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## Financial Regulation: What Good Really Looks Like?

*Karl Snowden*

### Summary

- Despite the touching faith of virtually everyone involved, from politician to policy wonk, MSP to mandarin and Commissioner to commentator, regulation is not the only or even the best means of avoiding financial crises.
- By its very nature regulation brings with it inherent flaws which may render it ineffective and can sow the seeds which themselves create future crises.
- With every regulation causing regulated entities to 'game the system'; creating a false sense of security for consumers; distorting markets and failing to recognise human frailty in regulators it is initially hard to see what 'good' could look like in regulatory terms.
- But regulation does have its place; its uses. And 'good' regulation, based on the three pillars of clarity, consistency and certainty – would go a long way to remedying the inherent flaws that come with it. It would, however, need significant behaviour changes from legislator, regulator and regulated alike.
- In the end even 'good' regulation cannot eliminate future crises, or produce a zero error regime. But any 'good' regime can and should "protect reasonable people from being made fools of".

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**CII Introduction: how much financial services regulation is appropriate to protect the public while promoting a free market has been a key debate within the industry and government in recent years, especially after the financial crisis and on the eve of a general election. In this thinkpiece, Karl Snowden examines various aspects of regulation, particular how it can and cannot be used to avert financial crises and produce the best outcome.**

Marx once said *“Politics is the art of looking for trouble, finding it everywhere, diagnosing it incorrectly and applying the wrong remedies.”* No, not Karl, Groucho, but valid just the same.

Since the start of this latest financial and economic crisis rarely a day has gone past without the great and the good of politics ‘looking for trouble’. From the House of Commons through the European Commission and on to the G20 stage politicians have produced their ‘diagnoses’. Regulation must be:

- “heavier” or
- “more effective” or
- “more wide ranging” or
- all three

The various reports produced in recent months have tackled all aspects of the regulatory landscape from implementation (FSA/Northern Rock), through structure (Sassoon and the Tories) and geography (EU/CDSs) to philosophy (Turner) and beyond.

What is clear is whether noble Lords, regulators, politicians or even journalists and consumerists all commentators seem to retain a touching, if not a naïve, faith in a process which has singularly failed to prevent or minimise, in any way, any of the current crises.

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Everyone hopes the steps instigated by financial authorities will be successful. But these steps are **extra**-regulatory or even, as for HBOS/Lloyds, **contra**-regulatory.

This is not just a UK phenomenon.

In the capitalist bastion of the USA the ‘ultras’ of financial markets have rushed into a maelstrom of ‘socialist’ recovery plans. Across Europe governments have forced takeovers, mergers or state investments usually an anathema to even the most left-wing regime.

The EU has signed off on extra- and contra-regulatory actions affecting, for example, WestLB

and Lloyds Banking Group under its state aid rules. So, even the regulatory-driven Commission recognises that regulation is not the sole answer to financial or economic security.

It seems therefore that governments, financial authorities and industries are now recognising regulation’s inherent weaknesses, but what are they?

## **The First Great Flaw of Regulation**

By their very nature rules challenge certain people and organisations to avoid them, exploit gaps or destructively ‘game the system’.

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The only effective regulatory regime is one where there is no chance of arbitrage, avoidance or evasion. In such a regime each financial services sector, to participate fully in future economic success, would have to submit itself to appropriate risk-based regulation.

A current campaign against including hedge funds in such regulation argues – correctly but irrelevantly – that proposals will fundamentally impact products and costs.

Why are such arguments irrelevant? Because just now influential commentators – such as Lord Turner, Chairman of the UK Financial Services Authority (FSA) and French Finance Minister, Christine Lagarde – are discussing (at best) the need for a ‘new social contract’ and (at worst) whether “Karl Marx was right”. In this context, effective constraints on what is seen as past excesses of unregulated sectors is the **smallest** political price governments can afford to extract in return for financial entities’ freedom to trade.

Industry sectors need to understand – and live with - what is now socially acceptable and work with regulators to eliminate regulatory gaps with minimum impact on their products.

