Tomorrow's Finance

Regulation – but is it effective?

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Let me begin with thank you's. To Tomorrow's Company together with MAM Funds plc for putting on this lecture as part of their *Tomorrow's Finance* programme, which asks what is the purpose of our financial industry, and whether the industry is fit for purpose.

But I'd like to do more than thank our hosts, since so many of my observations are simply reflections on what other people have said to me, I should thank the regulators, and many financial market participants, to whom I have spoken. And my particular thanks go the Stephen Davis and Jon Lukomnik, my co-authors and long-term collaborators. They have hugely influenced what I am going to say. Indeed in some places I'm not sure whether the ideas are their's or mine.

The aim of this talk is not to try to give any definitive answers. What I'd like to do is to encourage a debate. It seems to me, as an outsider in the field of regulation, that the way we think about the job of the regulator, and of the key instruments at the regulator's disposal may be overly narrow. As a result, the wave of regulation which has followed the financial crisis may fail in its purpose, or at least prove more costly than it ought.

So, in this lecture, I'd really like to ask, and perhaps at least suggest some answers to two questions. First, what do we need regulation for; what is its aim, its objective? Second, what levers might regulators use to achieve their goals. And throughout, I'd like to make some observations about our current financial regulatory system, in the UK in particular, and observe how it might look if confronted by those questions.

So first, what is regulation for?

Why do we need to regulate markets? Because regulate we do in almost every area of commerce. That the food we eat is safe, that our doctor is properly qualified, that the house we buy won't fall down, and that our neighbour won't plant a tree which will undermine its foundations. I could go on.

But the surprising thing is that much of this regulation is not about replacing markets, but rather trying to get them to work properly as they ought. I think if I was using basic economic language, it is not about replacing markets but about reducing transaction costs. So, for example, it is more cost effective to insist that our food is not poisoned than to find a market solution, because markets on their own often don't work as they ought. But what would markets look like if they were 'working as they ought'.

Well again, I think the answer lies in economics, this time, welfare economics. I heard it summed up recently by a young Conservative MP, Matthew Hancock, in a speech to Policy Exchange. He said roughly that he is a believer in free markets because they are efficient; they ensure the goods we want are made and sold at a price that reflects their costs. But that is also their moral justification, because those who do a good job of providing services prosper, and those who don't fail.

By the way, it would be my view that the extraordinary thing is not the failures in financial markets, it that they work at all. Adam Smith, you may remember, thought that the whole notion of allowing other people to use our money was a very poor one. "Negligence and profusion" would be the result. Yet, thanks to regulation, to institutions, and just plain common morality, we have created an extraordinary situation where a saver can give his money to a pension fund for years, it will be handed on to a fund manager, invested in a company at the other side of the world. And amazingly, that company will still, to a greater or lesser extent, be run in the pensioner's interest. Adam Smith would never have believed it possible.

So regulation should help make financial markets work effectively. That means to deliver services to those who use them. John Kay, in his recent report, takes a similar starting point. He would draw attention to the fact that effectiveness is measured by how well the market serves the outside world. For financial markets that means how well they can gather savings and invest that money with companies and individuals who need capital. Certain corollaries stem from that: how well it offers savers and investors returns commensurate with risks and how transparent is that risk/return profile; how well it maintains a system of payments, and so on. And of course how well it mitigates against negative, and promotes positive effects on the world outside its own system. What economists would call externalities.

So if you will buy my logic so far, let us at least hypothesise that regulation of financial markets involves ensuring that they work as well as possible for those whom they set out to serve, without harming others, and perhaps even helping them.

If so, the system should be judged the more effective if it can provide these services at a lower cost to customers, and without allowing externalities to place costs on the public. Thus, a financial system which takes up 5% of the GDP would be preferred to one which provides an identical service, but absorbed 10% of the GDP.

Indeed, the best diagnostic of whether we have good regulation would be just that. What does it cost for the financial system to deliver its services?

