

Some cost-benefit issues in financial regulation

David Simpson
Geoff Meeks
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Peter Andrews (Editor)

FSA OCCASIONAL PAPERS IN FINANCIAL REGULATION

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SOME COST-BENEFIT
ISSUES IN
FINANCIAL REGULATION

David Simpson
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FSA Occasional Paper

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Biographical Notes

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Abstract

On 17 September 1999 the Financial Services Authority held a public seminar on some cost-benefit issues in financial regulation. The seminar was part of the FSA's preparations for handling its new responsibilities for cost-benefit analysis under the Financial Services and Markets Act. As such, it yielded some useful insights.

At the seminar, there were presentations by David Simpson, Economic Adviser at Standard Life, Geoff Meeks of Cambridge University and Paul Klumpes of Warwick University Business School. David Simpson spoke on cost-benefit analysis and competition. Geoff Meeks spoke on the benefits of accounting regulation. Paul Klumpes spoke on competition among peer groups for influence over financial services regulation: the case of the UK pensions industry. Each presentation was subject to comment by a discussant, followed by questions and comments from the audience.

This Occasional Paper includes revised presentations from the three speakers. It starts with an overview of what they said and of the reactions of the discussants and audience (updated for subsequent developments as necessary).

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1 Introduction

The Financial Services and Markets Act (2000) gives the Financial Services Authority a duty to perform cost-benefit analysis that goes beyond any similar duty imposed on its predecessor bodies. The duty is also more extensive than those typically attaching to the counterparts of the FSA in other countries, although it is broadly similar to the requirement for Regulatory Impact Assessment that the UK Government imposes on itself. As part of its preparations for fulfilling this duty, the FSA held a public seminar on 17 September 1999 on some cost-benefit issues in financial regulation.

The seminar featured presentations by David Simpson, Economic Adviser at Standard Life, Geoff Meeks of Cambridge University and Paul Klumpes of Warwick University Business School. David Simpson spoke on cost-benefit analysis and competition. Geoff Meeks spoke on the benefits of accounting regulation. Paul Klumpes spoke on competition among peer groups for influence over financial services regulation: the case of the UK pensions industry.

At the seminar, each presentation was subject to comment by a discussant, followed by questions and comments from the audience. The audience was made up of academics, people employed by financial services companies or their trade associations, and regulators, most of the last being from the FSA itself.

The seminar helped the FSA to formulate its policy on cost-benefit analysis in a number of respects. These include the importance of setting cost-benefit analysis in the context of a wider economic analysis, possible approaches to the assessment of benefits and the need to distinguish carefully between regulatory impacts that shift resources from one group of stakeholders to another and regulatory impacts on the real economy.

This Occasional Paper includes revised presentations from the three speakers. It starts with an overview of what they said and of the reactions of the discussants and audience (updated for subsequent developments as necessary). As this Occasional Paper is largely an account of proceedings, it has not been refereed.

Each of the speakers is responsible only for his own revised presentation. The presentation by Geoff Meeks was, however, based closely on a paper that he prepared in collaboration with Gay Meeks and with the support of the Centre for Business

Performance of the Institute of Chartered Accountants in England and Wales. Gay Meeks is a member of the Faculty of Economics and Politics at the University of Cambridge and is researching the costs and benefits of accounting regulation.

The overview and the version of the reactions of the discussants and audience that appear here were written by Peter Andrews.

2 Overview

David Simpson's presentation had four main strands. He set out some of the informational problems faced by consumers in the retail financial services market. He suggested that regulation is not the optimal solution to many of these, whereas more market based responses would be. He went on to define an operational concept of competition as a 'process of continuous interaction over time between buyers and sellers...'. He then criticised the use of cost-benefit analysis as a means of determining policy on the grounds that markets do not behave according to the assumptions of the neoclassical equilibrium model on which the technique is founded. He said that those who nevertheless insist on the appropriateness of the neoclassical model face the insuperable difficulty of the theory of the second best – we cannot say what the effect of partial changes on the long run equilibrium will be and we cannot take full account of the possible cumulative or unexpected effects of regulation. Finally, he defended a broader role for economic analysis in the assessment of regulatory impacts.

Geoff Meeks's presentation concerned the benefits of accounting regulation. He drew attention to the failure of accounting regulators to live up to their policy of subjecting accounting standards to cost-benefit analysis. He said that the regulators attributed their failure to technical difficulties. He then suggested ways in which one might go about assessing the benefits of accounting regulation, having noted that assessment of costs would be more straightforward.

Paul Klumpes's presentation concerned competition among pressure groups for influence over financial services regulation in the case of the UK pensions industry. He suggested that competition among pressure groups for political influence might recon-

cile the opposing views that Government regulation corrects market failure and favours the politically powerful. He then used the case of pensions regulation to demonstrate the wide variety of costs and benefits that can arise for different interest groups and drew attention to the possible policy implications.

3 Reactions to the presentations

Cost-benefit analysis and competition

David Simpson suggested that cost-benefit analysis and competition could each be regarded as providing a framework for the assessment of regulation. The audience accepted that a particular focus on competition could give very valuable insights into the effects of regulation but many felt that a firm distinction should not be made between the framework of assessment provided by cost-benefit analysis and the one provided by competition. For example, FSA staff mentioned that the FSA's own approach to cost-benefit analysis requires specific consideration of the effects of regulation on the efficiency of competition. On the other hand, the Financial Services and Markets Act does require the FSA to have separate regard to the overall proportionality of its rules (and of certain other measures) and to their effect on competition.

David Simpson argued that the reputations of suppliers and norms within company cultures such as fair dealing can provide important protection to consumers and that both reputations and corporate cultures might be undermined by regulation. The regulators present were not attracted to this proposition, arguing that another characteristic of pensions alluded to in the paper, 'quality unknown until many years after purchase', made it questionable whether the managers of companies would have sufficient incentive to invest in a culture that would yield a high reputation. Many of the firms found to have been involved in large scale pensions mis-selling were well-known and generally considered to be stalwarts of the industry.

David Simpson cast doubt on the idea that CAT standards may be helpful in relation to investment returns. He also argued that some means of attempting to overcome infor-

mational problems could be counter-productive. He adduced CAT standards as one example because they can appear to guarantee something that they do not in fact guarantee. The audience accepted that one has to be very careful that consumers do understand what CAT standards do and do not offer. But, given lack of persistency in fund performance, it was suggested that in the long term the relatively low charge associated with CAT standards might be expected to result in relatively high returns. Clearly, it is important to reveal and promote the appropriate information.

In the same vein he argued strongly that the circumstances of the individual are complex enough to necessitate individual information and advice. Many in the audience saw this need for individual advice as central to policy making in the field of regulation of retail financial products. Others present felt that general advice can also be very valuable. The case of pensions mis-selling was thought to be particularly telling. While it might have been true that there was nothing wrong with the quality of the pensions being sold, it was also true that simple general advice might have prevented some of the inappropriate choices that were made. For example, it now seems that consumers considering leaving pension schemes to which their employers made significant contributions could (and should) have been told that in the long run, no matter what their individual circumstances might be, a self-funded personal pension would be extremely unlikely to make them better off. Perhaps the basis for that advice was less clear in the political circumstances of the time.

The nature and effects of competition were another source of debate between David Simpson and some of the audience. There was general acceptance that the process of competition is a non-linear one, that market outcomes are not monocausal and that competition is a process with long run positive consequences. On the other hand, part of this analysis raised questions about David Simpson's claim that the sharp reduction in the cost of personal financial advice is due to competition not regulation. Surely it could be due to both, especially as the disclosures required by regulation are designed to operate by helping competition to work better? And, while commissions have remained high following the introduction of improved disclosure requirements, the coincidence between those requirements and reductions in life office expenses is clear. A causative link should not be dismissed out of hand.

David Simpson's comments about the value of cost-benefit analysis in financial regulation were thought by many in the audience to be unduly negative. First, it was suggested that the distinction drawn between CBA and economic analysis was too strong. CBA as practised by the FSA is very much concerned with economic issues. For

example, one of the steps in the FSA's methodology involves considering the impacts of regulation on the ways in which affected firms compete.

Secondly, the argument, within the context of neoclassical equilibrium theory, depends on the proposition that the appropriate reaction to uncertainty (the theory of the second best) is to abandon cost-benefit analysis. On this point, an analogy was suggested between a person who is unwell and a market that is not working properly. The analogy was as follows. A patient is sick. The general nature of the problem is clear but the doctor cannot establish the exact causes of the illness. The doctor knows a remedy that is generally effective for that type of problem but, given the uncertainty, cannot rule out the possibility that the remedy will cause complications. However, if the remedy is not administered, the patient will either die or continue to suffer for a long time (pending self-recovery). The suggestion was that the doctor would administer the remedy rather than agonise about the uncertainty. It was argued that, on the same basis, it is sensible to act on the broad policy implications revealed by cost-benefit analysis, provided that there is robust evidence about the general shape of any new equilibrium likely to result. It was emphasised that it is important to use sensitivity analysis to determine whether the evidence is robust.

Thirdly, the unintended consequences of rules were adduced as an argument against the use of cost-benefit analysis. The example given by David Simpson was the 'minimum funding' rule causing a shift from defined benefit to defined contribution pension schemes. Others pointed out, however, that the potential unintended consequences of rules are often cited as a strong reason to undertake cost-benefit analysis. In the case of the example given, it seemed highly likely that a cost-benefit analysis would have drawn attention to the point that employers faced with a potential cost increase would seek ways to avoid or mitigate it. Certainly, the approach to cost-benefit analysis within the FSA involves considering how firms and others will react to rule changes over time.