Neelie Kroes, EU Competition Commissioner noted in a speech in June that these “Arguments apply at the global level. [Legislators] are not yet in a position to have a global regulatory system, but that does not absolve [them] from the responsibility to put in place regulatory systems around the world that are consistent and mutually reinforcing.”

## **The Second Great Flaw**

Regulation engenders a false sense of security amongst those that come to rely on it, whether they are consumers, industries or governments.

The 1997 Tripartite Agreement set up on the granting of independence to the Company of England is the clearest recent example of this syndrome. Much lauded until recently as a bold, sound action, it failed at the first hurdle.

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Once any – now recognisably misplaced - sense of security in the system is gone and the genie of insecurity is let out of the bottle, it is almost impossible to put back.

However, the crisis does seem to have made individuals take more responsibility for their own well-being. Not that this lets financial authorities off the hook. Regulators must constantly communicate when regulation *can* provide security and, more importantly, when *it cannot*.

Without such communication, and given the current crisis, consumer 'self-protection' can only increase in importance.

### **And on to the Third.**

Regulation distorts markets. It smothers innovation and restricts competition. But now, in the midst of a recession, within the prevailing febrile atmosphere of charge and counter charge, is not the time to implement long term regulatory changes. Governments must pause and think long and hard before deciding what extra 'socio-economic' distortions they want to put into the market place.

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***“The nightmare scenario is one where [companies] get addicted to public subsidies and governments get addicted to controlling [their] daily running.”***

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Given talk of a new social contract consumerists might well welcome such distortions. And the *regulated financial utility* produced might, even for private investors, have significant attractions. But a regulated utility is *not* the type of competitive company governments claim to want to see flourish.

As Mrs Kroes says. *“The nightmare scenario is one where [companies] get addicted to public subsidies and governments get addicted to controlling [their] daily running .... Nothing [is] more likely to undermine [the industry’s] long term viability, and we need to prevent that”.*

For its part the financial sector must - equally strongly – resist temptation to treat taxpayer support as an inalienable right. It must not indulge

in a gadarene-like rush to reward structures only possible with the taxpayer support, however indirect. (Unfortunately, given bonus news from certain UK and US investment banks this imperative seems already too late.)

If individual governments *really* want a socially accountable financial sector they need to make that clear and not just fudge reprivatisation goals and timescales. They should start a debate with its industry – nationally and globally – on the implications *for all stakeholders*.

### **The Fourth Flaw**

Regulators are human. In financial regulation there is no automatic 'fail safe' as exists in engineering or, transport, independent of human interaction or interpretation. Financial regulation is at the mercy of the individual regulators - and they can only regulate effectively what they understand.

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***“Certainly, individual regulators must feel confident they can ask for simple straight answers on disclosure, transparency and risk, with appropriate evidentiary back up (as opposed to mere theory), without being made to feel foolish.”***

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The burden of proof should now be on the industry to prove conclusively that the products it is introducing are not 'toxic'. The financial services sector has lost its right to the benefit of the doubt. This proof shouldn't focus on how the product works but instead on the professional consumer's ability to understand the inherent risks clearly and fundamentally.

Sir David Tweedie, Chairman of the International Accounting Standards Board, refers to it as 'the granny test'. If someone can't explain product upsides and downsides in terms their granny can understand then regulators can't regulate it. Certainly, individual regulators must feel confident they can ask for simple straight answers on disclosure, transparency and risk, with appropriate evidentiary back up (as opposed to mere theory), without being made to feel foolish.

It is fine – and may even be true – when the Bank of England and the FSA, among others, claim they *do* ask such 'killer' questions and *did* make a stand against perceived 'toxic' products. But speeches, articles and warning letters are one thing: a specific, focussed “*no pasaran*” statement from a regulator is quite another.

Regulators' analysis of which companies or individuals pose most risk must also be thorough and challenging. They must not focus on the big boys just because it is less time consuming.

Northern Rock's impact was missed because of its size and further back the collapse of a few medium sized IFAs led to the original Financial Services Act.

## OK, So What Does Good Look Like?

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***“One thing has not changed in the current maelstrom of charge and counter-charge, devaluation and de-leveraging, rescue and recapitalisation: financial services companies do need a regulatory regime.”***

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If regulation isn't the panacea that commentators claim, and consumers hope it is, does that mean *no regulation* is the answer?

