Burn it Down: Observations on the FSA

By Eric Bettelheim

For the last two decades the UK has been experimenting with a 1930s regulatory model to find a solution to the problems posed by modern financial markets. From its inception the FSA and its myriad predecessors have tried to distinguish between the needs of the wholesale or professional markets, which need very little regulation and the consumer market for financial products. Despite 20 years of trying the overwhelming evidence is one of increasing failure at both ends. The number, scale and scope of regulatory and financial market failures continues to increase despite draconian increases in investigative and punitive powers, and the steadily increasing breadth of regulatory jurisdiction, from swaps to mortgages, promises nothing but more of the same.

What is needed is a radical re-think of what is required by the markets on the one hand and retail consumers (the general public) on the other. It also requires some new modesty about what law and regulation can actually achieve. Let's begin with the latter. It is futile to try and legislate honesty or fairness. Fraud simply cannot be prevented while maintaining anything like free markets or a free society. It is the business of parents and churches to teach morality; it is the business of judges to punish criminal or quasi-criminal behaviour. Regulators are bad at both tasks. To increase deterrence (to the extent it works) and restore public confidence all that is needed is greater certainty of appropriate punishment. To achieve this a unified fraud investigatory and prosecutorial agency is long overdue. Among the obvious advantages, in addition to saving of costs and avoiding destructive bureaucratic turf fights, it would develop expertise and institutional memory as well as provide a clear career path for talented people. It would also be subject to the same restraints on violation of civil liberties as other agencies of government.

It is astonishing that the most draconian powers of government are not exercised against drug smugglers or violent criminals but against people whose worst conceivable crime is stealing money. Money, it will be remembered, is easily replaced, unlike lives or limbs. The conferring of extraordinary powers on an agency of government is a good indicator of that agency's failure. The recent blundering of the FSA in respect to everything from Equitable Life to split-capital trusts, not to mention persistent demands for higher salaries amidst staff complaints, also indicates a chronic inability to recruit, train and retain really capable staff. Anyone who has been on the receiving end of a compliance review or suffered at the hands of the kangaroo tribunals is fully aware of this even if they dare not say it out loud for fear of worse.

Most of all, the FSA is not succeeding in protecting either the markets or the public. The recent suggestions of moving to risk-based assessments are encouraging but the FSA can't meaningfully achieve them; it cannot recruit or afford the highly skilled people that can really do the job. Participants in the professional markets can afford them and know how to assess their risks and don't need the FSA or anyone else to help them. Failure of such enterprises is rare and virtually never threatens the general welfare. Even in the rare

circumstances that such failure could have systemic consequences they are best managed by central bankers and the market participants themselves.

Recent events do make clear, however, that providers of retail products do not know how to assess their own risk or the risks that their products present to purchasers. For them there is a better solution than trying to teach risk management to FSA staff. Outsource it to the best risk mangers there are, the world's large insurers and re-insurers on the basis that every provider of retail savings products must carry mandatory insurance cover to the point that the products offered to the general public are guaranteed. The only thing that matters to the purchaser of a pension or an endowment policy is that he or she gets the money promised when it is due. The same is true of all savings products. The price for entry into the business of selling such guaranteed products and of staying in that business would be adequate insurance by the limited number of very large reinsurers which, in fact, do have the staff, systems and skills (like most professional market participants) to manage complex, long term risk. Why? Because risk management is their business. If they can pay billions in losses for the world's disasters year in and year out and still make profits, they can pay the financial losses of UK retail product purchasers.

The irony is that the insurance markets charge market professionals much higher premiums (primarily because of the risks of mis-priced mergers and acquisitions) than they charge sellers of retail financial products. Politicians, who are subject to people, not financial, pressure, can't fathom what this means because they mis-perceive the risk by equating votes with scale of loss. But the bottom line is easy to sum up even for them.

The FSA costs £200 million a year to run. Burn it down and use the same amount to buy re-insurance to guarantee retail products. At current rates the insurance cover would be several billions of pounds per year, vastly exceeding all of the losses caused by the entire financial sector over the last 20 years. Best of all, not only would the money be available to reimburse everyone in full, (which government bailouts never do) it would be paid far more quickly than through regulatory or court proceedings. A simple claims form should suffice. Even if litigation were necessary, a single class action proceeding would efficiently represent everyone who suffers in a particular event and be settled far faster than the pathetic, ill-financed, badly lawyered individual and "representative" cases as at present. There would be no more lengthy appeals to the House of Lords, as in the Equitable case, trying to assert that a guarantee is not exactly what it says.

Using private insurance instead of public sector regulation would mean that the general public would be insulated from catastrophic financial loss at minimal cost and without tax-funded bailouts, the retail industry would be regulated by self-interested risk management professionals who do not need to be paid by the taxpayer, the compliance burden would plummet, innovation would not be stifled and the politicians would be spared the embarrassment of explaining why the regulatory system, on which they have lavished such time and attention, had failed, yet again, to protect the public.

A pipedream? You bet. Why on earth would all those officious intermeddlers put themselves out of a job?