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Deregulation of Financial Markets: A Review of the Past Outcomes and Current Issues

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Deregulation of Financial Markets: A Review of the Past Outcomes and Current Issues

Abstract

The aim of this study is to present the main aspects behind deregulation, including possible impacts on general economic activity, financial stability, and competitive effects in the financial services industry. The paper describes the expected benefits and costs of deregulation. It also discusses how deregulation should be accompanied with new regulations which aim to preserve the safety of financial institutions whilst encouraging competition. Possible challenges relating to the implementation of these concepts are also outlined.

JEL Classification: G18, G20, K20, K23
Keywords: deregulation, financial market development.

1. Introduction

Deregulation may be defined as the removal or relaxing of existing regulations. Throughout the past decades, the business world has gone through a process of deregulation, in a wide variety of industries such as electricity, gas, transportation, telecommunications and finance. The latter industry has traditionally been the epitome of regulatory custody, and therefore its deregulation process has attracted considerable attention. The deregulation of financial markets impacts on the financial sector as a whole, including banks, securities markets, non- bank financial institutions and international flows of funds.

Two reasons behind the trend towards deregulation were that:

◦ Traditional regulatory systems, which included interest rate ceilings, and segmentation of financial business in between various institutions, were limiting competition in the financial markets; and

◦ In their role as innovators, financial institutions, were developing new products and systems which were designed to avoid regulatory restrictions, thus making the latter ineffective. For instance, the Eurodollar market partly developed from banks' efforts to circumvent US interest rate restrictions.

In this way, we may speak of at least 2 sources of deregulation – De Jure Deregulation and De Facto Deregulation. The former type of deregulation refers to when authorities remove or relax previously existing regulations. De Facto Deregulation stems from the fact that regulations become ineffective, through other developments in the financial markets, as outlined in the above example.

The aim of this study is to present the main aspects behind the deregulation process, its possible impacts on financial stability and the economy in general, and the main lines of thinking relating to current regulatory efforts.

The paper starts with a historical background relating to deregulation in Section 2. After outlining the expected benefits to be gained from deregulation in Section 3, the outcomes of the process are summarised in the subsequent section. Section 5 outlines how deregulation is often accompanied with new regulations which aim to preserve the safety of financial institutions whilst encouraging competition. Thus, deregulation should also be discussed in a re-regulation framework. This concept explains the current regulatory trends as described in Section 6. Section 7 concludes.

2. Historical Background

Some of the benefits of a deregulated banking system may be inferred from Cameron (1972), concerning the Scottish banking system between 1716 and 1844, where there was a liberalised entry and exit in the industry, and banks could operate without any restrictions. This environment fostered competition, which led banks to innovate by introducing or improving a number of services, such as branch banking and overdraft facilities. This system is referred to as "free banking".[1] Does the latter concept imply that banking regulators were taking a step backwards with their regulatory policies?

In attempting to answer this question, one must note that in a "free banking" world, banks would be allowed to fail irrelevant of their size or negative repercussions on the economy. The latter repercussions may include the failures of other banks, through contagion and the fact that depositors may also run on other healthy banks.

1 Research on free banking systems is comprehensive and different authors have attributed it both with competition, innovation and soundness, as well as with instability. The detailed review of such research is beyond the scope of this paper, however.

Depositor protection and financial stability were two of the main reasons why regulators emphasized the creating of a safer financial environment, especially after the Great Depression and the banking crisis of the 1930s. Regulators should preserve the interests of depositors who tend to be more risk-averse than shareholders. Confidence in the financial system is essential, given that banks' liabilities have the important function of being accepted as money. Other objectives of "older generation" regulators were to influence macro-economic policy and to channel credit towards certain sectors in the economy, such as the housing market. These aims were pursued through the implementation of a whole array of regulations, which included maximum interest rates payable or chargeable, reserve requirements, constraints on geographic markets, segmentation of institutions by type of services offered and restrictions on the type of investments which may be entered into.[2]

