The theory of regulation: A review article

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ABSTRACT

This paper examines the various theoretical issues in regulation with a view to enhancing understanding of the regulation arena. Special emphasis has been placed on the banking industry. The paper shows how regulation serves different purposes for different interest groups on different occasions. It further argues that because of the ever shifting concept of 'public good', shifting individual and group interest and, perhaps the entwinement of individual and public good, neither the capture theory or the public good theory has yet fully explained the rationale for regulation. A clear understanding of the theoretical issues involved in regulation is therefore important if the forces that drive regulation are to be appreciated fully.

Regulation generally suggests some form of intervention in any activity, and ranges from explicit legal control to informal peer group control by government or some such authoritative body.[1] Regulation sometimes stems from market failure, which usually occurs when market transactions give rise to spillover effects (or externalities) on third parties, or when there is information inefficiency in the market.[2] Some forms of regulation, however, tend to be paternalistic in nature, often overriding the individual's right to choose, even when such an individual has all the relevant information available to him.[3] For instance, it is common practice for people to be prevented by law from driving a motor vehicle without putting on their safety belts or working under a contract of employment without contributing to a pension scheme. But paternalistic regulation is sometimes entwined with regulation on grounds of public interest. For instance, the failure to wear a safety belt, when driving a car, may give rise to medical costs, which are borne by the taxpayers via the National Health Service Scheme. The taxpayer thus has an interest in reducing such costs and paternalistic regulation is one way of achieving this.

Taxpayers may also have to come to the rescue when the individual is left indigent as a result of unwise financial decisions such as a reluctance to save for years when paid employment is no longer feasible. The end point of all regulatory processes is the enshrinement of some code of conduct for the regulated activity. Whatever rules are finally agreed they usually have diverse consequences for various interest groups. This has made the regulatory process — ranging over how such regulation is proposed, formally considered and approved, administered, interpreted, evaluated and altered — a political activity.[4]

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The aim of this paper is to examine the various theoretical issues in regulation with a view to enhancing understanding of the conceptual issues in the regulation arena. The emphasis is on the banking industry. To achieve its aim, the paper is divided into four parts. The first part discusses the two main theories of regulation while the second examines alternative styles of regulation. The third part discusses the special nature of the banking trade, which further impacts on its regulation, while the fourth concludes the paper.

THEORIES OF REGULATION

Two main conflicting theories have evolved over time in the attempt to explain both the origins and practice of regulation: public interest and capture theories. The public interest theory holds that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices.[5] It is therefore not surprising that until the late 1960s, most economists regarded the growth of regulation as an attempt by government to improve upon the allocation of resources which would otherwise occur in unregulated markets. This belief was based on the implicit assumption that some forms of activities, business or otherwise, do not always function in the public interest without supervision or control. This view has a historical antecedent: regulation in the past (and even today) had almost always followed some form of crisis or public dissent. It was, for instance, the protest of the populist farmers against the exploitative rates levied by railroads that led to the creation of the Interstate Commerce Commission in the USA.[6] The establishment of the Securities and Exchange Commission is yet another example of a crisis driven regulation.[7] The Food and Drug Act of 1938 in the USA was passed following a drug accident.[8] The 1962 Drugs Amendments Act, also in the USA, was passed shortly after the Thalidomide incident, even though the bill had languished in committee hearings for years.[9] Examples of crisis-inspired legislation in the UK include the Royal Exchange and London Assurance Corporations Act (Bubble Act) of 1719. This Act, which outlawed the joint stock companies of the time, was a direct consequence of the widespread abuse of the system, mainly in the form of fraudulent promotion of such companies, culminating in the famous South Sea Company Scandal.[10] Likewise, the 1956 Clean Air Act, was a direct consequence of the London 'killer smog' of 1952.[11]

An implicit assumption of the public interest theory is that regulation is, in the main, aimed at protecting the public. To achieve its aim, regulation based on the above principle should aim at equipping the public with all relevant information necessary for decision making. Regulation in the public interest should also strive to protect the public from monopolies and industries that generate substantial external costs or benefits. This does not always happen in practice.[12] Furthermore, were this theory right, one should also expect no support for regulation from regulatees.[13] This has not always been the case. In the USA, for instance, the railroads supported the enactment of the first interstate commerce act which was designed to prevent railroads from practising price discrimination. This was because discrimination was undermining the railroad's cartels.[14] Also, American Telephone and Telegraph pressed for state regulation of telephone services because it wanted to end competition among telephone companies.[15]

The image of government as a costless and reliable instrument for altering market behaviour has also been extensively questioned.[16] Costs are incurred in the provision of data and information to regulators. It is also possible for regulation to reduce the reactivity and flexibility of companies

to adapt to changing environments.[17] Regulation could also affect management style. Management, for instance, may become more oriented towards satisfying the regulators than towards meeting its proper business demands and objectives.[18] Based on the above, it has been widely claimed that the costs of regulation are greater than any welfare losses arising from inefficiencies in market-based allocation of wealth.

