

# **COMPETITION AND REGULATION: A SEAMLESS WEB?**

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When I was asked to speak this evening, it was suggested by the late and much missed Paul Geroski that I might like to "consider whether regulation can replace competition". That may have been Paul being deliberately mischievous – alas there is no longer opportunity to quiz him – but it could not be further from the position I wish to set out, which is how can competition take the place of regulation, and why is it necessary to have regulation at all. I would like to illustrate the points I want to discuss by drawing on my

experience both as head of the organisation responsible for energy regulation in Britain, Ofgem, and as head of the organisation responsible for regulation of financial services in the UK, the FSA.

2. I should start by explaining that in discharging both sets of responsibilities I have started from the belief, which should be shared by all sensible regulators, that the best means of allocating resources and satisfying consumer demands is through the operation of efficient markets, and that any sensible regulator first attempts to encourage and promote efficient market mechanisms, and resorts to contemplating regulatory intervention only when the prospect of a market solution is unrealistic. It is a belief which I held during the five years I discharged my Ofgem duties; it is the belief I

now hold in discharging my FSA duties. In both contexts, I have attempted to translate these beliefs into practical realities. This means that in both energy and financial services I have been concerned to intervene through regulatory action only when there is both market failure and when regulatory action has the prospects of doing more good than harm (market failure by itself is a necessary, not a sufficient condition: there are market failures whose harm is increased, not reduced, by regulatory initiative). But I am struck by how much easier it was in my energy job to translate these beliefs into practical reduction of regulatory activity than it is in my present responsibilities for financial services.

3. In gas and electricity, it was possible to withdraw from regulation of some 70 per cent of the activities which had been subject to price regulation at the time of privatisation of these industries. The activities of Ofgem are now concentrated on price control of natural monopolies (if I am allowed to beg several Chicago school arguments by using this phrase) – the transmission and distribution businesses of gas and electricity; the rules for the wholesale trading of gas and electricity; and the rules for the transmission and distribution businesses. But all end prices of gas and electricity, whether for industrial, commercial or retail customer, are uncontrolled and left to competition. I would add that, particularly in the present circumstances of rapidly rising prices for wholesale gas, the result is lower end prices than would be possible if

price controls had remained. The position in financial services is very different. The FSA, I am relieved to say, is not a price regulator; the industry it regulates did not come within its responsibilities as a series of vertically integrated monopolies, as occurred with gas and electricity, but is characterised by an industrial structure which is emphatically not monopolistic and is not, in many respects, oligopolistic either. But it has proved very difficult to withdraw from regulation, despite an industrial structure which is more competitive. There has been no recent equivalent to the major move away from regulation to competition which was possible in gas and electricity. The most recent structural change – Big Bang in 1986 – created competition by eliminating separate cartels, as did changes which opened mortgage markets beyond

building societies. But, by creating potential conflicts which had previously been ruled out by industrial structure, they created a demand for regulation.

Instead, deregulation has been piecemeal – and often opposed by those regulated, as is at present occurring with the FSA's proposals to withdraw from setting certain training standards. And the FSA's attempts to confine its responsibilities have not been helped by a tendency of government to add responsibilities.

4. The move from regulation to competition has been much easier in one regulatory context than another.

Why is this?

5. I do not think that the explanation is to be found in differences in legal powers and duties between the Utilities Act which empowers Ofgem and the Financial

Services and Markets Act which empowers the FSA.

There are of course differences: the Utilities Act gives Ofgem a specific competition objective (albeit in a less absolute form than the original competition objective in the predecessor Electricity and Gas Acts) whereas the Financial Services and Markets Act has competition as a secondary factor; conversely, the Financial Services and Markets Act requires the FSA to conduct cost:benefit analyses of proposals in a way which has no corresponding duty in energy regulation. But I do not think that the difference in ease of substituting competition for regulation lies in legislative differences.

6. Rather I think the difference lies in the difference between the route adopted towards achieving the end of improved consumer benefit – one a structural route, the

other a behavioural route. In gas and electricity, the need for regulation derived directly from the structure of the industries, where in gas one firm – British Gas – owned the gas storage facilities and the pipelines and delivered gas to all customers; and where in electricity one company – the CEGB – generated electricity and owned the national distribution grid, and where other companies, each a local monopoly, took electricity from the CEGB and distributed it over local networks which they owned. New entry was in practice made very difficult because those who wished to compete in providing electrons or molecules to end users had to use the distribution systems of the incumbent suppliers. Success in introducing competition only came about when structural changes were made which eliminated the conflict of interest between supplier of energy and

owner of the energy distribution system. This is most easily illustrated by reference to gas, where the vertically integrated monopoly of British Gas was broken into a network and distribution company BG, and a supplier of molecules company Centrica.

Because it no longer supplied gas, BG was indifferent as to whose gas was distributed over its pipes, which were open to all suppliers. Genuine competition was possible – and end price control no longer necessary.

The possibility of structural change rendered behavioural regulation – rules of access, rules governing connexions, rules governing speed of repairs, bundling of services – unnecessary. And, of course, the initial structure once a competitive structure was created could respond to economic changes – so that Centrica now provides both gas and electricity in a

market with other multi fuel competitors; and BG has been subject to changes, some which extended its national monopoly to the transmission systems for both gas and electricity, some of which have reduced its scope, as local monopolies have been sold on.

