Financial regulation: what are we trying to do?

The **Deputy Governor**[1] *discusses the objectives of regulation in a liberalised financial world, and how far these are compatible with other aims. The broadest purpose of official intervention in the field is, he argues, to contain systemic risk. Increasingly, financial regulation has also become concerned with providing consumer protection and ensuring high standards of business conduct. And while it is right that regulators are concerned with these issues, if* complete *protection were the aim, then the standards that regulators would need to apply would impose large costs in terms of damage to the competitive efficiency of the financial services industry and the benefit that it can bring to the economy as a whole. The* **Deputy Governor** *suggests that the difficult balance between regulation and competition is inherently a political rather than a technical judgement, and is, perhaps necessarily, determind piecemeal. Nonetheless, he argues that it is important that legislators and consumers are aware of the nature of the trade-off between the economic benefits of free, competitive markets on the one hand, and the social benefits of protective regulation on the other.*

Your conference theme, 'financial market reform and global market integration', has been a topical one for at least the last decade, and I have no doubt that it will remain a topical theme for many years ahead. That is a measure of its breadth and of its importance.

We are in the middle of a dynamic, and self-sustaining, process of technological innovation, liberalisation and intensifying competition, within and across different sectors of the financial services industry, and different markets. And although the process started sooner, and has progressed further and faster, in some sectors and some countries than in others, nowhere does it show signs of slackening.

The nature of the process is by now fairly widely understood and I won't spend time on that this morning, except to make one point. The process we are concerned with is essentially market driven. It was not for the most part initiated as a matter of deliberate, conscious, choice on the part of financial authorities; it originated rather in technological innovation and competitive pressure in the market place. Liberalisation—or deregulation—has certainly played a role. But to a considerable degree deregulation has been a response to market developments, usually outside the original area of control whether in the domestic market or in other jurisdictions. The blurring of boundaries between institutions and instruments, for example, often threatened the effectiveness of the control itself and the viability of institutions within the regulated area. Preserving the control in these circumstances often meant extending it or intensifying it, and the economic costs of doing so made this a less and less attractive alternative to liberalisation.

I am not suggesting that the authorities, either individually or collectively, had—or indeed still have—no choice in the matter or that they are condemned to the role of helpless spectators. To varying degrees they have positively welcomed and encouraged the process as part of a much broader commitment to free markets and more effective resource allocation; and it certainly has brought massive benefits to the users of financial services as a whole in the form of lower costs and a much wider range of products more precisely matched to consumer needs. But I want to discourage the idea that the authorities are entirely free agents as far as liberalisation is concerned. The costs of standing out against the market tide are an important constraint on the extent to which the authorities can choose whether or not to be part of the process of financial reform, although they have more choice over the pace and timing within their particular jurisdiction.

But rather than discussing the nature of the process of financial reform, or its wider economic benefits, I want to focus my remarks this morning on regulation, and in particular on the various *objectives* of regulation in a liberalised financial world and how far these are compatible with other aims. I have a sense that society is coming to expect an awful lot, including all the benefits of free markets on the one hand and increasingly high standards of protection against a widening range of financial risks on the other. I am all for high standards. But I am concerned that, without proper understanding of the limits to which protection in this or that particular area can be provided without compromising other, equally in themselves, desirable objectives, then public expectations are bound to be disappointed. The danger then is that a defensive reaction on the part of the regulators, or behind them the legislators, might shift the balance between conflicting objectives in a way which, if not fully considered, can produce a worse rather than a better overall outcome in the longer term.

(1) In a speech to the Chatham House Conference on 'Financial reform and global market intergration', on 18 May 1992.

The broadest, and I suppose the original, purpose of official intervention in the financial field is to avoid *systemic disturbance*, within the banking system in particular but not now confined to that, that would seriously damage the functioning of the economy as a whole. There are clearly other aspects of policy—from macroeconomic monetary and fiscal policy to policies designed to ensure the integrity of payments and settlements arrangements, for example—that have an important bearing on this. In the regulatory context the key element is the setting of minimum prudential standards for individual financial institutions.

There is an obvious tension between this regulation to contain systemic risk and increased competition. Under increased competition the pressure on profitability leaves firms, and markets, less well protected against loss than they were, and results in a natural tendency for capital standards to be driven progressively lower because the less the capital cover on any particular transaction the more cheaply that service can be provided. Minimum standards are therefore necessary to ensure that this process does not cause the more prudent firms to be dragged down by the less responsible, leaving the system as a whole vulnerable. But for this purpose the required minimum standards need not be so demanding that no individual institution could ever conceivably fail. In fact if they were, regulation would impose unnecessary costs on the wider economy by unduly *constraining* competition. Balancing these objectives therefore means avoiding excessive regulatory requirements. Desirably too it means that those requirements should be broadly equivalent across institutions undertaking similar activities—the well known level playing field.

Regulation to provide protection against systemic risk remains fundamentally important, and that risk is increasing with financial liberalisation and globalisation. It is being addressed through increasingly intensive co-operation between financial regulators to establish effective oversight of financial groups and financial markets as well as comprehensive minimum prudential standards, both multilaterally—at the EC, G10 and wider international levels—and through strengthened bilateral relationships. But there is still an immense amount to do in this field, even in relation to banking regulation, which is furthest advanced.

But increasingly, financial regulation is becoming concerned with providing protection at the level of individual consumers, depositors, investors and even borrowers. It is probably this *consumer protection* aspect of regulation that is now dominant in the public mind. It has several dimensions.

