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**DATE DEPOSITED**

8 November 2021

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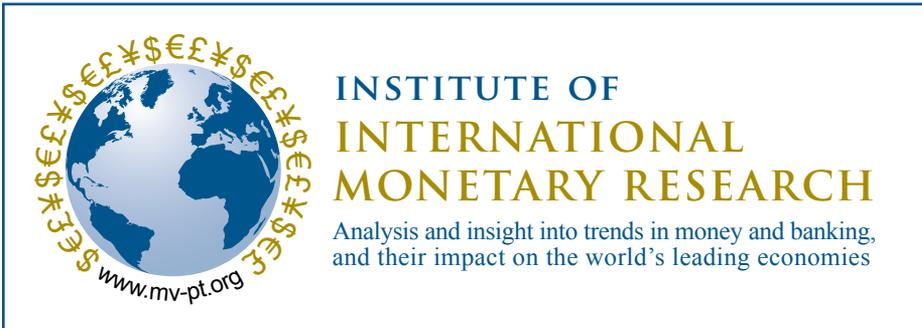
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In his 1970 Institute of Economic Affairs pamphlet on *The Counter-Revolution in Monetary Theory* Milton Friedman, who was to be awarded the Nobel prize for economics six years later, wrote,

“Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output. ... A steady rate of monetary growth at a moderate level can provide a framework under which a country can have little inflation and much growth. It will not produce perfect stability; it will not produce heaven on earth; but it can make an important contribution to a stable economic society.”

# Is ‘market failure’ a good justification for financial regulation?

by Philip Booth

In economic analysis the case for regulation is normally situated within a “market failure” framework. According to this approach, if certain conditions necessary in theory for markets to maximise welfare do not hold, regulatory interventions can increase welfare in practice. Specific justifications for regulating financial markets within this framework were discussed by Llewellyn in the first *Occasional Paper* published by the Financial Services Authority (FSA) in 1999.<sup>1</sup>

They included information asymmetries between buyers and sellers; the importance of market confidence which has externality effects; consumer demand for regulation to lower transactions costs; and the need to address externalities caused by the systemic effects of the failure of a particular financial firm. In many respects, however, those who make the case for regulation pose a false dichotomy. The alternative to markets that are not regulated by the state may not be the absence of regulation, but regulation by non-state bodies. The relevant comparison is then between the efficacy of state regulation and that of regulation by other bodies.

This paper examines the growth of state regulation, and historical and modern examples of private alternatives. It then provides a conceptual framework within which we can better understand the rationale for regulatory arrangements by the private sector. An argument is made that this framework is superior to the “market failure” framework. Finally, the lessons for regulatory policy are developed.

## I. Government financial regulation in the UK

### *The common law tradition*

It is unusual to question the role of and supposed need for government financial regulation in modern economies. However, until recent decades there was very little regulation of financial markets by the state in the UK. English legal development has been characterised by a blend of legislation with “the common law”.<sup>2</sup> The common law is to be understood as a body of law derived from decisions reached in courts by judges. It evolves from the accumulation of the precedents embodied in these decisions and in that sense is “judge-made”; it does not reflect input from either the executive or the legislature, and has often been seen as protecting individuals’ freedom against the power of the state.<sup>3</sup>

In the financial sphere the common law tradition was associated with so-called “self-regulation under the law”. A standard pattern was that the practitioners of a financial activity would form themselves into the members of a corporate body which endorsed their professional credentials, but then had authority over them. The corporate body would articulate and enforce rules of good conduct, in the understanding that breaches of those rules would be sanctioned.

An extreme sanction would be expulsion from the membership. (For example, solicitors could be “struck off” the roll of the profession maintained by the Law Society.)

However, the members remained throughout subject also to the law of the land. If members broke the law, they might be punished as a result of charges levelled against them by the corporate body to which they belonged. Alternatively, they could be made answerable to the law by aggrieved third parties or even sometimes by the state with its police powers. Self-regulation under the law certainly did *not* mean that the financial sector was outside the law, and that it could ignore public opinion and the government. In qualification, in British society until late in the twentieth century the great majority of transactions – including financial transactions – were subject to the principle of *caveat emptor*, which translated into English as “let the buyer beware”. Respect for contracts was so strong that the notion of “mis-selling” was hardly viable. If people made mistakes when they borrowed money or when they invested in life insurance policies, that was seen as their fault. They had no automatic redress if they had received bad advice.

### ***The advent of statutory regulation of financial markets***

The Financial Services Act 1986 was a revolutionary landmark in the change from self-regulation under the law to statutory regulation. Although it came into force in most of the financial sector in 1988, it is often associated with the so-called “Big Bang” in October 1986. The Big Bang was a set of reforms, mostly affecting the London Stock Exchange, which clipped the wings of the private institutions which had been involved in securities transactions for around 300 years. Before it securities markets were generally regulated by private stock exchanges, except for occasional primary legislation and minor provisions in Companies Acts. The Financial Services Act tried to preserve something of the self-regulation tradition, as it established “self-regulatory organizations” with distinct remits for different parts of the financial sector. They set some rules and supervised all aspects of financial business, covering securities markets dealing, investment products, investment management, life insurance and pensions products, and the provision of investment advice. However, in one respect the notion of self-regulation had been superseded. The SROs answered to the newly-founded Securities and Investment Board. The SIB was quasi-governmental, in that it was accountable to the Treasury and was staffed to some extent by civil servants.

In this sense the 1986 Act adumbrated a system of regulation of financial markets that was ultimately accountable to the state and all-encompassing in the prescriptions for the sectors to which it applied. Over time the British approach to financial regulation was transformed. From the late 1980s no person operating in financial or investment markets outside real estate could escape the remit of the regulatory bodies created after the Financial Services Act. Chapter II of the Act stated: “no person shall carry on, or purport to carry on, investment business in the United Kingdom unless he is an authorised person under Chapter III or an exempted person under Chapter IV”.<sup>4</sup> The following clause in the Act set out a maximum two-year prison sentence for those contravening the requirement for authorisation. Implicitly, this was the advent of state control of who could conduct investment business and how it could be conducted. Under the Act,

even hitherto independent professions had to be authorised so that their members could carry on limited business under the supervision of their professional bodies.

