Editorial

Is there an alternative to regulation?

Pensions (2011) 16, 1–3. doi:10.1057/pm.2011.1

The collapse of western civilization as we know it in the past few years, or at least of the banking system, has raised a few eyebrows here and there. Does it show the inefficiency of capitalism, or its reverse? Should the banks be cut down to size or do we need additional regulation? And if we do need regulation, what kind do we need? Is it financial services regulation – or competition regulation?

Some of the outlying observers have a slightly different take; it may be that one of the underlying causes of the financial collapse, especially the banks (which did not collapse in 1929 for example), was the existence of regulation itself. This is not a line that is taken by the great panjandrums of regulation, whose reflections following upon the disaster have broadly called for more, better and higher-paid staff.

The reason is that, as the former Chancellor Nigel Lawson observed, the Great Recession is merely a large form of what has happened since man became commercial, and feasts and famines, and booms and busts simply reflect the innate character of civilization – rather like the biblical fable of Joseph and the seven fat years and seven thin years. We may just have to live with cycles in the affairs of man, uncomfortable and unfair though it may be, with social democratic governments deadening the pain here and there for those who suffer as a consequence.

As mentioned, the regulators themselves argue that with just a slightly larger budget or a somewhat higher staffing or better teams, they could have stopped the rot. But the Financial Services Authority (FSA), while it lambasted minor financial advisers, was unable to stop a £14 million fraud by a convicted fraudster, because when he applied for FSA registration he did not disclose his previous convictions. In the

meantime, Royal Bank of Scotland (RBS) suffered the largest loss of any enterprise in world history, although of course regulated by the FSA. Similarly, it might be argued with some force that the Maxwell Affair was a financial services failure (and not a pensions failure) that occurred simply because the great perpetrator could hide behind the existence of regulation to carry out a fraud. It will be remembered that the money was stolen from a regulated financial institution, and not an unregulated pension fund.

Therefore the issue is: what is the point of regulation? If it cannot constrain failure, and it cannot keep out the rogues, and we are back to buyer-beware, the principle of both Roman and English law for over 2000 years until the invention of product liability and the snail in the ginger-beer bottle, we could save a lot of time, money and paperwork by reining back the world's fastest growing profession.

The position is clearly ripe for a review. And nowhere more so than in pensions. The Pensions Regulator in the United Kingdom is just hiring a new senior team – and preparing to double in size, just as the corporate pension system in the United Kingdom is in decline. Its new and additional role is not to simply protect pensions but to ensure that employers pay fairly modest contributions into the new auto-enrolment system coming on stream in 2012.

With a new Chairman and Chief Executive soon to take office, if not power, do they and their board need to reflect more broadly on regulatory policy in the light of what are now several years experience of a regulatory body for the pensions industry?

The UK Pensions Regulator has enjoyed so far a blessed existence; with a few hiccups, it has grown from an initial budget of around

£10 million to a budget of £25 million in 6 years. The senior management team have avoided most of the banana skins strewn along the pensions path, but have found it hard to recruit decent staff and have struggled to avoid the inevitable bureaucracy. It is now large, slow and probably ineffective. What would a rethink involve?

The time is not probably ripe for a complete abolition, and a return to the checks and balances imposed by contract, tort and criminal law. But, it may be that a small, tight, talented team would offer better value than, especially in times of austerity, the current planned 600, a figure immortalized by Tennyson and hopefully not with the same outcome.

And what should a new team think about once it settles into ministry-issue Aeron? Most regulators pronounce that they are not there to stop failure, they are there to protect the public and improve process. But for that we do not need to spend £40 million a year. What therefore should we spend the (much less) money on?

First, the new Chairman has had his salary cut back to not more than that of a prime minister. That means he should do less rather than more. Second, the risks are about to increase. Managing National Employment Savings Trust, which is what the UK Regulator now has to do, may have some hidden pitfalls. And whether it is Sod's law or Murphy's law, or the ubiquitous black swan, something unusual, expensive, unpredictable and awful is bound to make its appearance soon enough.

In the meantime, there are things to do, short of a detailed policy review (for which the government has little heart at present). First, it might be helpful to try and push down through the layers of management what the policy is at the top. Policy guidelines issued by the chairman and the board, declaring commerciality and proportionality in all its operations, are not always reflected in day-to-day dealings with users. The disconnect between pulling a lever at the top, and seeing what happens at the bottom was a major issue for Tony Blair when in his first term, and even in smaller organizations is hard to manage.

