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The rules and the market after the crisis

ABSTRACT

The financial and economic crisis which began in 2007 focused attention once again on the matter of market regulation. This paper aims at identifying in what measure the economic system should be left to its own devices, and how and when regulatory interventions onto the economy are made necessary both at a global and national level.

After a brief overview of the economic debate and the end of the deregulation period preceding the crisis, follows an analysis of the reasons and consequences of the crisis, and of the regulatory measures introduced to mitigate the economic and financial stagnation investing both the United States and Europe.

In Italy, although the supervision on financial market proved to be efficient, it is still fundamental to return on the path, taken in the nineties and never completed, of liberalisations and contrast actions against economic rents, of market flexibility, and respect for the competition principles and consequences.

If the theory according to which the market is able to self-regulate and adapt itself to new situations, overcoming on its own negative phases of the cycle, was once predominant, the events of recent years have shown how regulation is, instead, indeed necessary. Moreover, the current globalisation and introduction of new technologies, which have deeply affected the mechanisms of the market, and rendered out of date and burdensome the existing regulatory system, show that regulation is necessary in so far as it is of a transient nature.

Law, economy and politics must therefore jointly play a part in devising a new global agreement so to overcome economic negative phases in a rational effective manner, and avoid major crises for the future.

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THE RULES AND THE MARKET AFTER THE CRISIS

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1. Introduction.

The financial and economic crisis, which began in 2007, focused attention once again on the matter of market regulation, submitting theories and normal practices to a reality check. Examining them briefly, and recalling some of the reasons and consequences of the crisis, can be a worthy contribution to the discussion on the relationship between regulation and the market, which proved to be a fundamental element of the relationship linking the market to society.

2. The market regulation: the economic debate.

It is not at all obvious that the market needs specific rules.

The idea that economy has its own natural balance is the basis of the theory according to which the economical system is able to adapt itself to new situations and changes – if not caused by important external events or public interventions – and to overcome possible negative phases of the

cycle by means of the dynamic nature of the offer, which generates demand and, in any case, determines a price for the purchase of the produced goods. Specifically, this idea is foundational to the theory considering markets, including financial ones, efficient and able to self-regulate; better yet, efficient and able to attain conditions of balance only when left to their own devices. The products' price derives from the set of available information which allows for a reliable determination of their value and, as a consequence, an efficient assets' allocation through the offer/demand system. For instance, in the stock market, information is what enables issuing companies to foresee future profits and influence stock quotation.

Some economists are sceptical about attributing optimising rationality to economic phenomena, as said theories imply, and believe in economic instability, because of the intrinsic frame of uncertainty in which markets operate. They thus consider binding rules essential in adjusting and overtaking market failures caused by lack of competition, asymmetries, quantitative or qualitative lack of information, and negative externalities, i.e. effects on third parties caused by other people's actions. The financial market is a perfect example of this, being it characterised by deep discrepancies in information, aggravated by the extent and importance of agency relationships (for which certain individuals manage and decide on behalf of others), and by huge negative externalities caused by the interconnections and the complexity of the system.

Laws are considered as a set of incentives based upon which the market actors hold specific behaviours so to not pay the cost (penalties) of their infringement, a cost which must be greater than the profits they could garner from an unlawful behaviour.

The economical analysis of the law plays an important role, and among its representatives there are several preeminent jurists. For a long time the predominant approach has shared the belief that markets are able to self-regulate and that public intervention is generally a worst remedy than the harm itself, attributing to the contract – raised to a sort of ideological subcategory – the main legitimacy in defining rules, and to the State mostly

the mere role of "consultant", providing default rules applicable only in the absence of specific choices made by the contractual parties. It was claimed that *common law,* being free from laws and binding rules, *"seeks economic efficiency"*, naturally giving voice to economic rationality by means of the courts' rulings. The intent was to demonstrate that a common law context is – generally speaking – more efficient than a civil law one in fostering economic development.

Not everybody agrees with the more liberal theories. Partially different analyses have been made within *Law and Economics* itself. Especially, but not only, in non-Anglo-Saxon countries, where the epicentre of these theories lies, other economists stress the necessity for the State's intervention, not only to correct market failures, but also to take into account elements that are external to the market, such as public interests and social fairness.

3. The phase of liberalisation and deregulation policies ending with the 2008 crisis.

In light of the awareness given by history, it can now be stated that after the oil crisis, starting in the eighties of the past century – the years of Margaret Thatcher and Ronald Reagan –, began a long period of time during which the economic theories in favour of market freedom became true practice, with policies of liberalisation and financial deregulation, combined with a huge privatisation phenomenon which took place in Europe.