David Simpson attributed the high costs of operating a pensions business to the complexity of tax compliance. He also said that for any given level of costs charges could be unduly high if price competition were ineffective. It was suggested that the second observation provided an alternative explanation for the costs mentioned in the first. Absent effective price competition, firms would presumably lack the incentives to reorganise their businesses to take advantage of the latest technological developments in order to reduce operating costs. For example, mortgages are complex but are

now being distributed by telephone and on the internet, but pensions continue to be sold almost entirely through more costly channels.

David Simpson suggested that the response to his observation about unduly high charges ought to be steps to promote more vigorous competition. The regulators present felt that their response is indeed pro-competitive, for example in the development of league tables to enhance the disclosure regime. This pro-competitive response is now being developed further in the review of polarisation.

In questioning the value of cost-benefit analysis as a tool for policy making in financial regulation, David Simpson drew attention to an influential cost-benefit study that provided the basis for reform of life disclosure. He suggested that the benefits of £800 million alluded to in the study were merely assumed, and have not materialised in practice. Those present who had been involved in the study objected to this characterisation of the approach. First, the estimate of benefits was based on detailed interviews with product providers about their strategic responses to the proposed reform of disclosure. Second, the estimate was supported by past evidence of price reductions following increased transparency. Third, the estimate was supported by data about the size of the life market. Also, it was important to keep in mind that the conclusion of the analysis did not depend on the figure of £800 million being accurate. The conclusion was robust in the sense that the estimate of benefits was of an order of magnitude many times the size of the estimate of costs. As to the benefits that have actually materialised, it was mentioned that their size depends on one's view of how the market would have developed in the absence of disclosure.

Overall, the discussion on David Simpson's paper seemed to have two conclusions. One was that he had drawn attention to possible drawbacks, and the need for pragmatism, in the use of cost-benefit analysis. The other was that the difficulties he had identified were not so severe as to prompt the FSA to ask the Government to release it from the obligation set out in the then proposed Financial Services and Markets Bill to undertake a somewhat restricted form of cost-benefit analysis.

The benefits of accounting regulation

Geoff Meeks said that in considering the feasibility of cost-benefit analysis of accounting regulation he had chosen to focus on benefits because they are generally considered to be more difficult to address than costs. He felt that there would not be so much

dispute about the nature of the costs and pointed to the useful literature that is available on compliance costs. David Simpson, on the other hand, had said that formidable problems can arise in the quantification of costs, especially as the most important costs (the indirect ones) are usually the most difficult to measure.

Others present felt that accounting regulation could indeed give rise to major indirect costs that would be difficult to quantify. For example, complex but non-prescriptive accounting standards, unless rigorously interpreted by auditors, could provide scope for managements to spend resources on developing a picture of their firms' performance that suits their own purposes rather than provides the information that investors need. It is of course difficult to identify the extent to which such indirect costs arise but it was suggested that the extent might be significant. On the one hand there are a number of well documented individual cases, such as that of Atlantic Computers, in which the auditors seemed not to have insisted on appropriate accounting in a complex area. On the other hand, auditors seem in some areas to have acquiesced in generally accepted accounting practices that now appear almost inexplicable. For example, it was thought extraordinary that for many years (prior to the introduction of the now discredited SSAP 24 on pension costs) firms had failed to include in their accounts the enormous liabilities that can arise from employee pension schemes, in particular when a firm had decided to make good over five or ten years a deficit in its pension fund. This seemed unavoidably to be a failure of accounting and of auditing, and clearly involved a cost as it made comparisons between the financial conditions of firms difficult or unreliable.

The above example of pension scheme liabilities was thought potentially to be of particular interest to the FSA. The fundamental accounting principles that were set out in SSAP 2 required firms to be prudent in the preparation of their financial statements. This meant, for example, that provision had to be made for all known liabilities (expenses and losses) whether or not the amount could be ascertained with certainty. Regardless of the merits of SSAP 2 as a vehicle for producing the information needed for an efficient market, one might have expected it to mean that a firm's decision to pay additional amounts into its pension scheme over several years would have to be reflected in its financial statements, especially as the payments reflected the inadequacy of past payments. But, as already mentioned, this was not the case. One likely explanatory factor of firms' apparent failure to account prudently for these payments is that before SSAP 24 there was no specific rule telling firms what to do about pension scheme costs. But there were lots of specific instructions about accounting for other items. In that context, it might have been that the general guidance provided by

prudence and the other fundamental accounting principles achieved less influence than they would have in a regime whose other parts were less prescriptive. The implication for the FSA is that steps might need to be taken to ensure that the broad principles set out in its Handbook of rules and guidance are fully respected despite the highly detailed and prescriptive provisions that appear alongside them.

Geoff Meeks spoke of the role of financial statements in the market for corporate control. There was little dispute about the potential benefits of accounting standards that he mentioned in this context. At the same time, however, potentially serious countervailing costs were identified. It was suggested that often, even generally, the assets of target companies have turned out to be worth more than the amounts at which they were shown in the most recent financial statements. This seemed to be because accounting standards reflected the historical cost of assets, were biased to reflect liabilities more promptly than assets and indeed omitted some important business assets altogether. Thus some of the details of accounting standards might have caused potentially misleading information to appear in financial statements and made it difficult to compare different shares. It was, however, noted that in recent years the Accounting Standards Board has addressed most of these problems, including through FRED 21 the bias towards undervaluation of assets enshrined in SSAP 2.

Pending evidence of the success of the initiatives made by the Accounting Standards Board, there was a suggestion that the history of unrealistic accounting standards might mean that some of those seeking to buy or sell shares will still consider it necessary to expend their own resources on establishing the fair values of the assets of companies. And what if those private efforts really are needed but do not always occur, in particular because of misguided reliance on financial statements? Transactions in shares that are based on values in financial statements rather than on true economic values would then take place and result in the further cost of reduced market efficiency. Thus it was observed that any assessment of the benefit of accounting standards in equity markets ought to reflect the possibility that their net effect is in fact a cost, though this would clearly depend on the counterfactual: what alternative information mechanisms would have developed if accounting standards had not been imposed and what would the costs of those alternatives have been? It would also depend on the (rather large) amounts that are spent on compliance with accounting standards, on auditing that compliance and on the extent to which investors in fact rely on the information in financial statements.

A further concern raised was that the failure of accounting standards to reflect economic reality might not be confined to the past. The audience mentioned the continuing dominance of the principle of historical cost accounting, which tends to produce very misleading information about financial instruments (particularly derivatives) and long-term assets and liabilities. It was suggested that the former might more usefully be stated at fair value and the latter at present value. Another area of concern was intangible assets, which might account for much of the value of a firm but which tend not to be recorded in its financial statements.

Geoff Meeks said that there is an incentive for investors to use resources to obtain ahead of other investors information that is known to the firms in which investments might be made, and that will affect share prices. He therefore argued that a benefit of accounting disclosure standards is the saving of laborious search efforts. The audience readily accepted this but offered some observations about a related point he made, namely that if the information held by the firms in which investments might be made would not affect the 'real economy' then the gains of the active investors would simply take place at the expense of the less active investors. Overall, it would be a zero sum game.

On this point, attention was drawn to the widely accepted notion that measures against insider dealing reduce the risk premium demanded by those participating legitimately in financial markets. Thus the effect of such measures, of which disclosure that reduces the scope for insider dealing is an example, appears not to be a zero sum game. By analogy, it was suggested that, even in the absence of insider dealing, a lower risk premium might be demanded in a market in which routine disclosure of some of the useful information held by firms about themselves meant that transaction outcomes were not dependent – or were less dependent – on the extent and efficacy of private searches. So, even if private searches are a zero sum game (apart from the search costs) when the information does not affect the real economy, reducing the need for those searches could still provide an important benefit.

With respect to the point that accounting disclosure could reduce active investors' search costs, Geoff Meeks suggested that a possible route to quantifying the search costs of dispersed investors is to base an estimate on the difference between the costs of the active and passive services provided by fund managers.

This was accepted as a valuable insight but the resulting figure itself gave rise to a different question. Given that accounting standards have already set in place an exten-

sive system of disclosure, why is this estimate for the UK equity market of the search costs of dispersed investors as high as about £1.5 billion per annum? An obvious answer, given search activity on this scale, is that accounting disclosure is not providing the information that many investors want. And if investors still believe it worthwhile to expend such resources to try to obtain information before other investors, some doubt is cast on the extent to which accounting regulation actually delivers benefits.

It was also observed that financial accounts are essentially backward looking in nature while investors are actually interested in future prospects. Should a cost-benefit analysis of accounting standards prove feasible, an interesting topic would then be whether the resources spent on financial statements for finished periods would be better spent on five year profit forecasts, or whether the two would be cost-effective in tandem.

Geoff Meeks used the example of the Lloyd's insurance market to draw attention to the private and social benefits that can arise when accounting regulation reduces information asymmetry. There was general agreement with what he said and the possibility of further benefits was raised. One point was that managers of firms might waste economic resources in seeking to take advantage of information asymmetries. For example, lax accounting standards on connected companies seem to have enabled Lloyd's insiders to set up and operate vehicles that could be needlessly involved in transactions as a means of diverting profits to themselves. It was suggested that the cost of such failures of accounting standards may be greatly underestimated by a simple assessment of the time spent by managers and their professional advisers on putting in place misleading schemes of accounting and the vehicles of deception themselves. A far higher cost is likely to be the diversion of attention from competition on the basis of quality, price and innovation: if profits could not be massaged, hard decisions on improving businesses would be less likely to be deferred.

Overall, there was much support for Geoff Meeks's argument that cost-benefit analysis of accounting standards is feasible. It was also thought that such analysis is desirable and ought to be attempted. This was partly because of the high cost of accounting and audit. But it was more because standard setters' failure to undertake cost benefit analysis seems to have produced financial statements that do not tell investors what they want to know.

