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CHAPTER 2

SOFT LAW AS A FACTOR STABILIZING THE FINANCIAL SYSTEM

Introduction

The increasing globalization and liberalization of the world economy has made the problem of the stability of the financial system one of the main issues at both national and international levels. The rapid spread of financial crises with the so-called contagion effect has triggered lively discussions on methods of counteracting the crisis and has led to attempts to develop effective instruments ensuring financial stability.

The great involvement of supranational institutions, such as the IMF, the BIS (Bank for International Settlements) and the European Commission, should be emphasized. Their efforts to build an international network of financial security, which, in the conceptual dimension, is a set of institutional and regulatory frameworks ensuring the stability of the financial market and, in the institutional dimension, consists of supervision over the financial market, a lender of last resort and a deposit insurance system [Jurkowska-Zeidler, 2008, p.12]. There is also an increasingly strong bottom-up approach emerging directly from various entities in the financial sector. This approach usually takes the form of codes of good practice, which not only enhance the image of the institution, but also improve and make safer the operation of the entire system.¹

The essence of creating a financial safety net seems to lie in coordinated supervisory activities of national authorities, which in their actions should take into account the global situation and recommendations issued by international decision-making and advisory bodies. The architecture of actions aiming at financial stability should preserve the right sequence of responses to disturbances of that

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¹ In Poland, internal regulations on good practices have been formulated by: Bank BPH, Bank Gospodarstwa Krajowego (The Body of Ethical Principles of BGK Employees), Bank Pekao S.A. (declares compliance with the so-called Charter of Principles, applicable to all entities of UniCredit Group) and some co-operative banks (such as Bank Spółdzielczy in Gniezno).

stability, in the first place, by taking measures at the national level (taking into account the specificity of the country, e.g., historical conditions, the existing infrastructure, the working of the financial system and the real sphere), followed by supranational actions. This would eliminate possible inconsistencies [Houben et al., 2004, pp. 43-44]. According to this principle, recommendations formulated by the supervising institutions should be flexible enough to be adjusted to country-specific economic and legal conditions, while they should also suggest solutions whose implementation would effectively strengthen the stability of the system and make it possible to avoid risks. Such opportunities are provided by the application of so-called soft law, namely by formulating regulations in the form of recommendations or codes of good practice, which are voluntary and advisory in nature. State authorities and even economic entities are given wide discretion as to the extent of their implementation into business practice.

This paper aims to discuss the use of soft law as one of the factors stabilizing the financial system. The advantages and disadvantages of replacing traditional legal regulations with soft law regulations in certain areas of banking supervision will be presented. An attempt will be made to prove that soft law applied in financial supervision may not only increase the security of particular institutions, but also enhance their effectiveness and public confidence.

1. Soft law – definition, classification and origin of the concept

There is some controversy as to the origin of the term "soft law." While it is attributed to Arnold McNair [Bierzanek, 1987, p. 92], Wellens and Borchardt are of the opinion that the concept of soft law was derived from the work of Dupuy [Borchardt and Wellens, 1989, p. 268]. On the other hand, Van Hoof argues that Dupuy himself admitted to borrowing the term from McNair [Hoof, 1983, s. 187]. Notwithstanding its inventor, the concept in question appeared in legal terminology in the early 1970s, but in practice soft law instruments have been used since the inception of the United Nations [Bothe, 1980, pp. 70-75]. It can therefore be assumed that the establishment of a universal international organization made the sources of international law listed in Article 38 of the Statute of the International Court of Justice no longer sufficient to meet the requirements of the contemporary international community [Pellet, 1985, p. 123]. Attempts to establish supervision laws and methods at the international level led to a search for new instruments which would provide an opportunity to adjust guidelines to particular countries of the Community in a flexible manner. This gave rise to the formulation of declarations, communiqués, memoranda, codes of practice, guidelines, conclusions,

standards, charts, reports, gentlemen's agreements, etc. As emphasized by A. Pellet, these agreements have the advantages of treaties without their drawbacks. In his opinion, they are sources of inspiration and support; they determine aspirations and are catalysts for changes in countries which are going to implement them in practice [Pellet, 1985, pp. 126-127].