Empirical studies consequent to these contradictions in the public good theory show little evidence that government regulation, especially in the form of state intervention, is beneficial to the public.[19] If regulation could no longer be assumed to be implemented in the pursuit of efficiency objectives, then it becomes legitimate to inquire into its effective objective.

Stigler, in a path-breaking article,[20] attempted an answer asserting that 'as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit'.[21] This proposition has come to be known as the capture theory of regulation.[22] Bluntly put, the regulatory agencies are captured by the industry they are supposed to be regulating. In other words, regulation, far from supporting the general public interest by achieving efficiency gains, is enacted and implemented in the interest of specialist producer groups.[23]

Proponents of this theory argue that people in their political behaviour cannot be assumed to be motivated by fundamentally different forces than in their private choice-making behaviour. Self-interest is usually put above all other interests.[24] The industry which seeks regulation must be prepared to pay with two things a political party needs: votes and resources. In non-democratic societies the price can sometimes, be remarkably less: personal friendships with the junta members or family relationships can be very useful.[25] In general, people simply pursue their objectives, whatever they are, using the resources available to them. Persuading a customer to utilise one's services will no doubt produce a payoff, but so also can getting the government to impose some form of tariff on your competitors or to grant subsidies. The choice, therefore, between market and political action is essentially an economic one and will depend upon the relative costs involved and the chances of success in each case.[26] It was this trend towards analysing the use of political processes from an economic perspective, rather than implicitly assuming that they are infallible mechanisms for the production of the 'public good'[27] that led to the reappraisal of government regulation.

Regulation imposed on the grounds of public interest may sometimes end up serving the interest of the regulated group. An example of this can be found in the regulation of the tobacco industry in the USA (The Prohibition of Advertising Act of 1971). It has been argued that it was the industry, not the consumers, that benefited from this act which banned cigarette advertising in the broadcasting media.[28] Such benefits arose mainly because of the following factors:

- the ban on such advertising made the fairness doctrine inapplicable[29]
- the industry saved money after the ban because it reduced its advertising expenditures
- industry sales increased significantly after the ban
- it helped the then existing local firms perpetuate their control of the national market. This was so because the ban on advertising made it difficult for new firms to enter the market.[30]

Public and private interests, it has also been argued, are entwined. For instance, it has been suggested that the best way to act in the interest of the public is by putting one's private interest first.[31]

It is also the shifting concept and varied interpretations of 'public good' that have enabled the use of regulation to shield major players in some industries from public scrutiny and indeed to prevent competition in some.[32] Regulation therefore serves different purposes for different interest groups on different occasions.[33]

Because of the ever-shifting perception of 'public good', shifting individual and group interests and perhaps the entwinement of public and individual good, neither the capture theory nor the public good theory has yet fully explained the rationale for regulation.[34] Interest groups and accidents also impact on the method of regulation employed.

TYPES OF REGULATION

There are, in the main, two types of regulation: government regulation and self-regulation. Government regulations are sometimes administered through government parastatals or agencies. Such regulations are usually backed by statute laws established by acts of parliament or military decrees. They are, therefore, rules which are intended, in all stages of their application, to be interpreted and enforced by the courts. Such laws usually prescribe punishments for non-compliance. The power of statutes therefore lies in the general willingness of society to obey the law and in the willingness of the state to enforce the punishment for non-compliance.[35] Government regulation in some activities may however be advisable. This is especially so in the arena of social regulation[36] where externalities are widespread. An example is the case of pollution. In such a case a statute-backed regulatory regime may reduce both the information and enforcement costs.[37] Regulation by a third party, unlike self-regulation, also has the advantage of ensuring the maintenance of the separation of power doctrine.[38] This is so since it ensures the separation of the function of adjudication and enforcement of rules from the regulated industry.[39]

Government regulation is, however, not without its problems. Statute laws, for instance, are usually content with the provision of minimum standards.[40] This may be an incentive to companies just to adhere to the minimum standards. Another problem with statute laws is the fact that the very nature and power of the law make its change a serious matter, not to be undertaken frequently. Such laws therefore tend to be slow to be adapted to new developments and changing circumstances. Finally, an inherent feature of statute law is that it tends to be its letter not its spirit that the courts interpret and enforce. For the above reasons, statute law, particularly where it relates to the administration of regulation, is sometimes framed in a manner which gives some degree of discretionary authority to the regulator.[41] It is the above difficulties that make self-regulation attractive to some parties.

