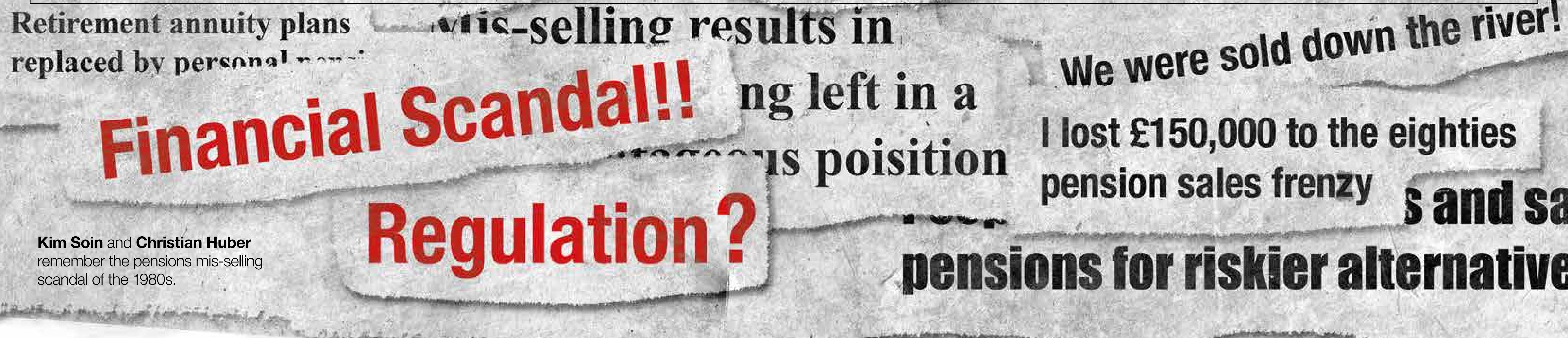
CARRRESEARCH

Financial Scandal!! Regulation?



Kim Soin and **Christian Huber** remember the pensions mis-selling scandal of the 1980s.

The evolution of financial services regulation in the UK has repeatedly drawn on scandals as justification for regulatory change. However, the connection between scandals and regulation is not straight forward.

Through an in-depth analysis of policy documents, reports, media articles, professional statements and prior research from 1986 to 2012 (cf. Soin & Huber, 2013), we identify four phases of regulation in UK retail financial services. Each phase is characterised by the (co)existence of four competing approaches to regulation: the practitioner-based, the state-based, the market-based and the market-and risk-based approach. These approaches co-exist but in each phase, one prevails. We show how advocates of the different regulatory approaches, fuelled by scandals, engaged in fierce competition, and we explain how the perception of these failing approaches have led to financial regulation in its current form.

The Financial Services Act (1986) resulted in the implementation of a regulatory framework that had a largely self-regulatory element and consisted of a two-tier structure. Regulation of securities and investments was delegated to a lead regulator; the second tier consisted of a number of smaller organisations that were responsible for overseeing the major areas within the financial services sector. In the early stages of regulation (1986-1988), the dominant approach was "practitioner-based, statute-backed regulation". Practitioners, it seemed, had a better understanding of the markets than the regulator and state controls were seen as coercive, unnecessary and disruptive. At the same time however, advocates of state-based regulations were challenging practitioner understandings by suggesting the need for regulation in the name of investor protection.

The opportunity to contest the practitioner-based, self-regulatory approach came in the form of the pensions mis-selling scandal of the late 1980's. As part of the wider deregulation of the sector, and endorsed by the government of the day, retirement annuity plans were replaced by personal pension plans. Individuals could now choose whether (or not) to join or leave their company scheme (with employer contributions) or switch to a private scheme with only minimal contributions. While these new pensions provided more flexibility, they also created a situation where many people were persuaded by financial advisers to leave perfectly respectable occupational pension schemes and invest the lump sum into a personal pension.

The heart of the problem lay in the commission based reward system: Financial advisers were only paid when they sold, which induced hard selling in the industry and financial advisers saw this as an easy opportunity to maximise their commission income. However, regulatory investigations revealed that most people were likely to be worse off when they retired than they would have been if they had stayed in the company pension scheme. And, as events and investigations progressed, it became clear that nearly all companies had engaged in these mis-selling practices.