Competition among pressure groups for influence over financial services regulation in the case of the UK pensions industry

Paul Klumpes's paper reflects a particular view of regulation as the outcome of a process involving competing pressure groups. Under this model, regulation is characterised as a zero sum game. Some in the audience did not agree and cited certain of the costs addressed in the analysis. For example, compliance costs might drive some small businesses out of the market, thereby reducing competition and possibly increasing prices. Again, investor detriment might not just be a transfer between groups.

For example, investors who have suffered detriment might choose to divert expenditure from saving to immediate consumption, which could ultimately lead to wider economic changes. Most importantly, regulation, in part at least, arises because of market failures. In those areas, the purpose of regulation, and many believe its outcome, is a positive sum game. The market can be made to work more competitively because people are better informed and the benefits can, quite plausibly, greatly exceed the costs.

Of course, the argument that regulatory change is subject to a political process in which some groups seek to obtain benefits that will effectively be paid for by costs imposed on other groups was readily accepted. For example, the trade unions that lobbied hard for the 'Pensions Review' succeeded in securing large compensation payments for those of their members that were misguided enough to opt out of their employer's pension scheme in favour of a personal pension. But these payments, and the very considerable cost of quantifying and making them, generally fell on other policy holders of the companies that sold the personal pensions. At the same time, however, it was emphasised that this role of pressure groups in the creation of regulatory policy does not necessarily mean that the net effects of regulation are zero. The case already cited, the pensions review, seemed to show this too. For example, the review might well have enabled some consumers who wanted to buy a pension, but were afraid to enter the market, to exercise their preference to purchase. More generally, if regulation promotes appropriate confidence, it can usefully expand the market.

The audience identified a possible connection between the argument that regulatory change is the outcome of a political process and some of the discussion of the paper by Geoff Meeks. The argument offers a possible explanation of the seeming failure of accounting standards to provide the information that investors actually want. The explanation is that historically investors have not had a dominant influence on the

setting of accounting standards, whereas auditors have had a very strong influence: auditors clearly have a powerful incentive to champion accounting standards that reduce their professional risk.

Paul Klumpes argued that the phenomenon of deregulation means that regulators cannot be neutral. This prompted the thought that regulators might in a positive sense lack neutrality. For example, increasing welfare might be part of a regulator's utility function.

One of the important arguments in the paper is that competition between pressure groups supports the view that regulation both corrects market failures and favours the politically powerful. There was wide acceptance of this view, on the basis that (a) correcting for market failures reduces deadweight costs, (b) the groups that benefit from a proposal that reduces deadweight costs have more at stake than the groups that oppose it (because the sum of the subsidy and the cost reduction exceeds the tax), (c) the subsidised groups accordingly devote more effort to securing the success of such a proposal than do the taxed groups to opposing it, and so (d) proposals that reduce deadweight costs/correct for market failures are more likely to succeed. It was also observed that if regulation does correct market failures it might reasonably be thought of as a positive sum game.

Paul Klumpes also argued that different groups of investors subsidise each other. He said that vulnerable investors (defined by their personal characteristics, such as youth or age) are subsidising sophisticated investors (defined as those that are not vulnerable). It was suggested by some that the true position might be more complex. First, while unnecessary transactions by vulnerable consumers would result in them paying more than their share of the fixed costs of pension providers, it would be useful to know more about the rates of profit generated by pensions companies from vulnerable investors and other investors. And the case of the pensions review, mentioned above, suggests a very large subsidy in the opposite direction. Second, the categorisation seemed rather bleak in that it does not allow for the possibility of advisors whose incentives are such as to prompt them to act in their clients' interest. A vulnerable investor advised by such an advisor would presumably switch to the other category.

The difficulty of identifying the true incidence of the costs associated with investor compensation schemes was raised in response to the claim that they tax investment firms and subsidise investors. Many indicated their firm belief that such schemes cause investment firms to increase the price of their products to all their customers, in the

same way as compliance arrangements and other business costs do. In such a case the net effect of a compensation scheme would be that all investors subsidise those investors that make successful claims on the compensation fund.

The paper characterised the costs of meeting regulatory requirements in operating defined benefit schemes as a tax on employers. This contrasted with David Simpson's point that the imposition of the costs associated with the minimum funding requirement had led to employers seeking ways to cut back the overall costs of their pension schemes. Under this analysis the net effect of the regulatory requirement could depend on whether the value of the costs savings exceeded the cost of the minimum funding requirement (which could be nil if the requirement were avoided). If the cost savings were greater and fell on the employees, then the effect of the regulatory requirements could be seen as a 'tax' on the employees. The issues here are complex but there was agreement that this might be an area in which regulation had the unintended consequence of reducing the pensions that it set out to protect.

Paul Klumpes argued that polarisation is imposing a cost by reducing the scope for competition. Others suggested that the position is unclear. (This topic is now the subject of a detailed review by the FSA.)

One of the final arguments in the paper is that the pressure group analysis of regulation raises doubts about whether regulators can both promote competition and protect consumers. Certainly, the regulators present did not agree with this proposition. Market failures can damage the interests of consumers by leading them to pay more than is necessary for the right product or unwittingly to buy the wrong product or, worse, to buy the wrong product at an excessive price. All those sources of consumer detriment are likely to be reduced if regulation can successfully target at least some of the features of markets that make them less than wholly competitive.

Overall, there was much agreement with Paul Klumpes's central arguments that regulation is influenced by pressure groups, including regulators, pursuing their own interests and that this could have important policy implications. On the other hand, there was little agreement with the idea that the consequence of the activities of these pressure groups is just a series of transfers that amount to a zero sum game.

4 Revised presentations

Cost-benefit analysis and competition

David Simpson¹

Introduction

Much of the present practice of financial services regulation in the United Kingdom has grown out of the Financial Services Act of 1986, and the subsequent experience of its implementation. The intellectual origins of that Act can be traced to the Report commissioned in July 1981 by the then Secretary of State for Trade and Industry from the late Professor L C B Gower (Gower, 1984). Gower was a lawyer who believed that there was a trade-off between market efficiency and investor protection. His criterion for the required degree of regulation was that it should be ‘..no greater than is necessary to protect reasonable people from being made fools of...’², and remarked that ‘In assessing the optimum degree of regulation, I have not attempted any sort of cost-benefit analysis, partly because I am not competent to undertake it, and partly because I am sceptical about its practicability’. This is the only passage in the Report to indicate that the author was aware that it might have some economic implications. Indeed, many of the problems that have arisen from the Act may be attributed to the fact that the Gower Report was entirely devoid of any economic analysis.

In this paper I shall consider the relationship between cost-benefit analysis and competition. Each can be regarded as providing a framework for the assessment of regulation. I shall begin with some general observations about the fundamental role which rules play in the operation of markets. The following section reviews some informational problems in the pensions market which suggest the need for additional regulation. Then two theories of competition are presented before turning to an appraisal of cost-benefit analysis. It is concluded that the theoretical as well as the practical limitations of cost-benefit analysis mean that the technique is unlikely to be helpful in assessing the impact of new financial services regulations. But a wider and deeper

1 The views expressed in this paper are those of the author, and not necessarily those of The Standard Life Assurance Company.

2 Nothing was said about the protection that might be afforded to credulous people.

economic analysis should play an important part in any assessment of regulatory impact.

Markets and rules

Competition takes place within markets. The function of markets is to lower the cost of transactions for buyers and sellers. Without markets, there would be no contact between buyer and seller, no knowledge of reciprocal wants, no agreement over price, no confidence that goods correspond to specification, and no confidence about compensation in the event of default³. In order to perform these functions, however, markets have to have rules. Some of these rules may be formal; others may be customary. Sanctions on infringement of informal rules may sometimes be more effective than formal penalties.

Certain basic rules constraining behaviour are fundamental to all markets. Participants must accept the property rights of others, they must be prepared to recognise contracts, and they must not infringe the rights of others or act negligently towards them⁴. But all markets are different in some respects, and different markets may require different additional rules. The question which underlies the present discussion is, I think, this: what rules are appropriate for the contemporary retail financial services markets in the UK, over and above the criminal law and the normal laws of commerce and fair trading? (A related question I shall not explore here is: who should set and enforce these rules? Should, for example, the Council of Mortgage Lender's code of practice have the force of statute?)

Nearly all of the problems found in financial services markets are informational ones. I should like to discuss five informational problems which are commonly encountered in pensions and other long term retail savings markets, and which give grounds for supposing that there should be additional rules governing the operation of these markets.

3 On this, see Casson (1982).

4 On this, see Ricketts (1999).

Informational problems of pensions markets

Radical ignorance

Most potential buyers in the pensions market suffer from radical ignorance, i.e. they do not know what it is that they do not know. In neoclassical language, they are unaware of the structure of their decision problem; nor do they know all possible states of the world. For this reason, the appearance of 'public awareness' as one of the four objectives of Regulation stated explicitly in the Financial Services and Markets Bill is greatly to be welcomed, as is the decision to undertake a programme of education in schools in the need for personal financial planning.

Also under the heading of information of value to potential buyers comes the preparation of league tables of product performance, pioneered by John Chapman (formerly of the Office of Fair Trading and now an independent analyst). John Sadler (former Chairman of Pearl Group and a director of IMRO from 1987-94) and I have for some time advocated the establishment of a ratings agency to perform this function. We suggested that it would be helpful if independently audited investment returns of companies' with-profits funds together with estimates of the profitability of their new business were published at the same time.

As this type of information is clearly a 'public good' in the technical sense of that term, it could justifiably claim government funding. But it should preferably be carried out by an agency independent of government, since subjective judgments are required which would be difficult for an official agency to sustain. Perhaps the task could be sub-contracted to one of the credit rating agencies.

Infrequency of purchase

It is not widely recognised that essential information is acquired by market participants from the process of competition itself.