While the above regulations limited opportunities, they virtually guaranteed a profit given that they created an over-protected environment, which Huertas (1983) referred to as "cartel banking". Bankers could borrow funds at stable interest rates and grant loans at practically guaranteed spreads. One main problem was that these restrictions created an artificially stable environment, where there were no incentives to foster competition or to manage volatility of financial markets. One example which illustrates how such regulations were limiting competition was the U.S. Glass-Steagall Act (1933). This Act (which was repealed in 1999), distinguished between US commercial and investment banks and no institution was allowed to operate in both fields. The main intention was to promote safe banking practices, on the grounds that integrating these activities could lead to abuses or conflicts of interest. In effect, the Act, made it more difficult for banks to diversify their business.

One further limitation on part of regulatory systems, such as the US one, was the resulting discrimination between banks and non-bank financial institutions. The latter were less regulated, and enjoyed more freedom to innovate and satisfy customers' demands for choice. Such types of institutions included Mutual Funds which sold shares to the general public and invested in diversified portfolios. Given that their liabilities are not deposits, Mutual Funds were not subject to Regulation Q. This made it possible for them to satisfy investors' desire for higher returns. These funds have grown at an accelerating rate in the US, and they have been a successful financial innovation which made investing an easier task for the small saver.

On their part, even banks tried to avoid regulations such as some aspects of Regulation Q, by operating through the Eurodollar market and by introducing new services such as cash management accounts and NOW accounts. The latter were virtually current accounts on which cheques could be drawn and had the additional attraction of an interest payment. Another example of financial innovation is the way in which institutions got around the geographical restrictions on expansion [such as the McFadden - Pepper Act (1913) in the US]. They did this by operating through subsidiaries and by entering into shared facility arrangements.

Therefore, one important aspect in the history of banks is their role as financial innovators - marketing new services and adopting new methods of operation, at times intended to avoid regulation. On their part, regulators often stepped in again with new restrictions, which banks again sought to avoid.

Financial institutions lobbied for deregulation, on the grounds that the existing structure discriminated between institutions, and was limiting competition. For example, it was difficult for US banks to challenge the efficiency of Eurobanks, which were not subject to interest rate restrictions. The next section discusses why such lobbies proved effective, in terms of the foreseen benefits that were to be gained following deregulation.

2 The examples of such regulations presented in the rest of this Section are US ones.

3. The Rationale Behind Deregulation

Deregulation was advocated for on various grounds. As already argued, traditional regulatory systems restrained competition, partly due to the fact that rigid pricing structures functioned very much like a cartel. Thus, one of the objectives of deregulation was to liberalise interest rates, exchange rates and prices, in order to create a market - oriented environment which induced competition. Competition was also to be enhanced by opening up the financial markets to foreign participants, and by allowing financial institutions to engage in different kinds of business, since this would increase the number of suppliers of a given service. Such policies tend to dampen the oligopolistic structures which are traditionally associated with banking systems in various countries, and potentially result in better terms for bank customers.

A further potential benefit is that new services provided by financial institutions and seeking business abroad result wider diversification possibilities.

Artificially low interest rates may lead to a shortage of savings needed to finance investment, and this results in credit rationing by financial institutions or by the government. Credit rationing might occur through the request of collateral, government regulation giving preference to particular sectors, and at times perks and rewards to bank officials. This results in a misallocation of credit, given that these policies do not select the best opportunities in terms of their risk-return combination, as is expected to occur in a market-determined system. Thus, deregulation permits financial capital to be directed to the most efficient and profitable opportunities, which leads to a higher degree of allocative efficiency.

More competitive pricing policies and better credit allocation should lead to a higher degree of efficiency in financial markets.

Liberalised interest rates, should lead to lower underground activity, given that more people would be willing to deposit funds in banks, where they receive a market-clearing interest rate.

It may also be argued that a deregulated environment is now a must, if a given financial market aspires to attract and retain sufficient business. Interest rates are now difficult to maintain fixed in a global environment and technological advances make past regulatory restrictions irrelevant and almost impossible to enforce. Telecommunications have brought geographical restrictions to a minimum. Thus, financial innovation makes regulatory reforms inevitable.