Occupational pension funds, the prudential regulation of insurance companies and banks, the provision of credit and bank loans (including mortgages) and non-life insurance were excluded from the regulatory arrangements in the 1986 Act. However, all have since been included in a statutory regulatory regime under one guise or another. The sale of mortgages continued to be regulated only by consumer protection law until 2004. The same was true of general insurance until 2005. Furthermore, until recent times the UK insurance industry was regulated by a regime known as “freedom with publicity”, of which the essence was, “do what you like as long as you say you are doing it”. It is difficult to date precisely the demise of this system for regulating insurance markets, but it remained largely intact until the early 1980s at least.<sup>5</sup> Pension funds were also largely unregulated by the state until the Pensions Act 1995. This Act was passed as a reaction to fraud and theft in one particular scheme, something which, of course, has always been illegal and the policing of which is the purpose of primary law.<sup>6</sup>

### ***The continuing development of government regulation***

Since the late 1980s state intervention in the financial sector has evolved further, becoming generally more burdensome and intrusive. The changes were concentrated in two periods, the first in 1997 with the election of the New Labour government, and the second during and after the Great Recession of 2008 and 2009. In the first of these the SIB and its retinue of SROs were abolished, and replaced by a single organization, the Financial Services Authority, with the new arrangements formalised in the Financial Services and Markets Act 2000. The mid- and late 1980s had seen an apparently embarrassing scandal, with the mis-selling of private pensions, which had undermined respect for both the regulatory system and the idea of self-regulation. (The episode is discussed further below.) Gordon Brown, New Labour's Chancellor of the Exchequer, was the driving force behind the 1997 upheaval. In his memoirs he noted how at his appointment he had been confronted with “nine separate financial regulators”, while the Bank of England had been recently under pressure from two serious financial failures, that of the Bank of Credit and Commerce International in 1991 and Barings in 1995.<sup>7</sup> The intention was that the FSA would look after both banking regulation and non-banking financial services of all sorts and in all their aspects, while the Bank of England – which was given independence in the setting of interest rates – lost its role of banking regulator. It was instead to concentrate on monetary policy.

The second batch of changes was a response to the Great Recession, and arose to a large extent from flaws in the 1997 – 2000 upheaval. In the summer of 2007 the international inter-bank market closed, presenting a challenge for those banks which had become dependent on inter-bank funding for their assets. Northern Rock, a former building society, was one of these and sought to borrow from the Bank of England when market sources dried up. But the Bank – which had been forced to hand over banking regulation to the FSA in 1997 and had to worry about losing taxpayer money on loans to Northern Rock – was unsure of its position relative to

both the FSA and the Treasury. It was widely believed that the so-called “Tripartite” – that is, the Bank, the Treasury and the FSA taken together – had unclear objectives and muddled lines of command.<sup>8</sup> From late 2008 UK financial regulation underwent another wave of disruption, with international input – some of it from the European Union and some from other sources – of increasing importance. The original British philosophy, of self-regulation under the law, figured hardly at all in the debate about the reforms.

Following the financial crisis and the election of the coalition government in 2010, the new policy consensus was that the transfer of bank regulation to the FSA in 1997 had been a mistake. The FSA was therefore abolished in 2013. Under the terms of the 2012 Financial Services Act the job of bank regulation was handed back to the Bank of England, and the Bank became the home of a new regulatory body, the Prudential Regulation Authority. The 2012 Act also established the Financial Conduct Authority, which is an overarching organization with responsibility for all kinds of financial regulation; it is interested in the conduct of around 58,000 businesses which employ 2.2 million people. Although financed by levies on the industries it regulates, it is a government-backed regulator. It is certainly not a professional association jealous of the principle of self-regulation under the law.

The approach of government financial regulators in the UK is sometimes described as “principles based”.<sup>9</sup> In other words, it is not – or rather it is not supposed to be – rigid, detailed and over-prescriptive. However, the description seems inapplicable today. Insofar as it was ever valid, so-called “principles-based” regulation created policy uncertainty: it allowed the retrospective interpretation of rules that were unclear or not obviously intended to prohibit activities that subsequently came under the microscope. In truth, there is no shortage of detail in the official regulation of the financial sector, partly because the principles of *caveat emptor* and freedom of contract are much less respected than they were in the past. In 2011 the machinery of UK financial regulation produced documents – of guidance, advice, discussion 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. Observers might reasonably ask what purpose this had. Not only were defaults on UK mortgages not a significant element in the financial crash of 2008 and 2009, but mortgage defaults have never been responsible for a serious bank failure in the UK.<sup>10</sup> Indeed, the success of the housing finance industry in avoiding losses is one reason that the statutory regulation of mortgages is a very recent development in the UK.

Today, the 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, but with none of the accountability or guarantee of due process that exists in proper courts. In 2014 the FCA levied £1,471.4 million of fines, and in 2015 £905.2 million, although later years have seen lower figures.<sup>11</sup> The statutory financial regulators, led by the dominant FCA, are pervasive in all UK financial markets and services. Despite their ubiquity, there is no competition between them, which is a serious problem, as we shall see below.

The PRA, the other successor body of the FSA, has issued documents explaining its philosophy

in relation to regulation. Some indication of the complexity created by the move from self-regulation under the law to statutory regulation is given by the length of a single document, an explanation of the PRA's philosophy in relation to insurance regulation. It is ten times as long as the 1870 Insurance Companies Act which, with hardly any amendment, governed life insurance markets for 100 years.

The growth of statutory regulation was highlighted by Haldane in a speech to the 2012 Jackson Hole conference of central bankers and financial regulators.<sup>12</sup> Haldane is not a supporter of deregulated financial markets in general. However, he points out that the Basel rules for determining bank capital have grown from 30 to over 600 pages. He then noted, amongst a range of other data about the growth of regulatory detail: "In 1980, there was one UK regulator for roughly every 11,000 people employed in the UK financial sector. By 2011, there was one regulator for every 300 people employed in finance." He did not point out that, if this trend growth in regulators and people employed in finance were to continue, the number of regulators would overtake the number of people employed in finance by about 2070 – and this excludes those who enforce regulation employed by regulated firms themselves (such as compliance officers).

These examples illustrate an important difference between statutory regulation and a system which emphasizes legal remedies, including basic contract and supporting law. Contract law exists to ensure that those things agreed by the relevant parties are enforced; it widens the scope of economic transactions because participants in markets can have confidence in the enforceability of the agreements they make. This approach, which need not be particularly prescriptive, leaves people free to take decisions in their own interests. Regulation, on the other hand, seeks to control participants in the market to achieve some kind of economic or social outcome. There is neither a limit to the amount of implied regulation nor to the exactness of detail that might be necessary, especially if the range of potential parties to the regulated transactions is widened through international trade and finance. The process of using regulation to achieve a particular economic or social outcome is akin to that by which a central planning authority might decide the quantities and types of various goods and services that should be produced.

