COMPETITION AMONG STAKEHOLDER GROUPS FOR POLITICAL INFLUENCE OVER BUSINESS REGULATION: THE CASE OF THE UK PENSIONS INDUSTRY

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This paper applies a stakeholder perspective to estimate various types of costs (taxes) and benefits (subsidies) affecting stakeholder groups whose constituents are most affected by recent, major reforms to the public regulation of the UK pensions industry. Both direct and indirect subsidies and taxes arising from regulation distinguishes groups representing both sophisticated and vulnerable investors. The analysis suggests that financial intermediaries, and industry regulators, are all effectively subsidised by other stakeholder groups.

Introduction

Competition among stakeholder groups arises from their disputes over major issues relating to changes in the nature and/or scope of pension regulation. Employers might view their obligation to fund pension benefits as being limited only to accrued benefits to their existing workforce. On the other hand, investors view pension benefits in terms of their lifetime labour contracts. Pension fund intermediaries (i.e. financial advisers and brokers offering personal pensions or trustees and their professional advisers operating occupational pension funds) alternatively might view pensions as being designed to provide adequate retirement income to investors. Both sophisticated and vulnerable investors are concerned with using the tax relief provided by government incentives to fund their retirement income savings, although only the former may be able to distinguish product quality. Regulators are concerned with acquiring and maintaining resources needed to enforce pensions law.

Political solutions to these disputes inevitably involve trade-offs between each of these groups as to how taxes and subsidies are translated into costs and benefits. This paper analyses contentious regulatory issues that influenced (i) the implementation of the Financial Services and Markets Act (FSMA) in relation to personal pensions; and (ii) the Pensions Act 1995 in relation to occupational pensions. This insight provides a basis for estimating major costs and benefits of regulation as they affected the income and expenditures of these stakeholder groups. The results of this analysis suggest that each group experiences sharp trade-offs between the direct and indirect costs and benefits associated with each of these major regulatory changes.

In order to resolve these claims economic cost–benefit analysis (CBA) is often used in order for policy-makers to justify whether government regulation is helpful in attempting to achieve the social optimum.[1] Indeed the UK government currently requires the calculation of the costs that any new regulation will impose on those affected. However, there is little consensus as to how such costs and benefits should be measured in the context of financial services regulation. Researchers have typically measured the costs of regulation as a 'sunk cost' to narrow (usually industry-based) affected groups.[2] Tuccillo views banking regulation as a method of taxation or public financing, and calculates the incremental effect of differential reserve requirements on US banks and savings and loans.[3]

However, recent developments affecting the UK pensions industry and lead one to question the adequacy of relying on either of these perspectives for analysing the justification for regulating such a diverse range of products. This is evidenced by recent moral hazard problems associated with the management of both the occupational and the personal pensions industries, both by regulators and those who are regulated. Government increasingly views the industry as serving a public policy role of providing self-financed retirement income savings for a large proportion of the working population who might otherwise expect to rely on government welfare.

Consistent with the perspective of stakeholder theory, this paper assumes that relevant costs and benefits of regulation are not objectively determined but are subject to influence by multiple stakeholder groups that compete for taxes and subsidies that arise from any politically determined regulatory system.[4] This assumption is also based on the economic theory of regulation,[5] which recognizes that any regulatory change is subject to a political process in which some groups (e.g. intermediaries) receive benefits (which, although not exactly the same in character as subsidies provided directly by the government, we call here 'subsidies') that are effectively paid for by costs imposed on other groups such as investors (which, although not exactly the same in character as taxes levied directly by the government, we call here, 'taxes'). Politicians and rule-makers are assumed to transmit these competing interests in their policy deliberations over the optimal form of regulation.[6]

Institutional 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.[7] The UK pension industry's regulatory environment has been subject to significant change in recent years. 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 also resulted in the establishment of the Occupational Pensions Regulatory Authority (OPRA) from April 1997. OPRA has been given wide, unspecified powers to ensure compliance with the law. However, OPRA is reactive in that it does not actively investigate possible breaches of relevant registration. Further, OPRA has been granted significant discretion in defining the scope of its supervisory activities.

By contrast, the Financial Services Authority (FSA) was established under the FSMA with four general regulatory objectives (market confidence, public awareness, consumer protection and reduction of financial crime) and a further six 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 (FSMA, section 125(7)). Whilst OPRA relies on a 'merit rule' approach: rules for compliance are limited to standards of conduct or behaviour, the FSA is legally empowered to require forms to be submitted to it and to penalise non-compliance.

Pressure produced by stakeholder groups that are directly affected by changing pension rules is of interest here because both regulators currently have supervisory roles in the industry which 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.

