental, because they would make the financial system less efficient and less effective. If the new laws restricted the development of innovative solutions benefitting enterprises and individual customers, the future economic growth would be at risk (Mishkin 2010).

According to G-20 "regulators and supervisors must protect consumers and investors, support market discipline, avoid adverse impacts on other countries, reduce the scope for regulatory arbitrage, support competition and dynamism, and keep pace with innovation in the marketplace" (G-20 2009). This is the role that neoliberalism gives to the state (Nesvetailova, Palan 2010).

[32] According to agency cost theory, multilateral relationships fan conflicts and increase coordination problems, but regulation makes one sector of society (economy) thrive at the cost of other sectors.

[33] Particularly in the case of bank liquidation policies and those applying to the functioning of deposit guarantee systems (Boot, Thakor 1993).

[34] They further explain that "there is no authoritative institution that (1) is independent form short-run politics, (2) is independent od the financial services industry, (3) has the power to demand and obtain information necessary for assessing and monitoring the Guardians of Finance, (4) contains the multidisciplinary expertise necessary for fruitfully processing that information, and (5) has the prominence to deliver such an assessment to the public and its elected representatives in an ongoing manner that materially affects the open discussion of financial sector policies".

OECD (2010) has published the general guidance for policy framework for effective and efficient financial regulation, concerning policy objectives, policy instruments and system design and implementation. It is stressed that "before financial regulation is developed, there must first be a good understandind of the features of financial system, both in terms of how it ought to operate, and of how id does operate in practice, including any problems that may affect its operations or its participants, including customers". Te documents includes principles of financial regulations, concerning: a pre-cautionery approach, risk-based, sound incentives, comprehensiveness, consistency and competitive neutrality.

Also the U.S. Government Accountability Office has developed a framework for the development and evaluation of proposals aimed to reform the financial system. It lists nine attributes that any regulatory system should have (Government Accountability Office 2010):

- regulations should have clearly defined goals,
- regulations should be appropriately comprehensive,
- regulations should take a systemic focus,
- regulations should be flexible and adaptable,
- regulations should be efficient and effective,
- regulations should consistently protect consumers and investors,
- regulators should be characterised by independence, authority, prominence and accountability,
- consistent financial oversight is necessary,
- the taxpayer exposure should be as small as possible.

The EBF has formulated the principles addressed to the regulatory and supervisory authorities and the banking sector. The rules are divided into nine problem areas (EBF 2010a):

– banking in an open market economy – reforms should respect values such as economic openness, the freedom of capital movement, the freedom of establishment and equal opportunities for financial institutions;

– properly supervised banking – banking supervision must ensure that markets are functional and stable, and that they can keep up with modern banking trends;

– truly commercial banking – banks must remain commercial organizations, so crisis-induced public intervention must be withdrawn as soon as possible, in a coordinated and market-sensitive manner;

– banking without size prescription – to make banking safer policy-makers should concentrate on the systemic aspects of financial institutions rather than on their size;

– diverse banking models – the prescription of a specific banking model would limit innovative and successful business; structural principles (legal form, regional principle, group membership) should not be mandatory;

– customer-oriented banking – the regulatory authorities in Europe should continue their focus on bank customers, which calls for increased transparency and trust-building activities;

– robust banking – capital requirements must be appropriately calibrated to ensure stability and to avoid a reduction in the availability of credit and other resources to the economy;

– sustainable banking – banks must further improve risk management, coordinate their compensation schemes with long-term value creation, and increase the fit between the incentive structures, customers' wishes and their long-term corporate interests;

– adaptable banking – banks must develop sound strategies to be able to adapt to continuously evolving market conditions and changes in the demand for banking services.

These EBF-promoted principles actually aim to create banking based on a *continuum* of regulation and self-regulation.

Freixas and Santomero (2004) have presented a general model for developing prudential standards that has a positive effect on efficiency, while ensuring balance between supervisory goals (mainly security). The starting point is different regulatory options (public regulation, self-regulation – i.e. negotiated standards, no regulation) for particular areas. In the next step, the number of the regulatory bodies to implement the approved policy and their legal situation are determined. The responsibility for developing regulations is delegated to various regulatory bodies that are stimulated in different ways to make them concentrate on their targets (for instance, a central bank will dedicate its efforts to financial stability rather than pursuing other goals of importance from the perspective of public interest, such as banking sector's efficiency and competitiveness). The regulator must be aware that the regulatory regime has effect on the incentives and strategies in the regulated sector and account for this in developing legal standards. Another fact to be considered is that competition in the banking sector may make the overall effects of regulation different from the responses of individual banks (the expected global impact may not take place, even if laws make single organizations show the anticipated behaviour). In other words, regulators working to prepare optimal legal standards must be sensitive to the overall equilibrium and the financial flows that the regulations will induce.