Of course, there has always been some statutory financial regulation. However, the focus has changed over the decades. Regulation or legislation that prohibits certain activities can be brief and not very complex. For instance, insider trading was prohibited in the 1980 Companies Act, with the required part of the Act taking fewer than nine pages.<sup>13</sup> Today, insider dealing is regarded by the regulator as one of many forms of market abuse: the FCA market abuse regime now is now defined in over 60 documents.<sup>14</sup> To take another example, regulation that requires insurance companies to make public their assets and liabilities, and the bases upon which they are calculated, is not intrinsically complex. However, regulation now sets out procedures for the calculation of the capital that insurance companies should hold in order to have a 99.5 per cent chance of remaining solvent over a given period. Given the diversity of risks under review, this is necessarily extremely complicated. Although regulation of financial markets by the state is a relatively recent phenomenon in the UK, this does not mean that markets were unregulated historically.

## II. Historical examples of regulation arising from markets<sup>15</sup>

Regulatory institutions developed historically within financial markets to deal with known (though not always defined) problems. Institutions that were important in creating a stable and well-regulated order in financial markets included independent professions; intermediaries; trustee bodies; and firms with special corporate governance arrangements (such as customer-owned firms). In addition, the use of “brands” or “reputation” helped counterparties and customers to distinguish between good and bad firms.<sup>16</sup>

### *Exchanges*

Historically, the most important regulatory institutions in financial markets have been exchanges. These are institutions on which securities and other financial interests or commodities are traded and which generally provide a comprehensive regulatory framework that promotes order. In the past, 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, they would enhance the reputation of the exchange as a whole. In other words, market confidence and trustworthiness can be thought of as a club good<sup>17</sup> or service, the benefits from which are excludable but not reducible in consumption, and the price of obtaining that good comprises both membership fees and adherence to the rules. 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.

The growth of exchanges is discussed in a number of texts describing the development of the City of London as well as texts on private governance in general.<sup>18</sup> In Britain, modern stock exchanges first emerged 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 evolved 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 promulgation 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. First, there were rules governing the 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. One interesting example of the enforcement of rules was when the exchange 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.<sup>19</sup> These are now matters that are entirely handled by government regulation.

Rule books governing the behaviour of members were followed by rules for the quotation of companies. In the mid-nineteenth century, it became a requirement for securities to be sanctioned by the stock exchange committee before being listed on the exchange. At the turn of the 20th century, these rules became more onerous. Also, just after the turn of the 20th century, the exchange strengthened the requirement for the separation of jobbing and broking functions which became an important focus of attention at the time of Big Bang in 1986.<sup>20</sup> 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 reach of the courts of law."

The Big Bang of 1986 meant the demise of private rule-making and self-regulation. The separation of broking and dealing functions was ended, as was the charging of fixed commissions. The Big Bang is often thought of as a process of deregulation. However, it would be more accurately described as an overhaul of practice, with certain types of private regulation replaced by statutory regulation managed by bodies accountable to the state. The sweeping-away of the London stock market's various alleged restrictive practices followed an agreement with the government that led to the suspension of a six-year-long enquiry by the Office of Fair Trading.<sup>21</sup> Through this, certain types of private regulation, agreed by Exchange members, was prohibited.

It is not only securities markets that developed their own regulatory codes by which members had to abide. The Baltic Exchange, which is involved in ship chartering and broking, provides another example. This was also established in a coffee house, in 1744. In 1823, to combat "wild gambling", a committee was established to regulate admission and to develop trading rules. These rules evolved over time. The Baltic Code was developed in 1983 and revised in 2012. The motto of the exchange is "our word our bond" and contracts were generally executed on trust without immediate exchange of signatures. (This is similar to the "dictum meum pactum" – "my word is my bond" – that has been the maxim of the London Stock Exchange since the eighteenth century.) The Baltic Code both requires and prohibits certain behaviours.<sup>22</sup> Members who flout the code can be expelled or suspended, while approaches to mediation and dispute resolution are set out within the code.

## *Professional bodies*

Another example of private regulatory institutions is the development of professional bodies. Professional bodies tend to have a bad name amongst supporters of a free economy. They are often thought to promote restrictive practices and to seek the status of monopolies, so that they can charge customers more. Such views have been reinforced by authors as distinguished as Milton Friedman.<sup>23</sup> Friedman regards the problem of professions as arising from restrictions on entry to the profession, combined with a government preventing non-members of a professional body from practising unless they are members of the profession. Of course, this kind of government intervention might well arise from lobbying by a well-organised professional body.

There is no reason in principle why a profession cannot control entry to ensure integrity and competence amongst a defined group of practitioners whilst non-professionals are also allowed to practice, albeit without the “badge of approval” from the profession. In other words, where the state does not control entry, professions in financial services can be thought of as part of the “spontaneous product of the market, which has evolved to meet the special problems [of] the financial services industry”.<sup>24</sup> Historically, professional bodies evolved and flourished in the UK and other English-speaking countries, perhaps to a greater degree than in other nations with different legal and political traditions. The flexibility of the common law may have been a contributory factor. One good example of this is the actuarial profession from the 1850s onwards. Although small, it has been pre-eminent in providing stewardship of insurance and pension funds, as well as in pricing products and determining equitable distributions of profits between different categories of policyholders in insurance funds.

Actuaries in the nineteenth century were split on the question of whether there should be a legal definition of an “actuary” and whether there should be certain protected roles to be carried out exclusively by actuaries. Members of the profession did not want to prevent competition from other specialists with similar expertise. Indeed, until the 1980s there was no significant state interference in or licensing of the profession at all. Late Victorian writers suggested that that the absence of state regulation helped the profession to thrive and that such private systems of regulation were, in fact, more effective than state-imposed models. For example, Nicoll wrote in 1898<sup>25</sup>:

From what has preceded, it would seem as if there had not been much in the way of aid or protection accorded by the State to the actuarial profession in the performance of its duties. Our Free Trade Government has, however, been rightly - as it seems to us - very chary at all times of seeming to favour any particular society, or set of individuals, more especially if that favouring was at all likely to be at the expense of other members of the community. It is really very doubtful whether the policy of non-interference is not, in most circumstances, the best for a Government to pursue; and, as regards the Institute of Actuaries, it is very questionable if it would have been so vigorous, or so surely founded as it is at the present day if it had depended, at its inception, on assistance or support in any form from the State.

