Regulatory Principles and the Financial Services and Markets Act

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1 Introduction

Regulation in the UK is undergoing fundamental change. Dissatisfaction with self-regulation and the self-regulatory organizations intensified steadily during the 1990's. The failure of regulation to avert the Maxwell pension collapse and the widespread selling of inappropriate pension policies were viewed as serious deficiencies of what many people had already come to regard as inadequate and expensive regulation. The Labour administration came to office with the clear intention of overhauling and strengthening the system.

The Financial Services and Markets Act (FSMA) suffered a tortuous process through the Houses of Parliament. Most concern focused on questions of governance of the Financial Services Authority (FSA): how accountable should it be and to whom, should it have immunity from actions for damages, should it have an independent complaints procedure, should the roles of chairman and chief executive be separated. These are critically important questions, which several of the papers in this volume address. Notwithstanding the concerns, the FSMA has been broadly welcomed for enhancing investor protection and eliminating the complex system of overlapping self-regulatory organizations that previously existed.

The objectives of the FSMA are to maintain market confidence in the financial system, to promote public awareness of the financial system, to secure the appropriate degree of protection of consumers and to reduce financial crime. These objectives have their basis in the market failures that afflict financial markets: market manipulation, systemic problems, asymmetries in information, incomplete contracts and problems in the enforcement of contracts. To meet the need for a more effective system of regulation, the government proposed the creation of a new statutory body, the Financial Services Authority (FSA), to replace its predecessors, the Securities and Investments Board (SIB) and its accompanying self-regulatory organizations. Self-regulation was deemed to have failed to live up to the requirements of effective investor protection.

But in the rush to bring in new legislation, there has been remarkably little academic debate about one of the most fundamental changes to financial regulation in the post

WW2 period. The questions of governance, referred to in a previous paragraph, are important but may not prove in the long-term to be the most significant. Instead, this paper will suggest that there are more fundamental questions that the debate about the FSMA leave unanswered.

The primary issue that regulation is supposed to address, and many people might feel is the only relevant issue, is investor protection. The FSMA has been welcomed for strengthening this. But the financial sector does not stand in isolation. It plays a key function in linking individuals on the one hand with the corporate sector on the other. The financial sector facilitates the transfer of funds between savers and borrowers and oversees the allocation of resources in the corporate sector through a variety of governance mechanisms. The financial sector is therefore a critical determinant of economic performance. In designing financial regulation, it is therefore important to be aware of its repercussion on the wider economy. It is this aspect of financial regulation that the paper will argue has received inadequate attention to date.

The paper will begin by considering how financial regulation impacts on the structure of the financial system. It will distinguish between financial institutions that are prone to systemic risks, most notably commercial banking, in section 2 from those that are not, for example asset management, in section 3. Where there are systemic risks then there is an inevitable trade-off between protection of the financial system and competition. A critical issue that has received little attention to date is how an appropriate point on the trade-off should be determined. In other parts of the financial sector where systemic risks do not arise, the paper will argue that regulation should promote competition through disclosure, auditing and enforcement. Sections 2 and 3 will discuss these issues in the domestic UK context, which is clearly the main focus of the FSMA. The paper will then consider international aspects in section 4, in particular in relation to the European Commission.

Having considered how regulation impacts on the structure of financial systems, the paper will then turn to how financial systems affect the real economy. There is a growing body of literature that points to the importance of the design of financial systems for economic activity. Section 5 will briefly review this literature.

Section 6 will bring the two strands of the argument together in a consideration of the criteria that should guide the formulation of financial regulation and an assessment of current legislation.

2 Bank regulation

An interim report on UK banking in 1998 co-ordinated by the UK Treasury and headed by Don Cruickshank raised a question which until then had received little debate: what is the appropriate balance between regulation and competition?[1] In banking, the nature of the trade-off is clear. Charter values are the most significant incentives that can be provided for depositor protection. Charter values offer a cushion against poor performance and discourage the excessive risk taking that otherwise afflicts banking. But the creation of charter values requires limitations to be imposed on competition and entry into banking. Depositor protection can be provided but at a cost of limiting competition in banking. What is the appropriate balance between competition and investor protection?

