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Response to CM 7667 on *Reforming Financial Markets* from Professor Peter Cartwright

These views are my own and do not necessarily represent those of the School of Law or the University of Nottingham.

I have limited my responses to questions relating to consumer law and policy.

A Primary Legislation Proposals

Q 15: The advantages of having consumer credit firms contributing to the costs of Money Guidance are considerable. Credit is an area where consumers are particularly in need of guidance and support and it seems reasonable to expect firms to contribute towards the cost of that. While any additional cost for firms is likely to be transferred to consumers to some extent, the impact of this for individual consumers should be minimal.

Q 16: I agree that free and impartial debt advisors should be exempt from the levy.

Q 17: The key issue is one of proportionality, preferably in relation to the amount of credit business in which the firms engages. Without a clear idea of the specific cost anticipated it is difficult to be more precise.

Qs 18 and 19: I take these two questions together as the principal issue relating to the authority's likely success is its scope.

My preference would be for the new authority to have a broad scope in championing consumers' interests. Care would have to be taken to share responsibilities between the new authority and the proposed consumer advocate. It makes sense for the new authority to have regard to (and commission further) research on the effectiveness of different forms of informational tools and remedies, including education and raising awareness as well as disclosure. We now have experience of comparative tables, of certification (through CAT standards) and will soon have experience of Money Guidance through the pathfinder project. We have also seen considerable effort put into financial

capability and have the opportunity to consider the range of initiatives to which that has given rise.

Consumers need to feel confidence that there is someone who will treat them fairly and be on their side. For that they need trust. There is trust in some parts of the system (for example, in the FOS) and any new body needs to build up that trust, preferably quickly. It is not clear at this point the extent to which trust extends to the FSA. A new authority with a mandate to give consumers helpful information and contribute both to their understanding and their capability would be a step forward.

My own University (through the Financial Services Research Forum) has undertaken research on trust and fairness and developed indexes to reflect both.

Q 20: Those set out appear reasonable.

Q 21: It should ideally be operationally independent of the FSA.

Q 22 and 23: There is a significant advantage to giving regulators the power to take action on behalf of consumers. The challenges for consumers posed by transaction costs are well-documented. The FOS has been a success in this regard and its power to decide cases on the basis of what is fair and reasonable in all the circumstances is of significant benefit to consumers. However, it is not particularly well-suited to matters of collective redress.

There is a case for a new power which allows the FSA to establish a consumer redress scheme which requires firms to investigate potential past breaches and make redress (of a type approved by the FSA). This might amount to a simpler and more usable version of s.404 FSMA. If such a power is created, it is important that the FOS has significant input into any scheme. FOS can assist in identifying appropriate areas for a scheme (as well as firms particularly involved) and might need to direct complainants to the scheme while it is operative.

It is also important the FSA uses its powers to secure redress where there is evidence of misconduct by one firm towards a wide number of consumers – for example through ss.383 and 384 FSMA. There is also a role for reputational sanctioning, particularly for unfair conduct which appears to have been tolerated or encouraged by the firm.

Qs.24-26: There are strong arguments for better-facilitating, or allowing for, collective redress. A representative action would be an appropriate way of achieving this. I would

suggest that regulatory bodies be consulted as to whether the action is appropriate, taking into account a variety of matters, but that the FSA should not have the power to suspend the action on the merits. Such merits are better seen as within the remit of the court. I am not in a position to judge the costs of the Government's proposals.

B Areas for Discussion

Q 12: The traffic light system is helpful in relation to food labelling but I am not convinced that it translates easily to financial services products. I would like to see some examples of how it might operate in practice, however.

Q 13: All the products mentioned could benefit from simple labelling. A single system of disclosure across product categories seems unduly ambitious, given the different things that the products seek to do. The danger with protection insurance may be under-inclusiveness, while with a current account it is more likely to be the cost of charges. Again, it would be helpful if illustrations as to how such labelling might work were provided.

Q 14: Preferably price should be benchmarked.

Q 15: Some products may not be well-designed, others will not be sold because of lack of incentive.

Q16: This seems an attractive prospect. Consumers need to know why they are being encouraged to pay more.

Q 17: the FSA (depending on the scope of any new consumer body).

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SYSTEMIC REGULATORS' ACCOUNTABILITY TO PARLIAMENTS: ADVANTAGES FOR STABILITY OF GLOBAL FINANCIAL MARKETS

A response to the UK Treasury's July 2009
White Paper on Reforming Financial Markets

by Nicholas Dorn, Erasmus School of Law

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Summary

This response to the 2009 UK White Paper on 'Reforming Financial Markets' argues for stronger democratic oversight of regulators and for regulatory diversity in order to reduce 'market herding' and the consequent systemic risks. In the context of hitherto weak democratic accountability and political challenges, international networking of regulators and those they regulate has resulted in convergence of regulatory thinking and standards – creating groupthink, common 'blind spots' and systemic vulnerability. The antidote, regulatory diversity, would correspond to the strategy of re-politicisation of financial market regulation, and democratic steering of regulatory agencies, displacing the currently dominant notion of financial market regulation as a purely technical, expert, 'insider' discourse. If it is too much of a paradox for policy-makers and market participants that international cooperation in pursuit of global stability must include making space for some regulatory diversity, then we may expect re-plays of recent stressful events.

Background and purpose

Financial market regulatory reform is on the agenda internationally, with a variety of substantive and 'architectural' proposals battling for attention and legitimacy.

Some of the proposals under discussion have important implications for *regulatory competence* and for *democratic accountability* – which in the view of the present author are inseparable.

The 'Council for Financial Stability' envisaged in the UK White Paper on *Reforming Financial Markets* (Her Majesty's Treasury 2009, section on 'Democratic accountability to Parliament') would replace and up-rate a 'Standing Committee'. It would take a more active role in safeguarding against systemic risks in the financial markets.

The Council will consist of the Treasury, the Bank of England and the FSA [Financial Services Authority] and will be chaired by the Chancellor of the Exchequer. The objectives of the new committee will be to analyse and examine emerging risks to the financial stability of the UK's economy, and coordinate the appropriate response. [...] The Government will consult on options for broadening and strengthening channels of democratic accountability and will work with the Treasury Select Committee [of the House of Commons] to consider whether and how emerging options should be implemented.

This response to the White Paper focuses upon the Council for Financial Stability and follows the format of the Treasury's consultation questions on that topic. The basis of response is an independent academic review, conducted 2008-9, of the role and responsibility of regulators concerning the turbulence that emerged in international financial markets from 2006 onwards (see references). The pages just below directly answer four questions posed in the White Paper, whilst later pages set out the basis for the response.

It may be noted that the plural word 'parliaments' is used in the title of this response. This is because the plural is consistent with the argument advanced, concerning oversight of a plurality of financial market regulatory regimes by parliaments in national, EU and wider contexts. See for example the work of the relevant House of Commons committee (Treasury Committee 2009), also the ongoing 2009 enquiry of the Scottish Parliament's Economy, Energy and Tourism Committee on 'The way forward for Scotland's banking, building society and financial services sector', and the hitherto feeble (but potentially important) responses of the European Parliament.

Question 1. 'A more systemic approach to financial regulation'

The White paper asks: What are the benefits in creating a more formal and transparent body to coordinate the authorities' more systemic approach to financial regulation? Do you have any views on the role and remit of the CFS?

Response to question 1. Two entities not one, please.

In para 4.11 the White Paper says, 'The objectives of the new Council will be to analyse and examine emerging risks to the financial stability of the UK's economy, and coordinate the appropriate response'.

There are clearly two objectives here, as shown by the use of the plural ('objectives') in para 4.11. The two are:

- to analyse and examine emerging risks to the financial stability of the UK's economy
- to coordinate the appropriate response.

The first is an analytical function – in relation to which issues of freedom of thought and independence from government must clearly arise.

The second is a functional objective.

These two objectives should be considered separately, for the following reasons.

Clearly, the second objective, coordinating preventative and ameliorative action, has to be pursued by an entity that represents those who have power to act: Treasury, the Bank of England and the FSA. (Or some similar constellation, depending on political choices about architecture and responsibilities.)

Also, there can be no question but that some mechanism is needed to analyse systemic risks. However, can it really be wise for this analytical and early warning role to be allocated to an entity which also brings together those responsible for current policies? No; surely the analytical/warning function operates best if separate from the action coordinators.

Prima facie, therefore, the proposition should be put in terms of two entities, one for each of the two aspects:

- an independent entity (meaning independent of the Treasury, of the Bank of England, of the FSA, of government generally and of course of particular commercial interests) to analyse and examine emerging risks to the financial stability of the UK's economy
- a governmental and regulatory capability to coordinate the appropriate responses, if and as needed.

It should be for those who advocate combining these roles in one institution to argue the case for that. The decision to merge should not be taken by default. The White paper perhaps could be faulted for failing to present such options.

Question 2. 'An annual report'

To what extent would an annual report on key developments increase knowledge and awareness of significant regulatory actions taken under the Banking Act and FSMA? From your point of view, what areas would it be useful for this report to cover?

Response to question 2. Standing items plus 'wild cards'.

This response to the White Paper is concerned with prevention rather than crisis management. In this context, a view can be advanced about the value of

independent analysis in identifying risks/uncertainties. This can be illustrated with a couple of simple illustrations.

(a) Consider for example certain reports emanating from the Stability Unit of the Bank of England (Haldane et al 2007) which, because of the institutional context, were somewhat sidelined (Giles 2009).

(b) Taking one possible benchmarking issue for financial market regulation, US work points to the possibility that the Central Intelligence Agency, which combines analytical and action roles, at certain times may have bent the analysis in order to fit the implementation roles that it, its paymaster and/or the public might be thought to favour (Stiefler 2004).

No doubt readers themselves will think of other historical illustrations of the benefits for policy makers to have access to analysis that is not pre-shaped to legitimize certain forms of action or to remove from the agenda non-favoured issues.

Thus, the work programme and outputs of the analytical/warning agency should not be subject to negotiation or agreement with the FSA or BoE or any element of government, rather it should be an independent report to Parliament.

As for structure and content of risks/uncertainties reports, whilst no doubt there would be some standing items for a report to cover (influenced by recent experience), it would be useful – since one cannot foresee the future and therefore cannot always enshrine relevant questions in legislation – for up to half of the report to explore in depth some special issues, identified for analysis by the agency.

Question 3. 'External advice and commentary'

In addition to the input of non-executives from the governing bodies of the FSA and the Bank, what other ways could external advice and commentary be incorporated in this process?

Response to Question 3. Staffing and Board independent of the authorities.

The answer here is confined to the independent entity that should, we say (see above) analyse and examine emerging risks to the financial stability of the UK's economy, writing an annual report to Parliament.

Non-executives from the governing bodies of the FSA and the Bank should not be embedded in the staff or governance of this entity – although they might of course be called upon to provide specific forms of being evidence for analysis. The reason for this is maintenance of analytical independence.

The independent analytical entity should be staffed and its Board should be populated by

- analysts drawn from the financial markets (in their individual capacities, not as representatives of their firms or institutions)
- analysts of systemic stability in other markets (other than financial services), environmental studies and sciences, international security, and any other areas in which modelling of systemic risks/uncertainties are found.

In order to avoid capture by financial market interests, quotas should be set at staff and Board levels. For example, it might be thought prudent that not more than half of the staff and of the Board should be economists or other academics have industry ties/consultancies. It would be one of the responsibilities of the Board to oversee staffing mechanisms and patterns in a manner that avoids fixed orthodoxies forming amongst staff, reporting on this aspect to Parliament.

Question 4. 'Enhancing democratic accountability'

What mechanisms might be used for enhancing democratic accountability? Is this important? Are there any risks that need to be considered – for example, around market sensitivity, or threats to consumer confidence?

Response to question 4. Democratic accountability is a vital safeguard against groupthink.

Up to recently, the theme of 'independence' was, most unfortunately, taken and championed to mean 'independent of politicians'. That is to say, independence was misread as lack of democratic accountability of regulators. The internationalisation and increasingly tight networking amongst financial market regulators and big firms, as seen from the 1990s onward, resulted in enclave thinking, groupthink, structured blind spots, and heightened systemic risk – constructing the recently experienced systemic instability, panic, losses, market lock-up in some areas, and economic and social distress.

This lack of accountability has to be reversed, both for reason of *principle* and for *functional* reasons. In short:

- The in-principle reason is that financial stability is an important public good that must, like other public goods, be underpinned by institutions that are accountable to democratic representatives
- The functional argument, more controversially, is that democratic accountability would enhance diversity in regulatory analyses and rule-making, and that such diversity would be a safeguard against the systemic risk and groupthink.

There is no implication here that regulators should not meet, cooperate and discuss issues. Rather, they should be constrained from forming a closed cabal, whose agenda is not open to influence through the democratic process. The state, through parliament, provides accountability mechanisms that should be strengthened in order to open up this world to scrutiny and to intellectual challenge. Parliamentary scrutiny, if taken seriously, could act as an important backstop to technical expertise/stupidity. Of course, with scrutiny comes political responsibility, however there is evidence that the UK Parliament is capable of discharging such responsibilities.

Rationale: systemic stability, via diversity, via democratic accountability

Whilst over the past decade or so concepts of 'risk society' Beck (2006) and precautionary action have dominated debates in relation to international security (terrorism, invasions of Iraq and Afghanistan, etc), and also to a lesser extent the environment (climate change), those precautionary concerns seem to have been pushed to one side in regulatory thinking on financial market stability and susceptibility to systemic crisis.

There are many markers of this, including the tendency to frame issues within an overarching concept of a 'great moderation' in markets (Bernanke 2004) – related to assumptions about risk having been so dispersed away from pivotal institutions and their counterparties that it no longer constituted risk in the systemic sense.

Such sanguine assumptions and their related methodologies turned out to be incapable of mapping the risks facing specific commercial interests, let alone the shared interests of the private sector, or the wider public interest, as is now widely acknowledged (Bernanke 2008, Hellwig 2008, Honohan 2008, Treasury Committee 2009, Investors' Working Group 2009, Dorn 2009).

All policy makers and regulators are critically reliant on strategic information and, in the run-up to the crisis, the 'models' relied upon were largely those derived by specific market participants. It is now acknowledged that regulators need their own, independent perspectives upon what they regulate (Bernanke 2008).

However, at a deeper level, and very relevant for consideration of regulatory (re)design and accountability, the question remains why the regulators felt comfortable lacking their own information base, when they might have been expected to require one in order to 'steer the ship'. One well-known yet understandably sensitive explanation is related to 'regulatory capture'. This is one of two broad perspectives on regulatory ineffectiveness found within the wider literature on regulation generally (see *inter alia* Moran 2002). From a perspective favourable to public regulation, it has been proposed that initially independent regulatory agencies risk becoming the captive of those they are supposed to regulate, through repeated interactions with them (see for example Martimort 1999 and, for an early US perspective, Bernstein 1955). By contrast, from a deregulatory policy perspective, regulatory ineffectiveness arises from regulatory over-reach: the markets know best (and will get their way). Thus, from both left- and right-wing perspectives (to use unfashionable language) one can arrive at a view that regulation is fated to fail (but see Prosser 1997).

There is another explanation for regulatory incapacitation: regulatory convergence, leading to groupthink and an inability to think 'outside the box'. Regulator convergence could have resulted from capture, admittedly, but it might equally have resulted from a variety of other sources and conditions, such as: regulators' international networking (Picciotto and Haines 1999, Picciotto 2006); political championing of the specific interests of certain commercial interests or centres (i.e., deliberate high-level championing, rather than any mid-level regulatory slippage), and/or regulatory *rapture* (Anderson 1985), a condition in which regulators become openly 'enraptured' by their industry (as distinct from being captured by it), predisposing them to do more or less what is asked of them. Indeed, FSA Chairman Lord Turner at one stage sought to blame government for undermining the capacity of the FSA to do more than 'light touch' regulation (Waugh 2009). Under conditions of rapture, it might be expected for some of the positive emotional tone to be shared between policy makers, officials, firms and regulators, rather than being foisted up the latter. Something similar occurred internationally, contributing to uniformity of thinking in regulator circles. Looking through the recent history, no doubt evidence and arguments could be offered for or against each of the above explanations – capture, rapture, networking, etc. These concepts may have common elements, including lack of critical distance, exacerbated by *introspective* regulatory networking.

Utilising Occam's Razor (*Entia non sunt multiplicanda praeter necessitatem*), the simplest explanation of regulatory convergence and failure, and the least deniable one, seems to be international regulatory networking, exclusion of non-specialists,

and a lack of real accountability to the public interest. In the context of lack of democratic accountability and external challenge, international networking of regulators and those they regulated resulted in convergence of regulatory standards – and creation of common blind spots – corresponding to private sector assumptions, models, data and mood.

What now could be an ameliorative policy response? Moving forward, and going against calls for a tightening of convergence between regulatory regimes, a case is made for regulatory diversity as a means for reducing market ‘herding’ and the consequent systemic risks. Regulatory diversity would correspond to a political strategy of democratic steering of regulatory agencies, diluting if not displacing the currently dominant notion of financial market regulation as a purely ‘technical’ discourse.

Meaningful regulatory reform will not be universally welcomed. One view from the markets and from policy-makers seems to be that one should start by asking the regulators themselves, seeking if possible a consensus view. This takes for granted that the people and types of expertise that generated the crisis can also generate a solution; and it too easily drifts to the proposal that an impediment to improvement is insufficiently intensive communication and coordination between such specialists. For example, the European Union’s High-Level Group on Financial Supervision in the EU (High-Level Group 2009) says that greater efforts should be put into surveillance, early warning and risk mapping (p 64). This should be done at the international level though the International Monetary Fund and at a European level through creation of a European Systemic Risk Council. This Council would be chaired by the president of the European Central Bank and composed of members of the General Council of the Bank and heads of the various EU market supervision committees (and possibly national supervisory authorities) (ibid p 45). In short, the same stakeholders and forms of expertise are envisaged, just institutionally re-configured. There would be no overt political element or input from outside the current regulators and their expert advisors; indeed ‘independence’ of the regulators is stressed. Whilst there would be ‘transmission mechanisms’ and ‘channels’ between the new improved regulators and policy makers, apparently these would be one-way, from the regulators to the politicians. However, this specialist (‘insider’) stewardship/governance is a large part of the problem, and it can hardly be helped by a further closing of the ranks.

On the contrary, transparency and democratisation are required, re-politicising regulatory issues. This is for two reasons. First for reasons of principle and second for reasons of effectiveness in reducing systemic risk.

Debates over governance: the in-principle case for democratic oversight

The White Paper asks what forms of accountability would be appropriate (Her Majesty’s Treasury 2009, pp 138-9). These are analytically interesting and practically relevant questions.

As Picciotto and Haines put it a decade ago, ‘The time is over-due for a strong reassertion of the crucial importance of a positive public role in regulating financial markets, not simply to prevent economic collapse, but to ensure that they operate in the broader public interest’ (Picciotto and Haines 1999, p 368). In short, a public interest perspective would identify the broad contours of market regulation as being matters for public debate. And as Picciotto more recently has observed of general trends in regulation nationally and internationally, ‘networked governance disrupts the

channels of democratic accountability, which in the classical liberal system are through national constitutional structures, ideally parliamentary representative democracy' (Picciotto, 2006, p 11). Such sentiments attract gravity as a consequence of the credit crunch. It is encouraging to see in the White Paper (Her Majesty's Treasury 2009) some signs of governmental awareness of this problem.

This leads to the question of what form accountability should take. To whom is accountability owed – who bears the public interest? From the literature, three possibilities may be discerned:

- ▶ a minimalist approach, in which industry spokespersons would bargain over regulatory matters in closed settings (the future envisaged for European regulation by the aptly-named High-Level Group, critically mentioned above)
- ▶ a middling or balanced approach, admitting NGOs as bearers of the public interest whilst not envisaging direct democratic oversight;
- ▶ a more robust approach, regulatory diversity underpinned by democratic accountability, as preferred here.

The middling approach to articulation of the public interest in regulation is set out in an oft-cited paper by Ian Ayres and John Braithwaite (1991) on 'tripartism'. This develops the proposition that indirect representatives of the public interests, such as NGOs, could be introduced into the relationship between an industry and its regulators. At an initial glance, such tripartism may have some attractions, however in the context of financial service regulators it seems not very robust. Up to now, in the UK at least, tripartism seems to have been operationalised more in terms of consultations with consumers, and education of them than in terms of powerful public interest groups holding the regulator to account. Indeed the prospects for tripartism seem modest in relation to financial market regulation, where such powerful forces are ranged on the side of private interests. Such arrangements beg the question of why the public interest should not be represented more directly in financial regulation (Snyder 2004).

Surely the starting point should be that there are *prima facie* grounds for robust democratic oversight of regulation – that is to say, oversight by elected representatives, with accompanying public debate on broad principles – unless there can be shown in-principle grounds for an exception. Therefore one wishes a fair wind to the UK government proposal to introduce an element of democratic accountability into financial market regulation. This brings us to the question of its possible consequences.

Functional advantages: reducing 'Gadarene' and 'too-big' tendencies

Strong forms of accountability of regulators to parliaments offers the prospect of a (re-)emergence of diversity in regional and national regulatory regimes, since political constituencies may differ (and change over time) in their understandings of the issues and in their policy preferences.

Why should this be preferable from the point of view of systemic stability? Clearly, the regulatory condition for the systemic crisis of 2006 onwards – the global sharing of assumptions and models, the reliance on a few ratings agencies, other shared vulnerabilities – was regulatory convergence. Such convergence was possible because financial regulation 'floated off' from its potential moorings in democratic politics. Had financial regulators at national and/or regional (eg, EU) levels been held democratically accountable (through elected representatives, even by referenda on

controversial issues), then inevitably regulators would have been somewhat constrained from convergence with their professional constituencies at international level. Ergo, there would have been greater diversity in regulatory systems, weakening the conditions for the particular type of crisis that erupted from 2006 onwards.

