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# Advancing Financial Regulation and Supervision

This volume, titled “**Advancing Financial Regulation and Supervision**” focuses on the ongoing evolution of financial regulation and supervision as authorities respond to geopolitical developments, technological innovation, and the pursuit of more effective and proportionate oversight. The articles are organized to cover key themes such as cross-border supervision and geopolitical risk, the regulation of emerging technologies and payments, and the advancement of smarter, outcomes-based supervisory practice, reflecting the comprehensive approach needed to support well-functioning, resilient, and inclusive financial markets.



4.2  
Academic Article

# **The Case for Targeted Deregulation of Finance**

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## Author's Bio



**Professor Zetzsche** is Professor of Financial Law at the University of Luxembourg where he holds the ADA Chair in Financial Law (inclusive finance) since March 2016 and co-leads the Faculty of Law, Economics and Finance's House of Sustainable Governance & Markets as well as Luxembourg's National Centre of Excellence in Research on Financial Technologies ("FT-NCER").

Prof. Zetzsche is the author of more than 400 publications, including some globally leading articles and treatises on FinTech/RegTech, corporate governance, sustainable finance as well as collective and alternative investment law and regulation. Prof. Zetzsche is a Director of the Society of Investment Law (Chicago, Illinois), a member of the consultative working group of ESMA's Investment Management Standing Committee (IMSC) and a member of the Financial Access Survey expert group of the International Monetary Fund. He also functions as independent director of financial institutions.

## Abstract

The purpose of financial regulation is to benefit society and regulated financial institutions. If the benefits generated by a particular rule do not outweigh its costs, there is a case for deregulation. Bounded regulatory rationality and political influence have undermined the consistent application of this undisputed principle. As a result, regulators' mandates have gradually expanded such that financial regulation today often addresses matters beyond finance. This has made cost-benefit analysis more difficult and has, in turn, weakened regulatory accountability and acceptance of rules by regulated entities.

I argue that targeted deregulation in finance is both appropriate and desirable as it strengthens the implementation of accepted regulatory objectives. Targeted deregulation is part of any due regulatory process: just as enterprises must regularly optimise their operations, financial regulators should regularly optimise their regulatory framework. Targeted deregulation is utterly distinct from Romano's 'iron rule of financial regulation' which is that crises drive regulation, and in turn the polity must curtail regulatory overreach from time to time in deregulation cycles.

To foster targeted deregulation I suggest five principles: regulators should position themselves as beneficent parents of financial systems; avoid ambiguous regulatory language; accept regulatory competition; adopt 'sandbox thinking'; and favour proportionate risk-based approaches over outright prohibition.

*Keywords: financial regulation, deregulation, simplification, competitiveness, bounded regulatory rationality, regulating innovation.*

*Regulators of financial markets must be capitalists. They must take the perspective of a well-meaning mother or father who is painfully aware of the deficiencies of her daughters and sons, but nevertheless wants their best in all they do.*

Jacques de Larosière (2025)<sup>1</sup>

## 01

# Times Of Deregulation

Following persistent lobbying efforts by pro-business proponents, deregulation has come to dominate recent US elections and the early months of the new US administration.<sup>2</sup> In particular, through the Congressional Review Act (CRA)<sup>3</sup> and executive orders,<sup>4</sup> the financial deregulation agenda has led to: (1) the Federal Trade Commission's premerger notification requirements;<sup>5</sup> (2) the Consumer Financial Protection Bureau's prohibition on the use of medical information in credit scoring;<sup>6</sup> and (3) the Securities and Exchange Commission regulating crypto-assets through enforcement.<sup>7</sup> The same trend is evident elsewhere.

In Europe, the shift toward deregulation began with EU Commission President von der Leyen's commitment in March 2023 to reduce administrative and reporting burdens and the outcome of the European Parliament elections in June 2024. Former ECB Chair Mario Draghi's influential report advocated enhanced competitiveness through regulatory simplification,<sup>8</sup> and the Eurochambres proposed to eliminate up to 60 burdensome business regulations.<sup>9</sup> In response, the European Commission released its 'Competitiveness Compass'<sup>10</sup> and established a

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- 1 Former managing director of the IMF, governor of the Banque de France, and President of the European Bank for Reconstruction and Development; chair of the High Level Group on Financial Supervision in the EU that authored the de Larosière report. The citation relies on the entry statement of the keynote speech provided at the ESMA conference 'Shaping the Future of EU Capital Markets', 5 February 2025.
  - 2 See U.S. Chamber of Commerce, Regulatory Relief Among the U.S. Chamber's Top 2025 Priorities | U.S. Chamber of Commerce.
  - 3 5 U.S.Code § 801.
  - 4 The White House, Presidential Actions, 'Ensuring Lawful Governance And Implementing The President's "Department Of Government Efficiency" Deregulatory Initiative' (February 19, 2025) <[https://www.whitehouse.gov/presidential-actions/2025/02/ensuring-lawful-governance-and-implementing-the-presidents-department-of-government-efficiency-regulatory-initiative/?utm\\_source=wh\\_social\\_share\\_button](https://www.whitehouse.gov/presidential-actions/2025/02/ensuring-lawful-governance-and-implementing-the-presidents-department-of-government-efficiency-regulatory-initiative/?utm_source=wh_social_share_button)>
  - 5 U.S. Chamber of Commerce, <PDF-GOI-HSR-CRA.pdf>
  - 6 U.S. Chamber of Commerce, <PDF\_GOI-Medical-Debt-CRA-01.pdf>
  - 7 U.S. Securities and Exchange Commission, 'Cyber, Crypto Assets and Emerging Technology' (02 april 2025) <<https://www.sec.gov/about/divisions-offices/division-enforcement/cyber-crypto-assets-emerging-technology>> (last visited 22 November 2025)..
  - 8 European Commission, 'The Draghi report on EU competitiveness' (September 2024)
  - 9 Eurochambres, '60 regulatory burden reduction proposals' (10 december 2024) <241210-60-regulatory-burden-reduction-proposals.pdf>.
  - 10 European Commission, 'Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions: A Competitiveness Compass or the EU' (COM(2025) 30 final, 29 January 2025) <[https://commission.europa.eu/document/download/10017eb1-4722-4333-add2-e0ed18105a34\\_en](https://commission.europa.eu/document/download/10017eb1-4722-4333-add2-e0ed18105a34_en)> pp. 16-18.

new Commissioner for Implementation and Simplification.<sup>11</sup>

Financial deregulation has become central to this agenda. The European Commission released its ‘simplification omnibus packages’ in February 2025 to: target the complexity of the EU Sustainable Finance Framework;<sup>12</sup> examine whether increased supervision at the EU level could enhance regulatory simplification and burden reduction (SBR);<sup>13</sup> and task the European Supervisory Authorities (ESAs) with large-scale reviews of EU financial legislation to identify potential simplification and burden reduction.<sup>14</sup> Meanwhile, lobby groups have put forward simplification proposals<sup>15</sup> that have been discussed at conferences held by the European Parliament.<sup>16</sup>

While labelled as simplification to avoid conflict with EU long-term policy commitments, the EU agenda in finance aims in many aspects at deregulation in substance. Simplification, taken literally, can include an outright ban where to-the-point regulation is difficult and complex – a strategy pursued by European financial regulators before.<sup>17</sup> However, outright prohibition of successful international business models rarely enhances EU competitiveness. Simplification is the political term for deregulating business-hostile rules in EU finance.<sup>18</sup>

In the UK, following the outcome of the US elections,<sup>19</sup> the current UK Chancellor of the Exchequer unexpectedly endorsed the claim by leading bankers that financial regulators went too far in their efforts to protect consumers, investors and depositors in the years following the onset of the Global Financial Crisis of 2007–8, and often did so

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- 11 European Commission, ‘Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions: A Competitiveness Compass or the EU’ (COM(2025) 30 final, 29 January 2025) <[https://commission.europa.eu/document/download/10017eb1-4722-4333-add2-e0ed18105a34\\_en](https://commission.europa.eu/document/download/10017eb1-4722-4333-add2-e0ed18105a34_en)> p. 17.
  - 12 European Commission, ‘Commission staff working document Accompanying the documents Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directives 2006/43/EC, 2013/34/EU, (EU) 2022/2464 and (EU) 2024/1760 as regards certain corporate sustainability reporting and due diligence requirements Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directives (EU) 2022/2464 and (EU) 2024/1760 as regards the dates from which Member States are to apply certain corporate sustainability reporting and due diligence requirements and specifying further steps, SWD/2025/80 final, 26 February 2025, <EUR-Lex - 52025SC0080 - EN - EUR-Lex>
  - 13 European Commission, ‘Targeted Consultation on Integration of EU Capital Markets’ <2025-markets-integration-supervision-consultation-document\_en.pdf> p. 7 Question 9.
  - 14 See, for instance, EIOPA, Board of Supervisors, ‘Bolder, Simpler, Faster: EIOPA’s views for better regulation and supervision’ (EIOPA-BoS-25/118 08 April 2025) <Bolder, Simpler, Faster: EIOPA’s views for better regulation and supervision>
  - 15 Report by an expert group under the leadership of Elisabeth Delahousse, ‘Less is More’ (10 February 2025) <report\_lessismore\_fin.pdf>.
  - 16 AEDBF Europe, ‘Less is More – Conference at the EU Parliament’ (30 April 2025) <Less is More - Conference at the EU Parliament>.
  - 17 An example includes ESMA’s Technical Advice on the revision of the UCITS Eligible Assets Directive, ESMA34-2087785638-1548 (26 June 2025). Following a consultation ESMA proposes to prohibit investment strategies that represent 10 per cent of the existing EU UCITS market, in a step that avoids complex regulations of new strategies like investments of retail investment funds into crypto-assets. The EU Commission responded that it would issue its own proposal after gathering evidence and launching its own consultation, a wording indicating distance from ESMA’s proposal. Another example includes the ESRB’s proposal to ban multi-party third-country issuers. See *infra*, at
  - 18 In the same vein, see S. Todeschini, ‘The Great EU Reversal: Fast-Track Deregulation and the Erosion of Europe’s Sustainability Ambition with the Omnibus I Regulation’ <<https://www.europeanlawblog.eu/>> (last visited 22 November 2025). EU Commissioner Albuquerque lists only deregulatory measures in her first year progress report, see ‘The 2025 Annual Progress Report on Simplification, Implementation and Enforcement’ (last visited 22 November 2025). < 2025 Annual Progress Reports on Simplification, Implementation and Enforcement - European Commission>.
  - 19 D. Bloom, ‘Britain’s Rachel Reeves needs a growth miracle’ *Politico* (29 January 2025) <Britain’s Rachel Reeves needs a growth miracle – POLITICO> (last visited 22 November 2025).

