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The Role of Regulatory Risk in The Concept of Banking Sector's Self-Regulation

Economists attribute the sources of the contemporary financial crisis to, among other things, three groups of factors: financialization, poor risk management, and inadequate process of regulating financial institutions under the conditions of globalization. Incidentally, the article is connected directly and indirectly with these three determinants of the subprime crisis that emerged in the U.S. economy in 2007.

Financialization is a term that is associated least with regulatory risk, perhaps because the regulatory issues are dominated by lawyers and the term "risk" has been only emerging slowly in the practice of making regulations in many countries [OECD, 2010]. Moreover, the multi-level character and complexity of different definitions of financialization are not favorable for the adaptation of this category in the prevailing concepts of risk or regulatory development and implementation [Dembiński, Beretta, 2014, Ratajczak, 2012, Palley, 2007 Bresser-Pereira, 2010, Epstein, 2002].

In the present article, financialization is not treated as an adverse phenomena connected with the excessive development of the financial sector in the economy, which makes financial institutions lose their servile role towards the needs for financing economy and society; it is treated as a process of shaping the dominant role of financial services where more and more business entities from beyond the financial sector try to enter the financial services market. High dynamics of financialization defined in this way is significantly affected by financial innovations, namely embedded in payment systems, business models or portfolios of offered banking products.

One of many sources of the present crisis includes serious reservations towards the risk management system, owing to:

- overestimated risk anticipation capacities,
- incorrect threat identification,
- unlimited trust in risk measurement results,
- poor cooperation between risk management and audit departments, and regulators,
- unethical behaviors of managers,
- ignoring risk,
- inadequate organizational culture.

Regulation in the form of administrative interferences of the government or its agencies in the functioning of the market has at least two faces. One shows positive consequences of this type of actions: they result from inefficiency of the market mechanism or a strong authorities' pursuit of the planned goals, generally social or ecological goals. Under the

conditions of a very harsh competition between companies and financial institutions and weak architecture of the supervision over markets on a global, regional, and, in many cases, regional scale, the crisis clearly showed that the system of financial markets control and regulation failed. It is confirmed by numerous new developed and implemented regulations that emerged after the outbreak of the financial crisis.

The own research of the author undertaken so far shows that not only do regulations developed with huge effort show imperfections, but they also have fundamental weakness. In this situation the following working hypothesis can be put forward: one of the reasons for low regulatory effectiveness and efficiency is ignoring, quite commonly, the already emerged concepts of support for regulatory development processes, in particular ignoring the issue of regulatory risk management.

Origin, essence and determinants of self-regulation

Because of a long history of setting standards concerning products, technical issues or ethical principles of marketing, it is hard to indicate an exact date of the creation of self-regulation. The U.S. authors state that starting from the 1930s, laws concerning the functioning of the securities market were determined by a form of self-regulations implemented by such organizations as NYSE, NASD, which assumed responsibility for creating a playing field and supervising any infringements. Moreover, the actions of financial services and lawyers were subject to supervision of self-regulatory institutions [Coglianese, et al., 2004]. I. Bartle and P. Vass state that in Great Britain the process of regulating activities of business entities by means of self-regulations dates back to the first half of the 19th century, and even earlier. The 20th century featured a quality change, which consisted in increase in the role of public regulations made by state institutions [Bartle, Vass, 2005].

Self-regulation has different definitions in literature, in particular with regard to the financial sphere. Conceptually, this form of regulation is considered as completely opposite to the rules created by the government and its institutions in relation to companies' unit or group initiatives. According to R. Baldwin and M. Cave self-regulation takes place when *a group of companies exerts pressure on their members' compliance with the adopted requirements, by controlling their behaviors* [Baldwin, Cave, 1999, p. 125]. K. de Weers presents a slightly different definition of self-regulation: *it consists in compliance with the rules, provisions, standards voluntarily initiated and determined by a company or a group of companies operating on a given market, but where supervision over these obligations is exercised by the government* [de Weers, 2011, p. 17]. According to M. Marcinkowska: *Self-regulation is based on negotiated and voluntarily adopted codes of good practice or other informal rules, so it is frequently termed "soft law"* [Marcinkowska, 2013, p. 127]. At the turn of the 1970s and the 1980s, Japanese manufacturers, in response to growth in the price of oil, launched energy-saving refrigerators and air-conditioners, adopting a uniform standard of their production. Presently, industry associations and International Organization for Standardization (ISO) show great activity in promoting self-regulatory solutions.

