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THATCHER: THE MYTH OF DEREGULATION

By Philip Booth
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About the author

Philip Booth is Editorial and Programme Director at the Institute of Economic Affairs and (from 1st May) Professor of Finance, Public Policy and Ethics at St. Mary's University, Twickenham. Previously, Philip Booth worked for the Bank of England as an advisor on financial stability issues and has been Associate Dean of Cass Business School. He has written widely, including a number of books, on investment, regulation, finance, social insurance and pensions as well as on the relationship between Catholic social teaching and economics. Philip has a BA in Economics from the University of Durham and a PhD from City University.

Summary

- It is commonly believed that, during the 1980s, Margaret Thatcher presided over a substantial reduction in government regulation of financial services. Indeed, some have blamed this deregulation for the financial crash that took place nearly 30 years after 1979.
- ‘Big Bang’ in 1986 did remove the restrictive practices and largely private regulation that existed in securities markets. However, this involved the state unwinding systems of private regulation and was not, as such, a simple act of deregulation.
- Furthermore, not long after Big Bang, investment and financial markets became regulated under the Financial Services Act. This also extended detailed statutory regulation into areas of financial markets which had previously been more-or-less unregulated by the state.
- Retail financial products also became heavily regulated at the retail level through the Financial Services Act, whereas they had previously been regulated by contract law, professions and industry agreements. Industry agreements that had been effective in reducing ‘mis-selling’, such as the maximum commission agreement, were made unlawful. The FSA (now FCA) have been fighting to deal with the problem of commission-incentivised mis-selling ever since.
- Overall, from 1979 to 2010 there was an increase from one regulator for every 11,000 people employed in finance to one regulator for every 300 people employed in finance. If the rates of growth of both regulators and people working in finance seen in this period continue, the number of people working in financial regulation will overtake the number of people working in financial services by around 2070. This excludes compliance officers working for financial services firms themselves.

- Some attempts have been made to estimate the costs of financial regulation. However, most of the costs are indirect and result from reduced innovation and competition and cannot be calculated. In 1986, the direct cost of financial regulation was estimated to be £20m; this rose to around £90m by 1992 and £673m by 2014. In the 1980s, a reasonable estimate of compliance costs was generally thought to be around four times the direct costs of the regulatory bodies; the 'excess burden' arising from the reduction in innovation and competition and the distortion of prices was thought to be around four times the compliance costs.
- Government regulation of employment contracts, which required employers to allow their employees to opt out of occupational pension schemes, led directly to the pensions mis-selling scandal of the late-1980s/early-1990s. Once again, this was not an act of deregulation but the state prohibiting a form of private contractual agreement. Although occupational pensions became much more heavily regulated over time, this did not happen until 1995, under the Major government.
- Before 1979, there was very little regulation of the activities of life insurance companies. There was then a huge increase in the regulation of insurance companies in the 1980s. This came partly from the regulation of their product sales activities under the Financial Services Act, but also arose directly from the Insurance Companies Acts 1981 and 1982 and the associated regulations. These Acts allowed the Secretary of State to spawn further regulation without proper reference to parliament and led directly to the situation that prevails today of a very heavily regulated life insurance sector.
- Until 1980, the financial sector was regulated by private institutions, professional codes and a small amount of well-drafted and highly targeted primary legislation. Under Thatcher, private regulatory mechanisms were unwound or prohibited and replaced by state regulation. Since the 1980s, the financial sector has been regulated by statutory bodies developing thousands of paragraphs of prescriptive statutory regulation and has gradually extended its reach into new fields. It is true that Thatcher undertook certain liberalising reforms such as the abolition of exchange controls. However, state regulation of securities and financial markets became much more intrusive.
- The idea that the 1980s was a period of increasing regulation and not deregulation is not revisionist history. Contemporary accounts argued that, under the regulatory system that developed, the City has ceased to be a place "where you look after yourself according to a code of

honour of conduct. It is a tough regulatory system"; that the regulator had a "very tough bunch of powers"; and that "There is a substantial risk, in fact, that we now have massive overkill of the supervisory structure in the financial industry".