The impacts of deregulation are presented in the next section.

4. The Effects Of (And Responses To) Deregulation

Deregulation brought about a radical change in the structure of financial markets. This section discusses the benefits and possible pitfalls arising from the deregulation process. Particular reference is made to the impacts of deregulation on competition, globalisation, bank management, the economy and banker-customer relationships. Additionally, some of the possible impacts of deregulation on smaller economies are outlined.

4.1 Competition

The reduction in barriers to entry, increased the number of financial institutions participating in the global markets. Deregulation, coupled with improvements in technology, globalisation, and "institutional integration", has enhanced the number of services available in the financial markets, as well as the number of suppliers of each service. Financial institutions now offer life assurance products,

off- balance sheet commitments, derivatives, collective investment schemes and a whole array of financial services. This resulted in higher levels of competition in banking systems, as shown by various authors including De Pinho (2000), Carbó Valverde et. al. (2003), Salas and Saurina (2003), Kumbhakar and Lonzano- Vivas (2004) and Sturm and Williams (2004). According to Hall (1987), deregulation has also brought about changes in the market share of each institution for every given service, as different types of institutions sought diversify into different business activities previously provided by other competitors.

Despite this, authors such as De Guevara and Maudos (2004) and De Guevara, Maudos, and Pérez (2005) still noted a relatively low level of financial integration in between European counties, which at times shelters national markets from overseas competition. The authors showed that despite the deregulation trend in Europe, market power for some institutions has continued and possibly increased.

4.2 Globalisation

Another significant development, which was partly instigated through deregulation was globalisation. Financial markets were opened to the entry of foreign banks, which further nurtured competition. Capital may now flow more freely in between countries to the most efficient investment opportunities, due to the removal of exchange controls from the major markets, as well as improvements in technology and information.

The resulting integration between previously geographically segmented markets enables borrowers to seek funds from the institutions they choose and in the currency they prefer, whether on a fixed or a floating rate basis. Investors are no longer confined to the financial instruments issued in their home country. This further induced authorities to deregulate, so as to enable financial enterprises to compete effectively around the world.

Nowadays, financial institutions should clearly consider foreign competition and overseas business possibilities, in their strategic management process.

Given the globalisation trend, it is likely that only the largest and most efficient institutions will be able to compete on a worldwide basis, and this accounts for the merger and acquisition activity which the international financial markets are continually witnessing. Thus, the largest banks are growing even bigger, while the smaller banks may loose their best customers to these banks. One potential concern is that if markets become characterised by a few giant operators, competition may be jeopardised, undermining one of the main objectives behind deregulation. For instance, Carow, Kane and Narayanan (2005), studied different cases of US bank mergers and noted that mergers may present increased bargaining powers for banks when dealing with regulators and other competitors.

Further effects from deregulation include increased integration of capital markets in different countries, as discussed for instance by Chay and Eleswarapu (2001) in the context of the New Zealand experience. This implies that problems in the financial markets of a particular country may more easily spread on to other capital markets, and thus regulators should become even more concerned with fostering financial system stability.

4.3 Bank Management

When financial market deregulation results in foreign ownership of the existing institutions, overseas investors may demand improved corporate governance and transparency procedures in the management of institutions.

When deregulation in the financial services industry results in increased competition, this may also instigate institutions to operate more efficiently as empirically found by Gropper and Oswald (1996) [US commercial banks], Sturm and Williams (2004) [Australian banking industry] and Ataullah, Cockerill, and Le (2004) [India and Pakistan]. Deregulation has widened the banks' potential to enhance their roles as financial innovators, not only due to their ability to offer new products, but also through adopting new organisational structures, delivery systems and methods of operation, designed to give the institution a competitive edge over its peers. As an example, one may cite the process of securitisation, whereby banks sell loan portfolios as marketable securities, removing them off their balance sheet and thus lowering reserve requirements and loan loss provisions.

