

# FINANCIAL REGULATION – THE NEED FOR A REVOLUTION

Philip Booth

The orthodox view is that financial markets have to be regulated by bureaus that are accountable to politicians. It is believed that there are special features of financial markets such as systemic risk in banking, information asymmetries within consumer markets and principal-agent problems in investment markets. One of the problems with that orthodox view, of course, is that it does not consider the problem of incentives within regulatory bureaus and amongst politicians. Is there a bigger principal-agent problem than the one that pervades the relationships between a regulator and a politician and between a politician and the electorate? In addition, regulators do not possess the knowledge to improve markets that are subject to what they call market failure. Furthermore, regulation has become so complex that capture is inevitable. How many politicians could even describe the different responsibilities of the European Union, the Bank for International Settlements, the Treasury, the Bank of England and the Financial Services Authority, never mind understand their regulatory objectives or the millions of paragraphs of regulations that they pump out?

It has to be said that there have been one or two constructive developments in financial regulation since the crisis. These include, for example, the desire to ensure that banks fail in an orderly manner. It is notable that these constructive proposals came from the conventional approach to setting regulatory frameworks that used to exist before regulation became increasingly bureaucratised in the 1980s. The ideas about bank failure were being exchanged amongst intellectuals – including within think tanks such as the Institute of Economic Affairs and Policy Exchange – and then the government set up various committees of enquiry (including the Independent Commission on Banking chaired by Professor Vickers) that reported directly to politicians who have decided to take action. This is not very different from the process that gave rise, for example, to a piece of legislation governing the winding-up of life

insurance companies in 1870 except that there was a time lapse of 17 years between the Select Committee report and legislation in that case! Of course, not every aspect of the Vickers' Report is positive. Indeed, there are many damaging aspects, as is discussed in the article in this collection by Lilico. Many issues have been ignored in the regulatory reform too. In particular, the articles by Lilico and Michie discuss the dangers of that relatively new innovation in the UK – deposit insurance.

In insurance, regulation is becoming centralised at the EU level and becoming horrifically complex. The 'Solvency II' regulations are covered in the article by Swarup. They adopt the flawed principles of Basel II to try to determine how much capital insurance companies must keep to have a given probability of insolvency in a given year. Can capital be determined with that sort of accuracy? What are the consequences of applying the same rules to all EU insurance companies if those rules turn out to be flawed and turn out to be flawed everywhere at the same time? Why do the rules artificially encourage investment in highly risky government bonds? Do consumers want this level of protection, given the potential increased cost? Should we be protecting consumers from insurance company failure at all? After all, in the century from 1870, the UK ran a regime that was described as 'freedom with publicity'; there were only two life insurance company failures and neither of them affected policyholders. The Equitable Life failure came after the introduction of more prescriptive regulation. There is no evidence that these fundamental economic issues are discussed by the regulators and no prospect of ever getting a return to first principles, given the complete absence of accountability of regulators at the EU level.

Other articles in this collection address the EU angle explicitly. Booth and Morrison call for an end to the single market in insurance and banking. The single market does not promote free trade or a free market but has led to the centralisation of regulation and incoherent regulation. It would be much

better, the authors argue, for countries to develop their own regulatory systems whilst the EU had strong rules to ensure that these systems do not inhibit free trade. Countries inside and outside the EU could then have multi-lateral agreements if they wished to unify their regulation.

Copeland looks at the EU regulatory agenda for investment funds. His conclusion speaks for itself: 'For the most part it consists of measures which are either unnecessary or potentially damaging or both. In particular the proposals to deal with hedge funds and private equity still bear many of the hallmarks of the anti-finance stance which pervades so much comment from EU politicians.'

Other authors in this collection take on the orthodoxy in areas as diverse as the regulation of securities markets, pensions, accounting standards and the regulation of banking. It is interesting that there was very little – if any – government regulation of securities markets, pensions or accounting standards until the 1980s. The government regulation that existed came in the form of common-law principles, basic primary legislation or tax compliance regulation. In addition, markets developed their own regulatory institutions, for example through stock exchanges. Yet these areas of finance thrived. Stringham and Chen note this and also trace the success of the lightly-regulated Alternative Investment Market (AIM) in the UK and compare it with alternatives. AIM is successful by any metric and the lack of regulation does not seem to increase risks. In addition, there were no difficulties within the pension fund industry in the 20th century that needed to be solved by prudential regulation. However, the government responded to the Maxwell scandal – a case of theft that was already illegal – by imposing solvency standards that have become more and more onerous. It would have been reasonable to tighten up the rules surrounding independent trustees of pension funds in the wake of the scandal, but the impact of onerous solvency standards and other technical rules has been to accelerate the decline of the pension fund industry with employees moving into much more risky defined contribution schemes: this is discussed in the article by Silver. In the accounting profession, professionals used to be able to use their judgement. In recent years, as the article by Myddelton discusses, accounting standards have been imposed. The imposition of standards has certainly not reduced the number of financial scandals and may well have contributed to the crash and its aftermath.

And this leads us back to a fundamental point. The excessive regulation of the financial sector comes at a cost.

That cost is not just the explicit cost of the regulatory burden and the technical inefficiencies to which regulation gives rise. Statutory regulation crowds out other forms of regulation that arise naturally in the market. Statutory regulation crowds out the development of forms of financial institution that exhibit virtues of trustworthiness; have good reputations; have mechanisms of corporate governance and ownership that protect customers; and so on. At the same time, the failures of statutory regulation are almost impossible to correct, given the absence of any real accountability of government bureaux – especially at the EU level. The current situation, whereby regulatory bureaux simply produce rule-books with no proper chain of accountability and no proper economic analysis, has led to a position where nobody but the most highly-educated specialist can understand what is going on. This is a situation where capture is inevitable.

Walsh *et al.* look at these institutional issues. They discuss how financial markets can develop regulatory responses of their own, without state intervention. They liken the situation to the common pool resource problems studied by Nobel Prize winner Elinor Ostrom. They suggest that experiments and games can be designed to help us develop beneficial regulation – including that which evolves within the market itself.

Perhaps what is most striking about the growth of regulation over the last century is that we started with brief, principled, well-drafted legal frameworks with a coherent economic purpose; we then moved to an era of ever-greater secondary legislation passed without proper scrutiny; finally we now have the current set of institutions that churn out millions of pages of rules. There needs to be a revolution. We need to throw off the idea that a bureaucracy that is weakly accountable to politicians who, in turn, are weakly accountable to the electorate, can control financial markets for the general good and do so without becoming self-serving. There is an agency problem at the heart of politics. There is an alternative. The alternative has been tried and tested and has worked. It involves simple legal frameworks that do not direct people's plans but ensures that their mutually agreed plans can be realised.

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