In the case of suppliers, each will observe buyers' reactions to a new development by a rival, and, if successful, will try to imitate it. For example, the success of First Direct in exploiting the telephone for retail banking has been widely copied throughout the industry. But similar attempts to conduct pensions business by telephone, pioneered by Virgin, Direct line and others, have been less widely imitated because they were perceived to be unprofitable. Imitation is perhaps the commonest way by which new

ways of doing things are diffused through markets. And those suppliers who are in direct contact with buyers can learn at first hand from their reactions what changes are needed in their products or in the ways in which they are offered.

Amongst the many things that buyers learn from the competitive process is that, from the experience of frequent purchase, they can distinguish those sellers they can trust from those they cannot. Trustworthy suppliers are those who can be relied on always to trade with integrity and to refrain from exploiting unduly any information asymmetries which may arise. A reputation for fair dealing becomes a commercial asset for the seller concerned.

One of the characteristic features that distinguish pensions from other products like cars or washing machines is that normally a pensions contract is bought only once in a person's lifetime. When an individual does hold several pensions contracts, they are usually different from each other. There is therefore little or no opportunity for the buyer to learn about the quality of the product from personal experience of repeat purchases. But information about product quality can often be inferred from the reputation of the supplier, and this information is usually freely available in markets to first-time buyers.

This illustrates one of the 'externality' properties of markets⁵.

To understand just how important reputation is in the pensions market, imagine this market without any regulation at all. (This is not so fanciful a hypothesis as it may seem, when one reflects on the development of Internet trading coupled with the likelihood of reduced tax relief on contributions.) In such a market, the only information that a potential buyer could rely on as a guide to the quality of the product would be the reputation of the supplier. In the absence of regulation, a supplier's reputation would become even more powerful as a competitive weapon, giving a material incentive for all suppliers to become more trustworthy.

Conversely, in a market that is heavily regulated in an attempt to substitute external for internal standards of integrity, the incentives to fair dealing diminish. Within the company culture, such norms of fair dealing as 'The way we do things around here' may eventually be replaced by 'It's OK if we can get away with it'.

⁵ On this, see Loasby (1998).

Quality unknown until many years after purchase

A characteristic feature of pensions which distinguish them from most other products is that the quality of the product only becomes apparent (to the supplier as well as to the buyer) many years, perhaps decades, after the purchase has been made.

There really is no solution to this particular informational problem. Prudential regulation is valuable in making it more likely that there will be a positive return, but it does not contribute to making that return higher rather than lower. Even corporate reputation is not a help: experience suggests that outperformance in investment return on the part of any given supplier lasts no more than a few years, although mutuals as a class are likely to perform better than proprietary companies.

There are, however, some pseudo-solutions to the problem of the unknown investment return. These make matters worse, because they mislead the would-be purchaser. One of these pseudo-solutions is the idea that uncertainty about the future rate of return can be removed by 'guaranteeing' performance. Either the guarantee is illusory, as in the case of so-called 'market adjustment factors' or CAT standards⁶, or else the return which is truly guaranteed must be very low.

Is this what the buyer really wants? That depends on the risk preference of each individual. Attempts to regulate product quality can sometimes mislead the potential buyer in another way – by implying that s/he will not require financial advice.

The need for personal advice

The need for personal financial advice is another aspect of the informational problems arising from the purchase of pensions. It is not of course unique: similar requirements and potential biases arise in the purchase of legal, medical and other professional services. In most such cases, the circumstances of the individual are sufficiently complex that an understanding of the appropriate remedy cannot normally be arrived at by the typical buyer no matter how much information of a general character is provided to him or her.

It is no solution to this problem to guarantee the quality of all possible products. In the notorious cases of pensions 'mis-selling' between 1988 and 1994, there was

6 Howard Davies' public warning on this latter point was commendable.

nothing wrong with the quality of the personal pensions being sold. They were simply unsuitable for the circumstances of the buyers concerned. Generally speaking, the needs of each potential buyer are so different and the nature of pension products so difficult to understand, that pensions should not be sold without advice at the risk of misleading the buyer.

Those 'new savers' for whom stakeholder pensions are intended need advice more than most. Are ISAs more appropriate to their circumstances than 'stakeholder' pensions? What should their contribution levels be? Should they save at all? If advice is considered to be too expensive, the correct response is surely to try to make it cheaper, not to suggest it is unnecessary. Fortunately for buyers at the present time, the cost of personal financial advice is coming down sharply. This is a result of competition, however, not of regulation.

Pensions are difficult to understand

A further informational problem with pensions is that they are very difficult to understand. This is almost entirely due to the tax rules which surround them and mean that a product's suitability cannot be assessed independently of the tax circumstances of each individual. Here is what the recent McKinsey Report had to say about the cumulative effects of these regulations:

The complex and constantly changing tax rules governing the life assurance industry have...led to higher costs and inevitably lower productivity. In short, these regulations have meant that highly productive companies have been prevented from growing, and less productive companies have been able to stay in business because of high price umbrellas. Furthermore, prospective new players that might have been expected to drive productivity up and prices down have been prevented or discouraged from entering. (McKinsey Global Institute 1998, p.16)

Note that this problem is not an intrinsic characteristic of the product, nor a defect of the competitive process. It is simply the result of the imposition of external rules. It is, however, a problem to which there is a straightforward solution, and one that it is within the power of government to achieve. Simplify the tax rules!

In this respect, the changes to the tax regime recently proposed by the Government (DSS, 1999) represent a major step forward. The fact that it will be possible for all defined contribution arrangements to operate under one single simplified regime, and

the removal of the link with earnings up to a flat rate limit, will make pensions easier to understand and cheaper to administer. It is to be hoped that these proposals for simplification will not be lost in complex legislative detail, as has so often been the case in our pensions history.

Competition

When I use the word 'competition', I am not thinking of the mechanistic model of neoclassical equilibrium theory to be found in the textbooks. You will recall that this is the model in which not only is there perfect knowledge on the part of all participants, but there is also an unchanging set of homogeneous goods, together with a large number of suppliers, none of whom can exercise any influence over the price of their product nor alter its quality. One has only to state these assumptions to recognise the irrelevance of the theory from an operational point of view. By 'operational', I mean a theory that one can use to make actual market developments intelligible.

The fundamental difficulty with the neoclassical model of competition is that among the 'perfections' it assumes is perfect knowledge on the part of all market participants of the opportunities available to them, present and future. To make this assumption is to assume away the whole problem to which the competitive market is a solution, albeit an imperfect one. There could hardly be examples of markets that illustrate more vividly the inappropriateness of the assumption of perfect knowledge than those we are discussing today. If the buyer of retail financial services were perfectly informed, would there be any need for any kind of regulation of those markets at all? I would imagine not.

I think instead of competition as a process of continuous interaction over time between buyers and sellers of possibly heterogeneous products, each of whom adjusts their behaviour in the light of new information revealed by the process itself. Such adjustments include the introduction of improved products (flexible mortgages), and improved processes (electronic) for their production and distribution. Consumers do not optimise in the light of complete knowledge of all the opportunities open to them. More commonly, people discover the consequences of their actions only after taking them.

This conception of competition was developed by the Austrians (Hayek, 1979, Kirzner, 1973), and has recently been further advanced by practitioners of agent-based computational economics (Arthur, Durlauf and Lane, 1997; Vriend, 1999). I should prefer to call it the classical theory of competition, to distinguish it from the neoclassical. The continuing direct interactions between buyers and sellers in markets such as these means that the process of competition is a nonlinear one. This means, *inter alia*, that outcomes are not monocausal and that an acceptable model of the market cannot be an additive one.

Cost-benefit analysis

There is little to be said about the practical difficulties of Cost-Benefit Analysis (CBA); these are already well documented. Some of the limitations of the technique in the particular context of the regulation of retail financial services are mentioned in the paper by Alfon and Andrews(1999). It is a relief to note that the statutory obligations⁷ of the Financial Services Authority require an analysis rather than a quantification of benefits⁸. Formidable problems can also arise in attempting to quantify costs: those costs that are most important, *i.e.* the indirect ones, are usually the most difficult to measure.

Kornai once described CBA as 'enlightened orthodoxy'. By this he meant that the technique accepts the orthodox framework of neoclassical equilibrium theory, but in applying that theory alters market prices in an 'enlightened' way. Most of the theoretical debate about CBA has hitherto focused on the procedure for 'enlightenment'. In its partial equilibrium version, cost benefit analysis requires making strong assumptions about interpersonal comparisons of utility, the cardinal measurement of utility, and the constancy of the marginal utility of income. These assumptions are very difficult to justify, but I do not wish to dwell on them. Instead I should prefer to focus on the

7 See, for example, section 155 of the Financial Services and Markets Act 2000.

8 The difficulties encountered in attempting to quantify benefits are illustrated in the study carried out by NERA (National Economic Research Associates, 1994) for the Securities and Investments Board of the costs and benefits expected to result from improved disclosure of commission and charges in the life assurance industry. This study is referred to in Alfon and Andrews (1999) at pages 23 and 24. The numerical estimate of the benefit of £ 800 million per annum, presented as a conclusion, is simply assumed. In fact, the expected benefit did not materialise, as commissions did not fall following disclosure as had been anticipated.

'orthodoxy' of neoclassical theory, where I believe the fundamental difficulties with CBA lie.

These difficulties come into view as soon as any policy application of equilibrium theory is attempted. Once any imperfection in any market is admitted, the neoclassical economist runs into the brick wall of the theory of the second-best. This tells him or her that, in general, no particular policy guidance can be offered. The usual procedure with CBA is to look this difficulty squarely in the eye and pass on. What then follows is described by practitioners as 'common sense'. This is fine, as long as one does not claim any theoretical basis for one's subsequent conclusions.