In considering the issues of soft law in the context of its impact on financial stability one should first take a look at all the recommendations of the BIS and codes of good practice. A summary of the latter shows that the source of the financial turmoil lies not only in the erroneous macroeconomic policy, but also in the misguided, often psychologically conditioned behaviour of managers and other employees of financial institutions. Standards of conduct in the form of codes of conduct formulated at the international level apply to regulations in the area of macroeconomics (Code of Good Practices on Fiscal Transparency, Code of Good Practices in Monetary and Financial Policy, Special Data Dissemination Standard) as well as to particular groups of economic entities, by proposing standards of conduct for employees of institutions operating in the securities, insurance and real estate markets [Jurkowska-Zeidler, 2008, pp.187-188].

The recommendations published by the BIS, and, to be precise, by the Basel Committee on Banking Supervision at the BIS, play an important role in shaping international supervisory regulations. The committee, composed of representatives of central banks and supervisory banking authorities² of the G10 countries, has no legislative powers and recommendations issued by the committee are a typical example of soft law instruments without legal force. However, the principles developed by the Basel Committee are so important that shortly after their announcement national banking supervisors introduce regulations based on those recommendations, which are binding for all national financial institutions. Today the implementation of the Committee's recommendations has become a kind of proof of legitimacy of supervisory authorities in relation to international institutions, political partners and investors.

Also at the national level standards for procedures and conduct for individual professional groups are becoming more precise. These standards are in the form of codes of good practice, also known as deontological codes or codes of ethics. Polish economic practice has seen several examples of such "soft rules," of which the most important for creating order and safety of the financial system seems to be the Canon of Good Practice for the Financial Market issued by the Polish Financial Supervision Authority. One should also mention the Best Practice Recommendation on the Polish Bancassurance Market in the field of protective in-

² In cases where banking supervision is not the responsibility of the central bank.

surance related to banking products, the Good Practice Principles for Members of the Conference of Financial Companies in Poland, the Code of Good Practice for Institutional Investors and, finally, the Best Practices for WSE Listed Companies.

So many examples of these canons of voluntarily implemented rules and their growing importance in building stable economic sectors which enjoy public trust have encouraged a formal definition of the notion of code of conduct. At the level of European Union legislation, such a definition can be found in Directive 2005/29/EC of the European Parliament and of the Council, where it is given as "an agreement or set of rules not imposed by law, regulation or administrative provision of a member state which defines the behaviour of traders who undertake to be bound by the code in relation to one or more particular commercial practices or business sectors" [European Parliament, 2005]. The International Federation of Accountants has defined a code of good practice as "principles, values, standards, or rules of behaviour that guide the decisions, procedures and systems of an organization in a way that (a) contributes to the welfare of its key stakeholders, and (b) respects the rights of all constituents affected by its operations" [IFAC, 2006, p.9].

These considerations show the dissemination of soft law in today's economic reality. It should be noted that it has both its ardent supporters and strong opponents, who embrace the traditional principles of legislation arguing that every legal norm should consist of a hypothesis, disposition and sanction. Although soft law lacks formally defined sanctions, it should be noted that usually the market sets a price for failing to follow certain principles of soft law. The lack of public confidence or withdrawal of lenders are often much more severe penalties than those set out in the official law. Therefore, the issue of "soft supervision" over the financial market should not be overlooked in the analysis of factors which regulate the principles of its operation and affect the stability of the system.

2. Basel Capital Accords – recommendations stabilizing the global financial system

The Basel Committee on Banking Supervision attempts to respond to the dynamic changes taking place in financial markets by announcing recommendations with the primary goal of strengthening the stability of the international banking system. The Basel Capital Accord (Basel I) was the first such document published in 1988, which established primarily two standards; the minimum capital requirements for banks (so-called capital adequacy), and measurement of credit risk associated with specific categories of balance sheet and off-balance sheet assets

[Żółtowski, 2011, p. 30]. Basel I introduced rigid 8-per cent capital to risk-weighted assets protection. Although the recommendation was not legally binding, shortly after its announcement more than 100 banking supervisors around the world pledged to incorporate it into the existing laws of their countries.

