Regulatory capture

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There are, on average, about 3,400 new regulations every year. They come from around the 674 recognised regulatory bodies in the UK. We spend £4 billion on regulations; that's about as much as we expect the new national ID cards to cost, but this will be every year. A fair amount of that money is spent on the salaries of 61,000 regulators in the United Kingdom. Quite apart from the health and safety and environmental regulations that affect us all, accounting audit regulations, apart from industries which are in effect public corporations being regulated, like the National Health system, some 30-40% of UK GDP is regulated by one of the super-regulatory bodies like the FSA, the Financial Services Authority, or OFCOM. In the past 35 years, we have basically moved from a nationalised economy to a regulated economy.

I'm not against regulation, per se. Much regulation has come from hard fought battles based on trying to have more decent behaviour by businesses: you think of child labour, you think of discrimination, you think of people working with asbestos. But my point is that regulation has now become so substantial, so significant, so pervasive, that getting it right is of critical importance – critical importance to a competitive and vital economy, critical importance to the protection of consumers, the main purpose of regulation. My concern is that we are getting it wrong, in so many ways, and in so many different circumstances, and when I consider why we're getting it wrong, I'm drawn to the sad conclusion that the prevailing theory, the prevailing idea, is wrong.

The prevailing idea is that we're getting it wrong, regulators are having a tough time, they're not getting regulations right, because they're struggling against the fact that the industries always move more quickly than regulators. That's the prevailing idea: there is nothing wrong with our regulation per se, it's just that regulations are always just behind businesses. There's new technology, new practices – how can the regulators keep up?

There's also a prevailing idea that there are many ways to do regulation, and yes there's an open debate about regulation, and people make mistakes sometimes, but nothing is intentional.

I believe, when I look at the mistakes we are making in regulation, not just in financial services but more pervasively. We're getting it wrong because of regulatory capture. Up and down our country, our regulators have been captured by those whom they should be regulating.

This is not an entirely new observation. It was probably first articulated in Adam Smith's The Wealth of Nations. The Wealth of Nations, if one reads it, is not the gospel of free enterprise some believe; it makes the very important point about the value of competition, but also warns against oligopolies, monopolies and captured regulators.

About 150 years later, the historian Gabriel Kolko also re-introduced the idea in his terms, coming from the left of centre spectrum. He wrote a book called The Triumph of Conservatism and talked about regulatory capture. A decade or so later, from the other side of the political spectrum, the Nobel Prize winner George Stigler also referred to regulatory capture as something that was destroying competition.

It's interesting that this accusation against regulatory capture is an unfashionable one today. Despite the fact that over the past 35 years, we've had the most major shift towards regulation, away from nationalisation in particular. I would say it's because regulatory capture today is second generation capture. It's much more subtle and sophisticated than in the past. It's not about bribery and corruption of officials. I don't believe that happens in any significant way in the United Kingdom. It's about big business persuading regulators about certain principles that seem eminently sensible, although on further examination I believe

are hollow and bankrupt; principles that the regulators grab hold of and believe are right, but actually ultimately support big businesses and the regulated.

I don't say this lightly. I intend to show you how this capture is actually plain to see if you use the right analytical framework, and how we can use this framework to reduce regulatory capture. I sincerely believe that this observation of regulatory capture goes way beyond finance. Indeed, in the literature, regulatory capture was first referred to in terms of transport regulation, but I think it's there across a wide spectrum of industries – transport, broadcasting, health, etc.

What I'd like to do is begin talking about finance, and in particular how we regulate finance, and how that regulation could be very different, and why it's not different. I will then refer to regulatory capture and look more generally at how regulatory capture could be affecting other industries too.

Our regulation today, in finance, is bottom-up, institution-focused. The regulators look at one industry – initially it was the banking industry – and they try to reduce risk in the banking industry. In essence, this regulation is a tax, so they tax risk in the banking industry. What happens when you put on a tax? People try to avoid it. And so risk moves from the banking sector to another sector: the insurance sector, and the regulators say, "Gosh, this insurance sector's got a lot of risks," so they go and regulate the insurance sector. This moves risks somewhere else, perhaps to the pension fund industry, and the regulators start saying, "Hey, there's risk in the pension fund industry. Let's regulate that too." What is the logical conclusion of this bottom-up approach? Put it through its paces. You end up with almost every sector of the economy being heavily regulated, with lots of cost, and risk being pushed to where we can't see it any more. Is that what we are trying to achieve? A huge edifice of regulation, but actually the risk not there any more, but somewhere we can't see it. That risk will only be in the right place by pure accident, by pure coincidence.