Introduction

It is commonly believed that, during the 1980s, financial markets were liberalised considerably in the UK. This is not, in general, true. In many important respects, regulation was increased and introduced into areas that had never before been subject to statutory regulation. That regulation – especially regulation covering sales of financial products, investment advice and trading in securities – was detailed, prescriptive and unlike the form of regulation that had previously prevailed in UK financial markets. In other areas, such as the prudential regulation of insurance companies, the level of regulation increased significantly whilst also adopting a style quite unlike the traditional common law and primary statute law approach that had previously been used in this field.[1]

The belief that there was deregulation of the City probably comes about from the perception that "Big Bang" involved breaking down a number of restrictive practices operated mainly by the stock exchange. Big Bang allowed trading and broking to be conducted by the same firms and it also allowed foreign investment banks into the City on the same terms as domestic banks. However, the main feature of Big Bang was not deregulation as such but the breaking up, using state power, of mechanisms of private regulation. Big Bang was then followed by the Financial Services Act, which imposed statutory regulation – delegated to industry bodies ultimately accountable to the government – on the City.

1 The situation with regard to banks is more nuanced. On the one hand, many controls were taken off institutions such as building societies. On the other hand, deposit insurance was introduced as a result of an EC directive and international bank capital regulation was also adopted: previously, bank capital had not been regulated. Commercial and retail banking will not be covered in this paper.

It should be mentioned that, in one respect, there was unambiguous liberalisation of financial markets under Thatcher. In October 1979, exchange controls were suspended. These were “temporary” controls, implemented during the Second World War and their suspension[2] helped the City to extend its role as an international financial centre.

Before 1979 financial activity was governed by private institutions, contract law and simple pieces of primary legislation which were generally very well drafted. In the sections following, these will be described. The paper will then discuss the regulatory developments under Thatcher’s government before analysing their overall impact on the regulatory environment in financial markets.

2 In effect their abolition.

Securities market regulation up to 1979...and just after[3]

At the time Margaret Thatcher became prime minister, in 1979, most regulation of securities markets arose from the stock exchange and other private bodies – in effect, clubs. These clubs had a long history.

Modern stock exchanges first developed in coffee shops, such as Jonathan's coffee house in Change Alley. The exchanges developed there from 1698 until 1761 when a group of 150 brokers and jobbers formed a club at Jonathan's. This developed into the first formally regulated exchange in 1801 and, the following year, the exchange moved to Capel Court. The characteristics of the exchange included restrictions on membership, the publication of prices and lists of stocks that were traded and the potential for the development of a rule book. The first codified rule book covering topics such as default and settlement was developed in 1812. However, even before this time, rules had existed. For example, those who did not settle their accounts would be labelled "lame duck" on a board and could be banished from acting as brokers.

The rule book included provisions for settlement, arbitration and dealing with bad debts. There were also rules about general behaviour designed to increase transparency (for example, partnerships amongst members had to be listed publicly) and about the quotation of prices (Davis et al. 2004). Davis et al. (2004, p. 12) also reports how the exchange absorbed collectively losses from an event of market manipulation and the inappropriate use of insider information in 1814 whilst ensuring that those

3 The historical detail from this section is partly summarised from Arthur and Booth (2010).

who attempted to profit did not gain. These became matters entirely handled by government regulation under Thatcher's government.

In 1844 it became a requirement for securities to be sanctioned by the stock exchange committee before being listed on the exchange (Davis et al. 2004). In effect, this was the introduction of the other important aspect of regulation provided by exchanges – rules for the quotation of a company's shares. Indeed, rules for the quotation of a company's shares complement rules in relation to the behaviour of members. Without an orderly market, companies will not seek a listing, and, without reasonable listing rules, investors will be discouraged from trading on the market. At the turn of the twentieth century, these listing requirements then became more onerous.[4]

This ability to determine membership and set the rules by which members work is crucial for an exchange. Members incur the costs and reap the benefits of an orderly market. The companies quoted on the exchange also reap the benefit of an orderly market through, for example, a lower cost of capital. The benefits of those rules were, broadly, excludable, as is required by a club good, in that the benefits would not, in general, be obtained by companies not quoted on the exchange or by those involved in exchanging stocks and shares who were not members of the exchange. Similarly, the costs of the rules would be borne by those trading in the form of membership fees and in the form of the non-pecuniary costs of self-restraint. Members were fined if they broke the rules (see Stringham 2002) and the fines were put to charitable purposes.

