**Reinforcing the responsibilities of financial regulators. Are we still barking up the wrong tree?**

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In this short essay we explore the regulatory criticisms raised within the “Changing Banking for Good” report (House of Commons, House of Lords 2013). These criticisms suggested UK financial regulators have been risk averse, loath to enforce regulation and often intervene in markets after a considerable delays and problems have growth in their magnitude and costs. The practice of regulation was also criticised as requiring excessive and overly complex rules fostering a culture of box ticking. Perhaps most tellingly a compact between government and the banking sector was reported through which regulators moderate their actions to ensure financial stability. The “Changing Banking for Good” report also proposed multiple remedies. These included harsher punishments, more enforcement activity, and multiple initiatives to ensure individuals accept responsibility for their decisions. Many of these proposals have now been translated into financial regulation, often altering how regulation is undertaken.

We propose this criticism of UK financial regulation requires re-evaluation. The scope and focus of financial regulation is ever shifting and defies precise definition. This uncertainty has generated both positive and negative perceptions of the operation of financial regulation. We propose this conflagration of regulatory criticism, requires more clarity as to the goals of financial regulation, comprehension of the assumptions underlying our regulatory models and enhanced methods to quantify regulatory performance.

When assessing regulatory performance, it is essential to comprehend the assumptions underlying how and why we undertake financial regulation. These models of regulation are contested, often politicised and have been in a continual state of flux for many decades. These models also reflect how we perceive regulation, a point critical to understanding why criticisms of regulation have developed.

This narrative starts with the neo-liberal revolution of the 1980s where scepticism as to the effectiveness and utility of regulation soared. This political movement viewed market-based outcomes as optimal and denounced the perceived waste and inefficiency resulting from traditional command and control forms of regulation. Subsequently, regulation relying on specific rules and backed by criminal sanctions, were criticised, constrained and discontinued in many areas. Alternative models of regulation focused on market outcomes, and a greater role for financial firms emerged. Within these pro-industry self-regulation methods, financial institutions adopted greater responsibility as to how they complied with regulation.

This market orientated regulation subsequently evolved and fragmented. Principles based regulation, an outcomes-based approach associated with light touch regulation, emerged in the 1990s. This model of regulation required financial institutions satisfy broad and often ambiguous requirements, through applying their best judgement, rather than adhering to detailed rules and much derided tick box approaches. This broad-brush approach to regulation was widely criticised after the financial crises for its limited control over firm actions and paradoxically the complex systems developed by firms to ensure compliance.

Management based or meta regulation emerged to allow firms to shape their compliance systems. The regulators’ role also morphed into one of assessing the efficacy of these corporate systems of regulatory compliance. This co-regulation strategy was reliant on firms embracing the goals of regulation and ensuring their systems of compliance are integrated with, rather than distinct from the firms’ internal operations. In 2007, many firms were seen to be inexpert or apathetic in developing effective compliance systems, particularly if regulatory goals conflicted with the firms’ objectives (Black 2012).

To tackle issues of financial stability, risk-based regulation also proliferated, whereby regulators identify and address different risks facing financial organisations and the financial system. As constraining financial risks is an intricate challenge, often complex rules and reporting requirements arose, with regulatory assessments dependent on the information provided by firms. Unfortunately, in some cases the wrong risks maybe been prioritised and those risks germane to financial stability insufficiently addressed.

All these models of regulation performed poorly during the 2007 financial crisis. While command and control forms of regulation may not have performed any better, we do suggest that faith in market-based regulation has been eroded. Despite repeated efforts to re-regulate finance, the oft cited ‘red tape’ and ‘box ticking’ criticisms persisted. It is proposed in many cases, such criticisms often reflected a long-standing partisan perception as to the wider unwelcome role of regulation in society, rather than engage with the practice of regulatory actions.

In the last decade, this consensus has been challenged. New non-market regulatory approaches have arisen. These include paternalistic approaches in consumer financial investments (Chiu 2021) or payday loans markets (Fejő 2015), where the public good arising from customer protection supersedes corporate concerns. Specifically, financial regulation has been augmented by measures to curtail damaging firm practices and to moderate customer harm. Indeed, since the criticisms of financial regulation were raised the ‘Changing Banking for Good’ report the goals of financial regulation have shifted. Where regulatory performance focused on market outcomes in 2013, today social, environmental and behavioural influences also shape the expected goals of financial regulation.

In light of the foregoing, we propose an overlooked area in the ‘Changing Banking for Good’ report is how regulatory performance might be quantified objectively and outside these wider political arguments as to the role of regulation. It is proposed we might measure regulatory performance though considering a central aim of regulators, limiting misconduct and wrongdoing by financial firms. Currently, when measuring this relatively narrow outcome, it is common to use metrics, such as enforcement activities, as a measure of success or otherwise. This form of assessment is problematic as the number of cases detected and subject to enforcement activity is not an unambiguous assessment of regulatory performance. If the number of misconduct cases detected increases, this could imply that the regulator has become better at detecting offending firms, but it could also be a sign of weakening deterrence. Conversely fewer enforcement cases can signal the regulator has deterred more wrongdoing and is successful. Disentangling these confounding effects surrounding detection and deterrence is amplified by partial observability; where non-detection of misconduct can lead to underestimation of the true level of misconduct and overestimate the effectiveness of regulation.

In my own work (Ashton et al 2021), we addressed this issue using an unorthodox capture-recapture method. This well-established technique from ecology is used to estimate population parameters of various species. When wildlife researchers want to estimate the population size of a given species, they don’t need to capture all the animals which exist. It is sufficient to repeatedly tag a proportion of this animal population and release them back into the wild. In this recurring process the proportion of tagged animals which are recaptured provides an estimator from which the proportion of all tagged animals within the whole population can be derived.

Although this is an extreme simplification of what is performed in our study, we analogously apply a variation of capture-recapture methods for financial firms. We recorded the frequency with which regulatory catch financial firms for wrongdoing to estimate the wider population of offending firms, be these captured by the regulator or otherwise. Using this approach, we report UK financial regulation has improved. While the number of enforcement cases has declined in recent years, the proportion of financial offenders caught has increased, suggesting regulatory deterrence has been strengthened. Despite this positive outcome, the actual proportion of offending firms caught remains surprisingly low, increasing from a tenth of offenders before 2010 to a quarter of offenders after this year. Clearly there remains a long way to travel when enhancing regulatory performance.

To conclude, assessing whether the performance of financial regulators has improved, requires clarity as to the current goals of regulation, cognisance of the assumptions underlying our regulatory models and plausible methods for quantifying regulatory performance. A critical aspect of assessing regulatory performance is viewing regulation objectively and as much as possible outside a political and partisan lens. In achieving these aims there are multiple international examples from which we can learn. Broader regulatory reporting considering the social obligations of financial firms as seen in the US Community Reinvestment Act (1977) may provide a model for future developments in addressing consumer harm. Financial regulation should also be valued and resourced appropriately to operate effectively. The example of Singapore is a useful example to follow in this regard. Lastly, there is much we still need to learn in optimising financial regulation; considered analysis and an awareness of regulatory history is essential to enhance regulatory performance.

**References.**

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