The development of new financial engineering instruments, and, along with it, the identification of new types of banking risk, made it necessary to verify Basel I guidelines. The Basel Committee recognized the need for an individualized approach to risk in particular banks and the need to move away from a rigid indicator designating a minimum level of internal capital. In 2004, considering these issues, the so-called New Capital Accord (Basel II) was developed to meet the new conditions of operation of banking entities. The partial rejection of rigid control of the level of capital and the recognition of new risks, the impact of which was to be taken into account when measuring capital adequacy, were important elements which distinguished this set of recommendations from the previous one.

Regulations contained in the New Basel Capital Accord can be considered a breakthrough in terms of banking supervision. This bold statement is justified by the fact that the risk measurement methodology was almost entirely entrusted to the management of the banks. The banks' boards of directors were required to define and monitor the activities of the entities they managed and to calculate the required internal capital according to their own internal models. Taking into account the fact that the Basel II recommendation were later almost exactly implemented in Community regulations and then in national supervisory rules³, one should realize that the Basel II recommendations were an enormous challenge for the management and executives of financial institutions. It can be assumed that the regulations formulated pursuant to Basel II were based on the strong conviction that the bank's management would follow the code of ethics, avoid moral hazards and strengthen the long-term stability of individual entities, and consequently of the whole financial system. Only on this condition allowing banks to determine the risk parameters of their own activities would bring the desired results.

Thus, analysis of certain provisions of the New Basel Capital Accord from the point of view of soft law is very useful, and not only because the NBCA itself is an example of a recommendation without legal force. Of far greater importance seems to be the observation that the Basel II rules are a specific expression of confidence in the principles of corporate governance in financial institutions, which, based on good banking practice, should effectively regulate the issues of rational risk management.

³ The New Capital Accord was introduced into the law of the European Union by adopting the Capital Requirements Directive, CRD.

The assumptions of the New Capital Accord are divided into three pillars. The first pillar, apart from capital requirements associated with risk, focuses also on the issue of operational risk. This kind of risk involves the probability of incurring losses due to erroneous internal processes and due to activities of people and systems, and therefore comprises elements usually not covered by banking law. What previously used to be only a requirement resulting from the use of good practice in the management of operational risk was now strengthened by the necessity to calculate capital requirements linked to this risk [Zółtowski, 2011, pp. 135-136]. The Basel Committee defined 7 types of operational risk which result in losses for banks; these are: internal fraud; external fraud; employment practices and workplace safety; clients, products and business practices; damage to physical assets; business disruption and system failures; execution, delivery and process management. It is easy to see that most of these issues are regulated by principles of corporate governance. It can therefore be concluded that the obligation to manage operational risk, introduced by the Basel II framework, is in fact an obligation to introduce principles of good corporate governance practices and develop methods of forecasting losses resulting from ineffective supervisory regulations.

The second pillar of the Basel II framework is even more focused on supervisory review and on assessment of risk not covered by the first pillar. There is only one condition: banks are expected to create internal regulations for measuring and assessing risk and take measures to reduce it. Banking supervision is defined as a body evaluating the manner and quality of risk management and formulating adequate suggestions. Regulation formed in this way gives plenty of room for using soft law instruments. First, the methodology of calculating the risk covered by the second pillar is entirely entrusted to the management of the banks with full confidence that their actions would be in accordance with good banking practice. Second, banking supervision, clearly accentuated in this part of the Basel II framework, can regulate the market of bank services mainly on the basis of soft law instruments.