ineffectively.<sup>20</sup> This trend has been accelerated by pro-bank advocates who are concerned about European banks falling behind their American and Asian counterparts, which face less stringent regulation.<sup>21</sup>

Indeed, deregulation cycles are not new in finance. ‘Better regulation’ initiatives,<sup>22</sup> the UK’s Big Bang in 1986,<sup>23</sup> and several deregulatory measures adopted prior to the onset of the Global Financial Crisis 2007-08 have all been characterised as forms of deregulation.

Deregulation has also been studied extensively. One severe type, ‘structural deregulation’,<sup>24</sup> involves deliberate limitation of the state’s administrative capacities. Recent examples include the agenda of the current US administration for the Department of Government Efficiency (DOGE) and the longest shutdown of U.S. public services in the history of the United States. Another type, ‘midnight deregulation’,<sup>25</sup> refers to deregulation reforms introduced in the final months of an administration before elections. In finance, deregulation has been associated with increased competition in credit and financial markets,<sup>26</sup> as well as changes in environmental outcomes,<sup>27</sup> mortality rates,<sup>28</sup> and reporting practices of financial intermediaries.<sup>29</sup> More broadly, deregulation has been situated in a recurring cycle: liberalisation promotes economic expansion, leading to crises and eventually to renewed regulation.<sup>30</sup> Finally, deregulation has been studied in terms of regulatory competitiveness, where regulators compete to attract financial institutions.<sup>31</sup>

20 E. Nolsoe, ‘Red tape has inflated our headcount by 40pc, bank boss says’ *The Telegraph* (yahoo!finance, 14 October 2024) <Red tape has inflated our headcount by 40pc, bank boss says> (citing the CEO of UK Saxo Bank).

21 T. Skeet, ‘Red tape is strangling UK and EU banks, while the US pulls ahead’ *The Banker* (3 February 2025) <Red tape is strangling UK and EU banks, while the US pulls ahead – The Banker>; C. Conchie, ‘PRA under pressure to cut red tape as growth plans fail to excite the City’ *CityAM* (22 January 2025) <PRA under pressure to cut red tape as growth plans fail to excite the City>.

22 Examples include: U.S. President Jimmy Carter’s Executive Order 12,044 in 1978 and U.S. President Ronald Reagan’s Executive Order 12,291 in 1981 which required an impact analysis of new regulations to ensure that the benefits outweigh the costs imposed by new regulations; the Australian ‘better regulation’ units; and the initiatives associated with EU Commission Charles McCreevy in the 2000s.

23 Cf. GoldmanSachs, ‘“Big Bang” Deregulation Bolsters London’s Position as Global Finance Center’ <<https://www.goldmansachs.com/our-firm/history/moments/1986-big-bang>> (last visited 22 November 2025).; R.C. Michie, *The London Stock Exchange: A History* (Oxford, 2001; online edn, Oxford Academic, 1 Nov. 2003) <<https://doi.org/10.1093/0199242550.003.0013>>, (last visited 22 November 2025)., Ch. 12; E.K. Clemons and B.W. Weber, ‘London’s Big Bang: A Case Study of Information Technology, Competitive Impact, and Organizational Change’ (1990) 6:4 J Inform. Syst. 41–60.

24 J. Freeman, Sharon Jacobs, ‘Structural Deregulation’, (2022) 135 Harv. L. Rev. 585.

25 J. Brito, V. de Rugy, ‘Midnight Regulations and Regulatory Review’ (2009) 61:1 Administrative Law Review 163.

26 J.Melitz, C. Bordes, ‘The macroeconomic implications of financial deregulation’, (1991) 35:1 Eur. Econ. Rev. 155-178, [https://doi.org/10.1016/0014-2921\(91\)90109-V](https://doi.org/10.1016/0014-2921(91)90109-V).

27 P. Weinberg, ‘Masquerade for Privilege: Deregulation Undermining Environmental Protection’, (1988) 45 Wash. & Lee L. Rev. 1321.

28 I. Hasan et al., ‘Banking Market Deregulation and Mortality Inequality’ (6 February 2023). Bank of Finland Research Discussion Paper No. 14/2022, <<https://ssrn.com/abstract=4349845>> or <<http://dx.doi.org/10.2139/ssrn.4349845>>.

29 Cf. H. Genberg, ‘The changing nature of financial intermediation and its implications for monetary policy’ Bank for International Settlements Working Papers No 39 (9 April 2008) <<https://www.bis.org/publ/bppdf/bispap39f.pdf>>, p. 102f; V. Behrmann et al. ‘The deregulation of quarterly reporting and its effects on information asymmetry and firm value.’ (2025) 64 Rev Quant Finan Acc 1221–1259.

30 J. Stiglitz, ‘Symposium on Bubbles’ (1990) 4 J. Econ. Persp. 13-18; F. Partnoy, ‘Why Markets Crash and What Law Can Do About It’, (2000) 61 U. Pitt. L. Rev. 741, 743.

31 See H. Laurence, ‘Regulatory competition and the politics of financial market reform in Britain and Japan’, (1999) 39:2 Asian Survey 348-373; D.M.Abdelhamid, ‘International Regulatory Competition and Deregulation’, (2000) 23:4 World Competition 89-114; J. Westrup, ‘The Politics of Financial Regulatory Reform in Britain and Germany’, (2007) 30:5 West Eur. Pol. 1096-1119.

In my view, none of these approaches adequately describe the attitude that regulators should take towards deregulation of finance. Neither should deregulation of finance be part of a political powerplay, nor should it come in cycles following periods of over-strictness and regulatory interventions. I argue herein that the question is not whether to deregulate, but *what* to deregulate. *Targeted* deregulation is part of any due regulatory process: just as enterprises must regularly optimise their operations, financial regulators should regularly optimise their regulatory framework.

To make the case for targeted regulation of finance, I argue in Part II that under certain conditions, deregulation aligns with widely accepted aims of financial regulation. In Part III, I identify ways to determine the optimal level of (de)regulation by outlining three preconditions that regulators must meet when deregulating finance. In Part IV, I examine why these three preconditions are often overlooked and in Part V, I offer recommendations for how over-regulation can be avoided in practice.

## 02

# The Case For Targeted Deregulation

Both under-regulation and over-regulation are considered harmful. Deregulation is considered necessary where over-regulation exists, just as regulation is considered necessary where there is under-regulation. The real challenge, however, is identifying when regulation is excessive enough to justify deregulation.

To contextualise, I first summarise the main arguments for and against financial deregulation before arguing that the traditional objectives of financial regulation support targeted deregulation, i.e., the removal of rules and standards amounting to over-regulation.

## 2.1 Justifying Financial Regulation

Two main theories analyse the regulatory process. One emphasises the abstract notion of the public interest and sees regulators as a “helping hand”.<sup>32</sup> The other focuses on individual decisions within legislative and regulatory institutions such as in public choice or regulatory capture theory,<sup>33</sup> where Shleifer & Vishny picture regulators as

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32 The public interest theory assumes that political actors, regulators and individuals working in regulatory and supervisory agencies are expected to make decisions that serve the common good, often employing tools such as cost-benefit analysis to identify the most efficient outcomes. Early representatives of this theory include Max Weber's concept of bureaucracy. It is sometimes unclear whether the public interest is understood as an ideal that regulators ought to pursue, or as a realistic description of regulatory practice. See M. Weber (1921 (1976)), *Wirtschaft und Gesellschaft* (transl. The Economy and Society), Tübingen: J.C.B. Mohr, pp. 124-130; 552-553. See also C.W. Lewis, 'In Pursuit of the Public Interest', (2006) 66.5 Public Administration Review 694.