Naturally, regulations must evolve following changes in the surrounding world and the behaviour of market players. According to one of the G-20 recommendations, "The boundaries of the regulatory framework should be reviewed periodically within national jurisdictions, in light of financial innovation and broader trends in the financial system" (G-20 Working Group 1 2009). It additionally states that "recommendations should promote proportionate regulatory reaction when needed, acknowledging the possible limits of the self-regulation approach in some contexts" (G-20 Working Group 1 2009).

12. Conclusions

The global financial crisis has brought to attention the need to find new paradigms, particularly paradigms concerning "the proportions of economic freedom and discipline, competition and cooperation, self-regulation and interventionism, centralization and decentralization, private and public ownership, self-financing and collective financing of an entity, current and future consumption" (Frąckowiak 2011). In fact, it has become necessary to redefine the roles and organization of the state, society and economy, and to establish the equilibrium points again.

Laws and public supervisory bodies alone are not enough to ensure the safe functioning of the financial system and its particular entities. They need market support ("private monitoring"), but mainly the backing from financial institutions and their key stakeholders (particularly from managers and owners, but also customers). Self-discipline – negotiated standards and good practices, consistent implementation of the existing tools and responsibility for ones' actions – is the mainstay of a safe financial market.

Neither extreme – free-banking and totally controlled financial intermediation – are feasible, therefore “financial regulators and supervisors will always operate in an interior space, in which there is certain to be a ‘boundary problem’ ” (Brunnermeier at al. 2009).

Finding a reasonable combination of regulation and self-regulation for the banking sector is not easy, because their optimum amounts depend on many external circumstances.

The process is hindered by globalization, multinationals and cross-border transactions that necessitate the harmonization and convergence of regulations for the purpose of ensuring equal competition conditions, but most importantly safety of the system and pointing supervisory responsibility and accountability.

This modified system of the financial market should be built around ethics (Figure 4). Incentives encouraging ethical conduct may come from different sources and operate at different levels. They may range from personal incentives (appealing to ethical values and the morality of individual persons) and professional incentives through the organization-level incentives (practical solutions motivating and obligating workers to comply with rules, regulations, laws, and ethical standards) to market and regulatory incentives (penalizing for unethical and unacceptable conduct) (Razaee 2007, p. 447).

This variety shows that self-regulation is a crucial, multifaceted source of incentives promoting ethical conduct. Therefore, the regulatory solutions should be considered “the last line of defence” or “the first triggering factor”, depending on what trends predominate in the banking environment. Psychological reasons justify trying to constrain the role of legal standards to supporting the negotiated initiatives.

It would be irrational to expect that regulations can be the sole underpinning of the monitoring and supervision of complex markets and financial institutions, but this is not to mean that the state should back off from the process. For a regulatory regime to be efficient it must be based on banks’ (and other institutions) willingness to obey high management standards and values constituting their corporate culture (Tomasic 2011).

To recapitulate the presentation it must be emphasised again that self-regulation is a form of regulation, “a soft law”, rather than an absence of law. This means that choosing between regulation and self-regulation is not necessary; their proportions that seem right in the given circumstances should be determined instead and the rules for their establishment should be made consistent.

A set of negotiated recommendations and good practices is not an alternative to sound supervision – these two areas are complementary and must coexist, if a stable, strong and dynamic global financial system is to be established (Ackermann 2008). It is known that the same set of regulations may produce different effects depending on the corporate governance structures banks have (Laeven, Levine 2009). Financial threats and crises may additionally distort incentives that encourage entities to develop good corporate governance. These circumstances make it even more important to have more independent, responsible and transparent institutional structures for supporting regulatory governance, i.e. to make sure that the supervisory institutions themselves implement good practices (Das, Quintyn 2002).

Overall, optimal amounts of regulation and support for self-regulation in the financial sector should be sought. Neither regulations nor negotiated mechanisms of corporate governance can guarantee success, if operating alone. The most productive approach is one where supervisory regulations foster strong corporate governance founded on ethics.

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Acknowledgements

The paper is a part of a project "The model of corporate governance in Polish banks" financed by the National Science Centre.

