BRIEFING PAPER

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Cure or Disease?

The unintended consequences of regulation

By Keith Boyfield

Introduction

Governments and regulators invariably claim that the regulations they introduce are done so for the most laudable of reasons. This may well be the case but far too often, whether through time pressures or ill thought through proposals, regulations can have unforeseen yet highly damaging consequences. This paper discusses some striking examples of this trend across a spectrum of business and social sectors, ranging from banking and finance to health and safety regulations.

1. Regulation of the UK finance and insurance sector

The financial turmoil that has gripped international capital markets has dominated newspaper headlines over the last two years and triggered one of the worst economic recessions experienced since the Great Depression of 1929. While blame can be shared by many different actors – government, bankers, shareholders and those who borrowed too much on their mortgages and credit cards – one of the key elements in this unparalleled financial crash was the watershed decision to split oversight of the UK banking sector between three separate bodies, namely the Bank of England, the Financial Services Authority (FSA) and the Treasury. This three way regulatory split led to disastrous consequences.

In practice, the decision to remove regulatory oversight of banks operating within the UK from the Bank of England has led to instability, not least because the FSA was given no statutory responsibility for the future functioning of the banking market – as Hector Sants, the CEO of the FSA, has recently acknowledged.[1] The financial bubble caused by an excessive expansion of the money supply, underpinned by cheap goods imported from fast developing economies such as China, was allowed to develop unchecked because neither the Treasury, the Bank of England nor the FSA intervened to limit bank lending and credit expansion. Banks such as Northern Rock were allowed to offer mortgages of well over 100% to prospective house purchasers yet insufficient supervision was applied to their lending practices and means of funding their mortgage book through the short-term commercial paper market. When the market in commercial paper seized up in 2007, we witnessed the collapse of Northern Rock and other banks that had sought to carve out a larger share of the UK mortgage market.

As Sir Martin Jacomb, a wise and experienced City hand (previously Deputy Chairman of Barclays Bank) points out, the Bank of England – as the central bank and lender of last resort – is the body that should have responsibility for financial regulation of the UK banking scene. Transferring responsibility to the FSA has denied the Bank its ability to maintain a close tab on players within the market and devalued its role – as Harvard's Professor Niall Ferguson notes – to being little more than a think tank attached to the Monetary Policy Committee.

2. Macroeconomic management

Another major contributory factor explaining why Britain plunged into the financial mess that has dominated economic life over the last two years is the decision to adopt the Consumer Price Index (CPI) as a measure of inflation to replace the previous inflation targeting measure, the retail price index (RPI). This move proved crucial since the Bank of England's Monetary Policy Committee was charged with keeping inflation below a level of 2%. However, the CPI excludes housing costs, so the MPC failed to take into account the rapid escalation in house prices that was such a feature of the earlier part of this decade. Indeed, as Lord (Maurice) Saatchi observes, "During the same period, the inflation rate of one particular asset class, property, was

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13% p.a., five times the Bank CPI target".[2] Meanwhile, over the course of ten years, the average household's financial liabilities soared from a figure of £23,231 in 1996 to £56,501 in 2006.

As a result of adopting the wrong inflation targeting measure the Bank of England largely ignored the soaring cost of housing in the middle of this decade, which helped to stoke up the misery experienced over the last two years. In establishing this regulatory oversight, the Government contributed to the financial bubble that has led to such disastrous consequences – and a huge bill for the British taxpayer to meet over the next decade.

3. Capital adequacy rules for banks

A crucial regulation that has far reaching effects on the international banking market are the so-called Basel Accords. First established in 1974, The Basel Committee on Global Financial Stability was a body that brought together representatives from central banks, regulators and commercial banks and financial institutions. The entity was given responsibility to provide a basis for international cooperation in bank supervision. One of the Committee's main tasks was to set the appropriate capital adequacy ratio to be met by banks in terms of their total liabilities as a ratio of their capital. The main purpose of this regulatory rule was to ensure that banks had enough capital to absorb prospective losses and still remain solvent.