The fact that the regulated entities are in charge of regulatory initiative and control in self-regulation does not exempt the government and its institutions from responsibility for regulatory effects. It often manifests itself in agreements signed between the government and the regulated entities, as well as prepared and even

financed from own funds reports and other accounts of compliance with regulations created on the regulated entities' initiative.

On the whole, a trend can be noticed where, besides regulations inspired and developed by the government and its agencies, the concept of self-regulation starts playing a more and more important role; there may be many reasons for that. A.D. Williams [2004, p. 12-14] identifies three crucial factors that induce to adopt this type of regulations:

- reputation; having and building reputation is an important and extremely appreciated component of companies' assets under the present conditions of their operations,
- legal and regulatory factors connected with the fact that responsibility of international institutions for creating rules of operations on global market is largely unspecified and blurred; in view of the above, companies and their representative institutions make efforts to reduce uncertainty with regard to competition and maintenance of clear rules of the market game. Under such circumstances, self-regulation is a right tool,
- obtaining competitive advantage by a company that will be the first on the market to accept higher standards of environmental protection, customer relationship, by modernizing its products, processes and techniques and methods of management and operations on international and international market.

Other conditions in favor of self-regulation can also be noticed, and these are: distribution of responsibility for regulatory efficiency, insufficient funds, organizational and information resources of the regulator (its weakness), high degree of conflict with regard to the problem being regulated, no familiarity with laws of development of new markets. Self-regulation may include regulatory actions (mainly initiative, preparation of a draft, consultations, ex ante efficiency assessment analyses) taken by the regulated entities operating on a given market or in a given industry.

Types and characteristics of self-regulation

Self-regulation has various forms: co-regulation (strict cooperation with the government and its regulatory institutions), enforced regulation (which does not come down to regulatory development and implementation, but includes also the methods of its enforcement), and *partial self-regulation*, which consists in accepting assumptions, provisions and working version of regulations or various hybrid solutions. I. Bartle and P. Vass propose a simple system of regulatory classification – see Figure 1.

Self-regulation takes place when the rules are determined, administered and enforced by the regulated entities. Co-regulation takes place when the rules are created, administered and enforced in cooperation between the regulated organizations and state institutions. Regulations are a legal product of state institutions. It is interesting to indicate various forms of interaction between public regulations and self-regulations (regulated entities). I. Bartle and P. Vass [2005] identify the

Figure 1 **Forms of market regulation**

Source: I. Bartle, P. Vass [2005], p 1.

following types of relation: cooperation, delegation, entrusting, facilitation and discreet cooperation.

On the whole, nearly each type of regulation in question can take a form of self-regulation. Based on the observations of the regulated entities' behaviors in the financial sector, it can be concluded that usually self-regulation takes place when the regulator aims to introduce a regulation that is extremely destructive for the sector development or shows complete ignorance of the functioning of the market or industry. Often the self-regulatory initiative is also taken when it is necessary to solve a problem significant for the whole industry (market), for instance money laundering, fraud restriction, privacy violation [Arnone, Borlini, 2010] or restriction in activities classified as unfair competition. A unique self-regulatory initiative is BLIK: it is a payment method created by the six biggest Polish banks – PKO BP, mBank, ING Bank Śląski, Alior, Millenium Bank, and BZ WBK. The payment model had been prepared earlier by PKO BP S.A. in the IKO application. Payments by means of the BLIK system became available in all banks forming the Polish Payment Standard. The BLIK system users have the possibility to pay out cash from cash dispensers and make payments in retail and web sales outlets. Payment in a stationary shop in the BLIK system consists in entering a code generated by the application. Then the application requires the amount entered in the payment terminal to be authorized. In web stores transactions are similar: at the beginning a code is generated and the customer enters it on the website of the web store and makes authorization by phone. The initiative of creating the BLIK system is a big opportunity to popularize mobile payments. The technological system has overcome many barriers imposed on the customer while making payments by phone.

An interesting domain of companies' interest in self-regulation is corporate social responsibility (CSR) [Albareda, 2008]. It seems that this interest is affected, among other things, by novelty of this concept, broad range of tools and actions that may be used, as well as lack of developed standards of methods for assessing the value of CSR and its impact on growth in competition of companies.