It is interesting to note that those brokers who were excluded from the new exchange petitioned parliament to ask the government to force the exchange to be opened to all members of the public in 1801 (see also, Stringham 2002). The opponents of a bill that was drafted to that effect argued that private rules had to be enforced if the institution was to thrive. So, from the earliest days, we can see the beginnings of a competition dispute that was, in the end, responsible for the series of events that led to the transfer of regulatory authority to the state in 1986.

As is discussed in Burn (1909), it was possible to deal in stocks through non-members of an exchange – the potential for competition existed. It is worth noting that, since the days of statutory regulation, introduced by the

4 The above two paragraphs are taken from Booth (2014), which includes a wider discussion of the economics of the club aspects of the exchange.

Thatcher government and discussed below, dealing through those who do not have statutory authorisation has not been possible. However, before statutory regulation, though dealing through non-members was possible, it was not regarded as advisable. Only the dealings of member brokers and dealers were considered as being beyond reproach.

A long-standing feature of the London exchange was the separation of brokers and jobbers (those fixing prices and trading on their own book). The rules surrounding this evolved but were clarified and made explicit in 1909 (again, see Burn 1909, and the article reproduced from *The Times*, pages 134-136). This rule involved considerable restraint on behalf of some members, as was made clear in *The Times* article, but it was considered that it benefited the reputation of the exchange by removing conflicts of interest.

Just as it was possible to deal off-exchange, it was also possible for non-members to form a competing exchange with different rules. It could be argued that there were considerable network benefits from a single exchange and, indeed, all the local exchanges were gradually absorbed into the London exchange. Arguably, there was at least some degree of natural monopoly and, insofar as competition did arise, it is most likely to have arisen from overseas exchanges. Competition from overseas exchanges was, however, made less practical by exchange controls between 1939 and 1979 and, furthermore, the developments in technology that began to erode barriers between exchanges did not really occur until the late 1980s. Without question, even without the reforms of Big Bang, the stock exchange would have come under competitive pressure. Indeed, though equity and government bond dealing remained national activities, there was already international competition for currency and euro bond trading by 1986.

The state regulation of the US stock exchange occurred before that of the UK exchange. However, Paul Mahoney (Mahoney, 1997), mainly describing the development of the New York stock exchange but referring also to others, said: “in summary, many stock exchange rules in the era before governmental regulation were premised on the idea that to attract investors, the exchange had to provide elementary protection against defaults, forgeries, fraud, manipulation and other avoidable risks. Thus stock exchange rules dealt with most of the broad categories of issues with which modern securities regulations are concerned.” This is the key point about private, club-good regulation. Indeed, the reputation for trustworthiness

on the London exchange was such that in 1923, when it received its coat of arms, its motto was: “my word is my bond”.

Some statutory law began to be developed that controlled the activities of companies before 1979 and this was extended under Thatcher in the early 1980s. In summary, at the time of Big Bang, securities markets were, in effect, governed by the following law and regulation (see Goff, 1982):

- Stock exchange regulations required companies to produce, for example, interim reports. These regulations were entirely at the discretion of the exchange. The stock exchange had requirements for companies seeking a quotation on the exchange as well as ongoing requirements for quoted companies.
- The Takeover Panel set rules for takeovers. The Takeover Panel did not have statutory power. However, it could, like the Council for the Securities Industry (another similar body), both issue a public reprimand and report an “offender” to an association of which he was a member (for example, the stock exchange). This would be a very powerful sanction. The City Code on Takeover and Mergers, and the Takeover Panel, were established by the City itself. The Council for the Securities Industry was established by the Bank of England but had no statutory force. Again, the Takeover Panel was essentially a market mechanism of regulation of the type that was so common at the time Mrs. Thatcher became Prime Minister in 1979.
- Companies were regulated by the Companies Acts 1948, 1967, 1976, 1980 and 1981. These acts required certain forms of information to be provided by companies, as well as dealing with the rights of shareholders, including minority shareholders, the duties of directors, and so on. More controversially, the 1981 Companies Act made insider trading a criminal offence. With reference to the topic of this paper, it should be noted that this extension of financial regulation took place in the Thatcher period too. It is only this last group of regulations that had full statutory backing.

The provision of investment advice by stock exchange members (in practice, brokers) was – like most other aspects of consumer-facing financial services activity - governed by professional standards and basic law in areas such as negligence. As we shall see, this became heavily regulated just after Big Bang in a separate process of financial regulation brought in by the Financial Services Act.