33 Lead authors of the public choice theory argue that political actors, regulators and individuals working in regulatory and supervisory agencies, like all human beings, are primarily motivated by self-interest rather than by a commitment to maximising the public good. Their decisions are shaped by various forms of market influence, including considerations such as future career prospects after leaving regulatory roles. See J. McGill Buchanan & G. Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (1962). In a more modern interpretation that includes regulated institutions, see also G.J. Benston 'Regulating Financial Markets: A Critique and Some Proposals' (1988) Hobart Paper No. 135, London, Institute of Economic Affairs.

a “grabbing hand”.<sup>34</sup> Despite these differences,<sup>35</sup> there is a uniform view of what financial regulation *ought* to do: reduce agency conflicts; mitigate negative externalities to address market failures; and reduce transaction costs.

First, financial intermediation gives certain people power over others’ assets as their agents, in exchange for uncertain returns: banks hold depositors’ funds; fund managers oversee investors’ funds; and insurance companies utilise clients’ premiums. This makes conflicts of interest a significant concern. Such conflicts traditionally take two forms: ‘stealing’, or the appropriation of assets not assigned to agents; and ‘shirking’, or an agent’s failure to perform what they are obliged to do.<sup>36</sup>

Financial regulation and effective enforcement counter both types of agency conflicts. By imposing minimum standards of organisation and expertise associated with a regulated activity, the risk of asset appropriation is reduced. Additionally, licensing rules ensure compliance with agents’ obligations and exclude dishonest and unfit actors from conducting business.

Second, financial intermediation can impose risks and costs on parties not involved in the financial decision, justifying financial regulation.<sup>37</sup> Financial institutions often bear counterparty risk stemming from the business conduct of another financial institution. The related counterparty risk is usually factored into the market price or expected returns of a given financial product.

However, a market failure may occur if such risks are transmitted without adequate compensation due to factors like asymmetric information, deficient internal processes that allow for adequate pricing of the risk, or the risk-transmitting institution’s dominant position. Further, when counterparty risks reinforce one another, ‘systemic risks’<sup>38</sup> may arise where one failure could trigger a chain reaction that eventually destabilises several other institutions, if not the whole economy. Such systemic risks are typically not reflected in the market price or returns, as they emerge from interlinkages invisible to counterparties.<sup>39</sup>

Regulations such as requirements for banks to hold prudential capital reduce systemic risk and enhance financial stability because if the risk materialises, the capital may absorb the loss (at least to some extent) and reduce or eliminate exposure of counterparties and depositors to the financial institution. The same rationale applies beyond finance, such as environmental regulation mitigating or preventing pollution affecting parties with no

34 A. Shleifer & R.W. Vishny, *The Grabbing Hand - Government Pathologies and Their Cures* (Harvard University Press, M.A. 1998). The concept was first published in A. Shleifer & R. Vishny, ‘Corruption’, (1993) 108 Qu. J. Econ. 599-617.

35 Public interest theory and public choice theory differ in both the methods and tools proposed to achieve regulatory objectives, as well as in their assessment of whether such objectives can ever be fully realised. See R.A Posner, ‘Theories of Economic Regulation’, (1974) 5:2 The Bell J. Econ. Man’t Sc. 335-358.

36 See M.C. Jensen & W.H. Meckling, ‘Theory of the firm: Managerial behavior, agency costs and ownership structure’, (1976) 3:4 JFE 305-360.

37 Cf. J Armour, D Awrey, P Davies, L Enriques, JN Gordon, C Mayer, J Payne, *Principles of Financial Regulation* (Oxford, 2016; online edn, Oxford Academic, 20 Oct. 2016) <<https://doi.org/10.1093/acprof:oso/9780198786474.003.0003>> (last visited 22 November 2025)., p. 57 f (section 3.3.2 on negative externalities).

38 See G.G. Kaufman & K.E. Scott, ‘What Is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?’, (2003) 7:3 The Independent Review 371-391, at p. 371 (defining systemic risk as “the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by co-movements (correlations) among most or all parts”).

39 Let’s assume A contracts with B, but A also enters into contracts with C to an extent that C’s insolvency impairs A’s ability to deliver on the contract. Unless the exposure to C is transparent to B, B will price the counterparty risk without regarding C’s influence on A (which sits on top of A’s insolvency risk) or the fact that B also bears the insolvency risk in relation to C.

contractual relationship with polluting firms.

Third, financial regulation also enhances the allocative efficiency of financial markets by reducing transaction costs.<sup>40</sup>

For example, mandatory disclosure through securities prospectuses allocates information-gathering costs to the issuer, who can do so at the lowest cost. Similarly, risk management rules assign responsibility to the institution best positioned to prevent harm, described by Guido Calabresi as the 'cheapest cost avoider' function.<sup>41</sup>

Further, clearly defining certain activities or products can allow the market to rely on standardised terminology instead of analysing each product individually.<sup>42</sup> In all these cases, financial regulation reduces the overall costs borne by all market participants collectively.<sup>43</sup>

## 2.2 Pro-Deregulation Arguments

The benefits of regulation hold only when regulators observe certain limits. When these limits are exceeded, over-regulation occurs. Six main arguments have been raised<sup>44</sup> in support of deregulation in such circumstances.

Over-regulation of financial institutions discourages the calculated risk-taking necessary for economic growth. Barriers intended to prevent risk-taking ultimately act as obstacles to innovation, and consequently, to economic growth.

Moreover, regulation increases compliance costs, which raises transaction costs, thereby undermining the allocative efficiency of the financial system. It is important to note that transaction costs weaken *all* financial decisions, whether risk-reducing or risk-enhancing.

Over-regulation also diminishes service quality and increases prices for consumers, as additional costs are passed on to consumers. For example, capital adequacy rules that require financial institutions and insurers to hold additional funds, which cannot be used productively for lending, providing insurance cover or investing, increase the cost of financial intermediation.

40 See D.B.Johnsen, 'A Transaction Cost Assessment of SEC Regulation Best Interest', (2019) 2018:3 *Columbia Bus. LR* 696–756, 706 et seq (arguing that the SEC's cost-benefit-analysis misses to consider transaction costs effects); D Llewellyn, 'The Economic Rationale for Financial Regulation' (1999) FSA Occasional Papers In Financial Regulation <[https://www.fep.up.pt/disciplinas/pgaf924/PGAF/Texto\\_2\\_David\\_Llewellyn.pdf](https://www.fep.up.pt/disciplinas/pgaf924/PGAF/Texto_2_David_Llewellyn.pdf)>.

41 R Padolesi, B Tassone, 'Guido Calabresi on Torts: Italian Courts and the Cheapest Cost Avoider' (2008) 1:4 *Erasmus LR* 7–39.

42 Examples include the terms 'credit' and 'securities', but also more specific legal terms, such as the EU-regulated UCITS (Undertaking for Collective Investments in Transferable Securities).

43 Cf. Armour et al., *Principles of Financial Regulation*, n 37, pp. 53f, 66 f., K. Pistor, 'A Legal Theory of Finance', (2013) 41 *J Comp Econ*. 315–330, p. 320 (section 3.4 stating that "[a]n important purpose of financial innovation is to alleviate the costs of regulation(...)" and "Regulatory reforms in the aftermath of the financial crisis have triggered another round of financial innovation to mitigate the costs of these regulations for individual firms.").

44 Eg C.M. Hardin, 'The Effects of Over-Regulation', (1979) 34:1 *Food, Drug, Cosmetic LJ* pp. 50–57; Ifo Institute, *EconPol Forum* 06/2024, *Overregulation in the EU? How to Boost Competitiveness with Smarter Legal Frameworks*; U.S. Chamber of Commerce, 'How Excessive Regulation Hurts the Economy', U.S. Chamber of Commerce, 16 January 2025, <[www.uschamber.com/economy/how-excessive-regulation-hurts-the-economy](http://www.uschamber.com/economy/how-excessive-regulation-hurts-the-economy)> (last visited 22 November 2025). I summarise in this section views from different policy platforms and domains without necessarily agreeing on these views.

Over-regulation often induces substantial risk to shift into less regulated sectors. Although intended to enhance financial stability and support other policy objectives, such over-regulation may instead lead the shadow finance system to expand.

Furthermore, over-regulation where decision-making authority is transferred from experienced, accountable and incentivised decision-makers within financial institutions to regulators – who are neither accountable nor incentivised in the same way – can result in ‘dead hands’ governing business that produces significant externalities.

Regulators operate outside the sector’s alignment mechanisms designed to reduce agency costs, such as various modes of management compensation. This may lead to higher regulatory-driven agency costs that outweigh the benefits of mitigating firm-internal agency costs.

Finally, financial regulators that are not part of the elected legislative institutions become an unofficial ‘fourth branch of government’. This intermediation of responsibility potentially undermines public accountability of rulemaking and supervisory agencies.<sup>45</sup>

### 2.3 Targeted Deregulation As A Precondition Of Effective Financial Regulation

While deregulation may be justified in abstract terms, such deregulation must be defensible in light of the specific objectives of financial regulation.

Objectives of financial regulation commonly accepted by regulators<sup>46</sup> and leading academic commentators<sup>47</sup> include: (1) client (consumer/investor/depositor) protection; (2) enhancing market efficiency; (3) ensuring market integrity; and (4) financial stability and prevention of systemic risks. More recently accepted regulatory aims<sup>48</sup> include: (5) openness to innovation; and (6) sustainability.