Unfortunately, the Basel Committee did not live up to its name; it turned out to be a Committee for Global Financial Instability. As Federico Foglia has pointed out, while almost all the leading financial institutions of the world have capital positions that are between one and two times the minimum regulatory requirements set down by Basel 2,I they nonetheless were allowed a maximum of 10 times leverage in equity or 50 times AAA bonds, many of which turned out to be of junk status.[3] The true extent of the liabilities taken on by these banks was confirmed when many of them, including RBS and HBOS in this country and Fortis Bank in Belgium, were obliged to seek government aid to save them from bankruptcy. Clearly, the capital adequacy regulatory regime aimed at maintaining a robust and sensible approach to risk turned out to have failed completely – leaving the poor suffering taxpayer to bailout the banks.

In practice the Basel Rules were hammered out in a highly politicised arena and were subject, as Professor Kevin Dowd points out, to "arbitrary decisions, irrational compromises and much political horse trading".[4] The result was poorly thought through rules, a compliance culture and excessively high implementation costs. Furthermore, as Dowd emphasises, "Over time, it also leads to ever longer rule books that attempt to standardise approaches in an area where practice is always changing and where the development of best practice requires competition in risk management systems – not an irrelevant and inflexible rule book that is out of date before it comes out".[5]

As a result, the Basel regulatory rules have encouraged the use of complex, quantitative models that offered a blanket of false comfort with respect to the risks that peppered a bank's balance sheet. Few people understood what the models demonstrated while management and shareholders were lulled into a false sense of well being.

The Basel regulations also acted as a catalyst for bankers to invent new off balance sheet vehicles, notably conduits and special investment vehicles (SIVs), to circumvent the capital adequacy rules implemented by the Basel rules. As the FT's Gillian Tett explains in her best-seller, *Fool's Gold*, banks were able to exploit a loophole in the Basel Rules by extending credit lines to SIVs for 364 days or less since the Basel Accord stated that banks did not have to reserve capital for any credit lines that were under a year in duration.

The banks calculated, falsely as it turned out, that they would always be able to tap the short term commercial paper market in order to meet any claim made on the credit lines offered to SIVs. However, in the summer of 2007 the commercial paper market began to dry up. This triggered disastrous consequences because banks were unable to refinance the credit lines they had extended. The results, as we know only too well, have been highly damaging. Yet these problems were compounded by the regulatory authorities, particularly those in London, which had noticeably failed to monitor and supervise the shadow banking system associated with SIVs and other related vehicles.

In an address given on 8th May 2009 to the annual conference of the Federal Reserve Bank of Chicago, Andrew Haldane, Executive Director at the Bank of England, acknowledged that, "Regulation may have contributed to perverse risk taking incentives among large, interconnected firms. And subsequent interventions may have worsened those incentives". Ironically, while scale and diversification was meant to reduce risk, in practice it exacerbated the potential dangers. Indeed, it was the

larger polygamous financial institutions that operated with lower capital reserves. And it was these super spreaders of risk that the taxpayer was obliged to rescue, mainly because while the bulge bracket banks were slicing and dicing risk on the one hand, they were accepting the same risks back through a range of ill understood financial instruments such as credit default swaps. Consequently, the largest packages of taxpayer support have been spent on propping up the global mega banks such as RBS and Bear Stearns. Yet these were the financial institutions that claimed to have minimised risk.

4. Debt recovery

The financial crisis that proceeded to grip the world in the summer of 2007 prompted banks and other financial institutions to recover the loans they had extended to customers who were unable to service their debts. Ironically, it was Northern Rock, the troubled and over-extended bank taken into state ownership, which was one of the most aggressive banks in terms of repossessing houses from struggling mortgagees. And this was at a time when the Government was declaring its apparent commitment to enabling people to stay in their homes and warning banks about overly aggressive repossession threats.

This July the Ministry of Justice (MOJ) consulted on changes to the limitation periods applied to legal proceedings to recover debts. The proposed reforms would see the limitation periods for bringing legal proceedings to recover a debt reduced (in most cases) from six to three years from the date the creditor becomes aware of the non-payment.

In this respect the Government's recent Consumer White Paper focuses on measures aimed at delivering responsible lending and borrowing in the consumer credit sector. One of these measures was the extension of a breathing space for consumers in financial difficulty to all unsecured credit products. Yet this may prove counterproductive.