Comparisons were then made by Nicoll with the US market, which was much more highly and

inefficiently regulated by state governments. A fair comment is that independent professions such as the actuaries did not flourish in the USA as much as they did in the UK, at least in the nineteenth and early twentieth centuries.

Various theories of professions are discussed in a 2000 paper by Bellis.<sup>26</sup> They can be thought of as sociological constructs along the lines of fraternal societies with a common interest or, as noted above, as players in a political process who try to seek monopoly rents by restricting access to a particular occupation. However, especially in financial services, they can be thought of as a group of people who have certain characteristics such as certified knowledge, a requirement to continually develop their knowledge and a requirement to uphold a professional code in markets that are often thought to be opaque or subject to information asymmetries. Professionals are also valued for their judgement in situations in which decisions cannot be made on the basis of objective evidence. Moreover, such judgement should be provided from an unbiased standpoint because professionals owe an allegiance to their profession and its codes of conduct, as well as to clients or the company for which they are working.

The use of professionals by companies selling financial services or by intermediaries of various types could then act as a simple signal to potential customers or other market participants in complex markets. By way of example, Bellis notes that the Australian Mutual Provident Society, a mutual life office in Australia established in 1848, set out rules that required the certification the value of its liabilities and of distributions to different classes of members by an actuary or accountant: this was regarded as necessary to signal that the job was done properly.<sup>27</sup>

The accountancy profession is another example of a professional body important in financial markets, which has always been more sizeable than the actuarial profession. It also evolved in its modern form from the mid-nineteenth century. Its roles included certifying the books of public companies and of auditing. The key requirements were for independence, judgement and expertise. Allegiance to a professional body which had the power to control entry could help ensure these. The accountancy profession was important in both the UK and the USA. In the USA it was not controlled by the state until the 1930s. Reporting and disclosure requirements for companies in the US came from the exchanges, not from the government. In fact, publicly quoted firms in the US did not have to be audited, though many were. By 1926 90 per cent of companies quoted on the New York Stock Exchange had audited accounts. Professional bodies of accountants operating with their own rules were responsible for auditing in many cases.<sup>28</sup> The American Institute of Certified Public Accountants had codes of conduct for its members, as would be expected by a professional body. However, it was carrying out roles that were neither licensed nor regulated by the state.

In recent years, professions and their activities have been increasingly regulated by government bodies. This has gone hand-in-hand with change in professional methods of operation, with a huge increase in formal codes and in appeals to these codes for guidance on behaviour. The International Financial Reporting Standards dictating accounting requirements within the EU are now over 3,000 pages. Until 1990 accounting standards formed *recommendations* to members of the profession. The first such recommendation, SSAP 1, published in 1971, was just eight pages long.

## ***Other evolved institutions designed to protect consumers and counterparties***

There are many other examples of sophisticated market institutions that have evolved to deal with perceived “imperfections” in markets. These include credit rating agencies<sup>29</sup> and intermediaries involved in the sale of financial products. The respect for financial intermediaries has, of course, been undermined by the mis-selling scandals, though these have happened since statutory regulation of the sale of financial services products has been introduced. The most serious of these mis-selling scandals, insofar as it involved financial intermediaries, was possibly the pensions mis-selling crisis of the mid- to late 1980s. This was the direct result of the UK government prohibiting by law, and changing retrospectively, paternalistic arrangements developed by employers which required their employees to join company pension schemes. Such paternalistic arrangements had their own regulatory mechanisms under the law, which were undermined by the advent of statutory regulation. The result was the mis-selling crisis which provided an apparent justification for more government regulation of sales process as for financial products.<sup>30</sup>

The insurance market developed mechanisms to regulate product sales through the intermediary market directly. One such market institution was a maximum commission agreement amongst life insurance companies. This helped ensure that intermediaries made recommendations based on the soundness of the life insurance company the policies of which they were recommending, or on the basis of other characteristics valued by the purchaser. This agreement was abolished by the competition authorities under pressure from the EU.<sup>31</sup> Since then there have been a number of mis-selling scandals related to the sale of insurance products based on commission rather than the needs of the customer.

We should not be surprised at the proliferation of institutions in markets designed to regulate behaviour. Market regulatory mechanisms can lead to a race to the top, rather than the feared race to the bottom and the elimination of the high-quality segments of the market that is predicted by the literature on information asymmetries.<sup>32</sup> In the market for second-hand cars, warranties have developed to help protect consumers from bad cars and to allow car salesmen to signal that they are selling good cars. In different ways, financial institutions can develop mechanisms that reduce the potential for conflicts of interest or other problems that can be inherent within financial markets and will be rewarded for doing so. Lightfoot points out that the historical evidence suggested that, before the regulation of financial markets in the US by the Securities and Exchange Commission, banks had higher capital-to-asset ratios than afterwards.<sup>33</sup> In addition, in the 1920s so-called universal banks, which conducted both investment banking and commercial banking, were effectively penalised by those entering into contracts with them so that securities underwritten by such banks had to offer higher yields reflecting the possibility of greater conflicts of interest than would exist where there were separately capitalised investment banks with their own balance sheets and separate boards of directors. In both banking and insurance markets mutual companies developed which reduce conflicts of interest between owners and customers. In banking, the trustees savings banks offered 100 per cent reserve accounts in the era before

deposit insurance and bank capital regulation.

These were not regulatory institutions as such. However, they are mechanisms that signal to those who interact with financial institutions that allow counterparties to make a judgement about the incentives that exist within those institutions for the kind of practices that might damage consumers and be difficult for them to perceive. These signalling and governance mechanisms have now been replaced by government regulation of behaviour.

### **III. Modern alternatives to government financial regulation**

As was discussed in the early part of this chapter, the club-like institutions described above are no longer the main regulators of activity in financial markets. As far as the main market of the London Stock Exchange is concerned, it is true that there are still special requirements in relation to listing and trading determined by the exchange. However, listing, trading and disclosure rules are so bound up with government regulation, some of it related to now-superseded EU directives, that the regulatory role of the exchange is now residual.