This principle is closely reflected in Polish banking supervision, where the Polish Financial Supervision Authority (PFSA) influences the stability of banks by issuing recommendations. As pointed out in the literature, the PFSA creates only a kind of code of ethics for the banking business [Krzyżewski, 2000, pp. 111-121] and provides banks with principles of good banking practice [Tupin, 2000, pp. 19-23]. Although the content of these recommendations would suggest that they are binding for banks, at this point it is necessary to look at the consti-

⁴ Pillar 2 concerns the interest rate risk in the banking book, credit concentration risk, liquidity risk, legal risk, strategic risk, and reputation risk, which are not included in Pillar 1.

tutional provisions on the sources of Polish law. The Constitution introduces a limited number of legal act types, dividing them into acts of universally binding law (such as the Constitution, statutes, ratified international agreements and regulations) and internal law acts [The Polish Constitution, 1997]. The internal law comprises of norms applicable only to units subordinate to the authority issuing the said legal acts. The relevant literature indicates that under the current legislation, Polish commercial banks are not subordinate to the Polish Financial Supervision Authority; therefore the PFSA's recommendation cannot be regarded as either generally applicable internal law acts [Pelc, 2010]. Therefore, although in Polish banking practice the PFSA's recommendations are treated as mandatory, it must be stressed that in fact they are soft law instruments and comply with the Basel postulate for the evaluative and advisory role of banking supervision.

The last area of the New Basel Capital Accord, so-called Pillar 3, concerns reporting issues. Similarly to Pillar 1 and Pillar 2, Basel II allows the bank's management full independence in terms of decision-making in the field of reporting documentation. Based on the principle of materiality, the bank's management and supervisory board should develop information and reporting procedures assuming the categorical requirement to include information which, if omitted, could affect the judgment of users making specific economic decisions in relation to the bank.

In concluding the discussion of the content of the New Basel Capital Accord it must be stressed that it offered a ground-breaking approach (in terms of requirements for financial institutions) to the methodology of calculating the risk of individual entities in the banking sector. The Basel II framework, based on the assumption that the bank's management and executives will act in accordance with good banking practice, let the management and executives develop their own strategy for building financial stability.

The events of the 2007–2010 financial crises highlighted the ineffectiveness of the Basel regulations. The question remains open whether the requirements of the NCA were insufficiently restrictive, or were not effectively implemented. It is worth noting that while the European Union directives obliged supervising institutions in all counties to implement the Basel II framework, in the USA, where the crisis began and had the most serious consequences, the New Basel Capital Accord applied only to certain operators in the financial market. That is probably why the political and monetary authorities in Europe point to the need for universal application of the Basel standards. Basel III, developed after the financial crisis, is to be gradually introduced from 2013. New regulations tighten capital requirements and limit the amounts of bonus and dividend payments. The regulations clearly demonstrate that the Committee's confidence in the rational

behaviour of management and executives has decreased as through specific provisions it limits the possibility to deleverage banking entities and prevents efforts to maximize short-term profits for managers.

3. The ethics of banking services as a base for the sustainable development of the banking sector

Economic entities in the banking sector are a special type of companies, also because of their low equity to assets ratio. But what especially distinguishes banks from other companies is the special role they play in the economy by accepting depositors' savings and crediting consumption and investment. Therefore, they are often referred to as institutions enjoying public confidence, which is rooted in detailed regulations imposed by external supervision and internal regulations (often created by the banks themselves as a grassroots initiative in order to promote a pro-consumer policy and to improve the image of particular entities or the entire sector). It should be noted that the consequences of the bankruptcy of a bank are borne not so much by the bank's owners (due to the aforementioned low proportion of equity to the bank's liabilities), as by the depositors who keep their money in the bank's accounts. Indirectly, the effects of the collapse of the banking sector are felt throughout the economy and slow down the GDP growth rate. Therefore, the safety of the banking sector lies in the public interest and the operation of the sector is subject to special supervision, which is much more restrictive than in the case of other companies.

Nowadays, the security of banking systems is achieved by providing banks with adequate equity, maintaining high professional and ethical standards of management, ensuring compliance with prudential norms, proper selection of borrowers, requiring collateral for loans, a strict system of banking supervision and a mandatory deposit insurance system [Janiak, 2000, p. 59]. These issues are usually governed by provisions of the law, the very existence of which builds greater confidence in the entities they cover. There is, however, yet another dimension in which the banks are trying to gain a good image – the dimension of non-binding guarantees of fair and sound principles of economic activity in this sector, usually taking the form of codes of good practice.

