Financial Regulation When the Government Goes For Growth: A Systemic Risk Centre Roundtable

In his 2022 Mais Lecture, Prime Minister Rishi Sunak – then Chancellor of the Exchequer – drew attention to one of the fundamental challenges now facing the UK:

> We are caught in what we might call a 'great slowing down' across the western world, that began even before the Covid pause. Productivity, living standards, and dynamism are not growing fast enough… So the question we face today is urgent and it is consequential: How do we accelerate growth, and, in doing so, restore people's faith in the free market?

Effective financial markets can play a key role in accelerating growth by: i) enabling firms to pursue the long horizon strategies that produce the innovations that fuel growth; and ii) reducing the risk of a financial crisis that derails the economy. Effective financial regulation in turn promotes effective financial markets. Consequently, putting into place an effective financial regulatory regime should be a core element of the government's growth strategy.

To explore what an effective financial regulatory regime might entail in practice, the LSE's Systemic Risk Centre (SRC) organized a Roundtable on 6 October. Lutfey Siddiqi (Visiting Professor in Practice at LSE IDEAS) chaired the panel, which featured:

- Kevin R. James (Co-Investigator at the SRC), proposing a new Market Effectiveness Committee to fix the market effectiveness underlap in the UK's current regulatory architecture;

- Charlotte Clark (Director of Policy at the Association of British Insurers), arguing that effective financial regulation means good regulation rather than lax regulation;

- Eva Micheler (Professor of Law at LSE Law School), making the case against giving the FCA and the PRA a Growth and an International Competitiveness objective;

- Jon Danielsson (Reader in Finance at the LSE and Co-Director of the SRC), suggesting the UK could improve financial stability and growth by allowing firms to take diverse approaches to dealing with risk instead of forcing homogeneity through prudential regulation.

A video of the event is available on the SRC website, and we provide a brief summary of each panel member's contribution below.

Kevin R. James: The UK Needs a Market Effectiveness Committee

Creating the innovations that drive total factor productivity (TFP) growth takes both ideas and firms that process those ideas into new products or techniques. New research by Kevin R. James, Akshay Kotak, and Dimitri Tsomocos finds that: i) an economy's idea processing capacity (and so growth prospects) increases with financial market effectiveness; and ii) the quality of financial regulation significantly influences the level of market effectiveness. Given the critical importance of accelerating economic growth in the UK, bringing about the effective financial markets that provide the foundation for a dynamic, innovative, and growing economy should be the principal goal of financial regulation.

But, in practice, it isn't a goal at all. To improve the UK's growth prospects, then, the Government must fix this flaw in the UK's regulatory architecture.

The FCA focuses upon investor protection. This means that financial regulation engages with people in proportion to their direct exposure to the financial system. But that is obviously wrong: a person's direct exposure to the financial system does not capture the total impact of ineffective markets upon them. The life prospects of people in the North East of England are not blighted because they pay too much for prepaid funeral plans, but because of the UK's disastrous TFP performance and the long lasting consequences of the financial crisis. Investor protection (as important as it is) isn't going to fix that.

Improving financial market effectiveness requires understanding and acting upon the financial system as a system. Acquiring this system-wide perspective in turn takes deep analytical and research capabilities.

The Bank of England's financial stability objective does give it a system-wide perspective and it has put into place the analytical/research capabilities needed to pursue it. But the focus on stability and the constraints of its mandate lead to the Bank engaging with markets in a defensive manner. That is, it takes the overall effectiveness of the financial system as given and works to minimize financial crisis risk given the system as it is. Consequently, the Bank is not going fix ineffective financial markets either.

So, there is no regulator with the mandate, powers, incentives, and capability needed to pursue a market effectiveness agenda. Consequently, the UK now suffers from a market effectiveness underlap that is analogous to the financial stability underlap the UK faced before the 2008 financial crisis.

The UK fixed its financial stability underlap by creating the Financial Policy Committee based at the Bank. The UK can fix the market effectiveness underlap by creating a Market Effectiveness Committee (MEC) based at the FCA.

Basing the MEC at the FCA makes sense because the FCA's mandate and legal powers could, with limited alterations, provide the MEC with what it requires to pursue an effectiveness agenda. To create the system-wide perspective the MEC needs, MEC membership would consist of senior FCA officials, outside members, and representatives from other regulatory/government bodies with responsibilities that affect market effectiveness (e.g. the Bank, BEIS, HMT, etc.).