According to the National Consumer Council in the UK (NCC), self-regulation means that:

> 'rules which govern behaviour in the market are developed, administered and enforced by the people (or their direct representatives) whose behaviour is to be governed'.[42]

The extent to which these people control these rules can in fact vary considerably[43] mainly because of a lack of a homogeneity in the interests of the forces that drive self-regulation. Typically, the debate over the setting up of self-regulatory schemes does not address constitutional issues.[44] Self-regulation, instead, usually arises out of two main circumstances: to repel the threat of government-imposed regulation[45] or to curtail the activities of fringe operators and protect industry reputation.[46]

The benefits of a self-regulatory scheme could be immense. For instance, by reducing reliance on statutes, self-regulatory schemes generally offer a speedier and more flexible means of solving problems.[47] Also, by utilising the skills of those involved in the business, self-regulation schemes may be able to overcome the information problems sometimes faced by government regulatory bodies, and standards can conceivably be set higher than in a statutory scheme.[48] Finally, the costs of self-regulatory regimes are normally internalised in the trade or activity which is exposed to regulation.[49]

Perhaps because of the variety of interests that impact on self-regulation, in practice it has not been without blemish and some schemes have found it difficult to meet some of the guidelines aimed at enhancing the credibility of self-regulation.[50] Criticisms of such schemes include the fact that such schemes do not necessarily cover all the firms in the industry.[51] The negotiation and bargaining necessary to introduce a self-regulation scheme, in some cases, also take place without an input from third parties.[52] Finally, it has been claimed that self-regulation schemes have a poor record of enforcing their standards against disobedient members.[53]

Apart from all the above disadvantages, self-regulation is not always possible. For instance, the industry concerned may be too diverse, making it impossible for the level of agreement necessary for such regulation to be obtained. An example is the Estate Agency Industry in Great Britain, where the Office of Fair Trading had for a long time encouraged the industry to take voluntary regulatory measures but with little success until the formation of the Ombudsman for Corporate Estate Agents, which still covered only half of the industry. This led to the enactment of the Estate Agents (Provision of Information) Regulations, 1991, by the Government.[54] In general, the greater the external consequences of an industrial practice, the less acceptable self-regulation becomes. An example can be found in the banking industry.

THE SPECIAL NATURE OF THE BANKING INDUSTRY

The banking industry is special in terms of regulation as experience has shown that failure (bankruptcy) in this industry has external consequences.[55] The concern to safeguard the viability of the depositary industry arose from the fact that financial failure had significant external effects that reached beyond the depositors and stockholders of the financial firm.[56] The depositary institution played an important role as the chief conduit in both the payment process and the savings and investment process. Failure of individual firms in the depositary industry may lead to widespread deposit runs that could overflow to other depositary firms.[57] This has come to be known as the contagion effect.[58]

Institutional developments like the rise in interbank lending and various money market operations, propelled mainly by the spirit of competition with the aid of advancements in information technology, have also added to the contagion problem. There has therefore been a steady rise in the entwinement of banks not just with their customers, but also with other banks. Therefore, no matter how small a financial institution may be, the impact of its failure may be far-reaching for the entire financial system.[59]

The danger of contagion is particularly acute for the banking system. If a cement manufacturer, for instance, fails, the ill effects are likely to be felt most by those who have had dealings with the institution. The repercussions for the industry and the general economy as a whole will tend to be much less serious. In fact, the competitors may inherit some of their late rival's market share. The above scenario can of course occur in an isolated bank failure

especially when the reason for the failure can be clearly seen to be specific to the bank or a group of banks. In certain circumstances, however, the collapse of a bank could, in the absence of any official action, lead to loss of confidence in the entire banking system and a subsequent mass withdrawal of depositors' funds from the system. In such a scenario, therefore, formal disclosure requirements are likely to be of little practical assistance. Irrespective of the bank's balance sheet strength, it may still be rendered insolvent by the actions of other depositors.[60]

The increased integration of the financial system, which has resulted in the rise in interbank dealings, has also increased the prospects of contagion should one bank fail. Therefore, when the banking system cooperates to save a distressed member, it is more an act of self-preservation than an act of charity. It is mainly on the above basis that it has been possible to secure the cooperation of the banking community in times of stress. For instance, during the 1973 secondary banking crisis in Britain, large sums of money flowed out from the secondary banks to the clearing banks. These funds were recycled back to the secondary banks through the famous 'lifeboat operation'.[61]

It is thus clear that it is the problem of contagion that is the reason for preventing those who do not meet the minimum requirement necessary to achieve the status of a bank or licensed deposit taker from taking deposits. If the problem of contagion did not exist, there might be a case for confining regulatory action to only 'club members' without going on formally to bar non-'club members'[62] from carrying on depositary businesses.[63]

But not all ailing banks have been saved in the past. Between 1933 and 1982, 620 banks failed in the USA alone.[64] The size of a distressed bank, no doubt, plays a major role in determining whether it gets helped.[65] In some developing countries, this may create problems. For instance, new indigenous banking businesses are likely to be small with perhaps insignificant effect on the financial system should such banks collapse. Such banks will therefore be unlikely candidates for assistance under the above regime. It is perhaps because of this that the protection of infant industries has become a reason for government intervention in banking (and other businesses) in some countries.[66] Size alone, however, is not the only explanatory factor in the theory of which distressed bank gets assistance.[67] Other factors, no doubt, are usually part of the explanatory variables.