7. In financial services, the problem is not essentially structural: although the responsibility for assessing competition questions in financial services lies not with the FSA, I would simply say that, for what my view is worth, structural problems are not particularly significant. But behavioural issues are.

8. In terms of behaviour, any efficient market requires three conditions to be satisfied: first, there must be customers, actual and potential, who are equipped to make the decisions required of them; second,

information must be available in comprehensible forms which can be accessed without excessive cost, whether of money or of time; and third, the providers of goods and services must meet standards of responsible behaviour. All three of these conditions pose problems for the retail financial services market – particularly for investment products.

9. I won't go into the first of these, the need for a marked improvement in financial capability, since it raises issues which are wider than regulation. Let me simply observe that there is a pressing need to improve the position of those who use financial services: it is hard to believe that investment products will be properly assessed by those adults in Britain – one in five – who do not understand percentages. But both the

second and third issues – clear information and responsible behaviour – have required, and continue to require, a raft of regulatory interventions: to define what information must be given (eg on risks, which those selling financial products often omit); or what information must not be given (eg projections of returns based on unrealistic assumptions as to growth); the need for those giving advice to understand the circumstances and risk preference of those they are advising; the need for competent complaints handling procedures. There is no magic bullet, nor any structural change, which enables us to pull back from this type of detailed regulation and move emphatically towards use of competition.

10. Nor on the wholesale side of financial services is there the prospect of large scale structural change to eliminate conflicts of interest of the sort which transformed the regulatory position in gas and electricity. The conflicts in large financial services firms are both inherent and pervasive – arising from the fundamental conflict which arises when one institution acts as both principal and as agent, but manifesting themselves in a multitude of specific circumstances: how is information to be used (eg by banks which have arranged loans, and then trade either the credit or associated credit derivatives); what timing rules govern transactions for clients and own account dealings; what services can properly be offered to managers of investment trusts (the familiar softing argument); what relationship should be permitted between so called

"independent" research and corporate finance.

Although some, rather specific, progress can be made by restructuring to reduce particular conflicts, as has been proposed by the SEC to reduce the problem of research analysts who were anything but independent, for the most part these conflicts of interest are too pervasive and deep rooted to be capable of resolution by restructuring: they have to be managed and regulated, but cannot be eliminated. And hence the scope for a competitive solution is much more limited – something I say with obvious regret.

11. There is only one other point I would make about the balance between regulation and competition. Even when regulators cannot escape regulation, they need to be very aware of the dangers which regulation poses to

innovation, new entry and competition. Regulation may, or may not, help consumers, but it often manifestly helps producers. One recent example of this is credit rating agencies, which have been given by the SEC a special status as Nationally Recognised Statistical Rating Organisations ("NRSRO"). This status – more specifically the difficulty any newcomer has in meeting the entry conditions to become a NRSRO – has established barriers to new entry which are a substantial inhibitor of competition. I am glad to say that European regulators in their approach to credit rating agencies are treading very carefully to avoid inhibiting competition, and concentrating on measures to control conflicts of interest within the credit rating agencies. But credit rating agencies are but one example. The general point is that regulation, by

imposing costs on new entrants, can inhibit competition. It is a danger all regulators should be sensitive to. I should add that the FSA is indeed sensitive to this risk: we take considerable comfort from the OFT's finding at the time of the so-called N2+2 review of the FSA's work that there was no evidence of the Financial Services and Markets Act having inhibited innovation or competition.

12. Regulators can go beyond being thoughtful (or not, as the case may be) about inadvertently inhibiting competition (I do not intend to discuss the occasions, which obviously occur, when regulation is used quite deliberately as distinct from inadvertently to impede competition, normally in particular to impede competition from overseas – something which, I am

glad to say, which is not a phenomenon in the regulation of either energy or financial services in the UK). They can think carefully about the interaction between competition and regulation, and how the two can most helpfully support each other. A good current example in the UK is payment protection insurance ("PPI") which raises both structural issues, principally whether these products should be unbundled from the primary product being sold (so that, for example, someone offering a loan would be prevented from requiring the borrower to take its own payment protection, but would instead have to separate the two transactions and point out that it was possible to buy PPI from independent suppliers – as happens with annuities), and behavioural issues, principally relating to the clarity with which exclusions and conditions are

set out. The first of these, and perhaps the second too, could equally well be classified either as a competition or a consumer protection issue. The former may or may not be addressed by the Competition Commission in response to a super complaint to the OFT; the second is being addressed by the FSA as part of our normal supervision and associated enforcement. But the FSA could also, within its powers, take steps to deal with the bundled question – and changes in market behaviour, perhaps in response to discussion such as tonight's – may result in specific competition action becoming unnecessary. The general lesson from this example is the need for regulator and competition authority to identify how their separate actions may interact. And that in many cases their concerns, if not their available remedies, are the same.

13. Let me conclude. I have explained why, as a credo, market solutions and competition are preferable to regulation; why a move away from regulation is much easier when structural rather than behavioural issues are at stake; why, when regulation remains, the regulator should be conscious of the risk of inhibiting new entry, and hence competition; and how both regulator and competition authority has to think about not only his own, but also the others', actions. I hope I have contributed to the debate in exploring both the possibilities of, as well as the limitations to, the replacement of regulation by competition.