Since the 1840s, Britain has opted progressively for protection of depositors over competition. In the first half of the 19th century, Britain was populated with a large number of local banks. Local banks were important in the funding of manufacturing. Many bankers were originally engaged in a business for which banking was a sideline. They launched banks as a way of funding their activities.[2] They were therefore knowledgeable about both borrowers and the trades in which they were engaged.[3] However, the existence of 800 small, private banks, empowered to engage in note issuance, caused serious stability problems. Over the period 1809 to 1830 there were 311 bankruptcies of country banks. The Bank Charter Act of 1844 which created the supremacy of the Bank of England did not eliminate banking crises: there were further crises in 1847, 1857 and 1866.

Large banks are less exposed to local disturbances and have more resources available to them than small, local banks. In response, banks withdrew from the illiquid

[1] Cruickshank (1999)
[2] Cottrell (1980), p14.
[3] Deane (1965)

investments in which they had been engaged and began to spread their activities geographically. In 1850, the average English joint-stock bank operated five branches; by 1913 they operated on average 156 branches. As a consequence, concentration increased dramatically: in 1850 there were 459 banks in the UK; by 1913 there were 88 and in 1920 the "Big Five" banks (Barclays, Lloyds, Midland, National Provincial and Westminster) accounted for 80% of English bank deposits.[4]

A convenient relation between the Bank of England and the banks therefore gradually emerged by which the clearing banks faced little competition and the Bank of England faced little failure. As a consequence, British banking became a club of a small number of large members. The cosy relation was disturbed by the arrival of foreign banks during the 1960's and the diversification of the secondary banks from their traditional retail lending activities into more speculative asset investments, prompting the secondary banking crisis in the 1970's. Nevertheless, the UK has endured less failure than, for example, the US. The critical question that this raises and has not been adequately addressed is how should an appropriate point on the trade-off be determined.

Inadequate competition is thought to create problems of excessive pricing and cost inefficiencies. In fact, UK banking is not for the most part characterized by static inefficiency. On the contrary, it is quite efficient in comparison with most of its Continental European counterparts.[5] Furthermore, it is unclear whether it is excessively profitable. Traditional measures of profitability do not take adequate account of the fact that banking involves relationships and risk sharing between lender and borrower. If banks support firms during periods of financial difficulty then it is reasonable to expect them to earn high rates of return during periods of economic boom. One cannot therefore draw inferences from observations on the profitability of banks during a period in which the UK economy has enjoyed an exceptionally long period of sustained growth.

The real cost of excessive regulation is probably neither static inefficiency nor excessive pricing but its impact on diversity and innovation of services. The failure

[4] Collins (1991), p 37.
[5] See, for example, Sarkis (1999)

of financial institutions to finance activities and investments that would have been funded under a more lax regulatory regime is difficult to measure and hard to observe. In contrast, bank failures are major events that create political storms. Unless considerable care is taken, there is therefore a natural inclination for the political process to introduce an inherent bias in favour of depositor protection over competition.

3 Non-bank domestic regulation

It is not just in relation to banks and depositors that there has been extensive regulation in the UK. Ever since the South Sea Bubble, investor abuse been a highly charged political issue. In response, minority investor protection has become more extensive in the UK than in virtually any other country. Recent international comparisons[6] suggest that both the UK and the US offer investors high levels of protection and that the UK and US are not dissimilar in the degree of protection that they offer shareholders. However, the UK provides more protection to its creditors through its insolvency code than the US Chapter 11.

One area in which shareholder protection differs between the UK and US is in relation to takeovers. The takeover code was introduced in the UK to achieve fair play in takeovers and to ensure that minority investors were not disadvantaged. Unlike the UK, the US has no 30% equal price rule requiring a bid for all shares in a company once 30% of shares have been acquired. There is no equal price rule in the US as there is in the UK requiring all shareholders to receive the same price as the highest price offered to any shareholder. Instead, the US relies on fair price rules to protect investors.

While the regulation of banking is primarily concerned with systemic failures, the regulation of non-banks is not. The main market failures that afflict non-bank institutions are market manipulation, imperfect information and contract failure through poor enforcement.

[6] See La Porta et al (1997)

Market manipulation: The efficient functioning of markets requires the avoidance of market manipulation through private information and dominant positions. Individuals are deterred from participating in financial markets in which they believe there is a risk of manipulation and abuse. This requires the active policing of market transactions and the prosecution of market abuse.

Information: Evaluating information of financial products and institutions is complex and expensive. Investors are discouraged from participating in markets in which they believe that they are at an information disadvantage. In particular, they avoid institutions and markets that they believe are afflicted by risks of losses from bad management or fraud. Disclosure rules and auditing of information are fundamental to the operation of and competition in these markets.