Codes of ethics became so popular in Polish economic practice that in 2007 the concept was formally defined in the Act on combating unfair commercial practices, where codes of good practice were defined as a "set of principles of conduct and in particular ethical and professional norms for entrepreneurs who have committed to comply with them in relation to one or more market practices." [Journal

of Laws, 2007] Article 4 of this Act deems a market practice unfair if it is contrary to codes of good practice and may significantly distort the market behaviour of the average consumer [Journal of Laws, 2007]. Thus, although codes of ethics are voluntarily implemented soft law instruments, the said Act gave them great legal significance on the ground of the Polish legal system.

From the point of view of the debate on the stability of the financial sector, it is worth looking into the content of the Canon of Good Practice for the Financial Market developed in 2007 under the leadership of the Polish Financial Supervision Authority in cooperation with thirty organizations, including providers of financial products and services, organizations and institutions representing the interests of the customers of other market institutions, and academic experts. The Canon was to serve as a proof of ethical conduct of the institutions which implemented it. Interestingly, although some thirty institutions contributed to the work on the Canon, only seventeen declared they would apply it. It should be noted, however, that some of the entities involved in the project had their own codes of ethics, including rules specifically tailored to the nature of their business.

The Canon of Good Practice for the Financial Market assumes that the "financial market is the common good of all its members" [PFSA, 2008], enumerating one by one the core values which should be followed by its participants to ensure sustainable and stable development of the sector: honesty, diligence and competence, dignity and confidence, resources and procedures, internal relations, preventing conflicts of interest, information from customers and for customers, protecting customer information, profiling services, honest advertising, honest competition, settlement of disputes and complaints and market development activities. It can be seen that most of these rules are not quantifiable, difficult to define precisely, and generally it is easier to describe behaviours contradicting them. That is why the ethical dimension of business is so difficult to define in a formal legal system. The critics of such regulations emphasize broad discretion in the interpretation of terms such as "diligence," "competence" and "dignity." Their proponents, however, are of the opinion that the very adoption of such general rules would raise the standards of business practices and build public confidence.

⁵ The then President of the PFSA, Stanisław Kluza, said in an interview that "the ethical dimension of the activity of participants of the financial market is one of the pillars of sustainable development, stability, security and reliability of this market", http://www.gazetatrend.pl/artykuly/155-wywiad-z-przewodniczacym-knf-stanislawem-kluza, last accessed 27 March 2012.

⁶ According to the PFSA website; http://www.knf.gov.pl/dla_rynku/kanon_praktyk/deklaracje_stosowania_KDPRF, last accessed 27 March 2012.

One might consider the actual consequences of the implementation of codes of professional conduct. Again, it is worth to refer to the 2007–2010 financial crisis, before the outbreak of which the majority of financial institutions applied such general regulations or had developed independently their own codes of business conduct and ethics. Again, it seems that certain standards had not been effectively implemented, while the imperfect quality of the regulations did not matter so much. The American banking sector is a good example of this issue, as both before and during the downturn one could see there multiple examples of unethical behaviour of managers, who promoted short-term profits without diligent attention being paid to careful calculation of risk and disclosure of sensitive information to supervisory authorities as well as to partners and clients of their banks. There is no doubt that moral hazard in the financial sector contributed greatly to the destabilization of the system. It was a sensation when former director of Goldman Sachs, Greg Smith, revealed in the pages of the New York Times some facts about the corporate culture of the bank where he had worked. According to Smith, the banking industry had become toxic and destructive and respect for the client and his dignity had disappeared. The former director frankly admitted that Goldman Sachs's management rewarded those employees who were able to convince customers to buy assets recognized by the market as unprofitable, and the customers themselves were called bad names and their interests were disregarded. Smith wrote, "I truly believe that this decline in the firm's moral fibre represents the single most serious threat to its long-run survival." [Tupolski, 2012] In this way he corroborated the thesis that ethical values are essential for a financial institution to maintain a stable position. On the other hand, the relationship between the introduction of a code of good practice as a regulation binding employees and the actual observance of the code in business practice remains an open question.