The desire by some countries to limit or preclude foreign participation in a sector which is regarded as vital to the proper functioning of the national economy and the attainment of national policy objectives is yet another reason for government intervention in banking.[68] This is usually entwined with the typical infant industry argument.[69] It was in this respect that the Reserve Bank of Australia cautioned that:

> 'Banking is a key sector of the economy providing the community with money balances and payments arrangements. Control of ownership of banks should therefore be maintained in Australian hands to ensure concern for the national interest. Foreign banks may be inclined to give prior place to commercial advantage or to another country's national interest'.[70]

The protection of depositors is yet another objective of bank regulation. Subsequent to the financial crisis of 1929–1933, banking regulators around the world emphasised this objective. Such an emphasis drew its strength from the political and social trends evident in many countries towards the protection of customers and away from the principle of *caveat emptor*.[71] There is

usually a case for deviating from the *caveat emptor* principle in certain industries. This is especially so where it is inherently difficult for the individual or consumer to assess the goods or services he or she is buying or where the learning process for society may be judged too costly or difficult.

The fact that an institution is supervised may be taken perhaps inappropriately, to mean that they have been given an official seal of approval. It is as a consequence of this that it may be argued that the supervisory authorities carry some responsibility towards the members of the public. The belief may also grow up that either the authorities will not allow the institutions to fail or, where they fail, depositors will be compensated.[72]

Many countries have deposit protection schemes in operation. In the UK, the deposit protection board provides protection for only 75 per cent of deposits for total deposits of up to £20,000. In the USA, where the bank failures of the 1930s proved a more traumatic experience, depositors have a better deal: deposits of up to US$100,000 are protected in full.[73] The limits on the protection of depositors in the UK implicitly assumed that even the small man should not be fully compensated for losses due to mismanagement. If a depositor can earn a higher return by placing funds with somewhat higher risks, full compensation may be an undue incentive to continue doing so as the depositor will be earning higher returns while the risks are borne by another party.[74]

Banking regulation does not, however, only aim at preventing banking failures. Banks may also be regulated to ensure that they carry out their activities in accordance with the wider economic and social objectives of the country. For instance, it is not unusual for banks, especially in developing countries to be given credit policy guidelines especially on the sectoral allocation of loans, either by government or the central bank. Banks have also been instructed by the government to avoid investments in certain sectors of the economy, either by direct ban or by making it unprofitable for them to do so.

Another reason for regulating the financial system stems from the need to foster the efficiency and integrity of the market by minimising the problems that may arise from conflicts of interest on the part of market participants. Here, there are various ways of ensuring that conflicts of interest do not arise and, where they do, that they do not impact on the integrity of the market.[75] In Britain, at least before the Big Bang in 1986, the brokering function was separated from the jobbing function.[76] In other words, stockbrokers could only act as agents to their clients and jobbers could not deal directly with the investing public.[77] The early bank charters in the USA also enshrined the separation principle. By 1930, however, such a separation system had been abandoned in the USA and commercial banks had become the dominant force in the distribution and underwriting of securities.[78] Whether the banking crisis of the early 1930s was a consequence of the abandonment of the separation principle has remained a contentious issue among scholars and banking practitioners alike,[79] although the advent of the Glass Steagall Act implicitly endorsed such a view.

CONCLUSION

The aim of this paper has been to examine the various theoretical issues in regulation with a view to enhancing understanding of the regulation arena. Special emphasis has been placed on the banking industry. The paper shows how regulation serves different purposes for different interest groups on different occasions. Furthermore, it argues that because of the ever-shifting concept of 'public good', shifting individual and group interest and perhaps the

entwinement of individual and public good, neither the capture theory or the public good theory has yet fully explained the rationale for regulation. A clear understanding of the theoretical issues involved in regulation is therefore important if the forces that drive regulation are to be fully appreciated.

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References

(1) Ogus, A. (1994) 'Regulation: Legal Form and Economic Theory', Clarendon Press, Oxford, p. 1.

(2) See Bromwich, M. (1985) 'The economics of accounting standard setting', Prentice Hall, London and Bromwich, M. (1992) 'Financial reporting, information and capital markets', Pitman Publishing, London for an extensive discussion of market failure.

(3) Dworkin defined paternalism as 'the interference with a person's liberty of action justified by reasons referring exclusively to welfare, good, happiness, needs, interests or values of the person being coerced'. Quoted in Ogus (1994) *op. cit.*, p. 51.

(4) Lasswell, H. D. (1950) 'Politics: who gets what, when, how', Peter Smith, New York. Lasswell defined politics as who gets what, when and how. For the purposes of this study, the Chambers English Dictionary definition of politics as the 'maneuvering and intriguing' involved in the formulation and implementation of regulation, will be used.

(5) Peltzman, S. (1989) 'The economic theory of regulation after a decade of deregulation', in Bailey, M. N. and Winston, C. (eds) 'The Brookins Papers of Economic Activity', Brookins Institution, Washington, p. 4; and Ogus (1994) *op. cit.*, p. 15.

(6) See, for instance, Huntington, S. (1952) 'The marasmus of the ICC', *Yale Law Journal*, Vol. 61, pp. 467–509.