If the Government reduces the limitation period from six to three years, the Finance & Leasing Association point out that lenders will be obliged to begin collections proceedings earlier than they would have done otherwise. As the FLA's Director General Stephen Sklaroff suggests, "This requirement will place significant pressure on lenders, at a time when they are being called upon to be more sympathetic to borrowers in difficulty and to help reinvigorate the economy." It is also likely to increase the burden on an already over-burdened court service. Such an outcome is directly at odds with the Government's drive in favour of greater forbearance. Meanwhile, lenders are generally acting responsibly and helping customers with payment difficulties

The new statutory debt management tools such as Debt Relief Orders have already eroded lenders' ability to recover outstanding debts. Changes to the limitation period would exacerbate this position further and could adversely affect the cost and availability of credit in the future. Consequently, everyone is likely to be disadvantaged.

5. Financial exclusion

Activity by loan sharks is on the rise as consumers find it harder to access credit. Mainstream lenders are reining in how much risk they will take and doorstep lenders are attracting new sub-prime borrowers who've left the mainstream market. The cost of complying with regulation has a part to play. Clearly, it was not envisaged that the introduction of additional regulation would mean more financial exclusion with the consequence that people turn to the unregulated market.

6. Regulatory rules on leasing could harm small & medium sized enterprises (SMEs)

New accountancy rules for leasing due to be applied in 2012 could hit hundreds of thousands of UK small businesses if proposals in a discussion paper by the International Accountancy Standards Board are adopted.

Leasing and hire purchase is currently used by around 750,000 UK small businesses, including at least 400,000 companies required by law to prepare financial accounts. Under the Standards Board's proposals all leased equipment – including cars, commercial vehicles, machinery, PCs and photocopiers – would need to be added to firms' balance sheets by even the smallest businesses.

Yet businesses choose leasing because it offers real business benefits, including being secured largely on the asset being financed. In a survey of 728 small and medium enterprises (SMEs) last year by the Open University, two-thirds said that not having to show the value of assets in annual accounts was not relevant or not important when deciding on sources of financing for the acquisition of assets. This response begs the question as to whether the rules are too complex for the regulatory goal that is meant to be achieved.

The potential unintended consequence of this measure is that a well intentioned initiative may well impose substantial additional regulatory compliance costs for thousands of smaller enterprises while delivering few meaningful benefits. The Finance & Leasing Association along with the Forum of Private Business (FPB) have argued that it is not sensible to apply the same procedures to photocopiers in use in a small manufacturing company and to an aircraft used by one of the world's leading airlines. Therefore, an optional, simplified procedure should be available for all but the largest leases, which will still provide interested parties with an accurate picture of a firm's financial position.

7. Regulating farmers

Turning to agriculture, undoubtedly the most perverse regulatory system foisted on us by the EU, is the Common Agricultural Policy. The regulations this has spawned are legion as are the costs and unnecessary damage inflicted on citizens of the EU 27 Member States. In our *EUtopia* study, the London Business School's Tim Ambler and I pointed out that the regulatory system implemented by the CAP has conferred responsibility for the assessment of agricultural land quality on individual Member States. Such a regulatory system inevitably encourages abuse. In Luxembourg, for example, 98% of farmland is officially categorized as less favoured. Yet as Peter Morgan observes, 'this will come as a surprise to anyone who has driven through its green fields'. This poor classification may have something to do with the fact that those who farm on land designated as poor farmland are entitled to additional generous grants under the CAP.

One of the original justifications for the CAP was to maintain smaller farmers in business, particularly in France where politicians are fond of referring to the importance of the 'terroir' and the need to maintain the beauty of the countryside.

However, the CAP has proved to be a big money–spinner for relatively few large landowners. Some 70% of the benefits derived from CAP go to a mere 20% of farmers, mostly in the more advanced EU economies (including the UK, France and Ireland). In Britain 10% of farms and businesses receive 67% of the UK's CAP payments. The top 100 recipients received more than 23% of the total UK CAP expenditure, while the bottom 50 received a mere 2.6%. In practice, the CAP has done little to sustain employment in the agricultural sector. Indeed, farming has seen more jobs disappear than in other sectors.