Contract failure: Contract failure is primarily associated with fraud. Risks of fraud can be diminished through rules requiring assets and monies to be held by separate custodians. Active auditing by private as well as public auditors assists in the identification of fraud. It is widely recognized that financial fraud has been difficult to prosecue in the UK in the past. The strengthening of powers of the regulator in this regard is clearly welcome, though questions of accountability have been raised. Other papers in this volume consider whether proposed appeals and compensation mechanisms offer adequate safeguards but the UK is clearly starting from a position in which powers to prosecute have been weak.

The regulation of non-bank financial institutions therefore hinges on information disclosure, monitoring and auditing and enforcement through the courts. Intermediaries that evaluate the quality of management and systems employed by financial institutions can help inform investors. Such institutions perform a function similar to that of credit rating agencies in bond markets but instead of rating risks of bond defaults they assess investor exposure to losses from fraud and operating failures. Investors can be further protected through private insurance markets. Indemnity and fiduciary insurance are widespread in the US but comparatively underdeveloped in Europe. In the absence of systemic risks, private insurance markets can enhance investor protection.

There has been considerable variation in the way in which different countries have employed these regulatory instruments. In Continental Europe, asset management firms are for the most part subsidiaries of banks and insurance companies. They have large amounts of capital and are able to draw on the resources of their parent firms in the event of financial problems. The entry of small firms is limited. In the UK, there are many small asset managers employing modest amounts of capital and offering specialized services to particular client groups. Regulation imposes limited capital requirements that are, as far as is practical, risk based. However, there are detailed rules regarding conduct of business and best practice to which financial institutions are required to adhere. In the US, there are few conduct of business rules and capital requirements are restricted to certain classes of financial institutions, such as brokers and insurance companies. Instead, US regulation emphasizes the importance of disclosure of information to investors, auditing of the behaviour of institutions and the imposition of penalties, in the event of failure being uncovered.

Systems of regulation therefore vary between those treating financial institutions as banks, as in Continental Europe, to those relying on disclosure, auditing and enforcement, as in the US, with the UK falling between the two. What is important to appreciate is that it is not necessarily the case that one system offers a greater degree of investor protection than another. Particular levels of protection can be achieved in different ways. The US emphasizes market systems. The UK has relied on conduct of business rules. Continental Europe has used capital.

Europe has therefore opted for *ex ante* systems of regulation that pre-select on the basis of capital and conduct of business rules. The US has rejected these in favour of the *ex post* auditing of firms and imposition of penalties where failure is uncovered. The example of regulation of takeovers mentioned above illustrates the difference in approach. The UK (and the European Union after the implementation of the Takeovers Directive) prescribe the rules of engagement in takeovers. The US in contrast permits price discrimination but facilitates minority protection in the courts through for example class action suits.

The advantage of disclosure, auditing and enforcement is that it does not prejudge what is acceptable. It does not require institutions to amass large amounts of capital before they are allowed to transact. It does not presume that there is a single best way of transacting business and impose common rules of conduct. Instead, it allows institutions and investors to choose how to organize their business and where to invest. If malpractice is uncovered then there is a significant probability that it will be uncovered through auditing and penalized through the courts.

While competition in banking is limited by systemic risk considerations, this does not apply to many other financial services. Instead, where systemic risks do not arise, regulation should be designed to promote competition and the operation of markets through enhancing information disclosure, auditing and enforcement.

4 International aspects of regulation

What is meant by the location of financial institutions and markets when financial institutions can sell their services globally from any location and investors can transact in any financial market? In the absence of legal, regulatory or tax differences, there is probably no sensible answer to this question. Regulation and taxation effectively define the location of a financial institution. Conduct is regulated on a host country basis and prudential regulation on a home country basis. Operating in UK markets means abiding by UK conduct rules. Operating from UK markets means abiding by UK prudential rules.

If institutions are mobile between markets then they will seek the regulatory and tax regimes that impose lowest burdens. If investors are mobile between markets then they will select the regimes that provide their preferred combination of investor protection and cost of investment. They will not necessarily select lowest cost regimes any more than they automatically choose highest risk investments.

