Institution: Loughborough University

Unit of Assessment: C19 Business and Management Studies

Title of case study: Enhancing Effectiveness, Structure and Consumer Protection in Financial Regulation

1. Summary of the impact

Loughborough University research into financial regulation has had a significant and enduring influence on how regulatory bodies are structured and how they use economic analysis. This work has been credited with shaping the groundbreaking culture and methodology of financial regulation in the UK with respect to consumer protection, recognising the special characteristics of retail financial products and contracts and applying cost-benefit and regulatory impact analysis in decision-making processes. It has also played a major role in redefining financial regulatory structure in the UK and South Africa. In addition, the research is now being used to help develop and guide approaches to ensuring high standards of bank regulation and consumer protection across the EU through the European Banking Authority's Banking Stakeholder Group.

2. Underpinning research

The importance of effective financial regulation has earned increasing recognition in policymaker, professional and academic circles over the course of the past 20 years, particularly in light of the global economic crisis. Research by Loughborough University's David Llewellyn (Professor of Money and Banking, 1976-present) has addressed a number of key themes related to this issue.

Studies carried out between 1994 and 2004 explored the application of economic analysis to financial regulation. This work focused on consumer protection issues to develop an analysis of market failures, information asymmetries, economies of scale and scope in monitoring and other related concerns. Llewellyn identified the principal characteristics and market imperfections in financial contracts and product markets which give rise to potential consumer detriment and the case for consumer protection regulation. The potential hazards in post-contract behaviour by financial firms (and the resultant limitations of *ex ante* information disclosure as a means of consumer protection) were highlighted. In particular, the research offered a challenge to the arguments against regulation commonly used at the time. Llewellyn suggested that, because consumers rationally demand regulation, the costs involved are not dead-weight and the provision of regulation can be welfare-enhancing. Similarly, he argued that regulation might not be a zero-sum game or a transfer of rents from producers to consumers: improved consumer confidence in markets and financial products could also be beneficial to financial firms **[3.1, 3.2, 3.3]**.

As part of this research, Llewellyn was commissioned to develop guidelines for the newly-created Financial Services Authority (FSA) with respect to the application of economic analysis to financial regulation. The resulting paper **[3.2]** set out key analytical issues regarding the special characteristics of retail financial products and contracts. Three features of the work set it apart and led to it being widely acknowledged as a landmark in the field: it emphasised the requirement for financial regulation to be firmly grounded in economic analysis and the identification of market failures and imperfections; it set out the case for evidence-based regulation in financial services; and it explained how the cost-benefit approach to regulation might be conceptualised.

In a related strand of research, carried out between 1998 and 2005, Llewellyn examined the optimal institutional structures and functions of different regulatory agencies. This work developed concepts of *integrated* and *unified* agencies. The main finding was that no single optimal structure exists for all countries: it depends on history, political and legal structures within a country, the complexity of the financial sector and the stage in a country's economic development. Comparing the *Twin Peaks* model (i.e. the separation of prudential and conduct of business regulatory agencies) with the *unified* model used by the FSA, Llewellyn suggested that the synergies between prudential and systemic stability supervision were likely to be greater than those between prudential and conduct of business regulation. The research argued in favour of a *Twin Peaks* model, with the Central Bank serving as the prudential peak **[3.3, 3.4, 3.5]**.

3. References to the research

3.1. Llewellyn, D.T., 1995. “Consumer Protection in Retail Investment Services: Protection Against What?”, *Journal of Financial Regulation and Compliance*, 3(1), 43-54, DOI: 10.1108/eb024826

3.2. Llewellyn, D.T., 1999. *The Economic Rationale for Financial Regulation*. Occasional Paper No 1, London, Financial Services Authority, http://www.fsa.gov.uk/pubs/occpapers/op01.pdf

3.3. Goodhart, C., Hartmann, P., **Llewellyn, D.T.,** Rojas-Suarez, L., and Weisbrod, S., 1998, *Financial Regulation: Why, How and Where Now?,* London, Routledge, ISBN: 978-0415185042

3.4. Llewellyn, D.T., 2005. “Integrated Agencies and the Role of Central Banks” in ed. D. Masciandaro*, Handbook of Central Banking and Financial Authorities in Europe*, Edward Elgar Publishing Ltd, 109-140, ISBN: 978-1843767893

3.5. Llewellyn, D.T., 2004. “Institutional Structure of Financial Regulation and Supervision: The Basic Issues”, in eds. J. Carmichael, A. Fleming, and D. T. Llewellyn, *Aligning Financial Supervisory Structures with Country Needs*, World Bank Institute, Washington, D, ISBN: 978-0821360026

The above outputs have made significant and original contributions to the development of the economic rationale for financial regulation and the application of economic analysis to regulatory policy; the analytical foundations of cost-benefit analysis in this area; and optimal institutional structures of financial regulatory agencies based on countries’ political and legal structures and the complexity and structure of the financial sector.

4. Details of the impact

Llewellyn’s research has had a major and continuing influence on how financial regulatory bodies in the UK and elsewhere are structured and how analysis is employed in the course of their decision-making processes.