Where over-regulation is present, a closer examination of these core aims reveals that they can only be upheld through targeted deregulation. In other words, situations of over-regulation require targeted deregulation to create a state of the law that pursues these six regulatory objectives effectively.

45 Cf. M. Tushnet, *The New Fourth Branch* (Cambridge University Press 2021), arguing that regulatory and administrative institutions do not always succeed in protecting constitutional democracy, and indeed sometimes undermine it.

46 Cf. D. Llewellyn, ‘The Economic Rationale for Financial Regulation’ (1999) FSA Occasional Papers In Financial Regulation <[https://www.fep.up.pt/disciplinas/pgaf924/PGAF/Texto\\_2\\_David\\_Llewellyn.pdf](https://www.fep.up.pt/disciplinas/pgaf924/PGAF/Texto_2_David_Llewellyn.pdf)>. See also releases by various regulators, for instance Monetary Authority of Singapore Objectives and principles of financial supervision (Apr 2004, rev Sep 2015), at p. 6 <[Objectives and Principles of Financial Supervision in Singapore.pdf](#)>.

47 Cf. C. Brummer, ‘Disruptive Technology and Securities Regulation’, (2015) 84 Fordham LR 977, 1037-38; C. Brummer, ‘Regulatory Agencies and the Inclusion Trilemma’, (2024) 87:1 MLR 1, 3-8; C. Gortsos, *The European Banking Regulation Handbook II* (Palgrave Macmillan, 2025), at pp. 99-100.

48 See RP Buckley, DW Arner, DA Zetzsche, *FinTech: Finance, Technology and Regulation* 315-325 (Cambridge University Press, Cambridge MA: 2023).

## 2.4 Client Protection: The Consumer and The Investor

All regulation increases the costs of compliance. While these costs will be passed on to clients in the form of higher costs, they are justified if the benefits of regulation outweigh the higher costs.

Some of this cost-benefit analysis can be assessed financially and mathematically, while others concern non-monetised goods such as the ban on using sensitive information for credit scoring.<sup>49</sup> The value of protecting such sensitive information is perceived differently depending on factors like: the political perspective of the decision-makers; their attitudes towards privacy; the degree of legal protection for privacy; and the interests of the respective financial service providers and recipients.

## 2.5 Market Efficiency

The compliance burden stemming from regulation increases transaction costs, which raise the minimum size of financial transactions and reduce the allocative efficiency of financial markets. When such rules do not mitigate risks or transaction costs, they are efficiency-reducing.<sup>50</sup>

Examples include rules embedding social values that are not uniformly shared, such as those regarding the inclusiveness of the financial system.<sup>51</sup> In some jurisdictions, financial institutions are required to offer low-cost or even free bank accounts to low-income clients. Some perceive these rules as risk mitigation, as individuals without access to the regulated financial system are exposed to storage and transfer risks from theft, fraud, and disasters. However, others view the same rules as cost-enhancing or redundant on the basis that any additional costs imposed by such accounts are not offset by the income they generate, or that these accounts would have been provided to such clients in any case.

## 2.6 Market Integrity

Regulation divides the economy into regulated and unregulated sectors. When the costs of regulated activities are not commensurate with income opportunities, business actors seek to avoid regulation and operate in less regulated sectors, commonly referred to as 'shadow banking'.

Shadow banking is a significant concern in finance. Overly strict bank regulation may lead to reduced access to regulated finance, thereby supporting the existence of 'loan sharks' and other irregular types of financial services<sup>52</sup> whose very existence undermines market integrity due to non-compliance with regulations like anti-money laundering and counter-terrorist financing frameworks.

49 Cf. K. Langenbucher, 'Responsible A.I. credit scoring – a legal framework', (2020) 25 Eur Bus LR 527.

50 Cf. J Armour et al., *Principles of Financial Regulation*, supra note 37, at pp. 102 f.

51 On financial inclusion more generally T. Beck, A. Demirguc-Kunt, M Martinez Peria, 'Reaching out: Access to and use of banking services across countries' (2008) 85:1 JFE 234-266; Brummer, 'Regulatory Agencies and the Inclusion Trilemma', n 47, 5-8.D Ha, P Le, DK Nguyen, 'Financial inclusion and fintech: a state-of-the-art systematic literature review' (2025) 11 Financ Innov 69; A Hannig, S Jansen, 'Financial Inclusion and Financial Stability: Current Policy Issues' ADB Institute Working Paper No. 259 (December 21, 2010) <<http://dx.doi.org/10.2139/ssrn.1729122>>.

52 See R. Mayer, 'Loan Sharks, Interest-Rate Caps, and Deregulation', (2012) 69 Wash. & Lee L. Rev. 807 (arguing that deregulation does not starve the nonviolent species of loan sharks into extinction but instead feeds it while violent criminal loan sharks loose importance).

## 2.7 Financial Stability

The Global Financial Crisis of 2007–08 highlighted the prevention of systemic risks as a key objective of financial regulation. Such prevention involves improved monitoring of factors that can prompt such risks, the containment of systemic risk, and enabling supervisory authorities to provide assistance during a crisis.

Depending on the state of the market, deregulation can both reduce and enhance systemic risks. If over-regulated, financial institutions bear excessive regulatory costs, which undermines their profitability and reduces their ability to maintain capital reserves during a crisis. Moreover, regulation increases the costs of doing business and erects barriers to entry in financial services markets.

While barriers to entry may be viewed as desirable, as regulation excludes bad actors from the market and reduces information costs associated with monitoring counterparty risk, it can also lead to fewer providers offering financial services and can lead to greater market concentration among licensed entities.

## 2.8 Openness To Innovation

All regulation limits openness to doing business, particularly in the financial sector. Financial regulation specifies which economic activities are strictly prohibited for those who are not licensed to pursue or offer these activities. The more intense the regulation, the higher the entry costs, resulting in a greater need for financial resources as a prerequisite for providing financial services.

To mitigate the adverse impact of regulation on innovation, regulators and scholars have sought to enhance openness to innovation through instruments like regulatory sandboxes, bespoke FinTech licences, piloting regimes, and innovation hubs.<sup>53</sup> However, these instruments also come with their own costs and challenges.<sup>54</sup> Further, none of these instruments have gained practical significance in the large financial markets of the United States and the European Union, although Luxembourg did introduce an innovation hub in 2014 and the UK Financial Conduct Authority has gained experience with the regulatory sandboxes since 2015.<sup>55</sup>

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53 See D.A. Zetzsche, Ross P. Buckley, D. Arner, and J. Barberis, 'Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation', (2017) 23 *Fordh J Corp & Fin L* 31.

54 Cf. R Parenti, 'Regulatory Sandboxes and Innovation Hubs for FinTech - Impact on innovation, financial stability and supervisory convergence', Study Requested by the ECON committee, European Parliament (2020); ESMA, EBA, EIOPA 'FinTech: Regulatory sandboxes and innovation hubs', Report JC 2018 74 (2018); A Attrey, M Leshner, C Lomax, 'The role of sandboxes in promoting flexibility and innovation in the digital age', OECD Going Digital Toolkit Notes, No. 2, OECD Publishing, Paris (2020) <<https://doi.org/10.1787/cdf5ed45-en>> ; RP Buckley et al., *FinTech*, n 48, 164-176; World Bank Group, 'Global Experiences from Regulatory Sandboxes', Finance, Competitiveness & Innovation, Global Practice, Fintech Note No. 8 (2020).

55 See RP. Buckley, Douglas Arner, Robin Veidt, and Dirk Zetzsche, 'Building Fintech Ecosystems: Regulatory Sandboxes, Innovation Hubs and Beyond', 61 *Wash. U. J. L. & Pol'y* 055 (2020).

## 2.9 Sustainability

In our view, sustainability<sup>56</sup> refers to the long-term viability and desirability of a given business model in light of environmental, social and governance challenges. This includes both the financial institution's susceptibility to sustainability risks and the impact it has on the environment and society at large.

Regardless of political preferences regarding individual ESG factors, unprofitable businesses are never sustainable as they impose externalities on other parts of society through lower corporate tax revenues, the need for subsidies, and costs associated with restructuring and insolvency. When the externalities prevented by regulation do not outweigh those created by regulation, the tide begins to favour deregulation.

### 03

## Targeted Deregulation as Due Regulatory Process

While deregulation can undermine the accepted objectives of financial regulation, deregulation of the rules and standards identified as over-regulation are likely to strengthen them as enforcement capacities can focus on the remaining, better drafted, regulations. This will result not only in better regulation but also in more effective enforcement at lower costs for society and institutions alike. Further, enforcing more effective rules will also support the credibility and standing of regulators within the financial system and society at large. In short, deregulation of the *right* rules is something regulators should pursue rather than avoid. I refer to this as 'targeted deregulation'

Indeed, any effective regulatory strategy is deficient without regular reviews of existing financial regulation and appropriate targeted deregulation. In the context of a 'crash-then-law' cycle of regulation, prominent commentators have long proposed tools such as sunseting to prompt periodic reconsideration of such rules.<sup>57</sup> While regular reviews of financial regulation are also mandatory in many countries,<sup>58</sup> I have not seen any evidence that suggests such reviews in fact lead to targeted deregulation. Rather, the amount of regulation continues to expand.<sup>59</sup>

56 European Commission, 'EU taxonomy for sustainable activities', <[https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities\\_en](https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en)> (last visited 22 November 2025).; Deloitte, Sustainability regulation outlook 2024 <<https://www2.deloitte.com/us/en/insights/environmental-social-governance/sustainability-regulation-outlook.html>> (last visited 22 November 2025).; ESGtoday, 'EU Regulators Propose New Sustainability and Transition Categories for Financial Products' <<https://www.esgtoday.com/eu-regulators-propose-new-sustainability-and-transition-categories-for-financial-products/>> (last visited 22 November 2025)..

