# Redesigning financial regulation of pensions and other retail products

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Things have changed quite a lot recently in the field of pensions due to the developments with the Pension Protection Fund and the new pension protection schemes etc. Indeed, if you would indulge me, I would like to spend the first ten minutes talking about some of the hot topics in finance. This will tell us what is happening in the sub-prime mortgage area in finance in the United States, and how that is leading to market volatility. I want to talk about this partly because there is a connection between that and the risks that pensioners face. One of the themes of the lecture series over the past couple of years has been that financial market risks have generally moved from institutions to pensioners, and I will talk a little bit about an example of this occurring. I will then focus on some of the problems with the regulation of pensions, and at the end I will propose some possible solutions to that.

Volatility and investor risk aversion has come back to financial markets after quite a long break. We have seen equity, bond and credit markets being quite volatile over the past couple of weeks or so. Initially there were some attempts to blame China for causing this volatility, but now market participants have come to focus on the problems in the sub-prime mortgage market in the US.

If you are not familiar with that term, it is basically mortgages being given to people who probably ought not to have them, or certainly people who have got a less than average credit history or perhaps no credit history at all. About 13% of these mortgages are now in arrears, and some 4.5-5% are in default.

Just for comparison, some of you have heard me talk about microfinance before; one of the interesting things about microfinance in developing countries is that the default rates there tend to be around one percent. So if you were to compare microfinance with sub-prime mortgage, then there clearly is a problem. The markets get a bit scared about this, as they always do; markets are places of quite schizoid behaviour, and there is either immense greed or immense fear. But in actually the sub-prime mortgage market is really quite small relative to the rest of the financial system. Only about 10% of all mortgages in the United States are sub-prime, and of that 10%, only around 4 or 5% is actually in default today.

But I am not so sanguine, and I would like to give you a bit of a background on some of the implications for finance in general and pensioners in general. Without getting too biblical, we have had seven years of feast when it comes to financial market liquidity. This really started off around the time of the dot-com collapse in 1999. The Federal Reserve responded with very aggressive cutting of interest rates, although what really got them aggressive was when the concerns in the dot.com sector began to become concerns about investor confidence in general. So in fact the Federal Reserve, the central bank in America, only really began aggressively cutting interest rates when we had the Enron disaster and the WorldCom disaster, which undermined confidence in the financial system in general. They cut interest rates from around the 5% mark to below one percent. In 2003 we had a low point, with US interest rates at around 80 basis points, so that was 0.8 of one percent. Compared to where UK mortgage rates are now that was pretty low.

We cannot just blame the Federal Reserve. At the same time, the Bank of Japan had interest rates at near zero, trying to recover from a decade long of deflation, and even the European Central Bank had interest rates quite low. Therefore, the average interest rate around 2003 in the major economies in the world - America, Japan, and Europe, the three biggest economies - was an average of about one percent. Many of us argue that the central banks kept rates too low for too long. Of course it is easy to say that in hindsight; there was always a lot of uncertainty at the time, but I think the evidence increasingly is the case that too much liquidity was fed into the financial system. This liquidity pushed up asset prices - the prices of shares and bonds - not least because the prices of goods was kept down by imports from China and other emerging countries. Thus, as the price of your fridges and computers were falling, the price of stocks and bonds rose.

Indeed, when the Federal Reserve began raising interest rates one of the problems they had was that they had already ignited some asset market inflation, and so pools of capital were coming towards America anyway. The largest pools were probably the result of the commodity exporters, who have had a huge windfall as a result of commodity and oil prices being high. If you are a small state in the Middle East with a couple of oil wells, what can you do with the money? You invest it in US Dollars in the United States. Also, another pool of capital coming to the United States was from Asia because after the 1997 financial collapse in Asia there was an excess amount of investment, and so savers did not want to invest in Asia and their savings came to America. Therefore, the Federal Reserve began raising interest rates at the same time as money began flowing into America independently, and so even though they were tightening monetary policy there was no shortage of liquidity.

One of the implications of that is it pushes interest rates down. If there is too much money around then the yield you can get from having money falls. That led to something passive and something active. Passively, it led to a revaluation of any asset which people tended to borrow money to buy. If borrowing money is cheap, borrowing money to buy property for example is cheap, more property is bought and so we had an asset market revaluation of anything which is normally leveraged. Property is a very good example but it was not just property. You could argue that the private equity boom we have seen in recent years, where companies borrow to buy stocks listed publicly and take them private, was part of that gain.