It was the answer to the inefficiencies and the lack of competition generated by law systems which had somehow become out of date or too restrictive, and, in any case, unable to keep up with the needs of new technologies and globalisation, encouraged also by the end of communism with the crisis of the Soviet Union (the 20th anniversary of which falls this year) and the opening to the Chinese market.

The liberal wave, strengthened by the new geo-political scenario, resisted the subsequent larger and minor speculation bubbles – between 2000 and 2002 the USA technological stocks lost almost 80% of their value – and the attack on the Twin Towers of September 11, 2001, and actually resulted reinforced by fiscal and monetary developing policies implemented especially by the United States.

The crisis, already perceived in 2007, exploded in 2008, bringing on a sharp change of direction.

It is currently well known that the origins of the crisis lie in the sudden blow up of the real estate bubble. The financial sector, being widely and gravely exposed because of the high risk securitised loans, is hit by the crisis: specialised financial brokers, hedge funds, investment banks, all risk collapse. After a few rescue operations piloted by Fed, the decision to let the natural market remedy the Lehman Brothers bankruptcy provoked, in a situation characterised by an exaggerated private debt, a wave of panic and a chain-reaction of devastating effects on the worldwide markets.

4. *States' reaction and International authorities:*

a) The direct intervention on economy.

The States perceive the systemic nature of the crisis that soon invests the entire economy, and the preoccupying analogies with the great depression of '29. They acknowledge the impossibility of letting the markets' mechanisms operate on their own, and of merely standing by as bankruptcy enfolds the major financial brokers, too large and interconnected to avoid a series of disasters. They return to deeply intervene in the economy, by then in serious recession, transforming private debt into public debt.

In October 2008 the Congress of the United States approves the so called TARP (*Troubled Asset Relief Program*) and provides the Treasury

Department with 700 billion dollars to buy toxic securities; so to, practically, recapitalise financial brokers.

In Europe, the Eurosystem adopts extraordinary macro-economical credit measures to contrast the credit stagnation in the interbank markets and the overall liquidity crisis of brokers. Many States devise for or supply banks in need – having been their liquidity risk underestimated – with last resort credit, and launch further massive financial measures upon authorisation of the European Union. Many banks become State owned, even in Countries with a strong liberal tendency. Huge resources are employed, and they tie up considerable portions of National GDPs, considering both those supplied [chart n. 1], and moreover those provided to the financial system, valued by the EU in some 4.500 billion of Euros; Great Britain, actually, ties up more than 50% of its GDP, Spain more than 30%, Germany more than 20%.

In Italy the Government promptly reassures markets and savers, and no intervention is made necessary to save the large financial brokers which, even if facing difficulties in keeping adequate levels of capitalisation, withstand them better than those in other Countries, avoiding insolvency. In Italy credit and financial models are mostly traditional; this manages to create enough value for both private managed funds and the enterprises' demand for credit to the bank system. The system of vigilance proves to be efficient, and to have also correctly evaluated, in the previous years, the new financial instruments and their impact on the banks' capital, thus contributing in rendering it of good quality, if not at the highest level on an international scale.

The main instrument of support is aimed at meeting the banks' needs for recapitalisation. It is the so-called «Tremonti bond»: a hybrid security issued by banks which the State can subscribe for. The financial remuneration rates are those set by the market and the impact on the public finances is confined.

The States also intervene in supporting the real economy. In Italy huge resources are allocated to the social safety valves, and their utilisation

has been broadened so to prompt an immediate reaction against employment problems; other minor finance resources are allocated as incentives to industries and for other measures in favour of small and medium firms, and for private borrowers.

b) The answers on the regulation level.

The structure of market regulation is also among the causes of the crisis, and relevantly so.

The rules are not up to date with the current globalisation, and reveal themselves as internationally inconsistent. The boundaries of the regulatory system are insufficient. Relevant asymmetries are found in the severity and efficiency of the national vigilance authorities' inspections.

The increase in number of complicated financial instruments (securitisations, derivates) capable of shifting the risk often in a virtual and non transparent way, is combined with and encourages the activism of brokers not subject to prudential supervision, despite their executing activities whose systemic degree of danger is similar to that of banks (hedge funds, investment banks).

The opportunity for large international cross-border groups to choose highly profitable sectors that ensure high revenues, also because of underestimated risks, and the opportunity of operating where controls are less strict, are associated with the proliferation of financial operations in over the counter markets, non-regulated and control-less.

In important Countries, a relevant part of the banks' holdings loses any capacity for absorbing losses. Credit risk becomes market risk, and instability factors arise in an often surreptitious manner.