The claim advanced is that democratically-fuelled regulatory diversity is a safeguard against the recently experienced 'Gadarene swine' tendencies in global financial regulation and markets. From this perspective, aspects of recent EU proposals for yet-closer further regulatory networking and convergence – via for example a European System of Financial Supervisors – could be counter-productive from the point of view of protection of systemic stability. As one market commentator puts it:

The intention [with the proposed European System of Financial Supervisors] is to write a "single rule book", a laudable aim – until a national regulator disagrees. Would Spain, for example, have been allowed its sensible counter-cyclical bank provisioning system under such a model? For now, the question has been fudged and may remain so. (Lex 2009)

The point being made is that regulatory convergence may deepen systemic risk. Thus, for the sake of stability as a public good, political diversity can and must intervene against the convergence of markets. The systemic advantages can be summarised in terms of (i) reduction in herding and (ii) safeguarding medium and small size financial market participants.

(i) Nationally-based, democratically-steered oversight carries the functional advantage that it can be expected to result in greater regulatory diversity – reflecting the twists and turns, indeed the idiosyncrasies of public debate, the unpredictability of populist agenda-setting. Such regulatory diversity, inconvenient to larger international financial market participants (increase in complexity, increase in transaction costs, etc), nevertheless would reduce the herding of market participants that has been a feature of the current crisis. A global regulatory framework made up of national and regional non-identical regimes is more robust than just one, increasingly homogeneous, eventually 'monoculture'-style regime. For sure, some transaction costs could rise – for example those for complex trades across multiple jurisdictions – however that is a secondary consideration alongside systemic robustness of the global financial system as a whole.

(ii) Furthermore, the reduction of the relative advantage that regulatory convergence currently gives to larger, so-called 'too big to fail' market participants, would remove an unhelpful bias in global regulation. Understandably, the world's biggest banks and may continue to advocate regulatory convergence, posing diversity as a threat, articulated in terms of 'fragmentation of the of the global financial system' (Institute of International Finance 2009). On the contrary: the reduction in incentives for very large players, and a safeguarding of the conditions in which medium-sized and smaller regional and national financial firms are competitive, would considerably strengthen the global financial system. In reality, fragmentation and worse come from synchronised risk-taking by 'too big' entities, as recently witnessed, this being a prelude to what could follow from any continuation of convergence.

Regulatory diversity would be exhibited primarily between nation states, since it is (still) nation states that provide the primary channel for participation by parliaments and thus citizens in public policy. In the longer run, diversity between regional blocks might be underpinned by enhancement of democratic mechanisms within the European Union (and later possibly also within other regional trade-based blocs).

In short, in order to ensure stability, global cooperation must recognise on the one hand the dangers of herding, convergence and shared fault-lines and, on the other hand, the positive value of regulatory divergence for systemic robustness. If it is too much of a paradox for policy-makers and market participants that international cooperation in pursuit of global stability must include making space for some regulatory diversity, then we may expect re-plays of recent stressful events.

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ABSTRACT

Since the enactment of the new Banking Act in February 2009, with a new 'Special Resolution Regime' at its heart, the debate about how to reform the UK's financial regulatory and supervisory framework has intensified. A major catalyst for this was the publication of Lord Turner's 'Review' in March 2009, which was followed by the Government's White Paper on financial reform in July. The same month the Conservative Party revealed its own White Paper on the subject, with both the Bank of England and the Financial Services Authority contributing to the debate at frequent intervals. The purpose of this article is to review and analyse these documents and viewpoints before coming to a conclusion about the most appropriate way forward on the domestic financial regulatory front.

1. INTRODUCTION

Events surrounding the collapse of Northern Rock,¹ in the wake of the sub-prime crisis which emerged in the US in the Summer of 2007, revealed the inherent fragility of the UK banking sector and the flaws in domestic financial regulation. This ignominious event, however, proved to be but the start of the UK's financial woes as a whole series of domestically-incorporated financial institutions – including the Bradford and Bingley, the Alliance and Leicester, HBOS and a number of building societies – subsequently succumbed to either nationalisation or officially-brokered takeover-rescues.² This *ad hoc* development of failure resolution policy then gave way to a system-wide, comprehensive approach which saw the introduction of industry-wide bank bailout schemes in October 2008 and January 2009, the costs of which will be felt by UK taxpayers for many years to come.³

Such events demonstrated the clear need for a drastic overhaul of domestic financial regulation and supervisory arrangements and the authorities responded accordingly. Two revisions to deposit protection arrangements were made and a variety of consultation documents were issued by the Tripartite Authorities setting out their proposals for, *inter alia*, strengthening the financial system, reducing the likelihood of banks failing in the future, and reducing the impact of bank failure should it happen.⁴ These proposals culminated in the enactment of a new Banking Act in February 2009, with a new 'Special Resolution Regime' as its centre-piece – *see* Appendix 1. Since then, Lord Turner, the new Chairman of the Financial Services Authority, has published a detailed review⁵ indicating how he believes the system of UK financial regulation and supervision should be reformed to try and prevent a recurrence of a similar financial crisis in the future; while the

Government and the Conservative Party have followed up with their White Papers on financial reform.⁶ At the same time, similar debates have, of course, been raging around the globe with national governments seeking the best way forward in the light of their systems' needs and requirements, taking due account of their own institutional idiosyncrasies.

This article duly seeks to shed light on the nature of these debates, with a particular emphasis on the UK. It will highlight the major differences and similarities between the proposals of the main protagonists – the Government, the Conservative opposition party, the FSA and the Bank of England – and conclude with a personal assessment of what constitutes the appropriate way forward.

The paper is structured as follows. In the next section, Lord Turner's Review is summarised and analysed. This is followed, in Section 3, with discussion and analysis of the Government's White Paper. This, in turn, is followed with a review of the Conservative's White Paper in Section 4. Section 5, which includes consideration of the "turf warfare" which broke out in the Summer of 2009 as the Bank of England and the FSA jockeyed for position in the run-up to confirmation of the shape and form of the future UK financial regulatory and supervisory structure, pulls the previous material together before establishing personal preferences for domestic financial reform. Section 6 summarises and concludes.

2. THE TURNER REVIEW

In October 2008 Lord Turner was asked by the Chancellor to review the causes of the current crisis, and to make recommendations on the changes in regulation and supervisory approach needed to create a more robust banking system for the future. Lord Turner duly delivered his Review in March 2009 (FSA, 2009a), focussing on the long-term rather than the short-term macroeconomic challenges facing UK policymakers. A brief summary of his Review is provided in Appendix 2, the main recommendations of which are analysed in more detail below and in the FSA's accompanying Discussion Paper (FSA, 2009b). The analytical framework used by Lord Turner is consistent with the taxonomic 'template' established by the Financial Stability Forum (FSF) (re-established as the Financial Stability Board (FSB) in April 2009), which called on member institutions to focus on the following areas in reforming their financial systems with a view to increasing the resilience of financial markets and institutions: (i) strengthening prudential oversight of capital, liquidity and risk management; (ii) enhancing transparency in financial markets and institutions and the valuation of financial instruments; (iii) changing the role and use of credit ratings; (iv) strengthening the authorities' responsiveness to risks; and (v) developing robust arrangements for dealing with stress in the financial system (FSF, 2008).

Capital Adequacy

Some of the most important of Lord Turner's recommendations relate to the issue of bank capital adequacy and stem from the deficiencies⁷ in the Basel I/II processes revealed during the financial crisis. Accordingly, he calls for the following:

- (i) an increase in both the quality⁸ and quantity of overall capital in the global banking system, resulting in a significant increase in minimum regulatory requirements;
- (ii) a significance increase (i.e. by several times) in capital required against trading book activities and a fundamental review of the market risk capital regime, including its reliance on VaR measures for regulatory purposes (for a review *see* Hall, 1995);
- (iii) a reduction in unnecessary procyclicality under the Basel II regime;⁹
- (iv) the introduction of a counter-cyclical capital adequacy regime, with capital buffers increasing in economic upswings and decreasing in recessions;¹⁰ and
- (v) the introduction of a backstop maximum gross leverage ratio¹¹ to guard against excessive growth in absolute balance sheet size.

Given its role in promulgating the international "rules of the game" on the capital adequacy front, the Basel Committee on Banking Supervision has already acted to address the revealed deficiencies in the Basel II process, thereby supporting most of Lord Turner's recommendations.¹² Accordingly, on 13 July 2009, the Committee issued an agreed final package of measures to enhance the three pillars of the Basel II framework and to strengthen the 1996 rules governing trading book capital. The measures are part of a broader programme designed to strengthen the regulatory capital framework by promoting the build-up of capital buffers that can be drawn down in periods of stress, strengthening the quality of bank capital, introducing a backstop leverage ratio, mitigating any excess cyclicality of the minimum capital requirement and promoting a more forward-looking approach to provisioning. A consultative proposal on this broader programme is promised by the first quarter of 2010.

Under the "enhancements" package (Basel Committee, 2009a), the Committee has agreed revisions to each of the three pillars of Basel II in the light of the financial crisis. Revisions to Pillar 1 minimum capital requirement will involve, *inter alia*, raising the risk weights for resecuritisation exposures (the so-called collateralised debt obligations (CDOs) of asset backed securities (ABS)) to better reflect the risk inherent in these products, as well as increasing the credit conversion factor for short-term liquidity facilities to off-balance-sheet conduits. The Committee is also requiring that banks conduct more rigorous credit analyses of externally-rated securitisation exposures. Under the revisions to Pillar 2 (which governs the supervisory review process), supplemental guidance has been issued addressing the flaws in risk management practices revealed by the crisis. Accordingly, it raises the standards for: firm-wide governance and risk-management; capturing the risk of off-balance-sheet exposures and securitisation activities; managing risk concentrations; and providing incentives for banks to better manage risk and returns over the longer term. It also incorporates the FSF's 'Principles for Sound Compensation Practices' issued in April 2009 by the Financial Stability Board (FSB, 2009b) – *see* below. Finally, under the proposed enhancements to Pillar 3 (market discipline), the Committee calls for strengthened disclosure requirements for securitisations, off-balance-sheet exposures and trading activities. Banks and supervisors were expected to implement the new Pillar 2 guidance immediately, and were given until the end of 2010 to implement the new Pillar 1 and Pillar 3 standards. The Committee also agreed to keep in place the Basel 1 capital floors beyond the end of 2009.¹³

Meanwhile, the agreed revisions to the Basel II market risk framework governing trading book activities (Basel Committee, 2009b) were designed to address the problems revealed during the crisis of a significant build-up of leverage in the trading book, as

banks arbitrated the relatively-low capital charges on trading book activities compared with the banking book, wherein significant losses were incurred. This was, in part, due to the failure of the existing framework, based upon the 1996 Amendment to the Capital Accord (*see* Hall, 1996), to capture some key risks. Accordingly, the Committee has supplemented the current VaR-based trading book framework with an incremental risk capital charge, which now covers both default risk and migration risk, for unsecuritised credit products (*see* Basel Committee, 2009c). For securitised products, the capital charges of the banking book will apply with a limited exception for certain so-called "correlation trading" activities. These measures should reduce the incentive for regulatory arbitrage between the banking and trading books. Finally, the Committee has called for a complementary stressed VaR requirement, which requires banks to calculate a stressed VaR taking into account a one-year observation period relating to significant losses in addition to the VaR measure based on the most recent one-year observation period. This requirement has proved necessary because most banks' trading book losses during the crisis significantly exceeded the minimum capital requirements derived using VaR models. It should also help reduce the procyclicality of the minimum capital requirements for market risk. The new trading book rules must take effect in complying jurisdictions by the end of 2010.

Liquidity Adequacy

In recognition of the significant role played by liquidity strains in the generation and transmission of financial turmoil during the crisis and the failure of both regulators and institutions to contain liquidity risks,¹⁴ Lord Turner recommends that the regulation and supervision of bank liquidity should be recognised as being of equal importance to capital regulation, apart from being fundamentally reformed. Accordingly, he calls for the

introduction of a more intense and dedicated supervision of individual banks' liquidity positions, including the use of stress tests defined by regulators and covering system-wide risks.¹⁵ He also recommends that consideration be given to the introduction of a 'core funding ratio' to ensure sustainable funding of balance sheet growth.

Remuneration¹⁶

Given the strong *prima facie* case that inappropriate incentive structures played a role in encouraging behaviour which contributed to the financial crisis (FSA, 2009a, Section 2.5(ii)), it is unsurprising that Lord Turner focussed on measures designed to reduce the incentives for risk-taking provided by such incentive structures. Lord Turner thus recommends that remuneration policies for top executives and traders should be designed to avoid incentives for undue risk-taking; and that risk management considerations should be closely integrated into remuneration decisions. He argues that this can be achieved through the development and enforcement of UK and global codes.

With respect to a UK code, the FSA had, in fact, already published a draft code in February 2009 (FSA, 2009f), before the publication of Lord Turner's Review. This, however, was superseded by a refined version of the draft code in March 2009 (FSA, 2009g), which was put out for consultation. This duly resulted in the publication of the final version in August 2009 (FSA, 2009h).¹⁷ The objectives of the principles-based Code, which will apply to certain large banks, building societies and broker-dealers, are to force boards to "focus more closely on ensuring that the total amount distributed by a firm is consistent with good risk management and sustainability" and to ensure that "individual compensation packages provide the right incentives. In this way, it is hoped to sustain market confidence, promote financial stability and protect consumers. The Code, which

covers the areas of governance, the measurement of performance (including risk adjustment) and the composition and structuring of remuneration, is also designed to be consistent with the remuneration principles/guidelines developed in international fora,¹⁸ and with Sir David Walker's Review of corporate governance (HM Treasury, 2009b), which is discussed below (*see* recommendations 28 to 39 of Appendix 3). Enforcement of the Code will involve the FSA in linking required Risk Mitigation Plans to an integrated assessment of remuneration policies within the standard risk-assessment process ('ARROW') and, if necessary, increasing a firm's Pillar 2 capital requirements. The FSA recognises, however, that the effectiveness of its new approach will depend, in part, on gaining widespread international agreement to publish and enforce similar principles in all other major markets.

Looking at the final version of the Code in more detail, the agreed "rule" within the Code states that "a firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management". This is complemented by eight principles, the first seven of which apply to all employees, with principle 8 only applying to senior management and employees whose activities have or could have a significant impact on the firm's risk profile.

Principle 1, which relates to the role of bodies responsible for remuneration policies and their members, states that:

"A remuneration committee should:

- (a) exercise, and be constituted in a way that enables it to exercise, independent judgment;

- (b) be able to demonstrate that its decisions are consistent with a reasonable assessment of the firm's financial situation and future prospects;
- (c) have the skills and experience to reach an independent judgment on the suitability of the policy, including its implications for risk and risk management; and
- (d) be responsible for approving and periodically reviewing the remuneration policy and its adequacy and effectiveness."

Principle 2, which covers remuneration procedures and the input of risk management and compliance functions, states that:

"Procedures for setting remuneration within a firm should be clear and documented, and should include appropriate measures to manage conflicts of interest.

A firm's risk management and compliance functions should have significant input into setting remuneration for other business areas."

Principle 3, which relates to the remuneration of employees in risk and compliance functions, states that:

"Remuneration for employees in risk management and compliance functions should be determined independently of other business areas.

Risk and compliance functions should have performance metrics based on the achievement of the objectives of those functions."

Principle 4, which relates to profit-based measurement and risk adjustment, states that:

"Assessments of financial performance used to calculate bonus pools should be based principally on profits.

A bonus pool calculation should include an adjustment for current and future risk, and take into account the cost of capital employed and liquidity required."

Principle 5, relating to long-term performance measurement, states that:

"The assessment process for the performance-related component of an employee's remuneration should be designed to ensure assessment is based on longer-term performance."

Principle 6, which relates to non-financial performance metrics, states that:

"Non-financial performance metrics should form a significant part of the performance assessment process.

Non-financial performance metrics should include adherence to effective risk management and compliance with the regulatory system and with relevant overseas regulatory requirements."

Principle 7, which concerns the measurement of performance for long-term incentive plans, states that:

"The measurement of performance for long-term incentive plans, including those based on the performance of shares, should be risk-adjusted."

Although full compliance with this principle is not being sought by January 2010, firms are expected to have initiated a review by then of how well their long-term incentive plans take account of future risks.

In its amended guidance, the Code cautions against the use of unadjusted 'earnings per share' and 'total shareholder return' metrics, which can both be boosted by increasing leverage.

Finally, *Principle 8*, which relates to remuneration structures, states that:

"The fixed component of remuneration should be a sufficient proportion of total remuneration to allow for a firm to operate a fully flexible bonus policy."

The accompanying guidance also makes it clear that it is good practice for a firm (or a part of it) which makes a loss in any given year to have the flexibility not to pay a bonus, for a portion (at least two-thirds, for 'significant' bonuses) of bonuses to be deferred for at least

three years, and for a significant proportion of the variable component of remuneration to be linked to the future performance of the firm and, where practicable, the employer's division or business unit, or otherwise the business undertaken by the employee.

The media response to the publication of the Code was generally rather negative. This was due, in part, to the Code's failure to tackle the issue of the scale of bankers' pay, implying the capping of bonuses, but Lord Turner and the FSA have argued all along that this is not an issue for the long-term nor for bank regulators, although it *is* a legitimate issue of public concern (particularly with respect to taxpayer-supported institutions) but one that should be addressed by politicians. This stance, however, overlooks the fact that the size of the bonus pool, rather than individual payments, is of relevance to regulators as it affects capital adequacy; and it would have carried more conviction had the final version of the Code not been watered down compared with the original. Moreover, some worry about the lack of legally-binding rules – although, it could be argued, that a principles-based approach based on "recommendations" is superior as it reduces the incentives for "gaming" and allows for greater flexibility - and the damage that still might be done to the City of London if widespread international agreement on the adoption of similar proposals cannot be secured (a danger already acknowledged by Lord Turner, as outlined above, and responsible for the watering-down undertaken). And it is not clear how the degree of risk generated by non-compliance will be calculated, nor how the additional capital requirement will be calibrated.

Lord Turner's apparent frustration at policymakers' unwillingness to tackle this issue at a time of general resurgence in bonuses due to a revival in the profitability of investment banking operations (due, in part, to reduced competition, post-crisis, and state-provided

subsidies of various kinds) subsequently led him to 'open his heart' to *Prospect* magazine, which published the interview on 26 August 2009. In the article, he expresses his concerns about the prospect of the City returning to "business as usual" (e.g. paying out large bonuses, offering 'golden hellos' and adopting short-term policies again), with politicians seeming to lack the will to radically transform the system to prevent a recurrence of the previous excesses.¹⁹ Arguing that the financial sector has grown too big for society (as was the case in Iceland), that it has destabilised the UK economy and that some of its activities (e.g. some derivatives trading and "churning") are socially worthless or worse, he suggests the introduction of an internationally-agreed 'Tobin-style' tax²⁰ on financial transactions to curb excessive profits and pay in the financial sector if higher capital requirements fail to adequately address the consequences for financial stability. While he was right to highlight the dangers associated with a bloated financial sector and of a return to 'business as usual' in the City – so soon after the havoc wrought on the real economy, the near-terminal blow dealt to the financial system and the irreparable damage done to the public finances by bankers' gross mis-management and insatiable greed – and right to consider alternative remedies to the problems posed by the payment of excessive bonuses for financial stability if higher capital requirements fail to do the job, he was misguided in favouring the solution that he did.²¹ For, even G20-sponsored action risks damaging the interests of the UK economy, while the tax itself would prove a very blunt instrument, affecting all transactions (socially-desirable or not) equally, would lead to higher costs for consumers and would reduce liquidity in financial markets. Predictably, howls of anguish could be heard from the vested interests in the City, led by the British Bankers Association but backed by the Investment Management Association, the Association of British Insurers, the CBI and the Mayor of London, suggesting Lord Turner had hit a raw nerve. Hopefully,

the brave, but nevertheless welcome, act by the senior regulator will spark a wider debate on the issues involved.

FSA's Supervisory Approach²²

In recognition of the failings of the past²³ and of the need to shift its primary focus from the regulation of individual institutions ('micro-prudential' regulation) to combining this with a strong focus on the overall system and on the management of systemic risks across the economic cycle ('macro-prudential' regulation), Lord Turner calls for a completion of the 'Supervisory Enhancement Programme' put in place in the aftermath of the near-collapse of Northern Rock (FSA, 2008b). This will involve: an increase in resources devoted to high impact firms and, in particular, to large complex banks; a more detailed focus on business models, strategies, risks and outcomes, rather than primarily on systems and processes; a focus on the technical skills, as well as the probity, of approved persons; increased analysis of sectors and comparative analysis of firm performance; further investment in specialist prudential skills; the introduction of more intensive information requirements on key risks (especially liquidity risks); and a new focus on remuneration policies. These changes should be further reinforced, according to Lord Turner, by development of capabilities in macro-prudential analysis and a major intensification of the role played by the FSA in balance sheet analysis and in the oversight of accounting judgements. These are deemed necessary to respond to the challenges posed by the crisis as it has developed since March 2008.

Given the developments in the deposit-taking industry after the nationalisation of Northern Rock, which saw the nationalisation of Bradford and Bingley and the brokering of takeover-rescues of Alliance and Leicester and HBOS (by Banco Santander and Lloyds

TSB respectively) and a number of building societies (*see* Hall, 2009a), there must be a fear that the FSA's failings with respect to Northern Rock were not a one-off. As Lord Turner himself concedes, the FSA had traditionally focussed on the supervision of individual institutions rather than the whole system, on ensuring that systems and processes were correctly defined, rather than on challenging business models and strategies and on the probity of approved persons rather than on an assessment of their technical skills. Moreover, the organisation was biased in favour of conduct of business regulation compared with prudential regulation, with bank prudential regulation being dominated by considerations associated with the agreement and implementation of Basel II. As a result, emerging problems, such as the rapid build up in trading book risk and liquidity risks, were missed.