While the MEC would be based at the FCA, it would be a distinct and high-profile part of the FCA with a specific mission to pursue market effectiveness. By being a separate high-profile unit with a specific mission, the MEC will have an incentive to focus upon its market effectiveness mission and the FCA will have a strong incentive to ring-fence the resources the MEC needs to function. If the FCA was assigned the market effectiveness mission without putting into place the MEC structure, there would be a significant risk that the resources needed for market effectiveness would be drained away to deal with matters that attract greater public attention but which are ultimately less important.

To improve market effectiveness, the MEC would need to identify areas where the status quo is not good enough. This task necessarily involves counter-factual analysis and so requires deep analytical and research capabilities. The FCA does not now emphasize these capabilities. So, to be successful, the MEC would need to operate more like a central bank. This would require a significant culture change at the FCA, and bringing this culture change about would not be a trivial task. Nonetheless, creating a successful MEC at the FCA would probably be easier than putting the MEC at the Bank or creating a new market effectiveness regulator (leaving the FCA to focus on consumer protection).

Continued low TFP growth will produce an economic, political, and social catastrophe for the UK. The government is rightly focusing on crafting a growth strategy to avoid this dismal future, and improving financial market effectiveness must be part of it. Creating a Market Effectiveness Committee would be a good start.

Kevin R. James (@kevinrogerjames) is an economist and Systemic Risk Centre Co-Investigator. Kevin's research focuses upon i) the relationship between financial market effectiveness, regulation, and economic performance; ii) economic and regulatory aspects of systemic risk; iii) corporate finance; and iv) the economics of fund management. His research on these topics has been published in leading finance and economic journals. He has previously worked at the Financial Conduct Authority, the Centre for Central Banking Studies at the Bank of England, the FSA, and the SEC. He has a PhD in Economics from UCLA and a BA from Swarthmore College.

Charlotte Clark: Good Regulation Provides the Foundation for A Thriving Financial Services Sector

While people might think that the financial services sector is always demanding a bonfire of regulations, this is not in fact the case. Financial services firms know that good regulation provides the foundation for a successful financial services centre, and that a successful financial services centre contributes to overall economic performance. So, if you care about growth, you care about good regulation.

Good regulators have the knowledge, respect, and powers required to create a regulatory regime that provides investors with stability and security. If people are going to invest and/or deal with risk through insurance contracts, they need to know that their insurance provider will be there when they are in a position to collect. A stable and secure insurance sector that people can trust enables them to delegate complex risk management tasks to the insurance sector so that they can concentrate on issues that matter to them.

Of course, there is potentially room for improvement!

Brexit provides a good opportunity to review the structure of UK financial services regulation. That said, while the financial regulations under which the UK now operates did come from the EU, those EU rules were in turn heavily influenced by UK ideas and proposals. Consequently, many aspects of the rules may not necessarily be far off from where they should be.

One significant area of regulation that is under review now in both the UK and the EU are the Solvency II rules. The rules have been in operation for 5 years now, and this experience with how the rules work in practice does highlight aspects of the rules that could benefit from reform.

One key area of possible reform for the UK involves asset allocation rules for Life Insurers and DB Pension funds. Life Insurers and DB Pension funds now each manage about £2 trillion (that is, an amount equal to UK GDP). Obviously, it would be fantastic if these enormous pools of capital could be used to promote growth in the UK economy.

Needless to say, this idea has occurred to all Governments in recent times. But there are real challenges in tapping into this pool of assets in a way that does not undermine the stability and security of the funds themselves. If it was easy, it would have been done already. But this will definitely be an important agenda item going forward.

One factor that has hindered regulatory reform is that the EU regulatory process took a very long time. Solvency II took 10 years, for example. Re-shoring financial regulation therefore creates the possibility of making the UK regulatory process more agile.

A big constraint on regulatory agility, however, is the incentive structure of the regulators. Basically, their failures are very public and their successes are little known. This asymmetry naturally leads the regulators to be very risk-averse, and risk aversion is the death of successful regulatory reform. The Government's plan to give the regulator's an objective to promote growth may offset their natural risk-aversion and so lead them to be more open to sensible reform proposals.