4. Soft law and the traditional legislative instruments

The stability of the financial system is the result of many factors. The IMF enumerates the most important of them: macroeconomic stability and a policy framework for maintaining it; an adequate and effective regulatory structure for financial regulation; supervision and surveillance over the financial market; the infrastructure of the financial system; standards and business practices and incentive structures, including a legal system that supports productive private financial contracts [Schinasi, 2004, p. 6]. This set of components stabilizing the sector indicates the essential role of both the traditional legislative instruments and non-regulatory tools. The use of an appropriate combination of these factors

leads to a compromise between flexibility and efficiency. There is no doubt that a well-designed and properly enforced law is the most effective instrument in the hands of financial market supervision. However, dynamic changes in the economic environment sometimes force the supervisory authorities to react immediately, which may not be possible due to the complexity of the multistep legislative process. In this situation, the only way to make immediate adjustments and react to unexpected situations in the financial market is to use soft law instruments.

M. Zaleska is of the opinion that the stability of the financial system depends on the institutional environment of the banking system and the economic and financial situation of the banks themselves. She notes, however, that while the institutional factors have a significant effect on the stability of the banking system, by their very nature "legal solutions in the field of external norms influencing banks are extremely unstable." At the same time, Zaleska indicates the importance of the institutions' reaction time to various types of adverse situations and stresses the fact that a longer decision time exacerbates problems in the banking sector [Zaleska, 2001, pp. 203-211].

Also Paul Krugman, a well-known contemporary economist, citing the maxim "go to the church of your choice, but go, goddamn it," advises to always react to issues appearing in the economic environment, especially the negative ones, and suggests that the mere fact of taking a decision by political or supervisory authorities evokes positive psychological reactions in the public, preventing a loss of confidence in the market or a market panic that would otherwise aggravate unfavourable economic trends. Krugman argues that any solution is better than no action and the authorities must not be afraid to make decisions [Krugman, 2001, pp. 180-181]. In this situation, controlling the market with soft law instruments seems to be the optimal solution. Using soft law, it is possible to immediately react to changes in the economy avoiding the long legislative path. Moreover, soft law is so flexible that it can be cancelled immediately after the factors threatening the stability of the system disappear.

But obviously it is not possible to supervise the market only on the basis of "soft rules." The financial system must operate within the rigid framework of the traditional legal system, while soft law instruments can be used only for determining some unquantifiable ethical values or for making immediate adjustments to the principles of operation of banking entities.

There is another important argument for the use of "soft supervision." Stephen Prowse's research proves that strict control of consolidation processes and restrictions imposed on potential owners of banks weaken the impact of market discipline mechanisms [Prowse, 1997, pp. 509-527]. Prowse made this point com-

paring the incidence of events involving the replacement of executives and other events suggesting a change of policy (such as hostile takeovers, voluntary mergers, actions of the board of directors, etc.) in non-financial entities and in banks. In addition, he made a list of supervisory interventions – actions which in some way discipline the managers but are of non-market nature. He adopted two concepts as to the occurrence of the said supervisory interventions: first, that an intervention takes place when the institution inspected is downgraded in the BOPEC rating⁷ to 3 or lower, and second, when a holding gets one of the lowest ratings, that is 4 or 5. Prowse studied a sample of 234 bank holdings and also used the study of Morck et al. [1989] on 454 more entities. Data for the years 1987 to 1992 are given in Table 1.

Table 1. The frequency of events disciplining managers in non-financial entities and bank holdings

Event	Non-financial entities	Bank holdings
Replacement of the management	20.5 %	10.26 %
Hostile takeover	8.8 %	1.71 %
Merger	7.5 %	10.68 %
Total events of market character	36.8 %	22.65 %
Supervisory intervention I (BOEPEC rating of 3, 4 or 5)	-	38.03 %
Supervisory Intervention II (BOEPEC rating of 4 or 5)	-	19.23 %
Total events leading to corporate control changes	36.8%	60.68 % (First case*)
		41.88 % (Second case**)
The number of entities in the sample	454	234

^{*} Event of non-market nature + BOPEC downgrading to a rating of 3, 4 or 5.

