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Regulation – A Panacea that will make the Whole Economy Sick?

Competition a Better Bet than Controls, say UK Economists in Politeia's new volume

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The financial crisis of 2007-8, its aftermath and the bank bailouts which followed have prompted an intense interest in the financial sector and its future regulation. Politicians have responded with a series of measures to regulate and prevent a recurrence. Banks will be obliged to have higher capital ratios; investment banking will be separated from retail and the presumption will be that in future there will be no bailouts.

The authors of Politeia's new volume*, *The Financial Sector and the UK Economy: The Danger of Over-Regulation*, who include some of the country's most distinguished economists and others with specialist knowledge of the financial services industry, are in no doubt that there are serious problems to be tackled. But they raise concerns about the emphasis, volume and efficacy of current measures, which may not bring the intended results or may prove counter effective.

The Problems

- Regulation in itself does not make people behave ethically, as Lord McFall points out in his introductory chapter. What is needed is a change in culture from within the organisations, greater accountability by those who lead them and a better balance between the risks and rewards of doing their job.

- The wider economy: costs, competition and impact. In particular, the current measures may damage the wider economy, add to the costs of banking, make credit difficult to access for small business and house buyers, and damage the wider economy. Professor Kent Matthews explains that the current and proposed measures could undermine the goal of safer banks. They could add to the costs of banking and the costs of the normal disruptions which occur in working markets.

  Prof Patrick Minford warns that policy may now be gripped by regulative fallacy, which has reduced competition in the financial sector and damaged the wider economy. Indeed, for those groups who help economies recover – small businesses and house buyers – credit may now be more difficult to access. David Green warns that the financial sector and the wider economy are intertwined. So, for example, higher bank capital ratios will have their impact elsewhere in the system (e.g. leave less for investment available for other parts of the economy). Regulation, he says, should be proportionate and targeted, and policy makers should assess the consequences in other parts of the system.

- International. To the actual consequences of UK measures must be added the problems posed by international bodies and the EU which add complexity and cost to the industry and make UK services less competitive globally.

  Scott Cochrane, a lawyer, warns of the consequences of huge volumes of indiscriminate and complex EU regulation and the impact on Britain's global competitiveness; industry sources estimate an incremental one off cost of compliance at £1.6 million per firm, with annual compliance costs increasing by up to £2.3 million per firm. John Hodgson, an insurance specialist, suggests that whereas UK legislation has been generally effective in rebalancing power between insurer and customer, recent developments in the UK and EU will have grave implications for the success of the industry. The trend is to decisions which properly should be taken by companies being taken by the regulator; while from the EU insurance regulation threatens the UK's ability to compete globally. For Jamie Dannhauser, an economist at Lombard Street Research, while the regulatory model under which debt escalated before the crisis should be reviewed, the bigger question remains, of the financial imbalances globally. Creditors (like China) need to spend and import more, and produce less. The opposite is true for debtors. What is needed is a new international monetary system with floating exchange rates.

- The 'causes' of the crisis may lie beyond the financial sector: so too must the 'solutions'.

  Prof David B. Smith explains that the crisis and the recession that followed should not be seen as the responsibility of the financial sector alone. The unsustainable fiscal balances and escalation of public spending as a percentage of GDP, which escalated rapidly in this century, played a significant part in bringing about the decline of growth and output, around 1 per cent in GDP for every 1 per cent increase in the ratio of government spending to GDP. Indeed, as Prof Patrick Minford explains, financial crises can be caused by changing circumstances (including non-banking shocks which are often no different to others except in size), rather than excessive lending.

The Solutions. For the future, policy makers should review the principles for regulatory policy, target the real problems and take account of the impact of regulation on the wider economy. In particular:

Too big to fail. The present banking structure, especially the size and role of huge monolithic banks – 'too big to fail' – must be tackled. Minford and Smith warn against keeping the 'big bank' model, and Smith proposes breaking up the up the big banks and returning to a number of smaller banks and building societies.

Banks should be allowed to fail. If banks are broken up they will be neither too big nor too important to fail (Matthews, Smith and Minford). They can and should be allowed to fail in an orderly fashion (Matthews, Minford) and the Bank of England arrange an orderly exit. The 'market liberal approach would eliminate the two main sources of moral hazard, the current 100 per cent deposit insurance and the absence of direct personal financial liability on the part of senior executives' (Smith).

Deposit insurance should be limited to 85-90 per cent of the deposits, to encourage prudence in those making deposits and prevent innocent savers *from losing their money.* (Smith)

Shadow Banks – A solution. The regulatory obstacles should not be allowed to hinder other intermediaries, including shadow banks, or capital markets, to stand in as channels of finance. (Green)

Accountability - Risks and Rewards Senior bank employees should be directly accountable for their actions, say Smith and McFall, with personal financial liability if their institutions need state bailout, remaining after retirement (Smith) and the balance between risk and reward proportionate, with the rules governing bonuses tightened.

Regulation Although there are serious problems with the size and system of accountability for senior executives, what is needed is not more indiscriminate regulation for the sector, but the right regulation and an effective supervisory role for the Bank of England.

Regulation should be targeted and proportionate and the impact on the wider economy assessed (Green). The system should allow the Bank of England to 'keep its finger on the pulse' and take prompt corrective action before a crisis. The Bank should discharge the role of supervisor in its traditional informal way, with a minimum of intervention and costly roles and as the body with detailed knowledge and good contacts within the banking industry. (Minford and Matthews)

Competition Encouraging competition should be the main aim of official intervention through the competition authorities. Our knowledge of the financial market's working is insufficient to intervene without causing damage, e.g. regulation blocking credit, or competition failure to prevent the emergence of the big banks. As Patrick Minford explains:

'Rather than interfere in the internal structure of banks, as in putting in ring-fences between activities that banks naturally are involved in, our competition authorities should ensure that the structure is competitive and that free entry is maintained'.

The Financial Sector and the UK Economy: The Danger of Over-Regulation is published on Tuesday 23rd July by Politeia, 33 Catherine Place, London, SW1E 6DY. Hard copies are available on request.
A digital copy can be found at http://bit.ly/1dJiGYJ

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