Some thoughts on financial regulation

*The **Governor** considers[(1)] the objectives of financial services regulation, and the extent to which regulation can be expected to provide protection in today's financial markets. He notes the trade-off between the tightness of regulation and cost, not just direct costs but also the resulting constraints on competition in financial markets from tighter regulation. The **Governor** stresses that there will be failures of financial intermediaries under any conceivable regulatory regime, and that these need not imply a failure of regulation. In the end, it comes down to how much risk society wants to see in the financial system, although we must of course constantly strive to improve the quality of regulation. On the institutional structure of regulation, the **Governor** notes that it is necessarily complex, though no more so in the United Kingdom than in other developed markets. There are many variants on the structure, and no structure can be set in stone because market conditions can evolve.*

It is hard to remember a time during the past 20 years or so when there was not public debate about some aspect or other of financial services regulation. But it is equally hard to remember a time when that debate embraced just about *every* aspect of financial services regulation—banking, securities and insurance as well as market regulation—as it does now. I welcome the present debate, because I agree with those who argue that getting the regulatory system right is of crucial importance to the future of one of our key industries, both in this country and south of the border.

But, if we *are* to get it right, the debate needs time. Much of the present discussion—as so often in the past—is in reaction to concerns about particular regulatory incidents. There are, too, concerns about the complexity of the regulatory structure, which causes frustration both to the regulated and to those whom regulation is intended to serve. Certainly there are important questions that need to be addressed. But I should like to start this evening by standing back a bit from these more immediate questions and ask what it is in fact that we are trying to achieve through financial services regulation—the reasons for public intervention in this area—and to consider the extent of the protection that regulation can reasonably be expected to provide in today's financial markets.

What then is financial regulation trying to achieve? There is in fact an increasing number of distinct objectives.

Historically, the first objective was *protection against systemic risk*, that is the risk that the failure of one financial intermediary would infect others, creating more general financial instability and economic disruption. Essentially, this is a problem of externalities. Particular institutions, in managing the risks in their own businesses, would not necessarily allow for the damage to the economy at large that would result from their individual failure, nor bear the costs themselves. This provides the basis for public intervention—in practice, the setting of minimum prudential standards for individual intermediaries, supported by the possibility of last resort financial assistance where prophylactic supervision fails and where systemic damage might otherwise result.

Traditionally, this concern related solely to banks, which were particularly vulnerable to the effects of contagion because of their distinctive role in maturity transformation (with short-term liabilities matched by longer-term and typically non-marketable assets) and in the payments system. Nor are such threats limited—as is often assumed—to the failure of very large institutions: in fact in recent UK experience, systemic threats to the banking system, ultimately requiring multiple lender of last resort assistance—in the early 1970s and again the early 1990s—arose in the small-bank sector, although that has not necessarily been the experience elsewhere. For the time being at least, these distinctive characteristics of banks largely remain. But it is a real possibility that, in today's far more complex and highly integrated financial markets, systemic threats can also arise from the failure of other types of financial institution and in almost any part of the world.

A second, distinct, objective of financial services regulation is *a degree of protection of individual depositors*—or investors or insurance policy-holders or pensioners—*against loss in the event of the failure of their particular financial intermediary*. This too in practice involves the setting of minimum prudential standards, supported in this case by collective protection schemes. Typically such protection is limited in amount, with the essentially *social* purpose of shielding retail consumers who may be ill-placed to assess the financial soundness of particular intermediaries—without at the same time providing an outright incentive to place funds with whoever promises the highest return, regardless of risk.

(1) In a speech at a joint meeting in Edinburgh of the Edinburgh Finance and Investment Seminar, and the Glasgow Discussion Group on Finance and Investment on Wednesday, 28 February 1996.

Now the question in relation to prudential regulation—for either of these purposes—is just how far it should go in seeking to reduce the risks of failure of individual intermediaries. All forms of finance necessarily involve risk, and the willingness of financial intermediaries to take on, and to manage, risk is the essence of their contribution to the economy. Prudential regulation is designed to protect the financial system and individual depositors and investors and so on, by limiting 'excessive' risk-taking by financial intermediaries. But there is a trade-off. The tighter the regulation the greater the costs—not just the direct costs of regulation itself, but more importantly the effect of the constraints imposed on the ability of intermediaries to compete by offering cheaper and more innovative and varied products and services—which would ultimately be to the detriment of the consumers of those products and services generally.