Deregulation resulted in the liberalisation of interest rates, and this implied that banks were to pursue their own pricing policies, which no longer guaranteed a profit margin in the new financial environment. Banks had to shift from policies of passive asset management, to active asset and liability management – they had to attract the funds they needed at prices which they could partly influence.

Banks nowadays have to deal with a wide variety of risks, apart from interest rate risk. As banks seek new business areas, their operations become exposed to market risk, exchange rate risk, country risk, and counterparty risk. At times, banks took on additional risks in order to protect profits, as discussed by Salas and Saurina (2003) in the context of the Spanish banking system.

In response, regulators tried to mitigate the perils associated with such activities by imposing capital adequacy regulations. As capital became increasingly costly,banks tried to undertake off-balance sheet activity, and concentrate on fee income as opposed to interest income. This further increased their risk undertaking as they started to offer new kinds of services, such as derivatives, which entail different management skills. Thus, risk management policies and adequate capital bases have become of crucial importance in bank management.

In order to present a more complete view, one should note that increased risks undertaken by banks may be viewed as positive by some players, such as those companies which were previously denied loans, for the simple reason that banks could not attach a sufficient risk premium to the interest rate charged. Still, this does not imply that higher risk-taking is desirable from a general economic point of view.

4.4 The Economy

Deregulation of the financial services industry can impinge on the general economy, both through effects on real factors such as entrepreneurship, as well on monetary factors. Wall (2004) presented empirical evidence that banking deregulation had mixed effects on entrepreneurship in different US states.

Deregulation may also impinge on the effectiveness of monetary policy in influencing the economy. Deregulation implies that monetary authorities can no longer impose direct lending controls. In order to influence the supply of credit monetary policy makers may only change interest rates. As financial markets start to participate in the determination of interest rates, monetary authorities might find it more difficult to influence this variable through their policies.

One may argue that more volatility has resulted from the liberalisation of interest rates and exchange rates. In fact, one of the main premises in favour of fixed interest rate and exchange rate structures is to create a more stable financial environment.

The volatility in financial prices emanating from deregulation may extend beyond the economy of the particular country, if the latter is in a position to exert a major influence in the financial markets, maybe

because of the importance of its currency or size of the economy. As an example one may refer to the 1980's debt crises of many Latin American countries, where one factor which exacerbated the problem was the increase in US dollar interest rates. In view of the fact that financial markets in different countries are competing with each other to attract deposits as well as loans, interest rates in different countries tend to move together. This further explains how volatility in one economy tends to impinge on the volatility of others.

Does this mean that deregulation and financial liberalisation lead to instability? Kaminsky and Reinhart (1999), found that banking crises are often preceded by financial liberalisation. On the other hand, in a study by Hon Chu (1996), it was found that "free banking is not more prone to bank failures[3] than regulated banking".

The above (apparently contradictory) findings, may point out that the aspect which may lead to instability is, really, the process of transition itself. Relying on the results of the latter study, we may assume that neither the past-regulatory frameworks, nor the deregulated systems are in their own nature unstable. However, the results of Kaminsky and Reinhart (1999) seem to indicate that the process of financial liberalisation may be one of the factors that could lead to a banking crisis. The bottom line is that the way in which the particular country approaches deregulation and financial liberalisation, is likely to impinge on whether the required stability is maintained throughout and after the transition. Deregulation should be approached in a diligent manner, as discussed in Section 5. Countries undergoing deregulation should dismantle restrictions in such a way as to avoid financial instability, and this partly explains why, authorities are implementing new kinds of prudential regulations, as well as supervising financial institutions.

4.5 Banker-Customer Relationships

Deregulation also impinges on bank-customer relationship. Customers can now bargain in search of the best prices from a larger number of possible suppliers. Companies have also shifted the financing of part of their operations through marketable instruments such as bonds, as described for instance by Anderson and Makhija (1999) in the context of the Japanese economy.

On the other hand, customers may require a higher degree of protection in a deregulated environment given that the trend towards offering a whole range of financial services may lead to conflicts of interest on part of the financial institution. For instance, in an attempt to increase the volume of business, the bank may market derivative products to customers who do not really need them. This might have been the underlying reason behind a number of complaints on part of customers of Bankers Trust, US in the mid-1990s.