As far as agriculture is concerned the worst example of a regulation is perhaps the December 2005 Common Agricultural Policy Single Payments Scheme which results in no payments being made to many farmers until months after the due date.

Moreover, in a study called *Green and Pleasant Land*, published by the Globalisation Institute, Anthony Batty and Cameron Carswell demonstrate how the CAP, far from serving as the saviour of the countryside, has perversely been an environmental disaster, creating pollution with no economic benefit, and requiring more chemicals and energy use than had market forces been allowed to operate unshackled.

8. Regulating the Fisheries Industry

Fisheries policy has proved an unmitigated disaster ever since the UK joined the EU and became subject to its regulatory regime with regard to fish stocks. The last quarter century has seen the large-scale elimination of North Sea and Atlantic fish stocks. As Tim Ambler points out, "Imagine a CAP where any licensed farmer could take crops from anyone else's land. That, in effect, is what the fisheries policy is – a costly example of the 'tragedy of the commons'".[6]

Given the EU free-for-all, it is no surprise that over-size trawlers come onto small fishing grounds, scoop everything up in their nets and then throw back enough dead fish to ensure their catch complies with regulations. The only surprise is that we have any fish left at all. Iceland, by contrast, has increasing stocks of the most important fish species, such as cod, because it fenced off its own waters and instituted a system of transferable fishing quotas, which give those in the fishing industry a long-term interest in conserving stocks in order to maximise long-term yields.

The latest regulatory move that has crippled the UK fishing industry is the explanatory Memorandum to the Sea Fishing (Enforcement of Community Control Measures Amendment Order 2005 No. 2624 which was actually three years late in being implemented since the regulatory policy that was amended expired in 2002. This measure has failed to conserve fish stocks, ruined the British fisheries industry and failed to discipline Spanish and Portuguese fishing fleets. Young fish continue to be caught and thrown back dead, which defeats the whole policy goal.

9. Health & safety

'Health & safety' is a phrase that has now regrettably passed into the lexicon as a shorthand term for imposing a raft of onerous regulatory conditions on some entity or some individual. Far too often health & safety regulations prevent some relatively mundane event or initiative from taking place. As Dr Eamonn Butler points out in his recent book *The Rotten State of Britain*, health & safety is robbing citizens of amenities and many of the activities an older generation cherished.[7]

Our society's aversion to risk threatens to emasculate it. People need to appreciate that there is no such thing as a risk-free environment; there are merely degrees of risk that require management. This is something the older generation are familiar with as growing up is not a risk-free zone: children learn by making mistakes. Yet risk is something our society is fast seeking to avoid. And nowhere is this more apparent than in the world of education.

A recent survey carried out by Teachers TV uncovered a litany of bizarre restrictions and precautions implemented by schools across Britain.[8] These include a requirement for children to wear goggles and protective clothing in order to use Blu-Tack; a five-page dossier for teachers on how to grapple with a Pritt Stick; and kids forbidden to eat sweets for fear of choking (well that's one way of tackling obesity). These restrictions cramp childrens' lives and make it far more difficult to organise school outings, whether it is to places of local interest or – heaven forbid - a rock climbing or potholing expedition.

Yet it is not always the regulations to blame; the bureaucrats charged with implementing them shackle enterprising initiatives for fear of being sued. Education authorities in England & Wales currently fork out £ 2 million a year in compensation claims to pupils. Eamonn Butler records that a recent tally revealed that £5,000 was paid to one child whose finger was hit by a cricket ball while £6,000 was paid to another child who was injured breaking in to a school one evening!