No. One thing has not changed in the current maelstrom of charge and counter-charge, devaluation and de-leveraging, rescue and recapitalisation: financial services companies *do* need a regulatory regime. But it has to be one that reflects and takes account of the inherent weaknesses already discussed.

What would such a regulatory regime look like? What principles could authorities base it on?

These are complex questions and difficult to answer fully. But certainly any regulator would be wise to build its regime – at least initially – on the 3 pillars of:

- clarity,
- consistency, and
- certainty.

### **Clarity**

For regulation to be at all effective regulated firms must understand what is required of them. By extension, consumers (professional or retail) must understand what any regulation covers.

The regulator must be *clear* about what they want and don't want and should 'sign off' *in advance* on valid courses of action. Counter to current regulatory (and indeed business) thinking, telling individual companies *in writing* that doing X fulfils requirements rather than waiting until they do Y before telling them they did not, is the way forward. This may mean companies requesting, and regulators providing, much more, and more frequent, guidance on the required outcome and whether company actions will meet it.

Companies will not, of course, universally welcome this 'signposting' of 'correct' actions. Anything approaching a 'one size fits all' restricts competition and innovation, but a 'validation approach' needn't produce a 'one size fits all'. At the same time regulators, particularly the FSA, will

argue that they already provide 'industry guidance' as part of an 'outcomes based' philosophy.

The recent crisis has proved that existing regulatory 'guidance' is little more than a 'tick box' exercise that has failed to constrain the excesses of company 'innovation'. In the new guidance detailed product understanding and even involvement would have to underpin any 'sign off'. A disengaged bureaucratic process would not suffice. Only with clear, advance engagement and understanding can regulators then allow companies to revert to 'comply or explain' for 'personalised' approaches.

This will, of course, mean more work - thinking, analysis and judgement - on both sides. But with the litigious US system as the *default from hell*, both regulator and regulated will always be wary of any drift in that direction.

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Of course, companies will have to know, and think through, how they want best to achieve a regulatory outcome. They would also need to do this well in advance of implementation. They will have to develop their plans in a way that really highlights consumer outcomes (retail *and* professional) and not just rely on the paper trail that is current the TCF regime.

The time, effort and – yes, - risk involved in validating various different approaches to regulatory outcomes will tempt regulators to produce a template and force allcomers into it. (Sandler products anyone?) They must avoid this temptation.

The time, effort and judgement they put into validating different approaches will both save their time in reviewing after implementation and provide invaluable insight into emerging companying models. In many cases they could do such analysis without them leaving their desks. Extrapolating wildly, such validation could allow the regulator to produce even more sophisticated 'what if' modelling designed to identify risks well before they arrive and therefore avoid time and effort in future disaster recovery.

No process is completely future proof. Moreover, given changing socio-economic circumstances, neither can regulators deem any product as completely 'safe' from all eventualities.



But real, increased clarity at the outset, underpinned by real regulatory understanding, is the first pillar of 'goodness'.

### **Consistency**

In today's global financial services market every industry and geographical location is linked with every other, either directly or through a network of nodes. With this increasing global complexity consistency of regulatory outcome, *and* consistency of rule application, is vital.

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***"Indeed, consistency of application is probably just as important to consumers in that it impinges so much on the quality of their personal outcome."***

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But whereas cross-border and cross-sectoral 'consistency' is one of avoiding gaps and arbitrage, within an individual sector the real problem is avoiding conflicting overlaps in regulatory outcomes. Such overlaps exist already within the alphabet soup that is UK regulation where the FOS, OFT, CC and FSA had constantly vied with each other for supremacy.

A 'good' regime, would avoid conflicting such outcomes by applying the 'clarity' principle, as previously argued. An individual regulator could not unilaterally impose an outcome in its sector until all possible implications were discussed and formally agreed with other 'interested' regulators in all other sectors.