Appendix

Table 1

The definitions of the safety of financial services market from the perspective of various stakeholder groups

Stakeholders	Definition
The public authority	Financial intermediaries properly complete their task for the national economy. Competence and responsibility of the safety net institutions are clearly defined. Country is perceived on the market as a reliable partner, which may limit the contagion effect. In case of a crisis there will be political consensus for intervention to overturn stability at both local and international; the rules for determining the responsibilities are determined ex ante.
Supervision (safety net)	There are regulations that allow a safety net institutions to assess and control risks associated with the functioning of financial intermediaries. There are formal mechanisms to intervene if it finds that the risk of an entity is or may be excessive. Bankruptcy of financial intermediaries is intermittent.
Customers	There are mechanisms which allow only trustworthy institutions to enter the market and affect the way of business conduct. The beneficiary of these services have adequate information about them (including on price and risk). Financial services are tailored to customer needs and opportunities. Protective mechanisms exist in the situation, if the financial intermediary becomes insolvent (anti bankruptcy protection).
Competitors	There are mechanisms that ensure free competition and protection from unfair competition. There are mechanisms (both formal – regulatory and informal – self--regulatory) that allow players to discipline the entities for excessive risk taking. All participants in the system work for the common good – the preservation of stability. There are mechanisms for getting help from a safety net in case of danger of insolvency of the financial intermediary. It is possible to guard against the contagion effect.
Economy and society	Financial intermediaries reduce the consequences of market imperfections. Financial intermediaries properly complete the task for the national economy. Financial intermediaries contribute to economic growth and social welfare.

Source: based on Iwanicz-Drozdowska (2008, pp. 27–28).

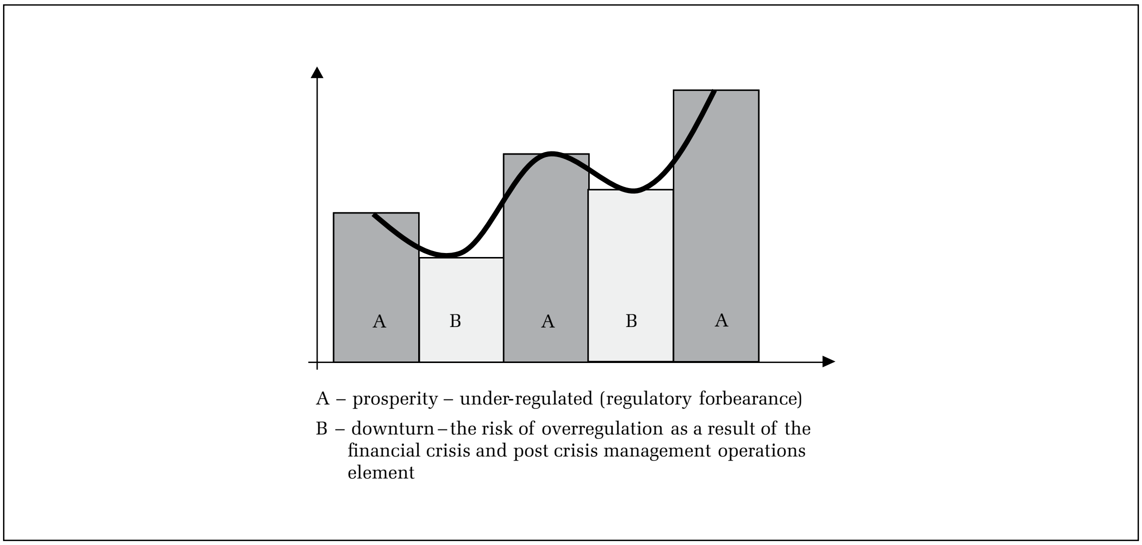
Table 2
The FSA principles

1. Integrity	A firm must conduct its business with integrity.
2. Skill, care and diligence	A firm must conduct its business with due skill, care and diligence.
3. Management and control	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. Financial prudence	A firm must maintain adequate financial resources
5. Market conduct	A firm must observe proper standards of market conduct.
6. Customers' interests	A firm must pay due regard to the interests of its customers and treat them fairly.
7. Communications with clients	A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8. Conflicts of interest	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. Customers: relationships of trust	A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10. Clients' assets	A firm must arrange adequate protection for clients' assets when it is responsible for them.
11. Relations with regulators	A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

Source: FSA (1999).