Now, you may not agree with me on the ultimate goal of financial services; it is only a hypothesis. But what must be clear is that ‘good regulation’ needs the regulator to be able clearly to articulate the purpose of the system. The success of regulation will then be measured by its effect on behaviours and outcomes. Let me refer to this perspective as ‘vertical regulation’, the helicopter view.

So how well are our current regulators structured to be able to do this? Let’s take the Pensions Regulator as an example. I’ve chosen that institution, in part because I know something about pension outcomes, and in part because in my experience they are some of the most public spirited of the financial regulators. You would think, indeed pension savers might think, that the regulator’s job would be to try to catalyse a system where we all got good pensions, with low costs, and high payments. But that is not the job the regulator has been given. Their job is not to help create the best system but something subtly different, “To protect the benefits of members of work based pensions.” (Also to promote understanding of good administration. Reduce risk of failure. To ensure employer compliance.) Perhaps as a result, in the UK we have a pension system which either rigidly protects benefits, and makes the employer pay, or one which ensures you know how much is in your pension pot. The only problem is that employers find the first unaffordable, and too often, the second just pays poor pensions.

I wonder then, if we were to go through the remit of each of our regulators, would they be able to articulate what they wanted their part of the financial system to look like? If we were, systematically, to map out their current remits, would they in total have the powers to create such a system? If not, how can we expect that they will be able to do their job well?

So, my first point is this. If we are to have an effective regulatory system, we need to decide what we need regulation for. And we need to be sure that regulators in total are able to help effect those outcomes. I would suggest that that is not where we are in Britain today.

Which brings me to my second question. Do regulators have, or are they using, the right tools to bring about good outcomes? For example, do they have the ability to intervene to create good outcomes. Turning to the pension regulator again, it appears most of its powers to act decisively come only after things have gone wrong. Is that appropriate, I wonder. Maybe so, maybe all that is needed is a police force. But in the field of pensions, where it is often decades before it is apparent that there has been a problem, it is certainly worthy of some reflection.

Note that the regulator's choice is not simply between the market or regulation. Markets will behave in very different ways depending on the nature of those participating in them; how they compete, the sophistication of customers, the relevance, reliability and availability of information. In most areas of life, regulators take these factors into great account. So a parent is regulated differently from the staff in a children's home because the motivation of the regulated agent is different. Good social services do their best to ensure children are fostered into caring families, where the agent can do a better job. Drugs are tested first by experts, otherwise they don't get licenced. A new drug won't get licenced unless it can convince the expert it has superior therapeutic effects. One can think of many such examples.

So regulation can be used not just to constrain market behaviour, but to construct the market institutions which guide outcomes.

These points may seem obvious. But I would be a bit concerned that the regulatory response to the crisis of the past three years has paid scant regard to them. Command and control regulation is still the overwhelmingly dominant form of financial regulation. So, for example, the national and international rules on solvency and liquidity for banks and other financial institutions require certain capital requirements calculated through complex formulae, rather than any demonstrated exercise of prudence, and increasingly accountancy regulations require the application of rules rather that the exercise of oversight and judgment.

Such regulation can be dangerous for a number of reasons.

First, it encourages a belief that we can, with accuracy, measure future outcomes. For example, in the case of the banks that we can measure, and therefore externally assess, risk. That in turn requires statistical modelling, and valuations. For those of you who are technical, most measures of risk in the financial world assume that events will follow a normal, Gaussian distribution. But as Taleb has demonstrated [1], risk in financial markets does not follow such a pattern. They are much more likely to be subject to very large swings. So, the very models used to measure risk are inadequate even in a single entity, let alone their knock-on effect for a complex system. Bluntly, they are no more likely to predict and prevent the next crisis than previous regulation was able to stop the last one. Put simply, our measures of future risk don't work. That makes it difficult for an external regulator to determine what is and is not a safe thing for a financial institution to do.

Second, regulation which only focuses on an entity level using a 'do this, don't do that' approach can, at the extreme, degrade the checks and balances within the system which keep it stable and effective.