This in itself would eliminate arbitrage and deliver the consistency not only at a micro regulatory level but also at a macro level, for example in the UK, among the Tripartite Authorities. They must co-operate and be seen to do so effectively. Their consummate failure to do so, so far, lies at the heart of the Conservative Party's proposal to set up a Consumer Protection Agency in the wake of a full regulatory restructuring.

Consistency is important not just to companies but to consumers too. Indeed, consistency of *application* is probably as, if not, more important to consumers in that it impinges so much on the quality of their personal *outcome*.

The interplay of product and advice/adviser is of paramount importance to consumers. So how would a 'good' regime deliver consistency of required personal outcomes?

The answer is through the three elements of good advice: quality -

- Of adviser
- Of application
- Of redress

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***"Competence only comes when regulators add to the mix a clear (and enforced) commitment to practical interpersonal skills with a solid ethical underpin."***

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The good news is, in UK retail markets at least, the FSA are actively addressing two of these elements. Its Retail Distribution Review (RDR) has proposed a significant increase in both minimum adviser qualifications and adviser capitalisation. These proposals – long promoted by the Chartered Insurance Institute (CII) and others – go a long way to tackling the adviser and redress issues. Probably not far enough for the CII and consumerists but, unlike where regulators are in other aspects of a 'good regime', this is a serious and positive breakthrough.

But this still leaves quality of advice application as an issue. Neither sound financial backing nor top quality technical knowledge on their own deliver competence. Competence only comes when regulators add to the mix a clear (and enforced) commitment to practical interpersonal skills with a solid ethical underpin.

Such a commitment to competence can only be delivered through one of two routes – faith or fear. At present regulators leave this element to the CII and other professional bodies, and they (have to) use the 'faith' approach and trust in the training and knowledge provided. This is not enough.

To do the job properly the regulator needs to equip the CII et al with the 'fear' alternative. Certainly the professional bodies in the 'established' professions – Law, Medicine and Accountancy – could not do their job without it. The threat to individual members of those professions of removal of their livelihood is the main tool the professional bodies have in keeping them competent and ethical.

Even with the fear factor these professional bodies still don't deliver perfect consistency of advice through their members. Without it, however, they wouldn't leave the starting blocks. So for RDR to ensure consistency in personal consumer outcomes it is going to have to go a step further. It must empower the industry's professional bodies to impose, directly, meaningful and punitive sanctions on recalcitrant advisers.

### **Certainty**

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***"Even negative certainty is preferable to uncertainty: even uncertainty that comes with a heavy dose of promise."***

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As well as clear outcomes, consistently delivered, companies and consumers need a regulatory

regime where they can be certain of the consequences (good or bad) of their actions. And consumers do too, whether financial services professional or private.

Even negative certainty is preferable to *uncertainty*: even uncertainty that comes with a heavy dose of promise. For example, the fight for certainty on bank fees is costing companies, the UK taxpayer (via the OFT) and the individuals concerned, significant time money and stress.

In a 'good' regime, were the banking fee structure a new model proposed in say 2012 rather than the actual date of 1982, it would have had to pass the regulators 'clarity' test before launch.

This brings us back neatly to the first pillar once more in a completed virtuous circle.

## Conclusion

A 'good' regime is one which understands and minimises the flaws inherent in regulation. It allows innovators to flourish while minimising opportunities for regulatory arbitrage and other 'gaming'. It encourages consumers to recognise that no regime provides total security and prevents them abrogating personal responsibility for their actions.

At the same time, a 'good' system emerges slowly, almost organically, after careful testing to

avoid unintended and market distorting consequences. Most importantly it encourages and empowers regulators to ask the 'stupid', but human, questions that show the 'Emperor has no clothes'.

'Good' regimes set out the clear consistent and certain outcomes they want for:

- Society (socially-controlled or market dynamics?).
- The regulated (commercial entity or regulated utility?)
- The consumers (guarantees or risk-and-reward?).

And above all a 'good' regime must have the right *philosophy*. In the UK Professor Jim Gower's Report drove the original Financial Services Act. His fundamental philosophy is as valid today as it was 25 years ago: "*Regulation should not be at a level set to achieve the impossible task of protecting fools from their own folly – it should be no greater than that required to protect reasonable people from being made fools of*".

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