Regulation of other aspects of financial services before 1979

Life insurance and pension funds

Other aspects of financial services were similarly liberally regulated at the beginning of the Thatcher period. For example, life insurance, (see Booth 2007) was regulated in a manner broadly consistent with freedom of contract. This followed a legal tradition that began in 1870 with the Life Assurance Companies Act. The 1870 Act required all companies transacting life insurance to place a deposit with the courts – this was certainly an impediment to new entry but became relatively less onerous over time as the deposit did not keep up with rises in prices. Secondly, the Act required the publication of accounting information. The information was, in effect, published to the market via the Board of Trade. Though the Board of Trade could exchange correspondence with the company, it had no regulatory power. Finally, the Act developed special procedures for winding up life insurance companies.

The philosophy behind this regulation was to promote what became known as "freedom with publicity". There was no desire to control how companies and individuals behaved as long as information was published so that intermediaries could assess the performance of the company. The special mechanism of winding up an insolvent company could simply be regarded as a legal framework necessary to ensure that contracting parties received what was justly and legally due to them.

This whole legal framework was very successful and remained more or less intact for 100 years. The original Act could easily be reproduced on just nine pages with all the schedules coming to a further nine pages. Developments in insurance legislation between Gladstone and Thatcher

were described in just six short paragraphs of the standard insurance regulation textbook used in the examinations of the Institute of Actuaries in the 1980s (Abbott 1984). Gradually, there was more power of intervention for the government if the relevant minister believed an insurance company to be trading whilst close to insolvency. However, the basic “freedom with publicity” approach was maintained. This all changed, though, in 1980. And there were further significant changes in regulation between 1980 and the end of Mrs. Thatcher’s premiership in 1990 which will be described below.

The regulatory regime surrounding pension funds was also liberal and designed in the best traditions of British common law and primary law. Pension funds were largely unregulated trust funds with trustees having a fiduciary duty to act in the best interests of the members of the scheme and to invest as a prudent person would invest. There were special provisions that were necessary in order for pension funds to qualify for tax relief and also to allow them to contract-out of part of the state pension scheme. These could be quite complex but they were designed in order to prevent abuse of the special tax status that they were given.

It is also worth noting that the role of professional associations was very strong in providing for a well-ordered market when it came to prudential behaviour. This was especially true of the actuarial profession which had very few statutory privileges and yet was effective in ensuring that the insurance and pension fund industries behaved in a generally prudent manner[5].

Regulation of product sales

Until 1979, the sale of insurance and consumer investment products was essentially unregulated or, more correctly, it was regulated by general contract law and by market institutions. One important such market institution was a maximum commission agreement amongst life offices. A difficulty with the sale of insurance products is that of ensuring that advice is independent. If insurance and unit trust companies compete on the basis of the commission they offer to intermediaries then there is a possibility that intermediaries will bias their advice towards companies

5 Insolvencies of life insurance companies were very rare. There were two significant events between 1870 and 1970 and neither of these adversely affected policy holders. See Booth (2007).

offering higher commission. This is a potentially serious problem because, given the information asymmetries involved in financial services markets, customers rely upon intermediaries offering reasonably disinterested advice. The major life offices formed an agreement that restricted the level of commissions paid to intermediaries and this had the effect of reducing upward pressure on commissions and reducing potential bias in advice.

Big-bang and "deregulation"

Statutory financial regulation in the UK up to 1986 was amongst the most liberal in the world – certainly, the most liberal in Europe. It relied on freedom of contract, the integrity of professional associations and evolved institutions within the market. Certainly it did not give rise to perfect results. However, the regimes that replaced this approach to regulation spawned an industry of "rule writing" and compliance.

The so-called deregulation of the City of London arose as a result of challenges to the existing structures from the competition authorities. Various Stock exchange rules were challenged either explicitly or in discussions with the exchange. These included fixed commissions, the separation of broking and jobbing and the refusal of the exchange to allow corporate and overseas membership. Arguably, the first part of the process arose with the requirement of the exchange to register the stock exchange rule book with the Office of Fair Trading as a result of changes to legislation in 1976. Once this happened, an investigation by the competition authorities was always likely.

