**Is government financial regulation necessary at all?**

**Philip Booth**

**Professor of Finance, Public Policy and Ethics**

**St. Mary’s University, Twickenham**

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The discussion is not about Economists have generally argued in favour of state regulation of financial markets. For example, it is often argued that financial markets need government regulation because of pervasive information asymmetries; because “market confidence” has externality effects; because of the problem of “moral hazard”; and because of systemic risk that can lead the financial system to fail if an individual financial institution fails.

This blackboard economics view of financial regulation, as the late Ronald Coase would have called it, is highlighted by the rationale put forward by financial regulators for state regulation of financial markets. In one publication by the UK financial regulator in 2003 (the Financial Services Authority – FSA) it was stated:

In meeting our objectives in a manner consistent with the principles of good regulation, we have adopted a regulatory approach based on correcting market failure…There are, however, numerous cases where unregulated financial markets will not achieve the best outcome due to some form of market failure, making action on our part necessary.

(FSA, 2003).

Note that they deem action *necessary.*

In more recent years, the approach has become a bit more subtle. The FCA, one of the successor bodies to the FSA, now explains its purposes in a 61 page document. It talks about: “In assessing whether intervention is needed, we consider a range of market failures including…”.

And then goes on to say that one such market failure is “existing regulation, which might have adverse effects on competition”[[1]](#footnote-1)

It is slightly bizarre that it should regard regulatory barriers to entry as a *market* failure, but then to a man with a hammer, every problem is a nail. However, it is its discussion of regulatory objectives that is especially interesting. For example, it suggests that an appropriate amount of consumer protection is necessary that varies according to the needs of the consumer, and so on. This is, of course, impossible to achieve. The reason is because regulation, like any other economic activity, needs to be subject to competition so that the best forms of regulation, appropriate to different types of market and consumer, can be discovered.

The inability of regulation to achieve its objectives is indicated by the length of regulatory documents which seem to give the impression – probably rightly – of chasing the regulatory pot of gold at the end of the rainbow.

In 2011, the UK financial regulator brought in regulation or issued guidance, advice, discussion documents or consultations, totalling 4.3 million words – more than five times the length of the Bible. This included a 585-page consultation on the regulation of the mortgage market, which led to a 312-page document on regulations relating to the sale of mortgages. Not only were defaults on UK mortgages not implicated in the financial crash, mortgage defaults have never been responsible for a serious bank failure in the UK. Until 2007, they were only subject to standard consumer protection and contract law.

Today, the UK Financial Conduct Authority (FCA) has the ability to determine its own burden of proof, levy fines, and prevent people from working in any area of financial markets. It has wide-ranging enforcement powers equivalent to those adjudicated in civil and criminal courts with none of the accountability or guarantee of due process that exists in proper courts. In 2015, the FCA levied nearly £1bn of fines. The statutory financial regulators, of which the FCA is just one, control every aspect of financial market conduct with no competition.

The PRA, the other successor body of the FSA also has documents explaining its philosophy when it comes to regulation. The document explaining its philosophy in relation to insurance regulation is ten times as long as the 1870 Insurance Companies Act which governed insurance markets for 100 years. Indeed, the list of typographical errors for one section alone of the EU Solvency II regulations for insurance companies is as long as the 1870 Act.

These examples might seem frivolous and amusing. However, they illustrate an important difference between regulation and basic contract and supporting law. Traditionally, law existed to ensure that those things we agreed to were enforced. So it widened the scope of economic transactions because those in markets could have confidence in the contracts they made. This is not very complicated. The state should not be involved in shaping the agreements people make, merely lending a hand in ensuring that those agreements are enforced. Regulation, on the other hand, seeks to control the participants in the market to achieve some optimal societal outcome. This is no easier than a central planning authority deciding what quantities of what goods should be produced.

When the state regulates markets, as when it gets involved in other forms of planning of economic activity, it neither knows the desired ends nor can design the means to attain those ends. Attempts to do so, as with all other forms of economic planning, lead to more and more complexity. Both the means and ends have to be discovered by the market.

So, the question is whether this is possible. Whether institutions that develop within markets can regulate markets. I am going to look at historical and current examples of private regulatory approaches and then discuss the conditions under which they might be problematic and then discuss a way forward.

**Historical examples of the market providing regulation**

Regulatory institutions did actually develop historically within financial markets to deal with known – thought not always well-defined problems. Institutions important in creating a stable order in financial markets included independent professions; the development of intermediaries and trustee bodies to deal with information asymmetries; special corporate governance arrangements (such as customer-owned firms, and banks with double or unlimited liability for shareholders) to address conflicts of interest; and the use of “brands” or “reputation” to distinguish between good and bad firms have all been important. There is a new era of market regulatory institutions developing today and I shall end by discussing those.