Finance drifts away from the real economy and from capital accumulation aimed at growth; it becomes self-referential. In 2007 financial products (shares and bonds) and derivatives become three times more than the underlying production of services and goods: around 150 thousand billion dollars of finance compared to 55 thousand billions of gross overall

product [chart 2]. At the end of 2008, the crisis peak, the overall amount of OTC derivatives was still higher than the world banks' capitalisation [chart 3].

Due to the crisis, public regulators are back on stage. Once aware of the impossibility of limiting risks and negative events due to the financial and economical integration, and once acknowledged the uninhibited use by stakeholders of the arbitration among national legislations in order to figure out the less strict rules and controls, an attempt is made to co-ordinate the interventions at an international level. A very important direction role is played by the Financial Stability Board.

In July 2010, the USA approve the Dodd Frank Wall Street Reform and Consumer Protection Act, a broad and complicated federal law aimed at paving the ground for a radical change in finance regulation. In the beginning though, its impact is limited, mostly because of the many secondary provisions – more than 240 – delegated to several authorities, and without which the main part of the new regulation cannot be implemented.

Furthermore, limitations are established on operations banks can perform on their own securities and on hedge funds and private equity trading (so-called Volcker Rule); derivatives and securitisations are regulated, as well as rating agencies, and stricter capital requirements and leverage levels are set. A new Council chaired by the Secretary of the Treasury (the Financial Stability Oversight Council) can demand that any company, other than a bank, national or foreign, be subject to Fed's supervision if it practices a mainly financial activity, and be subject to further prudential requirements in case relevant systemic risks are found. *The Council* and *Fed* are granted strong power so to compensate for the excess of systemic risk borne by any financial broker and for the subsequent impossibility of letting it fail. With regards to public companies, the shareholders' role is strengthened and rules are set for the managers' salary.

The European Union acts peremptorily. It harmonises the characteristics that hybrids (securities between shares and bonds) should have in order to be taken into account as regulatory capital, it reviews the provisions on great loans and those on cross border banks' monitoring, and it sets rules on securitisations similar to those later on provided by the Dodd Frank Act.

Moreover, the EU reshapes the architecture of the European vigilance system, adjoining to national authorities the European System for Financial Supervision (ESFS), composed by the new European Systemic Risk Board (ERSB) and by three new micro-prudential authorities on banks, insurances and stock markets (EBA, EIOPA, ESMA). The powers assigned to the new authorities are wide, if in a still too complicated frame of procedures and reaction times. Nevertheless, the ground is paved for ensuring coordination among national authorities, a more homogenous supervision, and a correct implementation of the European rules within each Member State.

In the meanwhile, the Basel Committee's work has been accomplished. The new prudential framework for banks (Basel 3) aims at giving more effectiveness and strictness, starting in 2013 and stepwise, to the regulatory system regarding capital, securitisations' and structured finance risks, financial leverage and cash flows. Contra-cyclical measures are set, so to provide, during times of growth, a patrimonial buffer to be used in case of recession. Along with further international provisions, stress is placed upon company organisation: new corporate governance principles are conceived, and rewarding and incentive policies are regulated.

The new prudential provisions, in order to become binding, need to be implemented by each single law system, thus meaning the European and National legislations as far as we are concerned. The huge work required is yet in pipeline and last December a first Directive was approved, regarding – among other things – the bank managers' salaries.

5. The necessary transience of public interventions on economy, and European and Italian discussions on the "Minimal State".

States and international authorities were fundamental in minimising the effects of the crisis and avoiding its further degeneration.

Rescue operations and other direct interventions on economy may nevertheless have distortive effects both on the market, which could, in the long run, according to some authors, even be compromised in its globalism, and also on the business risk allocation, that not only results in being borne by taxpayers, but is also no longer borne by those who own and exercise the business.

Thus the anomalous shift in enterprise risk increases; a phenomenon that in the last decades has already reached unbearable levels, especially with regard to the larger companies. Its causes are to be found in lack of transparency, intertwining and conflicting interests, company instruments that widen the financial leverage and modify that relationship between risk and management which is the foundation of capitalism itself.

Public interventions should therefore be temporary, even if implemented for excellent reasons; they should not only be set as temporary, but also prove to be so.

This extraordinary situation aside, the role of the States in economy is broadly discussed in Europe and Italy.

As for the EU, an indirect though fundamental influence is exerted by the monetary policy principles and the stability and growth pact. First of all with the budget restoration of many Member States – on which the *Annual Growth Survey* 2011 places a certain stress – which limits any public intervention, those in economy included, within the boundaries of financial sustainability and deficit reduction.