Three points are worth noting about these challenges to the exchange. Firstly, just as the exchange had been challenged on competition grounds in the early nineteenth century, it was again challenged on competition grounds. Secondly, private regulatory authorities require, by their nature, the power of exclusion and the ability to make rules. The removal of that ability, through action by the competition authorities, possibly fatally undermined the ability of the exchange to police its members' behaviour – though the exchange was able to continue with listing requirements for companies. Thirdly, and perhaps most importantly, the focus of the competition inquiry was on the restrictive practices of the exchange and the impediments to competition this created rather than on the potential for competition to take place *between* exchanges and the potential for off-

exchange trading that was developing given changes in technology. Competition between exchanges now occurs but, at the time, was inhibited by earlier exchange controls and the limitations of the then current technology.

Big Bang itself was undoubtedly an act of deregulation – but not in relation to state regulation. It is better seen as an act of prohibition. Big Bang prevented private regulatory bodies from developing their own rules for the benefit of their members and, arguably, wider society. This was one of two acts within the financial sector – the other being the abolition of the maximum commission agreement amongst insurance companies – where the power of the state was used to prevent private-sector rule setting on competition grounds in a way that led to unfortunate consequences. It could also be argued that this prohibition on private rule setting then led to government regulatory agencies filling the gap and doing so in ways that involved granting effectively unlimited powers to a statutory regulatory bureau or to a body that was ultimately accountable to politicians rather than to participants in the market. Certainly that is exactly what happened in the years that followed Big Bang.

Indeed, these actions reveal an important point about the Thatcher government. It is well known that the Thatcher government reduced the power of vested interests where these were protected by the state. However, the Thatcher government also broke open what were perceived to be vested interests and bodies that developed regulation and inhibited competition even where these were private sector bodies[6]. Unfortunately, such private bodies do not necessarily exist simply to restrain trade. As such, undermining their power – as in the case of the stock exchange – can inhibit the orderly and effective functioning of markets.

6 Another example would be trades union regulation. This involved the statutory regulation of trades unions which were, in effect, private bodies. An alternative would have been to remove immunities from claims to damages under the common law.

The development of statutory regulation

Regulation of securities markets

Soon after Big Bang – the act of prohibition of private regulation - there was a huge extension of the statutory regulation of securities markets as a result of the Financial Services Act 1986 which came into operation in 1988. It is impossible to go through all the requirements of the regime in detail in this brief paper. Goodhart in Seldon ed (1988) suggested that just one rule book relating to one aspect of regulation that was developed as a result of the 1988 Act weighed around two kilograms. The Act itself is reproduced in 230 pages in the standard textbook by Wedgwood et al (1986) (not including the associated regulations). Regulation of this extent, detail and prescription had never been known before in the financial sector in the UK.

The Financial Services Act 1986 act followed the Gower Report, *Review of Investor Protection*, published in 1984. The Act established the Securities and Investment Board (SIB) which was responsible to the Secretary of State. The SIB, in turn, established a series of other so-called self-regulatory bodies which regulated different aspects of financial markets – for example, financial products, fund management, financial intermediaries, and so on. The SIB's powers were very wide-ranging. It authorised businesses, intermediaries and individuals; it also gave recognised status to professional bodies whose members could carry on *de minimis* regulated activities under the supervision of their professional body.

Exchanges could apply to become Recognised Investment Exchanges (RIE) which allowed a relaxation of certain regulations because the exchange itself could police activity. However, to be an RIE, exchanges

had to meet the regulations set out by the SIB. Requirements for companies to be listed on exchanges were still determined by the stock exchange though EU Directives (which came into effect from 1984) and expanded Companies Acts requirements also had to be satisfied. Over time, the EU Directives (for example the Prospectus Directive) became more onerous. More generally, the principle had been breached that the regulation of securities markets was a private matter between the exchange, its members and the companies that wished to be quoted on the exchange. Though the bodies set up to regulate particular sectors and the exchanges were nominally self-regulatory bodies, they were not allowed to operate unless they satisfied the SIB such that their regulations were as onerous as those that would be imposed directly by the SIB.