Research into the application of economic analysis to financial regulation guided the FSA throughout the impact period. In 2011 the then Head of the authority’s Economics of Financial Regulation Division acknowledged in a published paper that Llewellyn’s insights served as “an important catalyst for the FSA’s groundbreaking work” and “introduced almost all of the concepts that have in practice proved to be important in underpinning the FSA’s work in the economics of financial regulation” **[5.1]**. Llewellyn’s FSA-commissioned Occasional Paper, *The Economic Rationale for Financial Regulation*, remained a key reference on the authority’s website until April 2013, when the FSA was succeeded by the Financial Conduct Authority (FCA), and is still referenced in documents on the FCA’s website, illustrating the research’s enduring importance **[5.2]**. The former Head of the FSA’s Economics of Financial Regulation Division, who is now Chief Economist of the FCA, remarked in his 2011 published paper that Llewellyn’s Occasional Paper “may be seen as a catalyst for the FSA developing its use of economics in regulatory policy to an extent that has not happened in many – possibly any – other financial regulator around the world” **[5.1]**. The continued relevance of the research, not least in the wake of the global financial crisis, has also been noted in publications such as 2011’s *The Financial Crisis and The Regulation of Finance*, a chapter of which revisited Llewellyn’s “classic work” and observed that “much of what Llewellyn wrote... remains true today” **[5.3]**.

The *Twin Peaks* model advocated by Llewellyn was adopted when financial regulation in the UK was restructured in April 2013. Sir James Sassoon, whom the Conservative Party commissioned to review the institutional structure of financial regulation in 2008, quoted Llewellyn’s recommendation in his 2009 report, which served as the basis for the overhaul **[5.4]**. Unveiling his findings in March 2009, Sir James wrote in the *Financial Times*: “There are arguments for adopting the ‘twin peaks’ model... by replacing the FSA with two bodies responsible for micro-prudential issues and conduct of business.” **[5.5]** The restructuring saw the introduction of the FCA and the Prudential Regulation Authority, part of the Bank of England, reflecting the system both highlighted in Llewellyn’s original research – that is, a *Twin Peaks* model that allows the Central Bank prudential oversight – and recommended in his published evidence to the review.

Similarly, the South African National Treasury and the South African Reserve Bank drew on Llewellyn's research into the institutional structure of regulatory agencies in deciding to move to a *Twin Peaks* model. Llewellyn was part of a team of international advisers whose proposal to adopt such a system was adopted by the South African Cabinet in July 2011. Explaining the reasons for the decision in a 2011 public consultation document, Minister of Finance Pravin Gordhan wrote: "We have committed ourselves to a wide-ranging set of reforms. One of the most important strands of this work has been the effort to improve the institutional structure to support financial regulation. A shift to a 'twin peaks' system... [will] separate the oversight of market conduct regulation from prudential regulation." **[5.6]** The prevailing view within the South African government had previously been that a unified model should be adopted. A former personal adviser to the Governor of the Bank of South Africa has noted: "Professor Llewellyn advised against this approach for reasons which have been outlined in his published papers. His strong preference was a Twin Peaks model, with the prudential peak being the South African Reserve Bank. [His] opinion proved to be very influential." **[5.7]**

In May 2011 Llewellyn was one of five officially designated "Top-Ranking Academics" in the European Union (EU) appointed to the Banking Stakeholder Group (BSG) of the European Banking Authority (EBA). He was the sole academic from the UK. The BSG is an advisory and monitoring board of the EBA and helps to facilitate consultation with stakeholders. It is composed of 30 members, who are drawn from EU member states and represent credit and investment institutions, consumers, SMEs and academia **[5.8]**. The group is consulted on actions concerning regulatory technical standards and their implementation, offers opinions and advice and has the power to submit requests to investigate alleged breaches or non-application of EU law. As the BSG's first Vice-Chair and its Chair since April 2013, Llewellyn has been developing and guiding approaches to ensuring a high and consistent standard of bank regulation across the EU. In the process, drawing on his research, he has been instrumental in enhancing the status of consumer protection within the EBA's remit. Llewellyn was re-elected as Chair of the BSG in October 2013 **[5.9]**.

5. Sources to corroborate the impact

The following sources of corroboration can be made available at request:

5.1. Andrews, P., 2011. "Economic evidence and financial regulation". Ch. 4 in C.J. Green, E.J. Pentecost and T.G. Weyman-Jones (eds), *The Financial Crisis and The Regulation of Finance*, Cheltenham, Edward Elgar Publishing Ltd, ISBN: 978-1849808705

5.2. Financial Conduct Authority webpage, Consultation Paper CP11/10: "Consumer Complaints: The Ombudsman Award Limit and Changes to Complaints-Handling Rules", http://www.fca.org.uk/static/pubs/cp/cp11_10.pdf (see page 29)

5.3. Richard J. Herring and Reinhard H Schmidt, 2011, "The economic rationale for financial regulation reconsidered: an essay in honour of David Llewellyn", in C. J. Green, E. J. Pentecost, and T. Weyman-Jones (eds), *The Financial Crisis and the Regulation of Finance*, Cheltenham, Edward Elgar Publishing Ltd, ISBN: 978-1849808705

5.4. Sassoon Report, 2009: *The Tripartite Review: A review of the UK's Tripartite system of financial regulation in relation to financial stability*

5.5. Comment article by Sir James Sassoon: 'Britain deserves better financial regulation', *Financial Times*, March 8 2009: http://www.ft.com/cms/s/0/3decd86c-0c13-11de-b87d-0000779fd2ac.html#axzz2k9FVGwAM

5.6. Public consultation document: *Implementing a Twin Peaks Model of Financial Regulation in South Africa*, Financial Regulatory Reform Steering Committee, February 2013: http://us-cdn.creamermedia.co.za/assets/articles/attachments/43314_twin_peaks_01_feb_2013_final.pdf

5.7. Letter from former personal adviser to Governor of South African Reserve Bank

5.8. Confirmation of membership of Banking Stakeholder Group, European Banking Authority: http://www.eba.europa.eu/about-us/organisation/banking-stakeholder-group/members

5.9. ‘EBA's Banking Stakeholder Group elects Chairperson’ http://www.eba.europa.eu/-/eba-s-banking-stakeholder-group-elects-chairperson