But low yields also led to something active: it changed behaviour. Investors' appetite for risk increased. The reason why this happens is that when you can earn, as you can today, about 5% by keeping your money very safe in the bank, you are not too worried about investing in risky things. When you are only earning 0.8 of a percent, and indeed the banks often gave you even less, because that was what the banks themselves were getting from the Federal Reserve, then you are thinking, 'Where can I earn an extra bit of yield?' That yield-hungry behaviour translated into an increased appetite for risk: people trying to get returns by taking on more risk than they would normally.

The key point here is that the problems in the sub-prime mortgage market is not some unusual exception related to just some bad credit rationing or bad credit decisions, but it is actually something far more general. Sectors of the market where asset prices have gone up and where people have borrowed immensely to buy these new assets are actually quite common, and that is why I am concerned that what we are seeing in the sub-prime market is probably something that will not die a quiet death but could become contagious into other parts of the financial system. Indeed, I think that the ingredients of contagion are there in the sub-prime mortgage market, because one of the things that happens when a sector is in trouble is that investors or people owning parts of that sector carry out a fire-sale of the their assets. So even if the rest of the mortgage market is much better regulated and much stronger, a fire-sale of properties for which there is sub-prime mortgages on could have a knock-on impact on the property market in general, which will undermine the collateral for other loans. So the ingredients of contagion are there in this sub-prime market.

Now I come on to the link between what is happening there and pensions. The financial markets have changed quite dramatically in the past 20 years, but I do not think most commentators have changed with it. Commentators tend to think that financial markets are fine unless a bank has failed; unless there are nice dramatic headlines of financial companies closing, things are really okay. Indeed, there have been some dramatic headlines, of odd occasions, be it Equitable Life or New Century Finance in America, a sub-prime mortgage company, but on the whole, the main banks look quite solid. But I think that one of the interesting things that has happened in finance is that our regulators have focused on institutions and they have made the institutions safer. In effect, regulation has been a tax on risk in institutions. But what do people do when they get taxed? They try and avoid the tax, and so institutions have shifted the risk to other people, which in general means individual investors and pensioners. Therefore, the institutions, the banks, look a lot safer, but that is not a measure of the financial system being safer, because the pensioners are the ones carrying the risk. I am not entirely sure that if you had a choice of where you would put the risk systemically that this is the right place for the risk to be.

Some people could say that this is a reasonable position because it is diversified across millions of pensioners; I would say no, because pensioners may not be able to manage that risk and understand that risk in the same way as a bank might be able to do so. This is the link between some of the trouble we are seeing in financial markets today, which I believe could get worse, and how that feeds in to pensions. Therefore, I think a measure of the health of our financial system today is not banks looking so robust, but it is the size of pension deficits. If you look at correctly measured pension deficits around the world these deficits are huge, and so it is odd for me to say that the financial system is safe. However, people say that it is safe, because banks are not failing, even as pension deficits are very large indeed.

Let us talk a little bit about pensions. One of the hallmarks of financial regulation has been a focus on the institutions. Indeed, in you could define regulation as bottom-up regulation. This is a common feature of regulation around the world. It is the belief that if we make individual institutions safe we make the system safe. It is actually an interesting belief because it is not at all clear that this is the case. The underlying idea of it is that systemic risk is made up of individual risks. It is quite possible for you to have individual risks which are large but systemic risks which are small, or more worrisomely, individual risks which are small and systemic risks which are great. Therefore, I believe that this concept that making individual institutions safe makes the system safe by is quite a worrying concept, especially since it is so easily accepted.

One of the other implications of this approach is that regulators focus on institutions and tax risk amongst them, the institutions then push risk somewhere else. Regulators then start saying, 'Risk has now moved from banks to pension funds. Let us now regulate the pension funds and the insurance companies.' They tax risk in that area, and so those institutions shift the risk to somebody else. By observing where the risk is going we can see that there are two interesting consequences of this regulating. One of them is that regulation becomes bigger and bigger. Thus today, America has 26,000 regulators, costing some £2.5 billion. In the UK, we are much more modest; our regulation probably costs around £300 million, and we have about 2,000 or so regulators. What is interesting to me is that back in 1999 the regulators at the Bank of England cost us about £10 million, and so we have increased the cost of regulation about 20-fold, and I am not sure that our financial system is 20-fold better for it. We have increased the number of regulators dramatically. I think this is a natural consequence of bottom-up regulation: of regulating one area, finding they have moved regulation to another, regulating that area, pushing regulation to another sector, and it goes on and on. Regulation will keep on creeping.