Matters which were previously governed by common sense, ethical codes, private exchanges, professional bodies or where good practice was encouraged by a firm's desire to have a good reputation for fair dealing, now became regulated activities under the Financial Services Act. The regulation became increasingly detailed and prescriptive because there was a desire to ensure that all customers were treated fairly and without bias at all times. The same principles applied in the wholesale markets as in the retail product markets, though the regulation was more detailed and prescriptive in the latter. Every firm had to introduce compliance procedures (see Wedgewood et al 5.2.15) for supervising every partner, director, employee and appointed representative. Extensive records had to be kept regarding dealings with customers so that they could explain the firm's transactions at any time. Every detail of every action within financial markets became subject to statutory regulation by the SIB or by one of the bodies it authorised.

Regulation of the sale of financial products

The Financial Services Act 1986 also introduced regulation of the sale of retail financial products for the first time, again implemented from 1988. The relevant regulatory organisations had the initials FIMBRA and LAUTRO. These bodies would authorise individuals and organisations and develop the rules by which they should operate (see Bannon and Moule 1987, for further detail).

These rules included the requirement to provide “best advice”. A unit trust or insurance company or intermediary that did not sell the most appropriate product to a customer could be fined several years afterwards. Meticulous records had to be kept so that the intermediary could demonstrate that the product was appropriate for the customer and, in effect, the market became a “caveat vendor” market. There were strict rules regarding how intermediaries were to be compensated (only by monetary commission) and regarding disclosure to customers[7]. Furthermore, businesses could only sell the specific business and products which they were authorised to sell.

One further notable feature of this regime was the requirement for “polarisation”. Intermediaries could choose to sell and offer advice either on every possibly product available in the market or on the products of just one company (thus making the intermediary a tied agent). It was not possible, for example, for an intermediary to sell unit trusts from six of the market leaders or life insurance policies sold only by mutuals.

The polarisation requirement was designed to promote transparency. However, the disclosure requirements and the detailed record keeping meant that the barriers to entry into the advice industry were that much greater and so, arguably, competition was reduced. It would become more difficult for less-well-paid people to obtain advice and yet the regulators under the Financial Services Act 1986 and their successor bodies were never satisfied with the ability of their own increasingly labyrinthine regulations to resolve the problem of biased advice. The Financial Services Authority was still introducing new rules in 2013 in order to try to make advice more objective – in this case banning commission-based advice altogether – when it was replaced by the Financial Conduct Authority in

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7 Quite soon, customers were given pages and pages of product details from intermediaries and from insurance and unit trust companies which contained huge amounts of information that customers could not possibly interpret.

April 2013. A generation after the Financial Services Act was passed, one of the major problems it was designed to solve was still unsolved. Furthermore, the market's own mechanism to prevent bias in product sales – the maximum commission agreement - was abolished by the competition authorities (see below).

The regulation of life insurance

There was a significant expansion of the regulation of life insurance in the 1980s. The regulation required minimum valuation standards of insurance companies, but these were based on actuarial practices that were rapidly becoming out of date[8]. Though this paper does not discuss the effects of this regulation, there is a strong argument to suggest that this approach created the worst of all worlds.

It should be noted that the expansion of insurance regulation in the 1980s was partly – indeed, perhaps largely - a result of European Union (then EEC) requirements. These were brought into effect in the Insurance Companies Act 1981 and the Insurance Companies Act 1982. Part of the spirit of the 1870 Act was retained: the main requirements of the new Acts related to the provision of information. It is also worth noting that the way in which information was provided had long since changed since 1870, so that the information was provided to the regulator which had the authority to take action against the insurance company rather than the information being provided to the market through the regulator.

Despite these qualifications, the 1980s led to important changes to insurance regulation. Perhaps most perniciously, the Acts gave power to the Secretary of State to implement new regulations which were simply "rubber stamped" by parliament – in other words, the Acts provided enabling powers to the Secretary of State. At a later date, under the Financial Services and Markets Act 2000, this was taken one stage further when the powers to make new regulations were then passed down to independent regulatory bodies which were only very weakly accountable to parliament or to a government minister. The Insurance Companies (Accounts and Statements) Regulations (1983) and Insurance Companies Regulations (1981) were two such important sets of regulations that were laid before parliament by the Secretary of State. These required insurance companies

8 They are described in Abbott (1984).

to provide detailed information to the regulator (the Board of Trade for most of the relevant period). The Insurance Companies Regulations provided for a margin of solvency to be required by the regulator and prescribed quite specific methods by which the value of the company's assets and liabilities should be calculated[9].