Where there are systemic risks then there are spillovers from one institution and market to another. Individual regulatory agencies will not take adequate account of the international repercussions of failures in their domestic markets. The protection of financial and monetary systems therefore requires international harmonization of regulation. In the absence of such harmonization, competition creates a run to the bottom. However, where systemic risks are not present, regulation need not and should not be harmonized. Competition between institutions and between financial centres in selecting different standards encourages product variety and efficiency in the delivery of financial services.

There are substantial differences across countries in the structure and organization of financial institutions such as investment managers, pension funds and venture capital firms. For example, the regulatory rules relating to capital requirements and segregation of client funds differ appreciably within Europe. This makes it difficult for investors to know on what basis they are transacting. The response of the European Commission is to seek harmonization of rules. Whether it intends to harmonize on UK relatively light prudential regulation or the much more extensive rules that apply to Continental investment firms integrated in banks, is yet to be determined and will be controversial.

But there is an alternative approach that eschews harmonization and seeks to improve disclosure, private insurance and enforcement. Investors are then free to choose the basis on which they wish to invest and transact. Provided they are informed about the degree of protection offered by different markets and institutions, investors should be able to select their preferred level of protection. Competition will then emerge between markets in the degree of protection that they offer and the type of institutions that they attract.

What is crucial for competition to operate is that investors are aware of the quality of services and protection offered and the ability to enforce contracts where failures occur. As in the regulation of financial institutions, the key to the successful development and integration of markets is information. Rules on disclosure should be strengthened to allow investors to select the markets and institutions with which they transact. Regulatory rules regarding disclosure of accounting and market transactions are far tighter in the US than in the Europe. This is the proper focus of attention of the European Commission rather than extensive harmonization of prudential or conduct of business rules.

5 The real impact of financial systems

The argument to date has been that where systemic risks arise in relation to banking then there is a tradeoff between competition and depositor protection and systemic risks necessitate harmonization of prudential rules across countries. Where systemic risks are absent, as in many financial services, then the tradeoff does not arise. Regulation should encourage as much competition and diversity in the provision of financial services as possible through information disclosure, auditing and enforcement. The development of efficient markets in custodianship and insurance should be promoted. Financial centres should be encouraged to compete in rather than harmonize the forms of investor protection that they provide.

Competition and diversity in the provision of financial services can be justified from the viewpoint of investors alone. However, there is a more substantial argument in relation to the financial sector. The financial sector not only provides services to investors but also to the users of capital, most notably the corporate sector. There is accumulating evidence of a relation between the development of a country's financial system and its economic performance. Several studies report a relation between the size of financial systems at the start of a period and subsequent economic growth.[7] Controlling for other considerations, financial development appears to contribute to growth. A range of measures of financial development are relevant - the volume of monetary assets, the size of banking systems and the size of stock markets.

To the extent that it is possible to establish the channel by which financial development contributes to growth, it appears to be through the external financing of firms. Comparing the growth of different industries across countries or different companies suggests that there is an inter-relationship between their growth rates, the extent to which they are dependent on external finance and the development of financial systems in which they are operating.[8] In other words, financial development confers particular advantages on industries and companies that are especially dependent on external finance.

[7] See, for example, Levine (1997).
[8] See Rajan and Zingales (1998).

These results are clearly consistent with the view that a primary function of financial institutions is to improve the allocation of funds within an economy. Corporate, industrial and economic growth are assisted by institutions that direct financing to activities that are most dependent on external finance. The studies therefore provide empirical confirmation at an aggregate economy or industry level of the theoretical underpinning of financial institutions.

Regulation is crucial to the successful development of financial sectors. Using data on degrees of investor protection in many countries around the world, La Porta et al (1997) argue that there is clear evidence that financial systems are better developed and provide more external financing to companies in countries with strong investor protection. In particular, they demonstrate that financial sectors are stronger in common law than civil law countries and they suggest that this reflects the greater degree of investor protection that is generally provided by common law than civil law systems. Strengthening financial regulation, as in the UK, can therefore be justified by its beneficial influence on the operation of its capital markets.

The question that these studies leave unanswered is which institutions and forms of regulation are particularly well suited to performing these functions. Do all institutions and regulatory rules serve all economies equally well or are there some that are particularly critical?

The view is beginning to emerge that there may be a link between financial institutions and systems and the types of activities undertaken in different countries. For example, one study of the growth rates of industries in different countries reveals that information disclosure and protection of minorities increase growth and investment in some but not all industries.[9] The main route through which financial systems influence activity in developed economies appears to be via R&D rather than fixed capital formation.