If one accepts that competition is a nonlinear process, then it is not possible to analyse by the linear technique of cost-benefit analysis the consequences of adding or removing one regulation. The 'before' and 'after' approach of comparative static analysis ignores what may happen along the way. A proper impact analysis would not only have to discover the future responses of buyers and sellers to their changing incentives, but also would have to take account of the interaction of the specified regulation with other regulations influencing these incentives.

It is therefore not surprising to find in practice that the addition of one single rule or regulation can often have unintended consequences. For example, the 'minimum funding' rule for occupational pension schemes introduced in 1997 is, in combination with other measures, having the effect of accelerating the movement of such schemes from the Defined Benefit to the Defined Contribution category. Since it is widely recognised that, in general, the former offer a better deal to the employee than the latter, in particular because of their association with higher employer contributions⁹, such a development is disturbing. One must ask whether this is an outcome that a prior cost-benefit analysis would have anticipated.

In summary, it seems that cost-benefit analysis is unlikely to be helpful in assessing the impact of new financial services regulations. The practical difficulties mean that numerical results are necessarily arbitrary, and there is scope for supporting almost any conclusion. The theoretical difficulties are twofold. First, in forming an analytical

9 A recent survey of pensions provision in smaller companies revealed that the average contracted-out final salary occupational pension scheme received an employer contribution rate of 10% of pensionable earnings. The comparable rate for a contracted-out money purchase scheme was 5.8%. The average employer contribution rate to employees' personal pensions when held in a group arrangement was 4.9%. See Association of Consulting Actuaries, 1998.

framework, assumptions are accommodated to the requirements of technique in an unusually severe way. Second, since markets do not behave according to the assumptions of the neoclassical equilibrium model on which it is founded, the technique is fundamentally flawed. These considerations may explain why cost-benefit analysis has ‘..been little used by financial regulators anywhere in the world’(Alfon and Andrews, 1999), and is now given less prominence in those sectors in which it has traditionally been deployed.

I wish to emphasise that these strictures apply to the pursuit of cost-benefit analysis in the technical sense in which that phrase is used by economists. They do not detract from the importance of attempting a regulatory impact assessment. In the following section, I should like to illustrate the role that I believe economic analysis can play in such an assessment.

Economic analysis in a regulatory impact assessment

Consider for example, the Government’s proposal to fix a maximum charge for ‘stakeholder’ pensions. How should this proposed regulation be assessed?

The proposal appears to rest on the belief that the price of existing pension plans is ‘too high’. Let us assume for the sake of argument that this proposition is in some sense correct. An attempt based on economic theory to remedy this problem would begin by asking what were its proximate causes. In the case of personal pensions, there would seem to be two. The first is the relatively high cost of their administration. While the cost of administering pensions may in part be a function of volume of output, the current high cost seems largely to be due to the necessity of conforming to the complex and cumbersome tax rules to which the McKinsey Report (see above) referred.

For any given level of costs, charges may be higher than they should be if price competition is ineffective. If that is the case, the right solution is evidently to take steps to promote more vigorous competition. This is precisely the response that the Cruickshank Review appears to be suggesting in the case of bank charges (Cruickshank, 1999). It is not clear why the same reasoning is not being applied to charges for pensions.

Fixing maximum prices for any commodity is an example of price control, a practice to which neither economic theory nor experience lends support. The experience of price

controls in the post-War period in the UK and in other Western market economies confirmed that their imposition either creates distortions on the supply side or else the regulated 'maximum' price soon becomes a minimum price. This is why they were abandoned.

The theoretical case against price controls can be simply stated. It is unlikely that an external body can know better than the market what the appropriate market price should be at any given time. If, by some chance, 1% were to be the appropriate charge for a certain type of pension contract on April 1 2001, it would be unlikely to remain appropriate for long, as circumstances would change thereafter on both the supply side and the demand side of the market.

Let us suppose that circumstances mean that the regulated charge becomes too high. Then consumers will pay more than they would have done in an unregulated market and suppliers will make excess profits, the opposite of what was intended. On the other hand, if the charge is too low, some suppliers will leave the market. It may be supposed, however, by the regulators that in the stakeholder pension market there are likely to be significant potential economies of scale available to individual companies. In these circumstances, it might be thought that some suppliers will for some time be willing to accept a price well below their costs.

Some suppliers might indeed do this in the hope that their less efficient rivals will be driven out of the market, while they themselves will attain eventual profitability from the lower unit costs which are expected to come with greater volumes. The market would then, according to this scenario, consolidate into two or three suppliers. The unit costs of administration, and hence charges to consumers, will thereby be kept to a minimum.

Among the possible consequences of the present proposal would therefore seem to be the creation of a privileged oligopoly, heightening barriers to entry and eventually stifling price competition altogether. In the case of the utilities industries, public policy is moving away from the practice of regulators setting prices for an oligopoly towards the principle of prices being set by competition. It would be bizarre indeed if public policy in the field of financial services were to move in exactly the opposite direction.

Conclusions

The market for long term retail savings requires the protection of the criminal law as well as the general laws of contract and fair trading which govern all markets. These rules are necessary to secure the confidence of participants so that they can enjoy the benefits which markets afford. In addition, prudential regulation may be necessary to secure the solvency of long term savings institutions. There is also a need for government to ensure the availability of information of a general character in such markets. Simplification of the complex and constantly changing tax rules governing long term savings would also confer significant benefits on buyers.

But the remaining informational problems peculiar to the long term savings market appear likely to be better resolved by the regulatory authorities promoting effective competition than by attempting detailed prescriptive regulation of the conduct of business. In the circumstances of the long term retail savings market, the application of external rules would require knowledge which the regulator cannot easily possess, observance of those rules would be difficult to monitor, and the rule book would have to change frequently to keep up with changes in market conditions.

The benefits of accounting regulation

Geoff Meeks

Introduction

At first sight the Sixth Fundamental Guideline in the mission statement of the UK's accounting regulator, the Accounting Standards Board (ASB), looks as trite as mission statements often do:

To issue accounting standards only when the benefits exceed the costs.

The interesting part comes only in a subsequent qualification:

The Board recognises that reliable cost-benefit calculations are seldom possible.

The same pessimism about such calculations was displayed by the ASB's counterpart in the US, the FASB¹, which held a conference to discuss just such calculations: one of the suggestions which emerged from the conference was that the US regulator should perhaps abandon the cost-benefit objective from its mission statement (FASB(1991)).

Some observers might be surprised by the reluctance of the accounting regulator to account for its activities when it is the accounting profession that has shown such zeal for introducing cost-benefit calculations in many other areas of activity, commercial and social, and when many employees have lost their jobs because the accountant has calculated that they do not bring sufficient benefits to an organisation to warrant their costs. But in this instance the accounting regulators might retort that highly respected independent academics have acknowledged that there are indeed special difficulties in assigning numbers to the costs and benefits of their activity. For example, Beaver (1989) argues:

Many of the potential effects of reporting regulations would be difficult to assess, such as the effects on resource allocation.

1 Financial Accounting Standards Board.

It is against this discouraging backdrop that we began to explore whether after all it might be possible to move towards a cost-benefit calculation for accounting regulation. A report on our progress so far is being published by the ICAEW² (Meeks and Meeks (2000)); the present paper highlights one or two of the issues analysed in the full report.

We focus here just on the benefits side. That is because it is the most difficult, both conceptually and in implementation. There are problems with measuring costs too, of course. But there is unlikely to be so much dispute about the nature of those costs – indeed, if different people tried to measure them, we suspect they would not produce wildly different answers. The regulators produce clear accounts of their own costs³, and there is available a useful literature on compliance costs and the problems such as response bias which arise in measuring them⁴.

But when it comes to benefits, the existing literature gives us limited guidance on what they consist of and where we should look for data. We have begun by trying to identify the decisions and the markets on which accounting regulation is likely to impinge. The main decision-makers affected by accounting regulation are likely to be the buyers and sellers of company securities; and the main benefit (if any) from accounting regulation is likely to come from mitigating information asymmetry between these groups in the various markets for those securities. Most obviously affected will be the market in which new capital is subscribed; but, we suggest below, the secondary market can be important too, particularly as the scene for the market for corporate control – the takeover market.

The scale of the markets affected by accounting regulation

What is the scale of the resources being allocated in these markets? Such numbers will be the starting-point of our attempts to assess the allocation effects that might be expected from regulation. In the primary market, new issues have recently totalled in the region of £13 billion to £16 billion a year for UK companies (ONS(2000)). And companies' financial statements, as regulated by the ASB, are one source of informa-

2 Institute of Chartered Accountants in England and Wales.

3 For example, Financial Reporting Council (1999).

4 See, for example, Carsberg and Page (1984) for an accounting example, and Franks et al (1997) and Alfon and Andrews (1999) for examples from other areas of financial regulation.

tion, along with prospectuses and informal channels, feeding into those allocation decisions.

But that is only part of the new subscription of new capital. A further part comprises retained earnings – the funds which shareholders release to management whenever they acquiesce in a dividend payout below 100%. In recent years these have roughly matched the cash received via new issues⁵. In addition, in a growing economy, part of current depreciation provisions can be added to retentions, since they will not be needed for immediate replacement investment (Meeks (1974)). The result is that, in aggregate, most of the new funds placed at the disposal of management come from internal sources, without the prospectus and scrutiny associated with new issues. In these cases shareholders have to rely more heavily on annual accounts governed by the regulator for information on the performance and prospects of the resulting investment.