Regulation: public choice or private interest?

Much of theory on the regulation on financial markets in recent years has relied on the efficient market hypothesis – that in competitive markets share prices reflect all available information. This has motivated arguments against UK financial services regulation.[8] However, the representative investor paradigm which underlies these theories does not reflect the limited information processing abilities of vulnerable consumers who seek to participate in many retail financial services product markets. The information failure resulting from costly information search has long been recognised by economic theorists.[9] It has been used to explain the impossibility of informationally efficient capital markets.[10] It has been used to justify the existence of credit rationing in bank lending practices.[11] It can also explain heterogeneity in consumers' ability to gather product information and inelasticity of demand for financial services products.[12]

Regulation is a process consisting of the intentional restriction of a subject's choice of activity, by an entity not directly party to or involved in that activity.[13] Traditional theories of regulation cite market failure as rationales for intervention. Conditions facing vulnerable potential buyers of financial services (e.g. imperfect information about prices and products) which can reduce consumer welfare serve as one rationale for government regulation. The competition implications of information shortfalls are well known. Less well known are the consumer detriment effects of informational shortfalls.[14] Regulation of financial services is typically justified on one of two market failure grounds: for facilitating the creation of mechanisms necessary for trade (e.g. determining default mechanisms in credit markets) or for forcing a monopoly to lower its prices without any countervailing disadvantages.[15] A further justification for government regulation is to reduce market imperfection in the provision of information about financial services.[16]

The traditional 'public interest' view of government regulation is based on the assumption that the objective of governments and those who are employed to act on their behalf is to maximise social welfare. Such activities are justified in order to overcome the apparent failure of free markets to deal with problems of consumer detriment arising from externalities, economies of scale, imperfect information and inadequate markets for risky outcomes, and also because of the problem of the maldistribution of wealth.

However, an alternative 'public choice' view of government regulation questions the assumption that such regulation is inherently beneficial to the operation of markets. It suggests instead that politicians and regulators seek to maximise and secure their own welfare through imposing taxes and conferring subsidies, as defined in broad terms in the introduction. Under this view, government regulation is only justified to the extent that it reduces or eliminates costs associated with observed market failure. Public choice implies that government regulation of activities incurs costs which are primarily borne by consumers and taxpayers which probably exceed the benefits they receive and that regulation favours the politically powerful.[17] The economic theory of regulation is an extreme variant of this view: it seeks to show that market-failure rationales for regulation may lead to 'undesirable' consequences.[18] However, regulators are also passive, neutral arbiters: consequently it cannot explain the phenomenon of 'deregulation' of financial services.[19]

Stakeholder theory combines elements of both public interest and public choice views of regulation. This allows regulators to be depicted as stakeholder groups in their own right. Thus, rather than being depicted as passive arms of government, regulators can be viewed as active stakeholder groups seeking to gain political autonomy for regulating their industry. This description appears to be appropriate for understanding the role of multiple regulators which existed under the former Financial Services Act 1986.[20]

Interest groups affected by regulation

Various interest groups can be expected to hold substantially different views on the appropriate scope of pensions regulation. This comes from different views on the objectives of pension provision, from the perspectives of these different groups. This section briefly outlines key stakeholder groups whose welfare interests are affected by pensions regulation.

Pension plan members might be expected to 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.[21] Employers would 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 maximise the value of this tax shelter to their shareholders.[22] On the other hand, pension intermediaries may 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).[23] These differing views may be manifested in various issues affecting regulation.

The pension fund industry is wide and diffuse: no specific organised interest groups solely represent their interests (versus those of pension fund trustees and administrators).[24] Nor are the interests of members homogeneous. For example, an increase in subsidy to personal pensions may be considered to be taxation of 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.

Pension fund administrators and their advisers, as well as independent financial advisers or brokers (or 'financial intermediaries') are fairly well organised. The National Association of Pension Funds represents occupational pension fund trustees, while the Association of British Insurers represents the insurance industry's exposure to pensions business. Various bodies also represent the interests of pension fund administrators and consultants, including the Pension Management Institute and the Society of Pension Consultants. Finally, other bodies represent professional advisers to pension funds, including the Association of Consulting Actuaries, the Institute and Faculty of Actuaries, and the Association of Pension Lawyers. As the remuneration of these interest groups is largely tied to the growth of pension funds, intermediaries have a considerable stake in any pension law reform.

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. Bodies representing employer interests include the Confederation of British Industry, the Hundred Group of Finance Directors and the Engineering Employers Federation.[25]

Early economic theories of regulation 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.[26] Thus both OPRA and the FSA are considered to be another interest group with a major stake in any proposals for regulatory change.