Of course this is not meant to excuse the regulator from thoroughly understanding and responding to the increasingly complex risks undertaken by financial intermediaries in today's markets, nor from applying rigorously the prudential standards that *are* established. But it is also important that the public at large should understand that there will be failures of financial intermediaries under any conceivable regulatory regime, and that they need not imply a failure of regulation. Otherwise there is the danger that every incident will simply ratchet regulation a notch tighter, to the point where not only the financial services industry is damaged but also those it serves.

A third objective of financial services regulation is *protection against business misconduct on the part of financial intermediaries*. This has been a particular growth area over the past decade but it extends potentially across a very wide range of financial business behaviour, and remains especially difficult to pin down with any precision. The justification for intervention in this area, in relation particularly to retail consumers, again rests largely on asymmetry of information—it is essentially a social argument for protecting consumers, who necessarily rely upon purportedly expert financial advice and assistance, against being sold a pup, whether through sheer negligence or incompetence extending through deliberate deception to fraud. Disclosure requirements and requirements to give good advice, taking account of the suitability of particular products or services for the particular customer, and to deliver those products or services at fair prices, do not apply to most non-financial goods and services to the same degree. This is perhaps because of the particular complexity of financial transactions or perhaps because financial transactions—particularly long-term financial transactions—often involve a high proportion of the consumer's financial assets. The same justification for intervention does not apply in relation to wholesale market transactions between professionals. In this case it probably has more to do with the need for transparency, to ensure that the market has sufficient information to enable it to operate efficiently and is not manipulated. Again this is a question of responding to an economic externality.

In either case, given the diversity of financial transactions and of market participants, there are difficult questions relating to the appropriate forms of intervention—from reliance on disclosure standards, or guiding principles or codes of conduct to detailed regulatory rules; there are difficult questions relating to the range of instruments or services that should be covered by these different forms of regulation; and there are difficult questions concerning the relationship between regulation and adjacent areas of the criminal or commercial law. And underlying all this, there is the extraordinarily difficult question of just how far the system should go in providing protection in all these various areas, or where the balance should be struck between the responsibility of the customer and the responsibility of the intermediary. Here too there *has* to be a balance. With inadequate protection, or inadequate disclosure, the customer will lack the confidence to use the financial markets. If on the other hand he is encouraged to believe that he will be protected come what may, he will have no incentive to take normal precautions, like shopping around and seeking a second opinion, and intermediaries will be discouraged from offering the range of products and services that they might otherwise because of the uncertain liability that they might then incur.

My own instinct, for what it is worth, is that in this area of business conduct, we are more likely to get the balance right through emphasis on disclosure, and on education and training—both of those working in the financial services industry and of the general public—than through increasingly prescriptive regulation, which would anyway be likely to result in disappointed expectations. I do not under-estimate the demands that this would make on the industry—but so too would increasingly detailed regulation.

This list of objectives is not exhaustive. Financial services regulation is, for example, becoming increasingly concerned with assisting in the *protection of society at large against crime*, through relatively new responsibilities for ensuring that financial intermediaries have adequate systems for detecting and reporting drug monies or other proceeds of organised crime. But it will serve for the purpose of my present remarks.

In a broader sense, of course, *all* the different dimensions of public intervention are designed to maintain public confidence—both international and domestic confidence—in our financial services industry. In this sense I agree that 'good' regulation is good for the financial services industry as well as for its customers. But that doesn't make all regulation good, and at the same level of generality 'bad' regulation will have the opposite effects. In the end I suspect that it comes down to how much risk of various kinds society as a whole wants to see in the financial system. You can go so far in squaring the circle by trying to improve the quality of financial regulation—and that obviously is what we must in any event constantly strive to do. But beyond a certain point less risk is, as I say, likely to mean more cost—in the broad sense I have described, including the effect on the competitive vigour of the industry. Before we try to reach conclusions about the future shape of the system of financial regulation I would hope there would be more debate about the nature of that trade-off, which is intrinsically a matter of political judgment.