Figure 1

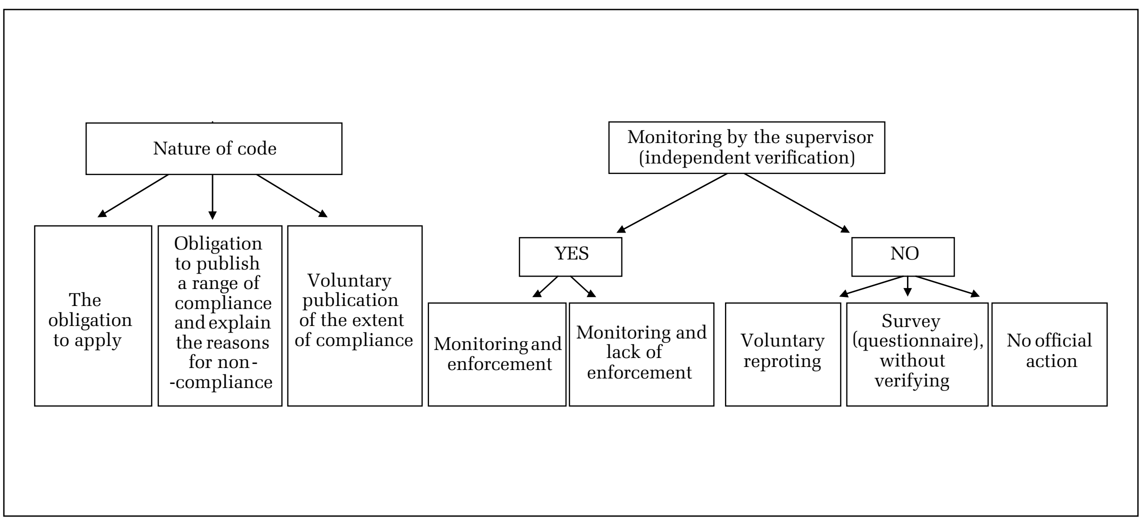
Irregular de-regulation – re-regulation cycle (a heuristic approach)



Source: Flejterski (2011).

Figure 2

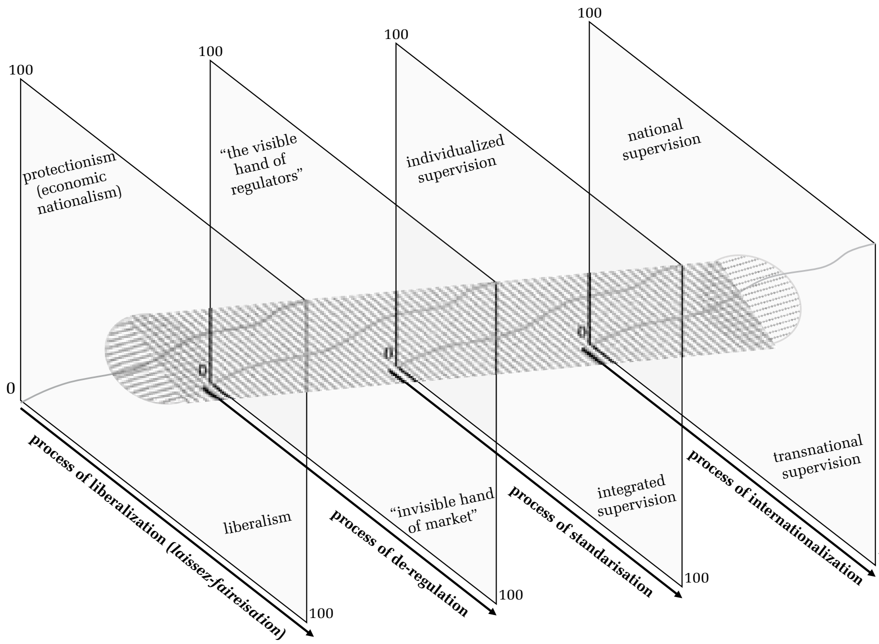
Types of corporate governance good practice codes



Source: based on De Jong at al. (2005).

Figure 3

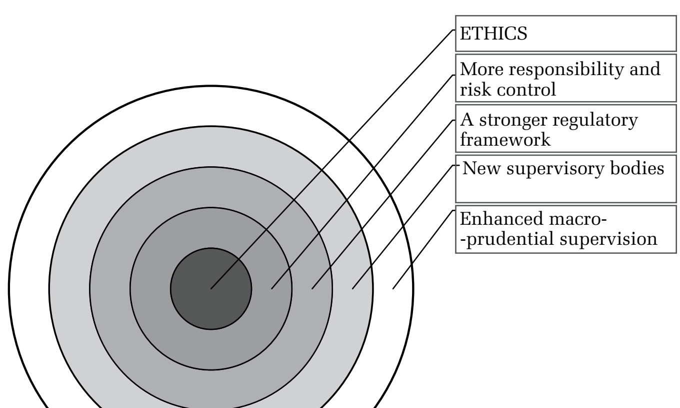
A comparative description of fields of choices



Source: based on Flejterski (2011).

Figure 4

Key elements for a sounder and responsible financial system



Source: European Commission (2010d).