In their quest to boost profitability and efficiency, banks might focus their attention on the most profitable customers to the detriment of less lucrative ones, and this leads to the concept of financial exclusion. According to Mullineux (1999), certain classes of people might find themselves excluded from the potential deregulation benefits. These include people who do not hold bank accounts, the illiterate, the unemployed, people with modest borrowing requirements which do not justify the costs involved in granting a loan, and borrowers who cannot grant collateral. The latter may include service businesses which do not rely as much on fixed assets and new enterprises set up by young people. The concept of financial exclusion does not only apply to individuals but also to communities; for instance banks at times opt to withdraw from deprived areas. As argued by Mullineux (1999), if special kinds of institutions are set up to grant preferential borrowings in such cases, these entities would have to be

3 The amount of bank failures are only one indication of the degree of stability in financial markets. One must also consider other aspects such as interest rate, exchange rate and general price volatility.

subsidized by the government, which would undermine the concept of a "level. playing field". In this way, banks might start thinking about filling up these gaps themselves, maybe backed by some sort of concessions or guarantees by the government. According to Carow, Kane and Narayanan (2005), the symptoms of financial exclusion such as reduced credit availability for smaller firms, may become pronounced through consolidation of the financial services industry.

Summing up, one may say that deregulation was an important element in creating a new financial environment. Barriers to entry were slackened, in order to foster competition and globalisation. Institutions are now entering the financial services market in general, instead of focusing on a narrow range of activities. New kinds of alliances are being sought, and these range from loan syndication to merger activity. This environment presents ample opportunities, threats and challenges in financial markets. As seen, this impinges on the activities of governments, regulators, financial institutions, as well as customers.

4.6 Possible Impacts On Smaller States

Smaller states, especially islands, tend to specialise in a relatively low number of industries since their size makes it difficult for them to reap economies of scale if they diversify excessively. According to Briguglio (2001), this factor and the lack of natural resources, makes small states rely on particular service industries, such as financial services. In this way, the financial deregulation phenomenon within smaller states is more likely to impact on one of the major industries of the economy. Given this, it may be argued that the effects of financial deregulation tend to be proportionately larger in smaller states, as compared to their impact on larger ones.

The comments in this section rely on the assumption that the main financial institutions in smaller states are of a small or a medium size, as compared to others. [4] Deregulation should enhance business opportunities for these institutions on the grounds that the potential new overseas business may enable them to take better advantage of economies of scale. The latter tend to be substantial in the banking industry, given the massive set-up costs involved.

Smaller institutions are likely to be more efficient in responding to change. In a changing regulatory environment, this is likely to give them a competitive advantage over larger institutions that may have to go through a more bureaucratic management process when implementing change.

When deregulation exposes financial institutions to foreign competition, this is likely to dampen the structure of oligopolistic financial markets, which are likely to be even more evident within small-state economies.

Nonetheless, the disadvantages associated with small size should not be overlooked.

If we assume that institutions in small states are less capitalized due to the fact that they are smaller ones, we may infer that this places them at a disadvantage as compared to international institutions. Highly capitalized institutions are recognised as healthier participants. In this way, they may have access to financial markets at preferential rates and enjoy a higher potential to engage in certain kinds of business such as the granting of large loans. This would imply a competitive edge for larger institutions over smaller ones.

4 Some institutions operating from smaller states and distributing their services internationally, through branches or online operations, may not be in line with this assumption.

One may also refer to the fact that smaller institutions may be absorbed by larger ones through merger and take-over activity. While this phenomenon is not limited to small economies, small institutions may be particularly vulnerable since it can be difficult for them to compete with larger counterparts operating on a global basis.

Finally deregulation of interest rates and exchange rates, may expose small economies to a higher degree of volatility as compared to larger ones. This is because it is difficult for the former to mitigate the effects of international interest rate and exchange rate volatility, given that this often requires high amounts of foreign currency reserves.