The market for new capital – whether the shareholders are active or passive in this – is, however, dwarfed by the secondary market – the market in the stock of securities previously issued and still listed on the Stock Exchange: the stock of listed shares is many times the annual new inflow quantified above⁶. In theory this market is expected to fulfil a crucial role: monitoring the stewardship of managers of the many companies which do not come to the market for new funds. There are several mechanisms for this monitoring⁷; but perhaps the most significant is the market for corporate control: under-performing managers are supposed to be taken over by superior ones who restore performance. The scale of this market is huge, with the company sector's total expenditure on takeover exceeding even that on new fixed investment in some years⁸. Financial statements that fall within the realm of the regulator influence these transactions materially, and in a number of ways. They inform the bidder's evaluation of the target. They influence the target shareholders' assessment of the bid price relative to their assessment of the company's value under the present management. They influence the shareholders of the bidder and the price of the bidder's shares – particularly important when the bid is financed by equity. And then, after the event, they influence the market's perception of the success of a takeover bid and willingness to sanction further ones.

5 See Meeks and Meeks (2000) for more information on this and subsequent measures.

6 Meeks and Meeks (2000).

7 See, for example Shleifer and Vishny (1997).

8 Meeks(1996).

The role of accounting regulation in financial markets

The markets informed by regulated accounts (though not just by those accounts) are, then, huge. Precisely how can regulation help inform the participants in those markets? It can be helpful to distinguish two channels of influence for the regulators. The first does not have an effect on the ultimate prices of securities in the market but instead affects the costs of achieving those informed prices. Centralised direction could reduce costs incurred by the market in absorbing the information. An analogy might be prevention of gridlock by installing traffic lights at an awkward junction: we would all get to our destinations without them eventually; but they may reduce the time and fuel we consume on the way. The second channel of influence is very different. This involves forcing into the public domain information that would otherwise not be available to one side of the market. And this would have consequential effects on all the resource allocation decisions triggered by the markets we have just described: which companies are allocated the funds to invest; what cost of capital is applied to investment projects; who gains control of the companies in play in the takeover market, and so on. In terms of the traffic analogy it is closer to building a road between two previously unconnected places: people would make journeys that they previously did not.

The benefits of cheaper information transmission

As an example of the first channel of influence, reducing the costs of disseminating information to the market, consider the search costs incurred by investors researching companies⁹. Suppose the directors hold inside information about a company, information which would be useful when trading shares, but which would not affect the real economy – it would not affect production decisions (this assumption is not necessary, but it does make the argument much simpler). Suppose that, once the information reaches the public domain, it will affect the share price; so there is an incentive for the investor to use resources in order to obtain the information ahead of other investors – and so make trading gains. But given our assumption that the information will not affect production decisions, this is by definition a zero sum game: the gain of the active investor comes inevitably at the expense of the less active participants in the market. Even though this is a zero sum game, however, it is still perfectly rational for the individual investor to spend time or money in order to secure the information first.

9 The argument which follows is a simplified variant of one developed by Hirshleifer (1971).

The potential role for regulation is probably obvious: disclosure regulation might mean the information was routinely and rapidly disseminated, saving the laborious search efforts of the active investor.

Quantifying the search costs incurred by dispersed investors looks at first sight a daunting task. So far, we have adopted an indirect route, and one that provides only an upper bound, below which total search costs would fall. Our approach is to compare the unit cost of actively managing a portfolio with the unit cost of passive management – for example managing an index fund; and then multiplying the differential – interpreted as the unit cost of the active part of management (searching for information) – by the value of society's aggregate portfolio of shares. The resulting figure (explained in Meeks and Meeks (2000)) for the UK equity market is of the order of £1.5 billion per annum.

Now actual search costs will be below that figure for the very reason that some funds are managed passively. A second important caveat is that many actual search costs would not fit our description of avoidable information search – many of them will have considerable social value, being essential to the operation of the markets for new capital and for corporate control. All we are attempting at this stage is an upper bound, not a best point estimate. But even this simple exercise does suggest that significant sums are at issue; so the approach may be worth developing.

Private benefits from reducing information asymmetry

Our second category of benefit from regulation involves cases where information might not actually reach the market in the absence of regulation. We ask what are the private benefits to investors if regulation reduces the information asymmetry in these markets.

The first example comes from the Lloyd's insurance market. It focusses on the principal-agent relationship between Lloyd's Names – the 'investors' in that market – and Lloyd's agents, who in effect manage the Names' 'investments'. This case involves the accounting arrangements between agent and Name up till the early nineteen-eighties. Names exposed themselves to far greater risk than their counterpart investors in the equity market, because they assumed unlimited liability. But despite this they had access to hardly any of the monitoring and reporting safeguards that company accounting regulation had provided for shareholders: there were no standard account-

ing or audit practices; no true and fair audit report; no assumption that auditors would test key variables in the accounts; and in some cases the accounts purporting to show the performance of their 'investments' were not even sent to the investing Names.

What happened in this laissez faire regime? The reports of investigating DTI Inspectors show that in a couple of examples tens of millions of pounds of Names' funds were diverted to the pockets of the agents¹⁰. And, according to the subsequent head of Lloyd's, this was not just a fringe activity: 'doubtful arrangements [breaching the laws of agency affected] syndicates covering 92% of the total membership of Lloyd's'¹¹.

Reducing that haemorrhage of funds was the benefit the Lloyd's Corporation hoped to secure with a raft of regulation following the 1982 Lloyd's Act, regulation which brought reporting and audit arrangements much closer to those in the company sector. A cost-benefit analysis calculates that these new regulations yielded significant net private benefits to Lloyd's Names (Gwilliam, Macve and Meeks (1999)).

It might be argued, though, that Lloyd's was an atypical case, and that, in the modern accounting regime facing UK listed companies, plunder of the sort observed in the Lloyd's market before the 1982 Act is not likely to be the greatest threat to shareholders' wealth. But one threat that persisted for shareholders came from creative accounting, which has provided managers with major opportunities to misinform shareholders – except that in this case, unlike the Lloyd's arrangements, it is legal. Griffiths (1986, 1995) and Smith (1992, 1996) provide much of the case material on this activity, especially for the loosely regulated UK regime of the nineteen-eighties: they show ways in which managers systematically manipulated accounting statements in order to exacerbate the asymmetry of information between manager and shareholder.

A telling example is provided by the listed company Coloroll in the late nineteen-eighties. Coloroll floated in 1985 and achieved more than ten-fold growth within four years, via a series of acquisitions; and then it promptly failed. It used a series of creative accounting devices to flatter its performance and mask its gearing. One such device was the reorganisation provision created at the time of takeover and then used in subsequent years to meet routine operating expenses that would otherwise have been included as costs in the profit and loss account. In 1988-9 Coloroll utilised such provi-

10 DTI (1990).

11 Davison (1987), p.62.

sions heavily; but in that year the group's total pre-tax profits (having benefitted from the diversion of £52 million of expenses to the provisions) were only £56 million. Gearing was distorted too. And the company died soon afterwards.

The main sources of distortion found in Coloroll's accounts were effectively outlawed by the new regulators (the ASB) in the early nineties. There is reasonable doubt whether, if Coloroll's accounts had been presented in the more transparent form now required, the company would have enjoyed the capital market's support for its vigorous expansion. And then, either the company would not have collapsed; or, if it had, the scale of the shareholder losses would have been much smaller. At its peak Coloroll was valued at £424 million; after the collapse the shares were worthless.

Avoiding that sort of loss is one of the rationales for the tighter regulatory regime of the ASB – i.e. a benefit of regulation.

Social benefits from reducing information asymmetry

The benefits we have been discussing in the Lloyd's and Coloroll cases arise from installing a better monitoring system in order to reduce the private costs to investors. But misinformation may have further, social costs: it may drive out of existence legitimate business which market participants would like to transact if only they were better informed. A classic description of the general problem is provided by Akerlof (1970, p.495):

Consider a market where goods are sold honestly or dishonestly: quality may be represented, or it may be misrepresented. The purchaser's problem, of course, is to identify quality. The presence of people in the market who are willing to offer inferior goods tends to drive the market out of existence ... It is this possibility that represents the major costs of dishonesty – for dishonest dealings tend to drive honest dealings out of the market. There may be potential buyers of good quality products and there may be sellers of such products in the appropriate price range; however, the presence of people who wish to pawn bad wares as good wares tends to drive out the legitimate business. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost must also include the loss incurred from driving legitimate business out of existence.

In terms of our Lloyd's example, the dishonesty of the intermediaries in the market, the agents, may mean that no matches can be found between 'potential buyers of good quality products [prospective policy holders] and potential sellers [Names] in the appropriate price range' – even though both would like to trade at that price if it were not for the dishonesty. Names are lost; Lloyd's capacity is reduced. Business shifts to other markets – domestic or overseas – or it disappears altogether, if some risks become uninsurable, potentially curtailing economic activity.

In the Coloroll case the corresponding causation might be: investors would be daunted by observing the unexpected losses; they would shift from equities, whose price would fall below the level appropriate with a better information system; the cost of capital for industrial and commercial companies would rise; desirable investment (desirable if everyone knew the facts) would be cut; and national output would be smaller.

Measuring these consequential social benefits of accounting regulation is not at all straightforward. A valuable attempt has been made to measure the benefit of introducing new British Standards for producing manufactured goods: Swann, Temple and Shurmer (1996) have been able to estimate econometrically the (significant beneficial) impact on trade levels of new British Standards in the manufacturing sector. However, much richer data were available than in the accounting case. Casual inspection does show substantial growth in the respective markets after the tightening of accounting regulation we have mentioned for the Lloyd's and the UK equity markets. But it is too early to say whether systematic econometric work is feasible for the accounting cases; and if it were, whether it would support Akerlof's conjecture that such social costs are the 'major costs of dishonesty', and therefore that their mitigation with regulation would be the major benefit from accounting regulation.