The Lisbon Treaty provides that the Union sets the internal market, and works proactively for a sustainable development "based on balanced economic growth and price stability, a highly competitive social market

economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment".

Competition keeps its central role in European Treaties. The Charter of Fundamental Rights recognises the freedom of enterprise, compliant with European Union law and national laws (Article 16), and the Treaty describing the Functioning of the EU (FEU) confirms traditional antitrust rules on agreements' prohibition and on the abuse of dominant positions, along with those on the incompatibility between State aid and the internal market (given exceptions excluded). Articles 119 and 220 FEU state that both Member States and the Union shall adopt and implement an economic policy in accordance "with the principle of an open market economy with free competition" for the purposes set out in Article 3, EU.

In the new European legal framework there is, therefore, no room for the principle of "Minimal State": a functional approach to the market economy is reinstated, and the need for economic policies aimed at realising a sustainable growth in Europe is clearly asserted.

At the same time, the liberal and competitive pattern, which was at the origin of the European Community itself, is strongly maintained and even reasserted in the treaties of the last two decades. The market, characterised by its openness and by a strong competition, is considered essential to social protection and growth.

Italy struggles in finding a similar balance and falls into contradictions.

A reform of Article 41 of the Constitution is proposed, even though it is doubtless that the choice, made by the Republican Constitution, in favour of a structured economic system yet based upon the market and the freedom of enterprise, has become stronger in time due to the influence of the European legislation.

In Article 41 the recollection of principles such as those of utility and social purposes are consistent with the European treaties, which provide that freedom of enterprise shall always be in accordance with the law; also, they qualify market economy as "social". Freedom of running a business,

therefore, requires a regulatory framework, even one lacking constitutional rank, necessarily devised to limit and prohibit – general principles excepted –, and which is also intended as a supplementary source of law able to ensure completeness and consistency to the legal system's values (Article 12, 2nd par., Provisions on the Law in General, Preamble to the Civil Code).

A hypothetic reform of the economic constitutional principles must be organic and well thought. It is important to include in Article 41 a reference to the fundamental value of competition and the subsequent entrepreneurial responsibility. Issues such as those of government control remnants and mixed economy need to be clarified: it should be considered as a preferable solution, instead of repealing the third paragraph of Article 41 in its entirety, as recently proposed, to rephrase it whilst recalling the European principles on the nature and goals of market economy, eventually modifying also Article 43. A constitutional relevance should be accorded to the market vigilance authorities, granting them full and constant independence, regardless of the political powers and interests at play at any given time.

It is fundamental to return on the path, taken in the nineties and never completed, of liberalisations and contrast actions against economic rents, of market flexibility, respect for the competition game and its consequences - even when negative (bankruptcy) -, and eliminating public interventions on the economy. Some cases of the last years (emblematic are, for instance, those of Alitalia and the Civil Protection Agency) bring one to believe that said direction has been recently taken with a lesser coherency and decisiveness than that envisioned by the constitutional reform intentions; especially lesser than what the growth of the Country would require.

6. *The importance and role of regulation.*

If on the one hand direct public interventions on the economy should be confined within limits of time and essence, on the other the importance of public rules in contrasting market failures (regulation) should now be considered a tenet.

In addition, though, the regulatory role of the State should be carefully calibrated.

Undoubtedly the finance reform must be achieved as soon as possible, so to avoid crucial crisis factors from occurring again. We need to ensure that the several interventions, already put in place by States and authorities, are effective and consistent, and overcome the current tendency of creating principles and rules which intervene, at different times and with different contents, on the same subjects. The competence concentration at an international level needs to be enhanced as well.

It is crucial to find a definitive solution to the problem of the risks shifting towards areas lacking effective rules and vigilance, or in which investment banks and other brokers benefit from a prudential preferential treatment. "Shadow banking" and "jurisdiction shopping" are made possible because of the still relevant differences among International regulations: after almost a decade, the USA still have not followed up on Basel 2, and the Dodd Frank Act has assigned wide regulatory powers to the implementing provisions with regards to financial companies. The same can be said as to the activity of supervision carried out by national authorities, which should, in any case, fall within a European framework yet to be further strengthened and rationalised.

Another issue under international scrutiny is the one concerning those financial institutions entailing great systemic risks (SIFI) and encouraging moral gambling, due to their size and interconnections, so to identify them with accuracy, enhance their capital solidity, make the risks evaluation and coordinated vigilance interventions among national authorities possible, and actually render bankruptcy effective as the last resort option.