[1] Taleb, Nassim Nicholas, *The Black Swan: The Impact of the Highly Improbable*, Random House, 2007. Particularly Ch 15.

For example, it tends to absolve executives of the responsibility for the stability of the regulated entity, leading them to believe that only legalistic compliance to the rules is required. This, in turn, encourages regulated entities often to try to unpick the regulations, or to find a way around them. The system can thus give incentives to bad behaviour. Yet it's so easy to slip into this mode of thought. During the Sharman inquiry we talked to one of Britain's most senior regulators about what should be the rule for a bank declaring itself a 'going concern'. His initial response was that if the bank met the various regulatory rules, then that meant it was a 'going concern'. But as we debated this, it became clear that such a position was dangerous indeed. It left the bank free to exploit any loophole in the rules. Indeed, Professor Hu, of the University of Texas, now at the SEC, would claim that there is an industry of people in the financial markets trying to find ways to press the limits and find ways around regulation, reporting and accountancy standards. It is difficult to see how such an industry adds value.

Third, the effectiveness of 'do-this-do-that' regulation lessens over time because regulation is rigid. Markets, by contrast, are dynamic and ever-evolving. At the micro level, new financial products are introduced and regulators are hard-pressed to determine ex ante whether such innovations are safe, toxic, or somewhere in between.

Is it possible to construct a better system? Can regulation, rather than just focusing on command and control of the entities that comprise the system, also focus on their construction, and on the interactions between them, in order to create the sort of systemic architecture and ethos which will spur positive and self-correcting behaviour? [2]

In suggesting such a philosophy of regulation, I am advocating a return to the sort of political economy which would have been familiar to Alfred Marshall.[3] He was well aware of the importance both of institutional structures, and of culture, to the efficient functioning of a market economy. Indeed he too looked at the nature of public companies, as had Adam Smith. How had they been so successful? Why had negligence and profusion not prevailed? Marshall tells us it is because of a change in business morality, of 'honesty and uprightness' in commercial affairs.

Now I am not suggesting that regulators can overnight create honesty and uprightness! But they can think about political economy; how to encourage structures such that their outcome is positive. To create systems where the participants themselves make profits through good and are deterred from bad behaviour. The aim would be a minimum divorce between the motivation of the market participants and the effectiveness of the systems. Of course, few systems are or can be totally self regulating. The question is how to craft regulation to nourish the elements of systemic trustworthiness that do exist.

In this we are enormously assisted by the fact that those for whom the system should work have similar interests to citizens as a whole. In most Western countries, the ultimate beneficial shareholders of our banks and financial institutions are millions of citizen savers through their pensions and fund investments. Their creditors are the same people through their deposits. The question is, how do we create a framework where these shareholders and stakeholders are well served, with high sustainable returns?

[2] This would be the assumption of equilibrium economics, which may underpin some horizontal approaches to regulation. We would caution that positive self-correcting behaviour should not be taken for granted.

[3] Marshall, Alfred, *Principles of Economics*, MacMillan and Co, 1920. Eg pps 302-303 on the principal/agent problem.

If we think in terms of political economy, we might posit that a successful economic system resembles a successful political system. Long-running democracies feature checks and balances, robust information and a culture of accountability. Such political regimes get off-kilter from time to time. But they tend to self-correct. While laws are important in such political systems, there are more basic tenets which seem so ingrained that we too often overlook them. In a political system they are:

- Responsibility: we are clear about their responsibilities and so can be held accountable
- Accountability: accountability mechanisms allow members of the citizenry to hold their agents accountable (most notably by election, but also through the legal system)
- Relevant and Unbiased Information: those accountability mechanisms function on relevant and independent information (e.g. a free and unfettered press, non-politicised statistical agencies, etc.)
- Vigilant Oversight: unless citizens care about the system and utilise those accountability mechanisms, nothing works.

I'd like to explore whether these characteristics might be applied to financial markets. Whether they might offer a new and constructive agenda to create regulation that encourages self-correction on a real-time basis.

What would such regulation look like?