Competition among peer groups for influence over financial services regulation: the case of the UK pensions industry

Paul Klumpes

Executive summary

Becker's (1983) economic theory of regulation implies that the influence functions of pressure groups seeking political influence over the optimal form of government regulation of financial intermediaries cannot be independent. The UK pension industry's regulatory environment has been subject to significant change in recent years as a result of various abuses, causing members of occupational schemes and investors in personal pension policies to sustain large economic losses.

This paper discusses various types of marginal costs (taxes) and benefits (subsidies) affecting pressure groups whose constituents have been affected by recent, major reforms to the public regulation of the UK pensions industry over the past decade. Consistent with Becker's theory, the analysis is restricted to those costs and benefits that involve wealth transfers between groups and hence involve a zero sum game in order to maintain political equilibrium. Both direct and indirect subsidies and taxes arise from regulation for intermediaries managing occupational and personal pension schemes, employer sponsors, regulators and both sophisticated and vulnerable investors.

The analysis raises interesting possibilities for analysing the sources of pressure exerted by various pressure groups that may be induced by the introduction of a dualistic regulatory supervision regime that affects the management of the pensions industry. It is relevant because both the Financial Services Authority and the Occupational Pensions Regulatory Authority are likely to supervise stakeholder pensions.

The UK government now views the UK pensions industry as serving a public policy role of providing self-financed retirement income savings for a large proportion of the working population that might otherwise expect to rely on government welfare. This is because the need to provide public reassurance as to the adequacy, equity and security of privately funded pension benefits is the primary public policy rationale for government regulation of pension funds (Altman, 1992). Pension funds are financial intermediaries that collect and invest funds on a pooled basis for eventual repayment to members as pensions (Davis, 1992).

It is reasonable to suppose that some form of economic cost-benefit analysis (hereinafter 'CBA') is needed in order for policy-makers to justify government regulation made in pursuit of its presumed overall aim of maximising social welfare subject to the constraints over which it has no control (Layard and Glaister, 1996). The UK government currently requires the calculation of costs that any new regulation will impose on those affected. However there is little consensus as to how such costs should be measured in the context of financial services regulation. Prior researchers (e.g.: Tucillo, 1978; Lomax, 1987; Peacock and Bannock, 1996), typically measure the costs of regulation as a 'sunk cost' to narrow (usually industry-based) affected groups.

Becker's (1983) theory of competition among pressure groups for political influence seeks to reconcile the opposing views that government corrects market failure with the view that they favour the politically powerful. Instead, it is assumed that both are produced by the competition for political favours. This paper applies the unique insights provided by Becker's (1983) model to analyse costs and benefits arising from two inter-related regulatory changes affecting the UK pensions industry: (i) (in relation to personal pensions) the implementation of the Financial Services Act (1986) and the development of the Financial Services and Markets Act (FSMA)(2000); and (ii) (in relation to occupational pensions) the implementation of the Pensions Act (1995). Competition among pressure groups arises from their disputes over major issues relating to changes in the nature and/or scope of pension regulation. This insight recognizes that any regulatory change is subject to a political process in which some groups (e.g.: intermediaries) receive benefits that are effectively paid for by costs imposed on other groups (e.g.: investors). Politicians and rule-makers are assumed to transmit these competing interests in their policy deliberations over the optimal form of regulation.

Institutional and theoretical background

Relative to most other OECD countries, the UK has relatively high private involvement in pension provision, both at the level of occupational pensions and personal pensions (Hannah, 1992). In 1991 the Maxwell scandal forced an exhaustive overview of the existing system of regulating the security of occupational pensions. This led to the Pensions Act (1995) which codified many of the existing fiduciary responsibilities of pension fund trustees, and established new rules governing the solvency, accountability, investment and other operating standards affecting occupational pension funds. It has also resulted in the establishment of OPRA, effective April 1997. OPRA has

wide, unspecified powers to ensure compliance with the law. However OPRA is reactive in that it does not actively investigate possible breaches of relevant regulation. Further, OPRA has been granted significant discretion in defining the scope of its supervisory activities.

By contrast, the FSA is established under the FSMA (2000) with four general regulatory objectives (market confidence, public awareness, consumer protection and reduction of financial crime) and a further seven specified matters to which the FSA must have regard (section 2(3)). Furthermore, the FSA is required to furnish a CBA whenever it proposes to make rules, unless a cost increase is of no more than minimal significance to those involved. The CBA comprises an estimate of the costs together with an analysis of the benefits that will arise if the proposed rules are made (FSMA, section 155(10)). Thus while OPRA relies on a 'merit rule' approach: rules for compliance are limited to standards of conduct or behaviour, the FSA adopts a more formal 'registration rule' approach: the regulator is legally empowered to require forms to be submitted to it and to penalise non-compliance.

Both regulators currently have supervisory roles in the industry that are envisaged to be more closely linked in the future. OPRA currently supervises occupational pension schemes, while the FSA supervises those responsible for marketing personal pensions. The UK Government recently proposed new legislation (the Welfare Reform and Pensions Bill, 1999) to set up a new pensions vehicle ('stakeholder pensions'). It is proposed that OPRA would regulate the new stakeholder pension schemes' compliance with prescribed standards, while the FSA would regulate the sales process, monitoring marketing material and investment advice.

Theoretical background

Regulation of financial services is typically justified on the ground that it can correct one of two market failures: by facilitating the creation of mechanisms necessary for trade (e.g.: determining default mechanisms in credit markets) or by forcing a monopoly to lower its prices without any countervailing disadvantages (Gowland, 1990). A further justification for government regulation is to reduce market imperfections in the provision of information about financial services (OECD, 1992).

The information failure resulting from costly information search has long been recognised by economic theorists (Stigler, 1971). It has been used to explain the impossibility of informationally efficient capital markets (Grossman and Stiglitz, 1980), the existence of credit rationing in bank lending practices (Stiglitz and Weiss, 1981), heterogeneity in consumers' ability to gather product information (Salop, 1977), and inelasticity of demand for financial services products (Brennan, 1995). Moreover, prior empirical evidence suggests that the processing costs incurred by vulnerable investors in evaluating financial information is likely to be higher than it is for more sophisticated investors (Libby, 1981).

A major criticism of this public interest theory is that government is assumed to be an independent and neutral factor, able to surpass all conflicts of interest and exclusively guided by the general 'public interest'. An alternative 'public choice' theory posits that regulation is acquired by industry and is designed and operated primarily for its benefit. It assumes that industry pressure groups prefer regulation in order to control market entrance, and influence competition by regulating substitution and complementary products and pricing policy. The theory seeks to show that market-failure rationales for regulation may lead to 'undesirable' consequences (Stigler, 1971; Posner, 1974; Peltzman, 1976). While public choice theory can explain the trend towards generalising supervision to all financial services, it cannot easily explain the phenomenon of 'deregulation' of financial services (Peltzman, 1989).

Becker (1983) seeks to reconcile these 'public interest' and 'private interest' views of regulation by modelling political competition among pressure groups. Competition among pressure groups for political influence determines the equilibrium structure of taxes, subsidies and other political favours. The taxes and subsidies are related by the identity between revenue and expenditures: the total amount raised from taxes equals the total amount available for subsidies. The distortions in the use of resources induced by different taxes and subsidies, deadweight costs, have a major effect on the competition for influence. Deadweight costs stimulate efforts by taxed groups to lower taxes, but discourage efforts by subsidized groups to raise subsidies. Thus, an analysis of non-cooperative competition among pressure groups can unify the view that regulation corrects market failures and what has seemed to be a contrary view that it favours the politically powerful (Becker, 1983, p. 384).

An important innovation of Becker's (1983) theory is that it allows regulators to be depicted as pressure groups in their own right. Thus, rather than being depicted as passive arms of government, regulators can be viewed as active pressure groups

seeking to gain political autonomy for regulating their industry. This description appears to be appropriate to understanding the politics of USA insurance regulation (Meier, 1988)¹. It also has application for understanding ambiguous regulatory product settings where regulators' interests genuinely conflict, such as has occurred for pensions product regulation in Australia (Klumpes, 1993).

Pressure groups affected by regulatory change

Various interest groups might be expected to hold substantially different views over the scope of pension regulation. Pension members view pension benefits as deferred compensation, and pension plans as being designed to achieve efficiency over a working lifetime, and/or as part of the long-term relationship between employer and employee (Ippolito, 1986). Employers view the tax-preferred status of pension plans as the principal reason for their existence or rapid growth. Thus corporations might be expected to manage their pension funding and investment policies to maximize the value of this tax shelter to their shareholders (Black, 1980). Financial intermediaries see pensions as primarily a savings scheme for the provision of retirement income, designed to protect people against retirement income risk that a risk-averse individual would like to insure against (e.g.: replacement rate inadequacy, longevity, investment and inflation) (Bodie, 1990)². These differing views may be manifested in various issues affecting regulation. It is likely that various pressure groups would seek to represent the interests of these constituencies, as outlined separately below³.

1 Krosner and Strattman (1996) have applied Becker's theory to analyse how competition in financial services affects political decision making in the USA.

2 There are other explanations for the existence of occupational pensions. Stone (1984) examines two alternative economic theories of the pension component of the employee compensation package, which were popular in the USA during the 1920s and 1930s: as a gratuity from a grateful employer for long and faithful service (gratuity theory), and as a current economic reward to employees reflecting the forces of competition in the market place (deferred wages theory).

3 In Becker's theory (1983), each group is assumed to maximize the income of its members, under the simplifying (Cournot-Nash) assumption that additional pressure does not affect political expenditures of other groups. Efficiency in producing pressure is partly determined by the cost of controlling free riding among members. Greater control over free riding raises the optimal pressure by a group and thus increases its subsidy or reduces its taxes.