Second, it is important for the board not to believe the external and quasi-independent surveys of how well the Regulator performs; the questions are not always neutral, and clients and others frequently express concern about the apparent disconnect between the outcome of the surveys reported in the annual reports and their own experience. It is critical for members of the board to talk (and listen) to users and the trade bodies. The challenge for all regulators (as with politicians) is losing touch with the realities of experience at the sharp end; it might be helpful for everyone to engage in regulation by walking about. And lunching.

Third, any reformed regulator would need to change the perception that pension funds are dysfunctional – and avoid sanctimony when issuing guidelines and press releases. Regulators of all descriptions find it hard to reconcile themselves to the fact that the funds that take notice of them are usually pretty well run anyway – and those which are not well run will not take much notice anyway.

Fourth, there is a desperate need for an organization or body (and it might as well be a regulator) to be a facilitator. We have plenty of controllers, but trustees in particular would welcome a regulator that acts as a kind of genuine clearance house to allow them to take difficult decisions without risk of litigation.

Fifth, all regulators need to think twice before hiding behind the data protection act and statutory restrictions on confidentiality – and only do so if it is really necessary. Post Wikileaks, the assumption should be that everything will get out in the end anyway, and another regulator, the FSA, has just learnt in relation to the non-publication of its RBS inquiry that the public need to know the reasons for decisions that may affect them in due course. It is being forced to make public its efforts, and is now speedily rewriting its report in English before publication.

Sixth, any pensions regulator needs to train its staff to remember the doctrine of proportionality, and that expenses paid out of a fund to deal with compliance matters will affect people's benefits.

Seventh, the current Pensions Regulator in the United Kingdom is a NDPB (a non-departmental

public body), and in particular gets its funding from the industry. Although that arrangement lends itself to charges that it is too close to the people it is supposed to govern, it also offers the benefit of the opportunity to be, and be seen to be, independent of the government and the civil service. That has historically not always been the case, and the fact that the incoming chairman is to be materially underpaid should give him financial and policy independence that should be fully exploited.

Eighth, every regulatory board should have an away-day or three once a year, somewhere comfortable and expensive, and discuss whether what it does is really necessary, or is just a nice-to-have. Regulatory documents issued by the FSA and the Pensions Regulator in the past few years are not always written with the crispness of style and brevity of content that the users need; they seem to be prepared and published in order to protect the interests of the Regulator rather than the interests of users. The users and the public might even be able to manage satisfactorily if they never saw the light of day. A major temptation for a regulator who does not have to bear the consequences is to allow the best to be the enemy of the good.

Ninth, all regulators should spend time exploring the dilemma of morals and law. Just because a regulator can does not mean a regulator should. For example, the Nortel/Lehman Brothers decision in the High Court in December 2010 revealed a major issue for the Pensions Regulator to think about in relation to public policy. The court felt itself legally obliged to make a decision in favor of members and the Public Protection Fund (PPF), which it thought would actually do damage to pension schemes and companies generally, because it would make it difficult (and sometimes impossible) for companies to raise capital or continue banking arrangements

necessary for the continuation of the business. The big question is whether even though the Regulator had the right to fight the action, and succeeded in saving money for the PPF, it was the right thing to do on public policy grounds. It is a dilemma, but it is one that might be better explored in public. And the dilemma is accentuated because of the earlier court decision that trustees, for example, should have regard to the interests of the regulator and the PPF on the grounds of public policy even at the expense of benefits for members (*Independent Trustee Services v. Hope*).

Meanwhile, and finally, it would help if regulators offered joined-up regulation. The retiring Chairman of the Pensions Regulator David Norgrove was reported in the *Financial Times* (7 December 2010) to have expressed his concern that certain pension funds were gaming the PPF by investing in equities, which he regarded as risky and inappropriate, and not in bonds, which he regarded as safe and appropriate. If the investments paid off, full pensions could be paid; if they did not, the PPF would in due course underwrite the losses.

In that same week, the PPF itself reported that its deficit swung from -£1.2 billion to +£400 million in 2010 largely because, according to its investment director, of its investment in equities and alternatives. And meanwhile, the former investment manager, government minister and Treasury adviser on pension investment policy Lord Myners was reported to have said that increased pension scheme allocations to bonds are nonsense and that the bond market is an enormous bubble that will burst. There is no doubt that the regulatory framework needs to be improved, and now is a good time to do it.

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