Nevertheless, there are examples of private regulators that are still important in their own domain. The Alternative Investment Market (AIM) developed to take advantage of exemptions from EU regulations, while the UK was an EU member state. Shares are traded on that market, subject to the regulations set by AIM.<sup>34</sup> Statutory regulation still applies in cases of market abuse, but otherwise the market develops its rule-book independently of government.

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 AIM regulations in relation to dealing in shares by directors and similar categories of employees together with other rules dealing with disclosure, conduct and trading.<sup>35</sup> At the time of writing (September 2021), the total market capitalisation of all the companies that trade on AIM is approaching £125 billion, while 14 companies on the exchange have a market capitalisation of over £1 billion.

Derivatives exchanges also develop their own regulatory environment. Even off-exchange dealing is regulated by a private regulatory body, the International Swaps and Derivatives Association (ISDA). 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".<sup>36</sup> Members have to apply to join ISDA and can have their membership revoked.

Members can choose to use the ISDA master agreement. This was used for 90 per cent of outstanding derivatives contracts at the end of 2016 of almost \$500 billion.<sup>37</sup> In addition, as part of its regulatory function, ISDA also has a dispute resolution procedure, which avoids reliance on use government courts in most instances, and a Credit Derivatives Determinations Committee. The latter uses a set of rules to determine whether a credit default event has taken place and thus whether counterparties to a derivative contract need to settle.

Of course, private regulators exist in many areas of the economy outside finance. The example

of sport has already been mentioned. Private regulators are becoming increasingly common in markets where new technology leads to the provision of services in new ways that transcend those existing modes of provision that are regulated by the state. Perhaps the most topical private regulator is Uber. Uber is a taxi-hailing platform, which regulates the drivers that use it and also has methods of regulating the behaviour of its customers. It is a dominant market player as a regulator in its own specific domain. However, it competes with government-regulated taxis, such as the black cabs regulated by Transport for London (TfL). Uber facilitates competition between drivers and breaks down information asymmetries within the market for private hire vehicles by promoting more effective regulation by reputation via the mutual rating of customers and drivers.

There are differences in approach between Uber and black cabs regulated by TfL. Uber uses a pricing system that ensures continuity of supply, but not a fixed price. On the other hand, various requirements are imposed on licensed black cabs (flat fares, knowledge requirements to obtain a licence) which benefit different types of customer. Customers can choose between the regulatory framework offered by licensed taxis and that offered by Uber or other platform operators. There is competition between regulatory frameworks and we should not assume that one framework is better for all consumers.

#### **IV. Government regulation as supposed solution to market failure**

The general presumption is that state regulation is necessary to deal with what economists often describe as “market failure”. This conclusion is often derived from the neo-classical approach to economic reasoning in which it is thought that particular conditions have to hold to maximise welfare.<sup>38</sup> Given that these conditions can never be met exactly, it is widely believed that an unregulated market fails to maximise welfare. Intervention by governments is then deemed necessary and desirable. Governments and government regulatory bureaux levy taxes or apply regulations in an attempt to move the market towards its welfare maximising position.

This is the rationale for regulation that has often been put forward by government-backed authorities. For example, in one 2003 publication by the Financial Services Authority 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.<sup>39</sup>

Perhaps, the most interesting part of this statement is the last clause. The FSA notes that they deem action on ‘our’ part ‘necessary’. In other words, *state* regulation is a *necessary* remedy for market failure. The possibility of other regulatory bodies arising or intervention by the state regulator actually making things worse is not considered. Here is essentially a blackboard economics view of financial regulation, as the late Ronald Coase would have called it: the reasons

for and proposed forms of intervention are derived using abstract theory.<sup>40</sup>

In more recent years, the publicly stated justifications of the statutory regulatory bodies for financial services have become more subtle. The FCA, which – as we have seen – is the main successor body to the FSA, now explains its purposes in a 61-page document. This document notes: “In assessing whether intervention is needed, we consider a range of market failures including...”. It then goes on to say that one such market failure is “existing regulation, which might have adverse effects on competition”.<sup>41</sup> It is bizarre that it should regard regulatory barriers to entry as a *market* failure. Nevertheless, it appears that “market failures” are just one of a range of considerations that determine regulatory interventions.

The image of the “market failure” model is one of the government regulator as a puller of levers designed to move the market towards its welfare-maximising position. Two problems with this analysis are to be highlighted. The first is that we have much prior theory and evidence to suggest that government regulators cannot perfect an imperfect market and may not even improve upon its outcome. Secondly, it fails to consider the development of regulation within the market itself, as already discussed above.

### ***Problems of government regulation***

The obvious critiques of government regulation would originate from the Austrian and public choice literatures. Firstly, in the same way that a central planner cannot know in advance how to produce and what to produce in order to maximise consumer welfare, we cannot know in advance what is the welfare maximising form of regulation. Will regulation be too burdensome and costly? Or will it not protect the consumer sufficiently or in the right way? Will the costs in terms of reduced competition and innovation outweigh the benefits? There is no effective way of communicating preferences or communicating the balance of costs and benefits of different forms of regulation and incentivising the regulatory bureau to provide the right amount of regulation in the right way. Indeed, some of the costs are unknowable.

In principle, at least, private regulators can compete and benefit from providing better regulation. A stock exchange would be able to charge higher fees to companies for listing their shares if the regulatory environment led to a lower cost of capital for the company. A taxi regulation platform which led to drivers being expelled from the system if they received one rating below the maximum number of stars would hugely raise the cost to consumers as drivers would be reluctant to use the platform without significant corresponding benefit. On the other hand, one which did not distinguish at all between consumer perceptions of the quality of drivers would be of no benefit to consumers and the platform would not be used. Markets have built-in incentives to optimise both the degree of regulation and the satisfaction of all the stakeholders concerned.