Charlotte Clark CBE is Director of Regulation at the ABI (@BritishInsurers), with accountability for relations between the insurance industry and the Bank of England on prudential regulation, for relations with the Financial Conduct Authority on conduct regulation, and also for taxation issues affecting insurers. Charlotte joined the ABI in 2020 after leaving the civil service, where she worked on financial services regulation at HMT and the DWP.

Eva Micheler: The Case Against Giving the FCA and the PRA a Growth and an International Competitiveness Objective

The FCA has three primary objectives: protecting consumers, keeping the financial services industry stable and promoting competition. The PRA is responsible for financial stability.

The Government is considering giving the FCA and the PRA two additional secondary objectives: i) to promote long-term growth; and ii) to enhance the international competitiveness of the UK financial services sector. It will be argued in this contribution that this is a bad idea.

Regulators are not equipped to engage in a political discourse on how to best achieve long-term growth. The trade-offs in determining how to best enable the economy to grow are for Parliament to debate and the Government to decide. If the regulators were to serve long-term growth, they would require substantial guidance and intervention from the Government. This would then undermine the independence of the Regulators.

Regulators are there to serve consumers ensuring that the providers of financial services are robust and deliver on the promises they have made to those, who entrust them with their money. For this they need independence.

Moreover, a good way to stimulate growth are project that improve infrastructure. It is tempting for the Government to try and fund infrastructure investments through pension savings. There may be a good financial case for a pension fund to invest in a particular type of infrastructure project. This investment may also contribute to economic growth. But very importantly not all infrastructure projects that the Government deems desirable for economic growth also generate financial return for investors. It is important that the Regulator stands between pension savers and the Government's political funding priorities. This ability will be undermined if the Regulator also has the mandate to stimulate growth.

Turning to the objective of enhancing the international competitiveness of the financial services sector. This objective opens the Regulator up to being manipulated into protecting the competitiveness of existing financial firms at the expense of consumers.

To illustrate the mechanism that could lead to this outcome, consider the case of the rules governing the way that securities are held. In ongoing research, Eva Micheler and Elena Zaccaria find that incumbent financial intermediaries (custody firms, etc.) do not provide a service that enables investors to exercise their rights.[1] This problem is well known and has been highlighted by Andrew Bailey when he led the FCA.

When new rules are proposed to correct this failing, incumbent firms respond in the consultation period with comments that support their existing business models. And they could hardly do anything else, as responding in any other way would adversely affect their shareholders and other stakeholders.

[1] Forthcoming

Unfortunately, Government tends to respond to consultations by quantifying the responses without analyzing them very deeply. Since incumbents have very strong incentives to respond while individual customers have limited incentives to invest the time and effort needed to advocate for reform, the pool of responses is biased towards the opponents of reform. Evaluating responses without taking this bias into account leads government and/or regulators to think that the case for reform is much weaker than it is and so to reject reforms that would in fact advance the interests of consumers.

So, while growth and an international competitiveness are important objectives these should not be pursued by the either the FCA or the PRA.

Eva Micheler (@EMicheler) is Professor in Law at LSE Law School and Systemic Risk Centre Co-Investigator. She is also an ausserordentlicher Universitätsprofessor at the University of Economics in Vienna. Eva studied law at the University of Vienna and at the University of Oxford before joining the LSE Law Department in 2001. She holds the venia legendi from the University of Economics in Vienna. Prof. Micheler was a TMR fellow at the Faculty of Law of the University of Oxford and teaches regularly at Bucerius Law School in Hamburg. Her most recent book was published with Oxford University Press and is entitled Company Law – A Real Entity Theory.

Jon Danielsson: What do we want to get out of regulations?

Financial regulations are vital. But do they give us what we need?

The objective of financial regulations can only be to maximize high level social objectives, like economic growth, subject to us not suffering too many costly crises and abuse of clients (macro and micro), as well as broader social objectives like protecting the environment and social cohesion.

$$Max \frac{Growth\ and\ other\ social\ objectives}{Undesirable\ outcomes}$$

We are not doing this joint social constrained optimization.

Instead, regulations focus only on the denominator — preventing undesirable outcomes. Which means only controlling the risk of something terrible happening and building up buffers, in practice de-risking.