When it comes to the regulated entities, self-regulatory initiatives emerge quite often in relation to the regulation of SMEs [Anderson, Russell, 2014]. Moreover, it is worth emphasizing that self-regulation is effective and efficient in the group of companies that are mature, with high organizational culture and clearly defined vision and perception of sector good. Partnership cooperation between the regulator and the regulated entities is a key determinant of self-regulation. When cooperation is courtesy, rather than based on trust, self-regulation is very rare.

Self-regulation is characterized by numerous characteristics:

- it is a voluntary action, which has a significant impact on the increase in its effectiveness and efficiency,
- it is flexible: it can cover all or only chosen stages of the regulatory process,
- it makes available the most valuable information for the regulator, which is usually hardly available or unavailable, therefore regulation is based on solid, hard facts,
- it is reactive, namely it reacts to a problem a given regulation is to address,
- it is classified as the so called "soft regulatory tools": it does not involve coercion, penalties and negative opinions of entities directly affected by a regulation [Jamison, 1998, p. 31-32].

Some U.S. authors are of a similar opinion [Coglianese, et al., 2004]. Ac-

cording to them, self-regulation has the following advantages as compared to the government regulatory system:

- proximity of a market or sector subject to regulation,
- they are characterized by a greater flexibility of taken actions and used tools,
- they may generate a higher level of compliance with the adopted rules, provisions and standards,
- they better express the interest of market players or sectors,
- they may assure to a greater extent resources required for the implemented regulatory process.

Weaknesses of self-regulation as a method of regulating companies or institutions are listed in the publication by C. Coglianese et al. [2004, p. 5-6]:

- conflict of interests,
- inadequate system of sanctions,
- incomplete enforcement of regulations,
- due to global competition, self-regulation may prove more costly and burdensome for some national companies,
- problems may arise with financing for the self-regulatory process.

As A.D. Williamson [2004] rightly claims, self-regulations are not remedies for any weaknesses of the economy and market. Often taken attempts of self-regulation fail, and the period of regulatory preparation and implementation gets extended. In many sectors it is difficult to form a consensus. Despite these weaknesses, self-regulation is a useful concept when aiming at de-regulating the economic activities and assigning more responsibility to the regulated entities for their effectiveness and efficiency. The latter characteristic is desired in particular for the countries operating within economic unions, for instance eurozone member countries or EU member countries.

The issue of risk in self-regulation of banking institutions

It was a surprise to discover that the publications on self-regulation hardly raise the issue related to the significant stages of regulatory risk management. When reflecting on the reasons, it can be concluded that some authors assumed that the adoption of an extreme form of the definition of regulatory risk would make such risk disappear. The risk appears when any kinds of risks are borne by the regulated entities, rather than the public regulator. In view of the above, neither the government, nor its institutions bear formal responsibility for shape and effects resulting from developing and implementing any regulations of companies. This approach is not fully funded, since practical legislative procedures force formal and informal contacts of the regulator with the initiators of regulatory projects. Moreover, a significant part of regulatory projects have a form of co-regulation, where the regulators are an active part of regulation's stakeholders. For instance, in Poland, the key financial market regulators, namely the Polish Financial Supervision Authority, the Ministry of Finance and the National Bank of Poland, were inducing banking institutions and main participants of the payments market, namely VISA and Master Card, to change interchange fee, however, an agreement on the rate of interchange fee was not reached. Therefore it is not surprising that, in view of the above, the rate was determined by way of an arbitrary decision of the regulator in 2014, and was changed as soon as in the early 2015 [NBP, 2015]. The reason for change in fees in 2015 was the necessity to neutralize adverse effects of an agreement between the European Commission and Visa card associations.

As part of the review of available publications that relate somehow to the issue of including risk in the concept of self-

regulation, it is worth paying attention to several of them.

A.D. Williams [2004] indicates legal and regulatory risk as one of the determinants of applying self-regulation. Perhaps it was a case of using the term "legal and regulatory risk". It seems that self-regulation can be risky both for the government and the regulated entities. If the government or its institutions assume a completely passive approach, these are the bases for acknowledging only the presence of legal risk. Explaining this determinant, the author of the analyzed paper clarifies that self-regulation is a form of regulation where two threats are noticeable: a threat arising out of the possibility that regulations are introduced in global competition by international corporations, and a threat of national regulators' temptation to implement unfavorable rules.

