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# Let's risk under-regulation!

**B**usinesses are probably more regulated today than they have ever been, not just in the UK but around the world. Indeed, I would say that most businesses and industries are now over-regulated. This trend may not be inevitable, but there is not much sign of it slowing down, let alone reversing. With respect to regulation, what I expect and what I hope for in the future are not quite the same. I believe we should risk a bit of under-regulation for a change!

## **Why over-regulation?**

Modern economists sometimes refer to a straw man of 'perfect competition' based on perfect knowledge and zero transaction costs. This leads us to regard any shortfall from such an unreal state of affairs as 'market failure' and to assume that governments can correct it, but can they?

Renowned economist Alfred Marshall used to ask: "Do you mean government all-knowing, all-wise, or governments as they are today?"

Two further points strengthen this fear of free markets. First, the media tends to dramatise specific items of bad news as if they were typical. Secondly, there is usually a further implicit assumption: that it should be possible to prevent such 'disasters' – which is often not the case.

Regulators are risk-averse. If it were up to them to approve a new drug which promised to save lives, but had a slight chance of serious side-effects, it is not surprising they would be inclined to defer approval until they were sure the drug was 100% safe. The months or years of delay may mean thousands of patients dying as a result. However, as those affected by the delay are 'invisible', the regulators have little incentive to care about them.



A recent example of over-regulation is the account of a coastguard who saved a 13-year-old girl stranded on a cliff. In his concern to save the girl's life, he breached health and safety rules by not being roped up for the descent. As a result, he was reprimanded and forced to leave his job. The coastguard said: "Saving her life was the important thing. She had been stuck there for 45 minutes. The cliff edge was crumbling away and I didn't think I had time to wait." In this situation, the regulators were more concerned with the process than the ultimate goal.

### The costs of regulation

The direct costs of regulation are only a small part of the total costs involved. The compliance costs to a business often amount to five times as much as the direct costs. The hassle factor can also be a serious cost to a business although is harder to quantify.

Perhaps even more important are the indirect effects: for example, all the jobs that employers fail to create because of the costs of 'employee-friendly' legislation. Those rules may indeed be beneficial to existing employees – who are highly visible – but perhaps not to potential future employees, who are not.

It is usually the case that retail purchasers of financial services will have less knowledge than the providers and therefore can often find it hard to tell which providers are both honest and competent. The same 'asymmetry of information' also applies for doctors and garages.

However, given that in financial services some transactions may be very large, a mistake could cause serious financial loss. Also, with few 'repeat' purchases (most people only buy one pension), the normal market safeguard of reputation may not work very well. So there may be a need for some regulation, at least for retail provision of financial services. The question is - what sort and how much?

The author of the Financial Services Authority (FSA) system, Professor Gower, rejected any kind of cost-benefit analysis. He himself was not competent to undertake it and was sceptical about its usefulness. Such an approach gave the FSA an incentive to over-regulate, hoping to avoid scandals at almost any cost. When a scandal does occur, 'despite' the existence of extensive controls, the preferred 'solution' is nearly always to reinforce failure with yet more regulation! The Sarbanes-Oxley legislation in the United States (which was a response to Enron and other frauds) is an extreme example.

Let me give you some idea of FSA regulation:

- The full FSA handbook contains 10 sections
- The section entitled 'Prudential Standards' comprises 11 sub-sections
- The sub-section 'Prudential Sourcebook for Banks, Building Societies and Investment Firms' is made up of 14 sub-sub-sections
- The sub-sub-section 'Market Risk' contains 11 sub-sub-sub-sections
- The sub-sub-sub-section on 'Interest Rate PRR' has 66 paragraphs!

In total the FSA Handbook may contain over one million paragraphs. This is what some people call 'principles-based light touch regulation' – a million paragraphs of 'principles'! Such a highly prescriptive regulatory regime tends to focus on inputs rather than outcomes. It can lead to 'box-ticking' and it may be slow to respond to changing market conditions.

Many restrictions involve more or less fixed costs, which vary little with a firm's size. They represent a much larger share of total costs and revenues for smaller businesses. This leads to large businesses sometimes even welcoming costly rules, as a barrier to entry to gain advantage over smaller rivals. The details of the rules matter far more to large producers than to consumers which is why they often seem to 'capture' regulators.

