Improved financial regulation deters misconduct, study finds

May 24 2018

Improved regulation has deterred a greater amount of financial misconduct in the UK since the global financial crisis, according to new research published today by the University of East Anglia (UEA).

Since the crisis of 2007, there has been increased awareness of the risks posed by the conduct of financial institutions and their employees. More incidents of financial misconduct have been investigated, with regulators applying increasingly large fines and demanding the repayment of profits.

However, it remains uncertain if these regulatory changes have limited how much financial misconduct occurs and so this study examined whether regulators have improved their capacity to detect or deter financial misconduct since the end of the crisis in 2010.

Researchers at UEA, Bangor University, and the Universities of Warwick and Otago conducted an analysis differentiating between detection and deterrence of financial misconduct during the period 2002-2016.

The findings, published in a working paper by UEA's Centre for Competition Policy, show that while detected breaches of UK financial regulation fell after 2010, the corresponding level of deterrence actually rose in this period.

The authors say this could be because of highly-publicised changes in

regulatory structures, the effectiveness of punishments, or cultural change in the financial services industry.

Dr. Peter Ormosi, senior lecturer in competition economics at UEA's Norwich Business School, said: "By examining pre- and post-financial crisis periods, we show that while detection rates for breaches of financial regulation have remained constant and the number of detected cases has dropped, there was a significant increase in the rate of deterrence occurring after 2010.

"We believe this is strong evidence that the UK regulatory environment improved after 2010, with an increase in the effectiveness of regulation of financial misconduct in recent years."

John Ashton, professor of banking at Bangor Business School, said it was important to assess if the increasingly harsh punishments have been effective in reducing misconduct and other risky practices.

"While financial misconduct alone is rarely the cause of financial crises, poor conduct by financial firms amplifies the macroprudential risks, for example through mortgage fraud, mis-selling of financial services, or even market abuse," said Prof Ashton.

"Therefore it is important not only to limit the dangers posed by financial misconduct through appropriate assessment of the risk and the creation of resilient financial institutions, but also to enhance methods to quantify the effectiveness of regulatory detection and deterrence in order to best minimise misconduct by firms and individuals."

The authors applied a new method of quantifying the detection and deterrence effect of financial regulation on financial misconduct, using a statistical approach employed in biological, ecological and demographic research—previously applied to assess other areas of criminal and

corporate offending.

Using Australia as a control country, the study drew on data from Final Notices and Enforcement Undertakings issued by the UK Financial Services Authority and Financial Conduct Authority and the Australian Securities and Investments Commission between 2002 and 2016.

Co-author Dr. Tim Burnett, from the University of Warwick, said: "One of the key difficulties in evaluating the effectiveness of financial regulation enforcement is that the data generally only shows us information on the number of individuals or firms who were actually caught. These figures, however, tell us little about what proportion of the crime we are successful in detecting, or whether our policies are deterring misconduct (where a potential perpetrator elects not to engage in crime in response to the potential penalties).

"Using a Capture-Recapture approach, typically used in biology or ecology, allowed us to examine data on detected offences and their associated punishments and use this to draw conclusions on both the effectiveness of policy at detecting misconduct, but crucially also to estimate the proportion of potential offenders which were dissuaded.

"Our headline results suggest that there was a shift in regulatory effectiveness after the financial crisis, and that this resulted in greater deterrence of financial misconduct."

More information: The working paper 'Has the financial regulatory environment improved in the UK? A capture-recapture approach to measure detection and deterrence', John K Ashton, Tim Burnett, Ivan Diaz Rainey, and Peter L Ormosi, is published by the Centre for Competition Policy: competitionpolicy.ac.uk/public … tions/working-papers

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