But here is the other consequence, which is perhaps an even more important consequence since regulators are at least employing lots of people making it a growth business. The other disturbing consequence is that the risk will end up in the system in places that you cannot see. Risk will keep on getting shifted until the regulator can no longer see it. That is probably the worst place for risk to be, and yet, that is a natural consequence of bottom-up approach to regulation. Though my friends at the FSA might accuse me of being rather Stalinist, I believe that we should begin by asking where should risk be, rather than looking at where risk ends up. There are certain places which are appropriate for risk, and we should ask ourselves, if risk is not ending up there but ending up somewhere else, either you can say, 'How do I get risk to be where I want it to be?' or you could say, 'How do I make sure I am not stopping risk going the way it ought to be?'

A good example of this is the whole issue of credit risks and liquidity risks. This is because one of the other problems of bottom-up regulation is that it gets very complex. Complexity means that regulators become run by lawyers. I have nothing against lawyers but you find that regulatory organisations become full of lawyers and the economists are a tiny group under siege. Behind this is a very important, powerful and good principle of law, which does not translate very well to finance: the equality of treatment. So the regulators turn round and say, with their lawyers? hats on, 'Surely, if we treat one institution like that, we have to treat them all like that?' But actually equality of treatment is not the right approach in finance, because what it does is it creates homogeneity. If I treat all institutions the same, they will tend to all end up behaving the same, but a key part of finance and financial liquidity is diversity. For every buyer, there is a seller who has a different view than the buyer. If we all had the same view, when I want to sell an asset you do too, leaving no one willing to buy it. Financial markets exist and liquidity works when we have a diversity of views, strategies, and risk management practices, but regulators, with their legal bents coming from other sectors, push this 'best practice' equality of treatment creating homogeneity which increases financial fragility. Thus the logical consequence of a bottom-up approach to regulation is that regulation gets shifted to those places we do not see and creates systemic homogeneity, which makes the system more fragile. That does not seem to be the right thing.

I think that one of the things we need to do is make sure that regulation fits in with the problem we are trying to solve. One of the good things about economic analysis is it tries to focus on what the problem you are trying to solve is. Solutions work when they are addressing a problem. It sounds like a fairly banal thing to say, but one of the problems of financial regulation seems to be that we have lost sight of the problem we are trying to solve, because, if you are not in the financial sector, you get heavily regulated as a company: you have product liability rules, you have all kinds of fiscal rules and accounting rules. So the question is why do we regulate financial companies over and above the existing regulation? We do that for two primary reasons.

One is about consumer protection. This is because finance is a fairly unique area whereby when you buy a product, by the time it takes you to work out whether it was a good product or not it may be too late to do anything about it. An illustration of this is, when I go to Northcote Road Market in Clapham and buy a pound of apples, if they are not very good apples then I do not go back to that particular stall. In contrast, if I buy a pension product and 20 years later I find out it was the wrong thing to do, I am in a difficult situation. It is too late to do anything about it. This is why there is a good argument for saying that you need additional consumer protection in the case of finance compared to other areas.

Also, finance is uniquely systemic. So if you imagine that there are two shoe shops in your high street and one goes bust, the other one is happy. In finance, if there are two banks on your high street and one goes bust, it undermines the other bank. People get nervous about the banking system and they begin to withdraw their deposits. You get a run on banks, in a traditional sense. Perhaps the principal reason why banks are systemic is they often lend to each other, and a bank loan, one bank's loan to someone, is someone else's asset, and so losing confidence in loans from one bank can undermine all other banks. This is a very unique feature about banks: they are more systemic than shoe shops or most other industries. Thus we have the two reasons why we regulate. We do not regulate for any other reason in the financial sector.

Increasingly, people have talked about terrorism finance and money laundering. You could add that as another reason to regulate but I am not sure it is a very unique aspect of finance. Therefore there are two unique reasons why we regulate finance: it has consumer protection; and systemic risk. So, given those two things, why have we ended up focusing on bottom-up regulation of institutions? It seems to me we should focus on consumers and systemic issues, but we tend to do neither very well - especially systemic issues, and these are perhaps the principal reason why we regulate.

One of the main systemic mistakes the market makes is the economic cycle. The market is very bad at predicting the cycle. The market is not very bad at assessing the credit quality between two different players. It can assess whether the credit quality of Australia is better than Argentina. It is not very good at knowing whether you are the top of the economic cycle or not. Maybe one reason for that market failure is that the banking system is incentivised to always say there are good times around the corner. You do not get people buying financial products by saying, 'Things are bad and could get worse.' So when things are good, you tend to have good long term stories of why things are good today and how they are going to get better and better. Thus I believe that there are good arguments you can make for why the banking system is not very good at the cycle, and that is where we get the systemic problem: we over-lend at the top of the cycle, and we tend to under-lend at the bottom of the cycle. So this is a fundamental and systemic problem financial regulation should address and yet it says nothing about these cyclical issues. Indeed, many people argue that the existing finance regulation compounds the cyclical problem.