Another practical problem is that often (though not always) the regulators mean well. So it is easy for them and politicians to take the moral high ground when their endeavours end in disaster, but is this justified? Philosopher Herbert Spencer refers to the chemist's assistant who poisons a customer by mistake. He is condemned for meddling with matters he didn't understand.

Economic rules are a means to an end; therefore the notion of 'balance' and 'trade-offs' is central. However, with social questions, the notion of 'balance' is much less evident. For example, if provision for the disabled is fairly cheap when erecting new buildings, then on balance there may well be net benefits in doing it. However to force owners to convert old buildings at huge expense within a short time period may not make sense.

Many new laws merely amend earlier rules that didn't work properly, or had unintended harmful side-effects. Once the principle of interference in a particular area is established, it seems to be difficult for the regulators to withdraw completely. Like traffic lights, regulations tend to creep across the whole urban landscape and rarely disappear.

The information regulators acquire comes mostly from incumbent producers. Market practices improve incrementally, not all at once in discrete steps. However, regulators tend to think in terms of 'standard' procedures and quality levels. The very notion of competition as a way of dealing with uncertainty is alien to them. Hence rules can amount to a 'ceiling' which it does not pay to exceed.

There is a big difference between voluntary guidelines (or 'suggestions') and compulsory rules ('instructions'). This affects not only the likely costs of compliance and the complexity of the regulation, but also the regulators' attitude. Are they aiming to provide genuine value, which implies listening, or are they just telling people what to do? Moreover firms may come to regard themselves as answerable to regulators rather than to customers.

Wall Street speculator, George Soros provides a useful reminder: "There is a natural tendency to regard [regulators] as superhuman beings who somehow stand outside and above the economic process and intervene only when the participants have made a mess of it. That is not the case." He continued: "They operate with imperfect understanding and their activities have unintended consequences. Indeed, they seem to adjust to changing circumstances less well than those who are motivated by profit and loss, so that regulations are generally designed to prevent the last mishap, not the next one."

### Voluntary market solutions

Rules can emerge, and win general acceptance, without any official body designing and imposing them. For example, most business schools require – as a rule – a minimum GMAT score for entrants to their MBA programmes. This is not required, and most schools will make exceptions on occasion – but 'as a rule' means what it says.

Companies use brand names to encourage customers to trust them. To win repeat business, reputation is important. Hence investment in a brand often enables brand owners to charge premium prices, as well as sustaining market share, because they give consumers assurance, which they value.

Another protection for consumers can stem from insurance. By requiring certain actions, and perhaps also requiring the insured to bear part of any loss, insurance companies can give those producers seeking protection an incentive to behave well towards consumers.

Retail products vary dramatically, for example the car market includes both Rolls-Royces and Skodas. By pretending to insist on 'best practice' for everyone regulators condemn average consumers

to pay for more quality than they actually want. What is the need to insist on better than 'adequate' standards? The real question is: who should choose, if not the customers themselves?

And what about voluntary regulation? Certain firms could advertise the fact that they are 'Members of the British X Association'; 'Chartered Y'; or 'Licensed Z'; while other firms may not be. Or else, most firms could be regulated, and others would have to declare themselves not – in which case, 'caveat emptor' (let the buyer beware).

### How to 'improve' regulation

There are many possible ways for governments to improve regulations, six of which are outlined below:

- Consider voluntary rather than compulsory rules
- Employ a 'devil's advocate' to argue against imposing rules
- Attempt a cost/benefit analysis, including compliance costs and other 'indirect' effects. Establish a very clear balance of advantage before regulating
- Insist on looking at outputs, not just inputs. For example, instead of just focusing on compliance with speeding laws, quantify how many road deaths per million miles travelled
- Use 'sunset' clauses making regulations expire after a certain time unless renewed
- Consolidate rules in a single document and simplify the terminology used.

The bad news is that unless governments start changing their approach to regulation, the burden on both producers and consumers is going to get even worse than it is today. The good news is that things do not have to be that way. By all means let us try to have better regulation, but we also need to have much less regulation. MF

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