5. Deregulation And Concurrent Re-Regulation

As discussed above, deregulation has resulted in new business possibilities for financial institutions. This implies the need for re-regulation of the financial services industry, on two grounds. Firstly, deregulating the activities of financial institutions may make the latter more prone to taking risks, as happened in the Spanish banking system according to Salas and Saurina (2003). Secondly, new activities expose institutions to new risks, and this implies that financial markets should be re-regulated to preserve the stability of the financial system. Reregulation should be done without compromising a competitive environment which was the main scope behind the deregulatory trend.

Therefore, we may delineate a difference between the regulations which havebeen (or are currently being) removed, and the new ones being implemented. While the previous limited competition by imposing limitations which functioned much like a cartel, the latter are designed to promote stability in the financial system. This is achieved by limiting the risks which banks can enter into, managing risk exposure and ensuring that they are strong enough to endure the risks that they choose to undertake.

New regulations include minimum capital requirements, liquidity requirements, and restrictions on large exposures. These issues are supervised by a competent authority, as discussed in the next section. One particular area where regulation has undergone significant changes is capital adequacy. The main trend is the shifting away from traditional accounting rules, to the surveillance of risk management systems employed by banks, and how such models are then used to assess the adequacy of the capital cushion of the institution.

The processes of deregulation and re-regulation should be implemented according to a plan, with definite objectives and time-frames, rather than through an offhand approach. Prior to undergoing deregulation, supervisors should establish that they are in an adequate position to monitor and handle any resulting problems. In particular, the supervisory authorities should implement a system for the identifying failure-prone institutions. They should also determine efficient procedures and guidelines to be followed when dealing with any required restructuring or liquidation of financial institutions which run into trouble.

The deregulation process should allow the economy and financial institutions enough “breathing space” to adjust to change, in such a way to avoid potential problems associated with a financial system, which is yet unprepared for such a conversion. Additionally, the process of re-regulation should continue, as new products are created, as innovative methods of operation evolve, as financial markets get more globalised, and as new technology permits institutions to offer services which were previously unavailable.

Particular features may be relevant when discussing re-regulation in the context of smaller states. For instance, Chami, Khan, and Sharma (2003), discussed the problems which may be encountered by developing economies when implementing Basel 2 Capital Adequacy regulations. Potential hurdles

include shortages of highly trained personnel required to assess the adequacy of banks' risk management systems. In addition, when the modest size of the banking industry in smaller countries, translates into a limited amount of competition, and securities markets are not sufficiently efficient, the foreseen market discipline relating to capital adequacy may be compromised.

6. Regulatory Trends Nowadays

The re- regulation process has brought about a change in the regulatory systems of most financial markets which now function on prudential regulation and supervision principles. We may also speak of a trend for all activities relating to financial services to be supervised by one institution. In addition, international efforts are aimed at achieving a higher degree of harmonization and cooperation among different regulatory regimes.

The main scope of prudential regulation is to achieve a suitable level of safety in the financial system. In this respect, we may mention Banking Acts, Depositor Protection Funds, restrictions on Large Exposures and Capital Adequacy Regulations. When banks have sufficient capital at risk, they have an incentive to act in a responsible manner. Banks are not expected to eliminate all risks, but they should hold enough capital to absorb potential losses arising from risky activities [5]This ensures that institutions maintain a sound Balance Sheet and that they operate according to some minimum standard.

Supervision of the financial system is intended to ensure that the prudential regulations set out by authorities are observed. Financial institutions and supervisors should develop an ongoing interacting process. Institutions file reports and statistical returns which are analyzed on a regular basis. The supervisor then publishes the information which is deemed suitable for such a purpose. The supervisory system should include the carrying out of periodic onsite examination or inspection of financial institutions, analysing aspects such as credit quality checks on loans and adequacy of internal controls. The system should also establish possible procedures for initiating timely remedial action relating to problem institutions.