An area in which the relation between structure of financial institutions and corporate activities is most pertinent is in the "new economy". The financing of new high tech

[9] See Carlin and Mayer (2000).

firms is highly reliant on own funds, families and friends. Once these are exhausted, external equity initially comes from private investors, "business angels", who are actively involved in the management of the investment. Venture capitalists come in at a later stage, acting at more arms-length than business angels and seeking higher returns over short periods. A small fraction of the most successful firms are floated on stock markets; most are sold as trade sales and sales to other investors.

In the US, around 25% of venture capital funds are invested in early stage firms. In the UK, start-up and early stage investments also accounted for around a quarter of venture capital investments in 1984 but this has fallen to a figure of around 4% at present. MBOs and MBIs have substituted for start-up financing increasing from 20% to 70% of UK venture funds' investment. An important reason for the greater success of US venture capital in funding start-up businesses is the structure of the industry. Venture capital in the US comprises two parties – the limited partners, which are the institutional and individual investors, and the general partners, which are the venture capital firms investing in individual companies and entrepreneurs. The general partners manage portfolios of companies and are frequently successful entrepreneurs themselves who want to manage larger portfolios of investments. They therefore provide intermediate technical expertise between the investing institutions on the one hand and the entrepreneurs on the other. Venture capital firms in Europe, including the UK, are generally captive funds that frequently lack the pool of entrepreneurial scientists on whom to draw to provide this intermediary function.

Corresponding to differences in institutional structure of venture capital industries are differences in high tech specializations. For example, the rankings of industries by the intensity of patent registrations in one European country, Germany, relative to a twelve-country average are almost inversely related to those for the USA. Information technology, semi-conductors and biotechnology, for example, are in the top six (of 30) industries by patent registrations for the USA and in the bottom four for Germany. Germany's patent specialization is highest in civil engineering and transport equipment, which are in the bottom three industries for the USA.[10]

[10] Patent specialization indices for 30 industries are calculated from patents registered at the European Patent Office. The correlation between the German and US indices is –0.78 (Cusack and Soskice, 2000).

Different financial institutions and systems may therefore confer comparative rather than absolute advantage on certain types of activities. There may not be a financial system that is best suited to all types of activities. What best meets the needs of old economy firms may be different from that of new economy firms and, even within the new and old economy, different types of activities may benefit from particular institutional structures.

If this is the case then financial systems should be allowed to evolve to meet the financing and governance requirements of their corporate sectors. Regulation that constrains this process will adversely affect real activity. Regulation should minimize this risk by promoting competition and diversity within and between financial systems. This points towards:

- A carefully considered balance between competition in banking and avoidance of systemic risks,
- Using regulation to promote markets through information disclosure, auditing and enforcement, and
- Promoting competition between rather than harmonization of different countries' regulatory systems.

5 Conclusions

This paper has argued that there are three critical issues that arise in the design of financial regulation. The first is the trade-off between competition and investor protection in areas of the financial system where systemic risks arise, most notably in banking. The second is the form that investor protection takes where systemic risks are not present. The third is the degree of harmonization of regulation of different financial systems in the presence and absence of systemic risks.

In the area of banking, there has been a strong emphasis in the UK on depositor protection at the expense of competition in commercial banking over an extended period of time. In other areas of financial services where systemic risks do not arise, Europe has opted for forms of regulation that impose *ex ante* requirements on capital and conduct of business – Continental European countries emphasize the former, the UK the latter. In contrast, the US places more emphasis on disclosure and *ex post* auditing and enforcement.

There are several desirable features of the FSMA, most notably the strengthening of enforcement. However, the emphasis on avoidance of systemic risks at the expense of competition in banking and on *ex ante* conduct of business rules in financial services remains. At the European level, the Commission is pushing in the direction of harmonization, even where systemic risks do not arise. In general, there is inadequate emphasis on using regulation to promote competition and diversity in European financial markets, through disclosure, auditing and enforcement.

The costs of imperfect competition are of course in large part borne by the users of financial services, namely investors. But the repercussions of excessive or inappropriate regulation may be wider than that. There is growing evidence of a link between financial systems and the real economy. This is reflected not only in overall economic activity and growth but also in the balance of activities in different countries. In other words financial systems confer comparative as well as absolute advantage. The importance of financial regulation may therefore come not only from its influence on the trade-off between risks and rewards with which investors are confronted but also from its wider impact on the performance and structure of economies.

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