57 Sunseting refers to legislation which, after a fixed time span, expires unless it is reenacted to remain in force. See Roberta Romano & Simon A. Levin, *Sunseting as an adaptive strategy*, 118 (26) PNAS (Proceedings of the National Academy of Sciences) (June 29, 2021; online pub. June 25, 2021); DOI: 10.1073/pnas.2015258118 (advocating the use of sunseting as a mechanism for mitigating the potentially adverse consequences of crisis-driven financial legislation).

58 Examples include the U.S., the EU and the UK. See *supra*, at I. For instance, U.S. financial regulators have been required since the early 1980s to review adopted rules, at least every ten years. These reviews seem, however, to face several challenges. See, on the legislative history as well as for a critique on the cost-benefit analysis applied by the SEC Johnsen, D. B. (2019), 'A Transaction Cost Assessment of SEC Regulation Best Interest', *Columbia Business Law Review*, 2018(3), 696–756, 706 et seq.

59 The website [www.countyoffice.org](http://www.countyoffice.org) counts the quantitative data on regulations published in the Federal Register and the Code of Federal Regulations (CFR). It noted that the number of pages in 2021 (approx. 86,000 pp.) and 2022 (approx. 80,000 pp.) were among the highest in history. As of 2019, the CFR contained more than 160,000 pp., an increase of 161 per cent compared to the 1970s.

Notably, the link between crises and regulation is also misleading. First, the evidence regarding regulators' response to crises with changes in regulation is mixed.<sup>60</sup> Second, as I will elaborate further below, regulation is increasingly pursuing policy goals beyond crisis-response. Thus, deregulation cannot occur unless these accompanying policy approaches are revisited.

Instead, I argue that targeted deregulation should become an ordinary part of the regulatory process: just as enterprises seek to constantly optimise their operations, financial regulators too should seek to constantly optimise their regulatory framework. The following parts identify how regulators can pursue this task with a three-pronged deregulation test, and then reviews why regulators often fail to apply this test in practice.

## 04

# A Three-Pronged Deregulation Test

The central difficulty in assessing whether deregulation is appropriate lies in determining when over-regulation is present to a degree that justifies deregulation. For example, prior to the Global Financial Crisis of 2007–8, banks' prudential capital requirements were less stringent than those under the current Basel framework, meaning certain financial transactions were generally less costly.<sup>61</sup> In light of the profound consequences of that financial crisis, during which many individuals lost their jobs, homes and, in some cases, their lives, the question arises: do the current Basel capital regulations constitute over-regulation?

In this Part, I propose a three-pronged test to help assess such questions.

Proceeding on the basis that any regulation should benefit either the relevant financial institution or society generally, if the costs of regulation exceed the benefits for either the relevant financial institution or society, the regulation in question should be repealed.<sup>62</sup>

I also propose deregulation if the costs of regulation are equal to the benefits on the basis that any additional costs or restrictions in freedom imposed on financial institutions can only be justified if the benefits *exceed* the costs.

Accordingly, I propose three cumulative conditions that favour deregulation, which I will discuss further below:

- The costs of regulation to the financial institution are greater than or equal to the benefits to the financial institution [ $C(FI) \geq B(FI)$ ]; and

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60 In fact, in a more recent paper Roberta Romano could not find consistent evidence that all or even most financial crises lead to more and deeper financial regulation, see Roberta Romano, *Are There Empirical Foundations for the Iron Law of Financial Regulation?*, Am. L. & Econ. Rev. \_\_ (forthcoming), Yale Law & Economics Research Paper, SSRN: <https://ssrn.com/abstract=4340042>.

61 Basel Committee on Banking Supervision, 'Evaluation of the impact and efficacy of the Basel III reforms', Bank for International Settlements (14 December 2022) <https://www.bis.org/bcbbs/publ/d544.pdf>, p. 50f; S Noess-Schmidt, JB Jensen, H Ehmann, M Facinio, A Lemberg, 'Economic Impact of the final Basel III Output Floor', Swedish Bankers' Association, Copenhagen Economics (16 March 2021) <https://www.financesweden.se/media/4902/2103-copenhagen-economics-output-floor-in-final-basel-iii.pdf>, p. 12.

62 Cf. GR Baldwin and CG Veljanovski, 'Regulation and Cost-Benefit Analysis', Public Administration, Vol. 62 Spring 1984 (51-69)

- The costs of regulation to the financial institution are greater than or equal to the benefits to society [ $C(FI) \geq B(S)$ ]; and
- The costs of regulation to society are greater than or equal to the benefits of regulation to society [ $C(S) \geq B(S)$ ].

#### **4.1 Costs Of Regulation At The Firm Level Are Greater Than Or Equal To The Benefits At The Firm Level**

The costs of regulation to the firm must be greater than or equal to the benefits to the firm. Benefits may include reduced agency costs and the avoidance of losses, specifically unprofitable risk-taking.

Example 1: Consider regulation aimed at reducing agency conflicts between the investment fund manager and unit holders. If, for instance, the costs of mandatory rules on fees and remuneration exceed the benefits of improved alignment of incentives between the fund manager's executives and the fund investors, the first condition for deregulation will be met.

Example 2: Consider regulation seeking to influence the risk-taking behaviour of a financial institution through prudential or risk management requirements. If the regulation leads to less profitable risk-taking on a risk-adjusted basis, the first condition for deregulation will be met.

#### **4.2 Costs Of Regulation At The Firm Level Are Greater Than Or Equal To The Benefits To Society**

The costs of regulation at the firm level must be greater than or equal to the benefits to society. Benefits of regulation for society may include, for example, reduction of externalities, counterparty risk or information costs.

Example 1: While mandatory disclosures may result in lower information costs for counterparties and investors, such costs will exceed the benefits when: (1) the information disclosed is immaterial for the counterparties and investors; or (2) the counterparties' and investors' collective search costs are lower than the issuers' costs of disclosure; or (3) the collectively identified and assessed information is more reliable than the issuers' disclosures.

Note that high search costs and low reliability of the information provided are often the case with disclosures involving non-firm specific information: social values; uncertain predictions on the future like with environmental developments; and any subject-matter on which the issuer is a non-expert, such as biodiversity impacts and climate change.<sup>63</sup> However, in the age of Big Data and artificial intelligence, technology impacts on such search costs as the focus shifts from searching and collecting to validating information.<sup>64</sup> Factoring-in technology can lead to entirely new cost-benefit-ratios of mandatory disclosure.

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63 Note that there is a difference between mandatory and voluntary disclosure of (potential) sustainability impacts. Where an issuer promises to deliver positive sustainability impacts in the course of its products or services it must be held accountable for its promises. Further, for *some* sustainability-related information the issuer *is* the cheapest cost avoider; for instance, the issuer knows its own energy costs and costs for raw materials best.

64 See Buckley et al., *FinTech*, n 48,

Example 2: Consider again regulation seeking to influence risk-taking behaviour of financial institutions through prudential regulations or risk management requirements. If the regulation leads to less profitable risk-taking on a risk-adjusted basis, and the reduction in profitability is greater than the societal benefits derived from that reduction such as diminished systemic risk and bankruptcy costs, the second condition for deregulation will be met.

### **4.3 Costs Of Regulation To Society Are Greater Than Or Equal To The Benefits Of Regulation To Society**

As regulation often imposes costs on third-parties, the third condition for deregulation will be satisfied when the costs of regulation to society are greater than or equal to the benefits.

Example 1: Certain financial activities, such as banks' provision of credit, can become more expensive when regulation influences the risk-taking behaviour of financial institutions through prudential regulations or risk management requirements. If the increase in financing costs exceeds the societal benefits such as reduced systemic risk and bankruptcy costs, the third condition for deregulation will be met.

Example 2: Enhanced compliance duties such as AML/CTF requirements can lead to higher compliance costs for opening bank accounts which, in turn, results in higher fees or a higher minimum balance required to open a bank account. Similarly, additional reporting requirements can increase the costs of the respective financial services, which can raise either the fees or the minimum transaction size for those services. If the reported data is not analysed by regulators, either because it is immaterial or because the regulators lack the capacity for data analytics, the third condition for deregulation will be fulfilled.

### **4.4 Jurisdiction For The Application Of The Three-Pronged Test**

Responsibility for applying the three conditions above lies with designated decision-makers: parliament; members of the polity such as ministers or secretaries of state; or members of expert administrative bodies with specific regulatory responsibilities. I refer to the latter as 'regulators'.