This does not fully explain, however, why so many "warning signs" were missed (Garcia, 2009). The fear is that the FSA were cowed into acceptance of the oft-repeated political demands (including by the current Prime Minister) for 'light touch' regulation, deemed necessary if the City was to preserve its traditional pre-eminent status amongst financial centres and continue to contribute to the nation's prosperity via tax payments, employment, invisible earnings, etc., etc. Such political/industry 'capture' of the regulator was evident in the days when the Bank of England had responsibility for banking supervision – witness their failings with respect to BCCI and Barings (*see* Hall, 1999, Chapters 11 and 12 respectively) – and appears to have been carried over into the FSA. The likelihood, as conceded as a possibility by Lord Turner in his interview with *Prospect* magazine alluded to earlier, where he warns that the FSA should be "very, very wary of seeing the competitiveness of London as a major aim", is that this objective had indeed conflicted with its regulatory remit. This would help explain the FSA's reluctance to

challenge banks' strategic objectives, especially with respect to growth, organically (Northern Rock) or by merger (RBS's takeover of ABN Amro). In other words, the FSA was reluctant to bring the party to a premature end given the apparent wealth creation that had occurred during the boom period of 1993 to 2007, the very 'benign economic era' in which the FSA had been established; and excessive bonuses were tolerated as a necessary 'by-product' of said wealth creation.

Of course, under Lord Turner's stewardship, things appear to be improving, as a more intensive and intrusive style of supervision is embraced. Indeed, judging by the industry complaints about its latest measures – sitting in on bank board meetings, demanding more data, questioning business plans, challenging judgments of senior executives, challenging bonus payments, widening and toughening its 'fit and proper' tests for approved persons, and increasing its activities (via fines and criminal cases) to deter fraud and malpractice – this step change has already been made. But, as explained below, this frantic activity may be all too late, as the likely winners of next year's national elections, the Conservative Party, have promised to dismantle the organisation as we know it, leaving it to focus solely on issues of consumer protection. This is reminiscent of the Bank of England's belated attempt to put things right after the collapse of Barings (*see* Hall, 1999, Chapter 12), an endeavour that did not impress the incoming Labour government of 1997 – hence the transfer of regulatory and supervisory responsibility to a newly-created, unified agency, the FSA. It seems history is about to repeat itself, but with the regulatory responsibility moving in the other direction. Only time will tell if this proves to be a sensible policy.

Firm Risk Management and Governance

As demonstrated before and during the crisis, internal risk management was often ineffective and boards of financial institutions routinely failed adequately to identify and constrain excessive risk-taking. Clearly then, there is a need to increase the standards of risk management and governance in financial institutions. Although Lord Turner was happy to await the outcome of the Walker Review (*see* immediately below) before deciding on the necessary changes to be made to the FSA's rules and processes, promising specific proposals by the fourth quarter of 2009, he nevertheless indicated his main areas of concern.²⁴ These relate to the need to improve the professionalism and independence of the risk management function, to embed risk management considerations in remuneration policy, to raise the skill level and time commitment of non-executive directors, and to enhance the ability of shareholders to constrain firms' risk-taking.

As anticipated by Lord Turner, the *Walker Review* (HM Treasury, 2009b), was published a few months after his own Review. Sir David Walker had been asked by the Prime Minister in February 2009 to review corporate governance in the UK banking industry (later extended to the whole finance industry), in the light of the banking crisis. Thirty-nine recommendations (*see* Appendix 3) were duly made to enhance corporate governance with a view to reducing the likelihood of a similar catastrophe striking the UK economy again. These recommendations of Sir David's Interim Report are now the subject of consultation with interested parties.

The recommendations are grouped under five headings: board size, composition and qualification; functioning of the board and evaluation of performance; the role of institutional shareholders; communication and engagement; governance of risk; and

remuneration. Five key themes are also identified. Firstly, the Combined Code of the Financial Reporting Council (FRC), embodying the principle of "comply or explain", remains fit for purpose, although tougher capital and liquidity requirements and a tougher regulatory stance on the part of the FSA are required. Secondly, the principal deficiencies of financial industry boards related much more to patterns of behaviour than to organisation. More should be done to promote an environment whereby the executive can be challenged. This will require, *inter alia*, changes to board composition and a materially increased time commitment from both non-executive directors (who need more experience, training and support) and the Chairman of the Board (who should be put up for re-election each year). Thirdly, board level engagement in the high-level risk process should be materially enhanced, particularly with respect to the monitoring of risk and discussion leading to decisions on risk appetite and tolerance. Board level risk committees, separate from audit committees, should be set up to ensure executives do not take any unnecessary risk. Fourthly, there is a need for fund managers and other major shareholders to engage more productively with their investor companies with the aim of supporting longer-term improvement in performance. Boards, in turn, should be more receptive to such initiatives. And finally, given the clear evidence of defective control and serious excess in some circumstances, substantial enhancement is needed in board level oversight of remuneration policies, in particular in respect of variable pay, and in associated disclosures. The remit and responsibility of board remuneration committees should be extended beyond board members to cover the remuneration framework for the whole entity, for those whose pay exceeds that of the average board level remuneration. Not less than half of expected variable remuneration should be on a long-term incentive basis with vesting, subject to performance conditions, deferred for up to five years.

Media reaction to the publication of the Review was mixed. Although commentators generally applauded Sir David's attempts to address the systemic threat posed by granting bonuses that encourage excessive risk-taking by, for example, calling for a higher proportion to be deferred, and for longer, and the other measures recommended to restrain excessive risk-taking, a number of concerns were voiced. For those wishing for a more draconian approach to be taken to the award of bonuses there was considerable disappointment. No cap on bonuses was proposed and a 'clawback' of bonuses was only sanctioned in cases of misstatement or misconduct, not subsequent poor performance. Similarly, on pay disclosure, there is no requirement that individual, high-earning bankers be identified, only that the number of employees earning above certain thresholds be published. And those who want Chief Executives to be barred from becoming Chairmen were also disappointed. The general criticism was thus that the Review was not tough enough nor prescriptive enough. Industry reaction, on the other hand, understandably focussed on the perceived damage that might be done to their personal interests. Concerns about the potential damage that might be done to the UK financial services industry if similar proposals are not introduced in competing jurisdictions were widely voiced. Some also raised fears about the likely increased difficulty to be faced in filling non-executive positions given the substantially increased burden they would face under the new regime. And yet others complained about the extension of the remit of non-executives into areas traditionally the preserve of management alone. It remains to be seen to what extent Sir David moves to placate both sets of protagonists; a delicate balancing act will have to be performed, carefully weighing the public interest against potential threats to domestic finance industry profitability.

European Regulatory and Supervisory Arrangements

The final area²⁵ of Lord Turner's Review to be covered in this article is the European dimension to the reform debate. At the moment, most aspects of financial services regulation are expressed in EU Directives associated with the 'Single Market', which then have to be transposed into national law (*see* Hall, 1997). These Directives set minimum standards which Member States can choose to exceed on a national discretion basis (under the principle of 'super equivalence'). In addition to the Directives, three committees (the 'Lamfalussy Committees'), representing national authorities, play important consultative roles. Supervision of financial entities remains entirely in the hands of national authorities, with cross border activities supervised in accordance with the allocation of responsibilities between home and host authorities agreed in the *Basle Concordat* in 1975, as subsequently amended in the light of flaws exposed in the regulation and supervision of Banco Ambrosiano Holdings, prior to its collapse in 1983, and of BCCI, prior to its closure in 1992 (*see* Hall, 1999, Chapter 3, for further details). Deposit insurance, subject to harmonised minimum standards, and crisis management arrangements are also operated on a national basis, the latter subject to 'state aid' rules.²⁶

In terms of 'architecture', this system survived until 2009 when the Jacques de Larosière 'Taskforce' reported (February 2009). This body argued against the adoption of a pan-EU regulatory body in favour of the creation of two new bodies – a 'European Systemic Risk Council' (ESRC), later (i.e. in September 2009) confirmed as the 'European Systemic Risk Board', and a 'European System of Financial Supervisors' (ESFS). The purpose of the ESRC, which would comprise ECB officials, national monetary authorities and EU officials, would be to co-ordinate the supervision of systemic risks which threaten overall financial stability and advise upon appropriate remedies. This would improve on

the current system which is inevitably nationalistic in nature and focuses on individual institutions. The second institution, the ESFS, comprising separate authorities for banking, securities and insurance, would decide on compulsory minimum EU-wide standards designed to stop 'regulatory arbitrage' between Member States, provide binding mediation between disagreeing national authorities, co-ordinate the operation of 'colleges of supervisors' for systemically-important cross-border institutions and licence and supervise some EU-wide institutions, such as rating agencies and clearing houses. National authorities would remain in charge of day-to-day supervision, as before, and could still impose tougher standards if desired. Finally, the Taskforce recommended the development and operation of a global financial stability early warning system by the IMF, with the assistance of the ESRC and central banks. The European Commission duly accepted the Taskforce's recommendations in March 2009 but called for much speedier implementation – the Taskforce envisaged the process lasting a number of years.

Lord Turner, in his Review, however, claims 'this philosophy to be inadequate and unsustainable for the future' (*op.cit.*, p.100), citing the failure of Landsbanki as an example of how existing single market rules can create unacceptable risks to depositors and/or taxpayers.²⁷ Accordingly, he argues that either national powers are increased, implying a less open single market, and/or there needs to be a greater degree of European integration. He prefers a mix of both, favouring more national powers in the areas of capital and liquidity adequacy assessment, possibly to include home country power to require local subsidiarisation of institutions where there are concerns about whole bank soundness and/or about the capacity of home country fiscal authorities and deposit insurance schemes (*see also* FSA, 2009b). This would protect the interests of UK depositors and taxpayers. As for the 'more Europe' option, Lord Turner suggests two²⁸ possibilities for

consideration; greater cross-European co-ordination of supervisory approaches and of macro-prudential analysis, and greater co-ordination of deposit insurance arrangements. With respect to the former, Lord Turner calls for the creation of a new EU institutional structure to replace the Lamfalussy Committees. A new independent body should be created with regulatory powers to act as a standard setter and overseer of supervision. It should also be involved, alongside central banks, in macro-prudential analysis, while leaving the primary responsibility for supervision with national authorities. [Note the similarities with the de Larosière recommendations.] And, with respect to the latter, he suggests that the option of introducing pan-European arrangements for the deposit insurance of banks operating cross-border in branch form should be considered in more detail.

3. THE GOVERNMENT'S WHITE PAPER ON FINANCIAL REFORM

On 8 July 2009 the UK Government set out its proposals for reforming UK financial regulation (HM Treasury, 2009a). The reform recommendations, designed to strengthen the financial system for the future, followed the Government's analysis of the causes of the financial crisis and a summary of the action already taken to restore financial stability in the UK (a critique of which is provided in Hall, 2009a and 2009b), embracing the introduction of a new 'Special Resolution Regime' for banks in the Banking Act of February 2009,²⁹ the reform of deposit protection arrangements, the brokering of takeover-rescues of ailing institutions, the nationalisation of failed institutions and the introduction of two industry-wide, bailout schemes involving, *inter alia*, state-funded recapitalisation of weak banks and capital protection through the 'Asset Protection Scheme'.³⁰

The further reforms proposed are designed to "strengthen regulation and supervision, and support corporate governance so that, in future, financial crises will be less likely and less damaging" (*op.cit.*, p.16). They are intended to deliver:

- "• more effective prudential regulation and supervision of firms;
- greater emphasis on monitoring and managing system-wide risks;
- greater confidence that the authorities are ready and able to deal with problems when they do arise; and
- greater protection for the taxpayer when an institution needs to be resolved" (*ibid.*, p.10).

The Treasury's proposals (a summary is presented in Appendix 4 of this paper) are grouped together under four main headings: (i) proposed changes to the governance, co-ordination and regulatory framework of the UK's financial authorities; (ii) the

Government's strategy for dealing with systemically-significant institutions; (iii) the Government's strategy for managing systemic risk more broadly; and (iv) the Government's plans to strengthen financial regulation and supervision at the international level. Each area will now to be addressed in turn. [Consumer protection and competition issues – addressed in Chapters 8 and 9 respectively of the White Paper – are not considered further, here.]

Proposed Changes to Governance, Co-ordination and Regulatory Framework

With respect to co-ordination, the Government has proposed that a new statutory committee, the 'Council for Financial Stability' (CFS), replaces the existing 'Standing Committee', to formalise and strengthen the co-ordination between the Bank of England, the FSA and the Treasury. The objectives of the new Council, to be chaired by the Chancellor, will be to analyse and examine emerging risks for financial stability and co-ordinate the appropriate response. To increase public transparency and accountability, the minutes of the standing meetings will be published quarterly, and an annual report will be published and sent to Parliament. The CFS will also co-ordinate the UK Authorities' position on EU and international financial stability and regulatory policy issues, and its Terms of Reference will replace the existing Memorandum of Understanding, as last amended in March 2006. The external members of the governing bodies of the Bank of England and the FSA will also be used to provide additional outside expertise.

In relation to the subject of governance, the Government will await the outcome of the FSA Board's review (due before end-2009) of its functions before making any explicit proposals for reform of the FSA's governance arrangements but, in the interim, it is to be given an explicit financial stability objective. This will complement the existing objectives

set out in the FSMA to provide a more explicit recognition of the FSA's expanded role in maintaining and enhancing financial stability.

As for enhancing the regulatory framework, the Government is proposing a number of measures. Firstly, it plans to strengthen the FSA's prudential regulation and supervision of banks through endorsement of all Lord Turner's recommendations with respect to enhancing capital and liquidity adequacy assessment (*see* Appendix 4).³¹ It also endorses Lord Turner's planned enhancement of the FSA's SEP, as the FSA's supervisory approach becomes more intrusive and systemic. [On 2 July 2009, the FSA announced a change to its organisational structure to better align it with its new functional model.] It will also take action to strengthen the FSA's powers in relation to authorised firms and individuals found guilty of misconduct, and to allow it to take emergency action to place restrictions on short selling and to require disclosure of short selling outside the regulatory framework governing market abuse. Finally, to better protect taxpayers/depositors, it is proposing the eventual (but not before 2012) introduction of an element of pre-funding into the deposit-taking sub-scheme of the FSCS, following full consultation with interested parties. The Government will also bring forward proposals regarding the governance and accountability of the FSCS.

Reforms Proposed as Part of the Government's Strategy for Dealing with Systemically-Significant Institutions

Although the Government recognises the need to deal effectively with systemically-significant (or "high impact") firms, it agrees with Lord Turner that the appropriate solution is not to impose artificial limits on a firm's size or breadth of activities through, for example, the imposition of 'Glass Steagall-type' regulations.³² Rather, it prefers to

strengthen market discipline and infrastructure, and enhance prudential regulation and failure resolution mechanisms, as explained below.

The Government's proposals are designed to do two things; to reduce the risk of systemically-significant institutions failing and, if they do fail, to reduce the impact of their failure. On the first front, the Government is focussing on strengthening market discipline by using the work of the Walker Review and the FSA's Code of Practice (backed by the FSB's code of practice agreed at the G20 Pittsburg Summit in September 2009) to provide guidance on the standards of discipline expected in corporate governance and remuneration respectively. Additionally, it will urge the FSA to establish and maintain dialogue on governance issues with the non-executive director of boards. It is also relying on an enhancement of the FSA's prudential regulation and supervision, both generally – as proposed by Lord Turner in respect of stricter regulation and supervision of capital and liquidity adequacy – and specific to systemically-significant firms through the imposition of additional capital charges relating to the size and complexity of the firm. The latter charge would, in effect, "internalise" the firms' higher costs of failure. The Government recognises, however, that international co-ordination on the last point is necessary if regulatory arbitrage is to be avoided and, accordingly, supports the deliberation of the issue at international fora.³³

With respect to the reduction of the impact of such firms' failure, the Government again has a dual plan of attack. Firstly, to strengthen market infrastructure (through, for example, enhancing the legal and operational infrastructure of the CDS market, as supported by Lord Turner) and, secondly, to enhance failure resolution mechanisms. The latter, in turn, is to be secured through the introduction of a new insolvency regime for

investment banks,³⁴ following the introduction of the new SRR for deposit-takers in the Banking Act of February 2009, and by forcing banks to draw up internal failure resolution plans ('living wills') to facilitate their unwinding at short notice, should that prove necessary. The nature of these internal resolution plans – the quality of which, the Government argues, should be taken account of in the FSA's overall assessment of the prudential risks borne by a firm and, if necessary, in its regulatory requirements – which will inevitably impact on corporate structure (and hence on tax payments and profitability) and the cost of capital (due to rating agency downgrades), will be the subject of consultation, but the Government is committed to the eventual adoption of the idea and is planning legislation this year to deliver it (*see* also Basel Committee, 2009d).³⁵

Reforms Proposed as Part of the Government's Strategy for Managing Systemic Risk More Broadly

The crisis has demonstrated how the accumulation of systemic risk across financial markets can have serious macroeconomic consequences. The Government thus wants to make sure that, in addition to securing the health of individual institutions, central banks and regulators pay close attention to:

- "• how the complex inter-linkage across financial markets, and financial institutions' tendency to respond in common ways, can threaten stability;
- the cyclical nature of risk-taking in financial markets, which can cause the extent and nature of threats to financial stability to fluctuate over time; and
- the links between the financial system and the wider economy" (*op.cit.*, p.77).

While recognising that, to be effective, any policy changes need to be adopted and co-ordinated internationally, the Government is working closely with the Bank of England and the FSA, as well as with its international counterparts (including the FSB), to develop an appropriate approach to mitigate the adverse consequences for financial and

macroeconomic stability of the pro-cyclical behaviour of financial institutions and markets.

In order to improve the management of systemic risk across markets and institutions, the Government advocates the following: enhancing transparency by improving accounting standards; improving the liquidity, transparency and robustness of wholesale markets (and, in particular, securitisation and over-the-counter (OTC) derivatives markets); and increasing the regulatory focus on systemic risk.

The increased focus on transparency (e.g. with respect to financial institutions' risk exposures) is deemed necessary to enhance market discipline, facilitate better risk management and enhance market liquidity in distressed conditions. Accordingly, the Government endorses the FSF's accounting recommendations in this area (to take effect by end-2009) and agrees that the FSA should engage with firms and auditors to ensure more consistent approaches in the valuation of financial instruments across firms. As for the increased focus on wholesale markets, the crisis clearly demonstrated the need to look more systemically at those key markets in which financial institutions operate and take a considered approach to the systemic risks they pose, especially in respect of liquidity.

To avoid illiquidity in securitisation markets, the Government believes greater product standardisation and transparency are necessary to attract a broader class of investors (additional to banks and their conduits).³⁶ And, with respect to OTC derivatives markets, the Government hopes to enhance their robustness and functioning through securing agreement on the introduction of a centralised clearing house for most products, with those deemed not suitable for such action (i.e. because they are bespoke, illiquid or new) being

subject to bilateral collateralisation and risk-appropriate capital changes to mitigate counterparty risk. Requirements to increase the amount of due diligence done by investors in structured products, which should be facilitated by greater standardisation, will also serve to enhance the robustness of securitisation markets.³⁷

Finally, to ensure a greater regulatory focus on systemic risk, the Government advocates enhanced monitoring and supervision and the creation of a responsive and dynamic regulatory boundary. With respect to monitoring, the Government expects the FSA to increase its focus on understanding the nature of the inter-relationships and networks between firms and proactively identifying systemic vulnerabilities, and in monitoring and assessing how systemically-important markets might trigger or amplify a shock. If additional information-gathering powers are necessary, the Government will legislate for this. As for enhanced supervision, the Government will review and amend the FSA's objectives and the principles of good regulation to clarify that the FSA's regulatory and supervisory approaches should include an enhanced focus on monitoring, assessing and mitigating systemic risks, and that its regulatory decisions take into account the wider economic costs of financial instability; while the FSA's enforcement powers will be enhanced and extended to, *inter alia*, allow it to take action to address systemic risk and protect financial stability. Meanwhile, in agreement with Lord Turner, the Government argues that the regulatory perimeter should be determined according to the principle that financial activities should be regulated according to their economic substance and the risks they pose, not their legal form. This suggests a closer scrutiny of off-balance-sheet vehicles³⁸ and hedge funds,³⁹ at the minimum. Moreover, the regulatory perimeter will need to be kept under review because of the industry's continuous financial innovation.

The final area of systemic risk management that has exercised the Government is that associated with the economic cycle. Concern about "pro-cyclicality", or the co-movement between lending conditions and the cycle, has led for calls to amend regulation in order to dampen excessive credit provision and risk-taking in the financial system which can amplify an economic upturn, and to ensure that banks are more resilient to economic shocks when they occur to prevent amplifying an economic downturn. The Government is thus working together with the FSA and the Bank of England and in international fora – e.g. the FSB and the European Systemic Risk Board (ESRB) (*see below*) – to develop these so-called "macro-prudential" tools. The Government favours the use of a complementary "backstop" maximum leverage ratio and the build-up of counter-cyclical capital buffers in good times, as argued for by Lord Turner, the latter to be achieved ideally through appropriate prudential regulation rather than by changing accounting standards (to allow, for example, for 'dynamic provisioning'). This, however, does not deal with the tendency for financial markets to amplify economic cycles through, for example, the creation of asset price "bubbles". The Government thus believes that more should be done to prevent this by, for example, linking capital requirements to indicators of risk in the financial sector or wider economy and firm-specific indicators, such as the growth in individual banks' lending activities or their liquidity profile.⁴⁰ These additional tools can be used to complement the action already taken by the FSA⁴¹ and that planned by the Basel Committee and the IASB to ensure that international regulatory and accounting standards (focussing on risk-based capital requirements and mark-to-market accounting respectively) do not act to unnecessarily amplify the inherent pro-cyclicality of the financial system.