Historically, the most important regulatory institution in financial markets has been the stock exchange which is a comprehensive regulatory institution within securities markets. These institutions operated on a club-like basis. They developed rules to which their members had to adhere. Adherence to the rules came with a cost because the rules involved the prohibition of certain practices that may have been remunerative to individual members of the club. However, the rules also had a benefit because, if they were obeyed by all members of the club, adherence would enhance the reputation of all the members. In other words, market confidence and trustworthiness can be thought of as a club good and the price of obtaining that good is adherence to the rules (in addition to any membership fees). It is important that free riders cannot operate under the protection of the private regulatory body without obeying the rules: that is, it must be possible to exclude rule-breakers.

**Private regulation and stock exchanges**

In Britain, modern stock exchanges first developed in coffee shops, such as Jonathan’s coffee house in Change Alley. A group of 150 brokers and jobbers formed a club there in 1761 superseding more informal arrangements that had existed since 1698. This club developed into the first formally (though privately) regulated exchange in 1801 and, the following year, the exchange moved to Capel Court. The characteristics of the stock exchange included restrictions on membership, the publication of prices and lists of stocks that were traded, and the potential for the development of a rule book.

In the early years, the exchange was regulated by convention, reputation and informal rules.

For example, when delayed settlement was introduced to increase liquidity, those who did not settle their accounts would be labelled “lame duck” on a board so everybody would know. In many of the historical exchanges, such as Amsterdam, contracts were enforced that were not even recognised in law.

Codification of rules happened in two ways. Firstly, there were rules governing behaviour of members and the quotation of stock prices. Secondly, there were rules for companies listed on the exchange. The latter type of regulation developed rather later. These are precisely the forms of financial market regulation that it is commonly thought necessary for the state to provide and which the state now does provide.

The first codified rule book covering topics such as default and settlement was developed by the London exchange in 1812. This rule book included provisions for settlement, arbitration and dealing with bad debts. There were also rules about general behaviour designed to increase transparency (for example, partnerships amongst members had to be listed publicly) and about the quotation of prices. The exchange also absorbed collectively losses from an event of market manipulation and the inappropriate use of insider information in 1814 whilst ensuring that those who attempted to profit did not gain. These are now matters that are entirely handled by government regulation.

In 1844 it became a requirement for securities to be sanctioned by the stock exchange committee before being listed on the exchange. In effect, this was the introduction of the other important aspect of regulation provided by exchanges – rules for the quotation of a company’s shares. Indeed, rules for the quotation of a company’s shares complement rules in relation to the behaviour of members. At the turn of the 20th century, these rules became more onerous. Also, just after the turn of the 20th century, the exchange required the separation of jobbing and broking functions which became an important focus of attention at the time of Big Bang in 1986.

A Royal Commission enquiry in 1877-78 commented that the exchange’s rules were “capable of affording relief and exercising restraint far more prompt and often satisfactory than any within the read of the courts of law.”

**“Big bang” and so-called “deregulation”**

In 1986, the stock exchange system of private rule-making was broken open and the London exchange opened to foreign banks. At the same time, the separation of broking and dealing functions was ended. This was known as “big bang”.

The sweeping away of the various restrictive practices (limitations on entry to the market, fixed commissions and the separation of trading and broking) followed an agreement with the government that led to the suspension of a six-year-long enquiry by the Office of Fair Trading which had previously had its powers extended to include service industries.

Big bang is widely regarded as a process of “deregulation”. However, what really happened is that, in 1986, the competition authorities removed from the private institutions that regulated the market their ability to exclude members and their ability to set rules (such as commission levels, separation of trading and broking etc). This breaking up of private regulation was followed by the development of government regulatory agencies which had arbitrary and more-or-less unlimited powers to regulate to correct what many perceived to be market failures.

**Modern alternatives to government regulation in financial markets**

The club-like institutions described above no longer exist as the main regulators of activity in financial markets. As far as the main market of the London Stock Exchange is concerned, there are special requirements in relation to listing and trading. However, listing, trading and disclosure requirements are so on are so bound up with government regulation and EU directives that the regulatory role of the exchange is now residual.

Nevertheless, there are examples of private regulators that are still important. For example, there are some exemptions from EU regulation relating to the trading and listing of securities. The Alternative Investment Market (AIM) has developed take advantage of those exemptions. Statutory regulation of market abuse applies to trading in companies listed on the market but, otherwise, the market develops its rulebook independently of government.

For example, AIM requires that companies must produce half-yearly reports and annual audited accounts. Where a company is located outside a jurisdiction that applies specific accounting standards, AIM still requires accounts to be produced according to recognised standards, but allows some discretion. There are also policies in relation to dealing in shares by directors and similar categories of employees of AIM-listed companies and many other sets of rules dealing with disclosure, conduct and trading[[2]](#footnote-2).

This market is not a trivial bit-part player. The total market capitalisation of all the companies trade on AIM was over £100bn. There are 11 companies which have a market capitalisation of over £1bn.

In fact, these market-based regulatory bodies are ubiquitous and there is only time to quite another few examples without going into detail.

