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Averting a Financial Crisis through Regulation, Including Legislation

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Abstract : The paper discusses regulatory and legislative measures implemented by various nations in an effort to avert another financial crisis. More specifically, to address the financial crisis, the European Commission followed the practice of other developed countries and implemented a European Economic Recovery Plan in an attempt to overhaul the regulatory and supervisory framework of the financial sector. In 2010 the Commission introduced the European Systemic Risk Board and in 2011 the European System of Financial Supervision. Some experts advocated that the type and extent of financial regulation introduced in the European crisis in the wake of the 2008 crisis has been excessive and counterproductive. In considering how different countries responded to the financial crisis, global regulators have shown a more focused commitment to combat industry misconduct and to pre-empt abusive behavior. Regulators have also increased funding and resources at their disposal; have increased regulatory fines, with an increasing trend towards action against individuals; and, finally, have focused on market abuse and market conduct issues. Financial regulation can be effected, first of all, through legislation. However, neither ex ante or ex post regulation is by itself effective in reducing systemic risk. Consequently, to avert a financial crisis, in their endeavor to achieve both economic efficiency and financial stability, governments need to balance the two approaches to financial regulation. Fiduciary duty is another means by which the behavior of actors in the financial world is constrained and, thus, regulated. Furthermore, fiduciary duties extend over and above other existing requirements set out by statute and/or common law and cover allegations of breach of fiduciary duty, negligence or fraud. Careful analysis of the etiology of the 2008 financial crisis demonstrates the great importance of corporate governance as a way of regulating boardroom behavior. In addition, the regulation of professions including accountants and auditors plays a crucial role as far as the financial management of companies is concerned. In the US, the Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board in order to protect investors from financial accounting fraud. In most countries around the world, however, accounting regulation consists of a legal framework, international standards, education, and licensure. Accounting regulation is necessary because of the information asymmetry and the conflict of interest that exists between managers and users of financial information. If a holistic approach is to be taken then one cannot ignore the regulation of legislators themselves which can take the form of hard or soft legislation. The science of averting a financial crisis is yet to be perfected and this, as shown by the preceding discussion, is unlikely to be achieved in the foreseeable future as 'disaster myopia' may be reduced but will not be eliminated. It is easier, of course, to be wise in hindsight and regulating unreasonably risky decisions and unethical or outright criminal behavior in the financial world remains major challenges for governments, corporations, and professions alike.

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