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). According to recent data from an Office of Fair Trading survey, it is estimated that 20% of the population do not have access to basic financial services. Certain types of vulnerable investors are also likely to be particularly disadvantaged in accessing and purchasing particular products. The self-employed can earn low and volatile incomes in periods of recession (e.g. during 1988–90) which make them less eligible for obtaining and paying for personal pensions. Incomes and invested assets of unemployed persons are often too low to permit them to purchase and regularly contribute to these products. Finally, elderly and disabled persons are likely to experience the greatest difficulty in obtaining competitively priced personal pensions.[27]

The detriment suffered by vulnerable investors effectively subsidises the level and price competitiveness enjoyed by sophisticated investors in obtaining such services (see below). Obtaining reliable information on some specific categories of vulnerable investors (e.g. residents of nursing homes, refugees and destitute people residing in boarding homes and hotels, educational establishments, prisons and detention centres as well as members of the armed forces) is difficult because they are not included in the Family Expenditure Survey or British Household Panel Survey.

Sophisticated investors are essentially defined by exception to mean those investors who are not 'vulnerable.' This group is very large and diffuse: at least two organised stakeholder groups may represent their interests (e.g. the Consumers' Association and the 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. By contrast, it is likely that vulnerable investors will possess few, if any, of these characteristics.

Costs and benefits of regulation

Previous literature examining the costs of regulations of the UK pensions industry has adopted a rather narrow, usually industry-based, perspective of the costs and benefits of regulation. Economists emphasise four reasons why regulation is costly. These costs are hidden, but may nevertheless be large. The costs arise from:

- changes in financial intermediary's behaviour which occur in response to some institutional or other change producing undesirable, usually counterproductive, effects;
- the possibility of regulation leading financial intermediaries to take on more risks, thus leading to a reduction in normal standards of prudence;
- the direct costs imposed on financial intermediaries by the regulation;
- a possible loss of economic welfare from financial intermediaries performing fewer transactions than they otherwise would.

Regulation also acts as a barrier to change and so preserves an inefficient structure of products and their provision.

However, there are multiple stakeholder groups with a stake in regulation reform, so that the costs and benefits of regulation are likely to be more complex and multi-dimensional. Any politically determined set of regulations that involves a cost or tax borne by one group can be considered as involving a benefit or subsidy to another group. Thus it is assumed that taxes, subsidies, regulations and other political instruments are used to raise the welfare of the more influential stakeholder groups. Groups compete within the context of rules that translate expenditures on political pressure into political influence and access to political resources. However, political influence is not simply 'fixed' by the political process, but can be expanded by expenditures of time and money. Consequently, groups do not entirely 'win' or 'lose' the competition for political influence because even heavily taxed groups can raise their influence and cut their taxes by additional expenditures on political activities.[28]

The analysis of costs and benefits below is based on the assumption that the financial performance of pension funds is affected by the endogeneity of financial intermediary's incomes and reputation (and hence costs of income). Since these intermediaries generally act on behalf of investors and/or members and their employers in managing pension plans, it is further assumed that incidence of regulatory-induced costs and benefits on each of these groups are not independent of their impact on other groups.

Table 1 summarises how each of the costs and benefits discussed below are posited to affect the various interest groups.

Direct costs and benefits

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

Table 1: Distribution of regulatory costs and benefits across stakeholder groups

Regulatory issue	Cost (tax)	Benefit (subsidy)
Direct		
(a) Intermediary spread	M_o, I_p	$FI_{o,p}$
(b) Compliance costs	$FI_{o,p}$	$R_{o,p}$
(c) Establishment costs	E_o, FI_p	$R_{o,p}$
Indirect		
(d) Solvency/indexing restrictions	E	M_o
(e) Administration costs	$FI_{o,p}$	$R_{o,p}$
(f) Fund termination option	M	E
(g) Lack of competition	I_p	FI_p
(h) Moral hazard	FI_p	FI_p
(i) Investor detriment	VI_p	SI_p

Legend:
$M_{o,p}$: members
$FI_{o,p}$: intermediaries
$R_{o,p}$: regulators
E: employers
$SI_{o,p}$: sophisticated investors
$VI_{o,p}$: vulnerable investors
Note: Subscript *p* means with regard to personal pensions and *o* with regard to occupational pensions.

The costs of establishing a new set of regulations will impose taxes on the financial intermediaries that subsidise 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 or members' reserve fund, which tax the intermediaries and subsidise the members. Members incur increased 'spread' costs imposed by the intermediaries to fund the costs of implementing new regulation.[29] These costs can arise from expert services needed to implement new rules. Sophisticated and vulnerable investors obtain tax relief, which provide subsidies to the financial intermediaries.