In the United States, responsibility for the prevention of systemic risks has been allocated to the Financial Stability Oversight Council (FSOC) since the adoption of the 2010 Dodd-Frank Act,<sup>65</sup> which is chaired by the Secretary of the Treasury and includes representatives from all federal financial regulatory agencies, along with a few other financial officials.<sup>66</sup> As the FSOC is led by the Treasury Secretary, the influence of the executive branch on its work is considerable. Similarly, commissioners of federal agencies are appointed by the presidential administration and confirmed by Congress.

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65 Dodd-Frank Wall Street Reform and Consumer Protection Act – P.L. 111-203, 21 July 2010.

66 Marc Labonte, 'Financial Regulation: Systemic Risk' (Congressional Research Service Report, 01 February 2022) <R47026.pdf (GESCHÜTZT)> (stating that „FSOC can make nonbinding recommendations to its member agencies and Congress on how to address emerging threats. It can also designate nonbank financial firms as systemically important financial institutions (SIFIs). To address the “too big to fail” issue, large banks and SIFIs are subject to enhanced prudential regulation (heightened safety and soundness standards) by the Federal Reserve.”).

By contrast, prevention of systemic risks in the EU is assigned to the European Systemic Risk Board (ESRB), which is chaired by the President of the European Central Bank.<sup>67</sup> A representative of the European Commission serves as a link to the Commission, which functions as the executive authority of the EU. However, the composition and working methods of the ESRB remain largely technocratic and operate with a considerable degree of independence from the political sphere. For instance, contrary to the European Commission's deregulation agenda, the ESRB recently proposed the ban of multi-issuer stablecoins involving issuers of third-countries.<sup>68</sup>

The foundation of financial regulation is often established by the financial regulators themselves, with many rules being drafted, adopted, and subsequently revised by these authorities. For instance, the Securities and Exchange Commission's authority extends to regulations under the Securities Act, the Securities Exchange Act, the Investment Advisers Act, and the Investment Company Act. Similarly, the European Supervisory Authorities (ESAs) play an important role in relation to Regulatory and Implementing Technical Standards, as well as supervisory guidelines, recommendations and opinions. These instruments function as de facto rules, constituting 'soft law' at Levels 2 and 3 of the EU Lamfalussy rulemaking system.<sup>69</sup>

## 05

# Factoring In Bounded Regulatory Rationality

While cost-benefit analysis may appear to offer a straightforward calculation as to whether a given rule should be removed, the implementation of such a test presents a range of practical challenges.<sup>70</sup>

## 5.1 The Limits Of Regulatory Rationality

Regulators' rational decision-making abilities are constrained for three main reasons. First, there are limitations in data availability. Second, even where all relevant data is available, there are limitations in jurisdiction, expertise and

67 See Art. 5 and 6 of Regulation (EU) No 1092/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (as amended).

68 European Systemic Risk Board, 'Recommendation of the European Systemic Risk Board of 25 September 2025 on third-country multi-issuer stablecoin schemes (ESRB/2025/9)' (25.9.2025) [https://www.esrb.europa.eu/pub/pdf/recommendations/esrb\\_recommendation251020.en.pdf](https://www.esrb.europa.eu/pub/pdf/recommendations/esrb_recommendation251020.en.pdf) (last visited 25 November 2025) p. 7, Recommendation A.

69 BaFin, European Supervision <<https://www.bafin.de/ref/19591252>> ; European Commission, Regulatory process in financial services <[https://finance.ec.europa.eu/regulation-and-supervision/regulatory-process-financial-services\\_en](https://finance.ec.europa.eu/regulation-and-supervision/regulatory-process-financial-services_en)> ; Kostas Botopoulos, 'The European Supervisory Authorities: role-models or in need of re-modelling?', ERA Forum 21, 177–198 (2020) <<https://doi.org/10.1007/s12027-020-00609-7>>.

70 Some of these limitations have been emphasised by the lead authors of public choice theory. See Kenneth J Arrow, *Social Choice and Individual Values*, Yale University Press (2012). JSTOR, <<http://www.jstor.org/stable/j.ctt1nqb90>> (last visited 22 November 2025).; Gordon L. Brady and Gordon Tullock (Eds.), *Formal contributions to the theory of public choice: The unpublished works of Duncan Black*, Norwell, MA: Kluwer Academic Publishers (1996); James M. Buchanan and Gordon Tullock, *The Collected Works of James M. Buchanan*, Vol. 3. *The Calculus of Consent: Logical Foundations of Constitutional Democracy*, with a Foreword by Robert D. Tollison (Indianapolis: Liberty Fund, 1999); Anthony Downs, *Political Theory and Public Choice* Books, Edward Elgar Publishing (1998); William A. Niskanen, *Policy Analysis and Public Choice* Northampton, Mass.: Edward Elgar (1998) 430 pp.; Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups*, Second Printing with a New Preface and Appendix. Harvard University Press (1971) JSTOR, <<https://doi.org/10.2307/j.ctvjsf3ts>> (last visited 22 November 2025).; William H Riker, *The Political Psychology of Rational Choice Theory*, Political Psychology, vol. 16, no. 1, 1995, pp. 23–44. JSTOR, <<https://doi.org/10.2307/3791448>> (last visited 22 November 2025)..

resources. Third, rational decision-making is further hindered by conflicts of interests.

Reliable data on future developments are impossible to generate. As far as complex multi-factor decisions outside of individuals' preferences and data trials are concerned, predictive artificial intelligence remains a Nirvana assumption.<sup>71</sup> Meanwhile, data on the past and present may be limited due to constraints in regulators' and the industry's data collection capacity or due to regulators' restricted jurisdiction in certain subject areas.

Even with full data availability, limitations in jurisdiction, expertise and resources impair the quality of regulatory decisions. For instance, a US banking regulator may be unconcerned by the impact of US bank regulations on China, unless significant Chinese counterparties encounter difficulties. Moreover, bank regulators have limited expertise in assessing the impact of their rules on other financial sectors and industries, even though a financial concern may arise from a non-financial event, such as new technologies or political conflict. In the context of systemic risk, while this limitation is mitigated by cross-sectoral bodies such as the FSOC and the ESRB, boards that consider macroeconomic factors are typically the domain of central banks and are less commonly embedded within specialist regulatory authorities.

Furthermore, regulators operate with limited resources, including restricted data analytics capacity. As a result, rational decision-making is affected by the growing complexity and interdisciplinarity of the matters subject to regulation. Notable examples include the emergence of quantitative mathematics,<sup>72</sup> financial and regulatory technologies,<sup>73</sup> and sustainability risks and factors within the financial sector.<sup>74</sup> Although the delegation of authority to financial regulators rests on the assumption that they possess subject-matter expertise, in each of these cases the regulators are not experts in the relevant fields and are tasked with regulating and enforcing rules that are financial in name only. Challenged by increasingly complex and less well-understood topics, regulators face a choice between acting out of fear of the unknown, which often results in overly restrictive or prohibitive approaches, or relying on the industry for additional knowledge, which may in turn increase the risk of regulatory capture.

Regulatory institutions are led by individuals who possess their own motives, challenges and ambitions. As a result, conflicts of interest may arise. The extent to which such conflicts influence regulatory and supervisory practice depends largely on the governance structure of the agency in question. For instance, some individuals may be motivated to serve within a prominent regulatory authority in order to engage in 'empire building'.<sup>75</sup> This may involve expanding the institution's mandate openly through legislative amendments, or more subtly through expansive interpretations of legal terms that define the scope of the regulator's jurisdiction. On the other hand, while regulators do not share in the benefits of financial institutions' risk-taking, they do bear the reputational consequences if such

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71 See IBM, 'Generative AI vs. predictive AI: What's the difference? | IBM' (last visited 22 November 2025). (stating that 'Predictive AI blends statistical analysis with machine learning algorithms to find data patterns and forecast future outcomes. It extracts insights from historical data to make accurate predictions about the most likely upcoming event, result or trend. Predictive AI models enhance the speed and precision of predictive analytics and are typically used for business forecasting to project sales, estimate product or service demand, personalise customer experiences and optimise logistics. In short, predictive AI helps enterprises make informed decisions regarding the next step to take for their business.').

72 For a doomsday account see Scott Patterson, *The Quants: How a New Breed of Math Whizzes Conquered Wall Street and Nearly Destroyed It* (New York, 2011).

73 See Arner et al, 'FinTech and RegTech: Enabling Innovation While Preserving Financial Stability', (2017) 18:3 Geo J Int'l Aff. 47-58.

74 See D.A. Zetsche, L.C. Anker-Sørensen, 'Regulating Sustainable Finance in the Dark' (2022) 23 EBOR 47-85.

75 See Daryl J. Levinson, 'Empire-Building Government in Constitutional Law' 118 Harv L Rev 915, 932-37 (2005).

risks materialise as regulators may be held responsible for ineffective regulation and supervision. This can lead regulators to favour risk avoidance and prohibition, even if more balanced risk management strategies would be more socially optimal. This tendency, which I refer to as 'regulatory discouragement', is typically accompanied by an over-emphasis on risks that are often less well understood.

## 5.2 The Dual Role Of Politics In Financial Regulation

Similar to the contrast between the 'helping hand' and the 'grabbing hand' laid out above,<sup>76</sup> political influence may have both constructive and detrimental effects on regulatory decision-making.