Apart from the above measures, the Government is also determined to improve banks' access to funding during economic downturns or crises, an important source of contagion during the recent crisis. While increased transparency of bank exposures may help in this respect – as mentioned above – further measures are needed to expand banks' sources of capital, other than from governments. One possibility being considered is for the FSA to be given the authority to order, in the event of a systemic crisis, banks to convert some of their debt (subordinated?) into equity.⁴²

Finally, the Government believes that an element of discretion, additional to rules-based policy, will be required if the inherent pro-cyclicality of financial markets is to be effectively constrained. Tools, such as the re-setting of leverage ratios or the imposition of prudential add-ons to regulatory capital requirements, might thus be used in response to the emergence of threats for financial and macroeconomic stability. As for the institutional responsibility for these and any other tools endorsed by the Government,⁴³ this will be decided once international agreement has been reached on what the new tools should be, and how they are to be used.⁴⁴ [As discussed below, however, the Conservatives, likely to form the next Government, have been less coy about their preferred choice of macro-prudential regulator!]

Reforms Proposed to Strengthen Financial Regulation and Supervision at the International Level

The recent crisis has demonstrated the need for strong domestic regulatory systems to be complemented by enhanced supervision of international firms and markets through robust international standards, close co-operation between authorities, and a more coherent international regulatory architecture. While much has already been done⁴⁵ in these areas, the Government believes there is still scope for a further strengthening of regulation and

international co-operation, particularly in Europe.⁴⁶ Their recommendations for delivering this are considered below.

In the light of the recent crisis, the Government believes that it is necessary to improve the authorities' ability to identify systemic risks within the EU and the quality (and scope) of rules applying to firms as well as to ensure proper enforcement of those rules. While welcoming the outcome of the European Council's deliberations of June 2009⁴⁷ on structural reform of the EU regulatory and supervisory system (draft legislation was proposed by the European Commission in September 2009) it believes more should be done. In particular, it wants to see a reduction in the number of national discretions available in Directives,⁴⁸ in order to secure a more level playing field and increase the effectiveness of regulation, and a strengthening of the rules and safeguards governing cross-border branching in the EEA. With respect to the latter, the Government is concerned, like Lord Turner, with the quality of supervision exercised by the Icelandic authorities and the inadequacies of their deposit guarantee scheme, and is calling for changes, there and elsewhere, to both reduce the likelihood of bank failure and the cost of failure should it occur. In relation to the former, the following policies are suggested for adoption: ensuring that minimum standards are strong and applied consistently to cross-border groups; strengthening information exchanges between home and host authorities, with host supervisors having access to micro-prudential information relating to the overall financial position of a group; and ensuring that peer review and supervisory audit of cross-border supervision take place. In addition, other countries might like to follow the UK's lead and ensure that foreign branches operating in their jurisdictions are self-sufficient for liquidity purposes, unless their parent companies meet certain criteria (this policy will soon be implemented in the UK by the FSA). With a view to reducing the costs of failure,

the Government argues that Member States (and, indeed, all countries) should possess minimum and compatible resolution toolkits (along the lines of the UK's new Banking Act) should develop and agree winding-down plans for significant cross-border banks, and should establish co-operation agreements between deposit guarantee schemes to enhance their operational effectiveness. [The European Commission is considering setting up a pan-EU deposit guarantee scheme.]

Apart from these measures, the Government also wants to see stronger enforcement of EU rules, including through better-quality supervision. The establishment of supervisory colleges, combined with supervisory audit, peer review and binding home-host mediation should all serve to further this end but appropriate implementation will be crucial. The Government also believes that, prior to the creation of the European Supervisory Authorities, the existing Level Three committees need to be better resourced to deal with the important jobs at hand – notably, in connection with the registration of credit rating agencies and the drafting of the Solvency II Directive, and that, in the longer-term, a single rule-making body should be created to improve the quality of regulation in the EU.

With respect to the wider need for closer international co-operation and cross-border supervision, the Government believes that more should be done to build on the recent initiatives adopted in respect of the creation of supervisory colleges for large cross-border firms, implementation of the FSF principles for cross-border crisis management and the launching of an 'Early Warning Exercise' (EWE) by the IMF/FSB to identify macro-financial vulnerabilities and propose policy responses. Accordingly, to further promote international macro-prudential supervision, the Government calls on the IMF and FSB to undertake the following:

- draw upon the relative strengths of each institution (it is vital that the FSB is a full partner to the EWE and uses its expertise to propose appropriate regulatory responses to the macro-prudential risks identified by the IMF);
- identify both quantitative and qualitative assessments of risks, focussing on those with potential cross-border effects;
- have a clear signalling system based on the likelihood and impact of a possible event;
- be a forum for articulating concrete policy responses to risks identified, particularly those that require co-ordinated as opposed to unilateral action; and
- draw on risks and advice identified in other appropriate reports.

Moreover, with respect to crisis management, there is a need to ensure that international rules facilitate rather than hinder appropriate action by national authorities, and that there is international consistency in approaches to cross-border bank resolution arrangements.

4. THE CONSERVATIVE PARTY'S WHITE PAPER

Given the Conservative Party's current standing in the polls, and hence the strong likelihood that it will form the next government in the summer of 2010, its proposals for financial reform are of obvious interest to all concerned. As explained below, its proposals, drafted in July 2009 in the wake of the submission of a review by Sir James Sassoon on the Tripartite system, are radical, embracing the abolition of the FSA and the Tripartite system, the creation of a new Consumer Protection Agency and the handing of micro- and macro-prudential regulatory powers to the Bank of England (for a summary *see* Appendix 5).⁴⁹

The proposed reforms can usefully be divided into those associated with changing the regulation "architecture" and those associated with a change in regulatory policy. The latter, in turn, can be divided into micro- and macro-prudential reforms. As far as the architecture is concerned, the proposed changes are seismic. The FSA would be abolished, its micro-prudential powers being handed over to the Bank of England (to be carried out by a new "Financial Regulation Division")⁵⁰ and its consumer protection remit would be transferred to a new Consumer Protection Agency, which would also take over the regulation of consumer credit from the OFT. The abolition of the FSA would, in turn, mean that the triggering of the Special Resolution Regime (SRR) introduced under the Banking Act 2009 would also pass to the Bank, which is currently only responsible for its operation, and result in the abolition of the Tripartite system. With respect to the latter, the current Standing Committee would be replaced by a new "Financial Policy Committee,"⁵¹ housed within the Bank, which would be responsible for monitoring systemic risks, operating new macro-prudential regulatory tools and executing the SRR for failing banks.

Finally, a single senior Treasury minister would be given responsibility for European financial regulation, where efforts would be concentrated on reducing barriers to entry to increase opportunities for UK financial firms.

With respect to changes to regulatory policy, changes to existing micro-prudential policy and the introduction of new macro-prudential tools are both proposed. On the former front, the Conservative Party endorses Lord Turner's recommendations for:⁵²

- the imposition of additional capital and liquidity requirements on banks to reflect an institution's size and complexity;
- the imposition of "much higher" capital requirements on high-risk activities, such as large-scale proprietary trading;⁵³
- using capital requirements to crack down on risky bonus structures; and
- the introduction of an internationally-agreed 'backstop' leverage ratio to constrain bank lending.

It also accepts the case for the preparation of "living wills" by institutions to assist in their orderly unwinding in the face of insolvency, as argued for by the Governor of the Bank of England and subsequently by Lord Turner.⁵⁴ As for macro-prudential policy, the Conservative Party argues for international co-ordination in the development of a macro-prudential "toolkit" which should comprise, *inter alia*, counter-cyclical capital requirements, as called for by Lord Turner and supported by the Government. It also promises to introduce additional safeguards against the risks created by complex or interconnected institutions through greater use of central counterparty clearing, the creation of a more appropriate balance between exchange-traded and over-the-counter securities, and greater financial transparency.

Finally, it is worth noting that the Conservative Party are also keen to enhance competition in the financial services industry, matching the current Government's belated focus on this area, in part due to the European Commission's "State Aid"-related concerns with the Government's approach to bailing out domestic banks (*see* Hall, 2009a). Accordingly, and with a view to introducing a greater degree of diversity and competition into the UK banking sector, the OFT and the Competition Commission will be asked to conduct a focussed examination of the effects of consolidation (increased during the financial crisis because of official bailout policies) in the retail banking sector. The findings will help to inform strategies for disposing of state-held stakes in banks. The Conservatives will also look at measures to enlarge the activities of credit unions.

5. THE WAY FORWARD

In the light of the discussion presented above, it is clear that there is a high degree of consensus as to what should be done to enhance financial regulation and supervision and to prevent a recurrence of the type of financial crisis recently experienced around the globe.⁵⁵ At the *domestic level*, this will require a strengthening of regulation and supervision along the lines already implemented by the FSA under its 'Supervisory Enhancement Plan', subject to the enhancement noted by Lord Turner and the Treasury. This should deliver a more intrusive⁵⁶ and risk-focussed style of regulation that is concerned both with individual institutions and the systemic consequences of their joint actions. In addition, as for other jurisdictions, it will require fundamental reforms to both *micro-prudential* and *macro-prudential* policy of the type set out in Part B of Appendix 6. Action demanded in the former sphere of operation embraces, *inter alia*, a strengthening of capital and liquidity adequacy assessment and a closer focus on systemically-important institutions; while action required on the latter front will see the introduction of counter-cyclical capital and liquidity requirements and accounting measures.⁵⁷

As for the additional *safeguards* needed, again there is a clear consensus as to what should be done in the future – see Appendix 6, Part C. The 'wish list' comprises:

- greater regulation and tighter monitoring of credit rating agencies;
- greater use of central counterparty clearing for (standardised) derivative instruments (including CDSs), and exchange trading;
- improved accounting standards;
- extension of the regulatory perimeter to include all systemically-important financial institutions (such as hedge funds);

- tighter regulation and supervision of off-shore financial centres;
- stronger corporate governance (including in relation to remuneration);⁵⁸
- enhanced failure resolution regimes for investment banks and cross-border banks;
- enhanced international co-ordination of the supervision and resolution of cross-border banks;
- enhanced market discipline (including through increased disclosure); and
- home supervisors enjoying increased powers under the EU 'Single Market' for financial services.

Where there is much disagreement, however, is over the most appropriate *regulatory architecture* to adopt. The debate, at a domestic level, is summarised in Appendix 6, Part A. Given the strong likelihood of the Conservatives winning the next election, it is sensible to start with a consideration of their radical proposals as these are what we are likely to end up with.⁵⁹

The first issue to address is who should be in charge of micro-prudential supervision. In the academic literature, this has sparked debate on two fronts; should the central bank be involved and, if not, is a single authority preferable to a number of functionally-focussed agencies covering, for example, banking, securities and insurance?⁶⁰ With respect to the former debate (*see*, for example, Goodhart and Schoenmaker, 1995, and Peek, Rosenberg and Tootell, 1999), the trend in the developed world has been to enforce the separation of function for the following reasons:

- that the occasional but inevitable bank failure will always taint banking regulators, whatever their degree of culpability, thereby damaging the credibility of the monetary authority;

- that tensions, created by potential conflicts of interest, can arise if the two functions are jointly administered by the same organisation (the main fear is that interest rate increases, necessary for monetary tightening in the face of an upsurge in inflationary pressures, may be compromised because of fears about the health of the domestic banking and financial system);
- that the central bank should not be distracted from its primary role of ensuring monetary stability through control of inflation; and
- that the change is necessary to elicit a much-needed change in supervisory culture.

Finally, there are those who worry that too much power is vested in the hands of unelected officials.

Contrariwise, those who argue for the continuing involvement of central banks in banking supervision point to the following:

- that there are economies involved in combining the two functions in a situation where the central bank will still be held responsible for ensuring overall financial stability and for activating the lender of last resort facility, if circumstances dictate, and continue to be involved in crisis management;
- that valuable information, from a supervisory perspective, is routinely gleaned from the central bank's intervention in financial markets;
- that benefits derive from the moral authority of the central bank which allows it to employ moral suasion, in addition to statutory powers, to secure prudential objectives;
- that confidential bank supervisory information can usefully inform decision-taking by the monetary authority by enhancing the accuracy of macroeconomic forecasting;

- that great difficulty would be faced by the replacement body in finding alternative staff (the danger is that the reform exercise merely results in a relocation of existing central bank staff, especially in the short run, with little or no enhancement in efficacy of supervisory policy); and
- that measures can be taken to enhance the accountability of central bankers to address the fears about concentration of power in the hands of unelected officials (indeed, the same fears surface in any informed debate about enhancing the independence of central banks shorn of supervisory responsibilities).

With respect to the debate about the optimal number of regulatory bodies (*see*, for example, Briault, 1999 and 2002, and Abrams and Taylor, 2000), those who favour the unification of regulation within a single body, emphasise the following:

- economies of scale and scope (e.g. due to the more efficient allocation of supervisory resources, the pooling of supervisory expertise under one roof, the elimination of supervisory overlap which causes the duplication of supervisory effort, the provision of a single port of call for financial conglomerates seeking authorisation, the merging of support services, such as personnel, administration and documentation, and the rationalisation of computer systems, etc.) which, in the longer term, will deliver lower supervisory costs and hence fees to regulated institutions;
- the introduction of a harmonised approach to compensation and Ombudsmen schemes;
- more able to adapt to changes in the market place (e.g. to the provision of more complex financial products and towards financial conglomeration and universal banking);
- better able to assess overall risk inherent in the financial system;

- reduces problems associated with co-ordination and co-operation between regulatory agencies' specialist divisions, and facilitates international regulatory co-operation;
- removes opportunities for regulatory arbitrage and the possibility of regulatory capture;
- facilitates the delivery of regulatory neutrality (because of the increased consistency of treatment of regulated firms and the harmonisation of rulebooks);
- increases the transparency of regulation for consumers/investors;
- increases the accountability of regulators (e.g. for performance against statutory objectives, for the regulatory regime, for the costs of regulation, for its disciplinary policies, and for regulatory failures); and
- the creation of a new supervisory culture unashamedly concerned solely with delivering cost-effective regulation and supervision in accordance with statutory objectives.

Those who oppose the creation of a single regulator (outside the central bank) meanwhile point to the following *fears/concerns*:

- that a bureaucratic leviathan, divorced from the industry it regulates, may result;
- that the economies of scale and scope may be more meagre than anticipated;
- that the effective integration of the different functional regulators/supervisors, with very different cultural backgrounds, under one roof may prove difficult to manage – moving to a single location doesn't guarantee effective communication and co-operation;
- that insufficient differentiation between retail and wholesale/professional investors may result;
- that any benefits of inter-agency competition would be lost;

- that a loss of specialist knowledge of supervisors (of both firm-specific and industry-specific information) may result;
- that increased transparency and the higher profile of the regulator may encourage irresponsible behaviour by the regulated and investors (i.e. induce moral hazard) if they believe that the risk of an institution being allowed to fail has been reduced (better education of the public can reduce this fear);
- that regulation may lack focus (i.e. on the objectives of supervision);
- that possible difficulties in recruiting and retaining supervisors with the right blend of knowledge, experience and specialist skills may arise (enhanced development and career prospects, however, limit this risk);
- that a loss of important synergies between central banking and banking supervision, leading to less effective supervision and crisis management, may result;
- that problems are likely to arise in co-ordinating the activities of the Bank of England (which retains responsibility for overall systemic stability and for activating the lender of last resort function), the FSA and HM Treasury; and
- that there is a risk that the intensification in supervision to be ushered in under the new regime may damage the international competitiveness, and hence attraction, of the City of London.

So much then for the traditional academic debate, which led most to conclude (*see* Goodhart *et al.*, 1998) that there is no magical, "one size fits all" formula for delivering the optimal institutional framework governing the regulation and supervision of financial intermediaries, but what has the recent crisis taught us that might alter the balance of argument? As regards responsibility for regulatory "failure", the global evidence is that

central banks, such as the US Fed (in its supervision of Citigroup, for example), are no less susceptible to incompetence than, say, the FSA (in its supervision of Northern Rock, for example). Moreover, the Bank of England came in for severe criticism in the early stages of the crisis for its handling of the lender of last resort liquidity facilities (*see* Hall, 2008) and for downplaying its financial stability mandate. This suggests a 'knee jerk' reaction to the FSA's failings, involving returning micro-prudential supervision to the central bank (which, ironically, lost it in part because of its own failings with respect to the supervision of BCCI and Barings – *see* Hall, 1999, Chapters 11 and 12 respectively), may be unjustified.⁶¹ Moreover, the large but necessary costs incurred in effecting institutional change are no guarantee of success, as policies/people are likely to prove more important than structure. What is clear, however, is that the hoped-for change in supervisory culture – from one based on trust amongst like-minded industry colleagues to a more intrusive, questioning and adversarial approach (Hall, 2001b) – failed to materialise following the handover of the regulatory reins to the FSA in 1997. For whatever reason, as noted earlier, the FSA proved susceptible to special pleading from Government and industry alike for "light touch" regulation – a clear case of political and industry capture of the regulator – in a mistaken belief that to act otherwise would damage the long-term health of the economy through a reduction in the competitiveness of the City. Under Lord Turner, however, there is a clear recognition that this approach was mistaken and, given the introduction of the SEP (post-Northern Rock) and its subsequent enhancement, that regulatory culture at the FSA has finally changed in the direction originally envisaged.⁶² Accordingly, I personally believe (*see* Appendix 6, last column) – like the Bank of England, the FSA and the Government – that the Conservatives would be wrong to transfer responsibility for *micro-prudential* regulation back to the central bank.⁶³

The choice of institution to discharge newly-granted *macro-prudential* powers, however, is somewhat different. In the run-up to publication of the Government's White Paper, "turf wars" broke out between the Bank of England and the FSA as to who should receive the new powers. The Governor of the Bank argued vociferously (for example, in his Mansion House speech of 17 June 2009) that the Bank did not have sufficient powers to allow it to fulfil its newly-acquired financial stability mandate (*see* also Bank of England, 2009b). Specifically, it wanted to be in charge of triggering the 'Special Resolution Regime' (the current preserve of the FSA) as well as having operational responsibility for it, and to be given the new macro-prudential powers identified in the Turner Review. In contrast, Lord Turner argued (for example, in his appearance before the Treasury Select Committee on 23 June 2009) that responsibilities for macro-prudential regulation should be shared between the FSA and the Bank to avoid "wasteful, competitive behaviour", a view first espoused in his earlier Review.⁶⁴ The Government, meanwhile, is happy to await international agreement on what the new macro-prudential toolkit should be and how it should be used before determining institutional responsibility for the new regime,⁶⁵ a stance backed by the Treasury Committee (House of Commons, 2009b, p.58, para.24). [Cynics might argue that, to do otherwise, would be futile given the almost inevitability of a change in government next Summer, with the Conservatives committed to awarding the new powers and responsibilities to the Bank (a new 'Financial Policy Committee' would be created for the purpose).] Personal preference, despite favouring the FSA's retention of micro-prudential powers, is indeed for such powers and responsibilities to be given to the Bank,⁶⁶ to allow it to deliver on its financial stability mandate which, I suggest, should not be diluted by the Government's proposal to give the FSA its own statutory objective for financial stability, which threatens to blur accountability. Such an arrangement would mirror to a degree that planned for adoption at

the EU level, where the central bank members of the new 'European Systemic Risk Board' are charged with monitoring and advising on (but not implementing) policies to be adopted by Member States to mitigate systemic risk, while the 'European System of Financial Supervisors' will focus on the co-ordination of supervision at the micro-level.

Closely aligned to the debate about the division of responsibilities for micro- and macro-prudential regulation is the question over the future of the current "Tripartite Arrangements" based on the "Memorandum of Understanding". In the Conservatives' model, a new 'Financial Policy Committee', comprising Bank officials and independent members, would replace the current Standing Committee of Bank, FSA and Treasury officials. In contrast, the Government has proposed that a 'Council for Financial Stability', comprising representatives from the current Tripartite Authorities (but also benefiting from outside expertise) and chaired by the Chancellor, replace the existing Standing Committee and that its terms of reference replace the Memorandum of Understanding (HM Treasury 2009a, paras 4.7 to 4.22). Its objectives will be to analyse and examine emerging risks to UK financial stability and co-ordinate the appropriate response, as well as to discuss and co-ordinate the UK authorities' position on EU and international financial stability regulatory policy issues. Increased accountability and transparency – the minutes of the regular standing meeting will be published, subject to confidentiality constraints posed by market sensitive information – are assumed to deliver advances on the current regime.⁶⁷ As for the views of the FSA and the Treasury, officials from both of which were at pains not to criticise the Tripartite Arrangements in their appearances before the Treasury Select Committee in the early days of the crisis (*see* Hall, 2008), the FSA has since (*see* above and in evidence given to the Treasury Select Committee on 27 June 2009) praised the virtues of reconstituting the Financial Stability Committee as a joint committee

of the Bank and the FSA, while the Bank has called for new protocols covering communication and information-sharing, especially with the FSA.