Gardener (1996) listed the challenges faced by financial services supervisors. These include ensuring that regulations are effective in retaining the risks of financial institutions at acceptable levels; implementing regulations that do not translate in competitive discrimination amongst institutions; and updating regulations in line with changing industry trends.

Apart from the above issues, other regulatory considerations have also centred around who should be responsible for supervision. It is often maintained that the supervisory function should be distinct from the Central Bank as this may conflict with the conduct of monetary policy. For example, the Central Bank may be unwilling to tighten macro-economic policy, due to possible negative consequences on banks emanating from an interest rate hike.

Other arguments tend to decline the entrusting of supervision of different financial institutions to different supervisory bodies, on the grounds that this may lead to cost inefficiencies. Such a policy would imply that financial conglomerates offering a whole array of financial services would be supervised by different bodies. In this way, various entities supervising the same institution may focus on the particular part which they have been delegated, and de-emphasise looking at the institution as a whole. Given this, a single regulatory body should lead to efficiency gains. Yet, one should also take

5 In certain cases, such as derivatives, the losses arising from a single transaction may prove to be immensely large. One should therefore speak of the "losses arising with a certain degree of probability".

Note of the various arguments against a "mega-regulator", such as excessive power devoted to one institution, which may become extremely bureaucratic and unable to distinguish between different financial institutions.

At the international level, various organisations and institutions such as the Basel Committee on Banking Supervision, the International Monetary Fund, the World Bank, the Financial Stability Forum and the Organisation For Economic Cooperation and Development (OECD), are stressing the importance of suitable cooperation between different regulators. This is becoming even more important nowadays, given the globalisation trend. For instance, the expansion of financial conglomerates operating across different countries makes separate national supervisory efforts inadequate, in the sense that probably no supervisor can grasp "the whole picture" of such an institution on their own.

International efforts are also directed towards attempting to fix a "level regulatory playing field" in the major countries. This includes a higher degree of liberalisation of international capital movements, the harmonization of activities which particular institutions are permitted to engage in, and dealing with a variety of investment restrictions for fund managers. These efforts tend to be undermined by the fact that accounting and fiscal practices follow different policies in different countries. For instance, such anomalies extend to the definition of "bank capital" which is used across countries.

Last but not least, in re-regulating the financial services industry, the crucial aspect of "policy balance" should be kept in mind. Gardener (1996) defined the latter term as "ensuring that supervision achieves its aims without negating or 'undoing' the competitive gains sought by deregulation; this is never an easy task". The effect of re-regulation on the pricing policies of financial services firms may be inferred from a Return on Equity decomposition as follows:

Return on Equity = Return on Assets x Equity Multiplier (1)

Assuming that banks have a fixed target for Return on Equity, and assuming that regulation translates into a lower Equity Multiplier due to capital adequacy regulations, this would imply that the banks would have to increase Return On Assets, for instance through wider margins and increased fees.

7. Conclusion

Preserving the stability of financial markets has always been a prominent aim of regulatory authorities. Traditionally, this was pursued through a series of restrictions which limited competition. Deregulation exerted a major impact on the financial markets, as additional objectives of enhancing competition and a more efficient allocation of funds were sought. Technology, globalisation and new methods of operation have made deregulation inevitable and this impinged on other areas such as bank management, banker-customer relationships, and the economy as a whole. Deregulation effects extend beyond the country undergoing the process of deregulation, if such a country's economy or currency exerts a major influence on global markets. Deregulation may exert particular impacts on the financial markets of smaller countries.

Financial market stability is still on top of the regulators' agenda, and this accounts for the re-regulation trend. The latter aspires to limit risk-taking, whilst avoiding to deter competition. Regulatory systems now revolve around prudential regulation and supervision. Additional, international efforts are directed towards enhancing collaboration between different national regulators and to achieve a higher degree of harmonisation.

As a concluding note one should point out that the considerable efforts directed towards the regulatory setup of financial systems may prove futile if such regulations are not adequately enforced. This presupposes the existence of supervisors equipped with sufficient resources – which in the case of smaller states might prove challenging when considering that this entails considerable financial commitments and technical expertise.

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