(7) Investigations subsequent to the great crash of 1929 revealed that the speculative fever of the 1920s had been worsened for thousands of small investors and speculators by fraud in the touting of equity securities. For instance, stocks were issued for worthless corporations without true information being made available to purchasers. Investment companies affiliated with commercial banks also manipulated market prices to the advantage of insiders and the distress of outsiders. The consequence was legislation in 1933 (information disclosure regarding new securities) and 1934 (regulation of securities market) culminating in the establishment of the SEC (Reagan, M. D. 1987 'Regulation: The politics of policy', Little Brown and Company, Boston.)

(8) The drug involved was elixir sulphanilamide which contained a poison that killed more than 100 people in September 1937. (Temin, P. (1979) 'The origin of compulsory drug prescriptions' *The Journal of Law and Economics and Management Sciences*, Vol. 2, pp. 94–95).

(9) The bill gave the Food and Drug Administration (FDA) authority to require that new prescription drugs be proven effective for the announced purposes. This followed the public disclosure, in the *Washington Post*, that there was a widespread birth defect problem of truncated or missing limbs in babies born to European women who had used the sedative, thalidomide, while pregnant (Reagan (1987) *op. cit.*, ref. 7, p. 20).

(10) Edwards. J. R. (1980) 'British company legislation and company accounts, 1844–1976', Arno Press, New York, p. vi. This Act was repealed in 1825.

(11) The incident, which caused the death of 4,000 people in Greater London, led to the government appointment of the Beaver Committee and the consequent legislation (Gunningham, N. (1974) 'Pollution, social interest and the law', Martin Robertson and Company, London, p. 59.)

(12) Posner, R. A. (1974) 'Theories of economic regulation', *The Bell Journal of Economics and Management Science*, Vol. 5, p. 336.

(13) An implicit assumption of the public interest theory of regulation is that public interest and the interest of regulatees are dissimilar.

(14) Posner (1974) *op. cit.*, p. 337.

(15) *Ibid.*

(16) See, for instance, Posner, R. A. (1970) 'A statistical study of antitrust enforcement', *Journal of Law and Economics*, Vol. 13, pp. 365–419, Gerwig, R. W. (1962) 'Natural gas production: A study of costs of regulation', *The Journal of Law and Economics*, Vol. 5, pp. 69–92 and Stigler, G. (1971) 'The theory of economic regulation', *Bell Journal of Economics and Management Sciences*, Vol. 2, pp. 3–21.

(17) Regulated companies are sometimes required to seek approval before adopting new technologies or venturing into new areas.

(18) Gardener, P. M. (1986) 'Supervision in the United Kingdom' in Gardener, P. M. (ed.) 'U.K. banking supervision: Evolution, practice and issues', Allen and Unwin, London, p. 29.

(19) Stigler, G. (1964) 'Public regulation of the securities markets', *The Journal of Business*, Vol. 37, pp. 117–142. Stigler, for instance, compared the performance of a typical portfolio of new issues before and after the setting up of the Securities and Exchange Commission which attempted to impose regulations to ensure the accuracy of the information accompanying the floatation of new shares. Stigler similarly concluded that 'grave doubts exist whether, if account is taken of the cost of regulation, the SEC has saved the purchasers of new issues one dollar'. See also Gerwig (1962) *op. cit.*, ref. 16, and Stigler, G. and Friedland, C. (1962) 'What can regulators regulate? The case of electricity', *The Journal of Law and Economics*, Vol. 5, pp. 1–16.

(20) The title of Stigler's 1971 paper (The theory of economic regulation) is somewhat misleading. As Becker, G. S. (1976) 'Comment', *Journal of Law and Economics*, Vol. 19, pp. 245–248, emphasised, it is best to think of an economic theory of regulation rather than a theory of economic regulation.

(21) Stigler (1971) *op. cit.*, p. 3.

(22) The capture theory was not new in 1971. Well-known versions had appeared earlier (see for instance, Bernstein, M. H. (1955) 'Regulating business by independent commission', Princeton University Press, Princeton). What was new was its broad appeal to economists based on the accumulating evidence of empirical research (Peltzman (1989) *op. cit.*, p. 5).

(23) Some scholars have since attempted a modification of the basic capture model. For instance, Peltzman (in Peltzman, S. (1976) 'Toward a more general theory of regulation', *The Journal of Law and Economics*, Vol. 19, pp. 211–248, argues that the complete capture of any agency by any group would imply that the activities of the agency were run exclusively in the interest of that group. Such a policy must inevitably arouse opposition from other groups who are adversely affected, and a more likely outcome of the regulatory process would be a balancing of opposing interests. The point of political equilibrium in the Peltzman model will depend upon the organisational costs faced by the two opposing groups.

(24) For instance, it is a well-known fact that the allocation of television channels among communities does not maximise industry revenue but reflects pressures to serve many smaller communities (Stigler (1971) *op. cit.*, ref. 16, p. 7).

(25) This is perhaps because such governments are usually less accountable. The absence of checks and balances discourages reason and dialogue in decision making. Any attempt, therefore to understand the mechanisms of decision making under such systems becomes onerous.

