

“Protection and risk: striking a proper balance in a market economy?”

“... a risk-based regime does not imply aiming to prevent all collapses or lapses in conduct under the regulatory system.” (one of FSA’s strategic aims set out in its Plan and Budget 2003/04, page 29)

BRIEFING NOTE

The right and ability to take risk lies at the heart of a healthy financial system: it encourages competition and innovation, and it helps stability by transferring uncertainty to those willing to take it. But risk is also dangerous: badly managed, it can destroy institutions and market confidence. The challenge for regulators and governments is to strike the right balance between allowing risk and controlling it. *What risks are reasonable for firms to run?*

Now that the FSA and the financial services legislative framework and infrastructure is fully operational, it is appropriate to ask how the FSA is addressing this balance and whether it is getting it right. It is an issue which has a significant bearing both on consumer protection and the cost of finance, as well as on the City’s ability to compete as an international financial centre.

Measurement of risk, proportionality of rules and statutory principles underlie the FSA’s policy approach to regulation. It classifies institutions according to the amount of risk they pose to its objectives of running sound and orderly markets, combating fraud, protecting consumers, etc. As a result, the FSA has done a huge amount of work on risk analysis and has acquired a justified international reputation for sophistication in this area.

This approach has been welcomed by the wholesale markets insofar as it ensures that sources of risk are well identified; that regulatory resources are focused on potential trouble spots rather than squandered across the waterfront; and it contains the promise of less onerous regulation for institutions and activities judged by the FSA to be low on the risk scale (and a number of them are already benefiting from a lighter regulatory touch).

Nevertheless, the City has detected some ambivalence by the regulator in its approach. On the one hand, it asserts (rightly in the City's view) that it does not run a "zero failure" regime. But on the other hand, it makes comments like "we want to ensure that institutions have enough capital to meet unexpected losses", which suggests that the regulatory requirements are closer to creating a "zero failure" regime. Are these statements compatible?

Does this suggest that the regulators views risk in terms of a threat to its objectives i.e. negatively, rather than as a positive force that drives business forward? Could such a negative view produce a regime dominated by control and protectionism rather one that facilitates competition, growth and innovation?

Capital adequacy, for example, is a notoriously difficult area. What types of risk should be covered by regulatory capital? At what level should capital requirements be set? True, the FSA has shown flexibility in, for example, relaxing insurance capital requirements to avert a downward equity spiral – though this has caused the sceptical to wonder whether, if the rules can be relaxed in this way, they were set at the right levels in the first place? This is a particularly important issue because cost of capital is key for financial institutions operating in a highly competitive marketplace. Clearly, regulators have the right to set broad capital standards for stability and consumer protection. But it is also in their interests to set these standards at a high level because this reduces the risk to their objectives. How does this square with firms that want minimal capital standards to avoid tying up too many of their resources in regulatory protection?

The title of this Round Table suggests that we are looking at a "see-saw" with risk on one side and protection on the other. To some extent this is true. But it is less so of the wholesale business which does not have dealings with retail investors, and therefore has a more light-touch regime. But the wholesale business is not completely cut off from protectionist pressures. There is, for example, the risk that a unified EU regime could import consumer protection objectives into the regulation of wholesale business; this is because the bulk of financial services business in EU member states involves retail consumers. There is also the tendency to impose higher levels of consumer protection and "more controls on the City" in the wake of every default or scandal. The real test for a rule is not whether it is "nice to have" but whether it is "necessary", and, if it is, does it represent the most cost-effective way of achieving its objective?

Insofar as the see-saw analogy holds, some will argue that it is tilting in a protectionist direction with adverse implications for the City's competitiveness. Others argue that recent failures show that excessive risk is damaging consumer confidence in the markets. Others yet believe the balance is about right and that the FSA's approach to protection and risk is proving attractive to financial institutions operating in the wholesale sector. Whichever view is correct, all would agree that maintaining a proper balance between protection and risk is vital to the UK's international competitiveness in financial services, the maintenance of market confidence and the economics of trading and investment.

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