Clearly then, there is much disagreement over how to reform the current Tripartite Arrangements and the 'Memorandum of Understanding' on which they are based. Like the House of Commons Treasury Committee, however, I believe that, despite the system's obvious failure with respect to Northern Rock, little good would come from its dismantling (Hall, 2008). Accordingly, personal preference is for a re-defining of the roles and responsibilities of the current Standing Committee members with a strengthening of lines of communication, and clarification of who is in charge overall – the Treasury. The impression one gets from its operation in the run up to and during the crisis is that no one was in overall control with each party possessing an effective power of veto (hence, for example, the delay in the Bank's provision of emergency liquidity support to Northern Rock and the market more generally). The current situation, where the Prime Minister is apparently hardly on talking terms with the Chancellor because of the former's failed attempt to move the latter at the last Cabinet reshuffle, the Governor of the Bank and the Chancellor are similarly distanced⁶⁸ and the Bank and the FSA are still at loggerheads over who should do what in the brave new world, is clearly untenable. Much damage is being done to the UK's reputation for providing a lead on what constitutes strong, cost-effective regulation, while the evidence of a dysfunctional Government is damaging the credibility of the administration in its attempts to fashion an internationally-agreed response to the financial crisis. The sooner relationships between the interested parties are returned to normality, albeit subject to a redefinition of roles and responsibilities, the better.

The final main area of disagreement over financial architecture relates to *deposit protection* arrangements. For, while the Government and the FSA (and possibly the Bank of England) are happy to allow the FSA to continue to run the FSCS, as amended from time to time, the Conservatives will pass the mantle to either the new Consumer Protection Agency or the Bank of England (to facilitate failure resolution). My own preference, as argued elsewhere (*see*, for example, Hall, 2009a), is for the creation of a new 'Deposit Protection Agency' which would assume responsibility for administration of a new Deposit Protection Scheme (no longer a sub-scheme of the FSCS) and for resolving failed institutions, as is done in the US by the FDIC. In this way, the deposit protection function would be aligned more closely with failure resolution but separated from the monetary policy and prudential supervision functions, with the last-mentioned being split between the Bank and the FSA along macro/micro prudential lines. This would, of course, necessitate agreement on the nature of the co-operation and co-ordination required between the four agencies and the drafting of protocols to deliver it.

6. SUMMARY AND CONCLUSIONS

As the financial crisis subsides and the global economy slowly recovers from its worst shock in over 60 years, there must be a danger that complacency sets in and banks return to pre-crisis modes of behaviour. This must not be allowed to happen if history is not to repeat itself and trust is to be restored with customers. Of course, over-regulation and a stifling of (useful) innovation and entrepreneurial activity should also be avoided but the world has to accept that, in the future, the interests of ordinary citizens require that state-subsidised risk-taking be substantially reduced. Primarily effected through increased capital charges, to more closely reflect risk-taking (including the operation of risky bonus structures) but also to internalise the costs of being "too-big-to-fail" or "too-interconnected-to-fail", such action will inevitably lead to lower rates of return on capital and assets and thereby cause a reduction in both size (assisted by a maximum leverage ratio) and profitability and hence remuneration. The real challenges, however, have yet to be faced – the calibration of these additional charges and the timing of their implementation. Improved regulation of liquidity has also been shown to be essential, at both the micro and macro level. Apart from enhanced micro-prudential supervision, a simultaneous focus on macro-prudential regulation and supervision has also proved necessary, both to reduce systemic risks and to reduce the degree of pro-cyclicality inherent in financial regulation (where accounting reform can also help). The most appropriate financial architecture to deliver all this, however, has yet to be resolved.

Closely allied to these issues is the design of failure resolution mechanisms, where arrangements for dealing with failed investment banks and large, cross-border institutions have yet to be added to the armoury provided by the 'Special Resolution Regime'

introduced under the Banking Act of February 2009. And agreement on the introduction of "living wills" by such institutions would greatly facilitate orderly resolution of failed entities, at minimum cost to society.

Failings in corporate governance and market discipline were also contributors to the severity of the crisis and both are now being addressed, although it remains to be seen how effective the proposed reforms turn out to be.

Consumer protection issues have, of course, also come to the fore in the wake of the obvious abuse perpetrated prior to the crisis, and with this a call for enhanced depositor protection. While the latter has already been delivered, much still remains to be done to maximise the cost-effectiveness of compensation arrangements. Additionally, with the consumer in mind, there is now a clear need to re-focus on competition issues given the ever-increasing consolidation being witnessed in the domestic banking industry, a situation worsened by the failure resolution policies adopted by the authorities.

And, of course, much of this will ideally be done under an internationally-agreed approach, to minimise opportunities for regulatory arbitrage and thus protect the domestic market share of international business.

At the end of the day, it will be down to ordinary people – regulators, central bankers, supervisors, auditors, compliance officers, board members, etc. – to deliver what society expects from reform, whatever the design of policy and the form of the institutional architecture and financial infrastructure put in place to facilitate it. It can only be hoped that, like the bankers and the traders, they are incentivised to act in accordance with the

wishes of the majority and prove up to the task of restraining the actions of those who should perhaps now be dubbed the 'Destroyers of the Universe'!

Endnotes

- ¹ Following the effective closure of international wholesale funding markets the bank was forced to turn to the Bank of England (the 'Bank') for emergency liquidity support, which was reluctantly provided by the Bank in September 2007. This failed to quell the financial panic, however, which manifested itself in the first fully-blown nationwide deposit run on a UK bank for 140 years. Subsequent provision of a blanket deposit guarantee duly led to the disappearance of the depositor queues from outside the bank's branches but only served to heighten the sense of panic in policymaking circles. Following the Government's failed attempt to find an appropriate private sector buyer, the bank was then nationalised in February 2008. [For more detailed analysis *see* House of Commons, 2008 and Hall, 2008.]
- ² For further details *see* Hall, 2009a.
- ³ For a critique of these schemes *see* Hall, 2009b.
- ⁴ A review and assessment of these proposals is provided in Hall, 2009a.
- ⁵ The 'Turner Review' – *see* FSA, 2009a (and the accompanying discussion paper – FSA, 2009b).
- ⁶ *See* HM Treasury, 2009a, and Conservative Party (2009), respectively.
- ⁷ Such as the inadequacy of capital buffers, particularly in the trading book, the flaws in the 'value at risk' (VaR) models banks are allowed to use to generate minimum market risk capital charges, the poor quality of certain elements of regulatory capital, the induced spawning of off-balance-sheet vehicles to accommodate the impetus given to securitisation (a form of 'regulatory capital arbitrage'), the induced pro-cyclicality in financial systems and the failure to prevent excessive growth in the absolute size of banks' balance sheets. [Note, most of these 'deficiencies' were widely foreseen – *see*, for example, Hall (1989 and 2004).]
- ⁸ The focus of regulators and the market is already on "Core Tier One" capital, which excludes allowable Tier One hybrid instruments and all Tier Two capital (*see* Hall, 2004, for an explanation), with minimum regulatory/market demands for this ratio commonly exceeding 7 per cent or so, compared with the current overall Basel II minimum risk-adjusted requirement of 8 per cent.
- ⁹ This was accomplished, to a degree, through a switch from 'point in time' to 'through the cycle' measures of probabilities of default in January 2009 (FSA, 2009c).
- ¹⁰ Although this is clearly desirable, it is not without serious practical difficulties – *see* Gerlach and Gruenwald, 2005.
- ¹¹ As, for example, applies in Switzerland and the USA, in the latter case through the application of a minimum Tier One leverage ratio – of between 3 and 5 per cent of total assets – originally designed to deal with interest rate risk in the banking book.
- ¹² In addition to the Basel Committee, the Financial Stability Board has also endorsed most of Lord Turner's capital adequacy-related recommendations (FSB, 2009a). This is reflected in the Board's acceptance of the need for counter-cyclical capital buffers and other measures designed to reduce pro-cyclicality, for a supplementary maximum leverage ratio, and for a fundamental review of the market risk framework, including the use of VaR estimates as the basis for the minimum capital requirement.
- ¹³ These floors determine the maximum reductions in required capital, relative to Basel I, allowed under Basel II.
- ¹⁴ The operation of a 'high quality sterling liquidity stock requirement', first introduced by the Bank of England in January 1996 (Bank of England, 1996), with respect to large UK retail banks, whereby such institutions were required to survive for five days without recourse to wholesale money markets, obviously proved woefully inadequate given the combined seizure of the international wholesale money markets for a period well in excess of one year!
- ¹⁵ The FSA's detailed plans were revealed in its consultation paper of December 2008 (FSA, 2008a), which followed its discussion paper of December 2007 (FSA, 2007). The final rules are set out in FSA, 2009d.
- ¹⁶ Lord Turner's recommendations on the reform of domestic deposit insurance arrangements and the bank resolution regime, noted in Appendix 2, are overlooked in this section as they have already been implemented via the recent reforms undertaken to the Financial Services Compensation Scheme (reviewed in Hall, 2009a, although more reforms have since been announced – *see* FSA, 2009e) and the introduction of a 'Special Resolution Regime' under the Banking Act of February 2009 (*see* Appendix 1), respectively. Similarly, his recommendations on credit rating agencies, which typically performed badly in the run up to and during the crisis – *see* FSF, 2008, Section IV and FSA, 2009a, Section 2.5(i) – are omitted on the grounds that the issues are being tackled at the international level (e.g. through the introduction of a new registration and monitoring system in the EU).
- ¹⁷ Compared with the refined draft version, the final version is generally less prescriptive and comprises 1 'rule' and 8 'principles' (*see* the text) rather than the 1 'rule' and 10 'principles' of the former. The former's principles 8 to 10, relating to the structure of remuneration, have been replaced by a single principle – principle 8 – although the 'guidance' provided to new principle 8 (it still contains the (amended) contents

of the old principles) makes it clear that guaranteed bonuses which run for more than one year and similar payments in addition to salary, are unlikely to be consistent with effective risk management. The implementation date has also been pushed back from 6 November 2009 to 1 January 2010, although those firms affected (approximately 26) are expected to supply the FSA with a remuneration policy statement by end-October 2009.

¹⁸ See, for example, the Committee of European Bank Supervisors (2009) and FSB (2009b).

¹⁹ No doubt wary of derailing one of the few surviving "gravey trains" – following the attack on members' expenses – for ageing politicians, a path recently taken by none other than our last Prime Minister. [The Japanese have a word for it - "Amakudari", roughly translated as "descent from Heaven".]

²⁰ In 1972, James Tobin proposed the introduction of a small tax – big enough to deter short-term speculative trades but small enough not to reduce the volume of international trade – on foreign exchange transactions to reduce exchange rate volatility and enhance national monetary policy autonomy in the wake of the collapse of the Bretton Woods system of fixed exchange rates – see Tobin, 1978.

²¹ Available alternatives to deal with the bonus issue comprise, *inter alia*, the adoption of more draconian approaches to the size, speed, nature and circumstances in which bonuses can be paid – the President of France, for example, has got agreement from the major French banks to ban all guaranteed bonuses, defer a portion of cash bonuses for three years, pay a minimum of one-third of bonuses in shares and adopt strict long-term performance criteria in the assessment process used to determine bonus payments, while he is also seeking G20 agreement to cap bonus payments (which he recognises he cannot do unilaterally) – and the imposition of tougher legal requirements on bank boards to oversee the actions of senior executives. The licensing of new products by the regulator (giving the latter the opportunity to prevent the introduction of undesirable financial innovation) could be used to reduce the destabilising influence of the financial system; the beefing up of anti-trust laws to raise the degree of effective competition in financial markets could be used to reduce excess profitability in the sector; and elimination of the capital subsidy (resulting from the provision of implicit state guarantees against default) enjoyed by financial institutions could be used to restrain their growth. If banks are so flush with profits, they might also be asked to start contributing to a free-standing deposit insurance fund, paying (via higher capital requirements) for implicit "too-big-to-fail" guarantees or, where relevant, repaying taxpayer support.

²² The self-evident need to improve the market infrastructure surrounding the trading of credit default swaps, through the development of clearing and central counterparty systems, is not discussed in this article; while Lord Turner's views on macro-prudential analysis are covered in Section 5 below.

²³ Notably with respect to the supervision of Northern Rock – see FSA, 2008b, for a painful self-examination of what went wrong.

²⁴ The Treasury Committee's views on what should be done to reform corporate governance and pay in the City are contained in House of Commons (2009a).

²⁵ As demonstrated in Annex 2, Lord Turner also made significant calls for change in other areas. On the issue of how to constrain commercial banks' engagement in risky proprietary trading activities, he advocates the use of new capital and liquidity requirements rather than a 'structured' solution – such as the adoption of a 'narrow bank' proposal, confining guarantees and official support to simple, utility-like operators, or the introduction of a 'Glass Steagall'-type regime to physically separate commercial from investment banking – on the grounds of the infeasibility of the latter. And, with respect to the supervision of global cross-border banks, he recommends enhancing international co-ordination through the establishment and effective operation of colleges of supervisors for the largest and most complex, and the pre-emptive development of crisis co-ordination mechanisms and contingency plans between supervisors, central banks and finance ministries. Moreover, he argues the FSA should, if necessary, be prepared to use more actively its powers to require strongly-capitalised local subsidiaries and local liquidity, and to limit firms' activities.

²⁶ Which, for example, will influence the outcome of the restructuring proposed by Northern Rock, Lloyds Banking Group and RBS and the terms on which the last two mentioned can access the 'Asset Protection Scheme' introduced in January 2009 (HM Treasury, 2009c).

²⁷ The Icelandic bank, as a member of the European Economic Area (covered by the Single Market programme), was free to branch into the UK with the FSA having only limited powers to constrain its activities. Primary responsibility for prudential supervision lay with the home authority, and the potential for support to prevent bank failure was dependent on the resources of the Icelandic government. UK depositors were also dependent on the resources of the Icelandic deposit insurance scheme in case of bank failure. In the event, both fiscal resources and deposit insurance funds proved inadequate, the UK government, for example, having to bail out the (personal) UK depositors.

²⁸ The case for a more integrated approach to EU bankruptcy and re-organisation procedures for cross-border banks might also have been considered – *see* Garcia, Lastra and Nieto, 2009.

²⁹ Used, for the first time, in the resolution of the Dunfermline Building Society in March 2009; *see* HM Treasury, 2009a, p.64 for details.

³⁰ The IMF, in its review of UK regulatory developments (IMF, 2009), welcomes the introduction of the new 'Special Resolution Regime' under the Banking Act of February 2009 although it cautions that its effectiveness will depend upon the timely and comprehensive information-sharing between the Tripartite Authorities. It also largely welcomes the Turner Review, which it argues represents an important contribution to the international debate on the reform of the regulatory and oversight system for financial institutions. In particular, it agrees with:

- the call for higher capital requirements within a risk-based capital framework for trading book and off-balance-sheet exposures, and for the introduction of a maximum leverage ratio as a backstop against excessive balance sheet growth;
- the proposed strengthening of liquidity provision, with a special emphasis on stress tests covering system-wide risks;
- the proposal to complement these measures with the development of new macro-prudential instruments to mitigate the amplitude of the credit cycle and reduce feedback loops between the financial sector and the real economy; and
- the idea that regulatory and supervisory coverage should follow the principle of economic substance not legal form, with regulators having expanded powers to gather information on all significant financial institutions (include hedge funds) to allow for assessment of overall system-wide risks.

Despite this general 'seal of approval', however, the IMF does make some recommendations for further reform. Firstly, it calls for an improvement in disclosure practices to reduce uncertainty and strengthen market discipline and public surveillance. Accordingly, it wishes to see an increased coverage and frequency (to quarterly from twice-yearly) of financial reporting on banks' finances; and, over the medium-term, regulators are asked to consider publishing non-commercially sensitive, bank-by-bank regulatory information at quarterly intervals. Secondly, it calls on the authorities to work more closely with its international partners to strengthen cross-border financial stability arrangements. This will require accelerated efforts to establish a dedicated resolution framework for the EU's cross-border banks – *see* note 28 – and to quickly implement the proposed (by the de Larosière Taskforce) radical overhaul of the EU's regulatory and supervisory arrangements. With respect to the latter, securing adequate resources, effective decision-making mechanisms, independence of the new institutions, and an unconstrained flow of information between the various bodies will be essential for the effectiveness of the proposed new architecture.

³¹ The extent of the Government's acceptance of Lord Turner's reform recommendations, which is virtually complete, is set out in the White Paper at pp.58-59.

³² The reasons for its eschewal of this approach are outlined in Section 5 of the White Paper at pp.74-75.

³³ In April 2009, the G20 asked the Financial Stability Board to work on producing guidelines on how to identify systemically-important institutions/markets, taking forward the analysis provided in a recent 'Geneva Report' (Brunnermeier *et. al.*, p.2009). The findings are due by the end of the year, following which appropriate institutional arrangements for implementing the new framework will be agreed.

³⁴ A consultative paper on developing effective resolution mechanisms for investment banks was published in May 2009 (HM Treasury, 2009d).

³⁵ Lord Turner, in an interview with the *Financial Times* (FT, 2009), has since backed the idea, arguing that a necessary clarification and simplification of legal structures is called for as regulators become less tolerant of regulatory and tax arbitrage.

³⁶ To this end, the Government has already introduced – effective from 6 March 2008 – legislation to encourage the development of the UK covered bond market. It also supports the work of the European Securitisation Forum (ESF) in establishing standards of consistency, transparency and accessibility for investors in European RMS. Finally, it endorses the proposed change to the EU's Capital Requirements Directive (CRD), which implements Basel II, which will restrict the purchase by EU-regulated banks of securitisations where the originator or distributor does not itself retain a net economic interest of at least 5 per cent. [The measure is designed to ensure that the ability to transfer credit risk through securitisation markets does not reduce incentives for those originating and securitising loans to assess and monitor on-going credit quality.]

³⁷ Requirements included in the CRD, which take effect in 2011, will ensure that investor credit institutions carry out substantial due diligence with respect to securitisations.

³⁸ As is planned by the Basel Committee and the International Accounting Standards Board (IASB).

³⁹ To this end, the Government is seeking the imposition of tougher disclosure requirements and enhanced surveillance by the FSA – backed by a credible enforcement framework – in part, through a stiffening of the planned EU Directive on Alternative Investment Fund Managers.

⁴⁰ The introduction of a minimum "core funding ratio", as called for by Lord Turner, would act to reduce banks' tendency to become increasingly-reliant on less stable sources of funding as they expand their balance sheets, thereby moderating aggregate credit availability during economic expansions.

⁴¹ UK banks are allowed to use "through the cycle" rather than "point in time" measures of risk when calculating their minimum capital charge under the "Internal Ratings-Based" methodologies of Basel II – *see* FSA, 2009c.

⁴² Such a policy also reinforces market discipline as the holders of such debt have a greater incentive to monitor the activities of the issuing bank (*see* Calomiris, 1999).

⁴³ The Government is also looking at the possible regulation of the characteristics of financial products (e.g. the loan-to-value ratios adopted by mortgage providers) rather than the behaviour of financial institutions – the results of the FSA's deliberations on potential regulatory reform of the mortgage market are due in October 2009.

⁴⁴ The Government, however, has made it clear that it does not believe that it needs to change the Bank of England's Monetary Policy Committee's remit by adding explicit macro-prudential objectives (e.g. for asset prices or credit growth) nor to amend the targeted inflation indicator (currently the CPI) to include asset prices.

⁴⁵ The G20, currently chaired by the UK, has been at the forefront of moves to reform the international financial system based upon the principles of strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets and reinforcing international co-operation. Among other things, the G20 has agreed:

- to establish a new Financial Stability Board, as a successor to the Financial Stability Forum (FSF), with a strengthened mandate and a broader membership;
- that the FSB should collaborate with the IMF to provide early warning of macroeconomic and financial risks and the actions needed to address them;
- to reshape regulatory systems so that authorities are able to identify and take account of macro-prudential risks;
- to establish supervisory colleges for cross-border firms and to implement the FSF principles for cross-border crisis management;
- to extend regulation and oversight to all systemically-important financial institutions (including hedge funds), instruments and markets;
- to confirm and implement the FSF's new principles on pay and compensation;
- to take action, once recovery is assured, to improve the quality, quantity and international consistency of capital in the banking system and agree a global framework for promoting strong liquidity buffers in financial institutions;
- to take action against non-co-operative jurisdictions, including tax havens;
- to call on the accounting standard-setters to work with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards; and
- to extend regulatory oversight and registration to credit rating agencies to ensure they meet the international code of good practice.

All of these moves will serve to enhance sound domestic regulation at the global level although detailed technical work remains to be completed in several areas. And the FSB will produce its first report to G20 Finance Ministers and Central Bank Governors in September, setting out progress made in developing agreed policies and countries' implementation of commitments undertaken.

As for strengthening the *international regulatory architecture*, the FSB will be at the centre of attempts to ensure consistency and coherence in the development and application of financial regulations. It will have to oversee the enforcement of standards and scrutinise members' adherence to such standards – joint reports (with the IMF) indicating the extent of compliance will be produced in September 2009. While all countries would benefit from IMF/World Bank reviews under their 'Financial Sector Assessment Program'.

⁴⁶ At home, the Government has promised to give the FSA an explicit international duty to complement its own and the Bank of England's responsibilities in this area. This new statutory duty would require the FSA to promote sound international regulation and supervision, and would involve the FSA in representing the UK's interests in international fora, having regard to international best practice and maintaining the competitiveness of the UK financial services industry. The FSA's new financial stability

objective will also require the FSA to take account of the impact of international developments on financial stability in the UK.

⁴⁷ For example, the Government agrees with the creation of a new European Systemic Risk Board (ESRB) to assess macro-financial risks in the EU and propose policy responses, thereby complementing the activities of the IMF and FSB in this area. Its analysis could also be used to inform the international Early Warning Exercise recently launched by the IMF and FSB. It firmly believes, however, that day-to-day supervision should remain in the hands of national authorities and that decisions taken by the newly-created European Supervisory Authorities should not impinge in any way on national fiscal responsibilities.

⁴⁸ A task which it believes the new European Supervisory Authorities should take on board.