First, it would abandon the normal bi-polar financial institution/regulator intellectual framework. Rather, it would consider all members of the system as both entities to be regulated and as accountable and responsible participants; quasi-regulators if you will. The aim is to get the system to work, not just to outlaw individual actions.

Second, it would regulate so as to enhance the four tenets. Let me give some examples.

Responsibility. The central dimension of responsibility is that each entity operates in the interest of those whom it aims to serve. For financial institutions, that would be in the interest of the ultimate providers of capital. For both financial and non-financial members of the system, this means a freedom from conflicts of interest and a reporting mechanism to allow those who grant its power to judge performance and hold it accountable.

So, for example, we might reinforce mechanisms which strengthen the notion of fiduciary duties; that is to act in good faith in the interest of the investor. In the UK, fiduciary duties exist for company directors, and for pension trustees. But there is no similar duty for financial intermediaries.

Further, we could do with a definitive decision about what fiduciary duties are. For example, that the fiduciary duty to serve the investor does include issues of stewardship, not just the trading of securities. But that responsibility is often lost in the contract, between, say, a pension fund, and a fund manager. And it all but disappears when the money goes from pension fund to fund manager, who invests in a hedge fund of funds, which in turn puts money with a particular fund which takes an opaque short position using derivatives. Who is responsible for the stewardship of that money? And if the answer is "no-one" how can such a system be one which is likely to properly fulfil its function?

Fiduciary responsibility is not just about legal duties. Indeed the reason for pressing legal duties is to change behaviour, to change mindsets. As one person said to me, it is about whether, when you come into work on a Monday morning you think about how you can serve the customer, and if you are successful to profit therefrom, or whether the aim is to use your superior knowledge to make as much as possible, and *“de’il tak the hindmost”*.

How else could we enhance responsibility? I’m sure that we could all think of many ways. Transparency, for example. Should not financial intermediaries disclose to all clients the various ways in which they get paid so that clients can make informed judgments about motivation and conflict? Should not a pension account holder receive the same sort of statement that a bank account holder does? Wouldn’t that help enforce responsibility?

And why would we not use some of the insights of behavioural economics? Some of you may be aware of the work done on the circumstances under which cheating takes place; i.e. where people are not responsible. For example, when offered the opportunity to do so, it’s not that a few people cheat a lot, it’s that everyone cheats a bit. They cheat more if they are removed, even nominally, from the deception they know they are involved in. So people will cheat more, if the reward is a token which can be returned for a dollar, than if they receive the dollar directly. They will cheat less if they feel their peers don’t cheat. They will cheat less if they are reminded of what is right. So, for example, honour codes at American universities do indeed change behaviour. So why would we not create professional standards, and constantly remind participants in the financial markets of them? Why borrow a notion from the medical establishment? Just as doctors sign and police the Hippocratic oath, so those who manage others money should be explicit and serious in their commitment to their clients. The initiative to create a bankers code is a good start. Anyway, you get my drift. There are a huge number of ways, and numerous disciplines we could bring to bear to increase responsibility.

What about accountability? Accountability to ensure that those responsible for enforcing responsibility do indeed do so. Many already exist; the UK Stewardship Code, for example. But such codes may be good in theory, but they will only work if someone is overseeing them. And it should be of some concern that, after two years of the stewardship code, 79% of companies saw no discernible difference in the conduct of their fund managers in this regard. Someone needs to check that those we appoint as guardians are doing their job properly, and report back.

In regard to accountability, don’t we need a debate about how our financial accounting system is working? It seems to me that its original purpose was for management to ‘give an account’ of what they had been doing. Audit after all, preceded accounting standards, the principal aim was to ensure that management was playing its proper role, not to be useful for people trading shares.

So what can the regulator do to strengthen audit and accounting? In the Sharman report, we suggested that there would be great benefit if we were to think about how audit and accounting can best create good behaviour, and that that consideration should precede regulating on whether assets be marked to market, or marked to model, or as cynics would say, (illustrating Professor Hu’s point) marked to myth.