A government regulatory body is not readily able to accumulate such information on the efficacy of its work and cannot be assumed to improve upon the market outcome. As noted by Hayek, “If the factual requirements for ‘perfect’ competition are absent, it is not possible to make firms behave ‘as if’ it existed.”<sup>42</sup> If, for example, there were no information asymmetries

in a market, the market outcome would be different from the one which arises when there are information asymmetries, but we do not know how different or in what respect it would be different. We cannot simply require the provision of information to consumers and assume that the market failure is solved. The information is costly to provide and needs interpretation, while a regulator cannot know what information is relevant to individual consumers' decisions. The regulation itself might add to the difficulties faced by both consumers and firms when acting within markets, and might bring with it other problems. Indeed, it may add to the complexity of the whole process of buying a financial product, thus worsening the problem.<sup>43</sup>

Further problems of government regulation relate to its capture by those whose interests it is not supposed to serve. Regulation is intended to serve market participants and perhaps the general public. However, a statutory regulatory body is disciplined by a government formed as a result of quinquennial elections that are fought on a range of issues and which is very remote from the management of individual regulatory bureaus. In other words, this whole area is beset by a huge principal-agent problem. Furthermore, regulation can be captured by firms who wish to raise the costs to rivals or it can be designed to fulfil the objectives of regulators or politicians.<sup>44</sup>

Unfortunately, whilst economic theory can tell us when a market will not give a theoretically perfect outcome, it cannot generally tell us whether the intervention of a state regulator will produce a better one. The market failure approach is an intellectual dead end or rabbit hole. The reasoning in the market failure model runs as follows: "a given set of assumptions is necessary to maximise welfare; these assumptions do not hold; therefore we should pull regulatory levers to improve welfare". But, once we accept that the government regulator will not be able to maximise welfare either, there is nowhere left for this line of reasoning to go.

### *Critiques of private regulation*

To argue that we cannot know if government regulation will improve upon market outcomes is not to say that private regulation is unproblematic. Indeed, there are a number of potential problems. The first is that it might not deal effectively with external social costs, that is, those costs not borne by the market participants or which are external to the system of parties who subscribe to the regulatory body. For example, if the costs of the failure of a bank have very wide ramifications, it could be argued that government regulation should be considered.

An argument could be made that private forms of regulation give rise to concentrations of power. Interestingly, a much-cited 1970 Akerlof paper adverts to the issue, although the paper is not focused on the institutional advantages and disadvantages of private versus government regulation.<sup>45</sup> The paper introduces the possibility of "market failures" caused by information asymmetries, while conceding that private institutions might address the problem. But it also notes that such institutions could not compete, as in an atomistic market with many participants. This is because such institutions have to govern standards across the whole market, or at least a substantial sub-section of it. They are therefore bound to be few in number in a given field of economic activity. The Akerlof analysis could be seen as relevant to the UK's Big Bang reform in 1986. As noted above, it was competition concerns that led to both the curbing of the regulatory

powers of the London Stock Exchange and the abolition of the maximum commission agreement amongst insurance companies.

Of course, government regulators are monopolistic by design. Private regulatory systems, on the other hand, will generally have competitive elements. They may also be contestable or, in an international context, there may be effective competition. Uber, for example, competes against other different forms of regulatory mechanism in the provision of taxi services and also has the threat of entry from other similar platforms. Indeed, it is Transport for London (TfL) has used its monopoly power as a statutory body to try to prevent regulatory competition between Uber and TfL-regulated taxis.

In the case of securities markets it is highly likely that the development of technology, combined with the removal of exchange controls seven years before the Big Bang would have led to international competition curbing the restrictive practices of the stock exchange. Indeed, exchanges do compete on an international basis.<sup>46</sup> Off-exchange dealing was also possible before Big Bang, whereas after the enactment of the Financial Services Act all those participating in securities markets were regulated by the monopoly regulator

A third problem with private regulation is that information asymmetries may be so radical that their existence is not understood. Hence, the value of market institutions to resolve them is not recognised by market participants. As a result, private regulatory institutions may not develop. Related to this may be the difficulty consumers have in determining the efficacy of private regulators.<sup>47</sup>

The final possible problem is that private regulatory institutions might lack powers of enforcement. Such limitations may arise from legal restrictions. For example, the law might prevent a profession or other organisation from expelling people on the ground that to do so would be regarded as a restraint of trade.<sup>48</sup> This may be related to the perceived monopoly status of the regulatory body. Alternatively, there may be limits on the fines that can be levied on those who submit themselves to private regulation. Clearly, a private regulatory body could not imprison a market participant who broke the rules under most penal codes! The Financial Conduct Authority by contrast has almost unlimited powers to invoke civil and criminal penalties. It is worth saying that that the vexed issues here have little to do with "market failure".

## **V. Conclusion: a realistic approach to the economics of regulation**

If market failure analysis leads to a dead end, perhaps it does not begin from the right starting point. The starting point should be a rejection of the idea that the market develops separately from self-regulatory institutions and that the latter need to be created to correct so-called failures in the former. Instead, we should regard the regulations that dictate how various parties to transactions operate as part of the set of services that can be provided by the market. They can be provided directly by market participants and also by independent institutions, such as exchanges or professions. If regulation is understood as part of the package of services which govern the operation of the market, then the process of competition is necessary to discover the best form of

regulation. It is not in doubt that the market can provide regulatory services. The open questions relate to the market's efficacy in doing so. Regulation is not something that has to be "done" to a market from outside. Instead of market failure analysis, the right framework for the economic analysis of regulation should involve three steps.

First, a comparative institutions analysis will help us understand whether market institutions or government institutions are likely to be most effective at maximising welfare in particular circumstances. At least it can help us define the relative advantages and disadvantages of private and government regulation in a particular context. In the market failure model, government regulation is always theoretically desirable because the market will never settle on a theoretical welfare-maximising position. Secondly, we can determine the legal environment most conducive to the evolution of regulatory institutions within the market. Thirdly, if government regulatory institutions are preferred, we can consider the policy environment in which they might best complement, rather than replace, evolved market institutions. In other words, we should consider the relative merits of alternative institutional approaches to the provision of regulation. This approach is not widely discussed in the literature.<sup>49</sup>

In terms of practical policy, the most obvious approach in financial markets is to make government regulation optional, but require market participants to make very clear whether their products are regulated by the state. That would at least ensure that the possibility of private regulation was not closed off. If private regulatory institutions developed, the public can choose whether they want to obtain services from institutions also regulated by the state. This approach of "regulatory competition" between state and private regulators does work. As has been noted above, AIM provides a regulatory environment for the trading of shares in companies, many of which are not affected by EU directives on listing and trading. Secondly, in a different field, in London, consumers can choose between cab services provided by Uber, with its own approach to regulating quality, and state, TfL-regulated black cabs with a different approach to regulating both quality and price. Furthermore, the state should be very careful before restricting the activities of private regulators on competition grounds. At the very least, when considering such issues, the market should be defined widely and the case that a regulatory platform might be contestable should be considered. Uber, for example, may have a virtual monopoly in its product field, but it competes with taxis, private hire cars, buses, tubes and private cars.