Let me turn now briefly to the less fundamental but also difficult issue of the institutional structure of regulation. What we have now is sometimes criticised as incoherent—having just grown up in response to changing social priorities, or grown out of a changing domestic and international market environment, with no overall design. Single firms are regulated for different purposes by different regulators with different particular objectives. Many see these arrangements as unnecessarily burdensome and complex, and look for varying degrees of simplification, ranging from regulatory consolidation in particular areas to radical change to perhaps just one or two regulators across the whole field. It is a tempting thought, but I'm not sure just how easy it will be in practice.

The fact, of course, is that the financial services industry is made up of a number separate industries or functions or activities, notwithstanding the blurring of the boundaries that has taken, and continues to take, place. Individual firms may be involved in any or all of these functions, operating just in this country or increasingly around the world. No-one has suggested, as far as I am aware, that you could sensibly have the same regulatory regime for all the different financial functions; nor different regulatory regimes for the same function. These factors together—or so it seems to me—preclude some of the more obvious forms of simplification of the regulatory structure, such as regulation *purely* by type of institution or regulation *purely* by function. In the first case each institutional regulator would need to apply the business rules appropriate for every function—which would be hugely inefficient in terms of regulatory resources. In the second case functional regulators would be unable to apply prudential rules to the financial institution as a whole (and it is institutions that ultimately fail) unless each function were separately capitalised—and that would be hugely inefficient in terms of the capital that intermediaries required. So what we have at present is something of a matrix structure where, broadly speaking, financial businesses are regulated institutionally for prudential purposes and functionally for purposes of business conduct.

It is—I think necessarily—complex, though no more so than in other developed markets, for example, in the United States. Now it would be possible to put the institutional and functional regulators under one umbrella—or at least fewer umbrellas. But the essence of the matrix problem—requiring both institutional and functional regulation—would remain. It can only be resolved effectively by close co-operation between different—specialist—regulators (including overseas regulators), whether they wear different institutional labels or simply different 'divisional' labels from within the same regulatory institution. Now that does not necessarily mean that some, further, institutional consolidation of the regulatory structure is not worth undertaking—there are many ways of skinning this particular cat and it may well be that in some areas, consolidation would make co-operation, between some domestic regulators at least, easier to achieve. In any event no structure can be set in stone—the markets continue to evolve and so too must the regulatory structure. But there are limits to what one can expect simply by putting different regulatory activities under the same roof.

An alternative approach in the longer term might be to seek to structure financial regulation on the basis of different regulatory objectives, such as those that I identified earlier in my remarks. In principle this approach could have the considerable merit of clarifying the objectives of different regulators. But I suspect that in practice you would still need specialist institutional and functional regulators, which would, in the interests of efficiency, need to straddle the different objectives in some degree, so that there would still be a need for close practical co-operation between different regulatory interests—again whether they remained institutionally distinct or were divisions of larger groupings.

I don't pretend to know the answers to all these questions, but of one thing I am sure. That is that they will be increasingly put over the years ahead and the way in which they are answered will be of huge importance to the future of the financial services industry—and of its customers. I draw them to your attention to encourage you to involve yourselves in the debate before positions crystallise.

In the meantime, whatever else we do, we must increase our efforts to improve the quality of financial regulation. By that I mean the quality and expertise of the people engaged in regulation but also the extent of practical co-operation between them—both within the United Kingdom and between our people and their counterparts abroad. The Bank is very actively engaged on both these fronts. In the wake of the Barings incident, we have commissioned consultants from Arthur Andersen to help us identify how we can improve our performance and ensure that our standards—throughout the supervisory function at the Bank—are as consistently high as we can make them. And we are involved in active discussions, with other regulators, domestically, in Basle and with IOSCO, within the European Union and across a range of countries bilaterally, directed at intensified cooperation in the prudential regulation of multifunctional and international financial institutions. I know that other UK regulators, including market authorities, are similarly engaged in this process. We need, too, constantly to improve the quality of those employed in the financial services industry—which is an important job for you. And we must all try to improve public understanding of financial risk—what the public can and should reasonably expect in terms of protection against that risk but what is expected also of them as consumers.