Occupational pension scheme members and beneficiaries

This group is very large and diffuse: no specific organized interest groups solely represent this group's interests (versus those of pension fund trustees and administrators)⁴. Nor are the interests of members homogeneous. For example, an increase in subsidy of personal pensions may be considered to be taxation on occupational pensions, while the interests of members and beneficiaries may not necessarily coincide. Yet members are often cited as the major beneficiaries of regulating the pensions industry (e.g: PLRC, 1994, p. 2).

Financial intermediaries

Pension product providers, pension fund administrators and their professional advisers, as well as independent financial advisers or brokers may be classed as 'financial intermediaries'. Pressure groups representing these bodies are fairly small and well organized. As the remuneration of these pressure groups is largely tied to the growth of pension funds, intermediaries have a considerable stake in any pension law reform.

Employers (occupational pensions only)

Employers establish, contribute to, manage and sponsor occupational pension funds. They also have considerable discretion over funding, and the investment policies of pension funds via their membership of the governing trustees.

Regulators

Early economic theories of regulation (e.g.: Stigler, 1971; Peltzman, 1976) assume that the interests of regulators always coincide with those of legislators. However this ignores the many incentive problems faced by any regulator in enforcing and administering a specified set of regulatory arrangements (Mitnick, 1979, p. 145). Thus both OPRA and the FSA are considered to be another interest group with a major stake in any proposals for regulatory change⁵. But since they are both likely to be involved in

4 Trade Unions and various other consumer bodies (e.g.: Consumers' Association) indirectly represent the interests of members from time to time, but only in the context of lobbying on behalf of more broadly defined groups of employees and consumers, respectively.

5 The FSA is funded by levies on intermediary members, whereas the OPRA is publicly funded.

the administration of any new regulation affecting stakeholder pensions, the potential impact of this product on their respective regulatory domains will be complex.

Vulnerable Investors (Personal Pensions only)

Vulnerable investors comprise those on low and volatile incomes, and those with particular difficulty in obtaining and assimilating information (e.g.: the young, the elderly, the unemployed, the long term ill or disabled, the poorly educated and ethnic minorities). The detriment suffered by vulnerable investors effectively subsidises the level and price competitiveness enjoyed by sophisticated investors in obtaining such services. The UK government is currently considering the introduction of 'stakeholder' pensions to cater specifically for the needs of vulnerable investors.

Other Investors (Personal Pensions only)

Other investors are essentially defined by exception to mean those investors that are not 'vulnerable'. This group is very large and diffuse: at least two organized pressure groups may represent their interests (eg: Consumers Association and National Consumer Council). Nor are the interests of sophisticated investors necessarily homogeneous: there may be significant variations in their wealth, tastes and beliefs. However they are also likely to share a number of common characteristics with the notion of a 'representative investor' which underlies the greater part of the current theory of capital markets and asset pricing (Brennan, 1995). By contrast, it is likely that vulnerable investors will possess few, if any, of these characteristics.

Costs and benefits of regulatory change

Since there are multiple pressure groups with a stake in regulation reform, the costs and benefits of regulatory change affecting the UK pensions industry are likely to be complex and multi-dimensional.

Table 1 summarizes how both direct and indirect costs and benefits associated with regulatory change are posited to affect the various pressure groups, each of which are discussed in more detail below.

Table 1

Costs and benefits of regulatory change affecting pressure groups

Regulatory Issue	Cost (tax)	Benefit (subsidy)
Direct:		
a. Intermediary spread	Mo, OIp, VIp	FIo,p
b. Compliance costs	FIo,p	Ro,p
c. Establishment costs	Eo, FIp	Ro,p
Indirect:		
d. Solvency/indexing restrictions	Eo	Mo
e. Administration costs	FIo,p	Ro,p
f. Fund termination option	Mo	Eo
g. Lack of competition	OIp, VIp	FIp
h. Moral hazard	FIp	FIp
i. Investor detriment	VIp	FIp, OIp
Legend:		
Mo – members	Eo – employers	
FIo,p – intermediaries	OIp – other investors	
Ro,p – regulators	VIp – vulnerable investors	
Example:		
FIo,p means financial intermediaries in occupational and personal pension schemes, whereas FIp means financial intermediaries in personal pension schemes only.		

Direct

Direct costs and benefits are those monetary amounts that primarily and significantly affect the economic welfare of relevant groups arising from regulation. The

costs of establishing a new set of regulations will impose taxes on the financial intermediaries that subsidize the regulator. Compliance costs impose a further direct tax on the intermediary and increase the regulator's subsidy. There are also the costs of administering an investor compensation scheme (personal pensions) or in meeting minimum funding requirements (occupational pensions), which tax the intermediaries and subsidize the investors and members. Members must also incur increased establishment costs, incurred by the financial intermediaries on their behalf, to fund the costs of implementing new regulation. These costs can also arise from expert services needed to implement new rules.

Indirect

There are also indirect costs and benefits associated with regulating the UK pensions industry. Taxes paid by retired members on their pension benefits and by employers on excess pension fund surpluses reduce subsidies provided to the industry by taxpayers. Financial intermediaries also incur higher administration costs in order to comply with new regulations, which indirectly subsidize the regulator. Regulation also increases the administration costs of operating defined benefit pension funds, relative to money purchase or defined contribution funds. This is a tax on the employer and a subsidy to the members of occupational funds.

Financial intermediaries also incur higher administration costs to implement new regulations, which indirectly subsidize the regulator. However financial intermediaries incurring such costs also provide benefits to investors who purchase financial services products. This can take the form of benefits that arise from professional training (such as fewer resources wasted on correcting errors, and making more suitable transactions), from better educated investors concerning the products they are purchasing and from improved reporting of information about the performance of these products.

Regulation may result in greater risk taking and imprudent behaviour by regulated financial intermediaries. Also, regulation of financial intermediaries through 'polarisation' can act to reduce their scope for direct product competition (Finsinger and Schmid, 1994). The Office of Fair Trading has recommended that this requirement be removed for collective investment schemes. Financial intermediaries can operate at a lower level of cost and profit efficiency than if regulation was absent, thus effectively taxing consumers (Goodhart, 1988, p. 18). Klumpes (2000) finds that the relative cost and profit efficiencies of a sample of 40 UK Independent Financial Advisor and Appointed Representative based firms selling personal pensions and endowment poli-

cies in 1995 and 1998 are supportive of the existence of market imperfections. However the welfare effects of banning polarisation are complex, since Bernheim and Whinston (1998) analytically show that banning exclusive dealing can lead to even less efficient forms of non-explicit exclusion.

For personal pensions only, welfare redistributions are associated with lower intermediary spread costs charged to sophisticated investors than to vulnerable investors in selling financial services products. Such costs may include the recovery of marketing, information dissemination, and administration costs related to the provision of the service. Since many financial services are not traded, members and investors must incur costs of investigation and search, which are sufficient to ensure less-than-perfect demand elasticity. This will result in the imposition of an implicit or explicit sales fee or spread that creates a wedge between the returns earned on the primary securities managed by the intermediary and the returns realized by the consumer (Brennan, 1995)⁶. The accumulated value of these spread cost differences over time magnifies economic welfare re-distributions between sophisticated and vulnerable investor groups.

Conclusion

This paper identifies various costs and benefits associated with recent changes affecting the regulation of the UK financial services industry in terms of their impact on various pressure groups. The impact of regulatory change is examined across multiple dimensions. Two publicly available pension-related products were examined which have in recent years been subject to moral hazard behaviour associated with government regulation (i.e., occupational pensions and personal pensions). The economic impact of regulating these products was examined for six pressure groups (vulnerable and sophisticated investors in personal pensions, financial intermediaries, occupational scheme members, employers and regulators). The analysis is motivated by Becker's (1983) theory of competition among interest groups for political influence over the optimal form of regulation, which posits that each group's political influence function cannot be independent in a political equilibrium where total subsidies must

6 The notion of an intermediary spread, or the difference between the assumed rate of return on pension investments and the rate of growth on assumed liabilities, is well known in the literature on mutual funds, life insurance and pension funds (e.g: Brennan, 1995). Klumpes (1998) and Klumpes and McCrae (1999) apply the spread to examine the determinants of the performance of pension funds and internationally diversified mutual funds.

equal total taxes. Consistent with this assumption, only marginal costs and benefits arising from regulation were analyzed that effectively create wealth transfers between various pressure groups.

The validity of this analysis is limited by the reliance on economic theory in explaining the nature of costs and benefits related to regulation, and by the underlying behavioral assumptions of Becker's (1983) theory. The major limiting assumption of this theory is that changes in pension regulation are effected via the relative burden of taxes and subsidies on various interest groups, whose competition for political pressure can be efficiently transformed into political influence in a zero-sum political game. Given that the theory admits that regulatory change might be driven equally by public choice (industry) as well as public interest (consumer) considerations, it is unlikely that the behavioural implications of the theory will be palatable to regulators. Finally, the political 'zero sum game' equilibrium conditions are unlikely to hold in reality, particularly since both OPRA and the FSA are likely to have overlapping involvement in regulating activities of a heterogeneous set of constituent interest groups whose interests will be affected by the introduction of stakeholder pensions.

Nevertheless, the analysis provided here may form a useful basis for examining further how and why various pressure groups may seek to apply political pressure in order to increase their subsidies received or reduce their taxes paid, relative to other groups likely to be affected by the introduction of new regulation. It also implies that financial intermediaries receive differential subsidies from these regulatory regimes that may well affect their behaviour in marketing and managing pension products. There are thus likely to be interactions between costs and benefits affecting various pressure groups. This raises the potential for possible gaps and overlaps in the various styles of regulatory supervision of the pension industry adopted by OPRA and the FSA, such as might occur with stakeholder pensions. Moreover, given that the supervisory interests of these regulators are likely to overlap in the administration of this product, the analytical approach outlined here can provide a useful framework for further analyzing the impact on the subsidies which they currently receive from regulating the UK pension industry.

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