The market failure model in which we think about regulation should be jettisoned. The conditions for perfect competition and welfare maximisation will never be met in a market. It can never be known in advance whether statutory regulation will help. Of course, decisions have to be made about regulation, but, if those decisions are made by statutory regulatory bodies themselves, they will be subject to behavioural biases and biases that arise from public choice interests. We should therefore avoid the creation of regulatory bodies that have no effective constraints and that can write rules widely and more or less without limit or any form of accountability. Where statutory regulators are set up, they should operate under strict constraints. Having different statutory regulators for different parts of the market, as used to be the case before 2000, is also an advantage. Comparisons can be made between regulatory bodies and approaches, while products that perform different functions can be regulated according to different principles. This

## Is 'market failure' a good justification for financial regulation?

allows trial and error, as well as promoting learning about different regulatory methods.

One further reform which might help us re-establish regulatory pluralism would be to allow the Competition and Markets Authority to investigate both whether regulatory services provided by the state are monopolistic and whether state regulators inhibit competition. Regulatory services are too important to be provided by statutory monopolies with in-built behavioural biases to expand their role.

- <sup>1</sup> David Llewellyn *The Economic Rationale for Financial Regulation* (London: Financial Services Authority, April 1999), 1st FSA Occasional Paper.
- <sup>2</sup> Hayek was one among a number of authors to emphasize the uniqueness of the English legal tradition. To quote from *Law, Legislation and Liberty*, “The only country that succeeded in preserving the tradition of the Middle Ages and built on the medieval ‘liberties’ the modern conception of liberty under the law was England...The freedom of the British which in the eighteenth century the rest of Europe came to much to admire was thus not, as the British themselves were among the first to believe and as Montesquieu later taught the world, originally a product of the separation of powers between legislature and executive, but rather the result of the fact that the law that governed the decisions of the courts was the common law.” (Friedrich Hayek *Law, Legislation and Liberty*, vol. 1, *Rules and Order* [London: Routledge & Kegan Paul, 1973], pp. 84 – 5.)
- <sup>3</sup> In Tennyson’s famous ‘You Ask Me, Why, Tho’ Ill at Ease’ in his 1842 *Poems*, one verse ends, ‘Where Freedom slowly broadens down, from precedent to precedent.’
- <sup>4</sup> See: [http://www.legislation.gov.uk/ukpga/1986/60/pdfs/ukpga\\_19860060\\_en.pdf](http://www.legislation.gov.uk/ukpga/1986/60/pdfs/ukpga_19860060_en.pdf)
- <sup>5</sup> See Philip Booth, “Freedom with Publicity” – the actuarial profession and UK insurance regulation from 1844 to 1945’, *Annals of Actuarial Science*, 2007, 2(1), 115-145.
- <sup>6</sup> The pension schemes in question were those in companies controlled by Robert Maxwell.
- <sup>7</sup> Gordon Brown *My Life, Our Times* (London: Bodley Head, 2017), p. 120.
- <sup>8</sup> Dan Conaghan *The Bank: Inside the Bank of England* (London: Biteback Publishing, 2012), p.152.
- <sup>9</sup> For example, in Financial Services Authority, *Principles-based regulation - Focusing on the outcomes that matter* (London: FSA, 2007), it is stated in the first sentence: “Principles-based regulation will sustain the current rigorous regulatory environment for UK financial services, but with better and more effective outcomes.” <http://www.fsa.gov.uk/pubs/other/principles.pdf>. To be fair, the FSA was arguing in the document that they had not reached that point yet and then the crash intervened.
- <sup>10</sup> The failures of Northern Rock and Bradford & Bingley in 2008 were due to their difficulties in funding their assets, not to losses when their assets were eventually realized. In fact, the realization of Northern Rock and Bradford & Bingley yielded significant profits to the UK government.
- <sup>11</sup> See <https://www.fca.org.uk/news/news-stories/2014-fines> to <https://www.fca.org.uk/news/news-stories/2020-fines>.
- <sup>12</sup> Andrew Haldane ‘The dog and the frisbee’, speech at the Federal Reserve Bank of Kansas City’s 366th economic policy symposium, Jackson Hole, Wyoming, 31 August 2012. <https://www.bis.org/review/r120905a.pdf>
- <sup>13</sup> See Companies Act, 1980, pages 80-88. [http://www.legislation.gov.uk/ukpga/1980/22/pdfs/ukpga\\_19800022\\_en.pdf](http://www.legislation.gov.uk/ukpga/1980/22/pdfs/ukpga_19800022_en.pdf)
- <sup>14</sup> See: <https://www.handbook.fca.org.uk/handbook>
- <sup>15</sup> It should be noted that non-state regulatory institutions are not unique to finance. They were pervasive in British society from the 1850s until the Second World War. For example, regulatory institutions developed in every branch of sport. The Royal and Ancient started to codify the rules of golf in 1897. The Football Association started to codify the rules of soccer in 1863, but then regulatory competition developed between the Rugby Football Union in 1871 and the Rugby Football League in 1895.
- <sup>16</sup> See Jonathan Macey *The Death of Corporate Reputation: How Integrity Has Been Destroyed on Wall Street* (Upper Saddle River, New Jersey: Pearson Education, as FT Press, 2013).
- <sup>17</sup> The analogy with Buchanan’s idea of a club good (see James Buchanan ‘An economic theory of clubs, *Economica*, 1965, 32[125], pp. 1-14) is not exact and would need more explanation than there is space to provide here.