Still open to discussion are the issues of independence and conflict of interests with regards to banks and brokers' management and activities (especially investment ones) , along with that of the external ratings' role, the pooling of the European and USA financial reporting standards when it comes to fair value and provisions for credit risks, the effectiveness of enforcement, which is in Italy dramatically linked to the exceedingly lengthy judicial processes.

From a general point of view, anyway, we should avoid following the "More rules" recipe.

The level of complexity and confusion in regulating the financial market and business was already excessive even before the crisis. A surplus of rules becomes an obstacle to the enterprises' efficiency and a deterrent to recovery, a potential ulterior reason to shift investments towards Asian markets [chart n. 4].

A balanced mix of private self regulation (through codes of conduct and specific provisions within bilateral agreements), recommendations subject to the "comply or explain" principle, and binding public rules must be found; without surrendering to the temptation of regulating every single aspect in an always more finicky and complicated manner. Substantial stability must be accorded to the regulation system, without it certainty decreases and administrative costs increase.

An excessive amount of rules, disorganised and constantly changing, overlapping levels of monitoring and supervision, and business bureaucratisation are, paradoxically, the best way to encourage a mere formal and not substantial respect for the provisions; they justify habits and behaviours distant from a true comprehension of how important rules and vigilance actually are.

The Italian law system, within the international scope, is still considered very critically in terms of complexity and its subsequent bureaucratic costs. The rationalisation and effectiveness of the rules remain priority goals, so to endorse legality and economic growth. The EU must play its part, by simplifying European acts, often overly detailed and only

formally recalling the proportionality principle. Emblematic are the Mifid directives: the gap between actual increase in investors' protection and the complexity of rules and duties resulted in being particularly high and unreasonable.

Regulation itself must strive for its own economic efficiency. Help may be provided by the Regulatory Impact Analysis (RIA), and, specifically, from a cost-benefit analysis, theorised and introduced some time ago in the USA.

The RIA is now widespread in Europe and in our Country as well. It allows for, also through a transparent consultation of the stakeholders, the acquisition of knowledge, comparison and evaluation elements with regards to regulation choices, especially on interventions assigned to agencies or public authorities or, in any case, with an implementing nature. With regards to legislation, the RIA proves useful especially for a retrospective analysis of the current rules, so to detect the outdated or inefficient ones and render the regulatory framework more rational.

On January 18, 2011 the President of the USA enacted an *Executive Order* concerning the improvement and revision of the *Regulation*, updating the regulatory impact system designed by Clinton (and before him by Nixon, and especially by Reagan). Among the general principles emerges the need for a regulation based on the best scientific knowledge, allowing public participation and an open exchange of ideas, encouraging predictability and reducing uncertainty, identifying and employing the best legislative instruments, more innovative and less burdensome, taking into account its own benefits and costs both in qualitative and quantitative terms, ensuring that rules are accessible, consistent, written in a simple language and easy to comprehend, evaluating its actual achievements and having the objective of enhancing them.

Firstly, though, the *Order* points out the necessity for the regulatory system to safeguard public health, social wellbeing, safety, the environment and, at the same time, promote economic growth, innovation, competitiveness and job creation.

7. *The joint effort of law, economy and politics for a new global agreement on market regulation.*

The RIA thus begins to be considered with a new emphasis on characteristics quite different from its initial strict ones and on the circumstance that the market is no longer self-referential, that rules shall rectify its failures and aim at economic efficiency, keeping in mind though that this is not enough.

The absolute and fundamentalist market theory (rationality, efficiency, natural balance, intolerance to rules, ability to ensure development, and even offer itself as a social model) proved as being unrealistic.

Even in traditionally liberal Countries and environments the belief is spreading that: if "the open markets and freedom of business are the best way to increase wellbeing, health and happiness of mankind", nevertheless "markets are an instrument to reach a goal, not a goal themselves", as was stated by the conservative British Prime Minister in Davos, in January 201.

Also in order to avoid that past theories and practices, currently receding – yet still alive – , prevail again, the right balance must be found in the relationship between market and society, so to not disregard neither the essential role of the first, nor the values and needs of the latter.

It is indeed a very difficult task, though fundamental for the future of a world based on the cardinal principles of modern civilisation: democracy, equity, quality of life, social progress.

The regulation of the market plays an important role in this challenge and is, at the same time, the first interpretative element necessary in understanding its results. The events of recent years show that facing it requires a joint effort by both the law and the economy, beyond any conceptual contrast. And it is essential, in their actual enforcement, that both be enlivened and mediated by political action.

It is, however, certain that the challenge cannot be won without an alliance, a global agreement able to overlook national short-term interests, either economic or related to each sovereign power's integrity, and achieve a market regulation not just efficient, but "good".

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