Clearly, there is no longer such a thing as bad luck. Nowadays there is a knee-jerk response that assumes that it is always someone's fault. It must be remembered that our Prime Minister Gordon Brown suffered the loss of his sight in one eye due to a school rugby accident. However, this misfortune was accepted and no one was sued. Today, the onus is on identifying someone to blame – and sue. Consequently, officials tend to cover themselves against all eventualities, often prompted by insurance companies. This means that many activities previously enjoyed by schoolchildren – including playground games of conkers – have been banned. The goal is now for schools to become places where no-one has cause to sue, or to blame health and safety officers for failing to anticipate accidents. Sadly, in doing so, they deprive kids from a wide range of learning experiences. Schools, like childhood itself, cannot be risk free – a view supported by Judith Hackitt, the chairman of the Health and Safety Executive, the organisation often blamed for these woes. Significantly, Ms Hackitt observes that "Health and safety is blamed for a lot of things not going ahead, but they're often about something else – high costs, an event that requires a lot of organising or fear of getting sued. Children cannot be wrapped in cotton wool – risk is part of growing up and our children need to learn how to manage risks in the real world."[9] School governers, teachers and not least parents please take note.

Conclusion

This paper has demonstrated that while regulations may be imposed for the best of reasons, they can have highly damaging unforeseen consequences. This may mean that the cure is worse than the disease. In order to address this very real danger policymakers would be well advised to consider five key principles of better regulation when they contemplate adopting a new regulatory programme. These five principles are transparency; accountability; proportionality; consistency; and targeting.

On **transparency**, the onus should be on the regulatory body to make a case for a specific regulation and why this is required. In communicating the purpose of a regulation or regulatory programme there should be an adequate consultation period accompanied by a thorough regulatory impact assessment of the costs and benefits of the measure, including the reasons why existing regulations do not already cover this identified problem. In practice, one tends to find that they often do.

Regulators need to be clearly **accountable** for their actions and there should be an efficient appeals procedure in place. In this context, the UK Competition Appeals Tribunal has fulfilled a useful role. However, further reforms are needed. As Tim Ambler and I argued in *Regulatory Myopia*, the Financial Services Authority (FSA), just like other regulators, should be made answerable to Parliament and not to a branch of government.[10]

With regard to **proportionality**, regulatory compliance should be both affordable and commensurate. This is where regulatory impact assessments are vitally important since they encourage a robust comparison of regulatory options including a 'do nothing' approach. In our analysis of the European Commission's proposals for financial services regulatory reform, Tim Ambler and I point out that the accompanying impact assessment fails to compare genuine alternatives nor does it quantify costs and benefits.[11] Indeed, in our analysis we set out ten specific flaws in the impact assessment.

On **consistency** it is crucial that any new regulatory initiatives that are adopted conform with previous regulations. This helps to ensure regulatory consistency: a crucial point when one is dealing with industries that require vast amounts of capital such as telecoms, water utilities or energy.

Finally, on **targeting**, it is important to focus regulatory actions on specific problems, thereby avoiding a scattergun approach. It also makes sense to review how far regulations have achieved their original goals. Regulations should have sunset clauses, so that policymakers can assess whether they are still required.

These five principles of better regulation will go some way towards ensuring that regulations, where necessary, fulfil their original objectives and minimise unintended consequences. However, experience suggests that regulatory initiatives will continue to trigger a raft of unintended consequences. Some will be fairly benign, but others may be seriously detrimental.

About the author

Keith Boyfield is a Senior Fellow of the Adam Smith Institute. He is also a consultant economist specialising in competition and regulatory issues. He advises a range of multinational companies, trade associations and non-profits and has acted as a consultant to some of the world's largest companies and professional advisers including Aon, the Association of Consulting Actuaries, the BBC, BNFL plc, British Sky Broadcasting Ltd, KPMG, Mott MacDonald Ltd. and Thomson Reuters plc. He has also acted as a consultant to the European Commission's Competition and Energy & Transport Directorates.

Endnotes

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3 Presentation to the Istituto Bruno Leoni conference by Federico Foglia: 'The Challenge of Financial Instability for Market Capitalism', Rome, December 2008.
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6 'Eutopia: What EU would be best and how do we achieve it?' by Keith Boyfield & Tim Ambler, Adam Smith Institute, 2006, page 12.
7 'The Rotten State of Britain' by Eamonn Butler, Gibson Square, 2009.
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9 Ibid.
10 'Regulatory Myopia: A response to FSA DP09/2' by Tim Ambler & Keith Boyfield, Adam Smith Institute, 2009.
11 'Financial Regulation: What is the solution for the EU?' by Tim Ambler & Keith Boyfield, Adam Smith Institute, 2009.