The report by U.S. economists from the Harvard University, on the role of the government in corporate governance, raises the issue of law enforcement, including risk resulting from sanctions [Coglianese, et al., 2004]. The report contains an apt suggestion to keep a certain balance between risk and effects, since not always does a threat of a sanction discourage the regulated entities from taking undesired actions. The authors see also important role of the government in eliminating on the capital market unfair practices that can cause big loss for investors. They pay attention to the fact that if a problem is left to be solved by self-regulation, the regulated entities may overreact at the expense of customer interests. In connection with the above, they raise the role of the regulatory enforcement mechanism as an element that affects the functioning of an efficient capital market, where useful role could be played by regulations and private self-regulatory initiatives.

The role of risk in self-regulation of the capital market is presented by J. Holland [1995], in his two-part article. He states that since 1987 the London Stock Exchange has notified the Department of Trade and Industry of 100 cases of fraudulent use of confidential information. 30 charges were formulated but sentence was issued only in 13 cases. Hence a conclusion that the probability of detecting use of confidential information and punishing those responsible is low. According to the author of the paper, this type of risk can be reduced by regular meetings between the stock exchange authorities and investment funds and analytics, and by exercising extra caution before making public and press announcements. He believes that self-regulatory actions are necessary, but must interact and be connected (by companies and financial intermediaries) with market pressure, legal control and professional self-regulatory institutions.

On the other hand, M. Ojo [2011] shows the purpose of cooperation between banking institutions and the government in corporate risk reduction. The necessity for partnership cooperation when developing regulations results from responsibility of financial institutions. The proposals contained in the publication are quite general for regulatory risk management. It is stated that: *The economies of scope and scale in universal banking, which permit a better risk diversification and lower transaction costs for banks, can also contribute to an increasing level of growth in turnover for the serviced companies* [Ojo, 2011, p. 145].

I. Bartle and P. Vass [2005] refer to risk several times in quite a comprehensive report on the concept of self-regulation. The most important statement concerns the issue of risk in achieving regulatory transparency. The authors acknowledge that the most adequate direction of action is in line with the concept of risk-based regulation. However, by highlighting this position, practical doubts arise,

since many papers and studies have already been created on this concept and they contain different methodological proposals. Hence, it is unknown how to define risk, how to identify it, how to measure it or communicate the obtained results to key stakeholders.

From this brief overview of the applications of self-regulation, an observation can be made that it is a form of regulation that has been developing intensively in the practice of the functioning of financial institutions, which is a kind of paradox, considering the fact that it relates to the whole area of the economy with the greatest level and intensity of governmental regulations. New areas of potential application of self-regulation have been emerging, in particular in the area of creating new markets and industries.

To sum up, on the basis of the analysis of the scope of the application of regulatory risk management in the concept of self-regulation, several critical opinions can be formulated. First, the issues of risk are hardly noticed and analyzed, and the research undertaken so far has focused rather on analyses of sources of risk factors or methods of their reduction. Second, the examined publications do not contain a complex assessment of regulatory risk management. Third, specific characteristics of regulatory risk management in the concept of self-regulation are not highlighted and the methods adapted to this concept are not used. Due to the above, commonly applied approaches towards risk management are applied in the practice of regulation of companies and institutions, and they are doomed to fail. This is particularly important since not each regulation will prove efficient in the self-regulatory procedure. In the case when a market is only in the phase of shaping, with low legal culture and low degree of cooperation between companies operating on that market, regulatory efficiency will be very low. Fourth, key elements of regulatory risk management are practically completely ignored, for instance the issue of risk identification, risk measurement, and communication with key stakeholders. Fifth, an interesting, important and specific field emerges for research on regulatory risk management with regard to the examined concept of self-regulation, especially towards various existing options.

The essence of regulatory risk comes down to searching for answers to key questions: What are the opportunities and threats related to the achievement of regulatory goals in the case of self-regulation? How should the companies (in an industry or on the market of product) try to determine the qualitative and quantitative level of this risk in this concept? On the one hand, the fact that regulatory risk is not included and studied in this type of projects may be a proof of methodological difficulties related to this risk measurement. On the other hand, the gap shown may motivate to a more intensive searching for adequate methods for assessing regulatory risk of self-regulatory projects.

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