The data clearly indicate a weakening of market discipline in institutions covered by banking supervision. The banks were affected by disciplinary events only in 23 per cent of the cases, which is over 14 percentage points less than in non-financial entities. It is worth noting that the greatest difference was found for hostile takeovers and the replacement of management by the board of directors, which took place in 1.71% and 10.26% of the examined banks and in as many as 8.8% and 20.5% of the other examined entities, respectively. It is evident that banks are

^{**} Event of non-market nature + BOPEC downgrading to a rating of 4 or 5. Source: K. Jackowicz [2004, p. 70].

The BOPEC rating system evaluated five key supervisory factors in American banks: the condition of the bank holding company's bank subsidiaries, non-bank subsidiaries, the parent holding company, profits and capital adequacy. The values range from 1 (best) to 5 (worst).

disciplined by supervision while the other institutions are primarily disciplined by the market.

Conclusions from the above analysis may be twofold. Supervisory interventions may be deemed strong enough as a regulator and sufficiently disciplining the banking sector, so disciplinary events of market nature are no longer necessary in this sector. However, it is also important to note that the cited results provide a strong argument for the opponents of "soft supervision," who claim that the lack of sanctions in soft law instruments means that they are not very effective. Prowse's study shows that when supervisory legal instruments are absent, the role of disciplinary tools is effectively taken over by the market. What is more, hostile takeovers and replacement of poor management (which characteristically occur in banks very rarely) are two of the strongest market mechanisms, which, as shown by the study, not only discipline managers in the entities covered by these mechanisms, but also those of other companies in the business environment [Mikkelson and Partch, 1997, pp. 205-228; Jackowicz, 2004, p. 71]. In addition, increased supervisory regulations weaken the motivation of the private sector to monitor the banks' condition and to influence their managers' decisions.

However, it should be emphasized again that the doctrine according to which bank are a public good absolutely excludes the possibility of disciplining the banking sector only through market tools and soft regulations. The mechanisms of regulatory disciplinary have a positive impact on the scope of negative information about the condition of banks disclosed by managers, providing the lenders with an opportunity to more accurately assess the banks' standing. Furthermore, in their decisions investors take into account supervisory disciplinary actions which facilitate the decision-making processes and build greater confidence in the financial sector, both among shareholders and creditors [Jackowicz, 2004, pp. 57-76]. Thus, seeking the optimum proportions between legal and non-legal regulations in the sphere of finance, soft law should be regarded as a complementary area, not contradicting legal standards. It is a major mistake to violate the optimum proportions, causing either so-called inflation of law or far-reaching deregulation in the banking sector.

A similar position on soft law instruments was expressed by the European Parliament. In the Resolution on institutional and legal implications of the use of 'soft law' instruments adopted on 4 September 2007, members of the Parliament decided that "in the context of the Community, soft law all too often constitutes an ambiguous and ineffective instrument which is liable to have a detrimental effect on Community legislation and institutional balance and should be used with caution, even where it is provided for in the Treaty" [European Parliament, 2007].

However, the entire document refers to laws established at the EU level and expresses some concern about the excessive use of non-legally binding rules for fear of reducing the effectiveness of the European Union in its capacity as a legislator. It also reflects worries about changing the unique model of the Community in the direction of a traditional international organization and about a lack of coherence and coordination in the legal systems of the member states. However, the same resolution contains also provisions revealing benefits of soft law instruments, on condition that they do not become substitutes for legislation. Furthermore, the resolution stresses the important role played by standards and codes of conduct and the need for individual consideration before deciding whether EU institutions should take legislative or non-legislative measures.