There is much that leads us too believe that risk is being shifted from the banks. Banks make a lot of mistakes and there are a lot of reasons why they continue to make those mistakes, but one would assume that banks are some kind of centre of financial expertise. Risk is moving from the banks to individuals. Risk is moving from risk management specialists to those who have no background, no ability, or limited ability, to manage these risks. It is a very odd way of doing financial regulation: taking risk, shifting it from the professional sector, and giving it to individuals. I think this is not ideal. How would we do this differently?

Well, given the way we can observe this, I don't think I am saying something that is rocket science, it's obvious to see: you tax something, they will avoid it. You should actually regulate by starting off by saying where do you want risk to be? Rather than have risk end up by accident, start off by saying where do you want risk to be. That requires you thinking about risk in a very different way than we currently do. It requires you to think about who may be better placed to manage certain risks.

There are broadly three types of risk in finance. There's market risk. Let's say you own a stock, that there is some information that changes the value of that stock. May be the company has had a great set of results and the stock price goes up, or a bad set of results, and the stock price goes down. That's market risk. You also have credit risk: the company goes bust; it's no longer there; the income stream was not just poor this year, it is non-existent this year. So you have market risk and credit risk. You also have liquidity risk: for example, if I have an investment, it may be earning a nice decent return, but I can't sell it, no one wants to buy it. So there are only really three types of risk in finance: market risk, liquidity risk and credit risk. Some people are better able at managing some of those risks.

Take liquidity risk. Imagine you are an insurance company, and you've got some liabilities in 20 years' time, and there is an instrument out there from a high credit rated company. Let's say coke nitrogen Industries, it's got a great balance sheet, a very high credit rated company. But they're in the business of building industrial plants – those aren't very liquid. It takes five years to build the plant, it takes another two or three years before you see the income stream coming in, and so those investors who invest in that illiquid asset get a high rate of return, they get the liquidity premium for investing in that asset. The alternative for the insurance company is to buy the bond, illiquid asset, of coke industries, and that gives them a much lower rate of return because that bond has liquidity. What should the insurance company do? The insurance company should earn the liquidity premium, because it can do: earning the liquidity premium but not sacrificing credit quality. Insurance companies and pension funds, with long term liabilities, should do that. A bank should not earn the liquidity and market risk premium, because they've got short term liabilities. People can go into the bank and take their money out tomorrow. They can't say, well, hang on, you can't take your money out, I've invested it in a plant and it will take me 20 years to sell the plant. So certain places are better placed to carry certain risks.

Take credit risk. Now, credit risk is a very interesting type of risk. Most risks fall over time. If I buy a portfolio of equities in my pension, the risks should fall over time, portfolio factors. Liquidity should fall over time. Credit risk does not fall over time. It rises over time. So just because you've got the ability to earn the liquidity premium, you're a long term player, that's no reason why you should own credit risk. In fact, the person who should own credit risk is a bank, because a bank, especially if it still has relationship banking, which I know is an almost extinct phenomenon these days, the banks perhaps have a relationship with the credit. They understand the credit. And over short periods of time, the credit risk is low.

So thinking in this way, you find that banks should carry credit risk, insurance and pension funds should carry liquidity and market risk. It's very simple. It's a way of reducing systemic risk in the financial system by placing risk in the most appropriate place. If you do that and reduce systemic risk, your next layer of regulation can be quite low. Regulation can be light. The hurdle of regulation can be low because the system is safer. We do the exact opposite. What we say is that credit risks, liquidity and market risks, they're all the same. There is a mantra that there is something called risk sensitivity, all risks are the same, they can be estimated – when I say "the same", I mean they can be estimated, they can be calculated, and therefore a bank can carry all those risks, an insurance company can carry all those risks, and a pension fund can carry all those risks. It doesn't matter. The problem with that, as I've shown you, is that you need a higher burden of regulation because the system is not intrinsically safer.

The approach I suggested would be simple, and is fairly easy to understand. It would not be costly, and it would be focused on actual behaviour of these different entities. In particular, if we have a lower hurdle of regulation, because we've made the system safer, it will encourage entry into the financial system, and therefore encourage competition and innovation. We don't do that. This would be an interesting form of risk management, it is simple, it is not complex, it's low cost, and encourages competition and innovation.