⁴⁹ They also propose a review to consider the case for putting housing costs back into the inflation target; and, given that the Bank will be responsible for both triggering and operating the Special Resolution Regime, they will consult on the case for giving the Bank direct control over the Financial Services Compensation Scheme. Finally, they will consult on the case for establishing a single regulator to tackle financial crime.

⁵⁰ The work of the Financial Regulation Division, which will be headed by a new Deputy Governor for Financial Regulation, will be overseen by a "Financial Policy Committee" to ensure close co-ordination between macro-prudential and micro-prudential regulation. The Deputy Governor for Financial Regulation will also be a member of the Financial Policy Committee.

⁵¹ This committee will include the Governor and the existing Deputy Governor for Financial Stability, who also sits on the Monetary Policy Committee, in order to ensure close co-ordination between monetary and financial policy. It will also include independent members in order to bring external expertise to bear on the problem of maintaining financial stability.

⁵² Although not mentioned, the Conservative Party also implicitly endorses the calls for increasing the quality and quantity of capital more generally, and for improving the regulatory focus on liquidity.

⁵³ The Bank will be called upon to examine the case for a more structural separation of these activities within international policy fora.

⁵⁴ The Conservative Party also makes clear that it will work at the international level to create a resolution regime for investment banks and to design a resolution regime for international banks.

⁵⁵ This consensus reform agenda is reconfirmed in recent publications by the BIS (2009, Section VII) and the Bank of England (2009a), pp.7-10.

⁵⁶ And hopefully one which will prove more challenging for firm's senior management as the perceived need to preserve the competitiveness of the City through 'light touch' regulation recedes.

⁵⁷ A degree of disagreement still persists, however, over deposit insurance arrangements (issues concerned with 'architecture' are considered below). While many have long-argued for the introduction of a pre-funded scheme and risk-related premia (*see*, for example, Hall, 2001a and 2002), policies endorsed by the Bank of England (*see* Tucker, 2009), the Government has only recently accepted the former idea (but pre-funding won't be introduced until 2012 at the earliest) and has not commented on the latter. Recent amendments to the FSCS have, however, strengthened funding arrangements, increased deposit compensation limits and improved the legal arrangements to allow for faster compensation pay out.

⁵⁸ The recent failure of the meeting of G20 Finance Ministers (London, September 2009) to support the imposition of caps on bankers' bonuses following opposition from the UK and US governments in particular (who argued against the idea on the grounds of impracticality because of its unenforceability) raises the question of how far agreed 'Codes' can deliver desirable outcomes. That change is needed to realign bankers'/traders' incentives more closely with the delivery of outcomes acceptable to long-term investors and taxpayers is irrefutable; but the question of the scale of bonuses is more political. Nevertheless, for governments – particularly socialist governments – to abandon the goal of wealth redistribution (which has been regressive in recent years) on the grounds of impracticality so soon after the excesses revealed during the recent crisis is rather tame. Of course, taxation policy and the other measures taken to improve regulation in the wake of the crisis (through their impact on profitability) can be used to address the issue of "equity", but why can't toughened "Codes" be enforced through the use of appropriate sanctions? If banks have "money to burn", which could otherwise be used to boost retained earnings and hence capital, why can't regulators bring forward proposals to force a pre-funding of the deposit protection scheme or a boost to capital requirements to reflect higher risk-taking or the firm's systemic importance? As was eventually proved with respect to "compliance" with Western demands by offshore tax havens (e.g. Switzerland, Cayman Islands, Liechtenstein, etc.), "where there is a will there's a way"!

In the event, the G20 Summit held in Pittsburg at the end of September 2009 (*see* G20, 2009) went some way to dispelling such concerns as the nations represented at the meeting agreed to the following

with respect to compensation packages: banning multi-year guaranteed bonuses; requiring a significant proportion (i.e. of between 40 and 60 per cent, and higher for senior bankers) of variable compensation to be deferred (for up to three years), tied to performance, subject to appropriate clawback in the event of future poor performance, and to be vested (at least 50 per cent) in the form of stock or stock-like instruments, as long as these create incentives aligned with long-term value creation and the time horizon of risk; making firms' compensation policies and structures transparent through disclosure requirements; limiting variable compensation as a percentage of total net revenues when it is consistent with the maintenance of a sound capital base (dividend payments and share buybacks may also be restricted); and providing supervisors with the ability to modify compensation structures in the case of firms that fail or require extraordinary public intervention. Firms are asked to implement these sound compensation practices immediately; and the FSB is tasked to monitor their implementation and, if necessary, propose additional measures by March 2010. Although the top five UK banks – Barclays, HSBC, Standard Chartered, RBS and Lloyds Banking Group – have since agreed to adopt the rules agreed at the Summit in the next bonus round, in advance of the Government's planned legislation (which will be informed by Sir David Walker's final report on corporate governance), it remains to be seen how overseas banks operate in the next bonus round, not least because the US Fed is thought to be looking for some "wriggle room" in the wording of the Summit's communiqué.

- ⁵⁹ Their announcement, in July 2009, has of course proved destabilising for the FSA, particularly with respect to their efforts to boost staff numbers to carry out their SEP enhancement plans. It is also distracting the FSA from its concerted efforts to enhance prudential supervision. The FSA, however, is known to be in discussions with the opposition party about how to effect a smooth transition to the new regime, if required, a process which is likely to take months, if not years. Presumably, the rump of the FSA will move over into the CPA, with supervisors and specialists joining the Bank of England, albeit with the majority remaining in Canary Wharf rather than moving to Threadneedle Street. Markets specialists – ignored in the Conservatives White Paper – may also be asked to join another organisation which combines the FSA's current remit for securities and markets regulation with those of the Takeover Panel and the Financial Reporting Council.
- ⁶⁰ The moves towards globalisation, financial conglomeration and universal banking, and the blurring of the distinction between the traditional institutional stereotypes forced a re-assessment of the traditional form of functional regulation by industry-focussed agencies.
- ⁶¹ The criticism over the Bank of England's handling of the emergency liquidity lifeline, however, does indicate that a central bank's credibility can be damaged by virtue of the exercise of its lender of last resort facility. So why be afraid of opening up yourself to criticism from an additional source, i.e. banking supervision? Notwithstanding this, the Bank of England is not keen to take back responsibility for micro-prudential regulation, even though a closer integration of banking liquidity supervision and central bank liquidity operations has been shown to be required.
- ⁶² Industry squeals about the increased intensity and scope of current practice are testament to this.
- ⁶³ Their proposal, with a new 'Financial Regulation Division' within the Bank carrying out micro-prudential regulation along with the creation of a new Consumer Protection Agency, reflects their preference for a "Twin Peaks" (Taylor, 1996) institutional structure largely because of a belief that the FSA was too focussed on consumer protection issues (i.e. enforcing conduct of business rules) to allow it to adequately discharge its supervisory functions, a situation likely to prevail in any non-Twin Peaks environment (*see* also G30, 2008).
- ⁶⁴ Possible modes of co-operation are outlined in Section 2.6(ii) of his Review, his preference being for a reconstitution of the Financial Stability Committee, currently comprising only Bank of England officials, to include FSA officials. This body would make the final judgment as to macro-prudential conditions and take the final decisions as to appropriate policy responses.
- ⁶⁵ *See* HM Treasury, 2009a, Section 6, para.6.60.
- ⁶⁶ It is interesting to note that, in the US, the current administration has proposed to Congress, despite concerns about the potential damage that might be done to its political independence and economic credibility, and to the conduct of monetary policy, that the Federal Reserve's regulatory mandate be extended beyond bank holding companies and state-chartered member banks to embrace all "systemically-important" (i.e. so-called "Tier 1 Financial Holding Companies") financial institutions. [The Fed will also be given new authority to oversee payment, clearing and settlement systems.] In this way, the Fed will assume responsibility for systemic regulation. The Government has also proposed that a new National Bank Supervisor be set up to supervise all federally-chartered banks (in replacement of the current Office of the Comptroller of the Currency) and that a new 'Consumer Financial Protection Agency' be established to improve protection for consumers (US Treasury, 2009).

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- ⁶⁷ Arguments rejected by both the House of Commons Treasury Committee (House of Commons, 2009b, p.58, paras 22 and 24) and the House of Lords Select Committee on Economic Affairs (House of Lords, 2009). Moreover, the FSA's right to reject the Committee's advice, so long as it explains why, further undermines the Government's claims for improvement.
- ⁶⁸ Apparently because of the Government's belief that the Bank is already looking towards life under the Conservatives, with concomitant consequences for its actions and outlook. [Clear evidence of the lack of trust can be gleaned from the Government's failure to consult the Bank on its reform White Paper, a fact revealed during the Governor's evidence to a shocked Treasury Select Committee on 24 June 2009 – *see* House of Commons, 2009b, p.58, para.25.]

**A response to the HM Treasury Consultation
Reforming Financial Markets
(Chapter 8: Strengthening the FSA's consumer capability)**

25 September 2009

Recommendation

There is no need to create a new Consumer Education Authority.

An advisory body is needed to co-ordinate the plethora of consumer education programmes that already exist to maximize the opportunities for consumer education, but this need not be a new entity.

Independent financial education charity pfeg (Personal Finance Education Group) already undertakes a co-ordinating and sign-posting role.

Given the significant levels of funding that the FSA, Treasury and Department for Children, Schools & Families have made available to pfeg in recent years, it appears that the Government also has faith in its abilities in this area.

pfeg has effectively been acting as an extension of the FSA financial capability division, giving them this advisory/co-ordination responsibility would therefore not amount to a significant change. However, it would avoid the creation of another layer of bureaucracy and thereby incurring unnecessary cost

Given this responsibility, pfeg should then cease the small amount of consumer education provision it currently undertakes. Instead pfeg should focus solely on championing the need for consumer education on financial matters, and the strategic co-ordination and sign posting of resources role that it already performs with some success.

About the *ifs* School of Finance

The *ifs* School of Finance is a registered charity incorporated by Royal Charter. As an international business school for and about finance, the *ifs* School of Finance provides financial education to financial services professionals in the UK and across the world, as well as to consumers in the UK.

This financial education consists of a wide range of regulatory qualifications as well as foundation, undergraduate and postgraduate degree programmes currently offered in partnership with the Universities of Manchester, Surrey and Kent.

However, of relevance to the consultation and this response is our experience in the provision of educational programmes that improve UK consumers' financial capability. These include:

1. The *ifs* Student Investor competition, which attracts in the region of 40,000 teenagers a year. Participation enables students to learn about savings and investments over a sustained period (4-6 months depending on progress).
2. Since September 2006 we have also been offering QCA accredited GCSE, AS and A level equivalent qualifications in personal finance (the Foundation & Intermediate Certificates in Personal Finance and the Certificate & Diploma in Financial Studies). These qualifications have been taken by over 50,000 14-19 year olds and a further 30,000 teenagers are expected to study one of these four programmes during the current academic year.

3. The *ifs* also offer a Programme in Personal Financial Planning (PPFP) for adults. PPFP is a QCA level 2 qualification which has one compulsory unit of study, the Award in Personal Financial Planning, and a range of optional units for example on Savings & Investments, Tax & Benefits, Financial Planning for Later life and Understanding Mortgages.

Introduction

Notwithstanding the considerable efficiencies and savings the above recommendation would create, we recognise that this might not fit with official thinking. With this in mind, we have responded in detail to questions asked in Chapter 8 of the Reforming Financial Markets consultation i.e. those relating to strengthening the FSA's consumer capability. These questions are:

18. What issues need to be resolved to establish a successful consumer education authority set up by the FSA?

19. What are your views on the scope of the new authority? Should it also, for example, champion consumer interests and act as a consumer voice in financial services?

20. What are your views on the governance and funding proposals for the authority?

21. To what extent should the authority be independent of the FSA?

18. What issues need to be resolved to establish a successful consumer education authority set up by the FSA?

The *ifs School of Finance* supports the basic principle that consumers should take responsibility for their decisions – something which is explicit in the Financial Services & Markets Act.

Whilst consumers should make a reasonable effort to understand information, it is also important to recognise that many consumers don't have the ability to comprehend even the basic principles of their personal finances e.g. 79% of people do not know what an APR is.

So, there is clearly a need for greater efforts to ensure that consumers have the skills, confidence, motivation and knowledge to be able to take responsibility for their financial actions and manage their personal finances effectively.

However, another separate government and taxpayer-funded entity is not necessarily the right approach given that there are already a number of well-established consumer bodies and financial education providers.

In these difficult financial times, a more effective use of public money could be directed towards supporting existing and proven efforts in this area. For example, our main recommendation that pfeg undertake a co-ordinating & signposting role that creates an environment where financial education providers work together rather than compete.

However, if there is to be a Consumer Education Authority, the addition of Money Guidance to the remit of this new authority confuses matters.

A national money guidance service from spring 2010 may well be helpful, but this will not be a panacea nor is it the only such service out there. This service will not result in sustained improvements in consumers' financial capability because it is a service designed to provide information and signposting, not to educate consumers.

Without appropriate education, substantial numbers of consumers will simply not understand either the information or the signposting.

We therefore believe that Money Guidance should not be talked about as being part of any strategy to improve consumers' financial education. It is a distinct area and should be treated as such.

Other issues that must be resolved in order to ensure this new authority (whether pfeg or a completely new organisation) proves successful include

- the need for a clearly defined role;
- clear lines of accountability,
- specific key performance indicators, and
- a willingness to engage constructively with other organisations from the outset, perhaps even at the stage of creating this entity.

Defining the role of this Consumer Education Authority or a newly empowered pfeg should include

- the full extent of its provision,
- how it will co-ordinate its activities, and
- precisely how it will champion consumer capability.

Critically important, the new Authority must be set goals that are measurable and periodically reviewed.

This will enable stakeholders such as the financial services industry, government and consumers to gauge more accurately whether or not the authority is delivering value for money, what improvements are actually being made and what changes, if any, might be needed.

We have previously expressed our concerns to the FSA in relation to how they measure their performance in improving levels of financial capability.

What little evaluation does take place is limited to inputs i.e. how many people have been "reached". Evaluation should instead be based on outputs i.e. have new skills been learned, what behavioural changes have taken place as a result of the learning, and are they long-lasting changes?

For example, in 2008 research from the LSE (commissioned by the FSA) highlighted that the approach of the FSA and their partners in simply administering questionnaires immediately after a lesson about personal finance was an inadequate means of evaluation.

In April 2007 the National Audit Office had been more critical. Their review of the FSA found that "*... measures relating to changes in behaviour and improved outcomes are not quantified*" and that the FSA is "*not able to estimate or measure the impact of its work on consumer behaviour and outcomes.*"

A new organisation must not repeat these mistakes. Instead, objective, independent, rigorous evaluation should be undertaken on a regular basis and this assessment should form the basis of their approach to improving consumers' financial capability.

The consultation paper also suggests that the new authority will have "*...the authority to delegate functions to other organisations that might be better placed to deliver them.*" We assume this means delegating to existing specialists such as the **ifs** School of Finance, the only provider of GCSE, AS and A level equivalent qualifications in personal finance?

If this is the case, then providing such organisations are similarly set goals that are measurable and periodically reviewed, we would support such an approach. Furthermore, the appointment of such specialists should be on the basis of open tendering.

The **ifs** and FSA have a shared objective to improve levels of financial capability in the UK. However, despite numerous attempts to engage with and work alongside the FSA on issues relating to financial capability in schools, there has been no help or support for any of our 14-19 activities, nor has there been any public acknowledgement by the FSA of the work we are doing.

We can only speculate as to why the FSA has taken this approach to ignore our increasingly popular educational programme in schools and colleges. In doing so, the FSA is also ignoring an increasing body of evidence which suggests that a standalone qualification like the 14-19 qualifications we offer produces far more financially capable young people than alternatives put forward by the FSA and others (see research from University of Cornell, 2001; University of Manchester, 2006; Ofsted, 2008; University of Manchester, 2009.)

We hope that if a Consumer Education Authority is created there will be a substantial change in both culture and attitude so that those organisations with a proven track record in providing effective education are embraced, not spurned.

Should pfeq undertake this new role it is essential that they be required to engage with all who provide meaningful financial education to consumers rather than a favoured few.

19. What are your views on the scope of the new authority? Should it also, for example, champion consumer interests and act as a consumer voice in financial services?

We believe the new Authority's scope should be closely defined around what its name purports it to be, an Educational body. Its remit should be to co-ordinate and combine the considerable range of activities in this area rather than attempt to re-invent a costly new wheel – again our suggestion that pfeq take these responsibilities could achieve this objective.

There is a lot of good work going on which could be greatly enhanced if there was a central body that brought together all these efforts. This would result in greater effectiveness which can also be measured. The current set-up makes no attempt to bring together these disparate efforts creating instead a totally unnecessary us-and-them competitive environment where there should be co-operation.

There are other organisations with proven effectiveness in championing the consumer's interests. This new Authority should not duplicate this activity.

20. What are your views on the governance and funding proposals for the authority?

The FSA has committed itself to spending £15 -20 million a year on financial capability each year between 2007 and 2011.

And yet, the 2007 National Audit Office report on the effectiveness of the FSA's activities in this area highlighted that because of its failure to measure appropriately the impact of its work, they (the Audit Office) "...cannot assess if its overall allocation of resources to financial capability is appropriate."

The National Audit Office's report suggests that taxpayers' money is not being used effectively. As the country faces spending cuts of almost unprecedented proportions, the consumer will look to every aspect of official spend to judge whether value for money is being achieved. Many will challenge whether simply 'reaching' people with 'information' is an effective use of such funding.

This Authority could reduce considerably its draw on public finances by engaging with the plethora of existing providers of financial education which do not have any call on public finances. As we suggested above, if this Authority played a co-ordinating and supporting role rather than attempting to go it alone, it could operate a great deal more effectively on a substantially reduced budget.

If this Authority was given this coordinating role, its governance should reflect the various interests and major providers that have the experience and the proven track record in providing effective financial education. These providers range widely across the private and public sectors where considerable sums are already being spent on this education. By bringing these efforts together, this new Authority would be able to point to positive achievements on a much reduced reliance on the public purse.

21. To what extent should the authority be independent of the FSA?

Reports from the National Audit Office in 2007 and research commissioned by the FSA itself in July 2008 both suggest that the FSA has been less than successful when it comes to personal financial education.

The London School of Economics (LSE) found that what is being delivered by the FSA and its partners in schools did not deliver the relevant behavioural changes and that “...*providing financial education to schoolchildren is pointless unless their adult behaviour changes.*”

Perhaps the fault does not lie wholly with the FSA given that this particular remit was enshrined in its founding legislation.

At the risk of stating the obvious, education and regulating the financial services sector are very different skill sets. Demanding that the regulator also engage with educating school students and adults made no sense and the ensuing struggle by the FSA to make this work suggests it was a policy based on idealism rather than pragmatism. It has been an expensive learning curve.

Financial capability education should be available to all students in the country. This availability and drive should come from the relevant educational departments of government, not the financial services regulator.

Conclusion

We are not convinced that a new Consumer Education Authority is necessary. As set out in our original recommendation, a co-ordinating organisation is required, but an existing body already undertakes this role.

A new educational authority for financial capability will be another drain on the public purse. If this is to be justified, it will need to have a very clear, detailed and accountable remit.

The responsibility for financial capability education should be taken up seriously by the relevant educational authorities. This would be a more cost effective and simpler means of dramatically raising levels of financial capability in the UK - for future generations at least - than creating yet another publicly funded body.

Our evidence-based approach to this issue led us to ask Government to add a standalone qualification in personal finance to the core school curriculum. This would put personal finance on an equal footing with other subjects such as Geography, History and Modern Foreign languages - compulsory for schools to offer personal finance as a GCSE or equivalent option but **not compulsory for students to take it.**

This would give financial education an equal footing with a wide range of other subjects and demonstrate that Government is serious about the need for future generations to become financially capable. This would lead to a step change in the number of young people leaving school with the necessary skills to manage their own finances effectively, the behavioural change the LSE referred to (see above).

Also, by having to offer a qualification to students as a Key Stage 4 option, it is likely that many schools would choose to offer younger students an introduction to Personal Finance before they reach 14, even if they don't then choose it as an exam subject.

A further benefit is that if all schools had to offer such a subject, they would doubtless seek to ensure that their teachers had the skills and confidence to teach personal finance effectively – often identified as a significant barrier to improving levels of financial capability.

Having an examinable subject also enables schools, parents and policymakers to determine how effective the teaching and learning of personal finance has been. As the FSA's own research has clearly demonstrated (July 2008), at present there is currently no effective evaluation for any of the numerous areas in which personal finance education is supposedly being delivered to young people.

Ensuring schools are obliged to offer their students the opportunity to become financially capable will take political courage and to date the Government has lacked such courage. Irrespective of Government action on this issue, the *ifs School of Finance* will continue to provide rapidly increasing numbers of schools and colleges with qualifications that are independently proven to make a positive difference to young people's financial capability - a key lifestyle skill at all times, not just in the current climate of financial uncertainty.

Reforming Financial Markets

Paper put forward by:

Michael Lister, Senior Lecturer, University of Westminster

Note: The views expressed herein are those of the author and not necessarily those of the University.

Introduction:

We would like to begin by saying how impressed we are with the extent and detail of the Treasury document and we welcome the opportunity to put views forward on this extremely important subject.

The past 18 months has been very costly to the British taxpayer in providing “last resort” capital and liquidity for the banking industry to cover the results of issues which could have been identified and expected. The British taxpayer now needs to be protected from the potential cost of inadequate regulation in the future.

The size of the banking industry in the UK is huge in comparison with the general economy and in particular with the ability of the Government to raise the funds required to support banks if there is a problem. The Government cannot afford to continue to act as the provider of last resort – the cost of action over the past 18 months will take very many years to recover from and the extra borrowing starts to erode the risk free status of UK Government debt.