Indirect costs and benefits

There are also a number of secondary or 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. Intermediaries also incur higher administration costs to implement new regulations, which indirectly subsidise the regulator. Regulation also increases 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. For the personal pensions market, new regulation reduces product competition.[30] This can lead to both dynamic and static inefficiency in financial intermediation, which effectively taxes members.

Financial intermediaries also incur higher administration costs to implement new regulations, which indirectly subsidise the regulator. However, financial intermediaries incurring such costs also provide benefits to wealthy and vulnerable consumers who purchase financial services products. This can take the form of improved efforts at professional training, and greater efforts to educate consumers about the products they are purchasing and reporting of information about the performance of these products.

Moral hazard is another type of indirect cost of regulation. Regulation may result in greater risk taking and imprudent behaviour by regulated financial intermediaries. Finally, regulation of financial intermediaries through 'polarisation' can act to reduce their scope for direct product competition. Polarisation prevents full competition among independent financial advisers and tied agents. Even after the introduction of mandatory disclosure of commissions by the Personal Investment Authority effective from January 1995, differential commissions charged by these types of intermediaries caused profit inefficiencies in the UK life insurance industry and resulted in relatively higher average commissions being charged by tied agents. Both of these activities may benefit financial intermediaries by enabling them to operate at a lower level of cost and profit efficiency than if regulation was absent, thus also effectively taxing consumers.[31]

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. Thus, most financial intermediaries offer products that are unique because they depend upon the difficult-to-describe and validate skills and policies of management. 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 realised by the consumer.

Although the financial intermediary spread seems to be relatively trivial as a percentage of the portfolio, its long-term impact can be economically significant. The accumulated value of these spread-cost differences over time magnifies economic welfare re-distributions between sophisticated and vulnerable investor groups.

There are three types of detrimental effects associated with these differences. First, non-competitive fees and charges are largely avoided by sophisticated investors, who are generally better able to shop around for the better rates than vulnerable investors. This is because vulnerable investors and members are more likely to purchase financial products directly from providers or their tied salesforce, rather than actively seek advice from independent financial advisers or purchase other information sources (e.g. *Which?* magazine) that are able to offer a choice from products selected from (a wider subset of) the entire marketplace that exists.

Second, financial service providers typically provide sophisticated investors with lower service charges or higher rates than vulnerable investors. These might include preferential lending or savings rates to 'high value' clients, lower mortgage interest rates and/or higher mortgage amounts than those with volatile incomes (such as the self-employed), lower commission rates or higher rates of return offered for larger investments than are available to those with relatively little to invest (such as the unemployed), and offering lower premium levels or higher payout amounts for consumers who can show that they do not belong to certain disadvantaged groups (such as the young, elderly or disabled).

Third, sophisticated investors are more likely than vulnerable investors to benefit from their knowledge about market conditions and trends in product offerings over time, either through personal experience, education or via social or professional contacts. Thus they are more likely than vulnerable investors to discern product quality and/or seek out the best terms to suit their individual financial planning circumstances (e.g. tax planning considerations, obtaining maximum commission discounts).

Conclusion

Stakeholder theory identifies various costs and benefits associated with governmental regulation of the UK pensions industry through analysing their economic impact on the economic welfare of various stakeholder groups. The impact of regulation is examined across multiple dimensions.

The analysis presented here can be extended to provide a full cost–benefit analysis of the recent reforms in UK pension regulation by allocating various costs and benefits to affected stakeholders. The author has provided an extended analysis, which suggests that financial intermediaries and regulators benefit the most from subsidies arising from regulating the UK financial services industry under the FSMA, the costs of which were mostly borne in the form of direct and indirect taxes imposed on both employers (occupational pensions) and investors (personal pensions).[32]

The results of the analysis implied by stakeholder theory, as sketched in this paper, can have a number of important public policy implications. A number of reforms to the present system of regulating financial services are recommended to address the investor detriment facing vulnerable investors. These include providing vulnerable investors with more equitable access to essential financial services. Improvements could be made to the quality of information disseminated about financial services to the UK public, for example about financial services products through the disclosure of industry-wide performance bench-marking. Incentives facing financial intermediaries to engage in certain types of moral hazard behaviour in regulated environments could be reduced by making available to consumers more speedy and accessible forms of restitution for poor service levels and/or performance. But it is also worth noting that, contrary to the suggestion of public interest theory, regulation benefits a group (regulators) who do not necessarily act in the general public interest against their own self-interest and that group can cause detriment to those they are meant to help.

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