What are the three hallmarks of regulation? Almost the exact opposite. The three hallmarks of regulation, in all spheres, not just finance, are that regulation is costly – set up a company and look at the bill for dealing with the regulations. Regulations are complex – one measure of that is how many lawyers do you need to have in your regulatory department? And regulation is process-driven not consumer-driven.

People look at that, and they say, well, that's because of inefficient regulators, heavy-handed regulators, anti-business regulators. Here is the slightly seditious point: these three things, costly regulation, complex regulation, process-driven regulation, they are items where there's an unusual and dangerous mutuality of interests between the regulators and those being regulated.

Let's take costs. Parkinson's Law states that bureaucracies grow into the space provided for them. If you don't limit the space, they will just get bigger and bigger. Regulators like big staff. You don't get a knighthood for running a regulatory agency with one person in it. Of the 64 national regulatory agencies, over half have staff well over 100, with much overlap between these regulatory bodies. At first sight, you might wonder why should big business like costly regulation? That's terrible! Well it is terrible, for small business. Big business likes costly regulation because it's a barrier to entry. It stops competition.

I always remember a headline in the Financial Times, about two years ago, which said: "HSBC pays seven hundred and fifty million globally on regulations", shock horror, bankers complaining, squealing about this amount of money. And then it occurred to me, who else could pay that? You have to be a big bank to pay that kind of regulatory cost. So those regulatory costs act as barriers to entry to small businesses. It's quite Orwellian. We stop competition in the name of consumer protection. We're stopping competition in the name of environment protection or employee protection. Now these people need protecting, but the best way of getting protection is often, not always but often, competition.

Let's talk about complexity. There are some subtle issues here, but I would argue that big business loves complex regulation. For a start, only they understand it. You're in a much better position with the regulator when you understand the regulations. You've been in it, you've helped shape it, it's very complex. Sitting on the other side of the table is the young graduate the regulator can afford to hire. Often, big business ends up teaching young graduates the regulation. What kind of relationship ends up where you have been working with the regulator in developing and evolving those complex regulations? And when they train up the graduate, where can that graduate go for a job? With their newly acquired skills, one of the very few people who can understand the regulation – the big business.

So in multiple ways, and this is a very important point, complexity is the avenue of capture. There is no reason why regulation needs to be complex. The more complex you see a regulation, and when you hear regulators say, "Oh it's awfully complex, this issue," beware, you can smell the capture.

Process-driven regulation, what do I mean by that? I think it's clearer in banks, so indulge me if I give you another banking example. I had one of the most enjoyable times of my career working for JP Morgan. At JP Morgan, at the time, we were developing a number of products. Some of you may remember my emu calculator; others probably remember risk metrics. Risk metrics has become a process which the regulators now champion. It's a type of approach to risk. It's a very sophisticated approach to risk. Its formulation, its background if you like, it was originally in-house, it was called 4:15. The reason why it was called 4:15 was that at 4:15pm every afternoon, Sandy Warner, the Chairman of JP Morgan, got one number on his desk, which was the number that his bank was exposed to a one basis point shift, a tiny shift, in interest rates up or down. It's a complex system of looking at exposure, looking at the interest rate exposure, and multiplying that through by all the correlations of this exposure.

Risk metrics is a fantastic system if you're the only one using it; it has problems if everyone is using it. But the point is it's a process. Regulators love the process, and big banks love process. Who can invest in the high technology to do the process? The fact that JP Morgan, with all this process, suffered a loss of $30 billion in the dot.com saga is by the by. Some of the biggest banks, using the most sophisticated processes, lost the most money in various bubbles we've had recently, but the regulators' response is not "you've got to overhaul your process", it's "you've got great processes, we're going to reduce your regulatory burden". Under the new banking regulation coming through, Basel II, big banks with expensive processes will have less regulatory burden, less capital charge – that seems a bit perverse to me. The outcome of what's happened is that there are lots of risks out there that they're not managing very well, but because it's process-driven regulation, it's okay.

We've seen very recently various problems in hedge funds using credit markets. Hedge fund managers are scratching their heads and saying this is all because of what they call model risk. They're using some of the most sophisticated models, models that regulators approve of, and finding they're entering into problems. The response? The more models you have, the lower the regulatory charge. We don't worry about the outcome; we worry about the process. Big business loves process. They can invest, they can out-invest any competitor in the process. They can out-invest in technology, in computers. They can always have the best process, maybe not the best banking, but the best process.