The financial markets and their regulators seem to have singularly failed to anticipate a number of the issues which led up to the failure of the banking system, yet looking back some of those issues must have had an inevitability that problems would occur at some stage. It had to be inevitable, for instance, that investors in short term securitised loan packages would at some time decide to withdraw from acquisition of further issues or refinance of existing issues, yet this was not anticipated.

It has to be part of commercial risk assessment to anticipate market changes and economic shocks rather than just reacting to them. The financial institutions should apply these in setting their own strategy for self regulation and the regulator should consider its own views of these in its analysis for measuring the strategy of the financial institutions it monitors and regulates. The different parts of the economy work in cycles which can be predicted to some extent, so the financial institutions and the regulator should not view such anticipation as impossible. It is clear that this has not occurred to date and the position of some of the institutions seems to have been one of assuming that predictable cyclical changes are actually totally unexpected economic shocks. This is a considerable

shortcoming in the financial markets and one which has been exceedingly painful for the taxpayer: the regulator has not done its job.

We must face the fact that if insufficient changes to the regulation of the banking system are now put in place, then in about 16 years from now the UK will again see an economic downturn wreck the banking system and cost the taxpayer dearly. Adequate regulation, both within financial institutions and externally, may even reduce the extent of a future economic downturn.

The proposals herein are intended to be highly constructive and are based upon 30 years of experience in banks including structuring internal procedures of regulation and assessment under Basel 2, and additionally studying the loan portfolios of other institutions for possible purchase.

Given the desire for greater transparency in financial markets, there is now an opportunity to structure and enforce material changes to the methodology of bank regulation, while allowing the banks to use such methodology to enhance their own credit analysis. The banks should view the changes as being of value in assisting them in maintaining shareholder value and protecting the banks against future losses. Transparency can be achieved by publication by the FSA (or an equivalent) of tables of degrees of comparative aggression in risk taking together with tables giving capital to business value ratios based on both mark to market values of transactions and on fair long term value of transactions using the concept of position-in-cycle (see later).

There is a clear need for the consumer to understand that those banks which are prepared to pay more for deposits than the general tone of deposit rates probably need to do so because of their credit rating; the regulators would have usefully served the consumer, for instance, by pointing out that some of the Icelandic banks were paying high interest rates because of their lack of security and so carried undue risk for the depositor (this risk was certainly not unknown by the financial community at large) . It is ultimately unfair for the taxpayer to compensate depositors who take excessive risk in order to obtain higher than market interest rates.

The consumer needs educating before taking part in financial markets. There needs to be an understanding of the difference between saving and investing. There are certainly times when the consumer needs to be aware of the concept of caveat emptor; the Government does not guarantee that a second hand car bought in the street will work and this concept needs to be brought into financial services.

This paper will propose that the current remit of the FSA in being regulator of the banking community at the highest level does not fit with its association with the consumer. The issues of the two parties sit far apart and perhaps the current remit has led to confusion of the precise issues to be examined.

The paper proposes greater use of the Basel 2 Accord as a basis of assessment of credit issues all the way from the deal by deal level up to general bank portfolio analysis and

even to strategic market analysis. Basel 2 is in use by many if not all banks and would be an excellent tool if applied correctly, fairly and consistently, yet currently the use is in many ways misleading and worthless; we propose education on the use of Basel 2, more rigid structuring of the interpretation of the inputs and much more (if there is any, currently) rigorous enforcement thereof. Basel 2 has been accused of being pro-cyclical, yet it does not need to be; its application might actually be used to smooth out highs and lows in markets and so to reduce volatility and hence the propensity of banks to lose money.

Replies to questions raised in the Treasury paper:

Replies are given below to the questions posed in your consultative document and thereafter additional comments will be made.

A1: What are the benefits in creating a more formal and transparent body to co-ordinate the authorities more systemic approach to financial regulation? Do you have any views on the role and remit of the CFS?

It is clear that the current system has failed the Government, the consumer, the banks and the taxpayer.

A new body is required to regulate the FSA (or a new body to replace the FSA) and the FSA should not be a member of this new body, but merely called upon to report to the new body. The new body should include those who may not actually represent any other body but who have a very clear understanding of the operation of a relevant part of the financial markets. The new body should have the power to investigate and enforce the activities of the FSA.

Later in this paper it is proposed that the remit of the FSA should be changed. No one body should be regulator of financial service providers and regulator on behalf of the consumer. Perhaps the combination of these roles has in the past confused the FSA and reduced its attention on the issues of the financial markets,

A2: To what extent would an annual report on key developments increase knowledge and awareness of significant regulatory actions taken under the Banking Act and the FSMA? From your point what areas would it be useful for this report to cover?

Actions are more crucial than an annual report. If the actions are correct, the result will be obvious to all.

A3: In addition to the input of non-executives from the governing bodies of the FSA and the Bank, in what other ways could external advice and commentary be incorporated into the process?

We are not at all clear that non-executives from the FSA and Bank are the correct parties and add anything at all. People working at more junior levels of organisations with real working knowledge of on-the-ground procedures and decision making are required.

A4: What mechanisms might be used for enhancing democratic accountability? Is this important? Are there risks that need to be considered – for example around market sensitivity or threats to consumer confidence?

Clearly care needs to be taken.

The banks currently have a very bad image resulting from their incompetent but highly paid management and the problems which have been extremely costly for the taxpayer to put right. The taxpayer is very fairly aggrieved.

What needs to be recovered is confidence rather than accountability. That will be restored only over a long period. The public need to be told why some bankers receive very high salaries or bonuses – perhaps they create much value for their employer. The public needs to understand why they do not earn as much as the bankers and that perhaps the bankers do a job which the public could not do. Salaries and bonuses however should be at levels which can be understood and accepted by the public.

The public also needs to be shown that the regulator has bite – the FSA has in no way ever shown this to be the case. In a long career in banking one has dealt with harsh investigation by the Bank of England, the Federal Reserve, the New York State examiners, internal and external audit teams, but has only ever encountered the FSA at drinks parties!

A5: What are the benefits of giving the FSA an explicit objective for financial stability?

There are no benefits whatsoever, in the current structure and remit of the FSA. It needs to be a different party doing this, as described above. The FSA's current staff may not be the most appropriate for what is required. There needs to be more working "at the coal face".

A6: What are the advantages and disadvantages of amending FMSA to make clear that the FSA must take into account any possible wider economic and fiscal costs in their decision making?

Firstly it would be a different party doing this.

It seems impossible to think that the relevant party could do their job without taking possible wider economic and fiscal costs into account. There can only be advantages.

A7: What are the advantages and disadvantages of amending FSMA to place a duty on the FSA to promote sound international regulation and supervision?

The answers to this question come out of such countries as Iceland and Latvia and to a lesser extent Ireland. It is crucial. The financial markets are now international and all countries need to be involved in regulation to an adequate standard.

A8: To what extent would these proposals improve the FSA's ability to have a more systemic or macro-prudential approach to prudential regulation?

This is covered elsewhere.

A9: Do you agree that the FSA's rule making power and powers on intervention should be explicitly deployable in pursuit of any of its regulatory objectives and not just that of consumer protection?

Firstly the regulation and consumer protection need to be governed by different parties.

It is crucial that a party has powers which can be explicitly deployed in pursuit of regulatory objectives. At the end of the day the taxpayer needs protection here as do the shareholders of the banks. Consumer protection is an entirely different objective.

A10: To what extent will the FSA's enforcement capability be enhanced by a power to suspend individuals or firms for misconduct?

This power is crucial and needs to be extended to include a wider interpretation of the word 'misconduct'.

This should be extended to the making of credit decisions; if lending decisions are seen to be wildly too optimistic, then there should be a power to enter the bank and remove the power of the relevant individuals and to impose tighter controls on the bank. This is the source of many of the issues at for instance HBOS and RBS and particularly at Anglo Irish Bank. Abuse takes place at the individual deal decision level up to the strategic policy making and implementation level. Someone needs to have the power to control this when ultimately the taxpayer picks up the bill for the losses.

A11: To what extent will the FSA's enforcement capability be enhanced by a power to penalise persons who perform a controlled function without the necessary FSA approval?

It is difficult to see any reason why this should not be the case. Such penalising has to be part of regulation.

The FSA needs to also penalise persons who are approved but still perform badly. All approved parties should be investigated continuously.

A12: are the Governments proposed amendments to FSMA the best way of ensuring that the FSA can continue to take effective action to tackle abusive short-selling practices?

Our view is that short selling is an unnecessary complication of financial markets and should be illegal. Pure speculation can have no place in financial markets when the taxpayer picks up the bill when things go wrong.

A13: can you identify areas where the FSA does not currently have sufficient power to request information that it requires in order to carry out more system wide analysis of the financial sector?

An entire new approach is required, which is discussed later. In a position where the taxpayer is the ultimate provider of equity and liquidity, the taxpayer's representative should have no bar whatsoever to the gathering of information.

A14: What are your views on this proposal to expand the role of the Financial Services Compensation Scheme?

The need for the taxpayer to pay compensation requires that tighter control must be placed on those where compensation might arise. The Icelandic banks for instance should have been prevented from taking high levels of deposits. The basis of different country's compensation schemes and ability to pay should be known in order to reduce the liability of the British taxpayer.

It should be accepted by savers who want a higher return on deposits than a market level that the saver should bear some of the risk for accepting the risk premium in the return. An alternative is for those banks which need to pay high rates to attract deposits which are guaranteed by the Government up to £50,000 to pay a standard market rate to the saver plus a risk levy to the Government for the provision of the guarantee – but the guarantee should only be provided if the Government is absolutely certain of the financial position of the institution. Anything else is entirely unfair to the British taxpayer.

The need to pay higher interest rates on deposits than market rates comes from either the bank having a poor covenant due to poor lending decision strategy or from the bank having too small a cushion of shareholders funds. It may also be to buy market share or to reduce reliance upon wholesale funds. In every case where the Government provides any guarantee, the regulator should be capable of obtaining any information required to see where the funds are being spent and how much risk is being taken with the funds (see Kaupthing), failing which a licence to take deposits will not be granted in UK.

A15: What are the advantages and disadvantages of the relevant consumer credit firms contributing to the costs of Money Guidance?

It is difficult to see why this should not occur. The firms need to feel they are a part of the process and paying towards it helps focus attention.

The Government should not be considered the ultimate payer for any possible expenditure – those profiting from the system should be paying.

A16: The Government believes that some organisations, such as free and impartial debt advice providers, should be exempt from the levy on consumer credit licence holders – do you agree? Are there any other cases where an exemption is appropriate?

The need for impartial advice is very important, so where advice really is being given for free by impartial providers, then an exemption from the levy looks fair. However the regulator should ensure that the advice really is impartial.

A17: What factors should be considered in designing an appropriate levy scheme for consumer credit firms?

The levy could be directly linked to the need for advice but this would hit hardest those most in need of the advice.

It would seem best that any levy is based on balance sheet size of the payer, rather than turnover size (so averaging the cost of the levy over all consumers).

A18: What issues need to be resolved to establish a successful consumer education authority set up by the FSA?

Firstly it is felt, as above, that consumer issues should not be dealt with by the FSA.

The consumer crucially needs to understand that higher return is related to higher risk taking.

The consumer also needs to understand that the world changes over time, so what was appropriate years ago may not continue to be appropriate – example why should people expect to retire on a pension at age 60 when their life expectancy is 21 years (as in 2005) in the same way as they did when their life expectancy was below 15 years (as in 1950).

A19: What are your views on the scope of the new authority? Should it also for example champion consumer interests and act as a consumer voice in financial services?

Perhaps one of the downfalls of the FSA in failing to deliver is that its remit has been too wide. Hence this new authority should be focussed with a remit which is not too wide and one which can reasonably be expected to be delivered.

There are already other groups which champion consumer interests and there does not seem to be a lack of current voice in consumer opinion of financial services.

Having the new authority champion consumer interests might dilute its authority.

A20: What are your views on the governance and funding proposals for the authority?

The authority should be funded entirely from the financial services industry.

Governance should in no way involve the FSA but should come from a new authority to which the FSA also reports, but this should not be directly the CFS.

A21: To what extent should the authority be independent of the FSA?

Entirely.

The FSA should be playing at a different level and with the obligation to protect the taxpayer from paying losses within the financial industries. This may at times conflict with consumer regulation issues.

A22: How can the better routes to collective address be achieved, which deal with claims more efficiently, reduce the time claimants may have to wait, and reduce the volume of individual cases dealt with by the courts of FOS?

It is crucial that:

1 the consumer feels that its case is being championed by an authority which is independent of that regulating the financial services industry and so feels that a ruling by the authority removes the need to go to court.

2 the consumer must be introduced to the concept of caveat emptor: if the consumer buys a poor investment, it should not expect compensation. If the consumer gambles by placing money with an unknown deposit taker in order to obtain higher-than-market return, the consumer must bear some of the responsibility for that decision. If fraud by the deposit taker or financial services provider has occurred then that is different.

3 the consumer must be educated.

4 financial service providers must be much more tightly controlled in their advertising in order not to mislead the consumer.

Then the number of cases to the FOS should be reduced and more efficient system can operate.

A23: No comment

A24: No comment

A25: No comment

A26: No comment

B1: Do you agree that the systemic significance of a financial institution should be explicitly linked to regulatory capital requirements?

The most important element of the balance sheet of any institution in the financial services industry is the cushion of shareholders capital which protects against either the need for an injection of additional capital (which may come from the Government as provider of last resort) or losses by those exposed to the institution.

The larger is the cushion relative to the size of the institutions overall business, the safer is the institution.

The quantum of capital should be calculated very carefully as per B2.

B2: How should systemically significant institutions be categorised? For example should there be a fixed list or a sliding scale of importance, how often should such a list be updated and should any list of systemic significance be made public?

The events of the past two years have shown that balance sheet size in the financial services industry is irrelevant. The important thing to all parties is the capability of the institution to be reasonably expected to continue its operations without the need to raise additional capital. There may also be a need for a separate measure related to the availability of new capital for the relevant institution only from the markets should the need arise. There should be no assumption that the Government will provide new capital as the provider of last resort.

The ability to continue operations is directly related to cushion of regulatory capital which should be calculated on each of two bases as below:

- 1 The capital base as a portion of total relevant activities based on a fair mark to market valuation of all activities as at the relevant date; and
- 2 The capital base as a portion of total relevant activities based on a fair mark to market valuation of all activities assuming a middle cycle position – so one which is capable of being achieved in a different part of the economic cycle. Perhaps guidance from the FSA (or replacement body) would be required to achieve this. An example of this is the pension funds were being valued at the bottom of the market and showing huge deficits. However these are very long term providers of financial services and will be in existence long enough for the markets to recover. A deficit at one point in time is good to know, but the deficit at a different point in the cycle might be much more relevant. Similarly a bank operating in a good lending market will show a certain regulatory capital base, but the bank should also be valued on the assumption of a poorer market if the valuation date occurs in a high point in the economic cycle.

The obligation to refinance securitised debt issues should be carried as a contingent liability and the relevant institution should be required to carry a portion of that refinance liability – perhaps 25% - as specifically held liquid reserve.

Institutions should also be examined for the degree of aggression in the general business approach to their activities. Hence for example a noting of those lenders who were known as being highly aggressive in property lending and making advances at a higher loan-to-value than was common in the market at the time. It would include the use of securitised funding and the paying of high interest rates to attract deposits.

The institutions should additionally be rated on the fairness of their use of Basel 2 as a regulatory tool – see later. This in effect is part of points 1 and 2 above.

So in conclusion to this question, publication to the public by the FSA or equivalent replacement should be made on a regular basis – say monthly – to show the regulatory capital on the actual basis in 1 above and the hypothetical basis in 2 above together with an ‘aggression’ index and Basel 2 index. The results would have shown before 2007 the issues facing the banking community and enabled the Government through its regulator to moderate their position. The results would be material to the institution as it would impact upon the ability to raise funds, whether capital or otherwise.

The above will be a moderator in the operation of the wholesale funding markets.

B3: Can you identify any other important challenges to implementing stricter regulation on systemically significant institutions?

See comments on Basel 2 later.

B4: Do you agree that banks should be required to establish more detailed contingency plans for use in times of failure?

Unquestionably. This has been shown to be entirely missing in the case of for instance Northern Rock.

The regulator should join with the banks to produce such plans and should not merely leave it to the banks to produce their own or not to. The regulator needs to set out firm instructions on what needs to go into such a plan (such as the end of the availability of securitised funds).

The regulator should inspect and be required to approve such plans (or ask them to be amended until satisfactory). The completion and holding of an approved plan should be a condition of continued operations in the UK of the relevant bank.

B5: What steps could the Government take to increase competitive pressures in the market, to the benefit of consumers?

Care should be taken in promoting increased competition in the financial service industry. The first need is to produce stability – which will be hugely beneficial to the consumer. Once markets are stable then the Government can look to produce greater competition but only so long as stability continues to be the highest priority.

B6: In addition to the barriers identified by the OFT and the Competition Commission are there any further barriers faced by potential retail banking providers?

Additional barriers include:

- 1 Access to acceptable standards of experienced staff to manage operations
- 2 Access to management with sufficient knowledge and experience of markets
- 3 Access to guidance from the regulator.

A barrier which should exist yet which has crucially and very noticeably not existed is the ability of the consumer to look fairly and critically at new entrants into the market (for instance the Icelandic banks as takers of deposits).

Another barrier which must exist is an acceptable standard of monitoring of the advertising by new entrants to ensure they are not misleading the consumer (for instance the open ended property investment vehicles which came about in 2006).

B7: How can the Government facilitate easier account switching in the retail banking sector?

A great number of operators are already in this field, with great availability of portability. Further facilitation seems unnecessary and unlikely to realistically aid the consumer.

B8: What additional work would be needed to ensure that the infrastructure to support faster payouts in the event of bank failure could also support account portability?

Greater degrees of satisfactory regulation would make this question irrelevant.

B9: With the development of new technologies, where might new entrants to the retail banking market come from and how can consumers be encouraged to take advantage of it?

Over the last 10 years there has been a massive change in retail banking arising from new technology, with a much easier access to market being available. Banks no longer need to have branches or be visible, yet the lack of need to be visible has led to the issues with

the deposit taking by for instance the Icelandic banks. So the technological advances need to be treated with care.

The next major advance will be a move from land based internet banking to mobile internet, extending the access of the consumer to financial affairs away from just the home or office to anywhere. Consumers will gradually move to this and do not necessarily need to be encouraged to use it; the move by users of mobile phones to I-phones and the equivalent will make mobile internet more available and better understood. At the moment the biggest shortfall is in the ability of existing systems to adapt to the more advanced standards of mobile internet technology.

B10: Do you support the Governments proposals to embed facilitating market entry into the medium term's financial sector policy making by requiring the FSA and OFT to specifically address the issue in: Cost benefit Analysis on new regulatory proposals; and the OFT's annual updates to its financial services strategy?

Other issues seem to be rather more important at this stage.

B11: would you support requiring the OFT to consider enforcing the adoption of industry-wide disclosure standards to ensure consumers are well equipped to make decisions about their financial affairs and to switch suppliers?

Yes.

B12: Would simplified labelling help consumer understanding of financial products? What lessons can be learned from the traffic light system of food labelling and how can these be applied to financial products? Should such labelling be compulsory?

This would seem as excellent advance on behalf of both the consumer and the provider.

There is a crucial need that any system is honest and fair, so there is a question over who actually sets the labelling – it would need to be entirely apart from the provider and checked by the regulator.

It would need to cover for instance the degree of risk in a product – such as the difference between saving and investing and the extent to which deposits are covered by Government guarantee. It should examine risk and reward.

It would consider the position of the provider and would apply those issues measured in the proposals above under B2.

The concept of caveat emptor must be applied, so if a system is provided, then it should be assumed in law that the consumer has been informed and will act accordingly, hence there will be fewer complaints to be examined by the FOS. If not then there is no point in taking this proposal forward.

B13: Which products would and would not be suitable for simplified labelling? Is it possible to establish a single system of disclosure for a diverse range of products?

Clearly different sets of labelling will be needed for different types of financial product, although an overall risk rating could be common to all.

Perhaps each product needs to be labelled by a series of label types, not just one, although with reduction of complexity in mind. The principle of environmental labelling for white goods seems to be universally accepted by consumers and applied by many, particularly in the context of the use of energy which has a direct impact on the consumer, proving that consumers are familiar with the concept. Labelling needs to be meaningful and relevant to the consumer.

It should be assumed that a single type of system can be devised.

B14: Should price be benchmarked? Should there be disclosure to help people identify products which are relatively expensive?

Yes but the regulator needs to investigate and have the power to reduce pricing.

B15: Why do some existing simple products not sell well?

There is good evidence that large adverts in the right newspaper advertising anything (however unreliably and purporting to offer huge returns) will produce huge inflows of money to manage.

So perhaps a product which does not sell well has not been oversold.

Unreliable advertising needs to be controlled by the regulator.

B16: Should the Government extend the concept underlying RU64 to other products ie require firms to demonstrate why a complex or expensive product is better than a simple or cheaper alternative?

Yes

B17: who should set benchmark standards for products?

The new consumer based regulator.

B18: Are there barriers to the provision of mortgage insurance in the UK?

In the past those borrowing for house purchase have proved themselves not good at understanding what they are doing. People think that the only security for their mortgage is the charged property whereas the prime security is the borrower's income – this pays

the interest and capital repayments – the borrower will always need somewhere to live so the security will never be sold to repay the debt.

The addition of mortgage insurance has complicated the thinking of borrowers and has been assumed to be part available to repay the debt upon certain occurrences. However this ignores the fact that firstly mortgage insurance is an indemnity rather than a guarantee and also that the insurance provider has an obligation to mitigate the loss (by suing the borrower if necessary).

A major barrier to the provision is therefore the misunderstanding of the position of the insurance.