On the one hand, political influence may counter the risk of 'regulatory capture', which refers to the danger that industry or social preferences influence regulators to such an extent that regulation primarily serves the interests of the industry or social group rather than those of society at large, resulting in suboptimal regulation or enforcement.<sup>77</sup> Indicators of regulatory capture include: dependency on advisory firms when drafting rules and regulations; strong representation in regulatory commission and staff; and financial dependency on particular industry groups.

Political influence may also counter the risk of 'regulatory discouragement', which refers to the tendency to overemphasise risks based on regulators' awareness that they may be blamed for any adverse outcomes, while the risk premium in the form of profits, rents or salaries will be internalised by the regulated industry.

At the same time, political influence on financial regulation can be potentially harmful where the decision-makers prefer ensuring their re-election and remaining in power over pursuing the public interest.<sup>78</sup>

The most obvious form of this negative impact is nepotism, whereby individuals lacking the necessary fitness and propriety are appointed to regulatory positions on the basis of personal or political connections. This can lead to political influence on financial regulation that reflect the political connections' ethical and social expectations. This holds true regardless of whether the connections favour a market-liberal or market-hostile agenda. When such expectations are integrated into regulation, the additional influences could divert attention from reducing agency costs, externalities, and transaction costs, ultimately undermining regulations' core objectives.

Recent examples of a politically induced widening of regulatory mandates include the expectation that financial regulation – rather than financial markets directly – promotes job growth and innovation by ensuring well-governed funding streams.<sup>79</sup> Further, financial regulation is now expected to: help reduce negative sustainability impacts beyond the immediate reach of business activities;<sup>80</sup> ensure that profits are fairly distributed to all parts of society; and ensure that firms treat all stakeholders (including employees) fairly, for instance after a take-over.

76 Supra notes 33 to 35.

77 Ernesto D. Bó, 'Regulatory capture: A review' (2006) 22.2 *Oxford Rev Econ Pol'y* 203–225; G.J Stigler, 'The Theory of Economic Regulation' (1971) 2:1 *The Bell J Econ Man'T Sc* 3–21; ME Levine, JL Forrence, 'Regulatory Capture, Public Interest, and the Public Agenda: toward a Synthesis' (1990) 6 *JLEO* 167–198.

78 D Acemoglu, JA Robinson, 'A theory of political transitions', (2001) 91:4 *Am Econ Rev* 938–963.

79 For a US perspective see Brummer, 'Disruptive Technology and Securities Regulation', n 47, at 1037 et seq.

80 It should be noted that disclosure on sustainability risks falls within the core mandate of financial regulation, as it enhances the information available to shareholders and creditors for assessing non-financial risks to which the firm is exposed.

Where outright prohibitions cannot be adopted in the regulatory process, the overburdening of financial regulation with political influences often results in additional obligations intended to compel behaviour favoured by the relevant political faction. This may take the form of expanded risk management requirements, whereby political expectations are reframed as risks to be addressed. The overload of financial regulation increases compliance costs for financial institutions and strains regulators' enforcement resources to their limits. This results in either weaker enforcement of the core aims of financial regulation or the accumulation of additional resources on the part of regulators – for instance, in natural sciences – which in turn leads to higher fees charged to supervised entities to cover the costs of these resources.

### 5.3 Non-Monetised Goods As Legislative Prerogative

In principle, financial regulation applies only to financial decisions and goods with a market price. However, an increasing range of goods for which a market price cannot be reasonably established poses a challenge for the application of the three-pronged deregulation test. For instance, what is the value of privacy? What is the value of a future with a healthy climate that will be experienced by our grandchildren in the future rather than ourselves today? What is the value of reduced drug trafficking and addictions, and greater personal security in society, due to enhanced AML/CTF regulations?

As these non-monetised goods are subject to the domain of politics and the legislative process, regulators *stricto sensu* must stay away from political infection as much as possible to ensure a neutral cost-benefit assessment that is so crucial for effective regulation. While politics must stop short of mixing its political agenda into financial regulation objectives.

## 06

# Curing Financial Regulation

By synthesising the three-pronged test into specific guidance, this section presents a set of recommendations for targeted deregulation of finance, arranged in a broadly thematic order.

### 6.1 Capital Markets Regulation 'By Capitalists'

The first recommendation concerns regulatory attitude. Capital markets regulation must take place under market influence. A regulator must be solely driven by the desire to establish the best financial system possible, facilitating the smooth channelling of financial resources from the supply side to the most productive demand. In this sense, financial regulators should not resist capital markets but rather embrace them. As the former central bank governor and head of the International Monetary Fund *Jacques de Larosi re* stated in February 2025: 'regulators must take the perspective of a well-meaning mother or father who is painfully aware of the deficiencies of their daughters and sons but nevertheless wants the best for them in all they do.'

This regulatory attitude implies that any effort to expand regulatory mandates beyond the core missions of financial regulation should be approached with caution, just as a good mother would not want to see her children overburdened with non-material concerns, allowing them to focus on the core values of life, whatever those may be.

Similarly, regulators must refrain from requiring financial entities to report data that they do not use for supervisory purposes. Even as financial entities gather increasingly more data in response to the datafication of finance and for internal steering purposes, regulatory reporting must be limited to material data relevant for supervisory purposes. A *bon père* will recognise the need for economic requirements and only ask for what is truly necessary for supervisory purposes.

## 6.2 Avoiding Unmeasurable Tasks and Terminology

The second recommendation is to avoid using regulatory terminology and reasoning that is unmeasurable. What cannot be measured cannot be managed or assessed. Whether financial regulation meets the three-pronged test relies on solid measurements. Avoiding measurable terms equates to avoiding accountability.

Examples of problematic regulatory language include the calls to ‘harmonise laws’ or achieve ‘cross-sectoral coherence’, both of which can be found in many legislative projects.<sup>81</sup> These terms serve to obscure rather than clarify the true legislative intention and act as harbingers of over-regulation.

Terms like ‘harmonisation’ can be (ab)used as an argument to justify *any* rule and *any* regulatory approach that creates more rules as harmonisation does not explain how regulation should be designed or why it should occur alongside additional rules. The alternative to adopting more rules could be the harmonised removal of restrictions, or the limitation to commonly accepted general principles where the details are left to the courts to consider their application in each case.<sup>82</sup> In other words, the freedom to do business can also be harmonised. Moreover, harmonisation through additional rules does not guarantee that markets following these rules will function effectively. For instance, a regulator’s uniform cap on interest rates does not necessarily promote efficient credit markets, as it disregards differences in service levels and risks among financial institutions. As such, I strongly suggest abandoning ‘harmonisation’ as a rationale for regulating finance.

The same is true for ‘cross-sectoral coherence’, which can only support regulation if it refers to two identical things. However, this is never the case, as existing rules would cover the situation. In fact, securities regulation addresses investments, which is a different subject matter from insurance contracts in insurance regulation and the provision of credit in banking regulation. For instance, the international harmonisation efforts prompted by the FSB in the aftermath of the US experience with the ‘breaking of the buck’ of money market funds, which aimed for

81 Art. 114 of the Treaty on the Functioning of the European Union (TFEU) assigns jurisdiction to the European Parliament and the Council with respect to ‘measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market.’ Almost all recent EU financial legislative measures have been based on Art. 114 TFEU.

82 As discussed in Louis Kaplow’s seminal article, rulemaking can take place *ex ante* (by regulators) or *ex post* (via the courts). See L. Kaplow, “Rules Versus Standards: An Economic Analysis”, (1992) 42 Duke LJ 557-629. *Ex post* rule-making by courts has, among many other advantages, better access to case-specific facts and can deliver, for that reason, a better ethical balance between the parties. See H.E. Smith, ‘Equity as Meta-Law’ (2020-21) 130 Yale LJ 1050.

a constant net asset value (CNAV) and were marketed as bank-like accounts,<sup>83</sup> have led to the adoption of money market fund regulation in many markets outside of the US. This was problematic because CNAV funds did not hold significant meaning in these markets, resulting in increased regulatory costs for investment fund managers in those markets.<sup>84</sup>

In particular, the adage ‘same risks, same rules’ implies that everything must be identical. However, substantive similarity, which is common in cross-sectoral comparisons, is not sufficient to justify regulation. For instance, when regulators adopt rules for digital assets that have previously been implemented in the context of securities, the aforementioned adage is inappropriate.<sup>85</sup> Some digital assets have features that resemble securities, but many do not. Similarly, when investment funds grant credit, they do so from the investor’s own equity, while banks grant credit from depositors’ funds which have become the bank’s property. In many countries, lending from equity without accompanying deposit-taking activity is not even regulated as banking activity. Against that background, applying rules governing the credit activities of funds that are similar to banks’ credit risk assessments is not justifiable.<sup>86</sup>

Other examples include terms that assign overly broad discretion to regulators, such as ‘fair’, ‘balanced’, ‘proportionate’, and ‘just’, along with other terms whose application presupposes a value judgment. Unless a financial test is provided to measure fairness, these terms invite deferring the decision on which rules apply until the regulator reviews a financial institution’s application or practice, long after the rule has been adopted. Regulated entities are incapable of handling such terms in the absence of detailed regulatory guidance. Hence, their use in regulatory texts will most likely lead to additional rules later, the costs and effects of which are not considered when the initial rules are adopted.