The report into the failure of The Equitable argued that the basic "freedom with publicity" approach remained throughout the 1980s[10]. There is some truth in this in that the regulation did not stop insurance companies from selling the types of business they wished to sell or from organising their business (within limits) as they wished. However, the regulation did prescribe accounting methods; it did require authorisation from the government minister or (later) the government regulatory body both for new insurers and for existing insurers to continue in business; and it did require insurers to hold a margin of capital or solvency calculated in a specific way. These regulations could well have had the effect of increasing moral hazard[11] as well as focusing the efforts of those involved in the management of the long-term risks of the business on ensuring that statutory provisions were met.

The extension of the arbitrary power of regulators then manifested itself in the introduction of something known as the "resilience test" in 1985. This was an attempt by the Government Actuary to implement that part of the Insurance Companies Regulations (1981) which stated that: 'appropriate provision against the effects of possible future changes in the value of the assets on their adequacy to meet the liabilities' had to be made. In other words, it was required that margins were held on top of the statutory solvency margin. More generally, these Acts established the

9 This is a very subjective matter for insurance companies and fossilising these methods in regulation is potentially problematic. Indeed, the whole Equitable crisis arose because antiquated valuation techniques, encouraged by regulation, were used to value products with complex financial options. It is worth noting that alternative approaches could be used as long as their compatibility with approved techniques could be demonstrated.

10 See; http://www.ombudsman.org.uk/reports-and-consultations/reports/parliamentary/equitable-life-a-decade-of-regulatory-failure-pt-2/13

11 When the 1870 Insurance Companies Act was passed, it was commented at the time that the nature of the act (which required insurance companies to publish their balance sheets but which did not have the state certify those balance sheets or provide authorisation to a company to operate) meant that the government was absolved of any responsibility if a company failed (see Booth, 2007). It is interesting to note that, when The Equitable failed, it was argued precisely that under the then-existing regulatory regime, the government authorised companies and therefore it was responsible if they failed.

principle that a Secretary of State and, subsequently, an independent regulatory body, could regulate the behaviour of insurance companies with no proper accountability to parliament. The Solvency II EU regulatory process which regulates every detail of accounting and capital setting for insurance companies can be regarded as a direct descendent of the Thatcher legacy.

Overall, perhaps the key characteristics of the development of regulation in this period were the increase in arbitrariness, the extraordinary detail and the wide-ranging powers given to government to establish specific regulations that controlled the behaviour and risk management techniques used within insurance companies. Responsibility passed from market institutions and professions to agents of the state.

Pension funds

Some similar changes took place in the field of pension fund regulation too. However, the major changes of this kind took from 1995 onwards: still under a Conservative government, but not under Thatcher. It is worth noting one major event in the Thatcher period in relation to pension funds, however. Until 1988, employees could enter contracts of employment that required membership of their employer’s pension fund. The Social Security Act 1986 made such clauses illegal with retrospective effect. Such voluntary paternalistic arrangements were, in effect, banned and the consequences led to large numbers of employees leaving their schemes and taking out personal pensions – an action which was not in their best interest. This, in turn, led directly to the pensions mis-selling scandal which involved large fines for industry participants and scarred the reputation of the financial services industry.

Analysis

The Thatcher government presided over a significant increase in the statutory regulation of financial services. This involved a growth of regulatory bureaucracies, detailed financial regulation and the cost of regulation. There was also another important change of direction under Thatcher. Until 1979, the markets had relied on their own evolved institutions, supported by the common law, contract law and some primary law. Under Thatcher, there was a strong movement towards state institutions, often with delegated powers, making regulation without any direct accountability to parliament. These aspects are the focus of this concluding section.

The development of regulatory bureaucracies and their costs

The paper highlights just a small sample of all the regulations that were developed under the Financial Services Act 1986. This was a major expansion of regulation and one that took place in an era of supposed deregulation. This is not revisionist history. In describing the transition at the time, Sir Kenneth Berrill, first chairman of the SIB, said that the City was no longer a place “where you look after yourself according to a code of honour of conduct. It is a tough regulatory system” (Hilton 1987, page 48). He described the SIB’s powers as a “very tough bunch of powers”. Lomax (1987) stated: “There is a substantial risk, in fact, that we now have massive overkill of the supervisory structure in the financial industry” (Chapter 3, section 9).