This misunderstanding also extends to the mortgage providers.

A further issue is the insurer. In the US the recent carnage in the mortgage industry has brought the insurers to their knees. Counterparty risk is very big. The size of UK mortgage business makes insurance on an acceptable basis difficult.

In the late 1980s mortgage insurance was available in respect of commercial property lending. It was badly misunderstood, badly misused and underpriced; it encouraged the lenders to hand out money irresponsibly. The insurer was almost bankrupted.

B19: What are the advantages and disadvantages of the Canadian model of mortgage insurance?

See replies to B18.

B20: Do you have any views on how the governance and accountability of the FSCS can be strengthened to help it successfully deal with these new challenges?

Monitoring and regulation of the financial services industry must be much tighter, so hopefully leading to a reduction of claims.

The consumer must not feel that FSCS is there to compensate for any investment loss whatsoever. Compensation has been too easily available at times and may not have been fairly treated. Payouts by a mutual insurer to one investor will unfairly hurt the returns of other investors so need to be treated equitably for all.

There does need to be an understanding on the part of the consumer that the consumer is responsible for its own actions.

B21: Do you agree that a single point of contact would be suitable way of handling cross-border compensation issues in the EU? If not, why not and what alternative would you suggest?

A single point is crucial.

B22: how should a single point of contact operate?

No comment.

B23: Should there be more or less harmonisation of EU deposit-guarantee schemes?

B24: what are your views on the possible introduction of a pan-EU deposit-guarantee scheme?

The EU needs to entirely harmonise deposit guarantee schemes, particularly given the issues of banks trading in countries other than the home base. A pan EU scheme would be better but there is still the issue of non-EU schemes, such as Iceland.

There is the issue of who would pay compensation? Would countries pay in on the basis of the quantity of deposits held in their country, or the quantum held by banks based in their country or on the basis of regulatory capital ratios or what? It will need careful thought so that the obligation does not rest on the few and it will need to be structured so as not to impact on the relationships between different countries. It should not be possible for one country to take deposits, have reckless use of those funds by its institutions through the lack of proper regulation leading to huge losses and then expect the other countries of the EU, who may have very adequately regulated their own banks, to pay compensation. Latvia is an example of a country where the economy expanded hugely just through its property market: its banks had all of their assets tied up in either residential mortgages or in loans to property developers, yet properties were not selling and oversupply was likely; the banks continued to lend: the lending policies were reckless and loss of deposits then became highly likely. Iceland was worse.

A failure to establish a working basis for harmonised deposit-guaranteeing with adequate financial support should lead to a withdrawal of deposit taking licences for those banks based in countries which do not comply. Clearly up to 2008 that would have included the banks of Iceland and Ireland. Alternatively the UK Government should specifically state, and require deposit takers to confirm, that the UK Government guarantee does not extend to deposits with banks of non-complying countries: the Government cannot afford to do otherwise.

B25: What features of shared operating models could be applied to the UK building society sector?

B26: What are the barriers to shared operating models?

B27: What legislative or other changes would be needed to make such models effective in the UK?

B28: Are there other measures the sector or Government should consider to achieve the long term aim of a robust, thriving building societies sector?

The answers to these questions can be looked at together.

Firstly the management ability is not equally distributed among the building societies.

Secondly lessons can be learned by observations of the issues of Northern Rock (although technically not a building society when it collapsed) and Dunfermline Building Society. The same points would have been appropriate to some other former building societies.

The building society movement has been a very valuable party within the financial services sector although its part has been much reduced over the last 20 years. The movement had a traditional model which worked well for all the members, both depositors and borrowers.

It has become clear, particularly from Dunfermline, that building societies are not well placed to have the experience to undertake lending to the commercial property market which is highly volatile and a long-time regular loss provider for the banks. Some of the building societies of the past have been well known as being overly aggressive as lenders in this market (e.g. Bristol and West). Commercial property lending does not fit with the traditional image of building societies and should be actively discouraged or banned. (Nationwide has been successful in this area, so perhaps needs treating specially).

Northern Rock and others took an overly optimistic view of the continuation of the availability of securitised debt. It had to be a consideration in their long term strategic planning that such a funding source might not be available at some time, yet it was not. The very nature of securitised debt, where the investors are removed from the actual lending activity and carry out little or no due diligence, was one which could easily disappear if market destabilisation seemed possible, so the collapse of debt securitisation was inevitable and should have been of no surprise. The term of securitised debt was also strange: how can 25 year mortgages be packaged and sold with refinance due after as little as 18 months. Loans for 25 years with little early amortisation should be sold for at least 10 years and preferably the whole 25 years. The building societies should be banned from using securitised funding. Any securitised issues which remain in place should be required to be covered by very large liquidity ratios. The relevant part of the Building Societies Act 2007 should be removed.

The building society movement should be encouraged to establish a readily tradeable bond market where, as in Germany, funds are raised for the very long term, so reducing the need for high levels of ready liquidity which have been a feature of building societies given their dependence on very short term deposits. The tradeable bonds could be operated on the basis of open-ended fund shares subject to tight liquidity restrictions.

The holding of securities by building societies should be banned. The holding of securitised issues by Dunfermline was part of its downfall. It clearly was unable to correctly credit-assess these, so should not have invested.

The building societies should continue to be required to hold high levels of liquidity until they can reduce their dependence on short term deposits and move to longer term bond finance.

The concept of building society shares is perhaps a little odd in the modern age and the capital structure needs to be re-thought to try to stabilise it. The mutual concept has worked very well and should be made a permanent feature.

Much tighter control is required. Consolidation is probably required, if for no other reason to spread the net of experience and skill.

It is perhaps sad that the largest part of the provision of house mortgages is now by the banks and tight controls need to be imposed here also.

B29: What is the best way of ensuring that Industrial and Provident Societies convey to their members the nature of their investment?

B30: Should a Code of Practice on withdrawable share capital be made statutory?

B31 are there specific measures the Government might take to help transparency and disclosure?

B32: Are there other measures that the Government should consider to enable credit unions, IPSs and friendly societies to thrive?

The Industrial and Provident Societies are extremely hidden from most investors and their position is not well understood. This frequently also applies to the friendly societies.

Perhaps these relics of the Victorian era are now too small to take on the advertising required to be noticed by the public. In the modern world, their existence may be an irrelevance. We would propose that such bodies do not form part of this document.

Other issues and comments on the points raised in the Treasury document:

Basel 2:

Basel 2 provides the banking system with a very valuable tool but only if it is used consistently and fairly. Although the BIS provided an outline of how Basel 2 is to be interpreted by the banks, each bank has been allowed to develop its own software for dealing with the issue. The result has been that those banks prepared to invest in complex software and to sit and think long and hard about the factors which need to be considered by the software have built systems which are capable of doing an excellent job of evaluating risk. In theory the system conceptually allows a bank to grade and monitor individual loans, sector-based portfolios of loans and even the entire business of the bank. To take the concept to its limit, Basel 2 could permit a regulator to observe the credit risk

and capital requirement for the whole banking industry. So Basel 2 is well worth working on and in any event at the moment there is no alternative tool available.

Sadly however Basel 2 has huge drawbacks in its current form. The first is that, given the ability of the individual banks to design their own software, the extent, complexity and adequacy of the software of the various banks varies hugely. While some systems are hugely probing, other banks hardly touch on analysis: some banks do not even allow for analysis of security and assume that all credits are unsecured (which gives rise to some rather confusing results). Secondly the bank systems require the input of data by a variety of people with different interests (some is by the account managers who are keen to promote their own deals as relatively safe) and the lack of strict guidance gives rise to an inevitable inconsistency of input. A system which makes an adequate attempt to fully analyse borrower and security will require the input of many factors, all of which act against each other, meaning that a small movement in each input has a major impact on the end requirement for capital.

The fact that systems for undertaking Basel 2 assessments vary from one bank to another must have made it completely impossible for the FSA to in any way begin to attempt to regulate banking using Basel 2. In its current form Basel 2 must have over 300 different sets of software doing huge numbers of different types of investigations; the FSA stands no chance at all of understanding all of these systems to the required level and therefore of using Basel 2 as a part of effective regulation. This must change.

Some of the banks seem unaware of the need for Basel 2 style analysis and some seek to use it to justify doing bad business for profitability purposes rather than as a real credit analysis tool.

There is also an issue with Basel 2 in that, having undertaken the process, the banks then do not understand the outputs.

There is a clear need for change, but a degree of change which is perfectly manageable by the banks and the regulator. Below is a proposal for a replacement of the current system, capable of being implemented immediately at low cost.

The proposal for Basel 2 is as follows:

A new regulator assembles fully comprehensive analytical Basel 2 software and sells it to the banks (replacing their existing software) with an absolute requirement that it is used for every transaction. Evidence that the new software is being used will come because the regulator will be monitoring the outputs centrally, with feeds in from each of the banks.

The regulator would need to run training sessions for the input staff of the banks, and would then need to check random inputs against relevant information to ensure consistency of approach.

The new system would produce Estimated Loss and RAROC figures on each relevant transaction, on the bank's sector portfolio, and on the bank's entire business: the regulator would be able to assemble figures on the UK sector portfolios and on the whole UK banking business, so being able to check sector exposure and undertake its own sensitivity analysis.

The whole system is capable of providing huge amount of useful information to banks and to the regulator at the same time as the banks are controlling their own exposure and the regulator is regulating the banking sector. The regulator would be able to assemble packages of information for individual large borrowers using information provided by each lender to that borrower, so being able to assess the risk of that borrower which could be material to the banking sector as a whole. The cost would be no greater than the bank's current monitoring on Basel 2.

Rather than taking high-level staff, the regulator would be heavily staffed by low-cost staff which understood the Basel 2 system and could assist banks in running their own analysis (a central information and assistance bureau would be run by the regulator). These staff would have the right to walk into any bank and demand to see files in order to check Basel 2 inputs.

The regulator could change some of the weightings within the calculations, to take account of the position-in-cycle, something which is largely absent from Basel 2 today.

This proposal would enable the regulator to introduce the concept of non-accrual as used by the Federal Reserve as a warning of problems to come.

Updates of the software by the regulator could enable the Basel 2 software to for instance put greater risk on lending at higher loan-to-value ratios if the market dictated the need to do so.

Without implementation of our proposals the regulator will find regulation of the banking system impossible.

Is Basel 2 pro-cyclical?

We are of the opinion that Basel 2 can be made to be not pro-cyclical.

Commercial real estate lending in UK:

Commercial real estate lending now comprises some 15% of total lending after the deduction of retail mortgages and is at an unprecedented level. Given the huge recent drops in the values of commercial property (figures of over 40% have been suggested), most loan-to-value ratios used in the recent boom will have moved into negative equity, leaving the banking system with huge potential losses on a mark to market assessment, and seriously eroding bank capital. Further the overhang of in-possession properties will cause damage to the attractiveness of the market for some years.

There would seem now to be a need for the property industry to attempt to produce a new type of valuation which builds in a concept of sustainable value – one which reduces the volatility; this sustainable value could be used to value properties held as security for loans, solely as a basis of calculating regulatory capital on a mark to artificial market basis. The University has put this forward, in principle, to the Royal Institution of Chartered Surveyors and proposes to work on such a concept.

As an extension to the proposals under Basel 2 above, we propose that the regulator takes a more active role in managing the exposure of the entire banking system to the property industry. Borrowing groups taking exposure of say greater than 0.5% of a bank's capital base could be monitored by the regulator, together with those borrowing more than say 0.1% of the total capital base of the banking system [there are currently a number of groups each borrowing more than £1 billion]. Securitised issues would be included.

The regulator could additionally monitor the industry as a whole – how much development, how much vacant space, etc, and could use this in its updating of the Basel 2 software.

Reforming the bank deposit system in the UK:

The banking system in the UK has a high reliance upon short term deposits which add volatility to the sector. The regulator should investigate a wider bond market, traded over the counter in banks and post offices (as in Germany) to be used by the public as an alternative to deposits. This would reduce the mismatch of term in the banking system.

Pending this, the regulator should increase the liquidity held by the banks.

Non-accrual:

The banking system in the USA is used to the provision to the Federal Reserve of figures showing loans on which interest has not been accrued for a certain time. This has the advantage of giving early notice of a potential problem loan. Its use should be considered in the UK.

There is a potential downside issue with non accrual in that the banks are keen to “dump” loans which are suffering non accrual, leading to the ready acceptance of write-offs upon selling-on such loans into the secondary loan trading market. There would need to be some safeguard to discourage such selling-on as a widespread practice.

Reforming the use of securitised debt issues in the UK:

The use of securitised debt issues has been fundamental in causing the recent problems in the banking industry.

The regulator needs to require that, in future, securitised issues should only be used when the sale period of the issue, as far as possible, matches the maturity of the debts being sold. Hence the selling bank would not need to expect to refinance the securitised bond, as happens now. This mismatch directly led to the collapse of Northern Rock and remains a major issue for a number of other banks. If refinance exposure to securitised issues is being taken, then the bank should be required to hold a high degree of liquidity purely for the refinance.

Banks should be required to undertake considerable due diligence before buying parts of securitised issues. Building Societies should not be permitted to hold securitised issues (as Dunfermline).

Reforming the use of syndication:

Loan syndication is subject to the rules of caveat emptor but many of the banks which become members of syndicates do so because they do not have the expertise in the relevant sector to undertake sufficient due diligence themselves. Traditionally banks have taken positions in syndicates purely based on the standing of the lead banks with little or no credit analysis of their own: this is unacceptable. The regulator must ensure that lead banks hold material amounts of syndicated debt and insist on syndicate members undertaking due diligence.

Standard terms for syndication and the management of syndicated issues should be set up in the same way as the ISDA agreement is used.

Short selling and buying and margin trading:

These activities increase the volatility of financial markets yet appear to be unnecessary to the normal running of those markets. They should be discouraged.

Open-ended funds:

Both the UK and Germany have suffered from the impact of the nature of open ended funds. The market-making by these funds leads to serious illiquidity problems in perceived poor markets and that illiquidity can have an acute pro-cyclical effect. In the UK commercial property market open ended funds significantly increased the volatility of the market in 2006 to 2009 firstly by becoming forced buyers, so pushing prices up when the market felt a top had already been reached and secondly by becoming forced sellers, so wrecking the market.

The concept and tighter regulation of open-ended funds needs to be considered.

Education of the public:

The consumer financial regulator should seek to educate the public about saving, investing and borrowing. Borrowers should more responsible and accountable. Savers

must understand that investing is not the same as saving in that it involves potential loss of capital. Depositors must be educated that they should not lend to risky deposit takers in order to obtain the highest return.

Tight controls should be placed on equity release. Lending to persons on an unsecured basis should be heavily discouraged – it damages both the lenders (e.g. Northern Rock) and the borrowers.

Advertising of financial products must be subject to much greater scrutiny.

Simplification of the financial markets:

The Government must do all it can to reduce the complexity of the financial markets, to make markets more understandable and transparent and to reduce the risk in those markets by strict regulation where there is none today. The new regulators must be well experienced in all major sectors of financial markets and must use their powers of regulation. Simplification will aid this. The financial markets regulator should take the lead in assessing the state of markets and the position-in-cycle and advise the banks on a regular basis.

The financial-markets regulator should seek to educate the banks. The banks should be told, by the regulator, what issues to investigate in risk management strategy (such as lack of the ability to refinance securitised debt – Northern Rock) and should regularly check bank strategy and sensitivity thereof.

The financial markets regulator should receive daily reports from the banks on counter-party exposure and should analyse this information. The regulator would then have a much better understanding of the potential for domino collapse within the financial markets.

Expanding regulation to give it more teeth:

The regulator of financial institutions must accept that its role should include the regular entry into those institutions and pulling out of files for investigation. Mere interviewing of personnel will not suffice and may lead to a highly distorted picture of the institution.

Banks at the limit:

In the banking market all banks want to do only the deals they are comfortable with. However, unfortunately, competition leads the banks to go beyond this natural comfort barrier in order to do business and individual banks will set the trend for more aggressive lending. Other banks, less experienced but keen for market share, will follow, perhaps unaware of the extra risk being taken.

The financial markets regulator should know the sector players well enough that they can recognise which the trend-setters are and should monitor their strategy and, if

necessary, restrain their policy. The regulator must, in any event, know and understand the lending strategy of all banks, in particular recording the extent to which policy exceptions are viewed as the norm.

Institutional size:

The banking system has seen consolidation which has resulted in some of our banks becoming very large relative to the size of the national economy and to the ability of the Government to readily assist with problems. The Government should perhaps give thought to the splitting up of some of those institutions in order to create more manageable bodies for risk assistance, while retaining the substance to effectively trade.. Nationwide for example is massive in comparison with the overall building society movement yet does not need to be; a split up Nationwide could trade as effectively as now yet, upon failure, would more readily supported. Some of our banks are in the same position. Lloyds does not need to have such a controlling stake in the house mortgage market; smaller lenders would be just as successful and would increase competition in the market.

Before 2007 no-one had ever anticipated that the British Government would need to become so involved in supporting its financial institutions, and so size was not an issue. Now it is. Bite sized institutions could be more easily rescued with more institutions remaining sound without help.

Summary:

The author is of the opinion that this is an excellent opportunity to radically rethink the financial markets and the regulation thereof. We seem to have recently had a period where, although there was a supposed regulator, that regulation of the banking industry failed. Huge changes are necessary and we are pleased to be given the chance to put forward our views.

The author has, in this paper, put forward proposals for significant changes which entail further research, some of which is currently being undertaken at the University. We would like to offer, to the Treasury, assistance in developing the above proposals.

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B Qs 1 to 4. Financial Sector stability is a genuine 'public good', in the economics sense. It is thus not clear that individual banks and their shareholders should cover the whole cost of the insurance necessary to achieve it (especially as it probably can no longer be delivered at a national level). Taxpayers should thus expect to pay in part (and governments need to come to burden sharing agreements). Alternatively the too big or complex banking problem needs to be sorted. If economies of scale and scope prevent this and if the taxpayers shoulder some of the risk, then the supervisors must manage the moral hazard. Birmingham grinds to a halt when the gritting lorries run out of sand and salt. The alternative of stock piling enough sand and salt and having a big enough fleet of gritting lorries to prevent this happening is too expensive. The public are not keen on carrying chains for the wheels to use when it is icy either. If the banks cover all the costs of insuring the system, they will be much much more restricted in their ability to lend, and the public may not like that.

Andy

REFORMING FINANCIAL MARKETS

Comments by Professor Rosa Lastra in response to the consultation

(1) Financial stability is a goal difficult to define (more identifiable in its negative definition of what instability is than in its positive definition), and yet it is a most important policy objective, one that transcends institutional boundaries (thus, affecting FSA, Bank of England, Treasury) and geographic borders (like a Tsunami it does not respect territorial frontiers). Financial stability is a national, European and international goal. There are a variety of instruments that can help achieve that goal. At the national level, the main instruments are supervision and regulation (tasks that are performed in the UK by the FSA), lender of last resort (a task of the Bank of England), crisis management (a tripartite task, though the Bank of England has a prominent role in the SRR) and fiscal support in case of bank public recapitalisation or nationalization (a task of the Treasury). Financial stability, systemic risk/contagion control and sound banking and finance are 'close cousins'.

(2) The central bank, in this country the Bank of England, because of its unique position as banker to the Government and bankers' bank, is best placed to undertake a leading role in the pursuit of both monetary stability and financial stability. Though the twin mandate of central banking is stable money and sound banking and finance, the latter has often been neglected in recent years, with too much emphasis on stable money. The central bank can rightly claim: 'if I am going to assist you in a rainy day (LOLR), I need to know what you do on a sunny day'. Given that supervision is a task performed by the FSA, the Bank of England and the FSA need to have close cooperation and coordination in this regard; in addition, the Bank of England should have macro-supervisory powers to identify negative trends, drawing on the statistical information that it already gathers for monetary policy purposes, on financial stability reviews, on the information granted by the FSA and on additional powers to request information from institutions or markets previously unregulated but that can cause systemic risk (like the AIG hedge funds that brought the firm to its knees, causing a major rescue operation via a \$85 Billion loan arranged by the Fed). The Bank of England should have a view of the 'forest' even though the FSA continues to supervise the health of each individual 'tree'. In the USA, the Obama administration has released proposals to grant the Fed new powers as 'systemic risk authority' (though the Fed has both monetary policy and prudential supervisory responsibilities). Monetary policy is the instrument to achieve monetary stability. Macro-prudential supervision (supervision of the system in aggregate terms, supervision of trends such as

the build up of excessive leverage in the system, wherever leverage comes from) is an instrument that the central bank can capably perform in the pursuit of financial stability (together with the other instrument mentioned above, exercised by other authorities).

(3) The idea of a Council for Financial Stability makes sense, because as I mentioned in (1), financial stability is a goal that transcends institutional boundaries. However, the chair of this Council should be the central bank. One institution needs to be in charge, as the MOU (tripartite arrangement) painfully demonstrated in the Northern Rock affair.

(4) The proposed Council for Financial Stability should work closely with the yet to be created European Systemic Risk Council (the European Council released fresh proposals on 17 September 2009) because financial stability as a goal transcends geographic frontiers. As well, it should work closely with FSB and IMF in identifying macro-economic trends that can have a negative impact on financial markets.

(5) The extension of the SRR to systemically significant financial firms would need to be accompanied by adequate regulation and a way to price the implicit government guarantee. The definition of a systemically significant financial institution is not an easy task (size, structure, interconnectedness are all factors to consider). I would add that almost all systemically significant financial institutions have a cross border dimension, thus calling for a cross-border solution, supra-nationally and/or internationally. A set of internationally agreed rules on cross border insolvency of banks and systemically significant financial institutions is very much needed. Cross border crisis resolution is the number one unresolved issue.