For that to work, three conditions have to be met.

First, risk has to be measurable. For that we need a riskometer, an instrument that we can plunge deep into the bowels of the City of London and get an accurate reading of risk. We can then design a feedback mechanism so that we increase it if risk is too low and decrease it if risk is too high.

However, risk isn't measurable in that way. It is easy to measure the risk of day-to-day events because we have a lot of data to train our models on. But we don't care about this day-to-day risk. What matters is the extremes. What is the chance that ten-year interest rates in the United Kingdom increase from 3.2% to 4.5% in one day, as happened last week, or the stock market will drop by 25%? Since we have practically no data on these events, we estimate the risk of day-to-day events (say 10 basis point changes in yields or 5% market drops) and assume the distribution applies to the extremes. The vicious margin feedback loops the pension funds suffered as a consequence of the 130 basis point increase shows what can happen when we get that wrong.

The second condition is that risk has to be well defined, a monolithic block we can shape to achieve our objectives. But it isn't. What is risk to a pension fund is not risk to a high frequency trader or a bank. What is risk to a small bank is very different to what it is for a large bank. Every individual and institution has a different view of what important risk is. So by treating it as a monolithic block, a considerable nuance is missed. And forcing the institutions to behave based on this monolithic risk block is inefficient — a waste of resources that might not achieve much. A risk theatre.

The final condition is that the buffers need to be sufficiently large. But unfortunately, buffers that are large enough to protect against the most extreme outcomes are also too large to be economically unviable. If we can’t buffer extreme shocks, then we also need the ability to absorb those shocks.

Dependence on risk being monolithic and measurable has misled the architects of regulations. A long time ago, regulations used to be based on activity. Financial institutions were restricted to particular activities. Today, we are much more likely to tell them what level of risk is acceptable, how they are to measure that risk and what they are supposed to do when that risk is too high. Regulation therefore forces homogeneity upon how financial firms deal with risk. And this reduces the ability of the system to absorb shocks and so decreases financial stability.

The way shock absorption works is to ensure that when some adverse shock hits the system, the financial institutions disperse it instead of amplifying it (just like the shock absorbers in a car). The way to achieve that is to make the institutions of the financial system diverse. A shock comes along, and some institutions buy, and others sell. That way, the shock is dispersed. Unfortunately, this is not the way we do things today. Because everybody has to be prudent, when a shock comes along, the prudent institutions have to reduce risk immediately, which means selling risky assets into a falling market, amplifying the shocks. Like the pension funds last week.

Thus, financial regulations, especially macro prudential regulations, have amplified procyclicality since 2008, thereby increasing and not decreasing systemic risk.

So coming back to the goal of financial regulation:

$$Max \frac{Growth\ and\ other\ social\ objectives}{Undesirable\ outcomes}$$

If we focus too much on risk it is not possible to hit the optimum, if only because risk is so imprecisely measured.

So what should we do instead? First, increase the diversity of the institutions in the financial system. Make them as different from each other as possible.

We can't, of course, force them to be diverse. Still, a very good start would be for the financial authorities to stop being anti-diversity and instead actively grant licenses for new types of financial institutions, with new business models, new ideas, and new ways of doing intermediation.

The standard objection is: "we have to protect the users of the system". Of course, micro-prudential and conduct rules are essential. But, users are not very well served by regulations that both limit diversity and increase the cost of doing business (where those costs are, of course, borne by those same users).

If we make the system more diverse, then: i) systemic risk will decrease, leading to less frequent and milder financial crises; and ii) the provision of financial services will become cheaper and more efficient. Both effects help with economic growth. Both effects help with meeting the objectives of financial regulations.

A win-win-win not The Illusion of Control.

Jón Daníelsson (@JonDanielsson) is Reader in Finance at LSE and Co-Director of the Systemic Risk Centre. His research interests cover systemic risk, financial risk, econometrics, economic theory and financial crisis. His latest book, The Illusion of Control: Why Financial Crises Happen, and What We Can (and Can't) Do About It, published by Yale University Press, is out now and will be launched on 10th November at LSE - details here. He has written two other books, Financial Risk Forecasting and Global Financial Systems: Stability and Risk and published a number of articles in leading academic journals. Jón writes regularly about his research on modelsandrisk.org and he blogs on VoxEU.