So there is much that could be done about responsibility and accountability. I’ve only touched on a few suggestions. What about information? Independent and unbiased information?

Data, transparency and relevant information are fundamental to the way the financial system works. Yet we have seen a drift away from principles-based measurement towards rules-based systems which can be gamed.

And should there not always be an assumption that transparency is best? Is it really sensible to be creating ‘dark pool’ markets, separate from the transparent exchange where securities are traded? And what about short positions? We insist that a company is able to discover who its shareholders are. Quite right. But what about those who have bought a life insurance against it? At present we have a huge market in Credit Default Swaps (CDS’s). These are insurance contracts on companies, yet the companies themselves are unaware who holds them. Yet we know that these can, and have been used to encourage irresponsible behaviour. At the very least, these and other financial derivatives require transparency, and we have the mechanisms to create it. Requiring a financial instrument to be registered and granted a CUSIP (Committee on Uniform Security Identification Procedures) or SEDOL (Stock Exchange Daily Official List) identifier would enable the world to judge the relative size of various markets, as well guarantee that the basic information on each instrument be known. Such registration and disclosure requirements should be a requirement before any financial instrument can be tradable or transferable. As it would only apply if an instrument were to be freely tradable or transferable, it would not apply to routine contracts.

And how about there being someone charged with reviewing how the system works and share with us where it might have weaknesses? The Financial Standards Board (FSB) has already identified ‘Key Standards for Sound Financial Systems’ [4]. These include previously published standards, such as the OECD’s ‘Principles of Corporate Governance’ and the Basel Committee’s ‘Core Principles for Effective Banking Supervision’. What is missing, however, is a commitment from the FSB to publish a market-by-market assessment of how well each market adheres to the standards. Wouldn’t that information encourage better behaviour?

So a few suggestions for better information. And then last, but by no means least, the question of oversight; vigilant oversight.

In political systems, we are all aware of the importance of vigilance. In financial markets, regulation should be reshaped to encourage, not discourage, vigilance.

One of the most important influences on financial market behaviour is the press. And one reason that the British system works as well as it does is because of the high standard of journalism in the FT and other broadsheets, and, sparing blushes, the clarity insight and expertise of people like John Plender and Anthony Hilton. As we now listen to the Leveson inquiry, we might think to ourselves, who is responsible for ensuring that the behaviour it is revealing in the political world does not become endemic in the financial world?

[4] See www.financialstabilityboard.org/cos/key_standards.htm

And if vigilance is needed, why are we so keen on promoting mechanisms which allow investors to think they can swap vigilance for liquidity? We all know that share turnover has increased, suggesting a growing short-term mentality. Doesn't this encourage investment managers and asset owners to believe that they can trade out of the way of danger, and that in turn gives them less encouragement to be vigilant participants self-policing a responsible and accountable financial system? Our regulatory system encourages such frequent trading in a myriad of ways. We have lowered the frictional cost of trading, we've privatised exchanges so that they too are incentivised to increase turnover, and even allowed them to profit from co-locating high frequency traders computers adjacent to the exchange's servers, so as to save milliseconds on computer-driven trades.[5] While such actions have benefits for the traders – increased liquidity and lower costs – don't they also have destructive qualities of decreasing market vigilance when viewed through a systemic lens? Maybe it's time for regulators and legislators to start questioning whether ever more rapid trading is really an unmitigated positive.

So what am I saying here? I think it is this. That these elements of 'vertical regulation', (responsibility, accountability, information, vigilance) can encourage a more self-correcting financial system. Now as I said before, in concept, this is not a new thought. It is essentially a call for a return of 'political economy'; to design economic systems so that they tend to deliver good outcomes. Indeed Basel II does advocate 'market discipline' as its third pillar.[6] But it would seem to me that the nature of market discipline, what it is, and how it can give best outcomes, is much under explored.

So what I am suggesting is hardly a radical demand, or one which our regulators should have difficulty in understanding. So we must ask the question, "why has this not been done already?" Well of course there are some situations where it has been used. The ring fencing of the banks for example. But why has market discipline not been the starting point of regulation?