- <sup>18</sup> See, for example, David Kynaston *The City of London, 1815 – 2000* (London: Chatto & Windus, new edition, 2011), Edward Stringham *Private Governance: Creating Order in Economic and Social Life* (Oxford: Oxford University Press, 2015), and Terry Arthur and Philip Booth *Does Britain Need a Financial Regulator?* (London: Institute of Economic Affairs, 2010), Hobart Paper no. 169.
- <sup>19</sup> See Lance Davis, Larry Neal and Eugene White 'The development of the rules and regulations of the London Stock Exchange, 1801– 1914', paper prepared for the Vanderbilt University seminar, 2004.
- <sup>20</sup> See *The Times*, 1st February 1909, reproduced in J. Burns *Stock Exchange Investments in Theory and Practice* (London: Charles and Edwin Layton, 1909).
- <sup>21</sup> The Office for Fair Trading had needed an extension of its powers to the service industries in order to deal with the London Stock Exchange.
- <sup>22</sup> See: [https://www.balticexchange.com/dyn/\\_assets/\\_pdfs/documentation/baltic\\_code\\_nov14.pdf](https://www.balticexchange.com/dyn/_assets/_pdfs/documentation/baltic_code_nov14.pdf)
- <sup>23</sup> See, for example, Milton Friedman *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), especially chapter IX.
- <sup>24</sup> Philip Booth 'The political economy of regulation, *British Actuarial Journal*, 1997, 3(3), pp. 675-707. The quotation is from p. 697.
- <sup>25</sup> John Nicoll 'The relation of the actuarial profession to the state', *Journal of the Institute of Actuaries*, 1898, 34, pp. 158-251. See, in particular, pp. 169 – 70.
- <sup>26</sup> Clare Bellis 'Professions in society', *British Actuarial Journal*, 2000, 6(2), pp. 317-364.
- <sup>27</sup> Bellis 'Professions in society, *British Actuarial Journal*, 6(2), p. 323.
- <sup>28</sup> See Stephen Zeff 'How the US accounting profession got where it is today: part I, *Accounting Horizons*, 2003, 17(3), 189-205. [http://www.ruf.rice.edu/~sazeff/PDF/Horizons,%20Part%20I%20\(print\).pdf](http://www.ruf.rice.edu/~sazeff/PDF/Horizons,%20Part%20I%20(print).pdf)
- <sup>29</sup> Credit rating agencies acquired a bad reputation in the financial crisis. However, for a full discussion of how regulators distorted their behaviour, see the chapter by Alan Morrison on pp. 117 – 27 of Philip Booth (ed.) *Verdict on the Crash – Causes and Policy Implications* (London: Institute of Economic Affairs, 2009), Hobart Paperback 37.
- <sup>30</sup> It is worth explaining the genesis of the crisis in greater detail. The 1986 Social Security Act prevented employees and employers agreeing contracts of employment which required membership of a company pension scheme as a condition of employment. Most of these schemes were especially good value for members. Pension company salesforces tried to entice such people to leave their company schemes and take out a personal pension scheme (which were generally much less good value and higher risk). Such pensions policies were regarded as being "mis-sold" – or not appropriate for the client. The Act actually involved retrospection so that previously agreed contracts of employment which required pension scheme membership were over-ridden by law.
- <sup>31</sup> See: <http://www.theactuary.com/archive/old-articles/part-2/regulation-of-life-assurance-commissions-ii/>
- <sup>32</sup> For example, George Akerlof 'The market for "lemons": quality uncertainty and the market mechanism', *Quarterly Journal of Economics*, vol. 84, no. 3. (August, 1970), pp. 488-500.
- <sup>33</sup> See the chapter by Warwick Lightfoot in Philip Booth and David Currie (eds.) *The Regulation of Financial Markets* (London: Institute of Economic Affairs, 2003), Readings no. 58.
- <sup>34</sup> To be precise, AIM is operated and regulated by the Exchange in its capacity as a Recognised Investment Exchange under Part XVIII of FSMA 2000. AIM is a prescribed market under the terms of FSMA 2000.
- <sup>35</sup> The rule book can be found here: <http://www.londonstockexchange.com/companies-and-advisors/aim/advisers/aim-notices/aimrulesforcompaniesjan16.pdf>

- <sup>36</sup> See: <http://www2.isda.org/about-isda/mission-statement/>
- <sup>37</sup> See Bank for International Settlements statistics at: [http://www.bis.org/publ/otc\\_hy1705.htm](http://www.bis.org/publ/otc_hy1705.htm)
- <sup>38</sup> Examples are perfect information and the absence of externalities.
- <sup>39</sup> Financial Services Authority *Reasonable Expectations: Financial Regulation in a Non-Zero Failure World* (London: FSA, September 2003), p. 15.
- <sup>40</sup> Ronald H. Coase *The Firm, the Market and the Law* (Chicago: University of Chicago Press, 1988), pp. 28 – 30.
- <sup>41</sup> <https://www.fca.org.uk/publication/corporate/fca-approach-advancing-objectives-2015.pdf>
- <sup>42</sup> Friedrich Hayek *Law, Legislation and Liberty*, vol. 3, *The Political Order of a Free People* (London: Routledge & Kegan Paul, 1979), p. 70.
- <sup>43</sup> The author examined the information provided with a unit trust product, the provision of much of which is encouraged by the regulator. During the purchase process of a very simple product, the customer was advised to read no fewer than nine documents. One of these was over 1,000 pages long and another about 500 pages long. These two documents had little information that was relevant to the particular fund. No attempt was made to be discriminating. Of course, this is not all required by regulation, but a risk averse provider, in the face of regulation designed to promote information provision will tend to provide more rather than less. In another example, it has been reported that the regulations implemented by the UK Financial Conduct Authority in respect of the EU Market in Financial Instruments Directive (II) run to 1,700,000 paragraphs. These regulations are designed to promote transparency.
- <sup>44</sup> See the literature on public choice economics. Buchanan and Tullock contrasted benign profit-seeking in a competitive economy with harmful rent-seeking in a regulated economy. (James Buchanan and Gordon Tullock *Toward a Theory of the Rent-Seeking Society* (College Station, Texas: Texas A & M University Press, 1980.)
- <sup>45</sup> The reference here is again to Akerlof “The market for “lemons”” *Quarterly Journal of Economics*, 1970.
- <sup>46</sup> Also, historically the UK has had regional stock exchanges and competition between stock exchanges. Furthermore, competition between different ways of providing capital to companies can develop, notably at present with the growth of “crowd-funding”.
- <sup>47</sup> Of course, with private regulators, despite the argument above relating to market power, there can be comparison, discussion and scrutiny.
- <sup>48</sup> A particularly good example of this problem is the case between the Test and County Cricket Board (TCCB) and the players who joined Kerry Packer’s World Series Cricket (WSC) in 1977. The TCCB, as the regulator of the game, banned players from county and test cricket who joined WSC. The court accepted that the regulation of cricket was a good thing, but that the action of the TCCB amounted to a restraint of trade and therefore was not valid. This was the case even though WSC provided an alternative way for players to gain a livelihood – there was regulatory competition.
- <sup>49</sup> There are analogies here with the work of Elinor Ostrom who won the Nobel Prize in 2009. She asked some of these questions in relation to the institutional framework for managing environmental resources.

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This paper has not been previously published.



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