Some attempts have been made to estimate the costs of the system that developed under Thatcher. It is impossible to accurately estimate costs of regulation because many of those costs arise from reduced competition and innovation. By their nature, these are costs arising from innovations and developments that did not happen and thus the costs are incalculable.

The attempts that have been made to estimate the costs are, nevertheless, interesting. Lomax (1987) estimated that the direct cost of the SIB and associated bodies would be about £20m. Franks, Schaefer and Staunton (1998) estimated that the cost was about £90m by 1992[12]. A reasonable estimate of compliance costs is generally thought to be around four times the direct costs. The excess burden from the reduction in innovation and competition and the distortion of prices is also often thought to be around four times the compliance costs (see Bannock 2002). This might suggest a total level of costs to the economy of about £1.5bn by 1992[13] [14].

In 1979, the number of employees involved in bank regulation was about 80. There will have been a small number of people with insurance supervisory responsibilities in the Department of Trade and Industry/Board of Trade and others working in regulatory roles in the stock exchange. By 1990, the number of employees involved in financial regulation had risen roughly five-fold – with the number involved in non-commercial-bank regulation rising by a much greater multiple. By 2010, there were about 3,500 financial regulators. Overall, from 1979 to 2010 there was an increase from one regulator for every 11,000 people employed in finance to one regulator for every 300 people employed in finance[15] (see Haldane, 2013).

12 This direct cost had reached £673m at the time of writing.
13 This is, perhaps about £3bn in 2014 prices.
14 Using the same ratios, we might be talking about total costs of around £12bn in 2014, though this is probably stretching the relationships used to reach the 1992 figure beyond reasonableness.
15 At current rates of growth of both the number of regulators and the number of people working in finance, the number of people working in financial regulation will overtake the number of people working in financial services by around 2070.

From market institutions to state institutions

Until 1979, investment markets were largely regulated by institutions that evolved within the markets themselves. From 1986, in effect, the state, through a delegated body, had the power to determine who should work in financial markets, to withdraw authorisations from professional bodies, to grant or refuse authorisation to investment businesses, to recognise exchanges, to require information to be produced, to make any rules relating to the behaviour of an individual or firm, to prohibit employment of named individuals and to approve certain products (especially collective investment schemes). The extension of regulation by statutory bodies was complemented by regulation developed by the EEC.

Market institutions were also undermined on competition grounds even if those institutions helped deal with some of the real difficulties that often arise in investment and financial product markets. The competition case against the stock exchange has already been mentioned. In addition, the agreement by life insurance companies to limit commissions to brokers, referred to above, was broken up in 1989 (though it had been creaking for a few years before then) by a combination of the Office of Fair Trading and the European Union on the ground that it was anti-competitive[16].

Even in those areas that were not subject to the Financial Services Act 1986, such as the prudential regulation of insurance companies, there was a huge expansion of regulation. This was, to a large extent, driven by Britain's membership of the EU. However, in recent years, the UK itself has been at the forefront of promoting an agenda of increased regulation within the EU.

Overall in the period from 1979 to 1990, we saw an enormous increase in statutory regulation of financial markets. This is quite contrary to the impression normally given. Certainly it is true that so-called "restrictive practices" (or "club rules") that developed within the market themselves were broken down and – in effect – made illegal. It is also true that the role of the Bank of England in banking regulation over the period is more complex. Furthermore, there was radical deregulation in foreign exchange markets – though only to take us back to the pre-1939 situation[17].

16 See: http://www.theactuary.com/archive/old-articles/part-2/regulation-of-life-assurance-commissions-ii/

17 There was deregulation of hire purchase too, but this is outside the scope of this paper.

A credible argument could be made that, overall, financial markets had reduced levels of regulation in 1990 because of the abolition of private regulation or that the picture was a mixed one. However, it is unambiguously the case that the statutory regulation of financial markets increased under the Thatcher government. If the cause of the financial crash was deregulation, then it has to be accepted that markets developed more comprehensive systems of regulation when left to themselves than when governments started to regulate them after 1986. Critics of Thatcher cannot have it both ways.

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The Institute of Economic Affairs
2 Lord North Street
London SW1P 3LB
Tel 020 7799 8900
email iea@iea.org.uk