(26) Ricketts, M. and Shaw, K. (1984) 'The theory of regulation', in Peacock, A., Ricketts, M. and Robinson, J. (eds) 'The regulation game: How British and West German companies bargain with govern-

ment', Basil Blackwell Publishers, Oxford, p. 14.

(27) Society's perception of 'public good' changes over time. This is because such perceptions are determined by a shifting interplay of a variety of forces: bureaucrats, careerists, professionals, political appointees, legislators, courts, interest groups, the media etc, with differing objectives, views and stakes that are subject to change depending on the issues and the circumstances (Katzmann, R. A. (1990) 'Comments on Levine and Forrence, "Regulatory capture, public interest and the public agenda: Towards a synthesis" ', *Journal of Law, Economics & Organisation*, Vol. 6, p. 200.

(28) Before the industry was mandated to stop advertising in the broadcasting media, it was low in the ranking of profitable American industries. In the 1970s, subsequent to the ban, they catapulted to the top (Doron, G. (1979) 'The smoking paradox: Public regulation in the cigarette industry', Abt Books, Cambridge, Massachusetts, p. 86). By 1972, the failure of the prohibition of cigarette commercials had been realised in some quarters. For instance, Bruce W. Wilson, then the Deputy Assistant Attorney General told the Senate Consumer Subcommittee hearing that 'the public interest might be better served through the assumption of both cigarette commercials and the anti-smoking messages that were so prevalent before the broadcasting ban' (Doron, 1979, p. 89).

(29) According to the American Cancer Society, 'While this law [The Prohibition of Advertising Act] was hailed as a victory for the anti-smoking forces, it could not be foreseen that it would also produce a serious drawback. Since the broadcasters could no longer advertise cigarettes, they no longer were required to carry anti-cigarette messages. How powerful these messages had really been was demonstrated by what happened when they were no longer there. By the end of 1971, the per capita consumption curve for cigarettes had begun to point upward again; then it continued to move up gradually through 1972, 1973 and 1974' (Doron (1979) *op. cit.*, ref. 28, p. 91).

(30) Doron (1979) *op. cit.*, ref. 28, p. 84. The tobacco industry in America has undergone extensive changes since Doron's work. This is perhaps due to the ever-increasing activities of the anti-smoking campaigners. Doron's findings, therefore, are unlikely to be legitimate now. See for instance, *Financial Times*, 18th March, 1996 and 9th April, 1996.

(31) According to Adam Smith 'As every individual ... endeavours as much as he can both to employ his capital in the support of domestic[k] industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public[k] interest, nor knows how much he is promoting it ... he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention' (quoted in Raphael, D. D. (1985) 'Adam Smith', Oxford, University Press, Oxford, p. 70. The invisible hand theory is not without its critics. See for instance Hahn, F. (1982) 'Reflections on the invisible hand', *Lloyds Bank Review*, Vol. 144, pp. 1–21.

(32) For instance, the 1905 Companies Act in the Gold Coast (Ghana) prevented Gold Coast registered companies from engaging in banking activities. This legislation effectively eliminated Africans from engaging in such practices. At the time, the Africans, though an interest group in the Gold Coast economic arena, were not a political force to be reckoned with. The political equation was altered in the 1940s. With the imminence of independence, the retention of the native exempt clause became politically inexpedient for the colonial government. Thus a shift from direct discrimination regulation to those that appealed to economic reasoning and the protection of the 'public interest'. See Trevor, Sir Cecil (1951) 'Report on bank-

ing in the Gold Coast and on the question of setting up a national bank', Government Printers, Accra and Uche, C. U (1995) 'From currency board to central banking: The Gold Coast experience', *South African Journal of Economic History*, Vol. 10, pp. 80–94 for a general discussion of the pre-independence regulatory changes in the Gold Coast banking industry.

(33) There is little doubt that the national policy objective of any nation is non-static. For a society in transit from colonisation to independence, the change in its perception of public good may be drastic. The rejection of the colonial system presupposes that the system acted more against the interest of the Africans. Implicit in the rejection of the colonial system, therefore, is a call for a change of status quo. All components of the old system, including its banking structures, must therefore come under scrutiny with a view to restructuring them to satisfy the new national interest.

(34) There have been calls for a synthesis of the two regulatory theories. See for instance, Reagan (1987) Ch. 2, *op. cit.*, ref. 7, and Levine, M. E. and Forrence, J. L. (1990) 'Regulatory capture, public interest, and the public agenda: Towards a synthesis', *Journal of Law, Economics, & Organisation*, Vol. 6, pp. 167–198.

(35) Bank of England (1978b) 'Regulation in the City and the Bank of England's Role', *Bank of England Quarterly Bulletin*, Vol. 18, p. 380.

(36) This is the term generally used to refer to regulation which typically affects a number of industries and is intended to promote a general societal good such as clean air or water (Wilson, G. K. (1984) 'Social regulations and explanations for regulatory failure', *Political Studies*, Vol. 32, pp. 203.

(37) Ogus, A. (1995) 'Rethinking self regulation', *Oxford Journal of Legal Studies*, Vol. 15, pp. 107–108.