The Parliament's position is therefore consistent with the findings presented in this analysis, and the definitely negative overtone of the said resolution results from the specific model of the Community. The EU institutions see harmonization of economic and political structures of their member states as a high priority, and this harmonization may be achieved amongst others through binding Community acts with unambiguous interpretation.

It seems that the main weakness of soft regulations is not so much their ambiguity but the problem of objective verification of entities in terms of actual observance of soft regulations. Although there exist rules which allow for obtaining specific information on the extent of implemented codes of best practice, such as the "comply or explain" principle adopted by the Warsaw Stock Exchange, however such rules are not applied by other entities which are not members of the WSE. Therefore, it often happens that pledges to use a specific canon of rules are not followed by their actual implementation in business practice.

A partial solution to this problem can be found in Article 7 of the Polish Act on combating unfair commercial practices, under which, if a company informs that it has undertaken to comply with a code of best practice, but it is not the case, it will be deemed an unfair market practice under any circumstances [Journal of Laws, 2007]. Article 3 of the same Act, on the other hand, forbids the use of unfair market practices. However, as mentioned earlier, some aspects of codes of ethics, such as "diligence" or "dignity," are often difficult to define precisely, and it can be very complicated to take action regarding such issues.

The advantages and disadvantages of soft regulations mentioned above make them complementary to the traditional system of law, filling the area not covered by statues, regulations, and other legal acts. At the same time it should be noted that it is important that these two systems of traditional law and soft law do not contain conflicting recommendations. They should, however, be complementary or may reiterate certain rules. Perfect examples of non-legal regulations being incorporated in laws include, in international law, the implementation of the Basel recommendations by banking supervision and, in national law, the evolution of the status of independent members of supervisory boards of public companies (the independence of these members was initially postulated in a code of good practice and was later reflected in an act of law [Journal of Laws, 2009].

Conclusion

Analysis of soft law instruments in the context of their impact on the stability of the financial sector leads to the conclusion that, first, soft law instruments are commonly used in business practice and, second, have a significant impact on the functioning of entities in the financial system. In addition, soft law instruments allow supervisory authorities to react quickly and do not weaken instruments of market discipline so much. However, it is not entirely clear how they impact the stability of the financial system.

The recommendations described in this paper, namely the Basel Committee's recommendations and those of the Polish Financial Supervision Authority, can undoubtedly be seen as factors significantly stabilizing the banking sector. But it is much more difficult to objectively define the significance of codes of professional conduct. It seems that their main drawback is broad discretion in adopting and interpreting them and a lack of effective mechanisms for assessing the degree of their use in business practice.

There is no doubt that the ethical dimension of financial institutions is one of the conditions for security and stability in the sector. Codes of good practice in a way systematize, organize and clarify requirements in terms of ethics, enhancing mutual trust between market participants. The Polish financial market is already defined as a saturated market and entities operating in this market must increasingly compete with added value, and certainly good banking practices are added value. Bank customers are increasingly careful about the transparency and reliability of the information they receive, and about the competence of employees and mutual relations. In this way, they enforce the use of higher standards of services rendered by the banks.

However, the evolution of the banking system towards banking partnership seems to be too slow and ethical principles are violated too often. Numerous examples of abuse show that the adoption of a code is sometimes a purely an image-building move rather than a real attempt to implement pro-consumer attitudes. Therefore, while assessing the impact of canons of good practice on the

stabilization of the system, it must be admitted that it is smaller than the impact of other regulations. This does not follow, however, from any imperfection of the recommendations but from the lack of a mechanism enforcing their application.

To summarize the discussion on instruments stabilizing financial sector, it is worth listing five areas of anti-crisis prevention formulated by the IMF advisor, Garry Schinasi. In his opinion, preventive measures must now take place at the level of market discipline, risk management and control systems, stakeholder governance, banking supervision and market surveillance [Schinasi, 2003, pp. 10-11]. This combination of components to ensure stability constitutes therefore a set of areas controlled by legal and non-legal regulations. Thus, one may conclude that both traditional and soft law instruments should be considered important elements contributing to the stabilization of the financial system.

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