The process is also legally heavy. I mentioned earlier about it being second generation regulatory capture. This is not about our regulators being bribed and corrupted. Regulators are decent people, like the rest of us, trying very hard to do the right thing. Big business has managed to convince them of certain principles that are actually not in the interests of the people they're supposed to be protecting, but in the interests of the big business.

Another part of second-generation regulatory capture is co-investing in regulatory capture with others. Lawyers, consultants, accountants – all these people have lots of vested interest in very process-driven regulation. It's very interesting, if you look at the board of many regulators, you will find quite a few consultants. They understand the regulations. They have produced the systems that help you deal with the complex regulations. You've got to buy their systems. I would say big business is co-investing in regulatory capture with the consultant community.

So, what are the measures of regulatory capture? What should you look for up and down the country in terms of regulation? I would say that the best defence we know of, after a few hundred years of trying, is competition. Competition has its problems, and often we need to intervene to try and deal with some of the worst excesses of competition, but often competition is the best way of protecting the consumer, and therefore the prime directive of regulation should be to see how they can introduce competition into a natural monopoly in a way that protects the consumer. Often that will be saying – for example – that you can't have competition in the rail tracks. The rail tracks should perhaps be part of a nationalised industry. But our operators, our managers, we can have competition there. So, what you should ask, when you look up and down the country at regulatory agencies, is how many new entrants have there been in that industry? How much competition is there, not in the whole industry, but at least in part of the industry? How much injection of new ideas, new innovation? How much is the market being allowed to innovate? That's why we have the regulator. That's why we're not a nationalised industry. If we feel there's no way in which the regulator can promote competition, one has to wonder why we made it private. So that's the first thing to look for: the numbers of new entrants, and the sad factor is, if you look up and down at our major regulated industries, it's very rare to find new entrants.

The second thing – I've mentioned this before – is complexity versus simplicity. The third thing is, is it very costly. And fourthly, is it process-driven rather than outcome-driven? Look for those things, and I'm afraid

to say, when you look up and down the country, in transport, in broadcasting, in health, you find those things. You don't find regulation that is simple and cheap. I challenge you to find me some regulation that is simple and cheap and is encouraging tremendous new entrants.

If this regulatory capture is pervasive, what can be done about it? People worry about this. They sit down and they develop elaborate methods of trying to restrict the cross-fertilisation between regulators and the regulated. We have now a number of new rules about whether ministers can get jobs in previously regulated companies, about whether regulators can get jobs straightway, or whether they do not have some kind of period of space before they can get a job in the regulated industry. I'm not sure this is the solution. Certainly, I think there is an issue: if the regulators believe that the regulated are basically their next employers, you have a problem. But I don't think you solve it by banning them from crossing over, not least because it will allow the public sector to continue paying regulators badly, if there's no competition for the best and bright. I think there's actually a very simple, zero cost way of managing regulatory capture.

What every regulator needs to do, before they embark on any regulation, is to write a letter to the press, and to their friends, and to the minister responsible for the regulation, and write in the letter what the regulation would look like if they were entirely captured by the big business interest. They should then stick a copy of that letter on top of their desk, and make sure it's had wide circulation, and keep that in mind every day, every week, that they're engaged with the industry. Knowing the agenda of thy enemy is the best way of avoiding being defeated by them, and I think that's a very cheap way in which we can deal with regulatory capture.

I know that these are strong accusations, but I fear that we have a system of regulation in the UK that is in grave danger of sapping the natural vitality and energy of entrepreneurs in this country. Moving into many of these regulated industries is extremely difficult to start up, almost impossible.

Recently, I was appointed a non-executive chairman of a company with a large number of established fund managers and they wanted to establish a new fund management company. Basically we found, as we looked around to list our funds, that the fund management listing requirement was that in order for you to be a fund manager, you had to be a fund manager, which made it impossible to be a start-up. So the way new entrance tends to occur in these regulated industries is by people buying into the established businesses. This is a real restraint on trade, on competition, on innovation.

I would like to end by saying we must be focused on what the object of our regulation is. It is for consumer protection – other protection too, but that's part of corporate law, like employee protection – but it's primarily for consumer protection, and it's to ensure there are no systemic risks, and we need to do this in the most transparent, in the simplest, in a low cost way, focused not on processes but on outcomes, because when you focus on process, you strangle innovation. When the regulator says "here is the way you should do regulation", "here is the way you should do banking", which is what banking regulation is today, the regulators, who have no experience of banking, tell the banking industry how they should do banking, and the problem with that is it strangles innovation.

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