(38) This may not hold when the regulatory authority is 'captured' by the industry as it then becomes a front for the industry.

(39) Ogus (1995) *op. cit.*, p. 99.

(40) Bank of England (BOE) (1978b) *op. cit.*, p. 379. This is perhaps because laws and rules often reflect compromise rather than the interests of any one group (Gunningham, N. (1974) 'Pollution, social interest and the law', Martin Robertson and Company, London, p. 61).

(41) BOE (1978b) *op. cit.*, p. 380.

(42) National Consumer Council (NCC) (1986) 'Self-regulation', National Consumer Council, London, p. 1.

(43) *Ibid.*

(44) Graham, C. (1994) 'Self regulation' in Richardson, D. and Genn, H. (eds) 'Administrative law and government action', Oxford University Press, Oxford, p. 195.

(45) This extensively explains the advent of codes of practice for the banking, press, advertising and building society industries in Britain (Graham (1994) *op. cit.*).

(46) An example of this is the British Board of Film Classification. Its origins could, to some extent, be traced to the uneasiness of the early cinema industry about the loss of reputation due to the activities of fringe operators (*ibid*).

(47) *Ibid*, p. 194.

(48) *Ibid.*

(49) In the case of independent public agencies, such costs are usually borne by taxpayers (Ogus (1995) *op. cit.*, p. 98).

(50) The NCC, for instance, recommended that self-regulatory schemes should adhere to the following guidelines: (1) the scheme must be able to command public confidence; (2) there must be a strong external involvement in the design and operation of the scheme; (3) as far as practicable, the control and operation of the scheme should be separate from the institutions of the industry; (4) consumers and other outsiders should be fully represented on the governing bodies of such schemes; (5) the scheme must be based on clear statements of principles and standards; (6) there must be a clear, accessible and well-publicised complaints procedure where breach of the code is alleged; (7) there must be adequate and meaningful sanc-

tions for non observance; (8) the scheme must be monitored and updated in the light of changing circumstances and expectations; and (9) there must be a degree of public accountability such as an annual report (NCC (1986) *op. cit.*, p. 15).

(51) Those who have not agreed to follow self-regulatory schemes are usually the source of consumer problems (NCC (1986) *op. cit.*, p. 6). Reynolds (1981) also asserted that as 'a social group grows and becomes more complex, the efficiency of non-market implicit controls declines. The group becomes more heterogeneous, and general agreements on ethical values and other institutional arrangements decreases' (quoted in Reagan (1987) *op. cit.*, ref. 7, p. 34).

(52) Ramsay, I. (1987) 'The Office of Fair Trading: Policing the consumer marketplace', in Baldwin, R. and McMrudden, C. (eds) 'Regulation and public law', Weidenfeld and Nicolson, London, p. 191 and Breyer, S. (1982) 'Regulation and its reform', Harvard University Press, Cambridge, p. 179.

(53) Graham (1994) *op. cit.*, p. 195.

(54) *Ibid*, pp. 195–196.

(55) The supervision of banks, unlike the other non-financial industries arises from the unique fiduciary responsibility which bankers assume when they accept other people's money for safekeeping. It is therefore not surprising that the defining activity for statutory control is usually the act of deposit. Cooke, P. W. (1982) 'The role of the banking supervisor', *Bank of England Quarterly Bulletin*, Vol. 22, p. 547.

(56) In an attempt to safeguard such depositary firms, it is usual for regulating bodies to set up entry barriers into such activities. For instance, a licence is widely required before any company can engage in banking functions. Licensing conditions usually include: a minimum paid up capital, security clearance of the directors, availability of competent manpower among others. Licensing is also sometimes influenced by the overall macroeconomic goal of the territory. Established financial institutions also come under regulatory scrutiny. They are usually subjected to various capital adequacy, liquidity, reserve, risk management and lending regulations.

(57) The losses of depositary failure are, however, not constrained to the depositors and deposits. The external effects are usually large. For instance, the cumulative failure of the depositary industry has been identified by some scholars as the reason behind the great depression of the 1930s (Spellman, L. J. (1982) 'The depository firm and industry: Theory, history and regulation', Academic Press, New York, p. 9.

(58) Justifying its support operations during the fringe-banking crisis of 1973, the Bank of England argued that it found itself 'confronted with the imminent collapse of several deposit-taking institutions, and with the clear danger of a rapidly escalating crisis of confidence. This threatened other deposit-taking institutions and, if left unchecked, would have quickly passed into parts of the banking system proper. While the UK clearing banks still appeared secure from the domestic effects of any run — indeed the money-market deposits withdrawn from the fringe were largely redeposited with them — their international exposure was such that the risk to external confidence was a matter of concern for themselves as well as for the Bank. The problem was to avoid a widening circle of collapse through the contagion of fear'. (Bank of England (1978a) 'The secondary banking crisis and the Bank of England's support operations', *Bank of England Quarterly Bulletin*, Vol. 18, p. 233.)