Derivatives traded on exchanges are subject to the rules of the exchange. So, derivatives exchanges have developed in the same way as stock exchanges. However, even off-exchange dealing is regulated by the International Swaps and Derivatives Association. ISDA’s mission is: “[to foster] safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products.” It achieves this by “Developing standardized documentation globally to promote legal certainty and maximum risk reduction.”[[3]](#footnote-3) Members have to apply to join and can have their membership revoked.

ISDA members can choose to use the ISDA master agreement which applies to over 90 per cent of over-the-counter derivatives transactions in the world. This represents 90 per cent of outstanding derivatives contracts at the end of 2016 of almost $0.5quadrillion[[4]](#footnote-4). In addition, as part of their regulatory function, ISDA also have a dispute resolution procedure (thus circumventing the need to use courts in most instances) and a Credit Derivatives Determinations Committee. The latter uses a set of rules to determine, for example, whether a credit default event has taken place and thus counterparties to a derivative contract need to settle.

**Private regulatory mechanisms not perfect**

Of course, private regulatory mechanisms are not perfect. But, the danger is that we look at markets with all their imperfections and assume that they can necessarily be improved by the intervention of a state regulator. Whilst economic theory can tell you when a market will not give a theoretically perfect outcome, it cannot generally tell you whether the intervention of a state regulator will produce a better one.

**Other examples of private regulators**

There are enough examples of private regulation to fill a text book – though not many text books consider the question at all. Professions provide another example – professions are able to deal with conflicts of interest in areas where there are information asymmetries, but, of course, they must not be protected from competition by the state. Perhaps the most topical private regulator is Uber.

Uber is a platform. It regulates its drivers and it also regulates its customers. It is in itself a dominant market player as a regulator (and I shall come back to that). However, it facilitates competition and breaks down information asymmetries.

Uber has been banned in many countries and has had its licence provisionally revoked by TfL. It has had is licence revoked because it does not meet TfLs regulations. However, the point is that Uber is a competing regulatory system. Passengers (and drivers) can choose between the regulation provided by TfL (the knowledge, flat fares, and so on) and that provided by Uber (sat nav, driver, no gap in supply because prices adjust, and customer ratings etc).

So, private regulation exists. It is so popular that in the car hire market, state regulators try to get it banned. What can we conclude about its efficacy, especially as compared with state regulation?

**Conclusion**

The first problem of private regulation is that of market power. It was a competition enquiry which ended the stock exchange’s role in financial regulation in 1986. Indeed, the person who gets this subject right is George Akerlof. Akerlof did not argue that institutions could not develop within the market to deal with problems such as information asymmetry, but he did argue that such institutions might accrue significant market power to which there might be objections. This is a much more subtle and insightful way of thinking about the problem than that followed by so many of his followers who talk about information asymmetries and automatically assume the need for regulation.

It is actually market power that ought to be the main concern about Uber. However, as with stock exchanges, it is a contestable monopoly. And, for the moment at least, there is competition between the state (TfL) and private (Uber) regulatory systems.

The alternative to a concentration of power in private regulatory systems, of course, is a non-contestable state monopoly regulator which has the power to exclude any player from the market.

Secondly, it is possible that private regulators do not always deal well with externalities that have ramifications outside the markets being regulated.

But, given where we are, where would we go from here? The most obvious thing to do in financial markets is to make state regulation optional, but require it to be made clear by whom market participants are regulated. That would at least ensure some degree of competition. The public would only have to make a choice between regulators – Uber or TfL.

A second approach is to not regulate new areas of finance. People could then choose between the regulated areas and the new innovative areas. There is a glimmer of light – but only a glimmer – [with the FCA’s regulatory “sandbox”](http://www.cityam.com/261244/why-red-tape-bonfire-wont-help-fintech-fcas-christopher). This allows the FCA to sanction innovations to take place outside the normal regulatory framework for financial services. However, the guidance for this leads to a situation which is rather like parents allowing their child to go to university, but only if they follow the parents go and live with him in the next door room of the university hall of residence.

In recent years, the size of the financial sector has shrunk. Innovation does not seem to have led to lower costs in many areas. This is not surprising given the growth of the statutory regulatory burden. What we need is not only a market that is regulated in such a way that innovation can flourish, but a market in regulation and a market that allows innovation in competing regulatory systems.

1. <https://www.fca.org.uk/publication/corporate/fca-approach-advancing-objectives-2015.pdf> [↑](#footnote-ref-1)
2. The rule book can be found here: <http://www.londonstockexchange.com/companies-and-advisors/aim/advisers/aim-notices/aimrulesforcompaniesjan16.pdf> [↑](#footnote-ref-2)
3. See: <http://www2.isda.org/about-isda/mission-statement/> [↑](#footnote-ref-3)
4. See Bank for International Settlements statistics at: <http://www.bis.org/publ/otc_hy1705.htm> [↑](#footnote-ref-4)