The perceived lack of a credible response from practitioners seriously damaged the dominance of practitioner-based regulation and self-regulation was deemed ineffective. This scandal proved to be a pivotal moment in the early incarnation of retail financial regulation in the UK. Actors who made sense of the pensions scandal as being tightly linked to overall financial regulation, reaching far beyond advice on pensions, quickly gained power. The scandal and the associated perception of the failure of regulation as such, started to cement itself in both the minds of actors and the general public. Although the structures didn't change, the way they operated did as a result of actors' making sense of the scandal. As it turned out, the pensions mis-selling scandal was not convincingly addressed until 1997.

In the second phase of regulation (1988 – 1993), the pendulum swung in favour of the champions of state intervention and a different approach to regulation emerged: a state-based approach to regulation which was characterised by "intervention" and "protection". During this phase, the pensions mis-selling scandal was still a hot topic: scandals, it appeared, were not exclusive to one group of actors and struggles emerged between the various regulatory bodies who offered competing assessments of the on-going pensions scandal.

Scandals do not speak for themselves but can be mobilized by various actors. In this case, the pension mis-selling scandal came back to haunt the advocates of the state-based logic. Supporters of the market-based approach to regulation turned their own arguments against them by connecting the scandal to deep-seated issues about the way in which financial products had been sold. By 1991, several of the regulatory agencies' views of what constitutes successful financial regulation faced dissent by other actors – like the government – and soon the market-based approach would become the prevalent way of thinking about financial services regulation.

The Large Report (1993) presented a new strategy to make sense of the world of financial regulation. The pensions mis-selling scandal was still being used as part of the social construction of regulation. Scandals were equated to the "failure" of financial regulation. And so a new version of regulation was proposed, one that was based on ideas around customer "choice" and "competition". This approach formed the foundations of the third phase of regulation – the market based approach (1993-1997). From 1997, the market-based approach was extended to incorporate the notion of risk. There was a commitment to maintaining cost-effective regulation as well as a dedication to maintaining consumer protection. The two-tier regulatory structure was abolished and replaced by a single super regulator – the Financial Services Authority (FSA).

The FSA started a campaign of "naming and shaming" companies who had not responded swiftly enough the pensions mis-selling crisis highlighted above. Again, the scandal was used to blame divergent practices, this time publicly. Ironically, the pensions mis-selling scandal which was first used to target practitioner-based understandings of regulation by advocates of the state-based approach was then used to undermine this very state-based logic and even some proponents of market-based versions of regulation. This era was characterised by a fear that "over-regulation" that would detract from the "positive impacts of market forces".

The market- and risk-based form of financial regulation enjoyed a relatively long tenure. We suggest this success was largely due to the absence of the successful mobilization of scandals in the early 2000s. Despite events like the mis-selling of mortgage endowments and the vast number of consumer complaints (70,000 complaints a year at its peak), these were not theorized as connected with faulty UK financial regulation – at least not by the most powerful actors in the field.

Events changed dramatically with the collapse of global financial markets in 2007. The complex reasons for these events – the paralysis of the regulatory agencies, the paralysis in the markets and the paralysis in inter-bank lending – meant that there were no quick fixes. However, the unravelling of these complexities and the instances of bad practices that subsequently emerged (eg, the fixing of LIBOR), resulted in another reconfiguration of the regulatory approach. Past events like the mortgage endowment mis-selling scandal and newer events like the collapse of Keydata in 2009, the payment protection insurance mis-selling scandal of 2011 and the mis-selling of interest rates swaps in 2012, were being re-constructed as failures of regulation that demanded a change in the regulatory approach and the structure of the regulator. The days of "light touch" regulation and "over deregulation" were over. As the FSA put it: "Since the events of the economic crisis unfolded, we have radically changed our regulatory approach". (FSA 2011, p.3)

Since 2012 there has been a return to a two-tier regulatory structure and in retail financial services, the pendulum has swung to an approach based on "heavy weight intervention" and "intrusion" at the product design stage (FSA 2011, p.3). What future financial regulation holds is unclear, but certainly there will be further changes; and future and past scandals will be used as a vehicle for these changes.

To conclude, we are not suggesting that scandals are not "scandalous" – frozen markets and bad advice on pensions do have very real consequences. However, scandals play a special role in financial regulation as they can be selectively drawn upon by actors to argue for new forms of regulation. But in order to work in anyone's favour, scandals need to be conceived of as important. As we argue elsewhere (Soin & Huber, 2013), the evocation of scandals is not the only catalyst for regulatory change. They are, however, a powerful means by which actors can mobilise their preferred changes in financial regulation.

References

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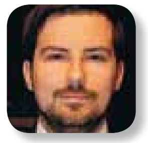
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