It will be seen that financial regulation deals better with the consumer protection issues. Indeed, I think they obsess a bit more about consumer protection than they ought to. It is one of the consequences of moving financial regulation out of a central bank. At the time when Gordon Brown announced this move that we were going to separate the functions of the Bank of England: it is going to be independent, it is going to set interest rates, it is going to focus on monetary policy, and we will create a new agency, financial services, and this will do regulation. It seemed to make a lot of sense - coming back to the economic principles, different agencies for different issues.

One of the unintended consequences is that when financial regulation was at the central bank, the central bank tends to be more concerned about systemic issues. When you take financial regulation away from the central bank, they obsess about consumer protection, and the problem about consumer protection issues is that really they are never-ending. If you are worried about consumer protection, you can always do more and more, and I think we have ended up stultifying the banking system whereby it is very hard for new entrants to come into the system. So innovation and competition suffer in the name of protecting consumers. Therefore, we need to find a new form of regulation where the points of regulation meet the problems the regulation is trying to solve. I am not claiming to have a blueprint that is better, but I will say that we seem to have the wrong focus and that whatever regulation we do have must address the systemic and cyclical issues very clearly. One of the interesting things about systemic issues is about concentration. Financial regulation should say something about concentration in particular areas, but it does not really do this at present.

What about consumer protection? One idea that John Nugée and I have been playing around with is the idea of, what you might call, trying to protect Aunt Agatha. We are trying to protect the old widow who goes on the Clapham Omnibus and does not know much about finance - we do not want her to be messed around by sharp practices in the City. That is really who we are trying to protect. We are not trying to protect George Soros or Warren Buffett. Thus we need to make a distinction between those we are trying to protect and those we are not.

It may seem that I am being elitist here, but I am not. The problem is that a financial system needs to have losers. This you may find to be an odd thing to say, but for every buyer we want to have a seller. Imagine that the market is going down whereby people want to sell. Aunt Agatha's life savings are going down too far so she is on the front line selling her stocks as they go down. Who is going to be the buyer? The buyer is going to be someone who is prepared to lose - at the beginning - because markets are going down. They are prepared to lose at the beginning with the hope that in the long run, if they hang onto it long enough, they will win out. I do not want Aunt Agatha to be in that position and making that kind of decision. I want the Warren Buffetts and the George Soros' of this world, who can afford to lose money and have time to wait for the rebound, to be in the vanguard. Therefore, I need to have members in the financial system who are relatively unregulated and who are able to play the role of the loser.

Here is an odd thing to say: we need to regulate who the unregulated person is. If we were to have a clean piece of paper and say who would be the unregulated person it would be someone we do not mind losing lots of money, has a lot of financial expertise, knowledge, training and certifications, etc. In many respects those of hedge funds fit this description. They know about the markets and they are experienced, and so hedge funds play a very important role. We would rather the hedge funds are buying markets that are falling than Aunt Agatha is. So if we are going to regulate what Aunt Agatha does to protect her, we need to make sure we have an unregulated sector, otherwise we will have financial dislocation whereby when everyone is selling and there are no buyers. So I would say a key part of consumer protection is actually identifying who it is we want to protect, and who we do not really care if they lose their shirt.

We have something of a system like that today in regulation called 'exempt persons' and we do not regulate their activities too much, but really this 'exempt persons' is a very narrow definition of people who are financial professionals. I think we need to broaden that category to people generally who you do not mind if they lose their shirt. The people we want to focus on in consumer protection are such who you do care if they lose their shirt and maybe you should make the distinction in terms of how much money they can afford to lose, or perhaps you could say it is based on how many years experience they have had in finance. But regardless to how we cut it, we need to exempt a wider group of people and have a larger unregulated area of people we do not mind it if they lose their shirt, whilst also having more regulation in dealing with the systemic issues of the economic cycle, in particular, and avoiding concentration.

Therefore my blueprint would be having an area of exempted people which was larger, and I also think what we need to encourage is the right kind of institutions, taking on the right kind of risk. Let me now tell an important tale I have mentioned a couple of times before, about how pension fund regulation is encouraging people to take on the wrong kinds of risk. In the bad old days pension funds used to have very little regulation and disclosure on what they invested in. We have since moved towards much greater transparency and disclosure, and we have almost a system of marking to market, with some exceptions. One of the problems with that is that it makes it harder for pension funds to buy illiquid assets - not impossible, but if they are forced to mark to market the valuation changes of assets, and most importantly they are forced to respond to these valuation changes. We do not allow them to earn what I called a liquidity premium.