However, I do not deny the need for value-based decisions by *courts*, which are facilitated by ambiguous, ethically charged terms. Court decisions not only add to the further development of law and provide legal certainty, but also serve an important ethical function and have merits as such.<sup>87</sup> In fact, it is one of the deficiencies of contemporary financial regulation that courts are less present; even well-governed regulated entities often pay deference to the regulator’s view.<sup>88</sup> What I take issue with is framing financial *regulation*, which is inherently designed to deliver legal certainty by ex-ante rulemaking, in a form and style that provides legal uncertainty and requires adjudication ex-post.

Naturally, banning ambiguous, boilerplate regulatory language makes the process of regulating much more challenging. Regulators must better analyse the potential effects and counter-effects of financial regulation and clearly describe the desired policy outcome and the rationale behind it.

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83 See W.A. Birdthistle, ‘Breaking Bucks in Money Market Funds’, (2010) Wis. L. Rev. 1155.

84 For instance, the EU adopted the Money Market Fund Regulation. See Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds, OJ L 169, 30.6.2017, p. 8–45.

85 This is the case, for example, with many rules adopted at Level 2 of the European Markets in Crypto-Assets Regulation, which have been drawn from the EU MiFID framework governing transferable securities and financial derivatives.

86 In these cases, a gradual buildup of rules over a very long time, informed by regulatory experience and cases, helps to avoid over-regulation.

87 See H.E. Smith, ‘Equity as Meta-Law’ 130 Yale L.J. 1050 (2020–21).

88 See on banking law S. Heitzer, *Messing with the Regulator* (Mohr Siebeck, 2023).

As the use of terms like ‘harmonisation’, ‘cross-sector coherence’, and value-charged language is an indicator of potential over-regulation, regulators should analyse existing financial regulation that uses such language to identify opportunities for deregulation.

### 6.3 Embracing Regulatory Arbitrage And Competition On Merit

As ‘harmonisation’ is not an argument for (de)regulation per se, regulatory competition<sup>89</sup> on a merits basis should be recognised in regulatory circles as unavoidable and even positive.

For instance, both innovation hubs and regulatory sandboxes<sup>90</sup> reflect a commitment to fostering innovation and advancing regulatory learning. Innovation hubs were introduced by the Luxembourg CSSF in 2014, and regulatory sandboxes by the UK FCA in 2015, both as tools to enhance competitiveness in attracting financial technology firms.<sup>91</sup> In the absence of regulatory competition, regulators have limited incentives to maintain high standards of performance. Regulatory innovation may also yield reputational benefits, which are particularly important in the market for supervisory staff, where financial regulators often operate at a financial disadvantage.

In the same vein, the term ‘regulatory arbitrage’<sup>92</sup> does not carry a negative connotation, *provided that all regulators apply equivalent rules effectively*. The fact that one regulator is conducting the same review with the same level of diligence faster, because it is equipped with better staff and technologies than other regulators, enhances social welfare. The same is true if certain regulators establish regulatory centres of expertise for specific sectors of the financial industry.<sup>93</sup> The respective sector will be better supervised in these cases as the staff members become more competent, and dependency on a few large national incumbents – which increases the risk of regulatory capture – is reduced.

Taking into account merit-based competition and regulatory arbitrage in all regulatory decisions serves as an effective safeguard against over-regulation, as these considerations prompt reflection on how market participants are likely to respond to the adoption of a given rule. Such anticipated responses should inform and guide the rulemaking process.

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89 Cf. K Gatsios, P Holmes (2002). Regulatory Competition. In: P Newman (eds) *The New Palgrave Dictionary of Economics and the Law*. Palgrave Macmillan, London. <[https://doi.org/10.1007/978-1-349-74173-1\\_317](https://doi.org/10.1007/978-1-349-74173-1_317)>, pp. 1671-1675; J.P. Trachtman, ‘Regulatory Competition and Regulatory Jurisdiction’ (2000) 3 JIEL 331; D.C. Esty, ‘Regulatory Competition in Focus’ (2000) 3 JIEL 215; P.B. Stephan, ‘Regulatory Competition and Anticorruption Law’ (2012) 53 Va J Int’l L 53; A.T. Guzman, ‘Public Choice and International Regulatory Competition’ (2002) 90 Geo LJ 971; C.M. Radaelli. ‘The Puzzle of Regulatory Competition’ (2004) 24 J Public Pol’y 24 1-23.

90 Cf. ; H.J. Allen, ‘Regulatory Sandboxes’ (2019) 87 Geo Wash L Rev 579; D.A. Zetzsche et al., ‘Regulating a Revolution’, n 53, at 31; Buckley et al., ‘Building Fintech Ecosystems’, n 55, at 55.

91 Cf. Buckley et al, *supra* n 55.

92 Cf. V. Fleischer, ‘Regulatory Arbitrage’ (2010) 89 Tex L Rev 227; J. Barry, ‘On Regulatory Arbitrage’ (2009-2010) 89 Tex L Rev 69; F. Partnoy, ‘The Law of Two Prices: Regulatory Arbitrage, Revisited’ (2019) 107 Geo LJ 1017; A. Riles, ‘Managing Regulatory Arbitrage: A Conflict of Laws Approach’ (2014) 47 Cornell Int’l LJ 63.

93 Examples include Ireland and Luxembourg in the context of investment funds.

## 6.4 Towards Sandbox Thinking

Regulators should also adopt what has been referred to as ‘sandbox thinking’.<sup>94</sup> This involves the experimentation and testing of new supervisory approaches and regulatory concepts in response to financial, legal and technological innovation. Such experimentation should be accompanied by the transparent disclosure and reporting of both the methods used and the results obtained, allowing other regulators to take these findings into account. When conducted with full transparency, this practice can enhance the overall effectiveness of cross-border financial supervision. This recommendation is necessarily dependent on our second recommendation as sandbox thinking is precluded where strict harmonisation leaves no room for national experience or experimentation.

As such, in untested or innovative fields, regulators are encouraged to limit themselves to reliance on broad principles (such as the ‘no conflict of interest’ and ‘no authorised profit’ rules of fiduciaries) while making space for experimentation. This approach may include reliance on decisions by courts and arbitrators who are better equipped to render value-based decisions following a case-by-case assessment.<sup>95</sup>

## 6.5 Towards Proportionate Risk-Based Approaches

Finally, regulators should favour proportionate risk-based approaches over outright prohibition. The purpose of any market activity is to fund the next cycle of innovation,<sup>96</sup> and innovation cannot flourish under conditions of strict prohibition and high regulatory costs.

There may be cases where doubt remains about whether a rule is justified. While regulators may have incentives to err on the side of caution and adopt a restrictive rule, even when the justification is too weak to preserve their reputation, I propose the opposite: if in doubt, deregulate.

Adopting such an approach will strengthen both the acceptance of new rules and the ‘deregulation reputation’ of the regulator, as market participants will understand that a costly rule will be repealed and revised rather than kept indefinitely.<sup>97</sup>

Further, nothing prevents a regulator from regulating later, in a better manner, once research or experience has revealed a regulatory approach that produces a positive cost-benefit ratio. In fact, with targeted deregulation approaches in place, the law in certain areas may change more frequently while remaining more stable in other areas. If ultimately leading to more societal benefits, such implementation costs borne by financial institutions and regulators in some sectors should be seen as inherent costs of regulatory optimization, in the same way that restructuring costs are seen as inherent costs of business optimization.

94 D.A.Zetsche, L.C. Anker-Sørensen, ‘Towards a Smart Regulation of Sustainable Finance’, in P. Câmara, F. Morais, *The Palgrave Handbook of ESG and Corporate Governance* (Palgrave MacMilla, 2022), 87, 89 et seq.

95 See H.E. Smith, ‘Equity as Meta-Law’ 130 Yale L.J. 1050, 1080-81 (2020-21) (using opportunism as example for the effectiveness of ex post principles based on equity).

96 See on J. Schumpeter’s cycles of creative destruction in capitalist systems J. Gupta, A. Srivastava, B. Alzugaiby, ‘Schumpeterian creative destruction and temporal changes in business models of US banks’, (2024) 91 Int’l Rev Fin Analysis 102951.

97 The alternative approach of sunset clauses presents the drawback that financial institutions may delay deregulation in anticipation of the rule expiring as proactive deregulation requires investing regulatory capital.

## Conclusion

Financial regulation should deliver benefits for regulated financial institutions and society at large. When the benefits created by a given rule do not exceed their costs, a case for targeted deregulation arises. While this principle is, to my knowledge, undisputed, and finance is particularly amenable to a strict cost-benefit analysis, bounded regulatory rationality and political influence on financial regulation have undermined the uniform application of this principle. Consequently, regulators' objectives have gradually expanded, resulting in financial regulation addressing non-financial issues. Cost-benefit analysis has become challenging, and regulatory accountability for rules, as well as the acceptance of those rules by regulated entities, has been compromised.

I have set out five principles for adjusting financial regulation. When regulators view themselves as beneficial parents of financial systems rather than autocrats, avoid the use of vague terms such as 'harmonisation' and 'cross-sectoral consistency', accept regulatory competition, adopt 'sandbox thinking', and favour proportionate risk-based approaches over outright prohibition, cases for targeted deregulation will inevitably come to light.