(59) In line with this, the 1985 Annual Report of the Federal Reserve Bank of New York, commented as follows 'The interconnections among institutions and markets in the new environment get more and more complex. A shock that starts in one market may spread quickly along this network until it finds a weakness in some seemingly unrelated place. In fact there is a growing tendency to build financial links along regulatory fault lines where the responsibility for supervisory oversight is weak, divided or clouded' (p. 26).

(60) Bank of England (1984) 'The business of financial supervision', *Bank of England Quarterly Bulletin*, Vol. 24, p. 49.

(61) Reid, M. (1986), 'Lessons for bank supervision from the secondary banking crises', in Gardener, E. (ed.) 'UK banking supervision: Evolution, practice and issues', Allen and Unwin, London, p. 100.

(62) Bank of England (1984) *op. cit.*, p. 50.

(63) There is, however, a case for protecting the unsophisticated depositor from the unreliable operators. This will be discussed later.

(64) Dale, R. (1992) 'International banking deregulation: The great banking experiment', Blackwell Publishers, Oxford, p. 8.

(65) For instance, the bailing out, in 1984, of Continental Illinois, was justified by the then FDIC Chairman, Mr William Isaac on the grounds that 'closing the bank and paying off insured depositors could have had catastrophic consequences for other banks and the entire economy. Insured accounts totalled only slightly more than $3bn. This meant that depositors and other private creditors with over $30bn in claims would have had their funds tied up for years in a bankruptcy proceeding awaiting the liquidation of assets and the settlement of litigation. Hundreds of small banks would have been particularly hard hit. Almost 2,300 small banks had nearly $6bn at risk in Continental; 66 of them had more than their capital on the line and another 113 had between 50 and 100 per cent. More generally, closure of a bank whose solvency was apparently not impaired, in response to its liquidity and confidence problems would have raised concerns about other soundly managed banks'. Quoted in Dale (1992) *op. cit.*, pp. 9–10).

(66) This will be discussed later on in this section.

(67) In the 1973 banking crisis, the 'lifeboat' committee, required the following conditions to be satisfied before support was provided: (1) that the company seeking support was currently trading solvently and was likely to remain solvent provided it received liquidity support by way of recycled deposits; (2) that the company exhibited sufficient banking characteristics to justify inclusion in the scheme (the possession of a s.123 certificate, for instance) and had attracted a significant level of deposits from the public; and (3) that the company did not possess any institutional shareholders whose interest in the company was such that they might properly be expected to provide the necessary support (Bank of England (1978a) *op. cit.*, ref. 58, p. 233).

(68) Reserve Bank of Australia (1979) 'Submission to the Committee of Inquiry into the Australian Financial System', Reserve Bank of Australia, Sydney, Ch. 12.

(69) It is usually argued that it is necessary to offer some form of protection to indigenous companies. Such protection is required in order to protect them from the usually better-equipped foreign companies. This is necessary for the survival and constrained development of indigenous companies (United Nations Centre for Trans National Corporations (UNCTC, 1981) 'Transnational banks: Operations, strategies and their effects on developing countries', United Nations, New York.

(70) Reserve Bank of Australia (1979) *op. cit.*, Ch. 12.6.

(71) Blunden, G. (1977) 'International cooperation in banking supervision', *Bank of England Quarterly Bulletin*, Vol. 17, p. 325.

(72) Bank of England (1984) *op. cit.*, p. 49.

(73) *Ibid.*

(74) A possible solution to the problem is to allow privately run insurance schemes to cater for the protection of the depositors. But this has its own problems: the possibility of a claim does not only depend on systematic risks but also on unsystematic risks. The incentive, on the part of management, to behave with due care may be reduced if deposit insurance can be purchased. Private insurers may tackle this problem by varying the premium rates depending on the riskiness of the deposit taker (*ibid.*).

(75) Fund management and bond issuing, for instance, involve potential conflicts of

interest, yet UK banks perform both activities and are able to maintain the confidence of their clients by ensuring that a Chinese wall of silence exists between the different activities. An alternative way of maintaining market integrity is to ensure full disclosure of the activities of the market. This will enable customers to check that they are getting the going prices. The best approach to adopt is open to argument. For instance, it could be argued that the abolition of a single capacity could lead, through agglomeration, to substantial economies of scale. On the other hand, the information required to make the disclosure system work could be very expensive both to produce and consume (*ibid*, p.47).

(76) As a result of the Big Bang, jobbers were replaced by market makers.

(77) The above regulations changed in 1986. Both stockbrokers and market makers are now able to act in dual capacity. They can, for instance, deal directly with investors (buying and selling securities from their own books), or act as agents, putting deals together for clients on commission basis. There are however rules in place to ensure that investors are not disadvantaged under this dual capacity system. See Bank of England (1985). 'Developments in UK banking and monetary statistics since the Radcliffe Report', *Bank of England Quarterly Bulletin*, Vol. 25, pp. 392–396.

(78) See Dale (1992) *op. cit.*, Ch. 2, for an analysis of events leading to this abandonment.

(79) See also Dale (1992) *op. cit.*, Ch. 2, for a review of the debate.