The liquidity premium is a complex concept, but the easiest way to think about it is that if you go to your bank and say, 'I want to put some money on something where I get instant access, I can take my money out, I can leave the bank and come back an hour later and ask for my money back, and there will be no charges.' That is a very liquid instrument, and as a result of that liquidity you will find you do not earn a lot of interest from that. Alternatively, there are some building societies that still have something called postal bonds whereby and you deposit your money for three months, and the yields are higher. That difference is the liquidity premium.

That is the ideal risk that a pension fund should be taking and earning. For example, if the pension fund has got 20 year liabilities, the first premium they should earn is the liquidity premium. Thus they should earn money by not taking any credit risk but simply the risk that they would have a problem if they needed their money between now and 20 years' time whereby they would incur a charge. That is an ideal risk for pension funds to take because they do not need their money between now and 20 years' time and so they get paid for that. However, the move to mark to market and responding to short term changes in asset prices means they cannot earn that premium anymore. If they have to respond to changes in the market and sell assets when prices change up and down, they need liquidity. So instead, the pension funds have moved out of illiquid assets which gave them an extra premium and they have tried to earn the premium by investing in credit risk. They have swapped one premium for the other. Most of them think this is great: 'I can now earn extra premium by buying a diversified collection of credit risk.'

However, credit risk is a unique risk because it is the one risk which goes up the more time you have. To illustrate this let me point to the American car companies who are under a lot of financial pressure, not least because of their health insurance liabilities and their pension liabilities. They are very odd: you think they are car companies, but really they are just big pension plans and health insurance plans, and they are under financial pressure. I give you a General Motors bond which you can sell anytime you like and you have got an asset, and if you sell it back to me tomorrow, you have got an asset. I give you a General Motors bond and say, 'You can not sell that bond, you have got to hold it for the next 20 years,' the likelihood that at some point in 20 years General Motors goes bust is quite high, so that credit risk actually goes up the more time you are holding it. That means that credit risk is something that needs to be managed and hedged actively. In fact, the best person to hold credit risks are the very people who have been selling credit risks - the banks, who have got the expertise to manage it and the access to a wide range outlets to hedge their credit risks. Yet what has happened is credit risks have gone from banks to pension funds whose only advantage is that they have got lots of time on their hands, which is not helpful if you are managing credit risk.

That is an example of how our regulation has actually led to a perverse holding of risks. The system would be safer if banks were holding the credit risk and the pension funds were holding the liquidity risks. Instead, we are doing almost the opposite.

But let me come to a conclusion. As I mentioned at the beginning, I am concerned that the developments we are seeing in the sub-prime mortgage market in the States are not a unique, isolated event and thus not a reflection of the odd poor credit decision. In fact it is symptomatic of seven years of feast of liquidity which has led to an over-evaluation of assets. Therefore people have been able to borrow against, and an increased risk appetite by investors, which mean that they are holding more risk than they think they are holding and they are doing that through overvalued assets. I believe that there are potential avenues of contagion from this market.

One of the interesting things though is who's holding that risk?  Increasingly, that risk has moved from the institutions who first gave the mortgages because they sold those mortgages on, and are being held by pension funds and insurance companies, and they have shifted that risk to the underlying policyholders.  Financial regulation is a bottom-up institution-based regulation.  It is not be the way you would design it if you had a clean piece of paper.  It is institution-focused rather than consumer protection-focused or systemic-focused, which is the problem we are trying to solve, and being bottom-up in a world in which risks are fluid, it is leading to more and more regulation.  As we regulate more and more sectors we chase risk along until it has moved under the bed and we cannot see it anymore.  Here we end up with a system with a large number of regulators but one which is not actually any safer.

I think there are solutions to this.  I think that we can redesign regulation in a way in which people are taking risk.  A very important point is that you need someone in society to take risk.  We get no economic activity if no one is taking risk.  The question is who and where is the right place for risk to be.  Risk is not best under a bed unseen by the regulator.  Certain types of risk are best held in certain places.  I think liquidity risks should be held by pension funds and insurance companies who have got time on their hands, and credit risks should be held by banks who have access to credit, and I think that we can end up with a system that is safer, whilst at the same time in aggregate holding more risks, and that means more growth, more jobs, etc.