Above all there appears to be a growing public expectation that the public should be *protected against all loss*, or even temporary inconvenience, caused by the failure of a financial institution. The implication of this is either that *no individual* institution should be allowed to fail, or that, if they do, the depositor/investor should not be allowed to suffer but should be compensated either by the Government or the industry. The reasons for this, at least in the case of the smaller, unsophisticated, depositor or investor, with no effective means himself of assessing counterparty risk, are understandable. But if we go too far in this direction the potential damage to the long-term health of the financial system is disturbing. In the extreme case deposits would simply flow to the highest bidder irrespective of the risks of the business he undertook; and competition would be doubly distorted if the more prudent intermediaries were required to bear the costs of compensation. If he *were* faced with this degree of responsibility the regulator would be bound to react by imposing prudential standards of such severity that no financial intermediary would be likely to fail —a cost that would necessarily be passed onto the consumer, to the detriment of the economy as a whole.

Higher standards of consumer protection are also expected in relation to *business conduct* by financial intermediaries, involving varying degrees of detailed elaboration, in law, in regulations or codes of conduct, of the principles of honest dealing. The reasons for this, too, again especially in relation to the smaller, less sophisticated consumer, are entirely understandable in the light of unacceptable practices that have come to light in financial markets around the world in recent years. I repeat—as I said at the outset—that I am wholly in favour of high standards of behaviour. That is not the issue. My concern is that it should be understood that seeking to impose uniformly high standards of behaviour essentially through regulation, rather than, for example, relying to a greater degree on the commercial effect of reputation and standing, at least in professional markets, has a cost which the consumer ultimately has to bear. It is not a free good available in unlimited amount—so that, each time more is demanded, the readily apparent *benefits* need to be weighed against the less visible and immediate *costs*. It is disturbing in this respect that demands for more regulation of financial business behaviour are quite often accompanied by complaints about the cost of financial services, especially those supplied to smaller depositors or investors.

Finally, under the general heading of consumer protection, although it does not quite fit there, there are rising demands for the *prevention of crime*, whether it be fraud, or abuse of the financial system to launder drug-money or the proceeds of other serious crime, or to finance terrorism. This too is, self-evidently, an admirable objective in itself. And, as with the other aspects of consumer protection, regulation certainly has an important contribution to make. Regulators can seek to ensure that financial intermediaries are run by 'fit and proper' persons, for example, and that financial firms have adequate systems and procedures in place to minimise abuses. Regulators also have a more general responsibility to be vigilant. But here too a balance has to be struck. It is no more possible for regulation to prevent *all* such abuse of the financial system than it is on a broader plane for the police authorities to eradicate all crime. In both cases the most that can realistically be expected is that the policing activity should represent a very powerful deterrent. Other objectives—which are also desirable in themselves—would unavoidably be radically compromised if absolute prevention *were* to be expected.

Mr Chairman, I hope that all this does not sound too much like a rather unmelodious rendering of Gilbert and Sullivan's famous song—'A policeman's lot is not a happy one'! That observation does, of course, contain a very profound truth. But it is not *all* that I am trying to say.

Regulators are, quite rightly, expected to attempt to pursue *all* the objectives I have identified—and it is an exhausting, but not necessarily exhaustive list; and they are rightly expected to do so with professionalism and vigour. For the most part I am sure that they do. But they cannot reasonably be expected to guarantee 100% success in the area of consumer protection, whether one is talking about protection against loss, or against malpractice, or against criminal abuse.

If too much is expected in this respect, there is a serious risk of moral hazard. If depositors and investors feel they are relieved of *all* responsibility for counterparty risk (ie for dealing only with those they can be reasonably sure they can trust) or if shareholders, directors and managers, who must clearly take responsibility for the running of their firms feel that *all* they need to do to be above reproach as far as prudent conduct or honest dealing are concerned, is meet the requirements of their regulators, that would place an intolerable burden on regulation. And the standards that regulators would then need to apply would impose huge costs in terms of damage to the competitive efficiency of the financial services industry and the benefit that can bring to the economy as a whole. Crudely translated into terms which relate directly to the individual, there is not much point in arrangements which provide absolute protection against risk in relation to financial transactions, if this means that the cost of those transactions puts them out of reach.

There has to be a balance. But that balance is difficult to pin down. It is, perhaps necessarily, determined *piecemeal*, through a range of separate pieces of legislation, or separate sets of national or internationally-agreed regulatory rules—rather like a fiscal process that provides for ad hoc expenditure decisions taken continuously through the year quite separately from revenue decisions.

Nor is what is expected wholly embraced by the rule-books at any particular time. It depends partly too on public reactions to particular incidents, and on the response to those reactions in Parliament or Congress or in the Diet. The way in which regulation is administered is inevitably sensitive to these sorts of pressure—and that can affect the balance too.

It is not for me to say where precisely along the spectrum the balance between conflicting objectives should be struck. It is why I entitled these remarks with a question—Financial Regulation: what are we trying to do? That is inherently a political rather than a technical judgement. But the outcome in different national jurisdictions will determine the minimum standards that can be agreed internationally, and these in turn will have a significant influence on the pace and pattern of financial reform and globalisation.

My concern is that politicians, parliaments, and the wider public behind them in different jurisdictions, should properly understand the nature of the trade-off between the economic benefits of free, competitive, markets on the one hand and the social benefits of protective regulation on the other. I am sure that this question will be among those that you will discuss over the next two days and that this conference will help to promote that public understanding.