One reason is simply that it is not clear who should take the lead. The plan we have described requires someone to define what is wanted from the financial system and from there to co-ordinate a regulatory response. Such will require political vision and authority. No individual regulator has such authority; hence they tend to continue, each in their own area, with a horizontal approach. Someone, or some group needs to take the lead.

Another reason is because our economic models have become too narrow. We understand that under the assumptions of neo-classical economics, any transaction which takes place will be welfare enhancing, because, of course transaction costs are zero. But in the real world those assumptions don't apply. Public goods, principal-agent problems and behavioural biases all combine to create a more complex world. So the institutions of our economic system need to be designed with responsibility, accountability, accurate and independent information, and vigilant oversight in mind.

Let me be clear. I am a great believer in the power of classical economics. But this is not the only lens through which we can view the world. What about behavioural and institutional economics. What about promoting what Alfred Marshall felt was at the heart of a good system, "honesty and uprightness". These are human systems. And they need to be regulated in human and institutional terms.

[5] See "Colocation: NYSE Euronext's US Liquidity Center," NYSE Technologies, 2010. Accessible at: http://www.nyse.com/pdfs/Colocation-NYSE-Euronext-US-Liquidity-Center.pdf

[6] At a very basic level, the Basel II framework rests on three pillars: minimum capital requirements, supervisory review, and market discipline. http://www.bis.org/publ/bcbs157.htm

This does not mean that horizontal regulation should be abandoned. But by combining the two, we could allow traditional horizontal command regulation to address the major abuses of the system, while designing the institutions of market-based self-policing to make continuous minor self corrections. Where to profit, financial market participants are encouraged to behave as they ought. Together, they should better allow regulators to steer between being overly restrictive or totally laissez faire as markets continuously evolve.

The combination also begins to address the challenge from Taleb, who urges us not to seek ever more complex systems to predict risk, but rather to "be approximately right across a broad set of eventualities".[7]

In summary then, what have I argued for? First for a debate about what financial markets are for. Second that the outcome of that debate be a compass point for regulators. Third that the job of regulation should begin by helping construct market institutions which do the right thing in the first place, not by micro level do-this-do-that commands. And I have suggested that the model for that construction might have four elements; responsibility, accountability, information and vigilance.

So perhaps today we can start a debate? Is it worth it? Well let me return to the question of pensions. In a recent study by the Royal Society of Arts (RSA), we looked into the relative efficiency of the defined contribution pension systems of Britain and Holland[8]. Our system is regulated in a horizontal fashion; agents selling pensions are constrained; pension accounts are individually assigned and accounted for; pensions are paid from annuities with high levels of reserves and solvency. The Dutch system is vertically regulated. Their's is a system which has triggered the creation of large, integrated pension fund managers whose governance comes through trustee bodies. Accounts are held in common, there is no individual annuity purchased. Both systems face very real challenges as the result of low interest rates and increasing longevity.

But the RSA compared the likely outcome for two savers, who set aside money throughout their life, retire at the same time and have the same life expectancy. The results suggest that the Dutch person will receive a 50% higher income in retirement.[9]

Now 6.5% of our GDP goes on private pensions and a 50% increase in productivity may be possible. And that is just pensions. So there is a huge prize from adopting a structure which incorporates vertical regulation, both in terms of the stability and the outcomes of the system.

Adopting such an approach gives us, I think, the best chance of creating effective financial markets. And that, seems to me to be of critical importance to the success of the financial industry. It is, after all, one of the country's leading industries. It is central to the success of our economy, indeed to the world economy. So let us regulate it so that it does its job. As the *Tomorrow's Finance* programme demands that regulation starts by answering the question, "what is the purpose of finance", and sees its function as making sure it is fit for purpose.

Thank you.

[7] Taleb Op Cit p284

[8] Pitt-Watson, David *Tomorrow's Investor: Building the Consensus for a People's Pension*, RSA, 2010.

[9] Pitt-Watson, Op Cit.

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