

Has the financial regulatory environment improved in the UK? A capture-recapture approach to measure detection and deterrence

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KEYWORDS:

Financial Regulation, Partial observability, Financial misconduct, Capture-recapture

BACKGROUND

- Has UK Financial Regulation improved since the global financial crisis of 2007-08?
- Since 2007, more incidents of financial misconduct have been investigated and financial regulators have imposed increasingly large fines and demanded the disgorgement of considerable sums.
- Despite the significance of these developments, there has been uncertainty over whether these regulatory changes have limited how much financial misconduct occurs in practice.
- This study advances a methodology for addressing such partial observability, where we quantify whether the detection and deterrence of financial misconduct in the UK has changed since 2010.

METHODOLOGY

- We design a simple framework of detection and deterrence of financial misconduct, which is used to make inferences on deterrence from the change in case numbers and detection rates.
- We use Capture-recapture (CR) methods to estimate annual detection rates. CR methods are frequently used in ecological and epidemiological research to estimate population parameters.
- We offer identification of the post-crisis effects in a difference-in-differences setting, using the Australian system of financial regulation as an unbiased counterfactual.

KEY FINDINGS

- To establish whether financial regulation has deterred a greater proportion of financial misconduct after 2010, the study tests two conditions required for this outcome. These include: (i) whether the proportion of detected offenders' has decreased, and (ii) if the rate of detection has not decreased.
- These conditions are tested using the population of Final Notices and Enforcement Undertakings between 2002 and 2016 from the UK Financial Services Authority and Financial Conduct Authority and the Australian Securities and Investments Commission.
- Evidence supporting both of these conditions is provided. Detection rates have remained constant and the number of detected cases has dropped significantly.
- We believe this is strong evidence that the UK regulatory environment improved after 2010 as the rate of regulatory deterrence has risen.

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POLICY ISSUES

- Quantifying the impact and effectiveness of financial regulation is an increasingly important policy goal.
- While much attention is correctly furnished on the efficacy of individual policies and the cause of individual crisis events, the effectiveness of regulatory systems at discouraging financial misconduct is ambiguous.
- This study addresses this concern by deploying a new method to assess the detection and deterrence of financial misconduct in the UK.
- We report that, while the detection rate of financial misconduct remains constant, regulatory deterrence in the UK has improved since 2010. The causes for this change remain uncertain yet, plausibly, could include the effect of large fines and disgorgement, shifting regulatory structures and a change in the culture of financial services firms.

SUGGESTED CITATION

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